

# Macroeconomic Consolidation: Achievements and Challenges

*Dhori KULE\**

*Sulo HADERI\**

*Abstract*

*In this discussion authors analyse the process of macroeconomic stabilisation during the transition period and Albania's successful achievements to reducing and controlling inflation; relatively high rates of growth; gradual decline of budget deficit and relative stabilisation of exchange rates. From this point of view, we analyse the role of monetary and fiscal policies; external variables of structural and institutional reforms; and the role of international institutions such as IMF to achieve and sustain the macroeconomic stabilisation. The main conclusion is that this success is mainly due to the application of prudent monetary and fiscal policies and relatively fast and substantial structural reforms. Macroeconomic stabilisation that contributes to growth, which on the other side makes it sustainable, cannot be maintained without having political stabilisation and long-term and consistent economic growth.*

## **I. Introduction**

The movement from a centralised to a market economy faces several major problems amongst which controlling the inflation and providing sustainable rates of economic growth are fundamental conditions for such a successful change. During the past years of transition, Albania has experienced a obvious success towards the macroeconomic stability; application of profound structural reforms; privatisation of small and medium size enterprises, financial institutions and public services; liberalisation of foreign trade; strengthening the public order and security; and institutional reformation. Albania is considered successful particularly in stabilising the macroeconomic situation<sup>1</sup>.

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\* Dr. Dhori KULE, Dean of Faculty of Economics and Professor of Public Finances.

\* Dr. Sulo HADERI, Member of Supervisory Board of Bank of Albania and Professor of Macroeconomics at Faculty of Economics.

<sup>1</sup> See World Bank (1998, 2001), IMF (1995)

Although the unfavourable initial conditions (see Table 1) and the low level of GDP per capita, the rate of economic growth is maintained relatively high. The high inflation rates experienced at the beginning of transition period that were result of liberalisation and structural reforms as well as the internal disorder (1991-1992 and 1997), not only are decreasing but have generally been under control reaching for one year negative level and moderate level (4.2%) during 2000 that were in accordance with determined targets.

Despite of obvious achievements, the Albanian economy continuous to be weak; with a fragile macroeconomic stabilisation; with fiscal and foreign unbalances; with one of the lowest levels of incomes per capita in Europe; with relatively high levels of poverty; and with relatively weak institutions. Macroeconomic consolidation is fragile and can be ruined as quick as it is achieved (1997), the trade balance is unbalanced, the budget deficit and debt are in considerable levels (Table 3), the financial market continuous to be in its low development stages, etc.

In the near and far future there are important challenges to tackle, which are related to fiscal consolidation; consolidation of reforms in the banking system and emerging of capital market; termination of privatisation process of industrial enterprises, public services and financial institutions owned from state; deepening of market institutionalisation, including the consolidation of property rights, promoting competition, and protecting consumer; deepening the reformation and modernisation of state institutions, in accordance with the standards of democracy and market.

## **II. Historical background**

In the scarce world literature of pre-transition, Albania was considered as the poorest country of Europe.<sup>2</sup> Located in a very favourable geographic position and owning a long history of inventions from foreigners, which means that it is the last European country gaining the independence, due to 'its next bad luck', after the World War II Albania entered the communist system of development. From this point of view, the beginning of transition found Albania as a communist country with similar features to the other countries of east

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<sup>2</sup> According to assessments from World Bank, GDP per capita in 1991 was \$340.

block lead from Soviet Union, and particularly with the communist countries referred to as the Countries of Southeast Europe.

However, Albania presented some distinctive features that differentiate it from other ex-communist countries.<sup>3</sup> From an economic, political, social and cultural point of view, Albania was the least prepared country to undertake radical reforms towards market economy. Albania was the only country of communist block that had undertaken no important economic and political reforms that would stimulate the economy, such as the decentralisation of decision-making, increasing the role of market or democratisation of the country. The model used in 45 years relied on the rigorous application of Marxist ideology and Stalinist practices.

In the economic aspect, the Albanian model was characterised by the elimination of all forms of private property through the total nationalisation of industry and the collectivisation of agriculture;<sup>4</sup> total dependence on centralised planning and management, hence completely abolishing the role of market as a distributor of resources;<sup>5</sup> and the excessive application of the principle of fully relying on domestic resources and maintaining economic independence that lead to the almost hermetic isolation of the economy.<sup>6</sup>

In the political aspect, the Albanian model was characterised by the lack of democratic tradition<sup>7</sup> and the extreme application of the principle of guerre of classes whose consequences continue also during these years of transition.

The Albanian economy, supported from foreign factors, presented growth signals until the end of '70<sup>8</sup>, and a obvious deterioration was observed after that particularly in the second half of '80. This period was accompanied by the increase of employment while the capital

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<sup>3</sup> For more details see IMF (1992), Aslund & Sojberg (1992), Pashko (1994), Muço (1997), Haderi et al. (1999).

<sup>4</sup> During the '80, the small private property also known as “cooperativist’s yard” or “personal property” was almost wholly eliminated.

<sup>5</sup> The other communist countries undertook various reforms aiming a greater role of market (e.g. Hungary, Yugoslavia) and a decentralisation of decision-making in the enterprise context (e.g. Soviet Union, etc.)

<sup>6</sup> During the communist regime, Albania gradually broke relationships with its allies (Yugoslavia, Soviet Union and China) passing to an autarkic economy. As a radicalisation of this principle, a constitutional law prohibited it to take loans and assistance from capitalist and revisionist countries.

<sup>7</sup> After the World War II, Albania inherited scarce democratic traditions from the monarchic regime of King Zog. After the victory of communist party an extreme dictatorship and fierce regime were settled. (Pashko, 1996)

<sup>8</sup> For more details, see Pashko (1991). The economic growth measured as an increase of the net material product was 44% during 1965-1975, 20% during 1976-1980 and less than 1% during '80.

investments didn't; a obvious deterioration of balance of payment; reduction of foreign reserves, increase of foreign debt, reduction of exports and absence of consuming products.

Although the price level was constant, the data demonstrates for a latent inflation that was quickly increased in the eve of changes towards transition (see Pashko, 1993). The end of communist regime and the beginning of transition<sup>9</sup> found Albania amongst accumulated structural problems, mismanaged policies, fiscal and foreign unbalances and in the conditions of the lack of political will to undertake reforms that were already underway in other communist countries.<sup>10</sup>

However, in the vast research literature on transition related to such criteria as the geographic position, the beginning period of transition, the macroeconomic progression and achievements, the application level of reforms, the speed and continuity of reforms, Albania is classified in the large group of East and Central European countries and in the subgroup of so-called "late reforming" countries. In some cases, Albania it is classified in the group of countries of Southeast Europe, where are also included Bulgaria and Romania that present inconsistent economic growth.<sup>11</sup> Whilst as beginning year of transition is considered 1991.

The worsening of economic situation, the increased pressure for political changes from the mass movements of the end of 1990 and beginning of 1991, lead to radical political changes in the first pluralist elections of March 1991. The accumulated economic and politic problems in a short time were followed by political changes consisting in the organisation of premature election and establishment of a coalition government that undertook minor reforms related to the privatisation of small enterprises; liberalisation of the prices of consume goods; adaptation of some controlled prices such as the price of energy; distribution of agricultural land; etc.<sup>12</sup>

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<sup>9</sup> In the case of Albania, 1991 is considered as the beginning of transition (see IMF, Occasional paper, 184, 1999, Pashko, 1995).

<sup>10</sup> The beginning of transition found Albania as the poorest country in Europe, with living standards comparable to the Third World countries (Haderi, et al., 1999).

<sup>11</sup> See Fisher and Sahay (2000), Havrylyshin Oleh et al., (1999) and Muço (1994).

<sup>12</sup> See Blejer et al., (1992) and Pashko (1995). This period was characterised by the deep worsening of current account due to the drastic reduction of exports and increase of imports, particularly for the consume goods; the instant increase of budget deficit because of the collapse of the system of collecting the incomes and the spending made to fund the wages and enterprises as well as the considerable increase of monetary expansion (see Table 1).

### **III. Macroeconomic development during transition**

#### *III.1. A general overview of macroeconomic stabilisation*

Although the minor reforming developments of 1991, the entire stabilising and structural reform started in mid 1992, after the win democratic forces. In Albania was applied the program of stabilisation, relied on the standard package consisting in the price liberalisation; the fiscal policy aiming to reduce and control the budget deficit; the restrictive monetary policy through the control of the increase of money supply and liberalisation of foreign trade providing convertibility of current account.

At the same time with the stabilisation package, structural reforms were undertaken related to privatisation; the increase of social protection; tax, financial and banking reform; and establishment of legal framework for a market economy (IMF, 1994). In close collaboration with the foreign factor, particularly International Monetary Fund and World Bank, the application of this package was constrained from the real conditions of our country, including the starting point and other factors related to politics, transition strategy, etc.

As a result of macroeconomic stabilisation and structural reforms, Albania experienced a positive macroeconomic development,<sup>13</sup> with an average economic growth of 9% per year during 1993-1996 and about 7.7% per year during 1998-2000, as well as a reduction of inflation from 236% in 1992 to 4.2% in 2000.<sup>14</sup> We can analyse macroeconomic development in Albania by dividing the transition period in four main sub-periods according to the progress of macroeconomic indicators, particularly according to the increase of GDP and inflation (Table 2 and Figure 1).

First period (1991-1992). The starting period of transition was characterised by a drastic fall of GDP and high inflation, worsening of current account, deepening of budget deficit and high social tensions that were accompanied by the destruction of production capacities.

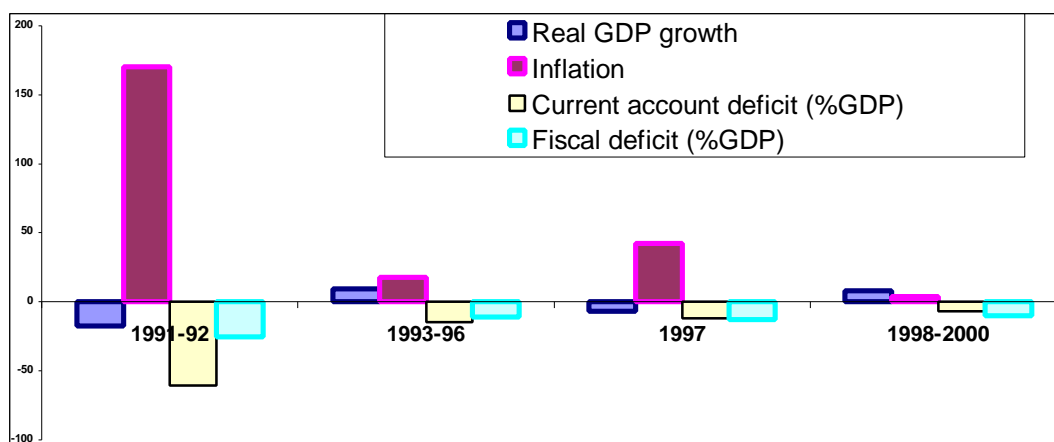
The first reforms were undertaken during this period, consisting in the stabilising package, structural reforms that began with privatisation, establishment of the network of social

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<sup>13</sup> The economic recession of 1997 with -7% does not permit us to say that economic growth was steadily, contrary Albania is classified in the group of countries with unsteady growth (see Fisher and Sahay, 2000, Havrylyshin Oleh et al., 1999)

insurance and the reform of financial and tax systems. Only in mid 1992 the first stabilising and structural reforms were undertaken, consisting in the total convertibility of current account, unification of exchange rates, abolishment of quotas on foreign trade and liberalisation of the majority of prices, measures that were widely radicalised in the second period. As a result of these first reforming measures and the humanitarian aid, the pace of recession was considerably slowed down from  $-285\%$  to  $-7\%$ , while inflation reached the highest levels of this transition period ( $236.6\%$ ), mainly as a result of the liberalisation prices in the conditions of a high percentage of cash over GDP of  $0.576$ , that is higher than the standard (see Bruno, 1992 and Table 1).

*Figure 1. Macroeconomic stabilisation in Albania, 1991-2000*



Second period (1993-1996).<sup>15</sup> This period was characterised by a considerable economic growth of  $9\%$  per year, the reduction of inflation in the average level of  $17.5\%$  and a considerable improvement of current account and fiscal deficit, although in very high levels. This positive development was a result of restricted monetary and fiscal policies that compensated the inflationist pressure of price liberalisation and privatisation of agriculture, retail and wholesale trade, small and medium enterprises that generated the economic growth.

During this period the privatisation of agricultural land reached the level of  $93\%$  at the end of 1993; began the application of the reform in the tax system that progressed with the

<sup>14</sup> Actually, the annual inflation rate in October of 2001 is was  $1.79\%$  (Bank of Albania).

<sup>15</sup> Although the economic growth in this year was  $9.1\%$ , the inclusion of 1996 in this period is debatable. Considering the negative political and economic developments as well as the contested elections of 1996, the large budget spending for electoral purposes, and the galloping extension of pyramid schemes, this year not only contributed to the deep crises of 1997, but in many macroeconomic indicators the crisis was clearly presented in the tripling the inflation in  $17.4\%$  and the increase of budget deficit in  $12.9\%$ .

introduction of a new tax on the value added (VAT); emerged the market for the treasury bills and began the mass privatisation by vouchers, while the majority of small enterprises were privatised. An important step was taken towards the independence of Bank of Albania through the new law of 1996 that determines the protection of price stability as fundamental objective of Bank of Albania.

Third period (1997). The deep economic and politic recession that occurred as a result of the pyramid schemes' collapse but that gave the first signals since in 1996 and had a wider basis,<sup>16</sup> lead to the reduction of production with 7%, increase of inflation in 45% and worsening of current account and fiscal deficit. The new government of mid 1997 applied a post-crisis programme relied on the international donators and further radicalised the structural reforms, particularly in the area of the privatisation of medium and large size enterprises and the strategic sectors. To reduce the fiscal deficit by increasing the budget revenues that considerably declined as a result of deep recession, the government notably increased VAT to 20% that for the moment put pressure on the increase of prices that however was not experienced.

Forth period (1998-2000). This was a period of macroeconomic restabilisation and progress in structural reforms related to the deepening and conclusion of privatisation of SME and the formulation of the privatisation strategy for large and public service enterprises. During this period, important progress have experienced the reforms of financial sector related to the privatisation of state owned banks and emerging of new private banks that have improved the financial intermediation and increased the quality of banking services. The achieved stabilisation and deepening of reforms lead to an increase of GDP with 7.7% and decrease of inflation to 3.9%. Although the improvements in the fiscal balance and current account, they are still in relatively high negative levels, respectively –10.4% and 7.1% of GDB.

### *III.2. Inflation and stabilisation*

The economic growth is mainly related to the macroeconomic stabilisation. According to Fischer et al., (1996) 'growth requires stabilisation and stabilisation leads to growth.'

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<sup>16</sup> The poor governance expressed in the high level of corruption and institutional and market weakness as well as the delays in the structural reforms particularly in the banking sector are other very important factors that

Referring to their arguments on inflation, there is 'a red line beyond which the increase cannot be sustainable' and an inflation threshold<sup>17</sup> such that we can have an economic growth, hence the reduction of inflation will be accompanied by further economic growth.

The analyse of macroeconomic stabilisation and particularly inflation, is present in a variety of literature of domestic and foreign authors.<sup>18</sup>

The stabilisation programmes generally aim preventing and reducing inflation; reestablishment of fiscal balance and improvement of foreign balance and rely on a mix of fiscal, monetary, balance of payment and exchange rates policies. The rigorous controlling policies of the increase of money supply and government expenditures are very important to keep a low inflation. Also, for a small and open country, with a high level of imports and inelastic demand for imports, keeping the exchange rates helps to maintain the prices of commercial goods in accordance with the foreign prices.

### *III.2.1. The monetary policy*

In the first stages of transition, the fast increase of government loans for state enterprises led to a monetary expansion that helped the increase of inflation. In mid 1992, important reforms were undertaken in the banking area consisting in the establishment of Bank of Albania as a new central bank and the transfer of commercial operations at the National Bank of Albania. Bank of Albania gained its independence, which has been continuously extended resulting of a particular importance to apply a full stabilisation programme.

Since the beginning, a response had to be given to the dilemma whether the disinflationist programme had to a stabilisation relying on the control of money supply or stabilisation relying on exchange rates.

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helped the crisis. According to EBRD (Table 5) the reform index in banking sector in 1996 was 2.0, while the index of policies on competition and reform of non-banking financial institutions was 1.7.

<sup>17</sup> This threshold beyond which there is no economic growth is valued in different levels from different studies of various countries in transition. For Fischer et al., (1996) this threshold is 50%; for Bruno and Easterly (1995), this threshold is at the level of inflation equal to 40%, while Christoffersen and Doyle (1998) this threshold is valued in the low level of 13%.

<sup>18</sup> See Pashko (1993), Domac and Elbirt (1998), McNeilly and Schiesser (1988), Haderi et al., (1999), Rother (2000) and Sadiraj (2000).

In Albania, as well as in other countries of Southeast Europe, the choice of a flexible regime of exchange rates was dictated by the lack of reserves in foreign currency necessary to support a fixed regime; considerable volatility of balance of trade and current account and inability to value the rate at which the domestic currency had to be fixed (IMF 1994, Sadiraj, 2000). Control of wages and loans also served as nominal spiral of the stabilisation programme, which is in accordance with the view of Sahay and Vegh (1995) that a spiral of nominal wage has a particular importance for the success of money based stabilisation programmes, in the countries in transition.<sup>19</sup>

By applying the monetary policy aiming the prevention of inflation and promoting the economic growth, Bank of Albania chose as an intermediate objective the monetary base and as instruments of monetary control the limit of credit and establishment of interest rates on the term deposits in the state owned banks. Through these instruments, the Bank of Albania imposed hard budgetary constraints to control the increase of cash and credit. The reduction of subventions by eliminating the subventions of enterprises and a part of subventions for prices led to their fall from 20.3% in the first half of 1992 to 2% in 1993 and further in 0.4% in 1999 (IMF, 1994). For state owned enterprises it was also established a rigorous system of credit control.

All these measures led to the fall of monetary increase from 182% in 1992, to 45% in mid 1993 and 42% in 1994. From the other side, the increase of the real balances of money in a consistent way until 1996, it was a signal of the increase of credibility of the stabilisation programme demonstrating that inflationist trends of public had fallen and population was ready to hold more money. The overall speed of money circulation after the initial increase from 1.9 in the first quarter of 1993, to 2.6 in the second quarter of 1994,<sup>20</sup> then fell in a consistent way demonstrating that the economic growth came with the decrease of inflationist expectations and the increase in the credibility of stabilisation programme.

Credibility of stabilising policy also increased because of the application of a hard constrained fiscal policy combined with a constrained monetary policy. The absence of securities market obligated government to get finance directly from Bank of Albania, hence increasing the

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<sup>19</sup> The total lack of wage indexation and syndicalism pressures considerably facilitated the use of nominal wage as a means to help in the reduction of inflation (Table 6).

<sup>20</sup> See Haderi et al., (1999)

money supply, which above all depends on the size of fiscal deficits. Other research undertaken from Domac and Elbirt (1998) confirms the fact that the credit for government and money supply are important variables to determine inflation.

The adjustment of interest rates as an instrument of monetary policy had an important impact on stabilisation of inflation promoting the increase of deposits and providing the opportunity that real rates to become positive in a short time, by 1993. Relaxation of monetary policy that was conditioned from the pyramid schemes phenomenon and the increase of budgetary expenses due to electoral campaign, lead to the increase of inflation at the end of 1996.

The interest rates offered by informal market were so high that completely eliminated the role of monetary policy. The hard crisis of 1997 that was accompanied by a total anarchy hardly damaged the public confidence and led to the flow of bank deposits and increase of funding for budget deficit from Bank of Albania. As a result the level of inflation at the end of 1997 arrived at the high figure of 42.1%.

The stabilising policies of post 1998 period initially involved the increase of interest rates. In a very short time the fast and proper response of public led to the substantial reduction of inflation of 8.7% at the end of 1998 and negative levels in 1999. After this first phase we have a lessening of monetary policies by considerably reducing interest rates. During this period the instruments of monetary policy also evolved and the role of credit limit considerably decreased until it was abolished in 1999, maintaining in use only interest rates of term deposits that soon were replaced by market instruments, where the main instrument is the interest rate of repurchase agreement.

### *III.2.2. Fiscal policy*

The reduction of budget deficit is another key factor for a successful stabilisation. This was the reason why the fiscal authorities aimed to keep under control and reduce the budget deficit since the beginning of transition. The considerable lay-offs in the public sector<sup>21</sup> led to the reduction of wage expenses accompanied by the decrease of real wages in 1992 (Table 6) and then small increases until 1996. The government also abolished the control on the

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<sup>21</sup> The number of employees in the public sector fell from 790,000 in 1992 to 296,000 in mid 1995 (Haderi et al., 1999) while the number of employees excluding the state enterprises and armed forces in 2000 was 129,640 (Department of Public administration)

contribution of social securities establishing a new system that rigorously regulates the criteria of payment limiting the profits from employment up to one year.

On the other side, the new laws on taxes that replaced the old system of differentiated tax with the new system of uniform tax on enterprise profit and establishment of circulation tax by improving the fiscal administration generated increasing revenues that improved the fiscal deficit from 20.4% in 1992 to 10.3% in 1995.<sup>22</sup> Up to 1994 the domestic source of financing the budget deficit was the direct credit from Bank of Albania. The treasury bills of 3 months maturity were issued for the first time in July 1994 until 1995 when the first 12 months treasury bills were firstly issued providing the opportunity to finance the deficit through the banking system and avoiding the inflationist pressures.

The increase of government expenditures at the eve of electoral campaign of 1996 and relaxation of tax collection increased the budget deficit in 12.9% at the end of 1996<sup>23</sup> that was a level also maintained during the crisis of 1997. Regardless the legal restriction of financing the budget deficit that derives from the law on annual budget and Bank of Albania, the government could finance the increased expenditures of 1996 by amending the law on budget and using the other legal spaces allowed by the law on Bank of Albania. The post-crisis programme aimed again to reduce the deficit by increasing the level of revenues and further improving the tax legislation and fiscal administration, with the resulting budget deficit of 9.1% in 2000 (Ministry of Finance).

### *III.2.3. The nominal exchange rate and foreign resources*

The nominal exchange rate is an important component of a successful stabilisation programme. In Albania because of the reasons mentioned above, it was chosen the flexible regime of exchange rates. The relatively high proportion of import goods (about 30%) in the consume basket and the relatively inelastic demand for import goods<sup>24</sup> makes the evaluation and devaluation of exchange rates an important factor effecting the volatility of price levels of import goods and therefore the level of CPI.

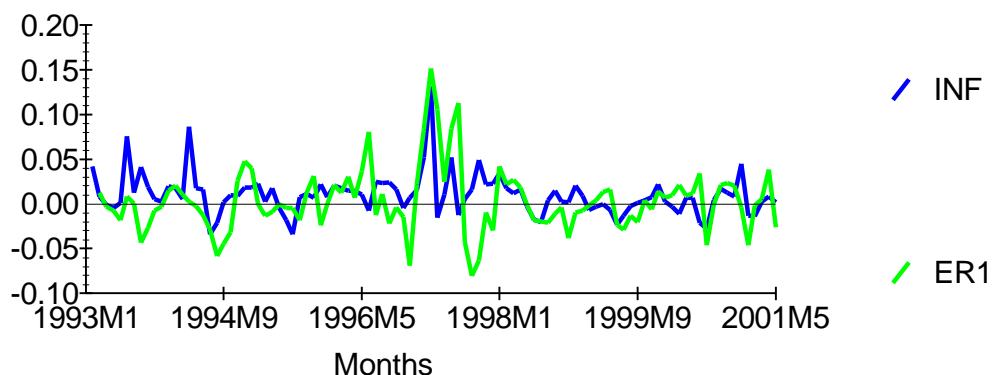
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<sup>22</sup> Statistical evaluations of Ministry of Finance and IMF.

<sup>23</sup> The legal restriction of financing the budget deficit through banking system derives from the law on annual budget, while the law on Bank of Albania regulates financing from Bank of Albania.

Various studies (Domac and Elbirt 1998, Mançellari et al., 1997, Mytkolli 1997) demonstrate for a positive correlation between the level of inflation and the nominal exchange rates during 1993-1997. This correlation is also confirmed from evaluations of Bank of Albania (Kolasi et al, 2001). Empirically, all these studies certify an adjustment with one-month delay, of the changes in the exchange rates and level of inflation (Figure 2)

Figure 2. The nominal exchange rates and inflation in Albania, 1993-2000



Besides the considerable worsening of current account since the beginning of transition that is result of the deterioration of trade balance<sup>25</sup>, the current account is considerably improved because of the revenues from private and formal transfers, moving from 14% of GDP in 1994 to 7% in 2000 (Bank of Albania). The relative stabilisation of exchange rates particularly during 1993-1996 and 1998-2000 to a large extent it is attributed to remittances that have been continuously increasing and reaching the level of USD 439 million in 2000 (Bank of Albania). This is also confirmed by the empirical findings demonstrating negative correlation between the remittances from abroad and the level of inflation (Haderi, et al)

Another important factor that effects the short-term stabilisation of exchange rates is the illegal activity related to the traffic of drugs, prostitution, clandestiners, etc. Although the studies and data given on these issues are insufficient,<sup>26</sup> the relative stability of exchange rates

<sup>24</sup> See Mançellari et al., 1997.

<sup>25</sup> Liberalisation of foreign trade, reforming changes in the main trade partners and the deformed structure of Albanian industry led to a drastic fall of exports, while imports are a constant source of consuming goods.

<sup>26</sup> See Muço and Salko (1996). According to a survey on the informal market of exchange in January 1996, results that the contraband and illegal trade during the UN's embargo against ex Yugoslavia have effected the volatility of exchange rates.

during the periods of political and economic destabilisation can be explained in an acceptable way from this factor.

#### *IV. The factors influencing growth during the economic transition*

Several studies (e.g. Fischer et al, 1996 and 1998, EBRD 1997) that analyse the growth factors in countries of transition include in their models factors as starting conditions, inflation, budgetary surplus, restructuring index, growth of population, number of students recorded in the high schools and level of investments over GDP. The empirical evidence from various studies demonstrates that exists a widespread consensus that stabilisation is a necessary condition for the GDP growth.<sup>27</sup> Second, regardless of contradicts that exist, it is wide accepted that liberalisation and structural reform are very important for the growth. Third, institutions and other conditions as rules and laws, corruption, justice, tax burden, etc. are other factors that although not so measurable as the first, do have a significant importance for the growth. Last, the classic factors of the growth theory, as investments, work and human capital are used not so much in the models, reflecting the view that after recession during short-term periods the economic growth has some particular features.

According to the ideas generated from the mentioned studies, acceptable explanations can be given for the growth factors of Albanian transition. Macroeconomic stabilisation and stable policies clearly explain the fast regeneration of GDP after the recessions of the beginning of transition and 1997. Besides the fact that the low starting basis creates the conditions for a greater growth pace when the economy starts recovering, the unfavourable initial situation that conditioned the deep recession of GDP at the beginning of transition were compensated from the positive effect of privatisation particularly in the agriculture, services and construction sectors (Figure 3). Amongst the other factors, the poor governance and incomplete structural reforms particularly in the financial sector (see Table 5) that led to the riot of 1997, can explain the destabilisation and recession of that year.

Referring to a study of researchers from IMF, the macroeconomic stabilisation is the main factor influencing the Albanian growth. In the Albanian case, besides this factor and ranked according to the given importance, have also had positive influences the liberal trade regime,

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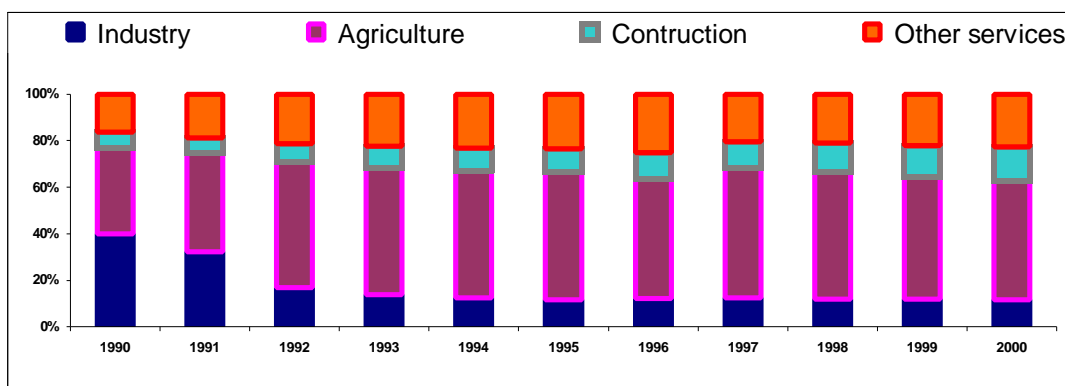
<sup>27</sup> See Fischer et al, 1998.

geographic position, regeneration from a low starting point being excluded from privatisation, foreign direct investments, domestic demand, banking and tax reform, maintaining a high level of investments (Havrylyshin et al 1999).

The following figure represents clear trends of the contribution of various sectors in the GDP, where the industry share is reduced from about 40% in 1990 to 11.5% in 2000, while in the first years of transition it is considerably increased the share of agriculture, services and construction, with the last continuously increasing up to 2000. The structural changes of GDP during the transition period reflect the effect of price liberalisation and the shift of demand from one sector to the other. The significant recession of industry was due to the high degree of price distortions during the centralised economy that relied on the priority of heavy industry, and the under valuation of services that after the price liberalisation led to the relative reduction of industrial products' prices if compared to services. The shift in demand and the decrease of foreign demand as a result of the liberalisation of current account and foreign trade, is another factor influencing the recession of industry

The agriculture sector experienced a significant growth because of the fast privatisation and the falling share of industry. At the same time, the price signals pressurised the resources shift that favoured the construction and service sectors, hence reflecting an increased domestic demand for their products.

Figure 3. Albania: GDP according to the origin, 1990-2000



## **V. Role of IMF's supporting programmes in the macroeconomic stabilisation and reforms' progress**

The support of international financial institutions and particularly IMF, to formulating and applying the reforms of transition, as in the other countries of CEE has been complex and of a positive impact and importance for Albania. This support materialised in various programmes as SBA and ESAF (respectively ESAF1 and ESAF2) consists in three fundamental aspects.

First, advises on policies. In the conditions of a lack of knowledge and experience on market economy that became the objective of future reforms, the need for experts' advise was indispensable. Of the same importance was the help of IMF's staff, which later was transformed in a continuous and periodic collaboration, to formulating and applying the policies of achieving and consolidating the macroeconomic stabilisation and accelerating the structural reforms.

Second, the programmes of technical assistance, which helped adjusting the monetary and fiscal systems, as well as the statistical system of exchange rates according to the requirements of a market economy. In Albania, the main areas of the assistance focus have been the policy and administration of taxes; accounting of national bank; bank supervision; improvements of monetary and fiscal statistics, national revenues, balance of payments and prices.

Third, financial support through SBA and ESAF programmes (Table 9). The analyses of IMF's supporting programmes, from their projection and application point of view, demonstrates that the countries with the most successful application of IMF's programmes experience the best macroeconomic achievements, more sustainable stabilisation and economic growth. The higher level of this index for Albania compared with the other countries of SEE, confirms this finding.<sup>28</sup>

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<sup>28</sup> The positive correlation may also reflect the high level of authorities' commitment to apply the macroeconomic stabilisation policies and structural reforms. This is also confirmed by statistical data

## **VI. Macroeconomic consolidation and future challenges**

The achieved success on the macroeconomic ground is as evident as it is fragile. Its consolidation and long term stability require facing short and long term challenges that are related to fiscal consolidation, increased effectiveness of monetary policy and price stability, intensifying of structural and institutional reforms particularly privatisation of strategic sectors of economy, financial sector development, maintaining and developing the human capital and improving the governance.

### *VI.1. Fiscal consolidation*

Reducing the budget deficit and maintaining an acceptable and constant level of public debt, while their levels are relatively high, are necessary requisites for a long-term fiscal consolidation. To maintain a constant level of debt requires long-term debt not to increase faster than the available resources serving it. Fiscal consolidation is a requisite to providing a sustainable economic growth but also a result of the sustainable growth. Only a sustainable growth provides increased budget revenues that are necessary to cover the increased government expenditures and reduce budget deficit, which from the other side is the premise to reduce the public debt.

The long-term economic growth requires increased expenditures for education and public health as well as public investments. In the conditions of an increased fiscal consolidation, the raise of public expenditures should be covered by a high-speed growth of revenues. Considering the increased pressure and need to stimulate the business and meet the obligations deriving from the membership in WTO, which require to reduce or at least not increase the taxes, the revenues increase requires the improvement of fiscal administration and extend the taxable basis.

Improving the tax system by overturning the rapport of tax revenues from customs<sup>29</sup> and simplifying the tax system hence reducing the tax collection costs and eliminating the abusive opportunities of state organs in collecting taxes, are requisites to increase the budget revenues and stability of fiscal consolidation.

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demonstrating a relationship between the index of reform application and economic growth (Havrylyshin Oleh et al., 1999).

## *VI.2. Increasing the effectiveness of monetary policy*

The monetary policy applied by the Bank of Albania as a function of its objective of maintaining the price stability requires the increase of its effectiveness. The increase of effectiveness of monetary policy cannot be achieved if we do not perfect the transmission mechanism, which requires the improvement of financial market in general and particularly money and capital markets. To reduce the cost of credit and increase investments, Bank of Albania through its monetary policy instruments should pressurise cutting of differences between credit and debit interest rates.

Improving the strategy of monetary policy is another alternative means aiming at the possible shift from targeting the money to targeting the inflation, and this could improve the effectiveness of monetary policy.

## *VI.3. Institutional and governance improvements*

One of the challenges of Albanian transition that should be tackled in order to provide long-term stabilisation and growth is the institutional and governance improvement. The transition experience demonstrates that while the governance improves, yet it is far from being good governance; instead in many cases it is proved to be bad governance.<sup>30</sup> Frequently, bad governance it is identified with corruption, while good governance means much more than just fighting corruption. First, it involves the establishment of an efficient legal system that refers not only to the legal basis but also to the application of law that guaranties the exercise of individual property rights hence encouraging activities that bring economic growth.<sup>31</sup> The governance of transition period and institutions suffer the poor application of laws and contracts; the lack of land market and property problems related to it; unsustainable economic policies related to the frequent changes in the tax system, administrative procedures, etc.; the structural weakness related to energetic crises and transport infrastructure; the high level of informal economy and unfair competition; the high perceived risk from business and banks;

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<sup>29</sup> This rapport of customs' revenues in the total of revenues is increased from 54% in 1996 to 58% in 2000 (Ministry of Finance).

<sup>30</sup> For more details see GRPS (2001), World Bank, Albania beyond the crisis (1998).

<sup>31</sup> According to Dhonte and Kapur (1977) and Johnson (1977) good governance involves maintaining a reasonable economic stability; laws and efficient rules, which are not applied in a discriminative way; predictable, stable and faithful government activities in the area of economic regulation that is related to taxes, licenses, natural monopolies, financial activities.

the lack of transparency and information and poor application of accounting and monitoring standards.

The most dubious and at the same time the less measured and fought aspect of the bad governance of Albanian transition is corruption. The scarce studies of this field demonstrate significant levels of corruption forms in various positions of central and local administration and juridical system, which prevent business development, increase costs and unfair competition.<sup>32</sup> According to a classification, Albania is ranked 84 out of 99 countries for the level of corruption (Human Development Report, 2000). On the other side, the capacity of public sector to fulfil its functions results conditioned from the lack of responsibility and low institutional capacity (World Bank, 1998).

#### *VI.4. Increasing the quality of education*

The knowledge and qualification of employees as long-term factors of growth are an important resource for the countries in transition (EBRD, 1997). Many models used from various researchers to explain growth, employ the rate of registration at the high schools as a measure of these factors (Fischer et al., 1996).<sup>33</sup> Although the high inherited level of education and working practices in the countries of Central and Eastern Europe (including Albania), if we relate working practices and qualification with education, the three main resulting groups of indicators represent a worsening of the education level for the population during the transition period, that could undermine the future economic growth.

First, in our country the registration rate significantly fell at the beginning of transition from 90.8 in 1989 to 87.6 in 1994 (Ellman, 2000), while in 2000 only 90% of school age children attend the compulsory education. Only 82% of children recorded in the first year finish the elementary school. Compared with 1990, in 2000 the level of registration in the high schools has fallen by 36%. 12% of the population over 15 years old is analphabetic (GPRS, 2001). The drop in the registration level<sup>34</sup> is also expressed in the decrease of the average education length from 11.6 years in 1989 to 9.5 years in 1989 while compared with 1990 there is an

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<sup>32</sup> Referring to a survey undertaken from ACER (1998), 15% of citizens bribes to obtain services from state administration, 40% bribes for medical services; instead according to Çipi (2001) about 60% of citizens bribes for medical services.

<sup>33</sup> At Fischer et al., (1996), the empirical evidence resulting from the testing of growth equation used in his model that analyses 26 countries in transition, certifies the importance of this variable for the medium and long-term growth.

<sup>34</sup> The registration rate in the high school fell from 0.79 in 1990 to 0.67 in 1998 (Dumani and Ruseti, 2001).

increase in the number of students attending the universities from 10 to 17% (World Bank, 2000).

Another important indicator would be the level of budget expenditures for education, which is very low, only 3-4% of GDP and 9-10% of state expenditures and what is more preoccupying is the decreasing trend of this indicator (see Table 8).

The brain emigration is the third worsening indicator of work force qualification level in Albania. According to some studies results that up to 1999, 40% of our universities pedagogues and researchers have emigrated and about 63% of interviewees want to emigrate (Gëdeshi, 1999).

As a result of participation increase in the secondary education and particularly in the high education; the quality of teaching staff; the budget expenditures for education and financially motivating the teaching staff and particularly the pre-university staff; are challenges that cannot

## Conclusions

- The successful macroeconomic stabilisation, despite its volatility, has in its basis the fast and complete liberalisation of prices; the structural reforms and particularly the privatisation of agricultural land and SME; restricted monetary and fiscal policies; the private and formal transfers from abroad, which help the relative stabilisation of exchange rates; and the help from the foreign factor and particularly the international financial institutions as IMF, World Bank, etc.
- Although the relatively low levels, the economic growth in Albania has been sustainable (in year 1999 – 7.0%) and only in 2000 the level of real GDP exceeded the level of 1989 (102% of real GDP of 1989).<sup>35</sup> In this trend has influenced the low comparative basis, the achievements in macroeconomic stabilisation and structural reforms, and particularly in privatisation. However, they are more related to an extensive growth of production.
- The budget deficit is still very high (9.1% in year 2000) while the foreign debt although has been decreasing since 1994 (52%), as a percentage of GDP is remains high (28% in year 2000). Whilst the domestic debt is increased from 25.1% of GDP in year 1995 to 34% of GDP in year 1999 (Ministry of Finance).
- Although the relative stability, the exchange rates are unstable because of the great deficit of trade balance, influencing the stability of price levels. The up to now researches demonstrate for a strong correlation between inflation and exchange rates. The profound deficit of balance of trade is also expressed in the dependence of import financing from foreign resources. In year 2000, the remittances from emigration amount for about 40% of imports (Bank of Albania).
- The Albanian economy is characterised by a high degree of informal sector, which evaluated with reservation amounts for about 30-50% of GDP (Bank of Albania) and which mainly exploits the institutional weakness. Despite the short-term stabilising effects, referring to the experience of Albanian transition, the informal sector obstacles the formal economy, deforms the market and distorts the allocating signals that market provides, promotes corruption, impedes the technical innovation, bringing particularly long-term negative effects.

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<sup>35</sup> EBRD: Transition report update, April 2001.

- Long-term macroeconomic consolidation is Albanian economy's challenge that is related to the fiscal consolidation, effectiveness increase of monetary policy, intensifying the structural reforms particularly in the financial sector, and privatisation of large and strategic enterprises.
- Improving governance and market institutions by reducing corruption, increasing the responsibility and efficiency of administration, perfecting the competition and protecting consumer, perfecting the law and its application, giving priority to education, public health and public investments particularly in infrastructure, are prerequisites for a sustainable and long-term growth of Albanian economy.

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## ANEX

**Table 1. Albania: Selected Indicators at the start of Transition**

Population (1991, Annual Average) <sup>1</sup> 3,242,000  
 GDP per capita (1991) <sup>2</sup> \$340.0  
 GDP Growth (Annual Average, Constant Prices) <sup>3</sup>  
     1970s 5.0%  
     1980s 0.8%

Administered Prices 100%  
 State Ownership Economy-Wide  
 Broad Money/GDP<sup>4</sup> 0.576  
 External Debt/GDP (1991) <sup>5</sup> 0.573

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 Sources:

1. IMF (1994)
2. World Bank estimates
3. IMF (1992). The figure for the 1970s is an approximation and refers to Net Material Product.
4. IMF (1994). The figure is the ratio of broad money at the end of the third quarter in 1991, divided by annualized GDP.
5. IMF (1994) and World Bank estimates. External debt is the sum of convertible and non-convertible components.

**Table 2 Macroeconomic Indicators, 1991-2000 (annual averages percent)**

	1991-92	1993-96	1997	1998-2000
Real GDP growth	-17.6	9.3	-7	7.7
Inflation	170.5	17.5	42.1	3.9
Current account deficit (%GDP)	-61.1	-15.1	-12.1	-7.1
Fiscal deficit (%GDP)	-25.8	-11.4	-12.9	-10.4

Source: Ministry of Finance

**Table 3 Albania: Macroeconomic Performance, 1991-2000**

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Real GDP growth	-28	-7.2	9.6	9.4	8.9	9.1	-7	8	7.3	7.8
Inflation	104.1	236.6	30.9	15.8	6	17.4	42.1	8.7	-1	4.2
Domestically financed deficit	-34.4	-20	-9.1	-7	-6.6	-10.6	-10.5	-6.4	-5.2	-3.2
Fiscal deficit (%GDP)	-34.4	-20.4	-14.4	-12.4	-10.3	-12.9	-12.9	-10.4	-11.4	-9.1
Revenues (%GDP)	32	23.5	25.7	24.5	24.1	18.3	16.9	20.3	21.3	22.4
Expenditures (%GDP)	64	44	34.9	31.2	30.8	30.3	29.4	30.7	32.7	31.4
Unemployment rate (%)	8.9	27.9	29	19.6	16.9	12.4	14.9	17.8	18	16.8
Current account deficit (%GDP)	-18.8	-14.7	-3.7	-5.9	-2.4	-6.2	-8.7	-3.2	-3.4	-4.2
Current account deficit (%GDP)/1	-18.8	-61.1	-29.7	-14.1	-7.3	-9.1	-12.1	-6.1	-7.2	-7
Trade Balance/GDP (%)	-27.7	-64	-39.9	-23.2	-19.6	-25.7	-22.7	-20.4	-18	-21.7
Gross international reservs (months of imports)		1.4	2.3	3.2	3.5	3.1	3.8	4.2	3.8	4.4
Broad money growth (in percent)	110	152.7	75	40.6	51.8	43.8	28.4	20.7	22.3	12
Growth in private sector credit (in percent)			----	61.4	15.9	30.5	19	14.7	22.6	29.4
Broad money / quart. GDP			3.68	2.83	2.22	1.97	1.92	1.92	1.73	1.63
Interest rate (3 months deposits)			14	7	10	18.5	26	20.4	14.8	7.8
Velocity of circulation			3.68	2.83	2.22	1.97	1.72	1.92	1.7	1.6
Exchange Rate(lek/\$)	25	98.7	98.68	95.39	94.24	103.1	149.1	141	135	142.6
Debt/GDP (%)				52.5	55.5	59.9	71.4	59.4	62.2	70.7
External		130.1	78.9	51	28	27	33	29	27	28
Foreign direct investment (mil US\$)	na	20	45	65	89	97	42	45	51	92
GDP per capita (in US dollars)		195	375	604	761	817	687	908	1102	1022

1/ Excluding official transfers

Source: IMF staff estimates and Bank of Albania

**Table 4 GDP in Albania by sector of origin** (Percent change over previous period)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
<b>Gross domestic product</b>	-10	-28	-7.2	9.6	8.3	13.3	9.1	-7	8	7.3	7.8
Industry	-14.2	-41.9	-51.2	-10	-2	6	13.6	-5.6	4.1	6.4	5
Agriculture	-5.4	-17.4	18.5	10.4	8.3	13.2	3	1	5	3.7	4.5
Construction	-12	-30	7	30	15	21.2	18.4	-6.3	21	15	18
Other services	-8.4	-16.8	-6	29	29	32.2	19.2	-45	30	27	25
	(Share of GDP at constant 1990 prices)										
<b>Gross domestic product</b>	100	100	100	100	100	100	100	100	100	100	100
Industry	39.8	32.1	16.9	13.9	12.5	11.7	12.2	12.4	12	11.9	11.5
Agriculture	37	42.5	54.2	54.6	54.6	54.6	51.1	56	54.4	52.6	51
Construction	6.6	6.6	7.6	9.1	9.6	10.3	11.2	11.2	12.6	13.5	14.8
Other services	16.4	18.7	21.3	22.5	23.2	23.4	25.1	20.4	21	22	22.7

Source: Bank of Albania

**Table 5 Albania-Main Transition Indicators 1991-2000**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
EBRD Index of price liberalization	1.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalization	1.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD Index of small-scale privatization	2.0	2.0	3.0	3.0	4.0	4.0	4.0	4.0	4.0
EBRD Index of large-scale privatization	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0
EBRD Index of large enterprise reform	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD Index of competition policy	1.0	1.0	1.0	1.0	1.0	1.7	1.7	1.7	1.7
EBRD Index of banking sector reform	1.0	1.0	1.3	2.0	2.0	2.0	2.0	2.0	2.0
EBRD Index of non banking financial institutions reform	1.0	1.0	1.0	1.0	1.0	1.7	1.7	1.7	1.7
Privatization revenues	Na	1.1	1.8	3.0	3.1	3.3	3.6	3.6	3.9
<b>Private sector share in GDP</b>	<b>5.0</b>	<b>10.0</b>	<b>40.0</b>	<b>50.0</b>	<b>60.0</b>	<b>75.0</b>	<b>75.0</b>	<b>75.0</b>	<b>75.0</b>

Source: EBRD Transition Report, 2000

**Table 6 Albania: Employment and Wages in Budgetary Institutions**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Employment (in thousands)	207.1	185.4	167.8	156	151	150	135	128.4	122.1
Monthly wage ( in leks)	1879	4738	6962	8745	10491	10491	13234	13195	15078
Percent change in wages		64.5	46.9	25.6	20	0	26.1	-0.3	14.3
Real wage (Dec. 95=100)	52.9	66.5	84.4	100	102.2	71.9	83.5	84.1	92.2
Percent change in real wage		25.7	26.9	18.5	2.2	-29.6	16.1	0.7	9.7

Source: IMF and Albanian authorities

**Table 7. Albania: GDP, Remittances, 1994-2000**

	1994	1995	1996	1997	1998	1999	2000
GDP, current prices (in billion of leks)	184.0	229.7	278.7	341.7	460.6	506.3	539.2
Remittances (in millions of Dollars)	379.1	384.7	476.0	235.7	437.7	188.4	438

Sources: Bank of Albania

**Table 8. Albania: Agreements with IMF, 1991-2000**

Agreement (Albania)	Approval date	Formal date of completion	The percentage of quota purchase	The implementation index of IMF*'s programmes
SBA	26/08/1992	25/08/1993	82.5	Albania: 90.9
ESAF1	14/07/1993	13/07/1996	88.0	Bulgaria: 50
ESAF2	13/05/1998	31/07/2001		Romania: 76.6

Source: Statistics of IMF

\* The index takes values from 0 to 100%, where 100% means that the country is progressing according to all criteria of IMF's programmes without modification of volatility.