MACROECONOMIC STABILIZATION DURING THE TRANSITION

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1. INTRODUCTION

Macroeconomic stabilization is a prerequisite for sustained growth (IMF, 2001). The experience of transition countries underscore this simple truth (Wyplosz, 1999). In the absence of price stability and sustainable macroeconomic policies, investors will be weary to commit long-term resources and growth will suffer.

Macroeconomic stability is a necessary but not a sufficient condition for growth. Strong institutions, well-defined property rights, an effective judicial system are also indispensable to the well functioning of a market system.

Albania has made greats strides in stabilizing its economy. It was feared that the collapse of the pyramid crisis would pave the way for a period of deep and prolonged instability. It did not happen. The firm handle of monetary and fiscal policies allowed Albanian authorities to restore macroeconomic stability. Inflation fell from 32.1 percent in 1997 to virtually nil in 2000.

Remarkably, the disruption of the Kossovo war did not take a toll on macroeconomic performance. In 1999, inflation remained surprisingly low, even by industrial countries standard, at 0.4 percent. Similarly, after collapsing in 1997, growth resumed in 1998 and since then has averaged 7.7 percent on an annual basis.

These achievements should not lead to complacency, however. There are still many major challenges that the Albanian economy has to face. Strengthening domestic institutions, fully restoring the rules of the law, enhancing the endowment of human capital, and creating the conditions for the emergence of financial intermediation are indispensable to ensure that growth will be sustained.

In this paper, I mostly abstract from the structural policy agenda and focus instead on macroeconomic issues. I first assess the macroeconomic record so far, focusing on growth, inflation, and the budget. In this assessment, I rely on a set of comparators countries that include Bulgaria, FYR Macedonia, and Romania.

The choice of these countries is somewhat arbitrary, but reflect the desire to select countries that are close to Albania in terms of GDP per capita.

The remainder of this paper is organized as follows. In section 2, I look at the macroeconomic record so far. In section 3 I turn to some key challenges in the area of macroeconomic policy. The last section offers some brief conclusions.

2. THE MACROECONOMIC RECORD SO FAR

a) The growth performance

By and large, Albania has performed relatively well, when compared to other transition countries.

Fig. 1 shows that for most transition countries, output in 1999 was still at or below its 1989 level, Poland being the only meaningful exception. For a handful of countries – all in Central Europe and most scathed to enter the EU with the first accession wave – 1999 GDP was relatively close to its pre-transition level. While, as noted by Fischer, Sahay and Vegh (1996), there are many reasons to be cautious about this kind of comparison (pre-transition GDP data are indeed likely to overstate the fall in output), fig. 1 nonetheless is emblematic of the problems associated with transition.

There has been a heated debate on the causes of the output decline during the transition, with the blame falling alternatively on the initial disruption to the centrally planned system, exogenous shocks, and faulty “cold turkey” policies.

Albania did not escape such a fate, with the real output ratio in 1999 still below unity. However, Albania performed substantially better than other comparable countries. If we exclude Central European countries, and focus only on Baltic and other Southern European countries, we see that Albania output decline was substantially less pronounced, in spite of the severe recession that Albania had suffered following the collapse of the pyramid scheme in 1997. The real output ratio for Albania in 1999, 0.93, is comparable to the average of EU non-Baltic accession countries (0.95) and markedly better than that of the Baltic countries (0.77).

If we extend the comparison to the most recent years, Albania’s growth performance is even more remarkable. Between 1997 and 2000, GDP growth averaged 7.7 percent on an annual basis, against 3.8 percent in Bulgaria, -0.2 percent in Romania, and 3.9 percent in Macedonia. With 2001 growth projected at 7.3 percent, Albania is now well above its pre transition level output.

b) the inflation record

Many transition countries experienced high, even runaway, inflation. The lifting of price controls account for the initial price shock, but cannot explain the sustained rise in inflation that followed. Propagation mechanisms in the form of wage indexation and accommodative monetary policies were instrumental in allowing a persistent rise in inflation. As noted by Wyplosz (1999), there is a remarkable correlation between inflation and the budget deficit, suggesting that fiscal imbalances were largely financed by monetary means. The lack of alternatives modes of financing explain why

Governments resorted to inflationary finance and highlight the tight link between fiscal and monetary policies.

How does Albania stand in comparison to the average inflation performance in transition countries? The answer is: it depends. If we consider the period up to 1997, Albania's record is somewhat less than impeccable. Between 1989 and 1997 inflation averaged almost 40 percent, less than in most of the CIS countries, but higher than in the Baltic and the other EU accession countries. Since 1998, however, inflation has been rapidly declining. Thanks to the implementation of firm monetary policies, inflation fell to 0.4 percent in 1999 and virtually zero in 2000. [32] The recent rise of inflation basically reflects exogenous shocks, such as the rise in oil prices, and should be easily dealt with, provided it is not propagated through inappropriate policies.

Fig. 2 shows how Albania performed in comparative terms with respect to inflation. Despite the 1992 and the 1997 bouts of inflation, price rose at a fairly moderate pace in comparison to other transition countries. The average inflation rate in Albania is comparable to that of both non Baltic EU accession countries (35.5 percent) and of Baltic countries (33.5) and substantially better than other Southeastern European countries.

c) The budget

As just noted, budgetary imbalances can play a substantial role in fuelling inflation. Albania is no exception to this rule. In 1992, the budget deficit stood at an astonishing 20.2 percent of GDP.
It then steadily declined, except for a rebound in 1997, but was still in the two digit territory in 1999. Only in 2000 did the budget deficit fall below 10 percent.

What matters most in determining inflation is the domestically financed portion of the budget deficit. Here too, Albania registers a steady improvement. The share of domestic financing in the deficit fell from 11.0 percent in 1997 to 4.9 percent in 2000.

3. THE CHALLENGES AHEAD

a) further fiscal consolidation

Fiscal policy is bound to play a key role in shaping Albania's medium term economic prospects. This is not only because fiscal rectitude is an essential ingredient for macroeconomic stability. More fundamentally, Albania's ability to raise revenues is still quite limited, despite recent remarkable progress, when assessed on the

[32] Board proceedings are typically confidential. I hope I am not breaching such confidentiality constraint when I recall that the view of the German Chair was that monetary policies in Albania were somewhat restrictive.

basis of comparator's countries. Table 1 shows that the revenue to GDP ratio is around 40 percent in Bulgaria, 35.3 percent in FYR of Macedonia, 31.5 percent in Romania, but only 23 per cent in Albania.

The gap is even greater if we consider the composition of total revenues. Custom duties play a much larger role in Albania than in the comparator countries, accounting for 2.5 percent of GDP and 11.4 percent of total revenues. For Bulgaria and Romania, custom duties represent only 0.9 and 1.1 percent of GDP respectively. Their share in total revenues is equal to 2.2 and 3.5 respectively. Only for Macedonia, the weight of tariff revenues, 4.0 and 11.2 percent respectively, are comparable to Albania's. The large contribution of custom duties to total revenue is a major hurdle to the development of a buoyant tax system. While it is true that trade, and imports, are set to rise as a percentage of total output, the imperatives of trade liberalization dictate a substantial fall in custom duties. First, Albania's accession to the WTO is bound to lead to a decline in the average effective tariff. More crucially, the process of closer economic integration with the EU, a vital requirement for Albania to be able to exploit the benefits of international trade, will require a substantial reduction in tariff barriers to trade, at least in the medium term. The need to look for new sources of revenue is therefore a key challenge for Albania's policy making, in light both of the decline of existing sources and the pressing demands on public resources for social and productive infrastructures.

Table 1. Revenue ratios

	Revenue/GDP	Custom duties/GDP	Custom duties/Revenue
Albania	23.0	2.5	11.4
Bulgaria	40.0	0.9	2.2
FYR Macedonia	35.3	4.0	11.2
Romania	31.5	1.1	3.5

b) reconciling price convergence and price stability

Most transition countries face a difficult trade-off. One the one hand, the desire to attract foreign investment calls for a stable macroeconomic framework and low price inflation. Foreign investors are deterred by high inflation and substantial, and possibly unsustainable, appreciation of the real exchange rate. At the same time, the process of economic convergence toward the European norm entails an increase in the price level, particularly of non-traded goods – the so-called Balassa-Samuelson effect – and an appreciation of the real exchange rate. This is an equilibrium phenomenon, but may be hard to distinguish from an unsustainably high degree of real appreciation.

It may seem that an appropriate choice of the exchange rate regime may go some way in addressing this trade-off. But this is not so. First, successful transition countries have adopted very different exchange rate regimes, ranging from managed float to currency boards. Second, the dilemma between price stability and equilibrium real appreciation is present, albeit in different forms, in all exchange rate regimes.

Albania has opted for a managed float system that requires a careful management by the Central Bank. A well-designed and cautious management of monetary policy has been instrumental in reducing inflationary pressures, even in the face of major shocks such as the Kossovo war. At the same time, it has not prevented a significant appreciation of the real exchange rate (fig. 4). When compared with other Southern European countries, where the real appreciation has been substantially more moderate, the question arises whether nominal exchange rate movements have been excessive in prompting the upward trend of the real exchange rate.

One distinguishing feature of Albania is the relatively large flow of foreign remittances. Private transfers account for 14.1 percent of GDP against 2.5 percent in Bulgaria, 2.3 percent in Romania, and 10 percent in FYR Macedonia. This by itself may partly account for the trend toward an appreciating real exchange rate. Yet, the fact remains that the real exchange rate in all three comparator countries did not appreciate markedly in the last few years and even fell in the case of Romania and FYR Macedonia.

c) the need to persevere with structural reforms.

Despite all its efforts, Albania still lags behind other transition countries in terms of structural reforms. The EBDR average transition indicator ranks Albania well below all non Baltic EU accession countries, all Baltic countries, and all Southeastern European countries, with the only exception of Bosnia-Herzegovina (fig. 3). Only for small scale privatisation and the reform of the trade and foreign exchange system is Albania at par with other European transition countries. Albania’s record is particularly weak in the fields of large scale privatisation, enterprise restructuring, competition policy, and financial market reform. The planned privatisation of the Saving Bank should go some way in addressing the latter issue. Financial market liberalization will however deprive the Treasury from a steady and relatively cheap source of financing. It will need therefore to be complemented by a determined effort to identify new sources of revenue, highlighting once again the need to implement a far-reaching tax reform with a view to strengthening the buoyancy of tax system.

4. CONCLUSION

Macroeconomic stability is a hard-won achievement and has already delivered fruits in terms of high and sustained growth. This has strengthened Albania's convergence toward Europe. To sustain such process, further progress on the structural reforms front is needed, particularly in the fields of financial sector reform and further trade liberalization. Both of these reforms could however entail a revenue loss for the Treasury, at the very same time when the social and developmental tasks of the government are bound to grow. A deep seated tax reform, as well as an increasingly rigorous scrutiny of existing expenditure programs will therefore be required to prevent the insurgence of a difficult trade-off between the imperative of macroeconomic stability and the need to press ahead with further reforms.

Fig. 1
PPP GDP per Capita 1999

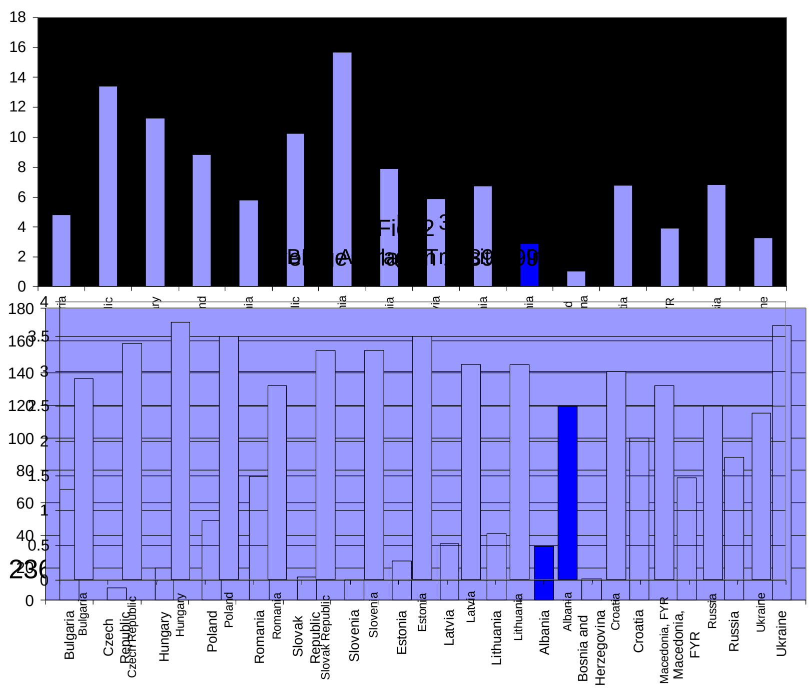

Fig 4

Real exchange rate