

Growth in Albania and South East Europe:

The Way Ahead



Ardian FULLANI

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Published by
South East European Studies at Oxford (SEESOX),
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www.sant.ox.ac.uk/esc/seesox

Cover image:

Typeset and printed by:

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© SEESOX December 2012 -- ISBN 978-0-9562098-3-2

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Preface

This collection of papers by Ardian Fullani, Governor of the Bank of Albania, explores the challenges facing Albania's economy in the wake of the global and euro area crises. It is based on presentations made by Governor Fullani at regional seminars in Oxford and Tirana, which were organised in the context of a co-operation agreement between the Bank of Albania and South East European Studies at Oxford (SEESOX).

This is a striking volume in several respects. First, it presents the range of economic issues facing Albanian policymakers in a unified perspective, drawing on a wide range of national and international sources. Second, it reaches back to the Communist era to explore where the process of economic transformation of the past two decades misfired, in that it failed to address adequately the deep-rooted problems of the past. Third, it seeks to give greater precision to such terms as 'enhancing competitiveness' or 'changing the growth model', asking what specifically these mean in an Albanian and South East European context. Finally, it is a book that places Albania squarely in the region of South East Europe, exploring the importance of shared issues and challenges – and the key role of regional co-operation – in the years ahead.

Building on much research and reflection that has been conducted at the Bank of Albania concerning priorities for the economy, the originality of this book is to highlight how these themes mesh with a wider regional agenda – to which the crisis has imparted added urgency. In all these respects, the volume bears the very distinctive hallmark and vision of Ardian Fullani. It deserves a wide readership among those, at home and abroad, who are interested in Albania and its region.

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Acknowledgements

I would like to thank all the colleagues and friends who assisted and supported me in this important project with their comments and opinions regarding the themes discussed in the book. Specifically, I would like to thank fellow governors from the region who have engaged in a very fruitful regional cooperation focused on the economic prosperity and financial stability of the region. My personal engagement in this process became the motivation and laid the foundations for this project. I would also like to thank the researchers at the Bank of Albania who helped in the process of data collection and whose previous and ongoing research provides comprehensive evidence to support the thesis discussed in this book. Last but not least I would like to thank South East European Studies (SEESOX) at Oxford University and in particular my friends Max Watson and Othon Anastasakis for their contribution in this project. The focus of SEESOX on discussing economic and political developments and regional cooperation, along with the many conferences and workshops organized across the South East European region or at Oxford, have provided me with the necessary academic environment to discuss, confront and advance the argument of the book. I feel obliged to Max and Othon for their comments and continuous discussion and support.

Ardian Fullani

In Place of an Introduction

Our current economic model cannot generate sustainable growth at the pre-crisis level. Prosperity in the 21st century requires a smarter growth model, and one that is implemented in a framework of regional co-operation.

Over the last 20 years the Albanian economy has undergone significant structural changes, which have strengthened economic incentives and fuelled economic growth. In the early stages of [post-communist] transition, internal migration – coupled by a rapid and significant transformation in the labour and later the capital markets – helped shift all factors of production toward more productive sectors. This shift contributed to higher productivity levels and consequently faster economic growth.

Driven primarily by EU-based banking groups, these changes were later followed by a rapid and robust expansion of the financial sector that boosted credit availability and consumption, fostering an absorption-led growth model. The same model has contributed to strong economic growth in the region and in other transition economies as well.

The current crisis however has revealed a number of problems with our growth model demonstrating that the so-called catching-up process now resembles more a model of unsustainable consumption, rather than of sustainable long-term equilibrium. Despite the overall fiscal consolidation and relatively high growth rates, macroeconomic imbalances have increased as shown most strikingly by the rapid rise of the current account deficit. From a micro-economic standpoint, this is manifested in an unsustainable financial position of enterprise and

household balance sheets driven in part by the unrelenting efforts of banking actors to gain a share in the products and services market.

The need for a new growth model

The existing consumption-driven growth model that was fuelled by an expansion of mortgage and consumer loans can no longer be sustained when faced with the post-crises realities. The macro- and microeconomic factors that encouraged rapid economic growth in recent years are no longer present in the global and national economies. The era of cheap money is finished! This is based not only on the fact that financial markets have adopted a different attitude toward risk, but also from the fact that rapid credit- and consumption-driven growth has weakened balance sheets in the household and corporate sectors of the economy. The level of debt accumulated under this model of consumption and growth has been relatively high, as evidenced by the large trade and current account deficits accumulated over the past 20 years. In other words, the economy resembled a human body that became accustomed to living for years with high cholesterol in-take, yet showing no external symptoms because of it. The problems were there all along.

Consumption, which is the main driver of investment and growth in the economy, relied heavily on imported goods. Our economy suffers from limited domestic production capacities, despite being relatively well endowed in production factors such as arable land, natural resources, hydroelectric power production, fresh water, a beautiful coastline, and a young and vibrant population. Sectors of the economy have not benefited equally or proportionally from the increase of foreign direct investment and financial intermediation. Private investments have focused largely on trade, services and construction of residential housing, with very little left to impact agriculture, manufacturing, and other traditional exporting sectors (such as mining and energy production). While this may reflect the low productivity of these financially starved sectors, it also shows that the current growth model lacks a clear vision for the development of underutilized factors of production in our economy. This existing economic model emerged and grew rather randomly

on choices made by young, inexperienced, and financially illiterate entrepreneurs. It produced impressive growth, despite lacking professional analysis to identify economic priorities that would truly reflect Albania's comparative advantages. International financial institutions that assisted Albania in the early stages of transition could have also done a better job to identify and incorporate these priorities in the framework of economic programs which they designed and supported. These institutions and their economic programs should pay due attention not only to macroeconomic imbalances but also to sustainable growth models that will rebalance the economy via durable growth and employment.

In the light of this discussion, it is imperative that Albanian decision-makers identify, discuss, and adopt a new economic model, which learns the right lessons from the past and on this basis deliver sustained economic growth – one that ensures the full utilization of all natural, financial and human domestic resources while limiting the accumulation of negative externalities. Such a model must be financially attractive, realistic, politically supported, and capable of successfully attracting financial resources by global markets. This is the topic I want to foreshadow in this opening discussion, and to pursue in the essays that follow.

Growth is not the most colourful or standard issue to be addressed by a Governor or indeed a by a Central Bank. Specifically, it does not fall within the set of key objectives followed by Central banks. Additionally, from a broader point of view, it is conventionally assumed that markets are the key mechanism through which an economy is directed toward the most efficient use of its resources. Traditionally, indeed, the model of growth is not a direct concern of the Central Bank.

Nevertheless, the current growth model in Albania, like in most other countries in the region, has contributed to the accumulation of large external and domestic imbalances – with direct repercussions on monetary and financial stability, the Central Bank's two key areas of responsibility.

More importantly, it is rather difficult at the present time to identify remedies that will adequately address these problems in the long run. In the meantime, 'efficient markets' because of market imperfections

and economic irrationalities are currently either non-existent or failing to perform their economic role in Albania. Policy makers in Albania are faced today with the challenge to identify a growth model that is better aligned with the country's assets and the opportunities that lie ahead. Only such a growth model can deliver sustained prosperity, unthreatened by external and domestic imbalances.

Addressing more fully the legacy of the past

Under Albania's socialist, centrally-planned economy, communist authorities attempted unsuccessfully for 45 long years to discover their own course. The country bore tremendous economic and social costs as a result of these efforts. However, both the efforts and their substantial costs were in vain, as such a successful course was never found. The tragedy was that those communist authorities searched desperately for this "unfound treasure", instead of attempting to invent it. The outcome was a unique economic and social model that continued to close in on itself until its last days.

Several illogical and counterproductive agricultural reforms undertaken during the late 1970s and early 1980s destroyed production capacities and economic incentives in this important sector. As a consequence, agriculture – which used to be a net provider of domestic consumption and exports – became a net recipient in terms of consumption. Thus, the Albanian economy lost its productivity and competitiveness. In the late 1980s, the overall economic equilibrium was severely shaken. After the economic and ideological split with China, the Albanian economy started to consume what it had labouriously accumulated over the years and simultaneously began to accumulate hidden debts resulting in its complete economic collapse.

I witnessed this process not only as a citizen, but also as a manager at the then State Bank of Albania. Since the mid-1980s, the State Bank had been receiving hundreds of overdue and unpaid invoices on a daily basis. In the meantime, export revenues shrank, and every single export imbursement was expected with much anxiety. Eventually, this inability to generate foreign exchange and to balance the country's foreign trade

shut down economic activity. Foreign exchange reserves vanished, leading to a reduced supply of imported basic everyday necessities, including bread. There was no economic solution without a political solution coming first. Current events are a vivid testimony that hidden and accumulating debts are as great a menace for a capitalist as they are for a totalitarian communist society.

At the beginning of its post communist transition, the Albanian economy was moderately well-supplied in factors of production (relatively abundant natural resources, physical capital, cheap labour and an immediate and relatively high demand for consumption and investment), but it was missing one thing – the “market” and the market mechanism to distribute those resources to the best uses. Until then, the blend of such resources in the production process had been determined by the bureaucrats of the centrally-planned society. This combination was completely at odds with the market mechanism and therefore yielded disastrous results. [More on this to follow shortly.]

As such, the “easy” task was to transfer state ownership of the factors of production. It was left to the developing “market” (which at this time amounted to newly established institutions and legal framework copied by champion capitalist economies) with its efficient forces to deliver prosperity. The strategy worked out with varying degrees of success and challenges for several economies in transition including Albania. In the early stages of transition, this strategy permitted and promoted a fast and efficient redistribution of production factors in the economy.

However, as this redistribution phased-out, the market outcome produced what the World Bank has defined as ‘growth without development’. The Albanian economy continued to grow at a relatively high and steady rate, which was mainly driven by consumption and investment, but without generating the same growth in the labour market. The question of why this happened is still to be persuasively answered. A reasonable hypothesis says that despite positive economic developments and welcomed political and social reforms, the Albania failed to implement early enough and effectively key market-oriented reforms (such as property rights, especially land ownership and registration, and land market and pension reforms). Most importantly,

this strategy lacked a thorough understanding of the market mechanisms and their true potential.

Before World War II, the country never had a close relationship with capitalism and free market mechanisms. The word "market" did not even exist in the Albanian language; we simply referred to it as "pazar" (the Albanian word for bazaar). At the onset of WW2, Albania was a poor agricultural country with almost non-existent industrial production and no organized markets. Despite the geographic location in Europe, the Albanian economy was predominantly more akin to a feudal ottoman village than to a modern capitalist society. Communist rule after the war with its particularly closed, centralized and socially repressed features of economy ensured that Albania's link to western Europe was completely severed.

This social, political and economic organization of Albanian society before 1990 may hold some clues to answering the question posed above. Unlike some other former communist Eastern-European societies, Albania's political and economic system, one of the worlds' most isolated and centralized, had significant differences and peculiarities. With the establishment of an economically closed and self-sufficient socialist economy, Albanian communism was unique and "creative" in its claim of "enriching" the communist political theory as developed first by Marx and as read by Lenin.

This is an important characteristic that explains the brutality and destructiveness of Albania's communist economic model. It is one of the fundamental factors that set off the gradual and inevitable degradation of all values including national historic heritage, tradition, art and religion. After the economic and political break-up with China in the 70s, Albania was no longer a member of any international economic organization or international treaty. Moreover, the Albanian Constitution prohibited any form of economic cooperation with – and borrowing from – the rest of the world.

The irony of it was that the foundations of such a philosophy were based primarily on the principle of the so-called "democratic centralization." The whole society, including all of its economic activity relied entirely

on a closed, self-sufficient economy driven by a brutal class struggle and enmity to religion. Any hint of political and social system inimical to the communist ideology, as well as individuals or groups who appeared to espouse such thoughts were brutally repressed including any forms of private property ownership.

These fundamentals of economic thinking in Albania were completely at odds with modern economics. After emerging from the war as one of the poorest countries in the region, Albania's communist authorities adopted a series of policies that increased human capital and with it labour productivity. Substantial increase in output as result of education and redistribution of the labour force from agriculture to industry (a new feature of the Albanian economy) as well as the introduction of new technologies spurred by investments in agriculture and extraction focused industries generated the progress. However, after reaping the initial benefits of these developments, growth soon ground to a halt, as the economic policy's objective shifted to setting up a closed, self-sufficient economy that relied solely on domestic resources. Under such a policy, the current account had to be balanced with capital and current account transactions under the strict control of the authorities.

These policies not only restricted economic specialization which could have yielded an increase in productivity and the emergence of comparative advantage – they also minimized the benefits of international trade, without allowing our economy to reap the growth and income benefits of trade in goods, services and capital flows. In fact, the argument that trade and free movement of goods, capital and labour can contribute to enlarging the economic pie was explicitly rejected.

The organization and distribution of power in the socialist society theoretically rested on the working class, one of the three classes identified by communist theory. It was the “proletarians” that who were entrusted with administering power and upholding the morale of society. They were the real force of development that was charged with the execution of “Class Warfare”. Unlike in other communist countries, total state ownership, guised under the principles of joint socialist ownership and control over the means of production, deprived Albanians workers from developing any sense of private ownership.

Under this division of society, the second class "fshatarësia kooperativiste" (peasants organized in joint ownership cooperatives), that resided in rural area and worked in agricultural cooperatives was the largest group and the second driving force of society, living in a non-antagonist contradiction with the working class. They had a stronger sense of private ownership. Besides their collective ownership of the productive assets of the cooperative, peasants were allowed to own rather small pieces of land, and livestock. The resulting agro-product of this private property was small, and barely sufficient to support family consumption.

However, in some specific regions, due to higher productivity (greater land fertility and labour productivity), extra agricultural output was sold in urban centres, bringing additional income and higher living standards. But, under communist theory, contradictions between the peasantry and the working class threatened to become antagonist, because the theory assumed that the village could not boast higher standards of living than the city.

The third class was the so-called intelligentsia – the group of college-graduate professionals and artists who formed the social elite of the country. This group and its activities were theoretically under the direct surveillance of the working class that monitored, controlled, and educated intellectuals in order to protect them from converting into "bourgeois". In this society, the initiative remained with the workers; the motivation to pursue individual interest lay with the peasants; and submission was the lot of the intellectuals.

Such a reality in real life kept any emergence of any private property and entrepreneurship from developing and prevented the understanding of ownership and market mechanisms, all serious obstacles to a successful and expedient transformation into market economy.

Due to extreme ideological, political, economic and social oppression, people lost motivation in life. They held neither trust in authorities nor confidence in the socialist economic model. This economy had clearly failed, and the socialist model of economic prosperity vanished overnight. The result was a negative – almost hateful – attitude toward

what was inherited from the communist regime, without distinction between ideology, capital, traditional markets and trade agreements.

Such an absolute rejection of the past left its imprint on growth model adopted in Albania. The economic theory of shock therapy was misinterpreted and in several cases yielded a total destruction of fixed assets accumulated and inherited from the socialist economy in the past. The prevailing attitude that state property did not belong to anyone and total ignorance concerning market economics and the market value of physical capital, presented the factors for releasing destructive forces into action. Extreme rent-seeking behaviour emerged in a relentless race for possession of inherited physical assets (mostly land), and this defined the characteristics and the objective of Albanian economic, social, and demographic developments.

There were these trends of developments, which triggered massive internal migration, emigration and “brain drain”. Traditional markets and potential industries became dysfunctional and lost relevance and the traditional trades were lost with them. These developments bear negative effects and are key factors for several problems that still haunt our economic model as well as our socio-economic development. The most significant of them finds its reflection in lack of efficient markets for important factors of production. Instead, markets evolve chaotically without the pricing of opportunity cost due to incoherent individual initiatives.

In particular, there are two outstanding examples of these market failures that impair the potential for growth under the current model. Financial market infrastructure and the instruments it provides still need to promote saving and financial investment. The current instruments prevail in the form of deposits and investment in government bonds, but are short-term, with at most a five-year maturity. Accordingly, they do not encourage households to balance between present and future consumption. Unlike our economy, the structure of savings in advanced economies clearly encourages long-term investment, mainly in the form of pension funds. These types of instruments provide proper incentives to increase the portfolio of long-term savings. Twenty years after dawn of socialism in Albania

and the beginning of transition, our market has yet to succeed in creating the full range of such institutions. The same phenomenon is also observed in the management and interaction between the agriculture and real estate sectors, especially the land. In the absence of a proper land market, this important factor of production remains highly underutilized and is currently plagued by inefficiencies and low productivity, despite several initiatives instituted by the government. Attempts to revitalize the use of land failed to take off due to internal migration, the small size of the farms, and the fragmented market. The absence of a properly regulated market has also spurred a change in land usage, away from productive activities and eventually towards reallocation from agriculture to construction.

The absence of such markets does not provide a proper measure of opportunity cost for choices made by agents as they use these factors of production. It is this particular feature of the present economic environment that is preventing the economy from reaching its true potential now, and undermining the prospects for prosperity in the long term projection. Such an output gap must, however, be considered and approached from an optimistic point of view. Rather than being viewed as a missed opportunity, it must be seen as a potential goal. It clearly shows that there are additional available factors of production, and/or that there are potential efficiency gains capable of yielding faster economic growth in the Albanian economy and higher standards of living for its inhabitants.

Seizing the window of opportunity today

Albania has had a successful transition from the economic point of view. It is obvious that the country has ended the transition chapter and turned the "page", achieving the status of being an emerging market. The economic growth that we have recorded in the two decades of transition has rewarded the hard work, risk taking and courageous business initiatives.

At the same time, the transition has revealed its nonperforming aspects. It lavishly rewarded the entrepreneurs, being owners of factors of

production – such as land and production infrastructure, which were inherited, purchased or transferred (redistributed) via the privatization process, or simply just seized in the early stages of transition. Large scale migration, that set off forced by social and economic hardships at the very early stage of transition, resulted in a relocation of the labour force away from traditional markets and trades and in the redistribution of state and private property away from legal and market considerations. These developments forced economic agents into excessive rent-seeking; resulted in considerable skills mismatch; and last but not least, damaged the legal system and market mechanism.

All these social, economic and demographic changes had a profound impact on the psychology of economic actors in Albania and on their perception of the market economy. Additionally, the entire society suffered from a lack of understanding of financial markets and had experienced no financial education.

In conclusion, the poor inherited experience of our society with capitalism and its market structures, as well as the prevented economic environment, restricted the Albanian economy from making the best possible choices and thus stifled the true potential of such factors of production.

While we have been rearranged our economy from a centrally-planned one into a market-oriented structure, the world economic situation has changed dramatically. During these 20 years, we have witnessed the globalization of the world economy and the emerging of China and India as important outsourcing hubs for developed economies. The liberalization of capital and current account in the emerging economies (the Third World) has enabled these countries to become the workshop of the world and a global provider of information technology and other business-related services. In the meantime, we have observed that these trends can potentially “spell disaster” for factories and their workers in every region of the world. Furthermore, over the same period, Brazil, Russia and certain African countries have followed the first two as major providers of important minerals and other raw materials. Traditional exporters of oil are diversifying into other industries, such as tourism, education, financial services, etc. Sadly to say, most of these

present industries that we frequently identify as potential comparative advantages of the Albanian economy.

This competitiveness reminds us that small, exclusive and sunny bay areas cannot sell on their beauty alone. All these new economic powerhouses, represent big economies with large scale of economic growth, even by world standards. It is important to consider that, all the economies of the South Eastern European region, just like the Albanian economy, are small in scale and open economies, but small is not always beautiful. The entire region can benefit from potential cooperation, economies of scale, clustering and policy coordination. These characteristics make a compelling case for regional cooperation and a development model in the era of a global economy. My experience, and the lessons I have learned during my career as a central and private banker, tell me that if you have to do something, do it right – from the beginning. Now is the time.

The book elaborates further on these themes of economic development for Albania and the region, brought together in the perspective of attaining sustainable economic growth.

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Chapter 1: The Albanian economy: The need for a new growth model

Our progress as a nation can be no swifter than our progress in education. The human mind is our fundamental resource.

John F. Kennedy

I. Introduction

The global financial crisis struck the world economy while Albania was experiencing sustained and rapid economic growth, accompanied by a low inflation rate, a consolidated fiscal position, and a stable foreign exchange market. Sound fiscal and monetary policies as well as low macroeconomic volatility supported the impressive growth of the country. Strong domestic demand was the main driver of growth: this was reflected in a rising trade deficit financed through remittance inflows, privatization and FDI. The crisis ended this favourable run, leaving its mark on several aspects of the Albanian economy. It started with an irrational withdrawal of banking deposits from the banking system, mostly on unfounded fears related to historical, albeit unrelated, events. Even though the impact of the crisis on the banking system was not as severe as in other emerging and developed economies, economic growth slowed down, as did credit and investments. The aim of this chapter is to discuss several implications of the economy's pre-crisis growth model, which, together with the financial crisis, revealed a number of domestic imbalances. The implications of these imbalances need to be considered in order to lay a basis for a new model of development. The main question raised in this paper is whether the

core pillars of growth that have sustained the Albanian economy from the beginning of the transition process until the present time remain intact, and can robustly support sustainable growth over the medium term. This question motivates the discussion that follows concerning the future growth model for Albania.

The chapter is organized as follows. The first section discusses the pre-crisis model in Albania, which was characterized by an increase in domestic demand and orientation towards the non-tradable sector. The second section presents the problems faced by the economy during the crisis, as well as the need to change its model of growth. The third section outlines the characteristics of the new model, basically explaining the need to find new sources of productivity improvement through investment in technology, human capital accumulation – and for a reorientation towards the tradable sector, with a special focus on exports.

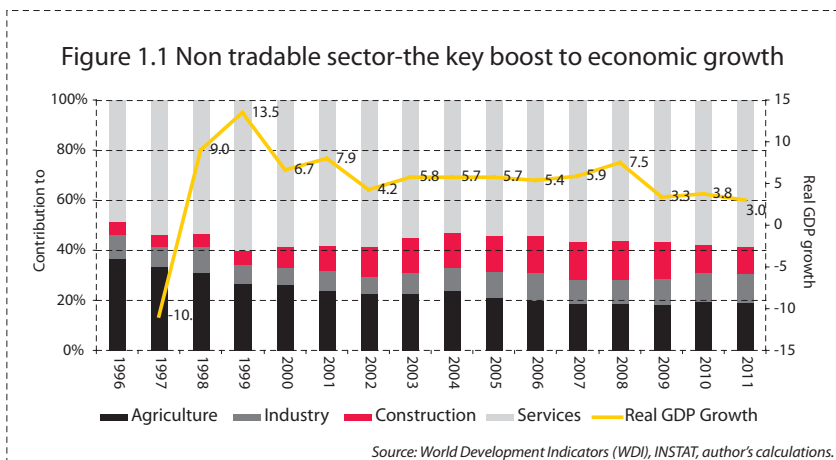
II. The pre crisis model – reliance on domestic demand and the production of non-tradable goods

The centrally planned economy had taken its toll on the factors of production, yielding a combination of inefficient factories, unproductively allocated labour, and inefficiently allocated resources. Furthermore, product and service markets were completely at odds with market mechanisms as domestic supply was unable to satisfy consumers' demand. Following the overthrow of the regime, market structures and production capacities disappeared with the system. Growth accounting analysis by Kota (2007) indicates that, in the early stages of transition¹, 1990-1992, Albania's real GDP decreased by a cumulative 39 per cent. However, with the introduction of macroeconomic stabilization policies, and due to the gain in efficiency resulting from liberalisation measures, the Albanian economy experienced a sustained economic recovery, averaging an annual growth rate of 9.3 per cent between 1993 and 1996. The desire for rapid wealth accumulation, coupled with the inability of the economy to absorb the available funds and financial illiteracy, led

¹ Source data is derived from World Development Indicators (2003), for the period 1990 to 1995 and INSTAT for the period 1996 to 2011.

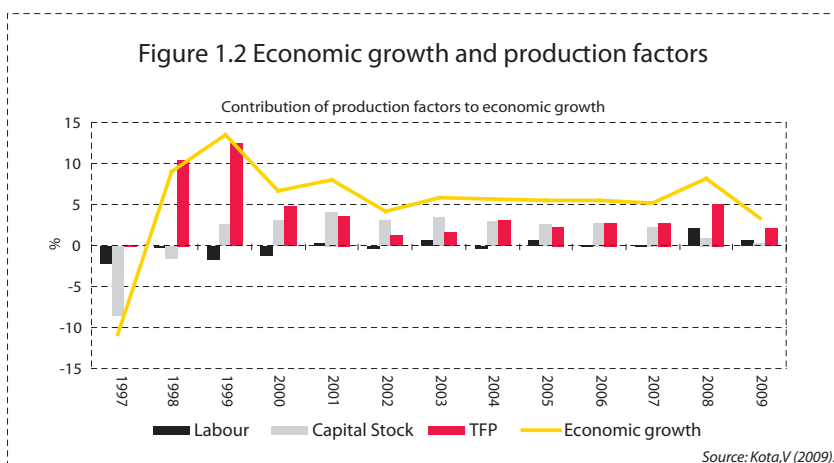
to the creation of informal financial institutions in the form of usury markets (pyramid schemes) that yielded extremely high returns on cash for short-term investments. The perception of wealth accumulation generated by extremely high returns on the informal usury market (pyramid schemes) in a short period of time, resulted in a rapid increase of domestic demand fuelled by household consumption. The first shock to the economy came as these pyramid schemes collapsed, leading to the crisis of 1997. The crisis took a toll on economic activity, which shrunk by a considerable 11 per cent. This event proved to be very short-lived as the annual growth rate of real GDP for 1998 reached 8.6 per cent. Growth increased again in the following year to stabilize around an average of 6 per cent from 2000 until the onset of the financial crisis.

It is very important to determine the sources of such impressive economic growth in order to better understand possible implications for the future. Like all centrally-planned economies, the Albanian economy determined resource allocation in line with the state's central planning priorities rather than market efficiency. Therefore, the emergence of market forces from the beginning of transition led to a reallocation of production factors from less to more productive sectors. The reallocation process, together with improvements in the productivity of the factors of production, is what shaped the growth model of the economy, biasing growth towards some sectors of the economy at the expense of others. Let us now consider this process in more detail.



Reallocation of the factors of production

Bank of Albania research on growth accounting shows that this reallocation process drastically changed the structure of the Albanian economy and that of its production factors (Kota, 2009). The industry sector, for example, dropped to a mere 7.6 per cent of GDP in 2009, compared to 39 per cent at the beginning of the transition process (1990), due to low levels of efficiency, and a lack of market demand. By contrast, the construction sector expanded considerably from about 3 per cent of the GDP in 1990, to 14.5 per cent in 2009, due to a high demand for residential housing, much needed improvements in infrastructure, and support for other sectors that placed demands on capital, land and the labour force. The largest expansion happened in the service sector, whose share increased from 33 per cent in 1990 to 63 per cent in 2009. Agriculture, on the other hand, expanded from 23 in 1990 to 32 per cent in 1997; by 2009, it had shrunk to 19 per cent of the GDP. These shifts in the composition of the economy's sectors initiated a reallocation of factors of production in line with market demand.² Khan (2004) finds that Total Factor Productivity (TFP) fell dramatically during the sharp contraction of 1990-92, to increase substantially during the subsequent recovery period of 1993-2003. During this process, the contribution of factor growth (i.e., the combined contributions of capital growth and labour force growth) was small. Later research on growth accounting by



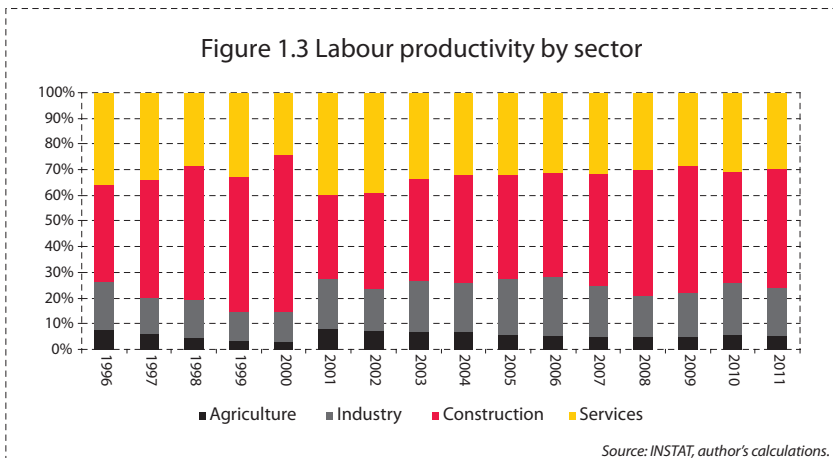
² See figure 1.2.

Kota (2009) (based on the same methodology employed by Khan, 2004) suggests that capital stock has played an important role in economic growth only after 2000, with TFP continuing to be an important determinant of economic growth.

Concerning human capital development, labour resources – as measured by official employment statistics – provided a rather low contribution to economic growth. This conclusion, however, may partly be a result of the fact that, first, employment data do not include estimates of the informal labour market – which is sizable in Albania; and second, the possible improvements of labour quality that may be reflected in the TFP upsurge. The positive contribution of labour to economic growth in Albania is certainly reflected to some extent in considerable improvements in labour productivity.

Kota (2009) finds that over the period 1996 to 2008, labour productivity in Albania increased on average by 6.4% owing mainly to improvements in within sector productivity (which is the major contributor to labor productivity,) but also due to the between sector effect (coming by employment reallocation among sectors in response to economic activity, and finally the convergence term (reflecting the convergence of each sector sectors towards the equilibrium level).

As official employment data show small changes between different periods, probably due to the exclusion of the informal market, it

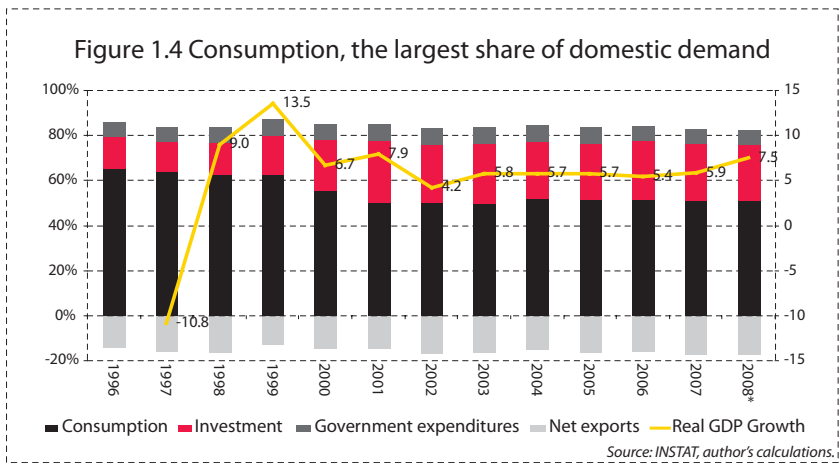


appears that the reallocation effect of employment did not provide a high contribution to productivity developments. However, the services sector benefited strongly from the process of labour resource reallocation from the other sectors (Fig 1.3).

The services sector experienced the largest productivity gains, because it has benefited the most from the labour redistribution process. According to the Albanian Institute of Statistics (INSTAT), it accounted for about 60 per cent of total employment as of 2008. This performance is reflected in its contribution to the GDP, which has made the non-tradable sector the main source of economic growth. Aided also by the construction sector, the non-tradable sector contributed by more than 50 per cent to real economic growth over the period 1997-2008. Agriculture is the only sector that has not experienced large labour shifts, while at the same time performing poorly in terms of productivity. The productivity of labour in agriculture is very low even when compared to regional standards. This could relate to the lack of human capital, which prevented a larger redistribution toward more productive sectors. The analysis could also be affected by the methodology employed by INSTAT to compute labour force and employment statistics in the agricultural sector³ in the face of large foreign and internal migration.

In line with theoretical observations and empirical evidence, the productivity gains from the rapid redistribution of production factors provided a decreasing contribution in the early stages of transition. From 2002, TFP stabilised at around 3 per cent annually, providing a modest contribution to growth relative to previous periods. Nevertheless, the Albanian economy continued to grow with the same pace of around 6 per cent annually. Domestic demand, especially in terms of elevated private consumption and investment, was increasing quickly – which was the main driver of the sustained growth rate (see Fig.1.4). Developments in these important elements of domestic demand were also affected by the speed of financial intermediation in the country. Credit to the private sector has grown rapidly since then, with the bulk of credit and private investment going toward non-tradable sectors, mainly construction (Fig. 1.10).

³ Problems with official data on employment also play a key role in this respect, as according to INSTAT, all persons owning a land, are considered to be employed in agriculture, which is not always the case in practice.



The larger size of the non-tradable sector, relative to the tradable sector, contributed to a rapid increase in trade and current account deficits, as the production of the agricultural and industrial sectors of the Albanian economy could not match the increasing demand for consumption and investment. Over the period 2004-2010, consumption goods accounted for around 32 per cent of total imports, with 53 per cent being intermediate goods and only 14 per cent being capital goods.

In a striking difference from other CEE economies, the bulk of credit was financed by domestic resources (bank deposits and capital) rather than by foreign borrowed funds. Even so, more than two-thirds of loans were denominated in foreign currency. The downside of this growth model is that the fast process of intermediation adversely affected the balance sheets of households and companies, while simultaneously contributing to a weakening of the economy's external positions, since growth was supported by widening trade and current account deficits.

Sources of financing and the bias towards non-tradables

The increase in labour efficiency also reflected a large and still continuing trend of emigration. Many Albanians left the devastated economy in search of new opportunities abroad, mostly in Greece and Italy, where they established themselves and found employment. Remittances transferred by Albanian workers to Albania have played a significant

role in supporting domestic demand and compensating trade deficits in goods and services. In the early stages of transition, remittances proved to be both a much-needed source of foreign exchange and a cushion for consumption for resource-strapped families.

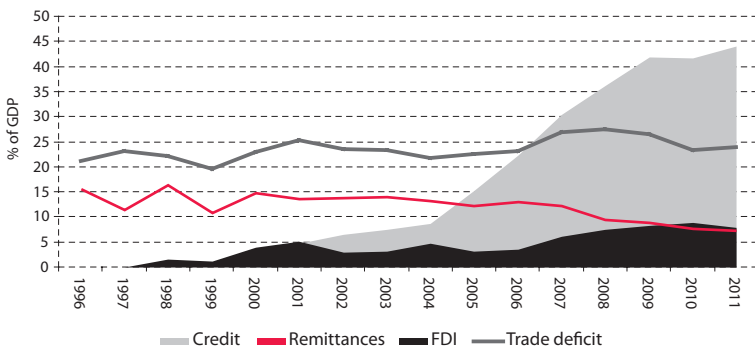
When considered at the macroeconomic level, remittances in Albania have been increasingly important relative to other foreign exchange-earning activities, representing on average around 12.6 per cent of GDP, being equivalent to 71 per cent of exports, and covering 30 per cent of imports over the period 1996-2010. Yet several studies find that they are used mostly to support consumption and construction or improvement of domestic residences.

To this day, remittances remain an important source of foreign financing. More than 20 years of emigration, and in stark contrast with theoretical and empirical predictions, remittances continued to flow into the Albanian economy at increasing amounts until the last crisis. By the end of 2010, however, remittances financed only 17 per cent of imports, while their flow represented only 29 per cent of exports and 9.4 per cent of GDP. The financial crisis not only helped to reveal our domestic imbalances in consumption and spending, but also emphasised our reliance on the economic activity in Europe. This last remark becomes even more troublesome if one recalls that the bulk of Albania's exports are oriented toward the European economy, and dependent on its demand. On a positive note, remittances allowed the Albanian economy to maintain higher levels of consumption and investment, as compared to what could be financed through domestic savings; however, they could have been used in better and smarter ways.

Several authors (Gëdeshi et al., 2003, and King and Vullnetari, 2003) find that remittances are spent first on primary consumption goods and improvement of the quality of dwellings, rather than investment. A relatively small portion is used to finance the education of the younger generation and invested in economic activities, which is mainly focused on trade and services aiming at employing family members. In general, remittances have been channelled mainly into the non-tradable sector (consumption, services, construction and real estate). However, their contribution to human capital development

(through education and management capacities of these enterprises), as well as to capital formation, has been trivial as investment in the production and manufacturing sectors is negligible (Piperno, 2005). Gërmenji and Swinnen (2004) conclude that remittances have shown a tendency to divert resources away from agriculture. As a result, domestic production through the tradable sector has not benefited substantially from the considerable flow of emigrants' transfers. This reliance on remittances has converted them into a reservation wage, with potential negative effects on labour force participation among receiving families.

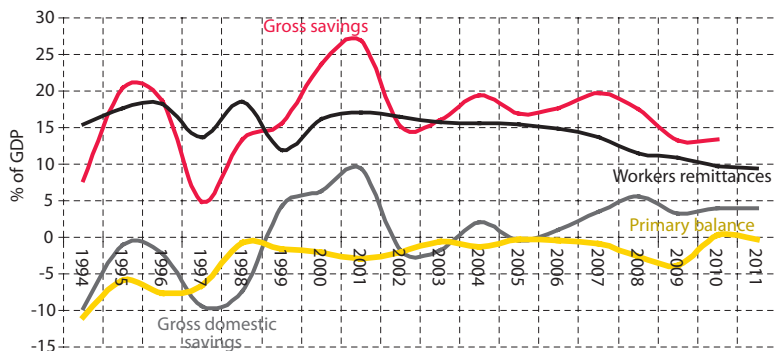
Figure 1.5 Remittances versus other sources of private sector financing



Source: Bank of Albania, MoF, INSTAT, author's calculations.

On the other hand, FDI flows to Albania have been relatively low, compared to other countries of the Central and Eastern Europe region. The FDI contribution to gross fixed capital formation averaged only 10 per cent during the period 1996-2008. Even though they doubled from 3 per cent of the GDP in 1996 to 9.7 per cent of the GDP in 2010, aside from the entrance of some large foreign banking groups, the largest source of FDI has been the privatization process, which cannot be a reliable source for the long run financing of the Albanian economy. The flow of investors is generally attracted by existing dwellings, market infrastructure and labour costs; but once a threshold level of FDI is reached, investors are attracted by the degree of institutional development, business environment and state welfare.

Figure 1.6 Savings and remittances



Source: World Bank, (2010).

As the privatization process of state assets comes to an end, Albania needs to invest more in terms of creating an attractive business environment and well-educated human capital. The latter is especially related to the need to attract FDI inflows to productive investments in tradable industries in addition to labour-intensive manufacturing, as is currently the case. This process becomes more important in light of the crisis and in its aftermath. The country will have to compete strongly in order to attract FDI flows. These flows are generally depressed, due to trade partners' economic problems, risk aversion and uncertainty among investors, liquidity constraints, etc. In general, the Albanian economy offers investment opportunities in tourism, agriculture, energy and the exploitation of natural resources.

Mainly through rapid credit growth, domestic financing (financial intermediation) has played an important role in the expansion of aggregate demand, especially after 2004. Domestic credit became important only after 2002. Credit to the private sector in Albania rose from a growth rate of around 20 per cent in 2002 to a peak of more than 50 per cent annually in 2007. Close to one-third of credit is used to finance capital investment, with the same amount used to meet business needs for liquidity and working capital. Nevertheless, on average, only 8 per cent of credit flows have directly fuelled consumption, as the rest of credit to the household sectors were mortgages leading to a rapid development in construction. In this context, credit growth has boosted domestic demand, mainly

through consumption and investment in the non-tradable sectors. In general, financial intermediation has favoured a few non-tradable sectors such as investment in construction, with only the equivalent of about 10 per cent of the GDP going to investment for productive purposes up to 2006 (Albania, CEM, 2010). Since then, the composition of sectorial growth in the economy has changed significantly (Fig. 1.1), especially in terms of industry and services, but credit decomposition has as yet to react significantly to match to these changes. Credit reorientation as well as increasing investment in such non-residential activities will be crucial to Albania's future growth pattern.

Finally, one could argue that Albania has a relatively flexible economy, as it has managed to bring inflation to normal levels in a very short period of time. Thanks to this flexibility, Albania has shown impressive results in terms of price stability. Inflation has been distinguished generally by lower rates relative to other transition economies. In the last five years, inflation has stabilized at moderate levels as measured both at the end and average period figures, though it sometimes diverges from the target due to unforeseen shocks and speculative factors that are beyond the central bank's control. Rigidities observed in some other economies seem not to apply in the case of Albania. Here, we have in mind the long hiring and lay-off procedures or the variety of rules related to the goods and services markets. Most importantly, the adoption of a flexible exchange rate regime has been and still is one of the main contributors to economic flexibility, with direct impact over the ability of the Albanian economy to adjust efficiently in terms of relative prices and production costs, as well as consumption and investments behaviour of domestic agents.

The question that arises here is: why all this flexibility and the comparative advantage that it implies for the economy in the macro and microeconomic scale has not materialized in higher foreign direct investments from abroad? Economic theory provides a large but finite set of explanations which can potentially answers this question. Each of them is considered and analyzed in order to identify the particular economic and institutional reasons that have inhibited penetration of foreign capital in Albanian economy. This process simultaneously helps to identify the necessary structural reforms and the economic policy adjustment in support of faster economic growth.

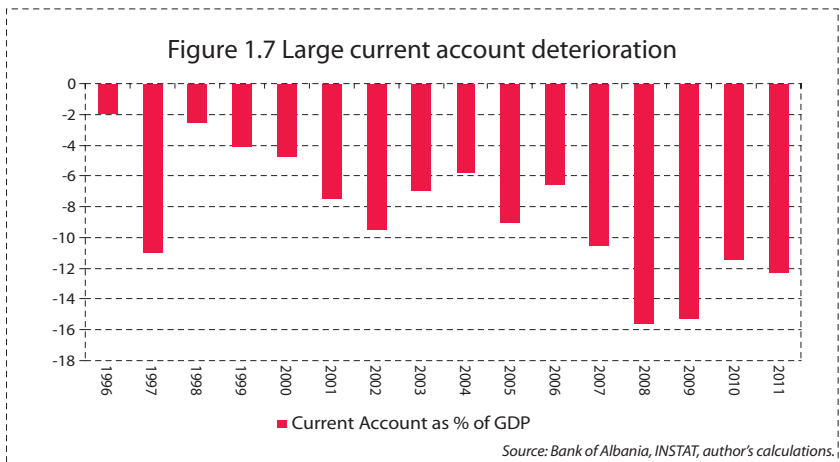
In the following section, we will discuss how the financial crisis hit the economy and revealed the vulnerability in its external imbalances. Then we will proceed to address the need for a new growth model.

III. The financial crisis changed it all....

Following a long period of high economic growth, in the last quarter of 2008 the Albanian economy slowed down – and this trend has continued through present day. Given the moderate level of financial deepening in Albania, and its low integration into the international financial market (referring to the fact that financial intermediation depended mainly on domestic sources rather loans from parent banks), the financial crisis did not initially affect the economy heavily through direct channels. The growth rate continued to be positive even in 2009-2010, with an exception of the last quarter of 2009 that marked a 0.6 per cent contraction.

Compared with other emerging market economies, Albania was not dramatically struck by the financial crisis. Since the economy's reliance on external capital inflows was insignificant, the country was not prone to high external vulnerability.

However, the reduction of foreign currency inflows (mainly remittances) from a slowdown in the European economy; the deterioration in household and private sector balance sheets resulting from depreciation; and a sharp slowdown in financial intermediation due to liquidity problems (caused by fears of contagion, supposing that the crisis could spread into the Albanian banking system as well) took a toll on aggregate demand and economic activity. The reduction in the growth rate of aggregate demand, and a significant increase in exports, resulted in a brief and relatively small adjustment in the current account deficit. This adjustment was short-lived (see Fig. 1.7) since increased commodity prices – and the inability of the Albanian economy to substitute increasing demand for imports of consumption goods – triggered a wider trade deficit and pressure on the exchange rate. These developments underscored the role of external current account stability in terms of safeguarding macroeconomic and financial equilibrium at home.



Furthermore, the domestic financing sources of Albania's so far successful economic growth were seriously affected by the crisis. Credit growth shrank from an annual 53 per cent in 2007, to 44 per cent in 2008 and only 25 per cent in 2009. In 2010, credit growth was almost half of what it had been the previously year. As a result, private consumption slowed down and private investment contracted, with no domestic demand to boost economic growth. With external financing sources impaired, the support for excessive consumption and overheating was cut off. Due to the crisis, the economy could not use its resources efficiently, leading to unemployment pressures and lower capital formation. The latter was also hit by the slowdown in domestic credit growth as well as a lack of financing for private investment.

The best cushion to buffer the economy's slow growth was the flexibility of the exchange rate. Albania's free-floating regime allowed the exchange rate to absorb the largest part of the shock to the economy. The ALL/EUR exchange rate depreciated by around 10 per cent on an annual basis; according to the estimates of the Bank of Albania, this further depreciated exchange rate is now in line with the new fundamentals of the economy.

The current state of affairs concerning economic activity, chronic current account deficits and a weakening in household and private sector balance sheets, are worrying signals that must be reversed in the long run. The Albanian economy must identify new sources of sustainable growth, as the existing ones are exhausted and have become intrinsically

less sustainable. Boosting investment in the tradable sector, especially in exports, is necessary in order to balance our current account in the future and put the Albanian economy on a sustainable path of economic development.

IV. The need for a new growth model

Before proceeding to the discussion of much needed changes in the current economic model, it is important to emphasize that generally, the philosophy of the country's economic development has been well-founded. Free and open markets, privatization and open competition have allowed the Albanian economy to benefit from the fruits of private sector initiatives. The private sector remains the most efficient engine of economic activity. At the same time, it is worth noting that the crisis has opened new windows of opportunity for the further growth of the country. The new equilibriums that the economy is now experiencing show that rapid, consumption-driven and credit-based growth models cannot support domestic demand and economic activity as the main engines of growth. Moreover, the fast growth of consumption and credit-driven growth have aggravated the overall savings–investment balance of the household sector and the financial balance sheets of agents in the economy.

Therefore, despite encouragingly positive growth, on-target inflation, and an exchange rate close to the medium-term equilibrium (in light of the new fundamentals), the crisis has left its mark on the Albanian economy. The past model of growth succeeded in maintaining economic expansion during the transition process, but it did so by introducing vulnerabilities that cannot be viewed as sustainable in the long run. By the end of the crisis, the current account deficit had narrowed, but it continues to be high. The medium-term development of financing sources, especially in terms of remittances, remains questionable – limiting the contribution that private consumption can make to future economic growth as compared to the pre-crisis level.

Accordingly, there is a need to identify a new long-term economic growth model, capable of absorbing financial resources – particularly

from abroad – in new and innovative ways, and generating economic growth without producing the negative externalities of the old model. Finding efficient ways to increase the productivity of production factors (looking at improving their quality or giving them better access to market and market mechanisms), and to combine them more efficiently, is the crucial step to overcoming the current problems of underused capital, the slowdown of credit growth, the high unemployment rate, unused agricultural land, etc. The first step in this regard is the identification of the competitive advantages that the Albanian economy generates and the acceleration of structural reforms in light of these priorities. For a moment, let us assume that our analysis finds that Albania is not competitive in factors of production. The next step would be to understand what structural changes could make our production factors competitive in the world economy. The analysis of competitiveness in the following chapter shows that the Albanian economy and its competitiveness reflects first and foremost structural and institutional problems rather than economic ones related to pricing and cost adjustment mechanisms. Therefore the coordinated plan of action which aims to address the above mentioned problems will in fact be the new model of growth.

Constrained by the circumstances of an economy that has just moved out of transition to emerging market status this coordinated plan of action requires political commitment and broad social understanding and support for continuous and long-term development from all economic agents.

These reforms should be the focus of our on-going analysis and forward-looking approach, in the aftermath of the crisis. The aim of the following section is to present the characteristics of a new growth model for Albania.

V. Albania and the new growth model

The success achieved thus far in terms of economic development indicates that Albania has the right capacities to grow, but only if it succeeds in shifting to a new economic model – investing heavily in

technology adoption, innovation and human capital, while achieving a reorientation of financial resources.

New sources of total factor productivity growth

The work of Robert Solow (1956) shows that long-run growth in income per capita in an economy with an aggregate neoclassical production function is largely driven by growth in TFP. Even though the Solow growth model includes a serious drawback in taking as given the behaviour of the main driving force of growth – technological knowledge – TFP continues to be a relevant source of growth but in an augmented form. This is confirmed in the more recent works of Klenow and Rodriguez-Clare (1997) and Hall and Jones (1999), who conclude that a large part of the income per capita gap between rich and poor countries is associated with major cross-country differences in TFP growth. Economic developments in Albania, as in other emerging market economies, have confirmed that TFP has been the main contributor to growth during the process of transition toward a market-oriented economy. However, as the fast catching-up process extends beyond its first decade, the reallocation of resources slows down; therefore, it is expected that TFP growth will decelerate also, thus reducing the speed of convergence. When this occurs, the large cross-country differences in TFP growth can be explained by disparities in the physical technology owned by the countries and/or in the efficiency with which technologies are used (Comin 2006). Solow's growth model was later extended by the neoclassical growth approach that treats technology as endogenous. Such an approach, presented by Romer (1986) and Lucas (1988), links the TFP growth rate to innovation and human capital accumulation, shedding light on the determinants of TFP growth.

The "new growth theory" states that there exist, possibly persistent, technological or "idea" gaps between developed and developing countries. Less developed countries could benefit from the know-how of more developed countries. Along the lines of Kurz and Salvadori (2008), the central feature of the "new growth model" is that it extends the concept of capital to include human capital and 'ideas' or 'knowledge', as well as the positive externalities generated from the accumulation of capital. The essential sources of new technical knowledge creation are

research and development activities (Romer, 1986) and the expansion of human capital through the education and production processes (Lucas, 1988).

Success requires that the improvement of human capital and the extension of technological knowledge are the outcome of deliberate investment activity of businesses and the society, rather than an outcome of a random process. Therefore, the economic growth rate will vary directly with the rate of innovation and technological progress, keeping in mind that spill-overs from private research and development activities increase the public stock of knowledge as well (Clark, 2006).

Empirical research on growth theory confirms the above conclusions. The process of technology development through adoption or endogenous innovation is crucial also to the convergence process.

In the context of a small open economy like Albania's, innovation need not be considered as producing new technology or knowledge, but rather as a process of adopting better practices, technologies and knowledge from more advanced economies. Dahlman (2009) finds that countries with a fast catch-up process have generally benefited from innovation in three distinctive ways:

- a. Acquisition of the existing technology,
- b. Domestic creation of relevant new knowledge and
- c. Dissemination of that the new knowledge throughout the economy.

When discussed in this context, the processes of technology adoption, research and technological innovation in the Albanian economy are still very slow compared with other former transition countries. Even though no official data exists concerning the level of technology adoption in Albania, the fact that only 2.5 per cent of the population had broadband internet access in 2009 (World Bank, 2010) indicates a very low level compared to other European or neighbouring countries. Acquisition of new technologies and their dissemination throughout the economy has suffered as the nature and composition of FDI in the country is poor and focused in the non-tradable sector. Most FDI are the outcome of the privatisation process rather than greenfield investments, attracted

by gaining the market share of the production facilities of former state-owned companies.

Several comparative advantages yielded by favourable geographic location, in the areas of tourism and agriculture, and by endowment in natural resources relating to electricity, mining and supporting industries (having traditional activities), have yet to materialise or take off, despite several attempts to make them attractive via special governmentally supported programs⁴. Lack of, or low quality of, physical and market infrastructure along with slow structural reform in markets for factors of production (particularly land), and the lacklustre foreign direct investments in these important traditional sectors, have prevented an increase in employment and labour productivity and failed to create economies of scale. The same is true with respect to the adoption of new technologies and the development of human capital. While research and technological innovation generated by private and public sectors in Albania are severely scarce, the adoption of recent technologies is constrained by the nature and size of foreign direct investments. In the process of competing with similar or more advanced economies, Albania has focused on factor-price competitiveness. Instead, policies should develop particular economic programs and proper capabilities to increase the productivity of its factors of production up to the point where they become economically profitable for the current price from the investors' point of view. While some of these are achievable by political will and administrative reform, the rest requires the mastering of new technologies – in all sectors where Albania has a comparative advantage from the endowment point of view.

Generation of ideas through human capital investment

Productivity improvement through technology and innovation requires investment in human capital by means of proper education and training. Studies on economic growth, including Salter et al. (2000) and Nelson (2005), conclude that the most important role of innovation is not the new knowledge that it produces, but rather the ability to apply this knowledge to the production process and use it to generate goods and services

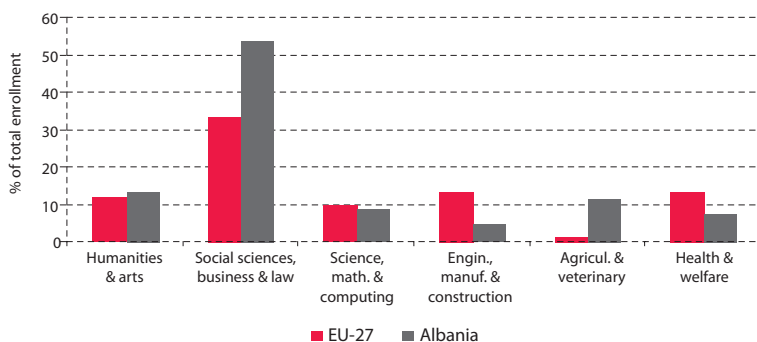
⁴ A very attractive support program has been presented as "Albania 1 Euro" aiming to promote FDI with the cost of "1 Euro".

more efficiently. Therefore, it is crucial for the process of technological development that the country cultivates a properly educated and skilled labour source capable of using the new technology efficiently and adapting easily to its changes and innovations. The ability of the potential work force to master modern technologies, and the management of organizational and institutional structures that make them productive, is crucial to the success of government programs striving to attract FDI. Good infrastructure and attractive fiscal policies or other governmentally supported programs are simply not enough to secure strong and persistent economic growth.

New growth models link the competitiveness of the economy to its ability to generate innovations and improve productivity through human capital. Efficiency improvements in production make human capital the real competitive arena in which emerging market economies vie for foreign direct investments. Thus, the competitiveness of a country is not related to its monetary wealth, but rather to the ability of its human capital to increase its productivity faster than its costs. For the society as a whole, the importance of human capital accumulation is considerable, going through positive externalities or through the direct impact of human capital on economic growth. In this context, it is worth emphasising the crucial importance of education as the key element of investment for the improvement of human capital.

Even though reforms in education have proven successful (reflected in the number of individuals who participate in basic and secondary education), participation in higher education is still low, at only 28 per cent. This figure is still far from those of the countries with which we are seeking to converge, whose participation in higher education averages over 50 per cent (Italy with 67 per cent, Greece with 95 per cent, and the Czech Republic with 50 per cent). Also, current educational strategies, from the perspective of demand, are generally based on adaptive expectations rather than on individuals' rational expectations. During the past 10 years, the labour market has generated jobs in the banking and construction industries, or has provided high-paid jobs in the legal sector. Albania has many lawyers, economists, construction engineers and architects. Based on recent INSTAT figures, in 2008, the preferred branches of study were undergraduate economics (17 per cent), jurisprudence (6.4 per cent), pharmacy, engineering construction and political sciences, accounting

Figure 1.8 Low enrollment rates in engineering and ICT



Source: UNESCO, INSTAT.

for approximately 42 per cent of graduate students. Investment of human capital in these branches over the years has resulted with the market being saturated with such specialists. With regard to other branches of the economy, such as mechanical, mining, chemical and electrical engineering, as well as industrial chemistry, mathematics and physics, the number of graduate students has fallen significantly over the last 10 years, representing only 5 per cent of graduate students in 2009. When compared to the European Union's figures (Fig. 1.8), the levels of enrolment in Information Communication Technology (ICT), engineering and business management in Albania are much lower.

Tertiary and vocational education training will need to adapt to comparative advantages as well as the needs and ambitions of the country's future socio-economic development in order to support economic growth.

Secondary education offers a similar example. In the early 1990s, about 50 per cent of high school students were attending vocational schools, while in 2009, only 16 per cent specialized in a specific profession. Such a gap between market needs and the generation of human capital, through gains in technical experience, is not an optimal choice for long-term development. As long as no discussion exists concerning priorities and branches that should be favoured in the development of the country, it is impossible to adopt rational expectations in the demand for education.

Labour market data provides the necessary input for sound decision-making in economic policy in general. This market should play an important role in determining the study curriculum in our educational system, not only from the perspective of attendance ratios (capacity), current programs and textbooks, but also from that of academic staff and base material for exercising academic knowledge.

Albania's approach to the European Union, and its progressive economic convergence toward the income level of EU member states, will depend on the level of education. Competition in national and international markets is above all based on the generation of ideas and their use in final products. Referring to the Global Competitiveness Index, Albania ranks 84th in regards to the level of higher education and training, and only 109th and 126th, respectively, at the levels of business sophistication and innovation (Global Competitiveness Report, 2010 and 2011). These vulnerabilities will ever-increasingly become an obstacle for the country's economic growth in the future, unless they are addressed in due time.

Public reform in the education system and the need for more backup funds should be a priority of every development policy. The history of economic development shows that countries that have invested in education are currently in the group of the most developed countries of the global economy.

This process is very important to further improve labour productivity in Albania. Long-term economic growth should be based on ongoing enhancement of productivity. Improvement of within sector productivity growth is the new challenge for Albania. As labour resource reallocation is drying out, more emphasis should be put on investment in output-oriented sectors with high productivity growth. Up to now, we have benefitted from the process of learning by doing, but with the advance of technology, proper education and training become important preconditions for success.

Greater reliance on tradable sectors, with a special focus on exports

Just using human capital, however, cannot be the only solution, for two main reasons. First, increasing human capital to the point where it

becomes a generator of technology is not a short-term process, and at the same time it might be utopian in the context of the global economy: the best-qualified human resources pursue abundant capital, seeking higher returns in developed markets. Second, even with the improvement of human capital in Albania, the current structure of the economy is not oriented towards production, as compared to offering mainly services. On the one hand, boosting domestic production is crucial to the ability of the economy to support internal demand for investment and consumption. On the other hand, the ability to generate extra income depends on the size of the economy. In this respect, for a small open economy, exports are of imperative importance, with the tradable sector becoming the keystone of the future growth model. The efficient reallocation of economic resources will be reflected in a fine balance between domestic demand-driven growth and an export-driven model.

Domestic consumption and investments have been the main beneficiaries of past growth, while the Albanian economy has not yet succeeded in establishing a competitive export sector. Even though export contribution to the GDP doubled between 1996 and 2010, the restructuring of export-oriented sectors continues to be slow. More than 70 per cent of exports are re-exports, which constitutes a major problem in terms of boosting the development of export sectors.

Export growth is the only component of demand that provides the foreign exchange which allows other components of demand in an economy to grow faster, such as investment, consumption and government expenditure, all of which have an import content which needs to be paid for in foreign exchange. Export growth relaxes a balance of payments constraint on demand, and impacts growth from the supply-side (Thirlwall, 2000). All other demand components, such as investment, consumption and government expenditure, have an import content that needs to be paid for in foreign currency. A competitive export sector is capable of generating stable foreign currency income, which enables the preservation of external economic balances. Consequently, 'export growth relaxes a balance of payments constraint on demand, as well as impacting on growth from the supply-side', thus allowing the other components of demand to grow faster (Thirlwall, 2000). Encouraging economic development through exports

and directing financial resources towards the economy's competitive advantages becomes essential to long-term growth. This process would enable the substitution of imported consumer goods with domestic products whenever possible and efficient. The purpose is to encourage production both for domestic consumption and exports in traditional markets and products as well as in new ones.

Export enhancement becomes a necessity not only from short-term and mid-term perspectives, but also from long-term ones. According to the neoclassical supply-side model of the relation between exports and growth, the export sector confers externalities on the non-export sector because of its exposure to foreign competition, and it also boasts a higher level of productivity than the non-export sector (Thirlwall and Pacheco-López, 2008). However, 'the impact of exports on growth depends on population size, trade orientation, and the importance of manufacturing' (Ibrahim and Mac Phee, 2003). Essentially, the export sector is likely to require the use of modern technology to be competitive, allowing for positive externalities to flow to the non-export sector. In addition to the benefits of trade, the exporting economy will also benefit from the transfer of technology and efficient management.

Increasing the importance of exports may also result in efficiency gains from cross-sector reallocation of factors toward the country's comparative advantage. 'Openness may increase productivity through increased economies of scale, enhanced technology spill-overs, and efficiency improvements within tradable sectors' (Atoyan, 2010, pp.344). Other studies, focusing mainly on micro-level data, also conclude that exporting leads to productivity improvements through inter-firm reallocations within tradable industries (e.g., Bernard and Jensen, 1999, and Aw, Chung, and Roberts, 2000).

Reorientation of the economy toward the export sector relies on the country's ability to improve its competitiveness. Exchange rate readjustment following the financial crisis has already occurred; as a result, the export sector should find other ways to enhance its profitability, rather than relying solely on relative prices differences. More focus should be put on enhancing external competitiveness through an improved business environment and cost competitiveness. All the reforms already

mentioned concerning human capital improvement and technology adoption are very relevant for boosting the export sector. "The policies should also aim to build sector-specific capabilities (e.g., loosening financing or infrastructural constraints) and improve the sector-specific operational environment (e.g., government investments in development of specialized industrial or professional skills and investments in trade infrastructure)' (Atoyan, 2010). The macroeconomic policies need to focus on improving the attractiveness of the economy for strategic long-term investors so that financial inflows and domestic lending are channelled to the tradable sector.

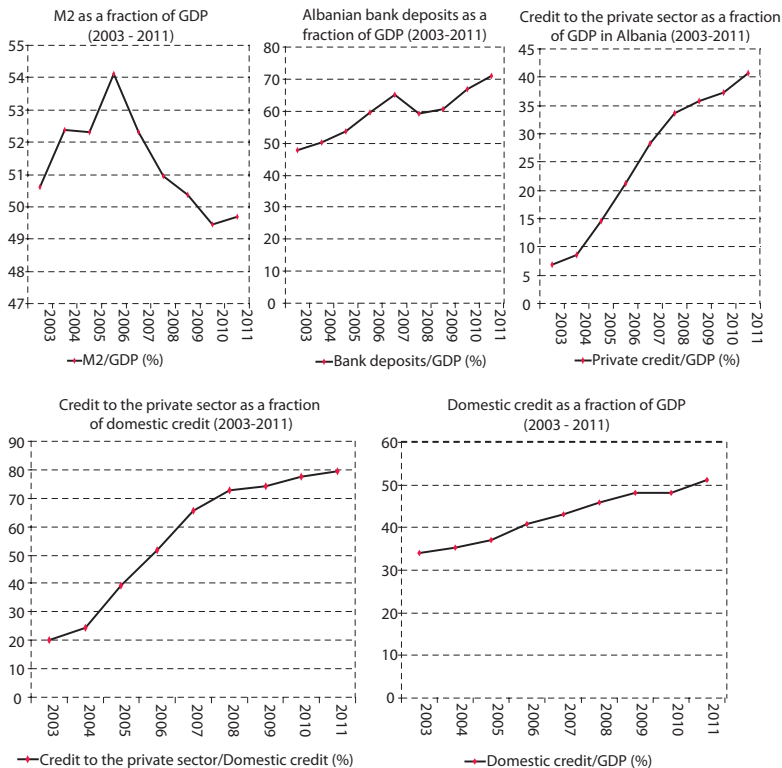
Credit growth reorientation

Economic growth over the recent years has been strongly supported by the banking system's lending (Fig. 1.9). The growth of bank lending has provided an impulse of about 7 percentage points of GDP over the period 2004-2009, making a pronounced and evident contribution to the growth of consumption and investment in the economy. Many studies find that the banking sector and the real one affect each other. The banking sector and financial intermediation affects aggregate economic performance. Obviously, with an increase in bank capital, banks may increase their loan volumes, thus triggering an increase in investments and GDP. On the other hand, during the last international financial crisis, the significant slowdown in worldwide economic activity caused an increase of non-performing loans. This phenomenon, combined with decreasing asset prices, rendered banks more risk averse, thus less willing to lend to different sectors of the economy (the so-called credit crunch), which in turn exacerbated the economic slowdown.

Financial intermediation and credit expansion, in particular, have played a significant role in the growth history via both consumption and investments in Albania and in the region. Bank of Albania's empirical research shows that financial intermediation and growth have reinforced one other due to the existence of a bi-directional relationship between all financial indicators and economic growth. Accordingly, financial intermediation is not automatically positively correlated with economic growth in the long run. Sometimes, it might lead to short-term episodes of absorption-led growth.

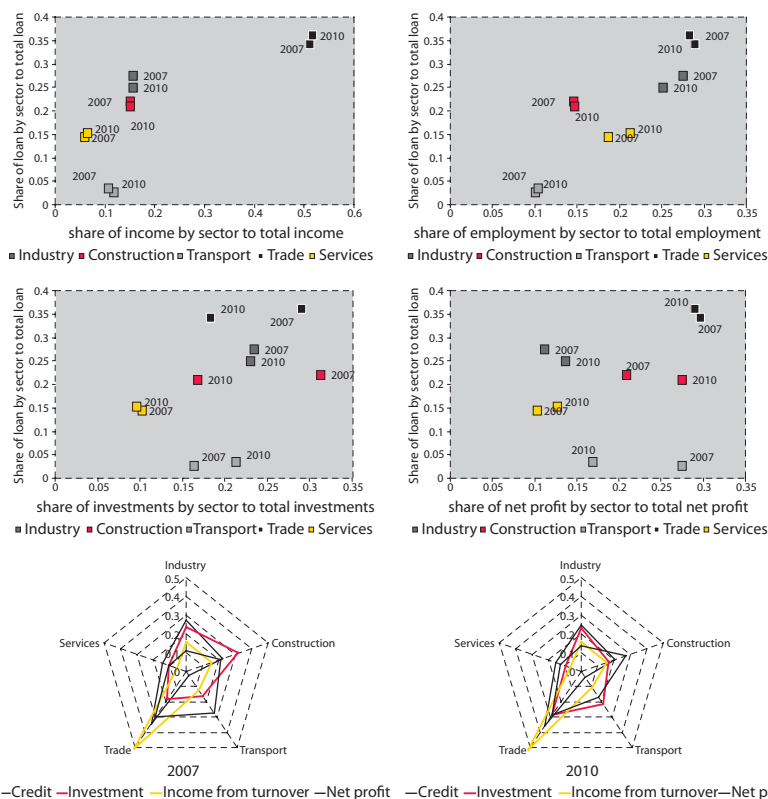
The above findings suggest that the quality of credit matters as much as the scale of financial intermediation. Lending strategies that pursue short-term profits rather than the long-term development of the economy as a whole will probably push banks against each other in a risky battle for market shares in consumer loans or rush in particular sectors which have limited capacities for enhancing growth and productivity in the long-run. In other words, banks and their intermediation strategies have a strong and lasting effect on the nature, results and sustainability of the growth model and consequently on the macro-financial stability of the economy.

Figure 1.9 Different proxies of financial development in Albania (2003-2011)



Source: Bank of Albania, INSTAT, author's calculations.

Figure 1.10 Credit development across sectors



Source: Bank of Albania, INSTAT, author's calculations.

The boom in financial intermediation in the Albanian economy beginning in 2004, with the privatization of the largest state-owned bank by Raiffeisen Group and the resulting credit growth, has provided room for expanding the production capacities and improving welfare through consumption. However, the necessity of diversifying Albania's growth drivers through supporting business activities that are profitable and externally demand-oriented will require a reorientation of credit growth. The Albanian financial sector needs to improve its efficiency in allocating savings among investment projects. In this context, we should bear in mind that the spill-over effects of credit growth, into high levels of consumption and imports, have worsened Albania's trade

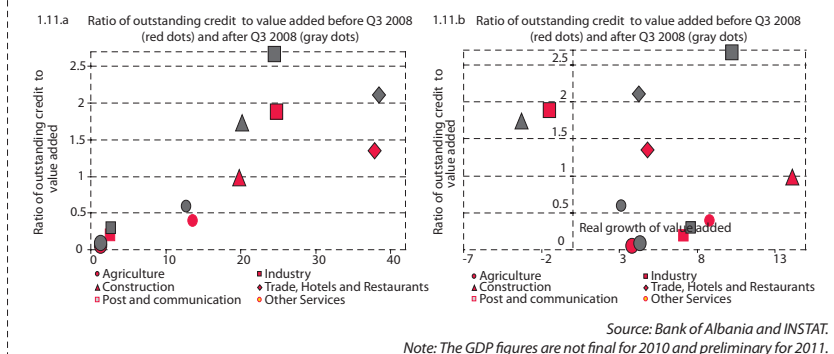
deficit, introducing instability into the past economic growth model via consumption-driven over-indebtedness. Our main policy goal remains a significant broadening and deepening of the financial market. I believe this is a challenge for the entire region: to focus on channelling domestic and foreign savings into productive investments, particularly those that contribute to exporting sectors of the economy.

For sustainable economic growth, it is crucial that banks allocate credit to meet the needs of more profitable and sustainable investment projects – that would be the model that supports and emphasises the comparative advantages of the Albanian economy. Figure 1.10 summarizes the distribution of bank loans across sectors for two sub periods: in the run up to (end of 2007) and in the wake of the financial crisis (2009). The distribution of bank loans is then linked to different performance indicators of the sectors, such as investment, income from turnover, net profit and employment.

The data show that bank credit growth prior to the crisis was skewed towards trade, with the industry and construction sectors ranking second and third, respectively. During this period, the trade sector has contributed less to total investment as compared to the industry or services sector, but it did have the highest share of income from turnover, of net profit and employment. On the other hand, the industry sector with the highest investment share and the largest contribution to employment received 27 per cent of credit, as compared to 34 per cent of the trade sector. In the aftermath of the crisis, as data from 2009 indicates, the restructuring of credit growth towards new productive sectors has yet to occur. The only reorientation of banks was to move away from construction, which suffered the most, and concentrate even more on trade. Banks persist in being more inclined to service the trade sector as it generally continues to perform well in terms of income from turnover. The industry sector, which has great potential to contribute in employment, investment and net profit, needs better access to credit, which will match its size and contribution to the economy.

Figure 1.11 illustrate the history of credit allocation from the point of view of productivity. The average ratio of outstanding credit to value added by sectors is used as a proxy that measures the debt burden of

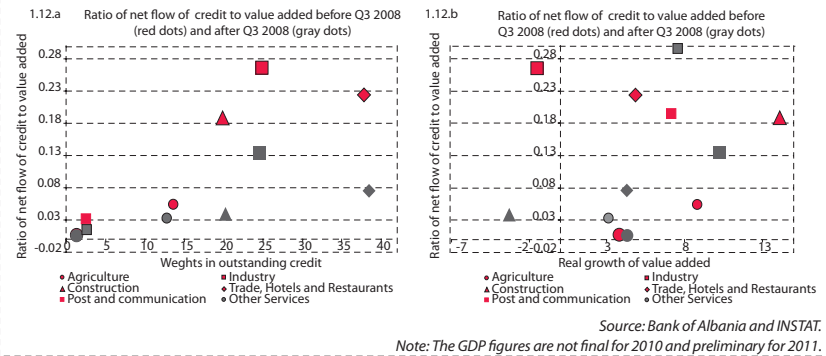
Figure 1.11 Ratio of outstanding credit to value added against weights in outstanding credit (1.11.a) and against real growth of value added (1.11.b) for various sectors of the economy, before and after Q3 2008 (until Q4 2011)



each of the economy's main sectors. In Figure 1.11, we plot the value added against the weights in outstanding credit for each sector. As noted above, it shows that most of credit is directed to sectors such as trade, construction and industry, while other sectors, including agriculture, are basically neglected by the banking system. As we move to the upper right corner of Figure 1.11, we can better note the financial leverage effect during a slow down episode: in the heavily debt burdened industries, the upward shift of the dots (from red to blue) is more pronounced. Due to slow or negative growth of the value added in sectors such as construction, the debt burden has jumped after the crisis, triggering a severe credit tightening with repercussions on investments. Figure 1.11 reveals that the choice of the sector in which banks have invested (with the exception of industry – but this is quite broadly defined) relied on high growth rates of these sectors up to the beginning of the crisis. What banks missed in this picture was the fact that such growth rates were not sustainable in the long run. Moreover, they did not contribute to the stability of the economy as a whole. Another interesting observation is that loans to “Trade hotels and restaurants” still take a large part in banks’ balance sheets.

The longevity of debt contracts makes it difficult to understand the reaction of banks towards a better redistribution of credit, therefore the second pair of charts considers the flow of credit (net of repayments) instead of outstanding amounts.

Figure 1.12 Ratio of net flow of credit to value added against weights in new credit (1.12.a) and real growth of value added (1.12.b) for various sectors of the economy, before and after Q3 2008 (until Q4 2011)



The charts in figure 1.12, show that there is a shrinkage in the ration of new credit to value added for all sectors, while their shares in the portfolio have remained basically unchanged. We also note that still there are no significant changes in favor of “neglected”, and therefore less credit-burdened sectors, sectors. Figure 1.12 b indicates that the higher growth rates in some of the sectors have not been matched by a reallocation of new credit towards these sectors. Though there are signs that the banking system may have internalized the need for a new growth model of the Albanian economy, concentration risks are still present, while potentially growing sectors are still neglected.

The restructuring and the resumption of lending activity cannot take place without first cleaning-up the non-performing part of bank balance sheets. The automatic adjustment mechanisms that have triggered consumer and producer behaviour in terms of consumption, saving and investment, have entailed an important rebalancing process in line with thenew economic equilibria. However, there is room for further correction given that we have not observed a similar adjustment in other important prices (e.g., the housing prices, which are frequently referred to as a proxy of wealth). The financial stability of the economy and the balance sheets of its individual sectors (fiscal, business or household) require simultaneous and equal changes on both sides of their balance sheets in order to allow for an efficient pricing of assets and evaluation of investment opportunities. The financial system has a particular and

important role in this rebalancing. It should evaluate carefully the nonperforming part of its assets and take appropriate measures to save the financially stable investments, while executing collateral with regard to ill-fated projects that cannot recover.

This process becomes crucial as past history of the crisis shows how the old model has been difficult to replicate, not only because the once expanding non-tradable sectors have slowed considerably after the financial crisis, but also because banks strengthen their credit assessment and risk management systems mainly out of concerns of rapid increases of nonperforming loans and other financial stability issues. The inability of the economy to generate faster growth and absorb more investments in the traditional sectors and the inability of the financial sector to expand faster toward potentially tradable sectors have restricted credit growth.

On the other hand, recovered confidence in the banking system and the rebalancing of agents' credit-loaded balance sheets has spurred a sustainable increase in deposits. These opposing trends pose potential risks to future profits and financial stability as the banking system sits on a considerable cushion of liquidity that is not used to credit the economy. Current Bank of Albania analysis and shock scenarios indicate that among all components of aggregate demand, investments have the largest multiplier, therefore faster credit growth and investments have the ability to simultaneously solve both growth and financial stability concerns. It is important, at this point, to emphasise that the investment and credit allocation process, the resulting composition of credit portfolio, and the landscape of economic growth must be achieved by pressing banks to improve their financial situations and increase their credit assessment and risk management capacities. Improving business environment, market institutions and market efficiency will allow for accurate pricing of opportunity costs and risks, will improve the process of credit allocation in the economy and lead to the desired sustainable model of growth.

This brings us to the next issue, which is the scope for improving market efficiency in pricing and allocating the economy's resources. This must be based on the micro foundations of the open economy, with a particular focus on the regional aspect based on economic scale, competition and cooperation points of view.

Achieving greater efficiency in resource use: the regional aspects of the growth model in a global economic context

The country's economic development has been characterized by a growth and investment model that has favoured services and construction businesses, as opposed to exporting or import-competing industries. Although this performance in some respects reflects the tendency to perform similarly to the economic structure of developed and advanced economies, it has resulted in over-investment in certain sectors. Economic development cannot be stable if the allocation of funds is not carried out by adhering to the principle of sector productivity and efficiency. The misuse of financial funds impairs the agents and the whole economy, with severe and long-term consequences for corporate balance sheets and debts, for the labour market, and for capital and technology allocation among sectors of the economy.

To minimize such risks, it is important that businesses stop the inertia in their behaviour and realistically assess the regional and European context of their choices. Albania's competitive advantages should not be sought only in natural resources, or in meeting demands of the Albanian market that are not yet well-founded, but also in the cheap work force of the country and in its position as a future EU member. Therefore, investors are encouraged to expand the time horizons in their decision-making and base their decisions on detailed and scrutinized business plans and analyses. Albanian businesses should avoid herd behaviour, where one business idea is almost automatically followed and adopted by others, without reference to potential market size, competitive advantages, and the level of expertise or financial efficiency of invested funds, as well as macroeconomic and sectorial analyses.

These choices must also consider the regional perspective. Albania is a small economy in terms of markets and demographics, with limited scope for economies of scale and clustering. Moreover, Albania is located in a region dominated by similarly endowed (in terms of markets and demographics) small open economies which offer and promote similar comparative advantages and share the same political, social and economic goal of EU membership. In fact, the above story of economic development and challenges is not only the story of the

Albanian economy – to some extent it describes the story of the entire Balkan region that we are used to calling South East Europe.

Just like Albania, the rest of the region has suffered a similarly painful transition process. Despite different underlying initial conditions and developments all economies of the region suffer from low FDI, political and democratization process, slow reforms, corruption etc. Former Yugoslavia territories, which constitute the rest of the region economies, had a very different attitude toward market economy, international trade and capital flows from the other centrally planned economies. Yugoslavian economy enjoyed a much opened economy and policy by communist standards; its economic activity was very much organized on the basis of economic specialization; and the (civil, legal, educational, and political) infrastructure was designed around this economic model.

However, the destructive conflicts that led to the dissolution of the former Yugoslavia, lasting until 1999 with the War in Kosovo, took high economic, political and social tolls on the newly independent republics. The Yugoslav wars destroyed the very infrastructure of economic cooperation. The new republics lost traditional markets of final goods and resources, and got caught up in a domestic and international political mess. Traditional economic relationships were replaced by hate, mistrust and suspicion. Such an emotional and political infrastructure prevented the flow of capital, goods and labour, resulting in missed economic opportunities.

In conclusion, countries of the region have been unable to manage the transition from socialist or communist societies to democratic societies in the best possible or optimal way. Anastasakis and Bojicic-Dzelilovic (2002) report, among other things, that local actors did not find value added in cooperation per se, and lacked sufficient knowledge about regional initiatives as well as a clear understanding of the term "region". Ten years have passed since that study, with maybe some discernible improvements in local perceptions about regional cooperation, yet there is still a gap between potential and actual cooperation in terms of concrete actions with concrete outcomes.

Later developments suggest that such a mentality is still preventing regional cooperation. Following the entry into force of the Central

European Free Trade Agreement (CEFTA 2006), trade within the region has slightly increased, however, the major trade partners of most countries continue to lie outside the SEE region. The latest Bank of Albania analysis, based on gravity models, reveals that Albania's external trade with EU partners remains at optimum levels, while trade with the region is well under its potential.

Expansion of foreign trade among the region's countries requires not only a further reduction of trade barriers related to poor infrastructure and ethnic-founded arguments, but also a regional approach toward markets, production capacities and products.

As noted above, all economies of the region are small, open economies with almost the same foreign trade partners. If one were to compare the Pre-Accession Economic Programs (PEPs) presented to the European Commission, they all claim to rely on an export-led growth economic strategy more or less in similar sectors and products, mostly because countries in South East Europe have very similar economic structures and trade patterns. Under these uncoordinated models, regional trade integration has the potential to result in a Cournot or Bertrand model of competition for the same markets and investors. This will not only provide disincentives for cooperation and/or trade diversion but, most importantly, will potentially transform the entire region into a region of losers, causing the failure of individual models in each economy. Thus, it is hard to expect tangible benefits from a regional trade agreement and successful economic stories given these current conditions.

On the other hand, recent trends in global financial markets indicate that investors are interested to engage in bigger and better coordinated projects that incorporate larger domestic markets, with existing networks of support or complementary industries. This implies building core-periphery industrial models that extend to cross-border relations as well. Broadly speaking, core-periphery models imply industry clustering among countries in the region. In this sense, regional cooperation calls for the identification of win-win strategies of country specialization and trade in goods and services. These are characteristics that the region can offer much better than its individual economies. Put in other words, it calls for economic structural cooperation, through the

identification of country-level comparative advantages and industry-level competitive advantages from the regional overview rather than from national viewpoints.

This is a clarion call for authorities in the region who should think strategically at two levels about every decision they make: at the national level and at the regional level, simultaneously serving national and regional development priorities. In this respect, the Albanian economy should restructure to find its place in the worldwide economy as part of an economic region, rather than individually as a sole market. This entails restructuring its linkages and role in the region, so that economic development policies of the Balkan countries become consistent and mutually reinforcing.⁵

VI. Conclusions

Albanian economic development prior to the crisis has been a success story, with fast growth rates, welfare improvement, and a total factor productivity upsurge. However, the recent financial crisis revealed many domestic imbalances that had emerged as a result of the transition growth model. The reorientation of the major part of Albanian productive capacities toward non-tradable goods (mainly investment in residential housing) and re-composition of the economy toward services increased domestic demand much faster than aggregate supply. In the case of tradable goods, such a dynamic resulted in higher imports. Remittances have been increasingly important to finance the economy, but in this process they have become dysfunctional, being oriented mainly towards consumption rather than investment.

As the financial crisis hit the sources of this successful expansion, there is a need to orientate the economy toward a new strategy of growth. Technology adoption and innovation should be the new cornerstone of our growth model. In this process, developing and accumulating human capital will be crucial, as a well-educated labour force will be able to use more advanced technology effectively. This will require an efficient reallocation of educational patterns and resources in all

⁵ The issue of regional cooperation in South East Europe will be discussed in detail in Chapter 3.

levels of education. In particular, it is important to increase the share of vocational education and training in secondary education and align enrolments and graduation rates in tertiary education with the development priorities of our economy and its comparative advantages.

The banking system will have to play an important role in this new model of growth. Its financial intermediation must support the development of new trades and industries away from the current focus on non-tradable activities. This is, in fact, a new model of banking business that relies on closer relationships with business and stronger research, risk assessment and risk management capabilities.

Finally, the Albanian economy should restructure to find its place in the region, as the region finds and redefines its place in the world economy. This includes not only the continuation of structural reforms but also a reconfiguration of its growth model from a regional perspective, so that economic development policies of the Albanian economy are compatible with regional comparative advantages and even act as complementary programs to reinforce and support them.

Looking beyond the episodes of war and conflicts that frequently define the region in our minds, it is not hard to identify similarities and signs of vivid exchange over the centuries, both economically and socially. It is a fact that countries of the region share the same ballads and legends. In addition to the cultural exchange, this also indicates that folklore themes have developed and evolved under similar historic, social and economic patterns of events. In her memoirs, Edith Durham describes the region in a single, desperate way, indicating similar economically underdeveloped, and prosperity deprived, countries in the region. Therefore, we should concentrate more on issues that deal with questions such as the following: What prevents the Albanian economy as part of the SEE region from creating opportunities and institutions that reach out and seize opportunities in global markets? What steps should we take so that such opportunities are appealing to foreign direct investors? How can the region encourage the implementation of existing technologies in the short-run, and the generation of new ideas in the long run, to make each economy attractive and to lend credibility to the region as a whole in the eyes of global investors and its political and economic counterparts abroad?

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Chapter 2: The competitiveness of the Albanian economy and a policy agenda

Most economic fallacies derive from the tendency to assume that there is a fixed pie that one party can gain only at the expense of another.

Milton Friedman

I. Introduction

Macroeconomic developments in recent years, and overall trends in economic indicators and standards of living, show that Albania has succeeded in completing the transition phase, entering the group of emerging economies. Nevertheless, with the increased integration, the Albanian economy has become vulnerable to shocks that typically affect more advanced economies. The outbreak of the financial crisis in the United States and Europe, along with the tightening of liquidity and credit conditions and the fall in output and employment, have caused sharp drops in credit and investment. This financial and economic crisis has affected most of all the southern members of the European Union, which also happen to be Albania's traditional export markets and its largest partners in terms of trade services and financial and capital investments.

Currently, the capital flows that had financed high current account deficits in the former transition economies in Central and Eastern Europe are interrupted. Faced with financial difficulties, in particular deleveraging in private and public sectors and a financial sector that is required to meet the constraints of new supervisory regulation, advanced European economies, exercising pressure to withdraw their funds from neighbouring

economies. These effects have become particularly pronounced with the spread of the sovereign debt crisis in the Euro area, where banking groups active in South East Europe are typically headquartered. All these developments have questioned the sustainability of current deficits and the stability of currencies in the region's emerging markets.

Such a close economic relationship with the EU economy was the contagion mechanism that spread the effects of the crisis from the EU's advanced economies to the Albanian economy. This contagion triggered the slowdown of economic activity, credit and investments in Albania, spreading the impact into the financial system and government finances as well.

Even though the financial system was not severely impacted by the global financial crisis, second-round effects have emerged, challenging the stability and persistence of strong economic growth rates and financial situations of the household, business, fiscal and financial sectors. According to the Bank of Albania's assessment, current developments, particularly those with our main trading partners, will exert particular pressure on Albanian exports and capital inflows in the form of FDI, and eventually on economic growth and employment. The prospects of growth and macro-financial stability will depend on the ability of the Albanian economy to find new export markets and foreign direct investment partners. On the other hand, success is contingent on our ability to become competitive in global markets; therefore, Albania must adjust to global developments and adopt new strategies that enhance its advantages in general, and export industries in particular.

The export industry is vital to the Albanian economy. During the transition period, our economy recorded a large negative trade balance (Figures 2.1 and 2.2), which is the main cause of the constantly large current account deficit. Long-run macroeconomic stability requires these deficits to be repaid from future trade surpluses. This means that the Albanian economy must increase its exports of goods and services considerably. The basis for this growth can and will only come through an extended export base and increased export value – both based on the comparative advantages offered by our economy. While comparative advantages are given based on endowments and certain characteristics

of an economy, it must be stressed that public policy institutions have a substantial role to play in this regard. Through their policies, such institutions create and support economic development initiatives – the relevant incentives, environment and infrastructure on which businesses will be based and promoted.

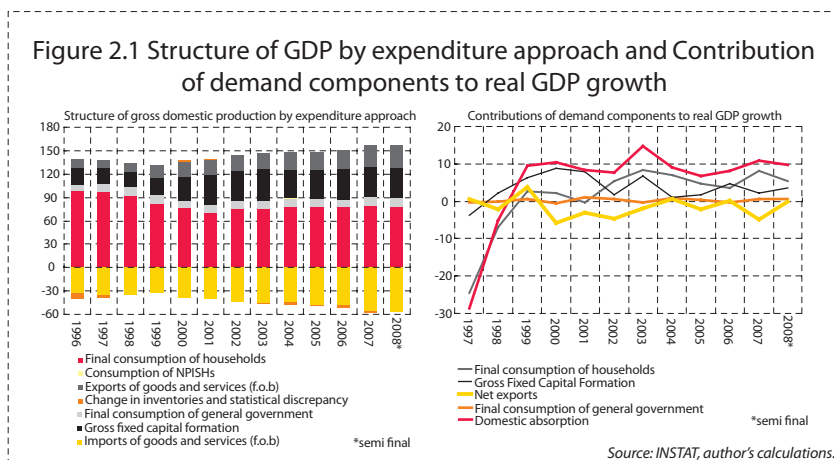
At present, the geographic, demographic, economic and social characteristics of the Albanian economy offer many advantages that, if wisely utilized, can indeed materialise into economic benefits. Increasing foreign currency income growth from all sources is a crucial element in assuring macroeconomic stability in general, which is highly relevant for overall financial stability in Albania. From this point of view, supporting export activities by all means is imperative for both the public authorities and the financial sector, not only with products and financial resources but also with financial guidance, fiscal and other supportive policies. Such policies, however, would not be productive unless the Albanian economy is able to build comparative advantages in economic activities, export products and services.

Against this backdrop, the present paper conducts an investigation of the long debated issue of competitiveness in Albania, aiming to identify policy actions needed to strengthen this competitiveness. It dedicates a particular discussion to the role of the central bank and other public institutions and their policies in the context of macro-financial stability and export-supporting policies. The second section examines the quest for growth and competitiveness, arguing that a sustainable growth model for Albania should rely on finding new sources of competitiveness. The third section takes a look into different definitions of competitiveness, highlighting differences in their policy implications. The fourth section makes use of some direct and indirect indicators of competitiveness in Albania, identifying major vulnerabilities. Finally, the fifth section discusses the role of the central bank in enhancing the country's competitiveness.

II. The quest for growth and competitiveness

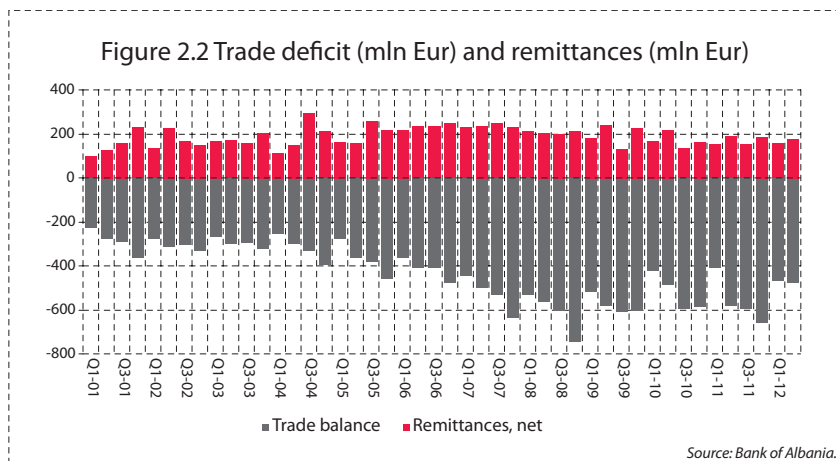
Over the last two decades, Albania has undergone significant structural changes, which have fuelled economic incentives and promoted

economic growth. In the early stages of transition, a rapid and significant transformation in the labour market, first, and the capital market, next, reoriented all factors of production toward more productive sectors. This reorientation benefited from large capital inflows, with a considerable part thereof financing imports of machinery and equipment as well as services. Such developments contributed to higher total factor productivity and consequently faster economic growth. This increase in income and the rapid credit growth that followed increased domestic demand for consumption and other durable household goods and services. The inability of domestic production to either satisfy local demand or gradually substitute imported goods gave rise to large imports, which turned into large and persistent trade and current account deficits.



This vulnerability reflects, most of all, the fact that domestic consumption and investment in non-tradable sectors have been the main beneficiaries of investment and credit expansion. Lack of investment in a competitive export sector, in addition to textiles and footwear, has impaired the ability of our economy to create strong export sectors in agriculture, minerals and tourism, as well as our ability to provide enough domestic production to substitute the imports of goods and services. Boosting domestic production and its quality to compete with foreign goods and services will improve the balance of foreign currency, and would enable

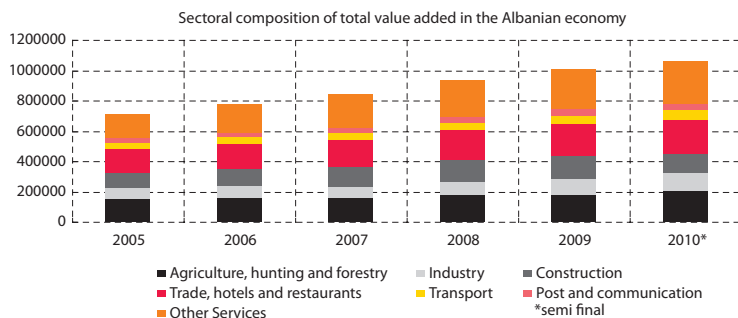
the economy to reverse accumulated external economic balances. Until now, the persistent, large trade deficits are covered by large inflows of remittances (Figure 2.2). These flows have proven to be sustainable over the past years, providing an important buffer against trade deficit growth, but their future sustainability is questionable, especially in light of recent developments in our partners, especially in Greece and Italy, where the majority of Albanian emigrants live and work.



At the microeconomic level, the growth of consumption was followed by increased indebtedness in household and business balance sheets, thus potentially creating overcapacity in certain sectors of the economy, particularly construction. This pattern of development shows, among other things, that so far the Albanian economy has not been able to introduce competitive projects in the country's areas of comparative advantage.

In sectoral terms, Albania's economic development has been characterized by a growth and investment model that has favoured services and construction of residential housing and apartments (in general, the non-tradable sector), rather than potentially successful exporting industries (Figure 2.3). In addition to these non-tradable sectors, which as a matter of fact were developed in line with a significant market demand, our economy offers other productive and potentially

Figure 2.3 Sectoral composition of the total added value at constant prices



Source: INSTAT.

profitable opportunities. Minerals, arable land, fresh water resources and renewable energy potential, a youthful population, beautiful seaside and very favourable geographic location offer vast potentials for profitable investments from both a domestic and global point of view. Taken together, these human and natural resources provide a sound basis for growth in exports in the future as the global economy recovers (as documented by foreign trade patterns of the past). Also, they may contribute in supplying substitutes or reducing imports of consumption goods. Unfortunately, it seems that business has been indifferent to these opportunities by opting to invest their money and efforts in other sectors, yielding to misallocation of financial resources with severe long-term consequences for private sector balance sheets, resource utilization and capital allocation.

The above analysis seems to blame current outcomes on poor business analyses and the financial sector's inability to efficiently distribute resources more evenly among productive sectors of the economy. Yet it hides an important fact: such an analysis is not complete until it provides an evaluation of the competitiveness offered by these potentially profitable sectors relative to the rest of the world's economy. The analysis must assess the Albanian economy's ability to convert these endowments into desirable goods and services and deliver them to the domestic and world markets at a competitive price, thus generating an economic profit. The following section tries to provide a detailed discussion of this important concept and the factors affecting it.

III. Competitiveness: Meaning and implications for policy actions

The discussion naturally brings us to the question of whether this generous endowment in human and natural resources constitutes real comparative advantages that would encourage investments in tradable sectors and foster development particularly in export-oriented sectors. Pertinent literature discusses factors that act like obstacles and prevent these resources from turning into comparative advantages, but what role do public institutions play?

The concept of competitiveness is a widely covered topic in the study of international economics. It builds on the concept of comparative advantage as defined by Ricardo (1817) and extends to include the entire set of national endowments, factors, institutions and policies – everything and every policy within the national economic space that determines the level of productivity of a country. Competitiveness has gained centre-stage in the economics of development. It has defined economic policy developments in emerging countries trying to match or even outperform the export-led strategies of the Asian economies (China being a perfect example), as a way out of poverty and towards development. Currently, restoring competitiveness is also becoming the centrepiece of the debate in the troubled economies of the Euro area that are suffering under the burden of large sovereign debts and risking default. Carrying out the necessary structural reforms aimed at increasing competitiveness is seen as the only way out of the crisis. The concept is extensively discussed and debated in many academic and policy papers, including the works of Porter (1990), Krugman (1994), Aiginger (2006), Ketles (2006) and Grilo and Koopman (2006), just to mention a few. Their work has laid the foundations to construct measurable indices of competitiveness such as the Global Competitiveness Index (GCI) published by the World Economic Forum. The definition of competitiveness may include three main concepts at the macroeconomic level: the ability to trade on external markets, capability to generate welfare, and productivity.

The first concept refers to a country's ability to maintain a sustainable share of its exports in the international market. Accordingly, a country

gains competitiveness at the expense of another country. In his analysis of the direction of trade flows, based on an appraisal of traditional and new trade theories, Smit (2010) identifies both comparative advantage related to differences between countries and increasing returns to scale as reasons underlying the direction of trade flows. The former concept can explain trade on the basis of cost considerations. Comparative advantages resulting from country cost differences, however, can usually be a misleading tool for trade analysis, thus wrongly leading to economic policy responses like reduced taxes and devaluated currencies, and other export incentives like artificial restraints on local wages and subsidies, which are designed to boost a country's comparative advantage. While these are viable policies in the short-run, they can be misleading and counterproductive when applied in long-term periods, or in the absence of real economic factors that boost competitiveness. Porter et al. (2007) show that cost based competition can be misleading since low wages may reveal a lack of competitiveness and depress prosperity for citizens, while currency devaluations lower the standard of living of a country through raising the cost of goods and services purchased from abroad.

Therefore, it becomes necessary to define national competitiveness as a set of policies, factors, and institutions that determine the level of productivity of a country (Global Competitiveness Report (GCR), 2011-2012). In this respect, Porter (1990) defines competitiveness in terms of the following five factors:

1. Factor conditions: the nation's position on endowed factors of production, such as natural resources, climatic conditions, geographical location and unskilled labour that represent endowments and developed factors such as accumulated knowledge and technology, human capital and infrastructure necessary to compete on a global scale. The latter do not only create the foundation for the materialization and intensification of the second set of factors, but also bring both sets together, employing them efficiently to gain sustainable competitive advantage for the national economy;
2. Demand conditions: the nature of home-market demand for the industry's product or service. Determinants of competitive advantage here are related to national characteristics like demographics and

- demand sophistication;
3. Related and supporting industries: the presence or absence in the nation of supplier industries and other related industries that are internationally competitive;
 4. Firm strategy, structure and rivalry: the conditions in the nation governing how companies are created, organized, and managed, as well as the nature of domestic rivalry.

Finally: government policy and institutions, and chance (or exogenous shocks), enter the complete competitiveness framework. They enter as complementary factors. They are both important for the long run competitiveness of the economy, but have very different effects. On one hand, exogenous shocks in general define the stochastic trends in national competitiveness and are not under the direct control of the society. On the other hand, policy and institutions play a more deterministic role in the overall competitiveness of the economy in the long run. Both institutions and government policies are under direct control and direct outcome of the society and its maturity.⁶

Fitting the discussion of the previous chapter in the framework of the above definition provides a better and more comprehensive understanding of the level of competitiveness of the Albanian economy on the global scale. The first observation is that the passage on competitiveness that opened this chapter neither considered nor discussed important determinants of competitiveness. Specifically, the endowment- and cost-based analysis is inaccurate because it lacks the content of efficiency and productivity related to factor and demand conditions as well as government policies and institutions. It explains why several economic initiatives like “Albania 1 Euro”, or flat tax, or cheap labour have failed to boost competitiveness and yield booming investments. The GCI, which defines competitiveness as the combined institutions, policies and factors (discussed above) in a single measure of the level of productivity, is consistent with past and current developments in Albania⁷. The GCR 2011-2012 ranks Albania 78th out of 142 major and emerging economies, positioning it below all EU and CEE economies.

⁶ More concerning this issue will follow.

⁷ The index rests on the following 12 pillars of competitiveness. These 12 pillars reinforce each other and they matter to different extents for economies in different stages of development. For an extended discussion of the index, see Global Competitiveness Report 2011-2012.

Consequently, the competitiveness of the Albanian economy is at the lower levels of the productivity chain in the EU and Central, Eastern and South-eastern European countries. This position is a direct result of efficiency problems in using resources and lack of innovation, and is consistent with the nature and sectorial evolution in the Albanian economy. According to the latest Global Competitiveness Report, Albania suffers particularly in the areas of market size, innovation, financial market development, technological readiness, business sophistication and infrastructure. In all these categories, Albania scores below 4 out of 7.

However, the situation is particularly difficult in terms of market size and innovation, where the score is below 3. Based on this indicator, it is reasonable to assume that investment in our economy would shift to the non-tradable sectors as the tradable sectors are less productive and cannot compete with the rest of the CESEE economies. Accordingly, rather than an outcome, productivity seems to be a determining factor of sectorial development and of the nature of economic growth. The competitiveness indicators confirm the particular vulnerabilities discussed in the previous chapter, especially the patterns and trends of educations in Albania. Among these, the weak and decreasing vocational training and education, lack of work training, and preferences of social sciences in the higher education contribute to reduced competitiveness. These particular educational trends of are at odds with the comparative advantages offered by Albania, its small market size, and the structure of its economy as measured by the sectoral value added as a share of the GDP.

Most importantly, low competitiveness in particular areas reduces or prevents the development of competitiveness in related subjects. The small market size and fragmented infrastructure has led to a high concentration of economic activity in the area between Tirana and Durrës for all types of industries, resulting in a very low concentration in the rest of the country. This pattern of development has prevented the creation of clusters that are usually and learning, innovative setting. Business preferences to gravitate to Tirana have prevented the concentration of particular industries and their supporting and supply chains close to one other, hindering the development of economies

of scale in the rest of the country, especially in the areas where factor endowments are located. A good example is the case of agro-business industry. Agriculture provides more than 20 per cent of the value added in the economy and is located mainly in the western and South Eastern part of Albania; yet Boc and Lanz (2011) indicate that the food and beverages industry is concentrated in the Tirana-Durrës area, a long distance from production. This distance between related industries and sectors damages operating productivity and production efficiency, therefore reducing the competitiveness of the agricultural sector. Thus, it is no coincidence that food consumption represents a substantial share of Albanian imports, while a sizeable amount of arable land remains idle (forcing the government to impose a tax on unused arable land in 2010). This behaviour is also result of other problems with land ownership and market reform, as well as with access to finance.

I do believe that current needs for financing and sectorial competitiveness can simultaneously benefit from the establishment of Development Financing Institutions. Such institutions have a particular focus on the financing of SMEs operating in particular sectors of the economy like agriculture and agri-business, mining and mineral enrichment, and tourism, in which our economy has comparative advantages. The perceived benefits of their establishment go beyond the low cost of financing as they are specialized in these respective industries – they know the emerging market environment, and, more importantly, are willing to offer technical assistance and share their expertise in the areas of production efficiency, employment and business administration, and business ethics and transparency. It is not surprising then that according to GCR 2011-2012, access to finance takes the first spot on the list of complaints, followed by taxes and tax regulations, corruption and the inefficiency of government bureaucracy.

For government and business alike, it is important to understand that endowments, efficiency and innovation boost the competitiveness. Consequently, economic development can gain or lose ground compared to the global economy. This view is not different from the notion provided by the European Commission in its Competitiveness Reports, which define competitiveness as closely related to productivity, that is: '[...] a sustained rise in the standard of living of a nation or

region and as low a level of involuntary unemployment as possible. For an industrial sector, the main competitiveness criterion is maintaining and improving its position in the global market' (European Competitiveness Report 2010:15). While the output per capita growth captures the standards of living, it is closely related to employment growth and labour productivity growth. Productivity is a crucial factor in determining outcome competitiveness, although it is neither the only source of process competitiveness nor the only indicator of outcome competitiveness. The rest of the problems on the list indicate that the continuation and the speed of structural and institutional reform and every single related process of political, parliamentary and economic life, are defining factors for improving the competitiveness of the Albanian economy. Unless these problems are addressed, Albania's competitiveness would score low in the global rankings while short-term and cost-focused economic incentives would not improve the prospect for FDI, faster economic growth and faster exports. These findings are consistent with the findings of the empirical work conducted by the Bank of Albania, which is discussed in the following section.

IV. Bank of Albania's understanding of the competitiveness of the Albanian economy

Figure 2.4 below shows the performance of particular groups of exports and their share in Albania's total exports. Exports of commodities are represented mainly by natural resources (raw materials, minerals, fuel, and lubricants) and exports of energy, which is entirely produced by renewable resources.

Nevertheless, the balance of trade in energy is negative, as it is in the case of food. Both of these sectors are considered as comparative advantages of the Albanian economy. The other significant group represents miscellaneous manufactures that are mostly compounded by re-exports of textiles and footwear. In the services account, the main exports are travel services. This simple overall narrative depicts a story that reveals important information about the country's competitiveness. It shows that exports are somehow in line with the general perception concerning the comparative advantages of the Albanian economy. It also shows that

Albania competes in the global market with factor endowments and low-skilled labour manufacturing. Both inputs are, however, offering less value than their true potential. The lack of greenfield investments in the exploitation and enrichment of infrastructure in the mineral industry, and in particular low investments and stagnation in export sophistication, indicate that exports face competitiveness issues. This is enough for a short discussion to give us a broad picture of where Albania stands in terms of competitiveness of its exports and the economy as a whole.

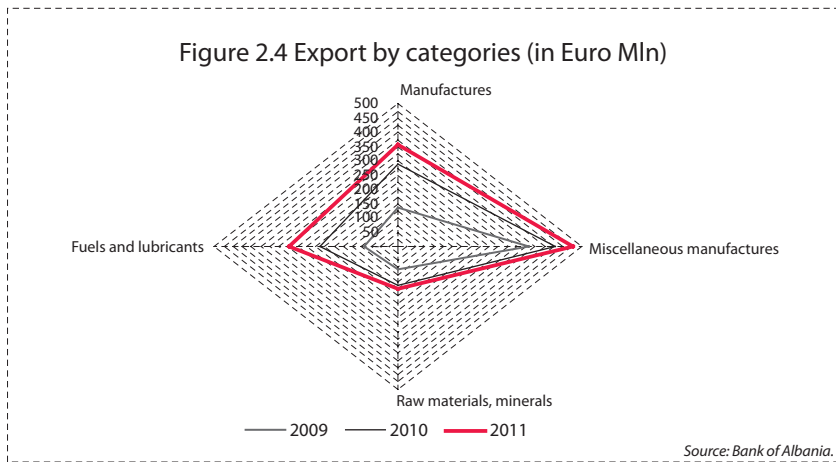
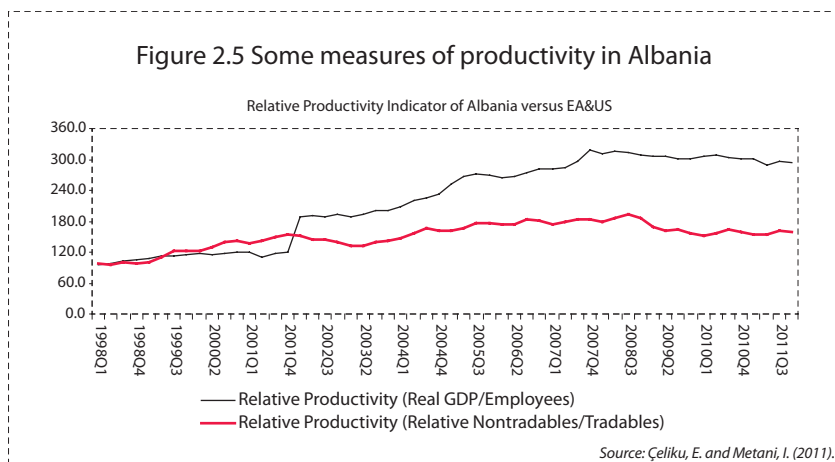


Figure 2.4 below indicates that exports have grown steadily over the last years, and the export base has widened as well. However, Albania is largely competing with natural resources (raw materials, minerals, fuel and lubricants) and miscellaneous manufactures that are mainly compounded by re-exports, competing through labour costs. Our discussion in Chapter 3 indicates that this success is likely to be reversed if other sources of competitiveness are not properly identified and exploited.

The general conclusion of this analysis is in line with the international appraisal of Albania's competitiveness above and is also confirmed by several empirical studies conducted by the Bank of Albania. This empirical work measures competitiveness in several direct and

indirect ways, including the Balassa-Samuelson (BS) effect, total factor productivity and labour productivity⁸.

A brief summary of these findings shows that the BS effect has accounted for the appreciation of ALL on average by 1.4pp (40 per cent in annual terms), indicating the low international competitiveness of Albania's economy. The underperformance of Albanian exports is explained by the relatively low differential growth of productivity in the traded goods sector compared with Albania's trading partners.

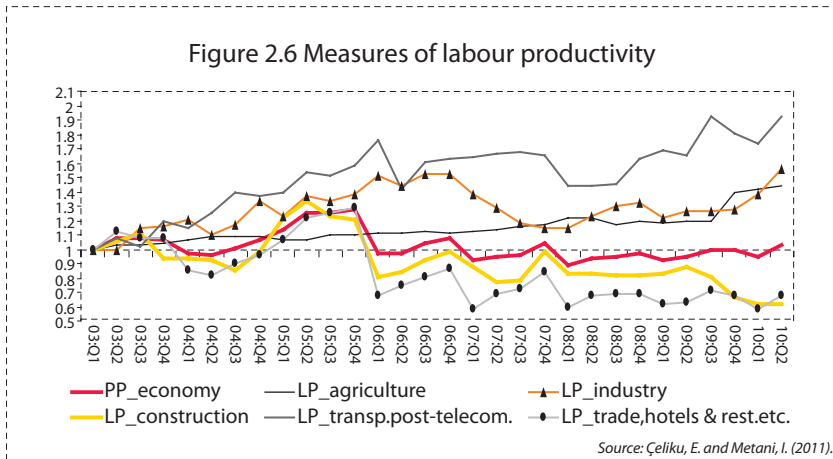


Measures of productivity indicate that the increase in total productivity, and labour productivity in particular, constitutes the major driving force for long-term growth in Albania. Figure 2.5 shows relative total factor productivity of Albanian vis-à-vis the Eurozone and the US using the ratio of non-tradable to tradable sectors and the output per employee. It should be noted that the relative productivity of Albania has started to slow down since 2005, and even shows a turning point, thus declining in the last periods (see Figures 2.5 and 2.6).

Empirical study of the factors determining labour productivity in Albania and its long-run trends conclude that between 2003 and 2010, labour productivity has been declining, despite a moderate improvement

⁸ A discussion of these concepts and their application will be found, respectively, in Celiku and Hoxholli (2009), Kota (2009), and Celiku and Metani (2011).

since 2008. Figure 2.6 shows that this trend varies among industries and sectors, and that it is higher in industry and tradable services. However,



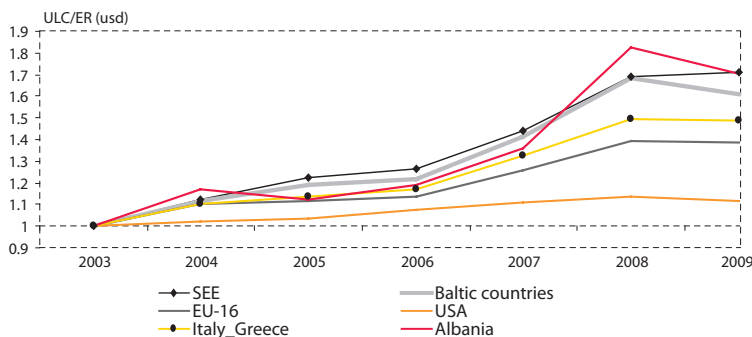
given the low weight of tradable sector output, we can suggest that it has yet to become a driving force in the economy as a whole.

Furthermore, the decomposition of relative cost per unit of labour (Figure 2.7), based on the method of Van Ark et al. (2005), indicates that Albania's unit labour cost stood below that of the Baltic countries and the South European Economies until mid-2007 but has increased since 2008 (though it is difficult to judge due to the low quality of labour market data; the sudden increase in 2008 may also relate to some undocumented methodology or statistical [accounting] changes in the data).

Further analysis shows that the relative labour productivity in Albania stands below that of the Eurozone (EU-17), USA and SEE for most of the period 2003-2010, as Figure 2.8 illustrates. Major restraining factors are the lack of new technologies and the low contribution of exports to economic growth.

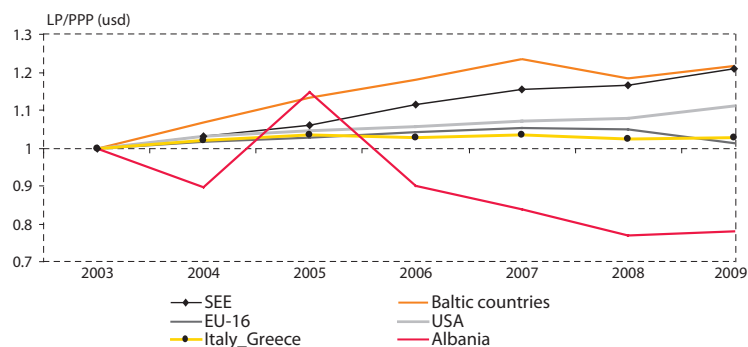
Referring again to the Global Competitiveness Index, Albania is ranked 78th overall, but its ranks in "efficiency and innovation" and "business sophistication" factors are respectively 82nd and only 102nd. According

Figure 2.7.a Unit labour Cost Performance



Source: Çeliku, E. and Metani, I. (2011).

Figure 2.7.b Labor productivity performance



Source: Çeliku, E. and Metani, I. (2011).

to these rankings, there are still vulnerabilities in all the pillars which will ever increasingly become an obstacle for the country's economic growth in the future, unless these competitiveness issues are addressed in due time.

In my opinion, it is also important to discuss another important issue of competitiveness – market size. With a market size index of 2.7, the Albanian economy scores particularly low in the overall ranking⁹ (Albania ranks 99th out of 142 countries).

⁹ The maximum value of this index is 7.0

Taking note of these particular vulnerabilities, the Bank of Albania has emphasized strongly the importance of regional cooperation as an instrument to boost competitiveness¹⁰. Individual economies of the SEE region represent relatively small markets that offer little incentives from the market size point of view for global companies and institutional investors. Despite the relatively small size of the Albanian and other Western Balkan economies, the SEE region is a large market of approximately 25 million consumers. As discussed earlier, studies of location and economic geography have revealed the vital importance that this factor plays in firms' decisions regarding location and investment. However, as well known the importance of regional cooperation may appear to be, in practical terms, cooperation among countries in SEE remains low. I will dwell into this issue in the following chapter.

The efficiency of allocation that helped transition economies improve their competitiveness in the early stages of economic transformation can be extended further in the case of regional cooperation. A more efficient allocation of resources in the context of a larger regional SEE market could bring potential improvements in specialization and economies of scale, thus improving competitiveness for Albania and the region. This new stage of re-allocation would reduce costs and improve competitiveness for all countries involved. Growth of possible clusters within such a unified economy (as per Krugman 1991) would bring benefits to all states. Yet for this to happen, we need to work hard to dismantle physical trade barriers – by improving our infrastructure, which still leaves much to be desired – as well as legal and political trade barriers. These barriers constitute business costs for firms, thus reducing our ability to compete on the world stage.

Last but not least, it is important to focus on the issue of institutions, as recent growth theory has strongly emphasised the role that institutions play in economic growth. The type of institutions that researchers have focused on has varied quite a bit, though property rights have often been the variable of choice. By all means, this is quite relevant to Albania as well. Trying to define the 'competitiveness of nations' and focusing on "process competitiveness", Aiginger (2006) includes among soft factors the following: capabilities, the quality of institutions, trust, the national

¹⁰ Further information on cooperation in the South East European region will be found in Fullani (2011a)

innovation system, political stability, and the rule of law. An important note made by both Aiginger (2006) and Ketles (2006) is that hard factors such as technical progress can be endogenised by cross effects between soft and hard factors. The detailing of drivers of competitiveness is particularly important in determining the sustainability of the level of prosperity attainable by a country. For instance, Aiginger (2006) discusses resource-dependent economies and distinguishes between human resource-driven economies and natural resource-driven economies. Even though high prosperity is possible in a resource-rich country despite its lack of competitiveness, it is not sustainable once resources are depleted. Another issue relates to the size of high-productivity sectors and their share of employment in the economy. Competitiveness that are realised in the form of productivity growth or endowments, in industries and trades that have a small share of GDP or small share of total employment, do not greatly boost overall competitiveness. For competitiveness to become a driver of prosperity, it must be a prevailing characteristic among all (or most of) the productive sectors of economy.

Therefore, it is important that authorities understand competitiveness and implement it in all its aspects, starting with the understanding of the important role of institutions and competitiveness as a process that looks beyond the micro foundations of productivity and competition. Competitiveness is a broader concept that must encompass the issues of macro foundations and macro-financial stability, improved human capital via education and on-the-job training, innovation and research development. All these issues highlight the role of state institutions and their policies as important determinants of overall competitiveness in the economy. Pedersen (2008) provides a comprehensive discussion on this topic and a comprehensive coverage of the relevant literature.

The Bank of Albania has yet to conduct dedicated research in this particular area of competitiveness. However, it is interesting to observe that the GCI sub-indexes in the institutions pillar indicate that despite an overall ranking of 57th, competitiveness is particularly low (ranked 90 or below) in the property rights, judicial independence and intellectual property rights, which is also in line with the general public perception. Notwithstanding these problems, Albania scores relatively well in the remaining sub-indexes, indicating that institutions have

played a positive role in economic development and competitiveness. In this context, the institutions have largely benefited from the policy-anchoring role of the economic, political and integrative programs and processes undertaken in cooperation with international partners. The role of institutions such as the IMF, WB, EU and NATO, has been vital in this process¹¹. Combining technical assistance with pressure, these institutions have served as anchors, thus being the major driving force behind most of the reforms in Albania. The role of such institutions and their policies is undisputable, as Albania has largely achieved, maintained and remains committed to macroeconomic, political and regional stability even throughout the global financial crisis. I will return to this important topic of the policy-anchoring role of international institutions in the following chapter, focusing the rest of the discussion on the central bank and its policy as important determinants of the country's competitiveness.

V. Policy actions: The role for the central bank

So far we have discussed the vulnerabilities of the Albanian economy in terms of its capacity to compete in global markets. This section addresses the role of the Bank of Albania in promoting the country's competitiveness. Discussed within the broader framework of institutional competitiveness, the central bank and its policy can play an important role as promoter of – or as a disruptive barrier for – operating businesses. Through explicit, but more often implicit costs, inefficient institutions can make for an anti-business environment. They can often add to uncertainties regarding current and future decisions for businesses. The central bank's impact flows into overall competitiveness via two main avenues: the macroeconomic and financial stability of the economy as well as the institutional framework.

It must be noted however that the behavior of economic agents is influenced and interlinked with central bank policy and structural reforms undertaken from all institutions. So the relationship between all agents is based on economic common sense that it is currently evidenced in several instances. The intuition of this relationship is

¹¹ The issue of internal and external policy anchors is discussed in the following chapter.

simple economic common sense, and it is currently evidenced in several instances. Recent noticeable examples include the immense global pressure on the Chinese authorities to let its currency float freely in response to large trade surpluses and despite potential imbalances they cause in the global economy. The inability of developed economies to grow out of recession and generate employment – mainly due to lost competitiveness and especially in the manufacturing sector of the developed economies of the EU and North America – has forced central banks to enter 'uncharted territory' and engage into policy actions that were beyond imagination only years ago.

Ever conscious of its institutional role, the Bank of Albania has constantly endeavoured to contribute to the strengthening of competitiveness in all areas that constitute traditional central bank activities. Additionally, the Bank of Albania has been engaged in addressing two particular issues of competitiveness: first, by launching an economic debate on the growth agenda that addresses the vulnerabilities of the old model of growth and the development of a new model based on the comparative advantages of the Albanian economy; and secondly, in the area of financial literacy. The Bank of Albania has also initiated and continues an open dialog with all stakeholders and the public at large, focused on the new model of growth with particular focus on competitiveness.

The Bank of Albania has focused on these issues for quite some time now, in order to understand how and where we can improve legislation, rules, regulations and policy goals and actions in order to increase the competitiveness of Albania's economy. In this respect, our policy – which I would like to summarise below – has been directed toward liberalizing trade in goods and services; enhancing central bank credibility, transparency and accountability; as well as strengthening macroeconomic and financial stability: First, the central bank should see itself as key promoter of institutional quality in the country (pillar one of GCI: Albania ranked 63rd). This particular pillar emphasises the credibility, accountability and transparency of its goal, policy decisions and operations to create the necessary premises for the financial and real sectors to adjust to temporary misalignments at a low cost. On the other hand, through supervision of the financial sector, it can also promote ethical practices in the business community with a long-term

gain of an improved role for financial intermediation. Our hope is to become an example of efficiency and transparency among Albanian public institutions, a successful model that can be followed by others. The adoption of the free-floating exchange-rate regime together with the convertibility current account since the early stages of transitions were two of our most important contributions to the institutional competitiveness of the Albanian economy¹².

Secondly, the central bank is a key contributor to the achievement of macroeconomic and financial stability and of the greater economic environment in Albania (pillar 3 of GCI: Albania ranked 101st). While having a clear focus to target inflation because of the price stability mandate, our forward looking policy seeks to address and minimize fluctuations in aggregate demand and aggregate supply and their effects on the labour market and agents' expectations. All this without prejudice to our financial stability role and objectives, for as the recent global crisis has shown, finding the right balance between these goals is not an unambiguous choice. Instead of aiming directly at unemployment or economic activity, the Bank of Albania's policy focuses on expectations and controlling wrong incentives that can potentially lead to unbalanced economic and financial activity, policy misconception, as well as inefficient risk assessment, pricing and management. Economic policy and decision-making in this respect are enhanced by our supervisory role. Acknowledging the simultaneous and reinforcing relationship between monetary policy and financial stability, the Bank of Albania has adapted its regulatory framework to address problems of rapid credit growth, in particular uncovered foreign currency loans in the run up to the 2008 financial crisis.

The Bank of Albania has been consistent in its approach to introduce gradually regulatory measures that would discourage rapid increase in lending, encourage banks to lend more in domestic currency, and increase client transparency on banking products and services. The efforts to adopt and improve the regulative and legislative system continue to these days, addressing every particular challenge that could arise due to some unexpected developments in the domestic market, our main partners and the global economy. As a result of this prudent approach, the Albanian

¹² The Bank of Albania is the institution mandated to decide the nature of the foreign exchange regime.

banking system remains liquid, well capitalised and profitable. Despite the solid performance thus far, the Bank of Albania, in its exclusive roles as monetary authority and banking supervisor, remains vigilant to point out areas of banking activity that require increasing attention from both the industry and the public. Maintaining a healthy financial sector requires strong coordination and responsibility between public authorities at the national and international levels, a full consideration of potential side-effects and other unintended consequences, and a commitment to push ahead with the necessary steps to reform and improve the supervisory superstructure at the regional, European and global levels. Financial market development is recognised as an area of low competitiveness (GCI rank 108th). Our financial system has grown rapidly over time. It has expanded by increasing the number of branches, services and financial instruments, improving its products, its transparency and public access, and increasing its intermediating role.

Therefore, at the end, I would like to emphasise the efforts of the central bank to foster financial sector development. In this context, the Bank of Albania has used its regulatory framework and operational policy as potential tools to provide the right incentives to developing the financial market and, through it, the efficiency of monetary policy. In this respect, our main focus has been on the modification of regulations and operational policy to enlarge the interbank market in financial instruments. Education and research (pillars 5 and 12 of GCI, Albania ranked 100th and 119th, respectively), though typically associated with the development of academic institutions and other central public authorities rather than the central bank, does not prevent us from taking a leading role when it comes to expanding the frontiers of knowledge in public education institutions and scientific work.

The Bank of Albania has been pursuing a strategy of economic public education, targeting different focus groups including high school alumni, economics and finance students, commercial banks staff, representatives from the business community and academics. Additionally, the Bank of Albania has increased the number of its publications and presence in the media and the number of education activities, eventually making financial literacy an important pillar of its long-term policy strategy. This strategy contributes both to aiding the transparency of the central bank

and in reducing the uncertainty about the future through accurately analysed economic information contained in such publications.

Finally, the Bank of Albania is continuously trying to improve the level of economic research published either in its working paper series or in dedicated volumes. This research work is regularly presented and discussed in conferences, seminars and other scientific activities, which are open and welcoming to academic researchers and practitioners from national and international institutions to present their work. Also, the Bank of Albania organises the Governors Award for the best Diploma, aimed at promoting and supporting economic and economics-related research by students and young economists having recently completed their studies in domestic and international academic institutions.

In general, it is safe to say that the Bank of Albania has done everything possible under its authority to promote the competitiveness of the Albanian economy and will certainly continue to do so in the future.

VI. Conclusions

Competitiveness is widely accepted as a key issue of economic policy, because it is of fundamental importance to the lives and long-term prosperity of all citizens. Competitiveness represents an even more pressing issue for small, open emerging economies with large trade and current account deficits. This chapter analysed the competitiveness of the Albanian economy from a global point of view and identified structural vulnerabilities that adversely affect our competitiveness in international markets. On the whole, we find that despite considerable achievements, the Albanian economy ranks low in terms of international competitiveness. This conclusion is supported by the Bank of Albania's research and several international sources. These sources indicate that Albania's economy must continue to work on structural reform in order to better realise its development potentials while increasing its competitiveness. In particular, Albania ranks low in the small market size, institutional reform and uncertain business environment, which followed also by the low financial intermediation, lack of innovation and infrastructure inadequacies weaken overall competitiveness. They

represent the challenges that should be addressed immediately by the adoption of a new model of growth, based on a better and more efficient exploitation of natural resources and other endowments, and the development of human capital and knowledge technology. Therefore, improved institutions, development of efficient markets, and modernisation of infrastructure are necessary to capitalize on our domestic advantages to build significant competitive advantages in the global economy.

The particular place of the central bank and the impact of its policies, its credibility and its success in safeguarding macroeconomic and financial stability, give it considerable influence over competitiveness. In this respect, we have the pleasure to observe that the Bank of Albania and its policies have contributed to overall competitiveness in Albania by preserving stable economic conditions. Additionally, the Bank of Albania's involvement in education and policy discussion is a further contribution in this direction.

Finally, the ability of the Albanian economy, like all economies in the SEE region, to compete in the global economy, achieving sustainable growth and raising the standard of living, will significantly depend on the ability of individual economies to engage and embrace regional cooperation.

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Chapter 3: South East European Cooperation: A window of opportunity for sustainable economic prosperity

Geography has made us neighbours. History has made us friends. Economics has made us partners, and necessity has made us allies. Those whom God has so joined together, let no man put asunder.
John F. Kennedy

I. Introduction

The South East European Region makes for an interesting discussion topic on many levels: economically, politically, geographically and culturally. Indeed, one can garner a glimpse of the complexities surrounding this region from a simple effort to provide a concise definition of South East Europe. Some link the term to the Balkan Peninsula. Others reference the group of countries in Eastern Europe that faced a slower transition to free market economy. In this paper, the term SEE is used to represent that group of countries¹³ that share geographical proximity, a similar cultural heritage, and a similar challenges in transition from socially-owned economy to free market, a common goal and challenges of European integration. Above all they share a great potential for sustainable economic prosperity through regional cohesiveness and cooperation. This last criterion is the motivation behind this paper. It reflects a conviction that a regional perspective of European integration will pave the way of effective and

¹³ Albania, Bosnia and Herzegovina, Serbia, Macedonia, Montenegro, Croatia and Kosovo, all referred to as Western Balkans by the European Union (see “Western Balkans: Enhancing the European Perspective”, Communication from the Commission to the European Parliament and the Council, 2008). However, our analysis will at times extend to include Bulgaria and Romania.

efficient structural reforms, increasing the region's attractiveness to foreign investment, and ultimately enhancing our economic welfare so as to naturally converge with more advanced European economies.

In the 21st century, a wide body of theoretical and empirical research emerged on regional cooperation and integration in general, and on SEE's cooperation in particular, in light of continuously observed under-performance and conflicts in most economies in the region. Even the European Union itself decided to adopt a stricter criterion on regional cooperation in South East Europe, promoting a number of regional political and economic initiatives. That decision came at a time when conflicts in the region were hampering the prospects of cooperation and integration into the EU. In 2003, in hopes that externally imposing regional cooperation would "force" countries of the region to pursue policies in favour of cooperation, the European Commission explicitly stated that regional cooperation 'constitutes an essential element of the Stabilization and Association Process' (the Thessaloniki Agenda for the Western Balkans, 2003). Despite these EU efforts, cooperation in the SEE made more progress in *de jure* rather than *de facto* terms. This fact is evident in the study of Anastasakis and Bojicic-Dzelilovic (2002), mentioned above in Chapter 2. Recently, however, regional cooperation is gaining traction via several institutional bodies in the context of EU based initiatives like the Regional Cooperation Council and OECD's Investment Compact.

In this chapter, we seek to elaborate on cooperation from a local actor's viewpoint, both in institutional and individual terms. Our analyses suggest that cooperation is the most beneficial mechanism that countries in the region have at their disposal to achieve optimal, non-zero sum outcomes in our games of economic, political and EU lobbying and in our development strategies. There are two important preconditions, however, to achieving such equilibriums, which are mutually dependent criteria. First, local actors ought to make a political commitment to regional cooperation, reflecting their willingness to build an integrated SEE region. This vision calls for a conviction that the goals of EU integration and sustainable economic prosperity are one and the same, and must be treated as such. Secondly, the European Union ought to adopt a "party treatment" of the region, both in the sense of pre-accession, structural-type funds and pre-accession instruments. Such an approach would only reinforce local actors' commitment.

The chapter is structured as follows. In the next section, we present a brief account of the region's economic characteristics and an assessment of the current state of cooperation. Section 3 presents theoretical and practical considerations of the benefits of regional cooperation. In Section 4, we set forth some ideas on how cooperation could be enhanced at several levels and present a conclusion of the arguments developed thus far.

II. Characteristics of the region and the current state of cooperation

Economic developments in the region

Over the last 20 years, the SEE region has experienced substantial political, economic and social changes. In addition to dealing with the long and painful disintegration of Yugoslavia and emergence of six new independent states, the region dealt with the economic regime change from planned or socially-owned to market economy, with all the accompanying reforms of price liberalization, opening up the economy, building market institutions, large scale migration, and continuous efforts to develop stabilizing macroeconomic policies. Finally, these states all engaged in an intensive and extensive adaptation of legal frameworks, establishing first bilateral and then regional trade agreements as part of their continuous efforts to adopt European standards in order to achieve the common goal of European integration. These developments did in fact materialise in faster economic growth and raised living standards.

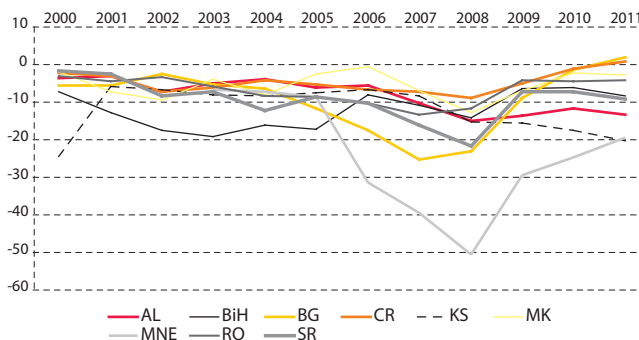
However, as discussed in Chapter 1, the financial crisis of 2008 exposed several vulnerabilities of the growth model on which economies of the region built their strong growth, demanding a reassessment of domestic and foreign balances. This short run adjustment materialised in the deterioration of real and nominal economic indicators (see Table 3.1) in the domestic economy, leading at the same time to an improvement in foreign imbalances (measured in terms of current account deficit as per cent of GDP). This later effect was not observed in the cases of Albania and Kosovo.

Table 3.1: Region's characteristics before the global crisis, and after (averages)

	AL				BIH				SB				MK				CR				MNE				KS			
	'08	'09	'10	'11	'08	'09	'10	'11	'08	'09	'10	'11	'08	'09	'10	'11	'08	'09	'10	'11	'08	'09	'10	'11	'08	'09	'10	'11
Population (mln, 2010)		3	3	3		4	4	4		7	7	7		2	2	2		4	4	4		1	1	1		2	2	2
Unemployment (%)	13	13	13	12	23	24	27	28	15	17	20	24	34	32	32	31	8	9	12	13	15	18			44	45	45	
Inflation (%)		3	2	4	3	7	0	2	4	12	8	6	11	8	-1	2	4	6	2	1	2	9	3	1	3	9	-2	3
Budget Deficit (% GDP)	-5	-7	-3	-3	-4	-6	-5	-3	-2	-4	-5	-1	-3	-2	-3	-1	-4	-4	..	2	2	-7	-8	-4	0	-1	-3	-2
Government Debt (% GDP)	55	60	58	59	31	35	33	34	33	37	40	21	24	23	25	29	35	41	46	32	41	37	43			-	-	
CA deficit (% GDP)	-15	-14	-12	-13	-14	-7	-6	-8	-21	-7	-7	-9	-14	-6	-2	-3	-9	-5	-1	1	-51	-30	-25	-19	-15	-17	-17	-20
Industry (% GDP)	20	21	19	19	19	18	28	26	27	24	27	27	27	30	28	27	32	28	27	27	27	-	-	20	20	-	22	20
Agriculture (% GDP)	21	20	20	20	5	5	8	9	11	13	9	9	11	12	11	11	7	6	6	5		-	9	10	-	13	12	12
Services (% GDP)	60	59	61	61	55	58	64	65	61	64	64	64	61	58	61	..	60	66	67	67	70	70	71	70	68	68	68	68

Source: Data have been obtained in IMF's World Economic Outlook Database, World Bank databank and at the National Statistical Offices.

Figure 3.1 Current Account Deficits as % of GDP

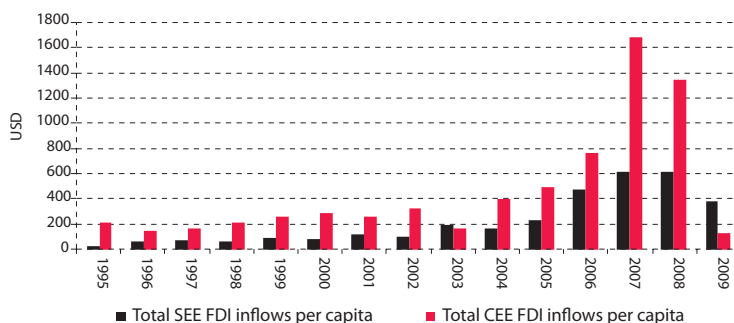


Source: IMF, WEO Database, April 2012.

Figure 3.1 shows that external vulnerabilities have, on average, increased over the last 10 years in the countries of the region, revealed by their large current account deficits. Although most countries experienced a reduction in current account balances after the crisis, their structural economic problems require the reorganization and reorientation of economic capacities to be sustainable in the long-term.

Worrisome developments with regard to the future sustainability of economic growth include the relatively low and decreasing FDI flows to the region; the relatively weak competitiveness of regional economies;

Figure 3.2 Total SEE and CEE FDI inflows per capita



Source: IMF's World Economic Outlook Database. SEE include AL, BiH, CR, MNE, SR, MK and KS. CEE include Hungary, Czech Republic, Slovenia, Slovakia and Poland.

and the lack of economic cohesiveness in terms of the regional economies' structural complementarity.

Figure 3.2 reveals the relatively low level of foreign direct investment in South East Europe as compared to Central and Eastern Europe. Despite increases between 2005 and 2008, the trend was reversed in 2009 for both regions, owing to the global financial crisis.

Historical regional dynamics and the current state of cooperation in SEE

Cooperation initiatives and, more importantly, cooperation outcomes in South East Europe today seem to be sluggish and to lack strong internal commitment. Indeed, most efforts have been in response to EU recommendations and preconditions for accession. However, it is important to stress that this situation is mostly determined by historical political issues, rather than being related to capacity or economic root causes.

A quick glance into the history of the Balkans reveals that countries in the region are notorious for their fierce competition in establishing political and economic influence. The Balkan Wars of 1912 and 1913, coupled with adversary alliances during WWI and WWII, permanently marked regional relationships. During the communist era, the region broke its political ties with the Soviet Union, seeking to establish ideologically influential states non-aligned with either of the leading forces of the Cold War era. On one hand, Yugoslavia was one of the founding members of the "non-aligned movement", a group of developing countries forcing their interests and priorities in the world's political and economic agenda. On the other hand, Albania became the only country to all but seclude itself from the rest of the world for about a decade, which led to the total collapse of the economy by the end of the 1980s.

The particular ethnic, social and economic characteristics of the region have defined and prolonged its transition and integration, and prevented further cooperation in all its aspects.

Overall, it could be said that a century of tense relations made the internally driven cooperation in the SEE a very demanding process in

terms of political willingness. Thus, the external spark of cooperation that was the EU integration process for the Western Balkans was both necessary and welcomed by regional actors.

In February 1996, the European Union officially adopted a regional approach to South East Europe. This development preceded the Stability Pact for South Eastern Europe adopted on 10 June 1999, which, for the first time, offered the region a concrete prospect of EU integration (European Commission, 1999). The Pact set forth three regional working tables concerning issues of democratisation and human rights; economic reconstruction, cooperation and development; and security issues. In 2003, this approach was reinforced by the Thessaloniki Agenda for the Western Balkans. Since then, several cooperation activities and initiatives have taken place in SEE. To name a few:

- The Regional Cooperation Council (RCC), established in February 2008 as the successor of the SP for SEE. Among other objectives, RCC aims to provide a regional perspective in donor assistance, mostly involving the EU's Instrument for Pre-accession Assistance (IPA);
- Pre-accession assistance instruments such as the Community Assistance for Reconstruction, Development and Stability (CARDS) during 2000-2006 and IPA funds, since 2007, aiming at support for institution building, regional development, capacity building, etc.;
- The South East Europe Transnational Cooperation Programme, established in 2007, concentrating on four priority axes: Innovation, Environment, Accessibility and Sustainable Growth;
- The South East European Transport Axis Cooperation (2009-2012), focusing on assistance in terms of spatial planning and regional cooperation and integration, and contributing to solving the existing problems in the traffic sector;
- Several Bilateral Free Trade Agreements that were regionalized with the establishment of the CEFTA2006, with the ratification of all SEE countries;
- Several Memoranda of Understanding between homologue institutions in SEE countries, including central banks;
- Numerous regional summits, academic conferences, and round tables;

- Cooperation initiatives in the areas of energy that fight against corruption and organized crime, arms control, etc.

Despite various efforts to achieve regional economic cohesion, cooperation outcomes still seem to be suboptimal in terms of trade, strategic policy coordination, and joint efforts to attract large-scale FDI. Preliminary results of empirical research at the Bank of Albania show that there are considerable economic possibilities to exploit regional cooperation in the region. Our analysis of external trade, based on gravity models, reveal that external trade of Albania with EU partners stays at optimum levels, while trade with the SEE region is well below its potential (Pllaha, 2012).

For a more formal assessment of the stage of cooperation and its outcomes, the literature suggests two types of indicators: Cooperation Readiness Indicators and Cooperation Outcomes Indicators. According to Hufbauer and Schott (1994), readiness indicators show the extent to which individual countries in a region fulfil the macroeconomic and institutional preconditions take part in regional agreements. When calculated for different time periods, one can check the progress of each country towards the fulfilment of such preconditions. The Cooperation Outcome Indicators, on the other hand, reveal the concrete results achieved in the shape of agreements, treaties, cooperation memoranda, etc.

Based on the methodology of Hufbauer and Schott (1994), this paper develops "Readiness Indicators" for the South East European region for three time periods: 2000-2002, 2003-2005 and 2006-2009. The overall index is built as an average of seven dimensions: price stability, budget discipline, external debt stability, currency stability, market-oriented policies, reliance on trade taxes, and functioning democracy. The first five dimensions account for macroeconomic stability, whereas the last two show the countries' structural and institutional readiness.¹⁴

Countries in the region have different exchange rate regimes. Macedonia and Bosnia and Herzegovina have a fixed exchange rate regime, while Montenegro is Euroized, and the rest of the countries have floating/

¹⁴ A detailed account of the specific dimension scoring will be found in Appendix A.

managed exchange rate regimes. To make currency stability comparable across the region and to account for differences in exchange rate regimes, we have used real exchange rates vis-à-vis the Euro, or real effective exchange rates when available. We use the standard deviation over the period as a measure of stability. For the scoring in market-oriented policies, we use the Transition Indicators of the European Bank for Reconstruction and Development (EBRD). The functioning democracy score represents the Freedom House average scores for Political Rights (PR) and Civil Liberty (CL).

Table 3.2: Cooperation Readiness Indicators

2000-2002	AL	BiH	CR	KS	MK	MNE	SR	BG	RO	SEE-6	SEE-8
Price Stability	5.0	5.0	5.0	4.0	5.0	2.0	0.0	4.0	1.0	3.7	3.4
Deficit Stability	0.0	3.0	2.0	5.0	5.0	5.0	5.0	5.0	4.0	3.6	3.8
External Debt	4.0	2.0	4.0	NA	4.0	0.0	0.0	3.0	5.0	2.3	2.8
Currency Stability	5.0	5.0	5.0	NA	5.0	NA	0.0	3.0	5.0	4.0	4.0
Market-Oriented Policies	2.9	2.3	3.3	NA	3.0	2.0	1.9	3.2	3.1	2.6	2.7
Reliance on Trade taxes	3.0	NA	4.0	NA	NA	NA	NA	5.0	5.0	3.5	4.3
Functioning Democracy	2.7	2.3	4.0	NA	3.0	NA	NA	4.3	4.0	3.0	3.4
Aggregate Index	3.2	3.3	3.9	NA	4.2	2.3	1.4	3.9	3.9	3.2	3.4
2003-2005	AL	BiH	CR	KS	MK	MNE	SR	BG	RO	SEE-6	SEE-8
Price Stability	5.0	5.0	5.0	5.0	5.0	5.0	3.0	5.0	3.0	4.7	4.6
Deficit Stability	3.0	5.0	4.0	5.0	5.0	5.0	5.0	5.0	5.0	4.6	4.7
External Debt	5.0	3.0	3.0	NA	4.0	5.0	1.0	4.0	4.0	3.5	3.6
Currency Stability	5.0	5.0	5.0	NA	5.0	NA	5.0	5.0	3.0	5.0	4.7
Market-Oriented Policies	3.0	2.5	3.5	NA	3.1	2.5	2.5	3.4	3.2	2.9	3.0
Reliance on Trade taxes	4.0	0.0	5.0	NA	4.0	NA	NA	5.0	5.0	3.3	3.8
Functioning Democracy	3.0	3.0	4.0	NA	3.0	4.0	4.0	5.0	4.0	3.5	3.8
Aggregate Index	4.0	3.4	4.2	NA	4.2	4.3	3.4	4.6	3.9	3.9	4.0
2006-2009	AL	BiH	CR	KS	MK	MNE	SR	BG	RO	SEE-6	SEE-8
Price Stability	5.0	5.0	5.0	5.0	5.0	5.0	4.0	4.0	4.0	4.9	4.7
Deficit Stability	3.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	3.0	4.7	4.6
External Debt	4.0	4.0	2.0	NA	4.0	3.0	2.0	2.0	3.0	3.2	3.0
Currency Stability	5.0	5.0	5.0	NA	5.0	NA	3.0	3.0	3.0	4.6	4.1
Market-Oriented Policies	3.1	2.8	3.6	NA	3.3	2.9	2.9	3.6	3.4	3.1	3.2
Reliance on Trade taxes	5.0	5.0	5.0	NA	4.0	4.0	4.0	5.0	5.0	4.5	4.6
Functioning Democracy	3.0	3.0	4.3	NA	3.0	3.3	4.0	4.5	4.0	3.4	3.6
Aggregate Index	4.0	4.3	4.3	NA	4.2	3.9	3.6	3.9	3.6	4.0	4.0

Source: Author's calculations based on IMF World Economic Outlook Database, Government Finance Statistics, European Bank for Reconstruction and Development's Transition Indicators, Freedom House's Freedom in the World Comparative and Historical Data, National Statistical Offices, National Central Banks.

Table 3.2 shows the individual countries' scores on different dimensions, the aggregate individual countries' readiness scores, and the regional scores over the period of 2000-2009. The best performance is measured by a score of 5, while the poorest one is scored 0.

The readiness indicators disclose some important issues with regard to these countries' efforts in fulfilling cooperation preconditions. Our analysis lies in four dimensions: indicator wise, country wise, region wise, and progress-in-time wise. During the period of 2000-2002, out of the SEE-6 group, Albania, Bosnia and Herzegovina, Croatia and Macedonia seem to be on similar grounds in almost all criteria, with the exception of the 'functioning democracy' dimension, in which Croatia ranks higher than the rest. In regional aggregate terms, the inclusion of Bulgaria and Romania has a marginal contribution of 0.2 points on the index. During the next sub-period of 2003-2005, we can observe considerable improvement in nearly all dimensions, driving the regional aggregate index up with 0.7 point to 3.9.

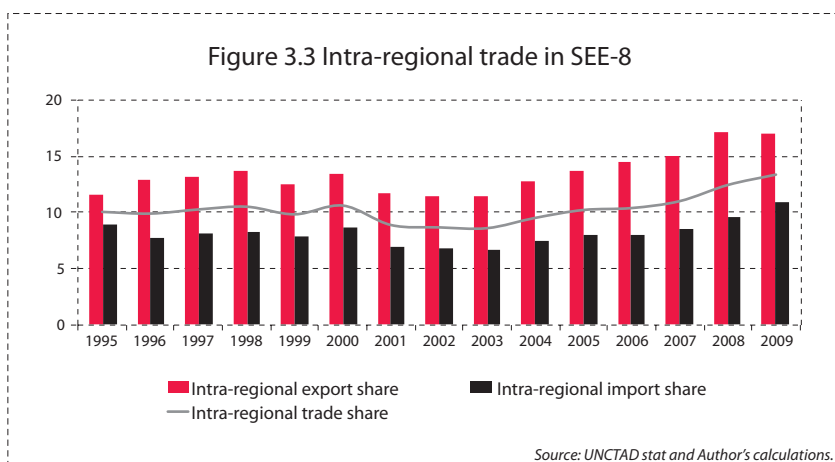
One of the most interesting observations is that the lowest scores for almost all countries are observed in the areas of external debt, market-oriented policies, and functioning democracy. In these areas, all countries score below their aggregate index (which represents the average of all 7 sub-indexes) and the same is true for the regional level as well. Such performance seems to confirm our thinking that suboptimal regional cooperation is mostly caused by politically rooted factors. While the external debt (public and private) scores speak about the absorption led growth model, market oriented policy scores suggest that more efforts are needed in terms of privatization and deregulation, which directly hamper factors of production mobility and cooperation opportunities in attracting large-scale regional FDI. Furthermore, overall progress from 2003 to 2009 seems sluggish in nearly all dimensions. Lastly, reliance on trade taxes has continuously been decreasing – a trend that corresponds to the ratification of numerous Bilateral Free Trade Agreements and the Multilateral CEFTA2006 between the countries in the region.

Table 3.3 Individual countries' TCI (Trade Complementary Index) with the SEE region and SEE's TCI with CEEC

	AL		BiH		CR		MK		SR&MNE		BG		RO		SEE5	SEE7
	SEE5	SEE7	SEE5	SEE7	SEE5	SEE7	SEE5	SEE7	SEE5	SEE7	SEE5	SEE7	SEE5	SEE7	CEEC	CEEC
1996	1	0	34	31	66	64	29	24	51	44	62	58	51	48	50	48
1997	0	1	21	23	63	65	25	23	47	41	59	58	43	42	41	43
1998	0	0	21	24	60	72	23	24	62	57	62	61	35	35	51	43
1999	0	0	30	34	67	77	27	28	55	52	60	62	38	39	48	41
2000	0	0	14	21	70	81	24	26	43	41	60	63	41	42	42	41
2001	0	0	25	31	72	79	28	30	49	48	58	63	42	44	44	41
2002	0	0	30	36	74	81	25	29	47	47	55	57	45	47	42	42
2003	0	2	28	34	73	78	28	31	47	47	52	56	44	46	43	40
2004	0	0	30	34	72	80	22	23	47	44	51	53	51	53	45	42
2005	0	0	42	43	75	79	27	24	45	37	61	59	62	64	44	47
2006	0	3	34	40	80	79	27	28	43	38	58	58	62	67	42	49
2007	5	2	39	36	80	83	17	11	50	39	64	57	65	65	43	56
2008	8	12	29	30	68	80	3	0			67	58	68	68	48	63
2009	33	37	36	37	66	76	24	20			68	59	55	55	54	69

Source: Direction of Trade Statistics, UNCTADstat and Author's calculations

Be that as it may, the trend of intra-regional trade is not fully consistent with developments in government reliance on trade taxes and Free Trade Agreements. Figure 3.3 gives an account of the progress of intra-regional trade as a share of the region's total trade. While regional trade share has never reached beyond 15 per cent, it seems that regional exports accounted for around 17 per cent of total exports in 2009, with



a relatively high sloping trend. The latter is mainly explained by the low level of regional exports.

Theoretical and practical considerations of regional cooperation

As already observed, all economies of the region are small open economies that rely heavily on the EU as the main trade partner. Moreover, European integration is widely cherished as their main strategic goal for social, political and economic progress and is the major driving force for structural reform in all these areas.

Generally speaking, under the current state of affairs, each individual country's goals are long-term economic growth and full-fledged EU membership. The economic and political influence that the EU has over the SEE countries has transformed the EU into an external anchor for the region. On its side, the EU has approached this role by focusing on regional cooperation in the SEE. This regional cooperation is a precondition of EU integration, as sanctioned in the Stability and Association Agreements (SAAs) and several regional initiatives like the Stability Pact and CEFTA. However, the assessment of progress towards the conditions set forth in the SAAs is carried out on an individual basis. Furthermore, institutional actors in the region's countries seem to perceive so-called enlargement fatigue on the side of the European Union, which could directly affect the political will of the Union itself in taking in the SEE region as a whole.

The medium-term policy framework, including public finance objectives and structural reforms priorities needed for EU accession are outlined in the Pre-Accession Economic Programs (PEP). The PEPs are prepared by the countries and evaluated by the Commission and the Council on an annual basis. These programs provide detailed analyses regarding past and future agenda of social, economic and political reforms in the form of a binding commitment by the authorities of each country. Current economic programs and structural reforms described in the PEPs reveal that the SEE 5¹⁵ envisage a strategy of export-led economic recovery that relies more or less on similar sectors and products. This is mostly because, as already noted, South East European countries

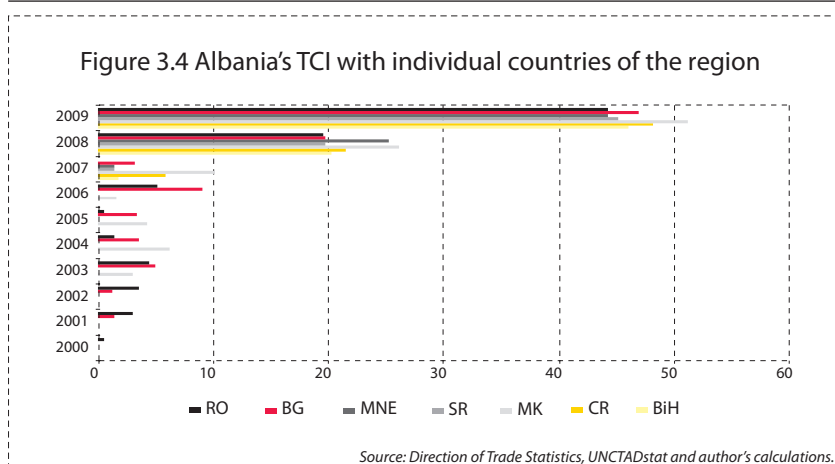
¹⁵ SEE excluding Kosovo.

have similar economic structures and trade patterns. From a political perspective, the SEE countries consider bilateral relations with the EU as more important than those with the region – and potentially even more important than relations with the region taken as a whole.

The types of policies that the region's countries designed in terms of "regional cooperation" are similar to collaboration and coordination games. If these programs were analysed in a simple game theory framework, under the current conditions (several small open economies fighting for the same market and the same partners), these un-coordinated models have the potential to yield an outcome similar to a model of competition for the same markets and investors, rather than a model of cooperation. This will not only provide disincentives for cooperation and/or trade diversion but, most importantly, will spell disaster for individual models in each economy. Therefore, one would not expect tangible benefits from a regional trade agreement and successful economic stories, given the current conditions. In such games, the principal problem that might lead to Non-Pareto optimal Nash Equilibriums is defecting on an agreement due to the drive for short-term income (myopia). Such a strategy would be unsustainable in the long term due to limited resources, low potential capacity and a sort of punishment risk from the rest of the players. In coordination games, the principal problem that might lead to Non-Pareto optimal Nash Equilibria is disagreement on which direction to take, due to lack of coordination and different individual political agendas.

The motivation behind different strategic preferences might be the drive for short-term benefits, and might include, among others, hidden lobbying for political and economic agendas. Unfortunately, the region can neither claim nor declare that it is immune from such problems. If memories of ethnic mistrust and suspicion culminating in episodes of war and conflict that frequently define the region were not obstacles enough, in particular cases, regional countries are embroiled in political and economic disputes that serve as barriers to regional cooperation.¹⁶

¹⁶ The conflict between Serbia and Kosovo over the latter's independence, and the political dispute between FYROM and Greece regarding the former, are the most prominent examples of such problems.



Judging on the prevalence of similar economic structures and trade patterns, regional trade integration – viewed in isolation and outside a regional analysis – would simply result in increased competition for the same markets and/or trade diversion, providing only disincentives to cooperation. Table 3.3 illustrates the individual countries' Trade Complementarity Index (TCI)¹⁷ with the SEE region. The TCIs are relatively high for the bigger economies of the region, indicating the potential for substantial benefits from trade with these countries. Smaller economies like Albania, Macedonia and Bosnia and Herzegovina, score relatively low, suggesting no benefits from cooperation. Yet this may not necessarily be the case. As demonstrated by Figure 3.4, Albania's TCI with countries of the SEE region has increased substantially since 2006, corresponding to the ratification of the CEFTA.

TCI statistics reveal an important truth: the more integrated an economy is with the EU, the higher the TCI in the region and the TCI of the region with other transition economies. Overall, the indexes show that integration and structural complementarity go hand in hand.

¹⁷ The Trade Complementarity Index is a sort of overlap index and shows the extent to which the exports of a country are compatible with the import patterns of another country. In international trade, such an index is used to predict to a certain extent the success of a Free Trade Agreement. In standard trade textbooks, the formula used to calculate the index is based on the following formula: $\left(1 - \sum_i \left[\frac{\sum_j m_{ij}}{\sum_j m_{ij}} - \frac{\sum_j x_{ij}}{\sum_j x_{ij}} + 2 \right] \right) \times 100$

It is also interesting to observe, however, that according to Monastiriotis (2009) some of the main obstacles to intra-regional cooperation in South East Europe are the within-country spatial disparities and unconnectedness that hamper both intra- and inter-industry linkages that enhance cost and quality competitiveness. Therefore, addressing these internal problems will improve intra-regional cooperation and trade.

In addition to potential gains grounded in microeconomic and international trade theories like potential economies of scale, encouraging core-periphery industrial models that extend to cross-border relations, and clustering among industries and countries, a regional development model has the potential to yield further productivity benefits to the region. At the current stage of development, SEE countries can only marginally benefit from the contribution of total factor productivity that comes from the redistribution of factors of production. The bulk of factor reallocation within each country has already occurred in the early stages of transition. However, a regional development model and regional trade have the potential to spur a second significant factor reallocation within the region, with regard to labour, capital, technology and markets.

The current times are a golden opportunity for our region to coordinate its efforts and strategies towards a new regional economic growth model that enhances competitiveness and sustains economic growth through exports and investments. A regional cooperation agenda for the SEE has the potential to benefit each economy at four interdependent levels: at the economic cooperation level; at a macroeconomic policy level; from a strategic point of view; and from a convergence point of view. In particular, central banks in the region have successfully exploited the benefits of cooperation in the last three areas. The leadership and the active exchange of central banks in this cooperation have materialized in the resilience shown by the banking sector in the SEE during the last financial crisis. This resilience reflected, among others, the particular efforts of central banks in coordination and cooperation through policy-making and the convergence of macro-prudential and regulatory frameworks in the SEE region. These efforts also demonstrated a strategic partnership between top central bankers to address problems from a regional rather than an individual point of view. The “Vienna Initiative 1.0” is an excellent example of this strategy.

The potential for regional policy making in the economic area goes well beyond central banking. In the economic literature, cooperation is argued to enhance intra- and inter-industry trade, expand markets for foreign investors, and increase economic competitiveness for the region as a whole, as well as for individual member countries in particular.

The patterns of development and the nature of economic transformation that we have discussed so far – in terms of structural change, factor redistribution, efficiency gains, trade patterns and partnerships – indicate that economic transition toward market economy in the SEE has been self-centred, reflecting a national focus rather than a global perspective. Transition has focused on the possession of factor endowments, investing a great deal of effort and energy in their redistribution and exploitation. The re-establishment and development of private ownership, individual economic choices, business entrepreneurship and political process in the SEE is motivated by (and hence focused on) developments in the domestic economy rather than in the global environment. This myopic approach will potentially leave the region and its factors on the sideline of global markets. In contrast to these developments, the rest of the world is changing to adapt to the challenges posed by rapidly emerging economies like China and India, with their abundant, cheap, productive and technology-savvy labour forces. While the challenged economies are responding with cost adjustments and diversification in new industries, they are increasing competition for the rest of the emerging market economies for technology transfer and capital investments. A comparative analysis of FDI in the SEE reveals that while FDI have recently increased significantly, they are considerably lower than those of the Central Eastern European countries CEE (see Figure 3.2).

Large economies of scale are important factors as well. Global developments show that financial markets are interested into bigger and better coordinated projects that incorporate larger domestic markets, with existing networks of supporting or complementary industries. Returning to Porter (1990), factors that determine the decision of foreign investors to enter a country are:

- Factor conditions: physical, capital, knowledge and labour resources;
- Demand conditions: sophisticated home consumers that pressure

for better quality;

- Firm strategy, structure and rivalry;
- Government, which can influence the supply condition of key production factors, demand conditions and expand markets (through regional cooperation and free trade areas).

It is evident that the small economies of the region are at a disadvantage, especially with respect to the first two points. The needs of foreign investors are much better served if one looks at the aggregate of the region, rather than at its individual economies. As noted above, the SEE region is a large market of approximately 25 million people (as of 2010). Seen as a single market from the point of view of factor and demand conditions and development strategies, the region offers much better opportunities and would attract more investors who could benefit from larger markets and economies of scale in undertaking small and big investment projects.

Finally, from a convergence point of view, regional cooperation would ensure a more timely and cost-efficient learning process in our common path toward the European Union. Since our countries have different learning curves resulting from different paces of transition, sharing experiences would avoid costly errors. Furthermore, if we can show that we can build regional cohesiveness, we will most certainly demonstrate that the SEE fits into a larger economic block that is the European Union.

At a macroeconomic policy level, the coordination of policies, legal and prudential frameworks would tend to improve the allocation of resources and prevent beggar-thy-neighbour policies. A race-to-the-bottom philosophy does not benefit the region as a whole, and if there are any country-level benefits, they are short-lived.

Conclusions and recommendations for enhancing regional cooperation

I believe that the starting point of any discussion that regards regional cooperation is the need to design and implement a Balkan Regional Strategy for Europe. To be effective, local actors should strategically think at two levels before making any decision: at the national and regional

levels, thus having both national and regional development priorities. Additionally, the mentality of our societies should change. Being a region with a history of ethnic conflict and political disputes, it rests with the younger generations and those embracing open-minded approaches to find solutions and to promote behaviour that will build and bind our futures together in the European Union.

The commitment to full integration with the European Union should serve as a solid platform for cooperation, and as an anchor for pursuing sound policies and coordinated structural reforms. The legal basis that supports such international cooperation should be fully in place. It is important that such cooperation be guided from a set of consolidated principles with regional relevance.

Furthermore, there is an urgent need for coordinated policies that would encourage stronger inward FDI and other non-bank flows. The region's growth model might need to be more self-reliant, emphasising domestic savings, better mobilisation of labour resources, and a much greater role for the traded good sector as an engine of growth.

A few gaps still exist in the region with respect to infrastructure, energy, tourism, financial architecture, mining and agriculture. Our common task is to identify missed opportunities, to incorporate those into realistic business plans, and to present these regional projects in a contemporaneous way to private investors and supranational agencies to gain their political, financial and technological support and finally ensure a stable growth model.

It is important to understand that regional cooperation does not hinder progress towards EU integration if approached in the right manner. On the contrary, it ensures medium-run economic growth through higher FDI, higher inter-industry trade. Moreover, through increased cooperation, the region would demonstrate readiness for accession through regional economic cohesiveness; would ensure regional competitiveness upon accession; and would speed up the learning process, which guarantees sound and fast convergence.

South Eastern Europe lags behind the rest of the former transition

economies in reforms, development and integration. Local actors in the region need to strategically think, plan, and design structural reform simultaneously and along the same goals. Our long-term objective of EU membership should become a platform for evaluating and demonstrating that the present value of future payoff in regional, coordinated cooperation exceeds the payoff of any individual strategy. On the other hand, the European Union structures should closely guide, monitor and assess this process. This is the only way to steadily transform our countries into highly productive economies, attractive to foreign investors against the backdrop of favourable labour costs.

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Appendix A – Readiness indicators' scoring method

The seven indicators used to compile the readiness index are:

1. Price stability
2. Budget discipline
3. External debt
4. Currency stability
5. Market-oriented policies
6. Reliance on trade taxes
7. Functioning democracy

Countries are given scores from 0 to 5 on all these indicators, then the average of the scores is taken.

1. Price stability

Score 5 - if it has maintained inflation rate less than 5 percent during the evaluation period

Score 4 - if it has maintained inflation rate between 5 – 10 percent during the evaluation period

Score 3 - if it has maintained inflation rate between 10 – 20 percent during the evaluation period

Score 2 - if it has maintained inflation rate between 20 – 30 percent during the evaluation period

Score 1 - if it has maintained inflation rate between 30 – 40 percent during the evaluation period

Score 0 - if it has inflation rate above 40 percent during the evaluation period

2. Budget discipline

Score 5 - if it has deficit/GDP less than 3 percent during the evaluation period

Score 4 - if it has deficit/GDP between 3-4 percent during the evaluation period

Score 3 - if it has deficit/GDP between 4-5 percent during the evaluation period

Score 2 - if it has deficit/GDP between 5-6 percent during the evaluation period

Score 1 - if it has deficit/GDP between 6-7 percent during the evaluation period

Score 0 - if it has deficit/GDP more than 7 percent during the evaluation period

3. External debt – percentage of exports of goods and services

Score 5 - if external debt is less than 150 percent during the evaluation period

Score 4 - if external debt between 150-220 percent during the evaluation period

Score 3 - if external debt between 220-290 percent during the evaluation period

Score 2 - if external debt between 290-360 percent during the evaluation period

Score 1 - if external debt between 360-430 percent during the evaluation period

Score 0 - if external debt more than 430 percent during the evaluation period

4. Currency stability – standard deviation of real exchange rate

Score 5 - if s.d. is less than 5 percent during the evaluation period

Score 3 - if s.d. is between 5-10 percent during the evaluation period

Score 0 - if s.d. is greater than 10 percent during the evaluation period

5. Market oriented policies – the extent of privatization and deregulation, taken from EBRD – scaled to 5-max score.

6. Reliance on trade taxes

Score 5 - if customs revenue/total gov't revenue is less than 5 percent

average during 3 years

Score 4 - if customs revenue/total gov't revenue is between 5-10 percent during 3 years

Score 3 - if customs revenue/total gov't revenue is between 10-15 percent during 3 years

Score 2 - if customs revenue/total gov't revenue is between 15-20 percent during 3 years

Score 1 - if customs revenue/total gov't revenue is between 20-25 percent during 3 years

Score 0 - if customs revenue/total gov't revenue is more than 25 percent during 3 years

7. Functioning democracy – Freedom House (FH) data of Political Rights and Civil Liberty

Score 5 – 1 on FH scale

Score 4 – 2 and 2.5 on FH scale

Score 3 – 3 and 4 on FH scale

Score 2 – 5 on FH scale

Score 1 – 6 on FH scale

Score 0 – 7 on FH scale

Chapter 4: External and domestic policy anchors

It is a far, far better thing to have a firm anchor in nonsense than to put out on the troubled seas of thought.

John Kenneth Galbraith

I. Introduction

Recent developments have highlighted the importance of maintaining macroeconomic and macro-prudential policies on a sustainable course. Inevitably, this is an uphill task in the presence of short-term economic and political incentives, and policymakers need powerful domestic and external anchors to guide their decision-making toward promoting growth and stability over the long run. IMF surveillance, first, and EU integration process, later, served as two important external anchors for transition economies. This chapter discusses the role of these anchors and concludes that the EU is a necessary but perhaps insufficient anchor for aspiring countries. It examines the role of the IMF as an external anchor in transition economies, focusing on the Albanian experience, and argues that both the EU and the aspiring countries of South East Europe would benefit from cooperation and coordination with the IMF in designing and implementing external policy anchors. Our suggestion is that it is important that the EU, in cooperation with the IMF and other interested stakeholders, designs and implements a special joint package for the region. This package should include a medium-term policy orientation, guidelines for better governance, a framework for setting quantitative policy parameters, well-targeted priorities for structural reform, and finally the key needs for supportive technical assistance.

Following a failed experiment with communism, isolation and a centrally planned economy in the early 1990s, Albania emerged as a poor transition country with a broken economy, which defaulted on its foreign obligations and struggled to survive with a wrecked domestic market. Agriculture and industrial production, once the main sectors of the economy, had fallen apart, while signs of fragile yet vibrant private initiatives emerged in the services sector. Against this background of a weak economic situation and socio-political discontent, Albania started moving towards a market economy and opening up to international markets. The move was part of the general political, social, and economic upheavals that swept Eastern Europe after the fall of the Berlin Wall. The main objective was the transformation from a closed and centrally planned economy to a free, democratic and market-based society. The final goal of this transformation was to approach Western models of developed democracies, whose political and social values of freedom were then, like today, highly appreciated by Albanians. The integration process was in fact much wider. Albania became a member of a number of international political and economic organizations such as the NATO, the International Monetary Fund, the World Bank, and the World Trade Organization. Membership of such international bodies serves as a pillar for structural reforms in legal, political and economic areas.

A consensus widely shared among Albanian citizens and politicians was that the adoption of free market democracy and free market values of the Washington Consensus would improve all social and economic aspects of life. As transition progressed, the aspiration of becoming a member of the European Union has yet to be fulfilled. Differently from several advanced ex-transition East European countries, Albania and most other SEE countries are lagging behind in this process and have yet to meet the political, economic and administrative criteria that will enable them to become fully-fledged members of the EU.

This paper focuses primarily on the role that the EU integration process has played in the establishment of domestic anchors for sustainable economic progress, and thus on the process of meeting the economic criteria for membership. That said, the distinction between economic and political criteria is difficult, since political attitudes have a significant impact on the applicability of particular economic

rules, while political incentives have the potential to drive economic choices in the short-run. This chapter therefore takes into account both aspects, and the potential interaction between the two.

As with most other transition and emerging market economies, the economic transformation from crisis to recovery and prosperity was aided and supervised by International Monetary Fund and, on structural reforms, by the World Bank. In 1991, the IMF was invited to design and help with the implementation of the first economic program in response to the crisis. This program was followed by several others, as the focus shifted from crisis resolution to poverty reduction. As a general assessment, it could be said that despite the ups and downs in economic results during the early stages of transition, along with a few episodes of crises due entirely to domestic developments and events, the end of the period showed that IMF economic programs were successful in stabilizing transition economies, thus restoring general macroeconomic equilibrium.

The IMF programs were tailored to achieving the same objectives in the entire group of transition economies. They promoted and preserved sustainable macroeconomic policies up to the point when they were essentially replaced by the Stabilization and Association process, or when countries graduated from the IMF as mature emerging markets. However, recent events have shown that despite the achievements of the last 20 years, extensive institutional reforms remain to be carried out in some of the economies after their graduation from the IMF programs. This is not just the case with “structural policies” but also in the area of macroeconomic institutions – and notably the sound anchoring of fiscal policy over the medium-term. In some specific cases, bold but unsustainable economic goals and fiscal policies triggered crises and a return to IMF support. The same story is relevant for several developed countries that were in fact guided by a different – though presumably similarly protective – set of rules under the Maastricht Criteria. Without completing the much-needed institutional and structural reforms, these economies remain fragile and vulnerable to risks.

In January 2009, Albania successfully completed the last medium term conditional IMF program. Currently, the European agenda is playing

the leading role in supporting structural reforms in all aspects of policy design and implementation. However, in light of recent history, the main challenge for Albania is to find solid economic anchors that will help assure high rates of economic growth while preserving macroeconomic and financial stability.

The issues of anchors and economic growth converge naturally to the discussion of institutions and their important role in stable, economic development. This chapter discusses the role of external institutions in the development of domestic anchors for sustainable economic progress, under the following outline. The first part reviews the role played by IMF programs in anchoring policy and achieving macroeconomic stabilization, with special reference to Albania; the second part discusses the role of external anchors; the third part explores the role of internal anchors; and the final part considers the future of the EU and the IMF as foreign anchors in South Eastern European countries.

II. Albania's experience with external anchors: the IMF contribution

Despite disastrous initial conditions, since the fall of communism Albania has made significant progress with regard to establishing a market economy, improving the welfare of its citizens and ensuring the extension of those initial successes. Throughout its transition, the country enjoyed substantial external aid, especially from the IMF, which also provided policymakers with a framework for designing macroeconomic policies, serving as an external anchor for the country. This part of the paper questions whether the IMF, through its conditionality, has also provided the necessary basis of institutional development leading to the creation of credible domestic anchors for the country. In other words, which elements of this IMF framework should policymakers retain and adjust to ensure long-term, sustainable macroeconomic policies? We begin by discussing the goals and conditionality of IMF programs, and then proceed to compare Albania's success under the IMF programs with other transition countries, seeking to identify possible trade-offs for these successes.

Albania has been engaged in a series of IMF-supported programs since the early stages of transition, with two interruptions. A Stand-By arrangement in 1992–93 was followed by a three-year arrangement under the ESAF program. This arrangement ended in its second year after failure to reach an agreement on the third annual program. A six-month program was established in the second half of 1997, following the pyramid scheme crisis, under the Fund's post-conflict emergency assistance policy. Since then, Albania has fully completed three additional programs: one ESAF between 1998 and 2001 and two different PRGF, the first in the period 2002–2005 and the second from 2006 through 2009.

In 1994, when he was serving as Managing Director of the Fund, Michel Camdessus summarised the IMF's objectives in transition economies. The policy strategy was designed on the basis of three essential and interdependent components. The first element was liberalization: in particular, abolishing price controls and liberalizing the exchange and trade system to ensure that the domestic economy was subject to the discipline of international competition. The second requirement was stabilization: ensuring, through appropriately tight fiscal and monetary policies, that decisive progress was made toward low inflation, together with sustainable external and budgetary imbalances. From the outset, this element was believed to be crucial in order to maintain public confidence in the presence of the impact of liberalization on price levels. The third essential component was the establishment of necessary institutions and markets for a competitive market economy. Under this heading, a whole range of structural reforms were covered, including the reforming of the tax collection system, central bank independence, privatization, reforming of bankruptcy legislation, the dismantling or regulation of monopolies, and social safety nets that are cost-effective and well targeted at the poor and most vulnerable. The success of this strategy obviously depended on the availability of external funding and knowledge transfer from abroad – and, as we will discuss later, program ownership and political will for the continuation of good policies.

IMF programs start after a country agrees to meet the initial framework of IMF conditionality requirements. Conditionality covers both the design of the programs – that is, macroeconomic and structural policies – and

the specific tools used to monitor progress toward the goals outlined by the country in cooperation with the IMF. Typically, it targets countries experiencing balance of payments problems and provides support for alleviating them. However, the primary responsibility for selecting, designing, and implementing the reforms and policies agreed under IMF-supported programs rests with the member country, although in practice, as discussed below, experience has been varied in this respect.

A large and growing literature assesses the success of IMF programs in achieving their objectives. Most programs were pursued around the ultimate aim of improving living standards through higher growth. Since stable growth relies on a wide range of policies over a long period, and on improved external financing conditions, policies aimed at securing immediate improvements in balance of payments were pursued more strictly. Particularly for transition economies, the results since the early stages of transition have been quite divergent. Unsurprisingly, success was determined by the timely implementation of liberalization, structural reforms and sufficiently tight macroeconomic policies. Though the relative importance of such policies varied, early success was evident in Albania, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia. Already in 1993, despite the initial output decline, Albania was one of the fastest growing economies in Europe. In some other countries (the Former Yugoslav Republic of Macedonia, Moldova and Romania), substantial progress with liberalization, and to a lesser degree with structural reform, was not accompanied by adequate efforts to control inflation, so the need to renew stabilization efforts was damaging to growth.

As previously mentioned, major improvements were achieved in the area of external sector performance (Schadler 1996, Bird 2001, Buira 2003), with official reserves rising and external arrears being cleared (after all, the external sector is ultimately linked to the country's ability to repay the adjustment loan).

On the domestic side, we witnessed a general reduction in inflation rates during the programs, but the situation reversed in some cases, like in Hungary and Romania, to name but two. Bird (2001), in a review of studies assessing the performance of inflation, reports that despite

a moderate success of IMF programs, the most problematic issue has been growth. By perhaps relying more on demand management, IMF programs centred around tight conditions for fiscal and monetary policies (Bird 2001, Buira 2003). Though fiscal adjustment, on average, was based equally on increasing revenues and cutting spending, the biggest “gain” was observed in restraining capital spending, in comparison to current spending (Schadler 1996, Buira 2003). The lack of medium term analysis of potential levels of government revenues, expenditures and financing prospects questioned the sustainability of the actual outcomes at the end of the program over a longer period. Concerning the viability of financial programs for both reducing inflation and increasing foreign reserves, Schadler (1996) argues that programs scored better in terms of achieving the later, since in two-thirds of the program years the higher money supply growth and the resulting inflation, occurred from higher than targeted inflows of foreign exchange rather than higher credit growth. The same author has argued that the achievement of financial market reform came at a cost when fiscal policy was insufficiently tight: the increase in real interest rates brought about by financial liberalization was further reinforced by tightening credit to control inflation and may have resulted in high real interest rates in domestic currency, thus creating incentives for Euroisation. Finally, Schadler (1996) criticizes the markets’ liberalization preceding the creation of an adequate regulatory and supervisory framework, reporting that liberalization reforms in exchange, trade financial systems and price liberalization were generally faster than the liberalization of taxes, public spending, public enterprises and labour markets.

An interesting perspective on IMF program assessment is presented by Bird (2001), whose study employs assessment criteria formulated on the basis of the IMF’s institutional objectives. To a considerable extent, high rates of recidivism (countries frequently using IMF drawings), low rates of completion, and an insignificant catalytic effect on other capital flows indicate that IMF programs have not performed in the way they were intended.

To overcome these problems, a greater focus should be put on program ownership, i.e., making governments and countries more committed to the programs. As Buira (2003) argues, ownership must result from

the authorities' conviction that compliance with the programs leads to the attainment of the country's own objectives, and that conditionality can neither substitute for nor offset a lack of ownership. Though conditionality imposes a reduction in ownership, which may create moral hazard problems, Bird (2001) suggested that a distinction should be made between mandatory conditions (kept at just the necessary level) and non-mandatory recommendations to be assessed by the country's authorities.

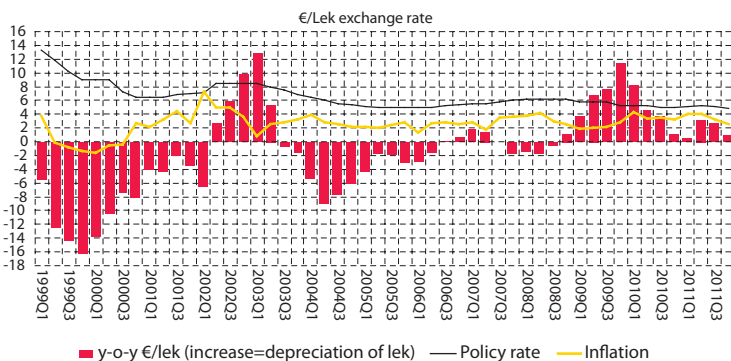
This wide debate led to a reform of IMF guidelines on conditionality in 2002, and more recently in 2009, strengthening the capacity for crisis prevention and resolution. Nowadays, IMF programs have higher flexibility in addressing structural reforms (IMF Conditionality, 2012). Structural performance criteria requiring formal waivers have been abolished, and structural reforms are covered by reviews of overall program performance. Accordingly, IMF structural conditionality in IMF arrangements approved during the 2008-10 financial crisis was more focused on core areas of the IMF's expertise than in the past.

Having outlined the objectives and potential shortcomings of IMF programs in general, let us now turn to Albania's experience. After opening-up from isolation, the private sector in Albania has been growing vigorously. Albania's economy was dominated by agriculture, which contributed to 53 per cent of GDP in 1990, while the industry's sector share fell from 45 per cent to 26 per cent between the years 1989 and 1999. Both sectors were all but bankrupt at the beginning of transition due to low productivity resulting from overemployment, a fixed and overvalued exchange rate, fixed prices, unbalanced foreign trade deficit, a lack of investment, and controlled or non-existent markets. The programs were thus designed around the liberalization of the foreign exchange market; prices; and current, and later capital, account transactions – coupled with proper design and implementation of sustainable monetary and fiscal policies. More than once (following the collapse of pyramid schemes), these adjustments produced a stable economic environment that created favourable conditions for fast and durable growth based on increased productivity, factor reallocation, financial intermediation and increased domestic demand. Since the early stages of these programs (1993–1995) and despite the initial

post-transition decline, improvement in Albania was evident as output grew at around nine per cent annually and inflation fell to single digits. Agriculture and industry shrank to make way for new, more productive sectors of the economy, namely services, trade, construction and financial services. Over the last decade, the performance of Albania's economy has been satisfactory, characterised by significant economic growth, the inflation rate coming within the target of two to four per cent¹⁸, as set by the Bank of Albania, and a stable exchange rate vis-à-vis major international currencies. In the meantime, fiscal policy has been following a continued path of consolidation. With respect to institutional aspects, thanks to public support of the country's opening to external markets, IMF and World Bank programs were naturally accepted as benchmarks for policymaking and served as good anchors in creating an important initial path for the establishment of credible institutions.

In the framework of the IMF's programs, Albanian authorities have undertaken many rebalancing and sustainable economic policies and have achieved significant results. The following analysis provides a brief picture of the most important economic trends and results achieved by the Albanian authorities in the framework of IMF programs:

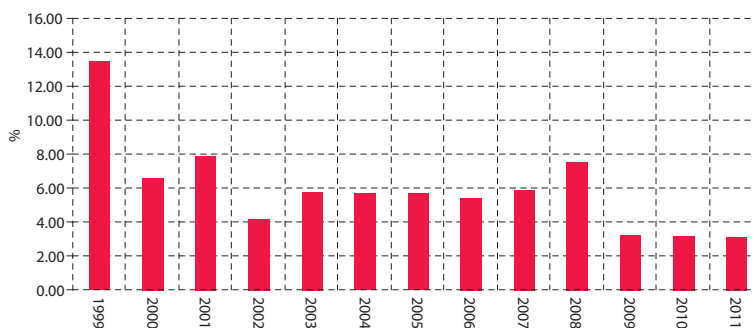
Figure 4.1.a Inflation, exchange rate and policy rate developments



Source: INSTAT, Bank of Albania, author's calculation.

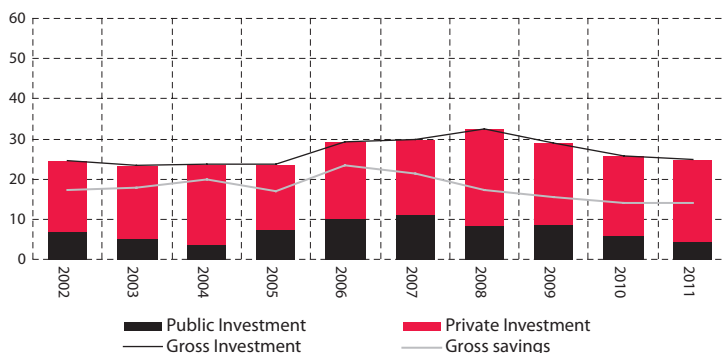
¹⁸ Later the objective was redefined as $\pm 1\%$.

Figure 4.1.b Real GDP growth (2002-2011)



Source: INSTAT, 2011.

Figure 4.1.c Saving and Investments (% of GDP)



Source: World Bank, IMF 2011.

In contrast to the high rates in the early 1990s, inflation in Albania decreased significantly. This success was rooted in the extremely broad scope of early price liberalization, coupled with policies that fostered competition and early supply response, restrictive financial policies and adequate (indeed, substantial) external assistance (McNeilly and Schuesser-Gachnang, 1998). The reduction in inflation contributed to a rapid increase in production despite the discipline imposed by monetary and fiscal policies. The advantages of a flexible exchange rate regime were also important in absorbing shocks and, unlike countries with a pegged exchange rate, Albania's competitiveness was maintained.

Indeed, Berger, Kopits and Szekely (2007) report that inflation in Albania, between 1996 and 2005, had been lower than the average inflation in low-income and middle-income countries as well as in the Western Balkans. As of 2003, the inflation rate in Albania has mainly been within the target set by the Bank of Albania, that is 3 1 per cent.

Initially, despite formally implementing a monetary aggregate targeting regime, in practice, decisions concerning the stance of the monetary policy were made by considering a wider range of information in addition to M3, such as pressures coming from exchange rate movements, price changes in different markets, and demand pressures.

Economic growth

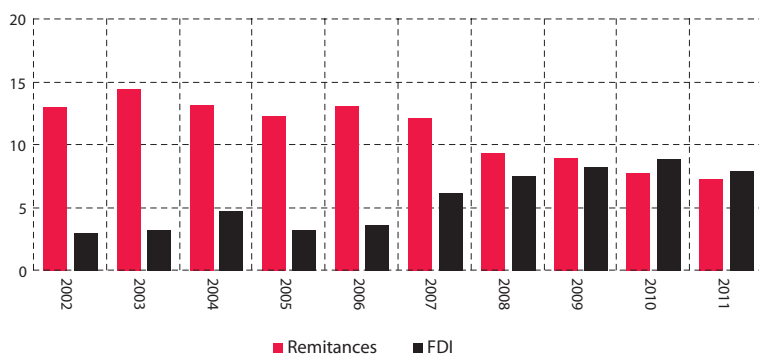
Real GDP growth figures suggest that Albania's economy experienced impressive progress in economic growth over the past decade, outperforming all other European transition economies. Since 1998, Albania's economy has grown at an average of six per cent, moving from a low-income to an upper-middle income country, (World Bank, 2010). During 2009 did real GDP growth shrink to about 3.6 per cent – credit growth almost stopped, the trade deficit widened, while consumption and investment slowed down. All these developments resulted from the global economic and financial crisis of 2008.

Contrary to criticism against IMF programs for failing to adjust the savings-investment balance of a country, in the Albanian case, strong growth was supported by a sustained increase in investments. Total gross investment increased from 24.5 per cent of the GDP in 2002 to 29.5 per cent in 2009, and private investment rose from 18 to 21.4 per cent over the same period (Figure 4.1.c).

External Imbalances

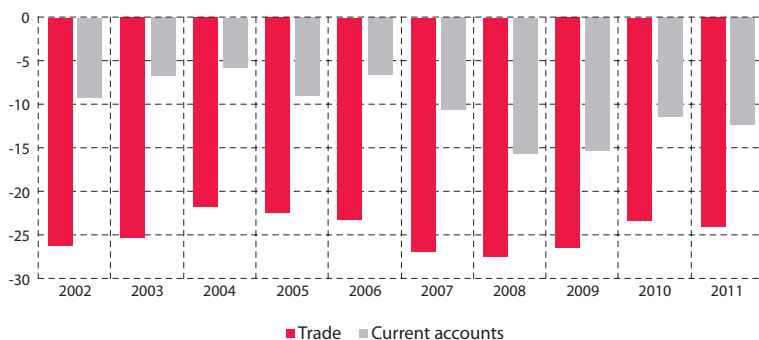
Since the beginning of transition, trade and current account deficits have continued to increase following the current and capital account liberalizations. On average, between 2002 and 2009, Albania recorded a trade deficit of around 26 per cent of the GDP, while current account

Figure 4.2.a Remittances and FDI (% of GDP)



Source: Bank of Albania, INSTAT.

Figure 4.2.b External balances (% of GDP)



Source: Bank of Albania, INSTAT.

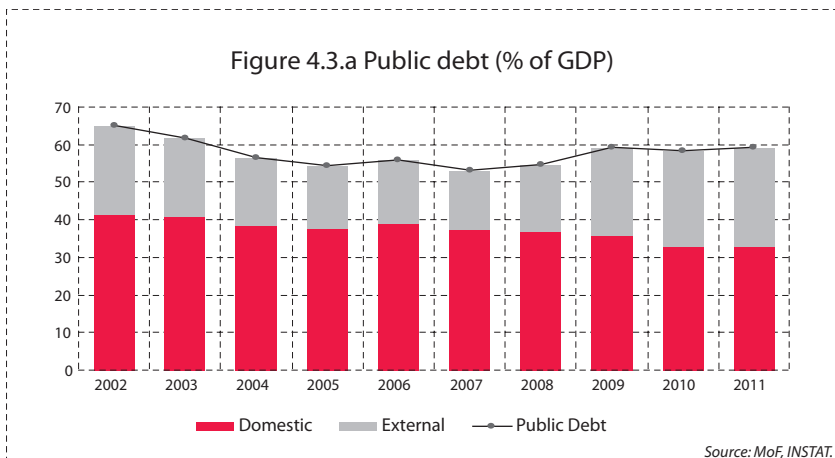
deficits were much lower, from 9.1 per cent in 2002 to 16 per cent in 2009, due to higher financing from remittances, estimated at around 13.5 per cent of the GDP. Both deficits continued to increase in the years preceding the crisis, and stand at high levels as the crisis did not spur a strong adjustment process, despite a depreciation in the (free floating) exchange rate. Sizeable external imbalances remain problematic, even though they are closely linked to the country's catching-up process and ultimately driven by fiscal expansion measures pursued to mitigate the impact of the crisis.

Fiscal policy

Gradual fiscal consolidation has been a defining goal of all IMF programs. Due to these programs, the fiscal position has improved in terms of general government spending and debt¹⁹. As in the orthodox case, these improvements were achieved by a combination of amending revenue administration and lowering interest payments on debt. As a result, and in combination with strong GDP growth, deficit and public debt declined from 9 to 3 per cent of GDP and from 62 to 53 per cent of GDP between 2003 and 2007, respectively (WB, 2010). However the caveats of more restrictive capital expenditures reported by the literature have also been present.

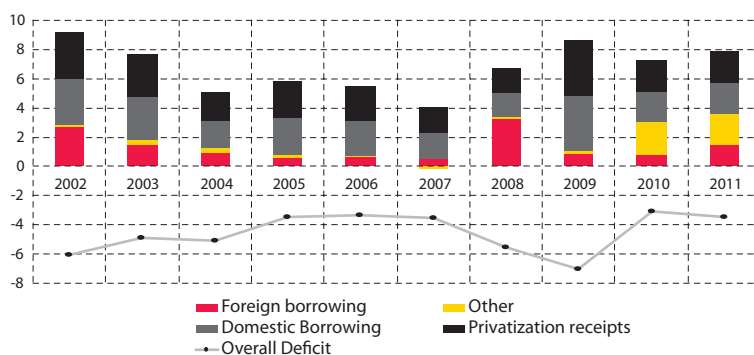
That said, the trend of consolidation reversed in 2008 with an increase in public investments, and resumed in the following years as fiscal policy provided a much-needed stimulus. This was a response to the considerable reduction in private investment due to the negative rebalancing effects on private sector balance sheets and slower economic growth following the global financial crisis.

Fiscal expansion that followed the financial and economic crisis of 2008 deteriorated the fiscal position in terms of both fiscal deficits and public debt. As such, consolidation of this fiscal stance toward a more



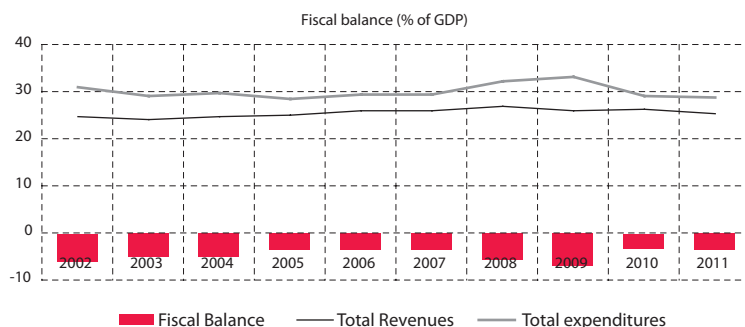
¹⁹ See Figure 4.3.

Figure 4.3.b Fiscal balance (% of GDP)



Source: MoF, INSTAT.

Figure 4.3.c Fiscal revenue and expenditure (% of GDP)



Source: MoF, INSTAT.

sustainable pre-crisis level is the main challenge for Albanian authorities. Unfortunately, this challenge is confronted in a relatively weak economic environment, with slower growth and a financially challenged private sector. Along with EU integration goals, the priorities of these programs remain the long-term development goals of the country, and the prioritization of sustainable economic policies.

These fiscal indicators represent important economic and stability norms that are translated into performance criteria in IMF programs. In this respect, the programs have acted as powerful policy anchors, contributing to responsible economic behaviour and promoting growth and stability.

Thus, the strategy of “PRGF/EFF” was focused not only on non-inflationary growth and sustainability of the external position, but also on reducing poverty through sustainable and comprehensive economic growth.

The country’s sustainable economic development also benefited from the advancement of the European integration process and the opening of negotiations on a stabilization and association agreement with the European Community and its Member States. The European integration process provided an additional anchor that developed simultaneously with IMF surveillance. With the end of the last IMF program in 2009, EU integration became the sole foreign anchor of economic and structural reform. However, the goal of EU membership was, of course, much wider. In addition to economic programs specifically reviewed by the PEPs, the integration process encompasses the overall convergence process, including progress in terms of political, legal and social reforms.

Thus, while the fulfilment of the economic Maastricht Criterion remains an integral part of the entire process, progress is assessed by overall achievements. The development of economic policies started with sectorial strategies, and converged into a general platform for economic and social development of the country as a whole. These strategies are conceived as a development platform that promotes more precise coordination of the individual political, social and economic interests in its implementation, while the main task was annually adjusted on the basis of monitoring results, objectives and prioritised public measures.

Based on development, the fulfilment of the performance criteria of IMF programs and the opening of negotiations on stabilization and association agreements with the EU will also provide the country with a framework to secure long run sustainable macroeconomic and financial conditions. This is in a way in which the philosophy of sustainable economic growth is embodied in the conditional criteria of foreign anchors.

III. The role of domestic and external anchors

Following the previous discussion, it is very important for the future of the economy that corrective measures are taken to help preserve the

macroeconomic balance, and in particular, to preserve a sound fiscal position. This need comes at a very difficult time, as the economy is still growing at a slower pace of around three per cent, compared to an average of six per cent before the crisis. In addition, particular elements of aggregate demand, namely private investments and consumption, are suffering as households and the corporate sector try to rebalance their financial positions following the fast growth of liabilities between 2004 and 2008. Such domestic developments are currently exacerbated by a global increase in commodities' prices and by Albania's economically and financially stricken trade and banking partners. In general, these developments have materialized into two opposite effects for the authorities. First, the economy could benefit from a continued stimulus, but on the other hand the above-mentioned difficulties have negative effects on the performance of fiscal revenues. Moreover, the supporting policies of the last two years, the introduction of the flat tax, and the Bank of Albania's interest rate policy – to name but a few – have already positioned the authorities at the edge of what is considered a sustainable position.

As a result, Albanian authorities find themselves at a crossroad, and must decide which path to follow. On one side is the short-term pain/long-term gain road of consolidation and rebalancing; on the other is the short-term gain/long-term hazardous road of sustained public sector expansion or tax increases. Based on pure economic reasons, the correct choice is obvious; the clarity blurs when political and social issues are brought to be fore. In this case, short-term political and social interests are at odds with the economy's long-term prosperity. Because of this predicament, the society needs strong political and economic anchors to shield itself from the allure of dangerous short-run policies.

"Anchoring" is a policy design issue that arises because of the time-inconsistency of optimal policy choices. Kydland and Prescott (1977) have demonstrated that time-inconsistency can be avoided by adherence to domestic rules. If domestic rules cannot be enacted due to political constraints, the time-inconsistency problem can be resolved by selecting an external anchor that would tie policymakers' hands (Tovias and Ugur, 2004). The removal of such anchors, as history warns, may be costly both economically and politically.

Morlino (2005) used the concept of domestic anchors to explain the process of democratic consolidation. An anchor, as defined by the author, is ‘an institution or a mechanism, entailing organizational elements and vested interests, that is able to perform a hooking and binding effect on more or less organized people within a society’.

Employing this definition, a domestic anchor must activate or put in place an automatic correction mechanism to eliminate collateral damage to the final objective. The main scope for anchors has been found in supporting fiscal consolidation and macro-economic adjustment, by committing the authorities to a measurable target and signalling to the wider public the stance of the policy with regard to that target. In this manner, economic anchors are powerful instruments that influence the expectations of economic agents, in particular with regard to future policy actions. These anchors must incorporate all other economic and social policies and develop and be implemented in full compliance with the objectives of other major economic and social policies of a country. Good anchors are not supposed to be used only by institutions that relate their policies to the anchor – good anchors must become a strong argument in the hands of the public to pressure government agencies to design and implement sustainable policies. However, as domestic anchors take time to develop, it may be important to rely on credible external anchors. The latter should be suited to the country’s conditions and sufficiently detailed in order to be implementable.

Economic literature on external anchoring is extensive, especially in relation to macroeconomic policies of developing countries.²⁰ As mentioned in Baracani (2008), this body of literature evaluates how an external anchor such as the International Monetary Fund or the World Bank, or a regional cooperation framework such as the EU or the North American Free Trade Agreement, has an impact on macroeconomic reforms in transition countries and helps to accelerate the process of institutional reform, supporting their deeper integration into the world economy. However, research has also concluded that the adoption of “foreign institutions” contains a potential danger: there is no institutional model that can be simply transposed from one economic system to

²⁰ Please see Francois 1997; Berglof and Roland 1998; Gros 2001; Tovias and Ugur 2004; Featherstone 2004; Dodini and Fantini 2006; Berger et al. 2007; Di Tommaso et al. 2007; Önis and Bakir 2007.

another. Historical and cultural conditions play an important role in the institutional development and implementation of "foreign" institutions.

External anchors can help domestic policy-makers override strong resistance on the part of domestic interest groups (Önis and Bakir, 2007). While the theory of external anchors relies on the ability to resist the pressure of individual groups, such anchors have a much more difficult task in transition countries. IMF agreements and EU integration objectives are to serve as external anchors for a society trying to transform itself into a well-functioning, market-based, democratic society by means of structural reforms. Such reforms usually take a long period of time, and are costly and painful. Moreover, the economic benefits of such reforms are not immediately obtainable and even decades later might not be visible to the society. In general, the role of this external anchor is to show to the society at large, and individual interest groups (first and foremost politicians), that there are potential benefits, hopefully visible to the entire society or most of it, when reforms²¹ are successfully implemented. In this respect, the external anchor plays an important role in the creation of domestic anchors.

For that reason, it is important to keep this reform alive by holding tight to the external anchor until the benefits of reforms have materialized, until foreign anchors have fully contributed in the establishment of strong and sustainable domestic anchors (Önis and Bakir, 2007). The impact of external anchors is not confined to reform implementation in the short-run. They can have a significant impact on the process of long-term improvements in the institutional capacities of the state.

IV. Convergence, the EU, the IMF, and the future of external anchors in aspiring SEE countries

In the Bank of Albania, the role of external anchors has been at the centre of discussion during the last three years in the context of potential future macro-financial implications for monetary policy and for the economy as a whole. Albania is a success story of transition supported by IMF economic programs. These programs have served as important

²¹ Specifically the reform that is supported by the external anchor.

and credible anchors for sound macroeconomic and financial policies for most of the transition period. The programs, as tools, and the IMF, as an institution, have provided strong motivation for Albanian authorities to design and implement sound economic policies in the long run due to several unique characteristics that are blended (or built) into the agreement process. The following comments are based on the personal reflections of our institution's leadership, drawn from the long and successful experience in policy-making at the central bank under the IMF program. The success of the IMF as a credible anchor has relied upon the following characteristics that must be met by any credible and working external anchor:

- The IMF provides economic and political motivation to follow sound economic policies in the long run.
- The IMF program is designed as a set of economic and political choices that aim at reducing imbalances in the short-run and generating a sustainable macroeconomic environment in the long run. They stand to promote prudential macroeconomic policies and economic choices. In this respect, the anchoring process is defined to have a final goal that is consistent with the mission of the anchor-setting institution.
- The IMF program is designed around a set of structural economic indicators called structural benchmarks that must be satisfied at a precisely defined moment in time. The program defines benchmarks that are easily understood by both authorities and by the public. These benchmark criteria provide a unique, simple, transparent and feasible quantitative platform for measuring progress with credible accuracy.
- The IMF program uses structural benchmarks as performance criteria, or as subject of program reviews, to measure the commitment of domestic authorities to the adjustment process and their ability to deliver results. Failing to reach the performance criteria, or to complete the reviews, calls for an interruption of the program. This relates the anchoring process to a credible threat.
- Anchors should not be given up, traded or exchanged, even in the case of clear, visible short-term benefits, including political ones. The IMF program is not in itself a subset of measures of a broader economic, political, regional or international agenda.

Thus, the anchoring institution does not have actual or potential benefits in negotiating or trading the set of the program's economic performance criteria to gain leverage in the implementation of one or more objectives in political, legislative or administrative reforms. The anchoring tool (the program) is not up for negotiation with the government because the program itself (meaning the structural benchmarks and the policies that condition them) is the only objective of the IMF, and there are no potential gains in trading the program benchmarks for benefits in other areas of bilateral cooperation. Therefore, the developments and status of the political, legislative and social environment do not interfere with the anchor.

- Though always designed around the same universal values and methodology, the IMF program is tailor-made to fit the characteristics of the specific country's economy. The program benefits from extensive knowledge, experience and research in all regions of the world, assisting countries that cover all stages of economic development. Moreover, the IMF as the anchor-setting institution can assist the country by reliably identifying potential endogenous threats or exogenous shocks and suggesting ways to minimize their occurrence or impact.
- Implementation of macroeconomic policies designed under the program has achieved the promised results in a relative short period of time. Predictably, the credibility of the anchor increases as the anchor leads to preannounced results.
- The IMF as the anchor-setting institution has adequate human and financial resources, technical capabilities and educational infrastructure to supply long-term or on-demand technical, economic and financial assistance regarding the fulfilment of the anchor's policies.
- The IMF program guarantees compatible objectives and coordination between monetary and fiscal policies. Most importantly, in its role as the anchor institution, the IMF acknowledges as local counterparts all interested parties (central bank as well as government), which are simultaneously involved in the discussion, negotiation and implementation processes.

The above characterization makes it clear that the role of the anchor is not constrained only to good policy design, as the anchor enforces

commitment to sound fiscal policies. Our last IMF program, however, ended in January 2009, at the same moment when the economic slowdown that followed the financial crisis in the developed countries started to spread its impact to emerging economies, including Albania's. Such problems have not been unique to the Albanian economy. Its peers in the SEE region are currently suffering from the same problematic symptoms, while their PEPs acknowledge an urgent need for fiscal consolidation, and for a reversal of trends in trade and current account deficits. Deterioration in fiscal and private balance sheets is explained by the same factors, and exacerbated by the global financial and economic crisis and the authorities' response to it. Moreover, being the main trading and financial partner for the entire region, current developments in the EU bear potential negative effects for all our economies. It is worth noting, however, that the region showed an admirable resistance to the unpleasant events that started in the autumn of 2008. Those same developments caused much graver problems in some other Central European Economies – especially the “successful” ones. These developments call us to reflect on the role of institutions and policies that have served as foreign anchors in this process.

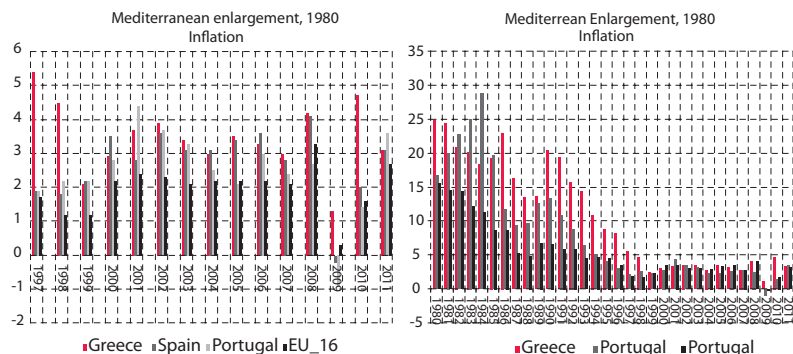
But can external anchors be permanent?

Considering our own past experience, and that of other emerging European economies, we are convinced that our countries can and will continue to benefit from international surveillance. As long as there is a need for structural reform, external anchors are important for achieving full political, economic and social integration with the European Union. By full integration we understand the moment when our countries will adopt the Euro as legal tender.

In this sense, convergence can be defined as a process, under which a country fulfils a set of performance criteria and structural reform benchmarks. Each country should adopt the standards stemming from the *Acquis Communautaire* and different international best practices, combined with significant steps in improving the economy, society, culture and environment – imperative to promoting political, financial and social progress in the entire SEE Region. The European integration process, and precisely the prospect of EU membership,

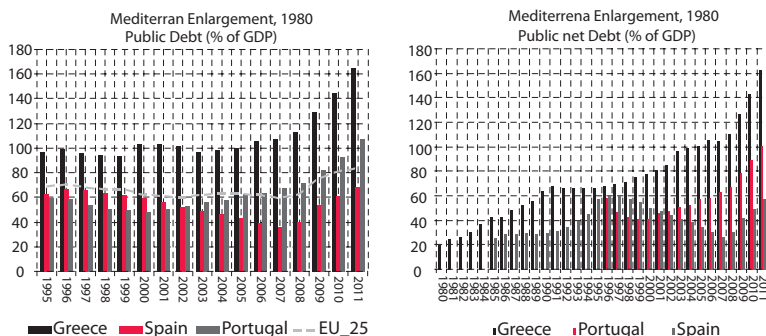
has so far been an important motivational tool for promoting reforms and pushing institutional development. This motivation is reflected mostly in political, legal and social aspects. At the same time, it has had a considerable effect on the impressive economic performance in transition countries, which were catching up relatively fast, by bringing optimism to the people and increasing the support for reforms. In the

Figure 4.4.a Inflation (y-o-y) Mediterranean Enlargement



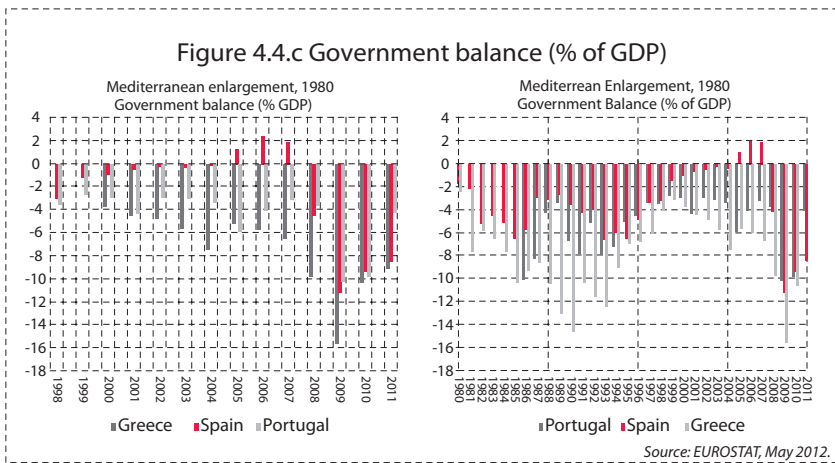
Source: EUROSTAT, May 2012.

Figure 4.4.b Public Debt Mediterranean Enlargement



Source: EUROSTAT, May 2012.

case of Albania, despite the EU's strong influence for political, legal and economic change and the authorities' compliance with the economic conditionality of the accession process, the IMF program has been



the foremost external anchor with respect to measuring economic performance.

Now that the IMF program has reached its conclusion, EU membership criteria remains the most important external economic anchor, with EU integration becoming the anchoring tool and the European Commission the anchoring institution. The efficiency and ability of the European Commission to serve as binding anchors in the economic area will bear important implications for the future macroeconomic and financial stability of the Albanian economy, as well as for the other economies of the region. Regrettably, recent history is not encouraging, and this perhaps suggests that a quite high degree of institutional and economic convergence should occur before a country applies for EU membership.

By the beginning of 2000, most of the CEE countries were on the brink of EU accession and the Maastricht criteria became important external anchors for these economies. The process resulted in further consolidation of general macroeconomic conditions. The new era of EU membership was coupled with rapid credit growth and a widening of fiscal and current account deficits. Fiscal consolidation reversed and all economies showed signs of overheating. Strong capital inflows were financing these activities, resulting in a persistent increase of current account deficits. Such worrisome developments were justified by many observers in terms of a rapid catching-up process, although this process was not underpinned by a convergence of productivity levels that

would have sustained its rapidity. The long-run stability that motivated all reforms up to accession was replaced with short-run benefits that favoured politicians. Recently, many new member countries have returned to IMF support, but as history demonstrates, anchors will be successful only if a country embraces the nature of the policy embedded within them.

The quantitative aspects of European fiscal surveillance are based on the Maastricht criteria. The main objective of this treaty is to ensure that when EU Member States join the Euro area they meet all necessary economic conditions to ensure price stability and effective financial and commodity markets. These criteria were also adapted to become the fundamentals of the economic safeguard process. The economic performance criteria and the PEPs are designed around these five criteria. However, recent developments show that the degree to which the criteria were implemented by the member states is very questionable, as implementation is enforced by the mechanism of the European Commission, compromising the whole process.

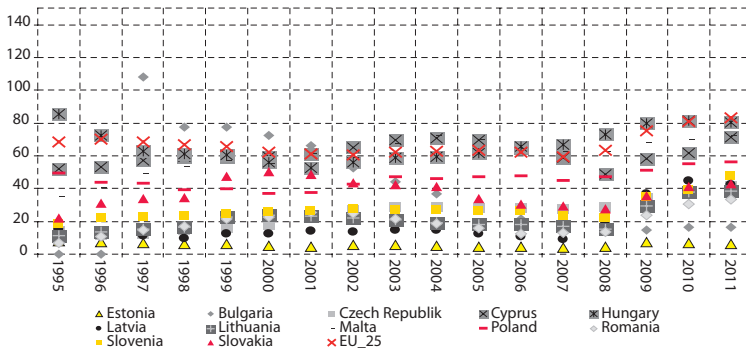
In terms of macroeconomic stability, the performance of new member states, as well as candidates and potential candidates, is measured in quantitative terms by Maastricht criteria. The criteria, however, provide a relatively narrow assessment, focused on nominal convergence. Countries are expected to gear their policies toward fulfilling these criteria before Euro adoption (Cihak, Dhe Fonteyne and Wim, 2009). It used to be widely believed that due to the conditionality of the accession process, the general social and political support for EU membership would become a powerful external anchor. Despite this widely held belief, fiscal developments in the Central European countries in the years that predicated the financial crisis of 2008 show that the EU integration process was not necessarily an effective anchor. Bergern et al. (2007) arrived at the same conclusion. Toviás and Ugur (2004) also argue that the EU's capacity to serve as an effective anchor for policy reform in non-member countries is highly limited. Moreover somewhat surprisingly, after accession the opposite seems to have happened, especially regarding fiscal policy.

The figures below show that economic performance of old and new

member states vis-à-vis the Maastricht criteria is not impressive. Most importantly, the economic performance of the new member states, referring to the Mediterranean Enlargement²² of 2004 and the Eastern Enlargement²³ of 2007, is very different for the periods before and after EU entry. Figures 4.4 and 4.5 show that while all countries have acted aggressively to fulfil the Maastricht criteria before joining the EU, some of them just abandoned those commitments once inside the EU or the EMU.

Figure 4.5.a Public debt (% of GDP)

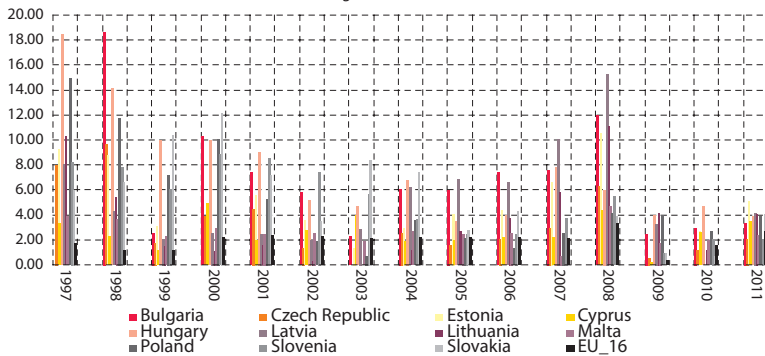
Public Debt Eastern Enlargement



Source: EUROSTAT, May 2012.

Figure 4.5.b Inflation Eastern Enlargement

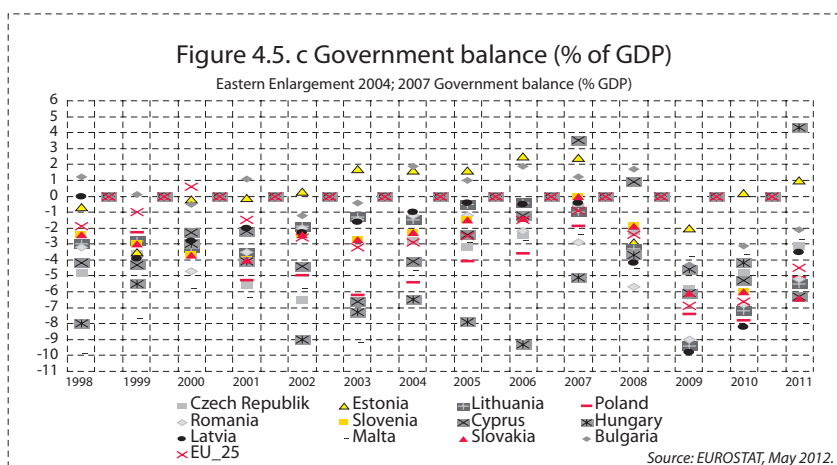
Eastern Enlargement 2004; 2007 inflation



Source: EUROSTAT, May 2012.

²² Greece (1981); Spain and Portugal (1986).

²³ Czech Republic, Hungary, Poland, Latvia, Lithuania, Cyprus, Slovenia, Estonia, Malta, Slovakia that joined the EU in 2004, and Bulgaria and Romania joined in 2007.



It is obvious, for example, that Greek public debt was on average 100 per cent of the GDP for the entire period, well above the Maastricht upper limit of 60 per cent of the GDP. The issue here is that, in reality, fiscal policy was not directed towards bringing down the debt level in line with EU Treaty obligations.

The same behaviour is also observed in other countries, like Portugal, Hungary, Cyprus and Malta, reflecting the fact that EU accession and the Maastricht criteria served as a benchmark anchor only for a short period, but lost their binding role in the long run.

Another Maastricht criterion related to government finances is the ratio of annual government deficit to GDP, which by definition must not exceed the level of three per cent. The figures below show how various countries failed to maintain these indicators within the limits prescribed by the Maastricht criteria following entry into the EU.

A key element of macroeconomic stability in the Euro area is the inflation rate, measured as the change in the consumer price index (Harmonized Index of Consumer Prices). Again, the figures below show that countries have the incentives to meet this objective only before EU accession; after, the whole picture changes.

In light of these results, it is important to understand the reasons behind this “weakness” of the EU anchoring process and to make the necessary adjustments. If one was to review this process using the criteria defined at the beginning of this section, it is remarkable to observe that three important structural flaws prevent the EU from becoming an efficient anchor:

- First, the European Commission is a political body and therefore its local counterpart is the government.
- Secondly, governments have discussed and negotiated a number of other objectives in the political and legal components of the Accession process besides economic performance criteria. Can the fulfilment of the economic criteria be traded for something dearer to EU policy and its short-term objectives? Will it become part of the negotiation, generating evident problems of moral hazard?
- Thirdly, the maximum leverage of EU conditionality is exerted in the run-up to a change in status (such as accession into the EU or the Euro area), and that the impact of the conditionality may wane after such a change in status.

For the reasons noted above, and considering the growing aspirations of the SEE countries for EU membership, the management of the Bank of Albania believes that the role of the EU as an external anchor should be given greater importance with regard to these two structurally essential issues:

- First, the European Commission should clearly identify as local counterparts two equally important actors: the government and the Central Bank. Despite its political character, the Commission must recognize the central bank as a partner in its own right, with comprehensive negotiation privileges. If this powerful anchor incorporates the central bank as well, then the coordination between policies and objectives will improve significantly.
- Second, it is imperative that each category of issues under negotiation receive due attention and is assigned due importance in comparison with other categories. In general, governments prefer to negotiate and to commit to many issues instead of economic performance criteria.

In addition, and beyond these structural issues, there are other practical problems that can weaken the European Commission's ability to play the role of a successful anchor. Were the Commission committed to playing such a role, it would be able to design and implement a comprehensive but country-specific and well-targeted package of economic reforms. The current stage of development of the SEE countries is very different from that of the EU developed economies. Thus, our countries have to adopt different economic standards, and need more tightly targeted macroeconomic and structural conditionality. Can the European Commission generate these standards? At this point, it is important to observe that the Commission, in general, does not have the expertise, experience and monetary resources of the IMF to identify the necessary macro-critical structural reforms; to design and support macroeconomic adjustment programs; and to set performance criteria to measure progress and enforce implementation. Moreover, the Commission is too lightly staffed, in comparison to the IMF, to fulfil a continuous and hands-on surveillance role.

Unlike the IMF, the European Commission lacks deep expertise in transition or emerging economies. Its current standards for imposing budgetary discipline, embodied in the Maastricht criteria, are designed for developed countries and might not impose the necessary constraints for responsible fiscal behaviour in the region's countries.

In order to meet all the Maastricht criteria and achieve Euro membership, however, the starting point of the development path that must be followed by SEE countries is different from that of developed European countries. The journey is a long, difficult, and challenging one; it requires specialized surveillance. Considering these necessities, it would be reasonable for the EU to play the role of external anchor in cooperation with the IMF as far as the economy and finances are concerned. Together with the IMF, and in cooperation with other stakeholders, the EU must design and implement a special joint package, including policy orientation, guidelines for better governance, a set of quantitative conditions, a bulk of key structural reforms, and finally relevant technical assistance.

The recent enhancement of the IMF's role as international lender of last resort and guardian of global imbalances will increase the effectiveness

of its surveillance and will provide a better allocation of international funds. In this context, the IMF itself needs to change and adapt to the new realities. The current events in the former transition countries show that the need for IMF-style surveillance remains relevant until domestic anchors are fully developed. This remains true even for countries that successfully end the Accession process as new EU members.

This economic package must be designed around the values of regional cooperation and integration, with flexible policies aimed at increasing confidence in the region. It must foster better EU and IMF surveillance. This will ensure that short-run political motivation in bilateral relationships between the EU and individual countries will not overshadow long-run goals. In fact, all such requirements have received detailed attention under IMF programs. The structural benchmarks of these programs have played a similar role to fiscal rules; however, they have been different across countries and across periods. In this respect, they allowed temporary adjustments without compromising long-run sustainability of macro-fiscal balances. Our countries have also gained substantial experience in the negotiation and execution of such agreements. In the absence of these agreements or arrangements, regional countries cannot make use of this accumulated experience, mainly because the counterpart in the new arrangement does not follow the same set-up as the IMF. Therefore, during the EU integration process and until full economic and institutional convergence is achieved, it might be a responsible and wise choice for all aspiring countries, including new member states, to have the macroeconomic and fiscal framework be designed and implemented under a three-party agreement between the country, the European Commission and the IMF.

In such an arrangement, the EU as well as the country in question will share the positive effects. Both will gain the experience of the IMF in the areas of policy harmonization, capacity building and in the implementation of economic policies. Finally, it is important to understand that external anchors may not support long-run sustainable prosperity in the absence of domestic anchors. External anchors are needed as long as domestic anchors are fragile. Thus, it is imperative for the society itself and for the international institutions to support the

establishment and strengthening of domestic anchors. Governments should bear systematic pressure to establish clear and measurable fiscal rules, immune from political rotation, providing our society with an efficient mechanism to control short-run time inconsistency in political behaviour.

VI. Conclusions

This paper analysed the role of external and internal anchors in transition countries like Albania, emphasizing the importance of these anchors in promoting growth and macroeconomic stability in EU-aspiring members of the SEE, not only in the short-run, but also in the long run. This assessment addressed the role of external anchors like the IMF and the EU, and their future as two very important institutions for anchoring domestic policies. The paper notes that the transformation process that has changed our societies since the fall of the Berlin Wall was irreversible. The real question for the countries of our region is: how long will these convergences in the transition countries last?

By analysing the past and current problems of the transition process, and answering the resulting questions, it is clear that these economies need further surveillance. Currently, the international body that fulfils that role is the European Commission – the EC assesses whether candidate countries satisfy the necessary conditions to adopt the Euro.

Analysing the events that followed the global crisis of 2008 and the last two decades' experience with foreign anchors in transition economies, this paper concludes that – despite its efforts to serve as a reliable external anchor – the EC alone will be hard-pressed in the performance of such a task, especially in the area of specific macroeconomic policy design in transition or emerging economies. More specifically, this is the case in the areas of macroeconomic policy co-ordination, relevant technical assistance, and surveillance of economic performance and progress. Therefore, it might be logical for the EU to invite the IMF to work together in all areas where the IMF has demonstrated comparative advantages.

Such a need reflects the fact that the criteria used by the EU are general in nature, and do not take into account the specific characteristics of these countries. Consequently, both country and regional characteristics deserve deeper consideration. In this respect, the EU must analyse and evaluate its abilities to serve as an external anchor before the next accession round. To design and implement this new role in the region, the EU must define and state clearly the political goals for the region. We also invite the ECB and the EC to explore the possibility of adopting a standard treatment for the entire SEE region, by adopting a specific program for a specific group of countries.

Finally, we must understand that external anchors will not support long-run sustainable prosperity in the absence of domestic anchors. They are vital, because our economies will ultimately need to stand on their own feet.

That said, the extent to which our progress will abide by the set of legal, political, economic, moral and cultural norms and rules embodied in external anchors will determine long-term progress and prosperity. Deviation from such norms, customs or behavioural codes would inter in huge political costs, thus conferring on this set of norms and rules the role of a natural internal anchor for performance evaluation.

While the benefits of economic growth and poverty reduction are both desirable and understandable, they entail costly reforms with a significant time lag and thus might seem too distant and uncertain to provide strong support for domestic reforms. For these reasons, we consider the pressure of external anchors to be of special importance to the establishment of solid domestic anchors in our societies. Such pressure must persist until society has achieved a higher level of emancipation and wellbeing, and can naturally factor the observance of domestic anchors into its political behaviour. In this process, the two will complement and reinforce each other, and deliver expected rewards once conditionality is fulfilled.

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Epilogue

While conversing with my fellow governors of the region, sitting around a table overlooking Skadralia Road in Belgrade, one of my friends suddenly asked, 'Governor Fullani, you have a bird on your flag, don't you?' 'Yes,' I replied, 'we have an eagle!' 'We have an eagle on our flag too,' declared a few of my fellow governors. 'Well, the eagle has significant national symbolism for us as well,' added someone else. To wrap up that discussion, I said, 'Listen, my friends, there is just one eagle staying one night in Tirana, and the next in Belgrade, and so forth.' I like this story especially as it is simple and directly portrays the spirit of our co-operation. I truly believe that the institutions and societies of our region share similar experiences of heartening co-operation. I hope they will expand to transform South East Europe into a successful, integrated economic area that furthers the prosperity of all its nations.

I did not have in mind to end this book with an epilogue. However, at the end, I would like the reader to see this book as an analysis that takes a serious look beyond the current crisis. In my opinion, this is the motive that will keep the debate of a new economic model of growth alive. It is true that in the autumn of 2008, the financial winds changed their direction. Since then, the problems have become more difficult not only for the financial system and the private sector but also for their governing authorities. This change brought to the top of the economic agenda a restoration of fiscal and financial stability, while demanding at the same time, a strong economic stimuli to support the fragile recovery of economic activity. The unavoidable solutions imposed by our current economic problems, and the related discussion toward a new model of growth, remind me of Odysseus' dangerous journey between the six-headed monster Scylla and the whirlpool of Charybdis.

Current global economic and political events are a vivid reminder of the fact that the economic crisis which followed the financial turmoil of 2008 is still underway. The resulting economic and social difficulties will probably remain with us for a long time. These problems are not limited to the group of former transition or emerging market economies, but are the problems of all economies – regardless of the state of their development. At present, slow pace of economic growth, and related

issues of debt and inequality, are becoming major concerns not only for developed countries but also for fast growing economies such as China and India. These issues are defining the current political and economic debate worldwide. They are the mainstream discussion of books, articles and editorials in the most elite journals, and the topic of on-going research and scientific work. This crisis has revived discussions about the appropriate growth model. The whole debate reminds me of the very first visit of the IMF mission to Tirana in 1992. The proposal of that mission was to start overall market reform with privatization and price liberalization. These structural recommendations and requirements are very similar to the ones needed among our European partners today.

In their analyses, several prominent economists point to globalization as a potential cause of the current situation. The implications of this argument may not be completely understood, or seen in the right long-run perspective, but at one level globalization may indeed have some relevance in explaining the disappearing manufacturing sector and the increased incidence of inequality in the developed world. If short-term political and economic concerns flowing from such a view take hold among developed countries, then support for globalization and related foreign direct investment in developing countries may be damaged. This would be a particularly unfortunate development for the emerging economies of South East Europe, which, despite all the efforts and bold changes of the last 20 years, are still at large net importers of goods, services, capital and crisis.

Moreover, due to the size, geography and importance of the current problems, the policy debates as well as the proposed solutions are focused mainly on the big economies of North America, the European Union and the BRICs, eclipsing the challenges faced by emerging economies in South East Europe. The region's economists and academics will certainly benefit from the growing global debate on growth, and from its policy conclusions, by translating them into a regional context. Yet, it is necessary to initiate a similar analysis of the specific economic and social developments in South East Europe, and to use this as a focal point to trigger awareness and concern among interested parties beyond the borders of the region.

The crisis has shaken the stability and slowed the convergence of emerging economies in this region. The redistribution of factors of production and the rise in productivity have stalled. Microeconomic fundamentals in the household and business sectors have worsened, causing a slowdown in aggregate demand, and increased savings. As a result of these developments, the economy is stuck in a limbo of low growth, low policy interest rates and growing debt. These macrofinancial problems have spilled over to the banking and financial systems. Mounting nonperforming loans and reduced demand for banking products are slowing down financial intermediation, affecting its support for economic growth.

As we live in the era of the "global economy", domestic policies – and in particular growth-oriented policies with regard to investment, education and technology adoption – should aim to create an attractive South East European economic zone. The benefits of such coordination will range from a reasonably large consumer base and a larger regional market, to higher productivity growth from economies of scale. Investment and production processes must benefit from specialization, cooperation, and a flexible regional labour market. This change will shift the balance of growth from consumption toward investment (private and government), and towards the external sector, while shrinking fiscal deficits and public debt.

These regional debates, and a new emphasis on coordination, make sense indeed. The economies of South East Europe are small by global standards, both in demographic terms and in their natural endowments. They are surprisingly similar in their stage of economic and political developments, face similar economic problems, and share the same partners. Last but not least, they have a very similar strategic goal: EU integration. Yet, in contrast to this vision, the region is fragmented by linguistic, infrastructural, psychological and economic barriers that are sustained not only by the past, but also by prevailing rent-seeking mentalities and by a mercantilist mind-set. A new model of growth could be a better way to foster European integration of the region as well. Countries of the region should think and act like a wise homemaker who enhances the welfare of the entire community operating a house that is as clean and tidy outside as it is inside. Their reforms and their

economic policies must take into account the regional aspect, and should shake existing barriers in the region.

Fortunately, these barriers have begun to be shaken, and are yielding to regional cooperation. The episode that opened this epilogue, concerning the cooperation between central banks in the region, is rooted in one of the best examples of such synergy. SEE must use this cooperation, and shared goals of EU integration, to build the critical mass necessary to secure the attention of the global economy and to build prosperity around this common goal and global economic strategy.

Globalization, with all its benefits and challenges, requires a new paradigm, a new economic model, as a solution to current economic outcomes and fragmentation. Above all, it requires a new regional mind-set. We already know the features of the past model: small, open economies supported by consumption, fast financial intermediation, and a fast development of non-tradable sectors. The small open economies of the SEE cannot sustain long-run growth based only on domestic demand, first and foremost because we have to sustain the overall stock of liabilities created by past and present external deficits, substituting imports and expanding our trading partners as well as our export base. This cannot be accomplished without efficient tradable sectors, especially manufacturing sectors that are aligned with the region's comparative advantages.

Most importantly current crisis in developed economies and EU member states in particular indicate that change is mandatory not only for emerging economies of the region, but also for our leading European partners. This crisis and its implications in terms of economic developments and macro-financial imbalances can potentially shake the confidence of the aspiring countries in the European integration process, its strategy and its efficiency. The European authorities must acknowledge the existing economic, institutional and structural differences among the member states and between the member countries and aspiring economies in order to provide country specific targets and economic policies as a good strategy of leadership. The EU integration process will benefit from stronger political and economic country specific benchmarks, and problem oriented political and economic

structural reform. These changes will guaranty the sustainability of the EU economic and political architecture in the long run, and therefore encourage confidence and hope in the aspiring economies. After all, EU and its integration process was and remains one of the most powerful driving forces of economic, politic, and social transformation in the SEE region. Finally I hope this book may help the entire SEE region to discover that the economic fundamentals provide economic incentives to cooperation that largely outpace the historic and emotional remains of hatred relationships and regional hostility.

The book is meant to argue the need for a new approach to economic growth, a need to discuss the features of this new model and its deep links to regional cooperation. To the reader that has completed the journey in search of a specific new model, with entirely different features, I would like to conclude with a reminder. A new model of growth is one that differs from the old model not through revolutionary change but by addressing the faults and limitations of the earlier approaches which experience has helped us to identify.

South East European Studies at Oxford (SEESOX) is part of the European Studies Centre at St Antony's College, Oxford. It focuses on the interdisciplinary study of the politics, economics and societies of South East Europe, and on the region's interaction with Europe. Drawing on the academic resources of the University of Oxford and an international network of associates, it conducts academic and policy-relevant research on the multifaceted transformations of the region, and on the historical and intellectual influences that have shaped perceptions and actions in this part of the world. In line with the traditions of Oxford, the SEESOX team is committed to understanding the present through the *longue durée*, and reflecting on the future through in-depth analyses and discussions.

