PROGRESS OF EASTERN EUROPE TRANSITION : IMPLICATIONS FOR ALBANIA

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I will draw my presentation from the transition report, publication of EBRD, where we give an account of the economic development of 27 countries in which EBRD invests. Albania is one of these 27 countries.

Our transition report for 2001 draws the attention on the issue of energy, energy use and energy resources in Central Europe and former Soviet Union countries.

In addition to that, as in the previous year, we give an account of macroeconomic development and of progress in transition. We

give also an account country by country, which is a resourceful source of information for the region.

The transition report of this year has three main messages. The first one is that compared to other emerging markets, the countries in transition are going to be a relatively bright spot in an otherwise black economic environment.

Even though Central Europe and former Soviet Union countries have been affected by international slowdown, the effect has been less pronounced than in Latin America, Asia, Africa and other emerging markets. So, the first message is that the rapid performance of Eastern Europe is going to be better or less bad than in other emerging markets.

The second message of the report is that some countries in other regions, particularly Russia and Caspian Sea countries have huge energy potential and resources, but sector reforms and prudent economic management are needed for these resources to be used in a meaningful way for the development of these countries.

The third message is that in the transition economies, in part because of the legacy of the central planning years, energy intensity per unit of production is high and energy use is inefficient.

So, here, our message is to underline the importance of:

a) pricing policy and collection in energy sector; and

b) supply side policies of energy efficiencies and alike.

The index of the progress of transition in different dimensions, liberalization, small-large scale privatization, of 27 countries in which EBRD operates includes the period from 1989 until today. We can see that there has been progress in both liberalization and smaller and larger scale privatization, year after year. We take the increase of the indicator of transition and we go country by country, score for each country and see the countries that have made in incremental terms most progress. The best progress has been in Yugoslavia, because of the change of the regime and the initiation of market oriented reforms and the least progress has been in Turkmenistan. Albania ranks in the lower middle similar to Poland, Estonia, in incremental terms.

On the performance of growth, we have an interesting phenomenon. How much the economic activity of European Union has affected the growth of both exports and imports? The countries of Central Europe had export growth running to 30-40 per cent in year 2000 and this has declined at a level of 10 per cent from May 2001 till now. This has obviously other effects on GDP growth.

Progress in transition and stability in different countries in which we operate has come hand in hand with more foreign direct investments in countries that have progressed most in structural adjustment and stability. Central Europe and the Baltic, the so called eight of the so called ten countries in process of accession, have attracted close to 250 dollars of FTI in per capita terms, growing year by year. The CIS and Southeastern Europe are relatively behind. In Albania we can notice a significant pick up of FTI per capita in the years 2000-2001 and this has come associated with the process of greater economic stability, faster growth after the crises of 1997 and of course privatization measures.

What is the outlook of growth for the region we are forecasting? The international authority, the OSCD has recently revised down-worse to about 1 per cent growth of OSCD member countries. In the year 2001, the IMF has revised twice the projection of world economic outlook and now they are projecting low growth in US, Europe and also low growth in the world economy to about 1 and 2 per cent. I am pleased to say that the region has proven robust so far, and this year we are forecasting 4.3 per cent growth for the region. This figure is spread between very fast growth of 6.7 per cent in CIS countries, excluding Russia (5.5 per cent), 4 per cent in Southeastern Europe, where Albania is included, and 2.9 per cent in Central Europe and the Baltic.
For 2002, we are projecting a growth between 3 and 3.5 per cent which is still a very good performance in this much worse economic environment. Albania, which has been growing at rates +7 per cent since the crises of 1997 will grow at 6 per cent as long as privatization process is maintained, as long as there is progression in regulatory reforms, business climate reforms and increase in macroeconomic stability. These are the assumptions underlying this 6 per cent growth.

This growth in the region has been in the context of reduced inflation; the average inflation for the region is 15 per cent and we are forecasting that if policies continue in the direction they have

followed this year, this could be reduced to 11 per cent during 2002 and hence to single digit inflation. We already have single digit inflation in Central Eastern Europe and the Baltic at an average rate of 4-4.5 per cent.

In the transition report, while we analyze the issue of energy, we also look at energy producers in the region, which are Russia and Caspian countries and some of Central Asia countries. We see that energy resources for the region are quite significant, for instance Russia has 33 per cent of all gas reserves in the world, whereas production is only 21 per cent and the Caspian countries have 2 per cent of oil reserves and 2 per cent production. In Russia, the resources are huge and Gasprom, who is the main gas producer in Russia, has 1/3rd of the world reserves. However, when we look at the per cubic meter market capitalization and the price of stock exchange of Gasprom and compare it with the per cubic meter stock capital of ExxonMobil, we realize that ExxonMobil has per cubic meter of gas market capitalization which is 100 times higher than Gasprom. This is due to the fact that there is uncertainty in the rights of cash flows of Gasprom even by shares in the eyes of shareholders, mainly due to enforcement and rotary regime in Russia. The diminished property rights in minority shareholders gives rise to low market capitalization of Gasprom. However, if reforms in Russia continue, we could expect improvements with this regard.

It is interesting to see as to what extend natural resources help or hurt reforms and adjustments. We notice that countries of Central Eastern Europe and Southeastern Europe, which do not have much natural resources like oil, gas, mine and others have progressed more with reforms than CIS rich countries, Uzbekistan, Kazakhstan, Russia, etc. The reason for this is that in a way, large stocks of natural resources can enforce countries a certain standard of living, and become substitutes for the reforms. Countries that do not have these resources embark more strongly in structural reforms, in a stabilization that can substitute for those. A clear cut case internationally, is the comparison of the performance of Nigeria or Venezuela, both very energy rich countries with South Korea which has no natural resources. This means that macroeconomic stability, structural reforms and work habits and organization which have substituted for these natural resources contributed to a fast growth rate in Korea and to a very dismal economic performance in Nigeria and Venezuela. We can see this very clearly in the countries in the region as well. Energy

intensity per unit of GDP continues to be a problem in countries in transition.

During central planning years, since allocation of embezzlement and production process, even trade followed political dictats rather than economic rational, energy was not used efficiently. Energy use was wasteful and energy intensity was very high. In US, per 1,000 dollars of GDP energy used is lower than 0.5, whereas in Central Europe and Southeastern Europe the energy use could be as high as 2. In Albania it is 0.75. In CIS countries, energy intensity is 4, which means it is 8-9 times higher than it is in USA. This clearly shows that industrialist structure in the region has not fully internalized and it has not fully factored into the price and opportunity cost of energy. It shows also that the way we are heading is going to be one of economizing energy use and the key factor is going to be the pricing policy in energy sector including electricity, gas, petroleum and also the supply side policy of industrial structure.

In Central Eastern Europe and the Baltic there has been a tendency toward a more rational use and less intensive use of energy. This has not happened though in Southeastern Europe. The industry has continued to become more energy intensive and this is the case also in CIS countries. What is the importance of this tendency towards a more rational, more economic use of energy?

The first relates to the tariff reforms. In socialist central planning system, the electricity was used as a tangible good by households, residential sector, but also by enterprises. This is not the case, however. Electricity is an economic good, it has a high opportunity cost and it should be used efficiently. Tariff reform and enforcement of electricity and other energy use payments should be a key priority. However, through the process of transition, many countries have very low income and in order that pricing the cost of energy into households and enterprises be feasible, one needs to devise target subsidies for the poor households.

The second point is that it is important to open up the private sector embasement for new incentives and efficiency. In the case of Albania, the unbundling privatization of KESH should be one of the first orders of business. The same is trues for the petroleum company which has been unbundled and, as I understand, it is in the process of privatization. It is also very important to facilitate the

entrance of private sector to predictive and strong regulations so that risk can be properly measured and allocated.

Another issue is that of affordability. Some countries like Georgia, Armenia, etc. have current prices. In Georgia, if people were to pay full energy cost and all the utilities, the share of their income that could be spend on energy use and utilities would be 12 per cent at current prices. If the tariffs would reflect full cost, low-run marginal cost, this share would be 16 per cent. So, it is not reasonable to assume for the poor households that they are going to be able to afford the price if there is a move from current tariffs to full cost pricing tariffs. That is why it is important to have target subsidies for this group. In the report, we propose the use of life-line tariffs, in the sense that poor households are given the allocation of a given amount of KwH per week or per month for free but any increment beyond that has to be paid at full cost.

How should countries go about the reform of energy sector, in particular of the electricity sector? It is very difficult to make proposals after having seen the electricity crisis in California. In January of this year, the most advanced market economy in the world and the wealthiest state of that country, California, run into a very serious crisis in the process of liberalization of regulations. They kept control on the price of electricity to the users and liberalized the price to generators. However there were problems, and the whole system went to crisis. California experienced electricity sufficit and therefore several companies went bankrupt. It is important to do it well, it is important to sequence it well.

How should it be done in countries on transition? The way it should be done is by unbundling, separating generation from transmission and distribution. Generation can be supplied competitively, while distribution can be done by concession. Transmission has a profit so called “public good” nature, which means that a set of transmission lines can be added another and the ownership can be public or private, but heavily regulated.

Our model is to start first with the privatization of distribution so that private participants in distribution have already enforced target regime, have collected the generated cash and can pay the transmission company, while the transmission company can pay generators and thus create an electricity market. We consider Georgia and Moldova as modeling countries as they have a little advantage, since EBRD has invested with international strategic investors in the privatization of distribution. In Georgia, the tax

collection of total bills before privatization was 8 per cent while it went at 14 per cent the first year after privatization. In the case of Moldova, which is more recent, the rate has increased from 23 per cent to 58 per cent. Having done privatization of distribution, these countries will be able to privatize generation because the cash starts being generated in the system. We think this is a model that could be applicable to Albania as well. We are supporting the Albanian public electric company KESH, with its rehabilitation loans and we expect movement towards unbundling and eventual privatization to start with distribution in the near future.

In conclusion, there are two important points to mention. The first is that in a black world economic environment, we expect countries in transition to perform relatively better than the other emerging markets and if the proper policies are continued in Albania, we expect a relatively good growth for the next year (we are projecting 6 per cent).

The second point is that energy use in the whole region continues to be highly intensive and wasteful and industrial restructuring has to factor this into account. For this to happen, it is very important that the tariffs trend towards reflecting full cost and the payments for the energy sectors be fully enforced.