
**"THE ALBANIAN ECONOMY:
PERFORMANCE AND POLICY CHALLENGES"**

**4TH CONFERENCE OF
THE BANK OF ALBANIA**



Contents

Welcoming address	1
<i>Professor Dhori Kule</i>	
<i>Dean of the Economics Faculty, University of Tirana</i>	
Complimentary speech	3
<i>Professor Shkëlqim Cani</i>	
<i>Governor of the Bank of Albania</i>	
FIRST PANEL: “THE MARKET ECONOMY: TIME TO ESTABLISH RULES & COMPETITION”	7
<i>Institutional Development of a Market Economy in Albania: Some Observations Based on the Experience of the Financial Services Volunteer Corps</i>	9
<i>J. Andrew Spindler</i>	
<i>Executive Director, Financial Services Volunteer Corps</i>	
<i>Improving the business environment in Albania</i>	15
<i>Franco Pasacantando</i>	
<i>Executive Director for Italy, Portugal, Greece, Malta, Albania and San Marino at the World Bank</i>	
<i>How the business environment in our country is and will be improved</i>	19
<i>Professor Kastriot Islami</i>	
<i>Minister of Finance</i>	
	3

Comments on: "Improving Business Environment in Albania"	23
<i>Professor Shyqyri Llaci</i>	
<i>Economics Faculty, University of Tirana</i>	
<i>Professor Vasilika Kume</i>	
<i>Economics Faculty, University of Tirana</i>	
 Albania's Informal Economy: An Impediment to Economic Development?	27
<i>Jan-Peter Olters</i>	
<i>IMF Resident Representative in Albania</i>	
 Comments on "Albanian Informal Market"	51
<i>Professor Fatmir Mema</i>	
<i>Economics Faculty, University of Tirana</i>	
<i>Ph.D Zef Preçi</i>	
<i>Adviser of the President of the Republic of Albania</i>	
 Assessing Monetary Policy in Albania Using an Interest Rate Rule	59
<i>Hossein Samiei</i>	
<i>Financial Division Chief, European I Department, IMF</i>	
 LUNCHEON SPEECH	69
 Few words about the distinguished guest, Mr. Dervish	71
<i>Professor Shkëlqim Cani</i>	
<i>Governor of the Bank of Albania</i>	
 Complementary speech	73
<i>Kemal Dervis</i>	
<i>Member of the Parliament of the Republic of Turkey</i>	
 SECOND PANEL: "POTENTIAL CHANNELS OF FOREIGN EXCHANGE CONTENTS INFLOWS - FROM UNCERTAINTY TO AN EXPORT - ORIENTED ECONOMY"	79
 Sustainability of current account balance	81
<i>Professor Ahmet Mançellari</i>	
<i>Economics Faculty, University of Tirana</i>	
<i>Ph.D Selami Xhepa</i>	
<i>Albanian Center of International Trade</i>	

Comments on: "The sustainability of current account deficit"	111
<i>Ph.D Erjon Luçi</i>	
<i>Head of Research Department, Bank of Albania</i>	
<i>Ph.D Evelina Çeliku</i>	
<i>Deputy Head of Research Department, Bank of Albania</i>	
Role of Remittances in the Social Economic Development of the Country	117
<i>Assoc.Prof.Dr. Esmeralda Uruçi</i>	
<i>Head of Public Relations Department, Bank of Albania</i>	
<i>Ph.D Ilir Gedeshi</i>	
<i>Center for Economic Studies</i>	
Comments on: "Role of remittances in the social economic development of Albania"	135
<i>Kliti Ceca</i>	
<i>Deputy Head of IT Department, Bank of Albania</i>	
Constructing the path of the albanian exports for the future	141
<i>Professor Bardhyl Ceku</i>	
<i>Economics Faculty, University of Tirana</i>	
Comments on: "Constructing the future path for Exports"	159
<i>Sokol Qeraxhiu</i>	
<i>Head of IT Department, Bank of Albania</i>	
Comments on: "Foreign trade agreements: the benefits and drawbacks"	165
<i>Professor Sherif Bundo</i>	
<i>Economics Faculty, University of Tirana</i>	
<i>Professor Beshir Ciceri</i>	
<i>Economics Faculty, University of Tirana</i>	
"Capital Account Liberalization - What should Albania do?"	169
<i>Professor Shkëlqim Cani</i>	
<i>Governor of the Bank of Albania</i>	
<i>Diana Shtylla</i>	
<i>Research Department, Bank of Albania</i>	

THIRD PANEL: “ECONOMICS OF TRANSITION” 193

Albania: The Future Path To Sustainable Development 195

Geoff Nicol

Team Leader on the Project "Consulting Services for Macroeconomic & Fiscal Analysis"

Luiza Jano

Director of the Macroeconomic Department at the Albanian Ministry of Finance

Ph. D Ardian Harri

Albanian Long-Term Expert on the Project "Consulting Services for Macroeconomic & Fiscal Analysis"

Comments on: "Albania: The future path for sustainable growth" 251

Sybi Hida

Head of Fiscal Analysis, Budgetary Policies and Investments Sector, Budget Department, Ministry of Finance, Albania

The Size of the Public Sector 257

Professor Dhor Kule

Dean of Economics Faculty, University of Tirana

Professor H.-Dieter Wenzel

University of Bamberg, Germany

When is Transition Over?

Theory versus Reality in Albanian Case 277

Professor Ermelinda Meksi

Deputy Prime Minister

Auron Pasha

Executive Director of IDRA

**Comments on: When is the transition over?
Theory versus reality in the albanian case** 295

Professor Genc Ruli

President of Contemporaneous Studies Institute

FOURTH PANEL: “MONETARY POLICIES IN THE REGION” 301

Inflation, exchange rates and the role of monetary policy in Albania 303

Marta Muço

Anteon Corporation

Peter Sanfey

EBRD

Anita Taci

EBRD

Comments on: “Inflation, exchange rates and the role of Monetary Policy in Albania”	323
<i>Professor Lavdosha Zaho</i>	
<i>Economics Faculty, University of Tirana</i>	
<i>Erald Themeli</i>	
<i>Deputy Head of Monetary Policy Department, Bank of Albania</i>	
Monetary Policy in Greece on the Road to EMU	331
<i>George S. Tavlas</i>	
<i>Director Advisor, Economic Research Department, Bank of Greece</i>	
<i>Theodoros Papaspyrou</i>	
<i>Advisor, Bank of Greece</i>	
Turkish Economy and Monetary Policy Framework	337
<i>Yusuf Bora Enhos</i>	
<i>Deputy Director of General of Foreign Relations Department, Central Bank of Republic of Turkey</i>	
Monetary policy in Croatia - the challenge of slowing down the lending boom	343
<i>Vedran Šošić</i>	
<i>Research Department, National Bank of Croatia</i>	
Monetary Policy Efficiency and Currency Substitution under a Currency Board Arrangement in BiH	349
<i>Dragan Kovacevic</i>	
<i>Vice Governor, National Bank of Bosnia Hercegovina</i>	
Should Bank of Albania adopt the IT regime?	359
<i>Professor Sulo Hadëri</i>	
<i>Economics Faculty, University of Tirana</i>	
<i>Gramoz Kolasi</i>	
<i>Head of Monetary Policy Department, Bank of Albania</i>	
Comments on: “An approach on monetary policy: Selective Balkan’s countries experiences”	377
<i>Marian Gjermani</i>	
<i>Head of Monetary Operations Department, Bank of Albania</i>	
Conclusions	381

WELCOMING ADDRESS

Dhori Kule

Dear ladies and gentlemen, representatives from the Albanian government, international central banks and financial institutions

I have the great pleasure to welcome you in the Fourth International Conference of the Bank of Albania, organized together with the Economics Faculty of the University of Tirana, a conference focusing on the performance and challenges of the economic policy in Albania.

During the two days of this conference, as organizers, we have paid a special attention to including in its content a rich social program and a proper logistic organization.

Hoping to achieve what we aimed at, I would like to invite the Governor of the Bank of Albania, Mr. Shkëlqim Cani, to address the opening speech of the Fourth International Conference of the Bank of Albania: "Albanian Economy: Performance and Policy Challenges".

COMPLIMENTARY SPEECH

Shkëlqim Cani

Dear Ladies and Gentlemen,

I am really glad to greet the honorable guests of this conference, friends and colleagues of mine, those who have continuously assisted in our previous conferences and those participating for the first time this year.

It is a great pleasure for me, that in the name of the organizers of the conference “Albanian economy: Performance and policy challenges”, to express gratitude and respect to the dear friends of Albania and Albanians, who are present here today and who have contributed and have marked the performance of our economy.

I do hope that such meetings also serve as public deeds, delivering a message of gratitude for those contributions, which in a certain way have helped the Bank of Albania in organizing scientific-thinking events regarding subject matters that focus on the Albanian economy.

Dear colleagues and collaborators,

In these 13 years, Albania has been “on track” of progress. The economy is finally development-oriented. As actors of our times, we all are inclined towards the best, towards the future.

Living in a society that is trying to build up a safer future; having institutions that tend to establish outstanding models; establishing a democratic popular mentality oriented towards a positive attitude of a variety of ideas, is a success for the country and for the economy.

The Albanian society, state and mentality have in overall evolved simultaneously. Maybe this is related to our early tradition; maybe imposed by the challenges of our survival through the years; maybe this is related to our greatest desire to see our country and ourselves among the most developed.

One thing is for sure: that progress relies on an economy that is developing. Nevertheless, this speech does not focus on how much and in what way the Albanian economy has grown, what its directions have been and how often it has got stuck. What I would like to underline, is that the Albanian economy has recorded significant and tangible growth, evident to everyone. This growth has is becoming a strong support to our future projects and challenges. This growth strengthens the belief that all of us are trying to give ourselves and our country the best offered by the current development, and that we really do deserve more.

In order to win ever more, one should really try hard; should use efficiently what he has earned and at the end should also have the generosity to leave something to the other generations. Thus, one may ensure the development track.

We have already laid the foundations of an overall economic development. Whether this development is rapid or slow, secure or fragile, peaceful or full of wonders is another issue. What matters is the fact that we have planned for our economy an ambitious future.

Attaining this requires many efforts; requires a clear economic vision; requires courageous decision-making; requires a wide vision while treating problems and real strategies for economic development. And this is what I would most expect from this conference.

My dear friends,

We are gathered here today to speak about an argument that is not unknown to every one of us. What we are going to say, the way

we are going to approach the future of our problems, and the real chances for further progress, all of these, I am sure will be useful. Together with our co-organizers of the Economics Faculty, University of Tirana, have tried our best to achieve this.

Therefore, I would like for this Conference to further serve the mutual economic co-operation and development.

Upon concluding my speech, with the hope to have transmitted all my gratitude to your presence here, I would like to extend my very best wishes to this conference, success to the honorable speakers, and an enjoyable stay in the beautiful city of Saranda to all of us.

Thank you!

FIRST PANEL: "THE MARKET
ECONOMY: TIME TO ESTABLISH
RULES & COMPETITION"

INSTITUTIONAL DEVELOPMENT OF A MARKET ECONOMY IN ALBANIA: SOME OBSERVATIONS BASED ON THE EXPERIENCE OF THE FINANCIAL SERVICES VOLUNTEER CORPS

J. Andrew Spindler

At the outset, I would like to note that we are meeting here on the second anniversary of the terrorist attacks on the World Trade Center and the Pentagon. Our topic at this conference, the performance of the Albanian economy, may seem quite far afield from those terrible and sad events and their repercussions. But strengthening emerging market economies everywhere can help to reduce poverty, improve the quality of people's lives, and address the conditions of hopelessness and despair that can serve as a breeding ground for terrorist ideologies. The forces of market capitalism and globalization have improved the material well-being of hundreds of millions of people, but most of the world's people have not benefited in any meaningful way. Working together, we must somehow find a way to change that.

It is a pleasure and an honor for me to be here today to speak about the institutional development of a market economy in Albania. The focus of my presentation will be on financial market infrastructure. But before considering the pieces of financial infrastructure that are most important for supporting a market economy, I would like to step back and consider more broadly a fundamental question whose answer most of us take for granted. Namely, why should Albania or any other country in transition seek to develop a market economy? I believe that the case for doing so is compelling, but there are risks in pursuing that course as well. I would like to consider some of those risks, as well as steps that

Albania and countries in similar positions can take to reduce their vulnerability and maximize the benefits they can receive from going the market route.

I. THE CASE FOR DEVELOPING A MARKET ECONOMY

What is the case for developing a market economy? The most powerful reason for heading in that direction, I believe, is the potential to improve standards of living within a country for the broadest portion of the population possible. The market mechanism, while by no means perfect, has proven over time to be the most efficient and reliable allocator of economic resources. It offers prospects for economic growth, and a better quality of life, that directed and state-planned economic systems cannot duplicate. When working properly, it offers consumers a vastly broader range of choices, and a greater variety and quality of services, than would otherwise be available. Market-oriented countries also have the opportunity to join the global economy, and to benefit from the advances in technology, the quantum improvements in the speed of processing information, and the access to new markets that now characterize the highly interdependent modern world.

The benefits of a market system also apply to the financial sector. Within the banking sphere, the market mechanism works to allocate financial resources to the most creditworthy borrowers, and to projects that are most likely to produce the highest economic returns. A market-oriented banking system can serve as a powerful catalyst to economic growth, funneling credit to the most viable and promising endeavors. A modern, healthy banking system offers further support for economic growth through the money multiplier effect of bank lending. If the system is functioning properly, and banks are lending based on arm's length decisions about creditworthiness, then a country should be able to achieve significantly higher rates of growth than would be otherwise possible.

But there are also risks. For a country such as Albania to operate a true market economy, it must open its economy and its borders to a vast array of powerful forces. At least in the short run, not all of the consequences are likely to be positive. Throughout much of Eastern Europe and Russia, for example, living standards actually declined in the early years of market reform before beginning to

rise again. In the experience of emerging market countries in other parts of the world, there is further ample evidence of the risks. We at FSVC have recently undertaken work in Morocco, where structural weaknesses and the removal of market protections are adding to the uncertainties as that country becomes increasingly open to the world economy. Foreign companies may start to become significant players in sectors that were once the sole domain of local businesses. Substantial job displacement is likely to occur, and large-scale creation of new jobs will need to be an urgent priority. Inevitably, as further liberalization occurs in Albania, some sectors of the Albanian economy will lose jobs, and in a country already burdened with a high unemployment rate, this is no small matter.

Within the banking sector, the tradeoffs can be quite stark. On the one hand, a closed banking sector may be able to employ more people, and it may also be able to maintain a level of profitability that would be severely challenged if the sector were more competitive and/or if foreign institutions were attracted to the market. But a closed banking system can also quickly become a complacent one, and the goal of providing credit and other important banking services in a quality way may become of secondary concern or lost all together. Whole sectors may not be serviced. For example, a critical sector in any economy, whether advanced or emerging, is the small- and medium-sized enterprise (SME) sector. It is often the key engine for a country's economic growth. If competition in the banking sector is weak, and if the infrastructure for banking and accounting/financial reporting is not well developed, experience strongly suggests that the SME sector will fail to get adequate credit.

II. ARGUMENT FOR STRONG INSTITUTIONS

I would like to make the case to you that strong institutions can help Albania weather the storm of developing a market economy, and, in a broader sense, of joining the global economy. "Institutional Development" covers many constituent components, and I would like to provide a definition of what I mean by this phrase. Specifically, I have in mind all of the infrastructure — physical, legal, conceptual, skill-based, and even cultural — that must be in place in order for a market economy to function. At the core of this institutional infrastructure is a sound, healthy banking system and the rule of law.

Let me begin with the banking component. A healthy banking system serves as the central nervous system of a market economy, providing a reliable repository for people's savings, a critical source of credit to support entrepreneurial activity and ultimately economic growth, and an efficient means of transferring financial resources to facilitate day-to-day commercial transactions in the real economy. A healthy banking system is not built overnight, and I have come to hold considerable respect for the complexity of the institutional components that must be present to enable such a system to work efficiently and reliably. These components include bricks and mortar, but they are the easiest part. Also included are laws, complex systems — ranging from management information systems to the entire payments system — and trained personnel. Ultimately, these must exist a “culture of banking” that reflects intangible qualities such as professionalism, integrity and trust. Some of these components can be developed in a few years. Others can take a generation or longer to build.

A banking system, no matter how well-built, cannot function without the rule of law. Commercial transactions beyond the level of barter will never flourish without respect for contracts. There must also be reliable and widely trusted means of resolving disputes. Critical here is a court system that operates with integrity, and whose judgments are routinely enforced.

III. WHERE IS ALBANIA IN THIS QUEST?

We at the Financial Services Volunteer Corps have made an earnest effort over the last seven years to help build stronger financial infrastructure in Albania, and to promote the institutional development of the Albanian financial system. We believe that tremendous progress has been made, but there is still much work to be done.

A rough picture might appear as follows. Albania's transition poses unique challenges due to its legacy as an isolated country during communist times. Poor physical infrastructure, including transportation, communication, power, and water shortages, has compounded underdeveloped financial infrastructure to create roadblocks to business and economic development. Lack of rule of law and a reliable court system are deterrents to economic growth, as is corruption. Foreign investment levels have fluctuated

in the past few years, but are generally low by regional standards. Geographic concentration of exports is very high, with the top two trading partners receiving more than 80 percent of all Albanian exports. Commodity diversification is low, leaving the economy more vulnerable to external and internal shocks. In 2002, Albania imported *four times* as much as it exported.

The grey economy is large. Conservative estimates suggest that one-third of total economic activity is informal, while higher estimates range from 50 to 60 percent of the economy. This negatively affects tax revenue and the circulation of money in the banking system and economy. Albanians working outside of Albania greatly impact the economy. In 2002, remittances comprised 13 percent of GDP. The Albanian economy is highly dependent on these remittances, which are used mostly for consumption rather than capital investment.

Albania's banking sector is arguably the least developed in the region. A "culture of banking" does not currently exist, and many citizens keep savings under their mattresses rather than in banks. According to Bank of Albania statistics, the ratio of private sector lending to GDP is only 7.2 percent, which is similar to lending in Romania but much less than in other nearby countries. The number of banking offices per capita in Albania is also one of the lowest in the region.

These factors are all hurdles to overcome in order for Albania to develop a strong market economy. However, Albania *has* been making strides toward development. The government has crafted a market-oriented legal and regulatory framework. Macroeconomic stabilization has been relatively successful. Albania has one of the highest growth rates in the region, inflation has been brought generally under control (after a temporary spike last spring), and the banking sector is indeed developing. Currently there are fourteen privately owned banks, while there were only four operational private banks six years ago. The Bank of Albania is a strong institution that is dedicated to promoting the safety and soundness of the banking sector. And there is evidence that the banking sector can handle a serious problem — the run on the Savings Bank last spring due to the new deposit insurance law did not cause a widespread banking crisis. Lending to the economy is on the rise, albeit slowly, and the level of bank loans classified as non-performing decreased last year. Albania has privatized or liquidated nearly all of the formerly state-owned SMEs, and is

working to privatize remaining state-owned enterprises (including the Savings Bank).

In many ways, Albania is well positioned to attract foreign direct investment. Ports on the Adriatic, a literate and educated workforce, competitive salaries, and natural resources all are attractive elements for investors. As is evident here in Saranda, a beautiful coastline could also be a source of tourism revenue, but physical and financial infrastructure must be developed to attract international tourists. Tourism can be a large boost to an economy, and one need look no further than Italy and Greece to observe how positive the impact can be.

Albania has many opportunities for growth, as well as many hurdles that must be overcome along the way. Strong financial market infrastructure, comprised of physical infrastructure, systems and processes, the rule of law, a trained workforce, and a culture of banking, can help stimulate domestic and foreign investment, promote economic growth, and help establish the conditions needed to promote a flourishing market economy.

IV. WHAT DOES THE FUTURE HOLD?

The course that Albania is now pursuing points inextricably toward development of a market economy. It also points toward eventual integration into the European Union and the broader global economy. The road is certain to be rough at times, but strong institutions can play a critical role in helping Albania to stay the course.

Some of the needed components of infrastructure are already in place, such as a central bank committed to reform and a banking system that is beginning to function as it should in a market economy. Other pieces of institutional infrastructure will take a much longer time to develop. The cultural or more intangible elements are among the ones that may take the longest. The trust of citizens in the banking system, for example, is likely to be firmly established only after the system itself is well-established and functioning smoothly. This could take years. It will take political will and enormous discipline to stay the course, but the benefits of doing so will justify the effort.

Thank you.

IMPROVING THE BUSINESS ENVIRONMENT IN ALBANIA

Franco Passacantando

Thank you governor Cani, it's a pleasure for me to be here. I don't mind the weather as long as tomorrow gets better.

I'm happy enough to talk about improvements of the business and investment climate in Albania. I have been using for this presentation the results of a study that the financial investment advisory services (FIAS) of the World Bank have done recently on the investment climate in Albania and this study has been done through a survey of 500 companies and interviews with governmental officials. So, I will briefly present the results of this study and some of the recommendations that this and other studies have done. But before doing this, I would like to express a word of caution. Economists think they have a good understanding of the factors that promote, private sector investments, but there are still many areas of uncertainties, there are places and countries which seem to have more than an obstacle, where private sector development still flourishes and countries where everything is done right and there is no private sector. So there is an element of unknown, even though I will not mention those areas, I think we have to keep them in mind when we discuss these issues.

My presentation will first mention the broad policy and regulatory taxes that promote private sector development. Then, I will mention how business can be facilitated by the government. I will then look

at government issues and broad economic development issues, and then I will draw some conclusions.

So let me first move to policy reforms and institutional development. Well, I will be talking about foreign direct investment (FDI), but this is also equal for domestic investment and in fact I think that they help the private sector. The private sector is developed where foreign direct investment and domestic investment both grow and prosper. FDI flows where the business opportunities are the greatest and the obstacles for business are small. So what are the main factors? First macro stability, of course the role of central bank that is very important, macro stability, low inflation, and political stability is important. Of course political stability has to be defined, and this is one of the areas where uncertainties arise, what we mean by political stability and certainty: a clear study of the rules of the game and institutional framework. It doesn't mean that the govt doesn't have to change, otherwise Italy wouldn't have been developing in the past 60 years, but it means the establishment and clear rules of the game. Furthermore, an adequate legal and regulatory framework is needed, good functioning of factor markets; finance, labour and land, a good system of property rights and contract enforcement, and low corruption or a mechanism to fight corruption.

From the point of view of the government: what can be done to facilitate direct investment and FDI? The traditional approach is to consider investment incentives: financial and fiscal incentives, targeting of investors and sectors to enhance competitive advantages of a country. These factors still need to be considered, even though one has to be careful because we often create serious distortions by using incentives of this nature, but they are used and can be used. But the most important activity that the government can do to promote this investment is the action on the administrative barriers, the action to reduce corruption, the action to promote and develop solid sectors through a number of indirect mechanisms and creation of an attractive business environment, in terms of factor conditions; investment in human capital of course and investment in infrastructure. And rather than direct support more and more the emphasis is being done on these indirect factors that can promote development

So let me now give some brief assessment of how Albania has performed through the combination of these macro policies and

structural policies in recent years. I will use a transition report of the European Bank for Reconstruction and Development, which is an excellent document that gives an indication of how different transition countries perform in a number of areas like: private sector, percent of GDP, governance, privatisation, trade and competitive policy. Now the picture is that even though Albania is not at the top in a number of areas it has performed quite well first of all in trade and foreign exchange liberalisation, where it gets a 4+. Where less has been done is in competitive policy, in price liberalisation, and in banking reform it gets a 2+. I think you pass with a 2+, but there are countries which have done better. Infrastructure reform is slightly behind the average of the other countries, but is in line with the neighbouring countries.

Let us move to the other factors: the governance and rule of law measures which are quite difficult measures. Here you see that there have been improvements in accountability or regulatory quality. The rule of law is more mixed and control of corruption has been improved with ups and downs. But overall, the level even in 2002 is still below the average of the region, in all these areas.

So let me turn to the recommendations that can be derived from the analysis that we have made. First of all, what are the deterrents to private sector investment? First of all there is a lack of implementing regulations and guidelines. Laws that are introduced are not supported by force to set up procedures, criteria and responsibilities. Often there is a high degree of administrative discretion by regulatory agencies and their officials. This is the result of many laws that have been passed recently, but it is true that there is more promise on the introduction of laws than on the measures to implement them. The institutional structure, the responsibility of individual and agency responsibilities are often not properly indicated. Investors from this survey appear they do not know exactly where to go for what. So, there is some unpredictability in also in the responsibilities. Certainly regulations should be designed taking into account the administrative capacities. We don't need to build very detailed regulations, very sophisticated regulations if we do not have the administrative capacity to administer them. It is better to have a simpler regulation, more transparent regulation, if you know that you cannot implement rather than aim at perfection. Many countries with very tough laws and regulations usually are totally mitigated by the lack of

compliance with them, so that it's better to have a simpler than a more complex. The enforcement, we know that the legal enforcement of laws and regulations is weak and the lack of effective settlement mechanisms creates informal settlement mechanisms of disputes and these create of course corruption and vicious circles, especially because once this mechanism is set in motion each agent behaves thinking that other agents work in that way too. So it is important to strengthen these formal settlement mechanisms, which in turn can create a virtuous mechanism.

The FIAS study and the business environment study that we have done indicate three main areas of concern: the first is custom and tax administration, the second is land and construction permits and third is sector licensing. A number of recommendations in each of these areas have been developed in partnership with the government. Of course there are also a number of lower level irritants that are difficult to identify, but that sometimes are as important as the major rules, so this report also indicates some of them and especially also the importance of an attitude of trust towards the private sector. Sometimes the private sector is still viewed with some feeling of hostility from the government sector. Hence, it is important to develop an aptitude of trust and reciprocal respect.

In conclusion, first of all macro stability remains the most important thing, and Albania is a good example of high growth, low inflation and growing in private sector. Administrative and institutional areas of key importance especially as a country moves from the first stages of development. The competitive advantages of a country are particularly important in the area of FDI. Financial sector of course is important, but what is most important is to give priority to governance and accountability, to avoid duplicative, complex and non transparent procedures. In this light one can also think that what is done in the infrastructure including private sector communication should go hand in hand with the regulatory reforms, and reforms in the areas of judicial and administrative sector.

Thank you very much, this is all I have to say and I look forward to the discussion.

HOW THE BUSINESS ENVIRONMENT IN OUR COUNTRY IS AND WILL BE IMPROVED

Kastriot Islami

Honorable Professor Cani, honorable participants,

First allow me as a member of government council to thank the Bank of Albania, now an independent institution, for the arrangement of this international activity. Together with our foreign partners, we will evaluate and analyze the performance of the Albanian transitional economy and based on the lessons learned, transmit messages and opinions regarding the possible economic policies that may be suggested for implementation in the future in Albania. I also, want to thank all the Albanian and foreign participants for their participation. Special thanks to Mr. Franco Passacantando and Mr. Kemal Dervish, who yesterday were awarded by the President of the Republic of Albania for their continuous contribution in increasing the performance of the Albanian economy.

Regarding the improvement of the friendly environment for the business community, as the Finance Minister, I will try to be as realist as possible by not ignoring neither the Albanian businessmen and foreign investors' concern nor the progress made by all the Albanian institutions. Mr. Passacantando referred most of the problems, and I totally agree with his recommendations. The research by FIAS has raised a series of specific problems about the business environment, which the government has been responded through an action plan, part of a whole matrix of action plans. Through these actions, the government has addressed main issues like economic stability, strengthening of financial system,

resolving of land ownership problem, strengthening of judiciary system, improvement of infrastructure, improvement of fighting against corruption, facilitation of licensing procedures, etc.

I need to repeat shortly what is known by all of us related to macroeconomic stability framework. Albania is keeping the pace of having a considerable economic growth of 6 percent with evident structural changes in GDP that reflect changes in aggregate demand of the Albania economy. Meanwhile, inflation, as another important macroeconomic indicator, has kept the slight increasing tendency of the first years of transition period. The 2 - 4 percent target of the last 5 years has been achieved. The budget deficit over GDP rate has been decreasing to 6.2 percent at the end of 2002, as a result of the careful approval of budget expenses and achievement of ambitious objectives.

During these years, one of the important factors that has had a positive effect in the economic development and macroeconomic stability in general, as well as in the business environment has been the political stability. Although, factors that have determined the level of political stability have had various origins, their effect on macroeconomic stability has been evident, by helping at the same time in building positive image and environment for the local business community and in withdrawing of strategic investors. So, one of the lessons received from the first phase of transition period is related to the importance of the role of stability and political fragmentation in the macroeconomic stability and the creation of necessary environment for business. But as a Finance Minister, I would like to share with you the information related to the latest developments in fiscal policies, relations with the business community in general, as well as the implementation of reforms that the customs and taxing administration has started. The latter are the steps undertaken in order to create a proper and friendly environment, for doing business and at the same time for increasing the tax base.

Macroeconomic stability and stable economic growth, in strong correlation with each other, are achieved not only through a progressive reduction of deficit, but also through progressive increase in revenues and continuous improvement of programming and managing of public expenses. The aim has been to increase fiscal revenues not only based on economic growth and

administration improvement but also through implementation of a new reform aiming at reducing the fiscal burden progressively and improving the state-business relationship tenting the increase of tax base and reduction of administrative barriers. The basic steps of reforms in fiscal administration have been: the improvement of tax and custom legislation and its adjustment with European standards, continuous institutional strengthening of fiscal system, the build-up of stable fiscal administration and set-up of human capacity, modernization IT systems, set-up and functioning of independent mechanisms for the appealing of taxpayers, implementation of facilitative administrative procedures that create access for businesses and guarantee transparency and integrity of fiscal administration activity, set-up and strengthening of mechanisms that guarantee reduction of fiscal evasion and help the formalization of economy. Formation of friendly environment for the businesses is based on rigorous implementation of the law for all businesses, aiming the reduction of fiscal evasion and formalization of economy, that both aim at widening the tax base. During 2003-2005 are foreseen several measures that minimize the fiscal evasion such as implementation of internal auditing, of anticorruption and investigation as well as an *a-posteriori* control. Part of the function of creating a friendly business climate is the establishment of the consultation with the business for all its fiscal aspects and the assignments of several understanding agreements. In this sense the mentality how to treat the business is changing, making it an important partner. A factor that serves as an inducement for the business and for the foreign investment is related to the improvement of the overall government starting with a sound juridical system and ending with concrete plans against corruption always in function of minimizing the parasite cost for the business. Steps are undertaken even for stimulating foreign investments in Albania, as the role and the contribution of them in the Albanian economy is unquestionable.

The attraction of foreign direct investment has been and remains a priority of our government's economic reforms. Related to this, the government is working on to finalize the privatization process on the strategic sectors; to improve further the infrastructure especially in road sector, electricity sector, telecommunication, etc.; to increase the level of public security; to deepen the integration and cooperation process not only within the region; to increase the resources of domestic financing and also to obtain grants and

concession and quasi concession loans which will take place during 2003-2005. Further improvements of legislative nature are noticed and consist on the improvement of the law frame regarding the foreign investments, the increase of the level of security for the investments including the implementing of a sound long term economic stability with policies that assure this even for the future, the gradual reduction of the fiscal burden for foreign investment.

Recently is created the agency for foreign investment in order to promote the new image of our country, to provide services for the investors and to help the Albanian government with concrete propositions on the intentions of this latter for improving the legislation on this field. Based on the recommendations of FIAS report about the improvements of business climate in Albania are undertaken several steps on government levels, ministry and non ministry levels in order to produce an action plan with concrete steps, demanding the support of the responsible government institution.

Nevertheless, my idea is that in the future we have a lot to do toward creating an appropriate business climate in Albania and the attraction of foreign investors. The government will pay a great attention to all the recommendation raised in this conference. Once more, congratulating the BoA's staff for organizing this successful conference in order to evident the economic performance of the country and the future challenges, I do believe that this distinguished table with international political and economical personalities will contribute in the efforts for further consolidation of the Albanian economy in the future. Thank you for your attention.

COMMENTS ON: "IMPROVING BUSINESS ENVIRONMENT IN ALBANIA"

Shyqyri Llaci

Vasilika Kume

Leaving aside other problems, we are already aware that the transformation process of our economy was accompanied with some special features of the new emerging businesses, which have to face various difficulties and problems. Nowadays, as the severity of the market competition is expected to be more emphasized and environment is changing rapidly, the need for increased effectiveness in the businesses' management is becoming more evident.

MEDIUM-TERM STRATEGY FOR SMEs DEVELOPMENT

Medium -Term strategy approved by Government in 2001 included some objectives:

- Institutional development and strengthening of the cooperation government-foreign donators and business community.
- Improvement of fiscal and legal framework
- Improvement of SMEs operational management
- Improvement of SMEs crediting system
- Supporting of SMEs development, in order to have sectorial and regional equilibrium. (*agro-business, underdeveloped regions, promotion of new businesses in these regions*)

ADMINISTRATIVE BARRIERS FOR BUSINESS

Some findings of the survey initiated by the Government in the Spring 2002 with the assistance of the Foreign Investment Service

- The businesses in average are not satisfied with both the quality of regulations and administrative requirements as well as with the bureaucratic behavior affecting businesses in Albania.
- It results that the most problematic areas for businesses to operate and growth are the customs regulations and the tax administration.
- The management of businesses spend an average of 10.5% of their time dealing with regulatory and administrative requirements.
- The registration process is expensive and time consuming.
- The overall business environment in Albania is between moderately and not very supportive.

GOVERNMENT POLICIES SUPPORTING SMEs

In order to improve the business environment:

- Specific policies have been designed and implemented for restructuring of former state enterprises.
- SME development have been going through several institutional strengthening policies on the 3 levels (strategic, tactic and operational):
 - A positive predictable legal and fiscal framework, conducive to SMEs development (consisting on a database on laws and fiscal measures affecting SMEs, scrutinizing draft legislation etc).
 - A comprehensive training program for improving operational management of SMEs.

GENERAL ACCESS TO FINANCING

However:

- The access of SMEs to different sources of finance is rather difficult.

- A great number of SMEs that applied for loans at some stage of their development, most of them either did not succeed to get it or withdrew their application before a decision was taken.
- High interest rates quoted by the lending sources is the main reason for rejecting loans delivery to SMEs.
- Albanian banking sector has not yet succeed in establishing appropriate mechanisms for the purpose of risk-assessment and also they lack professionalism in evaluating business-plans.
- Knowledge of entrepreneur is another reason mostly taken in account by banks during loan request's evaluation and thus there is a tendency that large firms –rather than small firms- are more likely to get loans if they apply.
- Large companies are more likely to the banks than small companies to be successful in their application.
- Pricing of some credit lines is unrealistically high, resulting in low pay-back rates.

POLICY, LEGAL AND PROCEDURE CHANGES

Proposed changes in current policies

- A key role of the Government would be to keep a comprehensive review and summary of all legislation and monitoring their effects on SMEs;
- Establish a consistent definition of SMEs in order to simplify administration and provide a clear profile of government policy between different Line Ministries (define sector priorities and associated fiscal policies);
- Consider SME policy as integral part of the global development of industrial sector, regional policies and legislation;
- The SMEs strategy must have the endorsement and final agreement of all Line Ministries once it is broadcaster to all of them;
- Promote export-oriented policies in sectors that use domestic resources;
- Improving competitiveness of private sector, reviewing VAT levels;

- Caring out a well grounded and efficient policy for agro-businesses.

Proposed changes in current procedures

- Due to the fact that unfair competition of informal economy to legitimate businesses, the Government should make a vigorous and sustained effort to reduce the size of informal economy (through selective tax incentives);
- The role of business advisory services should be expanded covering not simply business-plan formulation but also marketing mix, accounting and cost management etc;
- As a first step developing the set of approval procedures needed for starting a new activity/business (all kind of permissions issued by local or central government..
- Later on setting up a network of centers which will assist all investors/entrepreneurs for starting new activities/businesses.
- Computerization of information in national level near the Directory of customs in order to provide information for all SME-s “Universe”.
- Computerization of information in national level near the Directory of Customs and Directory of Taxes in order to provide information for all SME-s Community.
- Establishing a National Center for information collecting and processing regarding the Annual Reports of private businesses.
- Cooperation among the Ministry of Economy, Faculty of Economics and INSTAT for developing, following and analyzing performance indicators of SME-s. Including in Public Statistics National Programme the SME-s Performance Indicators.
- Implementation of contemporaneous statistical techniques for informal economy evaluation.

ALBANIA'S INFORMAL ECONOMY: AN IMPEDIMENT TO ECONOMIC DEVELOPMENT?¹

Jan-Peter Olters

“The improvement of fiscal administration is considered of special importance by the government both to overcome the challenges for the country’s long-term development and European integration and to secure the financial resources that are necessary for the implementation of the GPRS. The main objective[...] of the reform of the fiscal administration will be ... [to] increase budget revenues by expanding the taxable base and reducing the informal economy ...”

Government of Albania (2001, p. 59)

1. INTRODUCTION

The ongoing negotiations with the European Union (EU) on a stabilization and association agreement (SAA) reflect the recognition of the progress² made thus far during Albania’s—at times troubled—transition. In order to advance these negotiations, strict adherence to the standards of a European pre-accession country³ is required, politically as well as economically. With regard to the latter, Albanian policy-makers—having passed the stage of post-crisis stabilization—are now in a position to focus their energies on the more complex challenges of economic development. In complementing the politico-economic integration in Europe with a comprehensive strategy for socio-economic development (NSSD;

formerly GPRS),⁴ the government seeks to overcome the legacy of half a century of misguided economic policies that had left the country with widespread poverty, a decrepit public infrastructure, and weak public institutions. However, corrective public investments, expected to generate important crowding-in effects, presume the access to increasingly larger budgetary resources. As Albania is about to become ineligible to important sources of highly concessional foreign financing, this—already crucial—condition is gaining even more urgency. Recent problems with revenue collection, as evidenced by the consistently low revenue-to-GDP ratio and repeated shortfalls relative to initial budget projections (IMF 2003a), raise the concern whether (and under what conditions) it is reasonable to expect that the realization of Albania's ambitious development goals, including the continued maintenance of macroeconomic stability, can indeed be achieved within the timeframe envisaged by the NSSD.

Subsequently, policy measures designed to increase budgetary revenues remain at the very center of any development strategy in Albania, circumscribing the enormous—but certainly not unique—challenge the government is facing; viz., to simultaneously strengthen revenue collection, upgrade public services, and improve the strained taxpayer relations with the formal private sector. This is possible; and it has been successfully demonstrated by other, particularly smaller transition economies (e.g., the Baltic countries). As will be argued in the following, a replication of these experiences in Albania presupposes a considerable correction to key elements of the underlying economic regime. As succinctly noted by Alesina (1999), “improving government performance to achieve social goals means switching from a tax-evading economy with no infrastructure and with mistargeted safety nets to a tax-paying formal economy with relatively small but efficient social safety nets. However, many of these reforms are not likely to be successful without a reduction in corruption and bureaucratic inefficiency” (p. 229).

Alesina's characterization of a government that is too small and too ineffective to tangibly improve the socio-economic environment is rooted in the rapidly growing literature on informal markets;⁵ particularly, the seminal studies by Loayza (1997) and Johnson, Kaufmann, and Shleifer (1997), who argue that economies with large informal sectors tend to be stuck in a “bad” equilibrium with a

low-quality public goods and a high degree of fiscal evasion. Analyzing a large number of transition economies in eastern Europe and the former Soviet Union (excluding Albania), they find that businesses react to an increasing degree of “politicization” of private-sector activities⁶ with a trend withdrawal from the formal sector, implying that macroeconomic stabilization without accompanying reforms to strengthen market-supporting institutions does not suffice to maintain high rates of economic growth. Like many other authors, Friedman et al. (2000) substantiate this finding, arguing that “[d]iscretion in the application of rules, and the corruption that this produces, seems to have a more important effect” (p. 481) than, e.g., higher marginal tax rates, which are frequently cited as a principal reason for large informal sectors.

Apart from the pleasure derived from the puzzle work necessary to estimate the “hidden” elements of economic activities, a large part of this literature is motivated by the attempt to identify the effects of economic informality on growth and economic prosperity. Most researchers have found a negative correlation between these two variables,⁷ for mainly three reasons. First, a large informal sector leads to an increase in economically non-productive activities (particularly the concealing, protecting, or detecting of hidden and illegal economic activities) and, subsequently, to a considerable waste of scarce resources (Shleifer and Vishny 1993). Second, it tends to cause a misallocation of production factors, principally because informal enterprises—unable to (fully) make use of market-supporting institutions, such as police, courts, or banks—employ an insufficiently capital intensive production technology, which will make their goods and services ultimately uncompetitive (de Soto 1989). And finally, a large informal economy results in an important sum of foregone tax revenues (Loayza 1997), which—particularly in countries like Albania—reduces economic welfare as urgently required (social) infrastructure investments cannot be made, thereby holding back private-sector activities.

Therefore, to assess a country’s medium- to long-term growth potential and define policy priorities, an understanding of the size of the informal market (relative to formal activities) is crucially important. Contrary to most other transition countries, for which a considerable literature has developed that provided estimates of the size of their informal sectors, very little research has been done to approximate the magnitude—and/or composition—of Albania’s

shadow economy (and, therefore, the implicit extent of fiscal evasion). One notable exception is Schneider (2002), who used a method combining the physical input (electricity), currency demand, and model-based approaches⁸ to estimate Albania's shadow economy. With the caveat of "unreliable figures" (cf. footnote in Table 5, p. 14), he estimated that around one-third of total economic activities in 2000 were informal.⁹ This figure is comparable to the one used by Albania's Statistical Institute (INSTAT) when calculating official GDP figures.¹⁰ The Albanian media, however, have periodically suggested that the size of the informal sector could, in fact, be considerably larger.¹¹ This paper will look at several macroeconomic indicators and discuss whether they could indeed be consistent with the suggestion of a larger-than-currently-estimated informal sector.

2. THE INFORMAL SECTOR AND ECONOMIC DEVELOPMENT

Defining the Informal Sector

There is an intensive academic debate taking place on the "correct" definition of the informal economy, a thorough discussion of which exceeds the scope of this chapter.¹² In this paper, the term "informal economy" will be defined to comprise both "hidden" and "illegal" economic activities, of which the revenues should have been reported to the tax authorities but, for some reason, have been concealed from them—for the following reasons:

First, the "hidden" economy includes activities that, apart from breaking the tax law, are principally legal, such as unlicensed micro-enterprises, unregistered barter trade, under-invoicing, and the smuggling of non-prohibited commodities. Thus, these types of activities are largely viewed as a problem of fiscal evasion that represent a vital challenge to economic policy-making. Second, the informal sector is defined to also include those activities that, by their very nature, are "illegal". As a result, organized (economic) crime activities¹³—which include primarily the trafficking of arms, drugs, and women—are considered as well. While these represent, first and foremost, a problem of law enforcement, this definition will be used to permit subsequent studies estimating the relative size of informal activities that rely on macroeconomic data; these types of analyses would naturally encounter additional obstacles if they had to separate those activities that are, in principle, legal

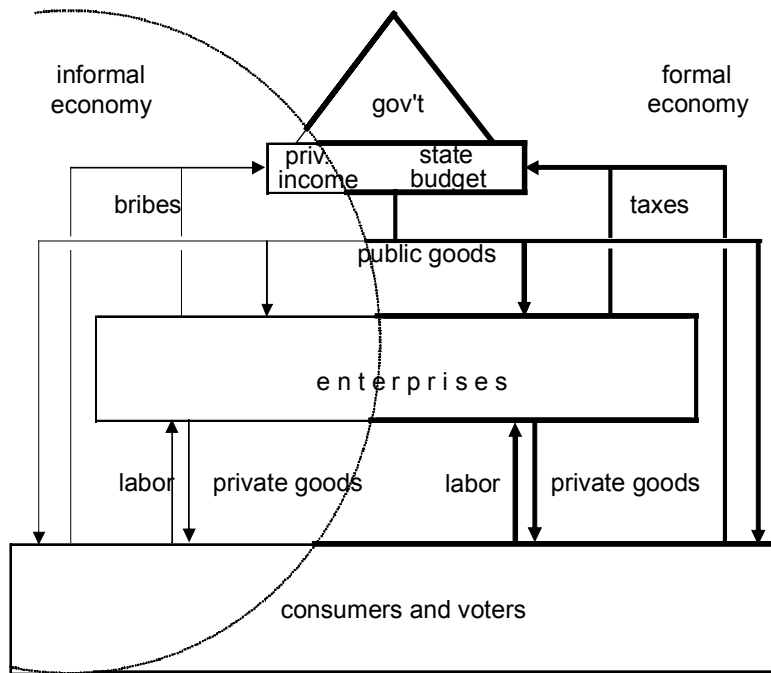
from those that are not.¹⁴ In the following, the “informal sector” will be defined as the sum of all undeclared commercial activities that, de facto, contribute to national income.

As the participation in the informal economy represents a violation of the legal norm (even if the activities are per se legal), unofficial activities tend to be accompanied by an increased level of public corruption, whereby (poorly paid) officials accept bribes in exchange for protection or other favors to the detriment of the state. In recent years, a rather extensive literature has developed showing that, in a system rooted in bribery and corruption, economic incentives are distorted “as government officials and favored private individuals receive a larger share of public benefits or bear a lower share of the cost of public goods” (IMF 2000, p.130), which results in lower private investments, lower government revenues, while increasing inequality and poverty; see Mauro (1995), Tanzi and Davoodi (1997, 2000), Gupta et al. (1998), and Abed and Gupta (2002), with the key arguments being nicely summarized in Tanzi (1998). The large majority of recent studies confirms the existence of a negative correlation between corruption and growth, thereby stressing the crucial importance of improved “governance” as a core element in successful economic reform programs.

The Informality “Trap”

For a policy-maker, the most difficult aspect of reversing the trend increase in the relative size of the informal market is the juxtaposition of private benefits and public costs. As summarized in Figure 1, every market participant in the informal economy benefits—directly and personally—in some way: (i) individuals tend to receive higher net-of-tax salaries and are able to buy private goods and services at lower prices; (ii) firms can produce more competitively without the costly and often very time-consuming interaction with government officials; and (iii) corrupt officials and politicians receive additional private income (bribes) in exchange for accommodating those participating in, and profiting from, the informal economy. By contrast, the corresponding costs are all “public” in nature. They include, for the most part, reduced fiscal revenues and, subsequently, lower expenditures on—generally valued—public goods such as hospitals, schools, universities, roads, or the continuous provision with electricity and water.

Figure 1. The Stylized Dual Economy

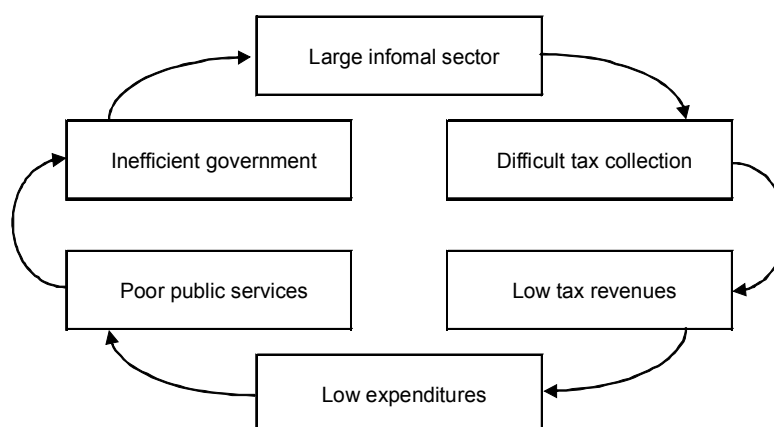


Typically, households, firms, and government officials understand that everyone would benefit from a more “formalized” environment, in which the degree of fiscal evasion is low and the quality of public goods high. However, due to this conflict between private benefits and public costs, no economic actor is truly prepared to “voluntarily” take the first step in the direction towards increased economic formalization. The certain reduction in private benefits derived from informal activities weighs higher than the uncertain expectation of improvements in the provision of public goods—i.e., economies that have developed a substantial informal sector tend to be stuck in a “vicious cycle” (Alesina 1999), where the large degree of informality complicates the government’s task of collecting revenues for the budget. With low tax revenues, expenditures for important public goods will be low as well, which, in turn, will be reflected in their substandard quality (thereby constraining private-sector investments). With an inefficient public sector, taxpayer discipline will remain low, leaving the economy being stuck in a fiscal trap (Figure 2).

Conditions for a Trend Reversal

Economists tend to represent such a situation in a dual equilibrium model, in which an economy without credible, firm, and coordinated actions by all market participants will not be able to “automatically” find a path (back) towards the superior outcome with high-quality public goods and a high degree of tax discipline. Even in free-market economies, the only actor capable of initiating and coordinating necessary measures remains the government. The dual equilibrium interpretation of economies with large informal sectors implies that—with the “wrong” policies (or no policies at all)—an economy could converge to, and subsequently be “stuck” in, an equilibrium with a large informal sector, a weak tax collection rate, low tax revenues, and poor public services, reinforcing economic incentives to (continue to) operate informally. Placing the discussion on the growth implications of a large informal economy in a dual equilibrium framework means that an economy requires an impulse to find the virtuous path towards the “superior” outcome. Such a credible stimulus, strong enough to change people’s behavior, would need to combine the government’s (credible) political commitment for reform with the economic agents’ recognition of an overall changed environment. The SAA negotiations, with a view towards eventual EU membership, could perceivably represent a sufficiently momentous event to permit the implementation of those—politically often very difficult—measures that are necessary to reverse the trend increase in economic

Figure 2. The Vicious Circle



informality. In this task, the principal challenge typically relates to the need to have structural reforms implemented at the expense of—typically well-connected—vested interests.

Looking at the experience of other transition economies, it is not surprising to see a possible relation between efforts to join the EU and a decline in informal activity. For example, when taking the informal-sector estimates by Johnson, Kaufmann, and Shleifer (1997) and re-arranging them according to the countries' status vis-à-vis the EU, it becomes evident that a decline in the relative size of shadow economies is observed in those countries that were expected to join the EU in the "first wave" of enlargement (see Table 1). While the figures do not define causality, the implication of the almost uniform trend reversal in the relative size of the informal market in prospective EU accession countries during the mid-1990s would be consistent with the policy implications of a dual-equilibrium explanation of informal-market activities.

Several economists¹⁵ have long argued that the existing incentive structure in economies with large informal sectors—resembling the "prisoner's dilemma" discussed in game theory—prevents economic actors from sudden (unprovoked) changes in their conduct, for a simple political economy argument: as individual participants in the shadow economy, whether in form of a worker, consumer, voter, or tax-payer, benefit from the status quo¹⁶ as much as firms profit from relatively lower labor costs, regulations, and tax obligations, elected politicians have no incentive to propose a reform that reduce their voters' economic advantages. Hence, a strategy aimed at formalizing economic activities has only a chance to be successful if the corresponding costs of changing one's behavior are more than compensated by (i) (the expectation of) an accompanying tax cut; (ii) improvement in available (and generally valued) public goods; and/or (iii) other tangible benefits (such as a possible EU membership in the foreseeable future).

	1995 Population (in million)	1990	1993	1995
EU accession countries*		17.4	20.7	15.5
Czech Republic	10.3	6.7	16.9	11.3
Estonia	1.5	19.9	24.1	11.8
Hungary	10.2	28.0	28.5	29.0
Latvia**	2.5	12.8	31.0	35.3
Lithuania**	3.7	11.3	31.7	21.6
Poland	38.6	19.6	18.5	12.6
Slovak Republic	5.4	7.7	16.2	5.8
Other transition countries*		15.8	35.8	41.8
Azerbaijan	7.7	21.9	51.2	60.6
Bulgaria	8.4	25.1	29.9	36.2
Georgia	5.4	24.9	61.0	62.6
Moldova	4.4	18.1	34.0	35.7
Romania	22.7	13.7	16.4	19.1
Russia	148.1	14.7	36.7	41.6
Ukraine	51.7	16.3	38.0	48.9

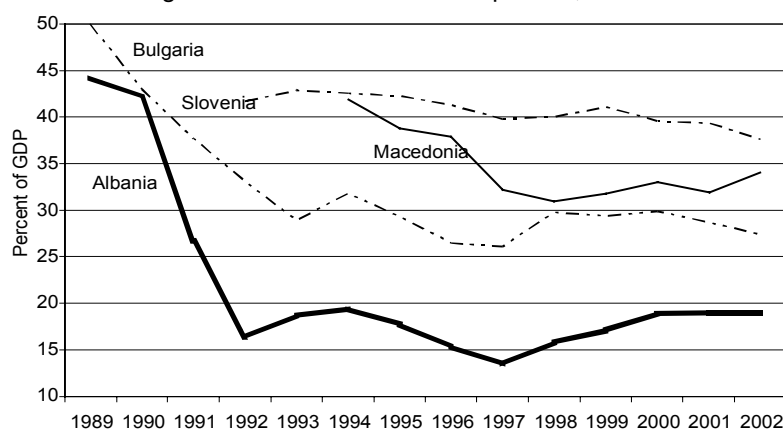
Source: Johnson, Kaufmann, and Shleifer (1997, p. 183).

* Weighted according to population (IMF, 2001b).

** Initially not regarded as a "first round" accession country.

enterprises are willing to register their activities and comply with the laws and regulations only if they feel sufficiently certain that their respective competitors will comply as well. Otherwise, the cost of compliance will continue to exceed its benefits.

Figure 3. Tax Revenue Developments, 1989-2002



Source: Tanzi and Tsibouris (2000, p. 18), and various IMF Country Reports.

3. THE INFORMAL ECONOMY IN ALBANIA

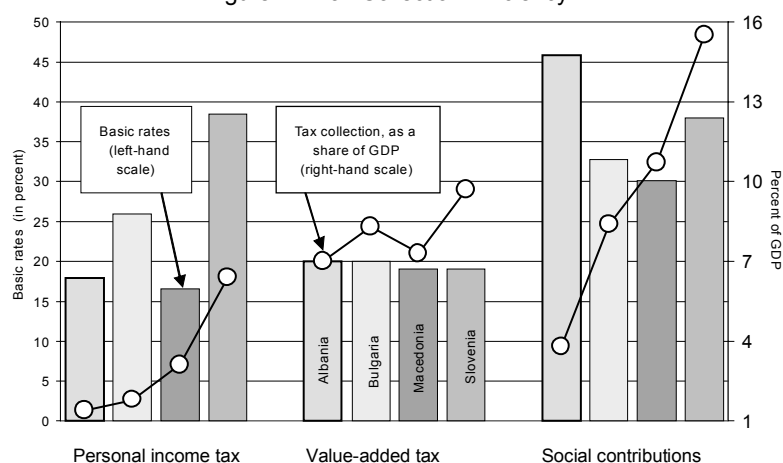
A detailed and reliable estimation of the size and composition of Albania's informal market—given the limited nature of data even on formal-sector activities—is, no doubt, a very challenging exercise, and further research is needed.¹⁷ This paper will unambitiously restrict itself to an examination of several important macroeconomic indicators that should help to better understand the situation in Albania. As mentioned in the introduction, current GDP estimates incorporate an assessment of informal activity at about one-third of total output. Data on tax collection, however, suggest that this tentative assessment could well be on the low side. Figure 3 summarizes the key differences in tax-revenue collections among several countries in the region. Whereas even the relatively poorly performing transition countries in South-Eastern Europe managed to collect tax revenues, including social contributions, of around 30 percent of GDP during 2000–02 (Table 2), the corresponding figure for Albania stood at less than 20 percent, notwithstanding the gradual—but consistent—improvement in tax collection since 1997. Still, only a relatively small fraction of the loss in enforcement capacity experienced in 1991–92 could be recovered.¹⁸ As Figure 4 indicates, the reason for the considerable difference in performance is not the level of tax rates levied in Albania (which are comparable to those in neighboring countries) but the difference in tax-collection efficiency.

Table 2. Tax Revenues, 2000-02
(In percent of GDP)

	2000		2001		2002	
	tax, customs, social security	of which: social security	tax, customs, social security	of which: social security	tax, customs, social security	of which: social security
Albania	18.9	3.6	19.0	3.7	19.0	3.8
Bosnia-Herzegovina	42.6	15.9	40.2	14.7	41.6	15.2
Bulgaria	29.9	8.3	28.7	7.8	27.4	7.3
Croatia	42.1	13.3	41.2	13.2	41.1	12.5
Macedonia, FYR	33.0	10.6	31.9	10.8	34.0	10.6
Moldova	22.3	5.6	22.4	6.3	--	--
Romania	29.2	10.8	28.0	10.7	27.6	10.7
Russian Federation	35.3	7.9	34.9	7.4	34.9	7.7
Serbia-Montenegro	35.3	12.5	35.5	11.1	39.4	10.6
Slovenia	39.6	13.7	39.4	13.6	37.4	13.4

Source: Various IMF Country Reports.

Figure 4. Tax Collection Efficiency



Source: Various IMF Country Reports.

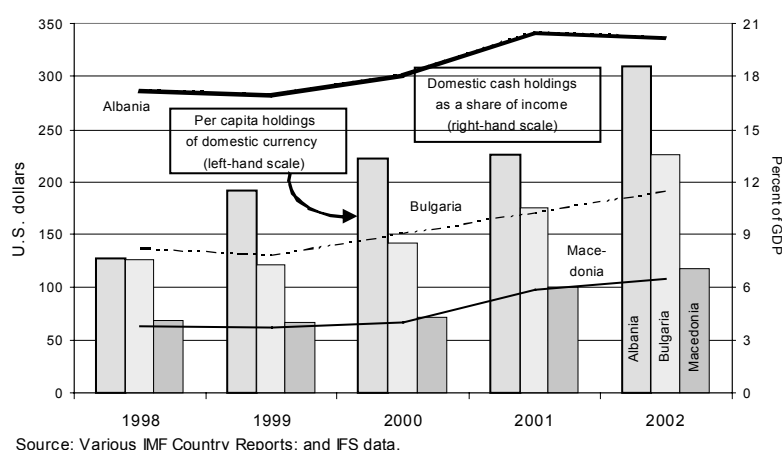
Table 3. Frequency and Extent of the "Bribe Tax"

	Percentage of firms making bribes frequently		Average bribe tax as a percentage of annual firm revenues	
	1999	2002	1999	2002
Albania	46.7	36.4	1.7	3.3
Bosnia and Herzegovina	20.5	22.4	2.1	0.9
Bulgaria	23.0	32.8	1.3	1.9
Macedonia	33.0	22.7	1.4	0.8
Slovenia	7.7	7.1	1.0	0.8

Source: EBRD (2002, p. 28).

Pervasive smuggling, underreporting on invoices, falsification of balance sheets, and a general weakness in (tax) law enforcement have, thus far, defined limits to domestic revenue collection and, subsequently, the government's ability to provide public goods at an adequate level (and in a satisfactory quality). Breaking up the figures on a tax-by-tax basis (again, see Figure 4), one sees that the worst-performing tax in Albania are social-security contributions. With somewhat higher rates, Albania managed to collect about 3.8 percent of GDP in 2002, compared to Bulgaria's 7.3 percent or Macedonia's 10.7 percent. It is encouraging to see though that Albania's authorities have reacted and, with the help of their international development partners, begun to devise a plan to transfer the collection of social-security contributions to the tax department, thereby allowing the social-security institute to focus its efforts on improving the targeting of entitlements.

Figure 5. The Importance of Domestic Cash, 1998-2002



However, administrative weaknesses are only one part of the reasons explaining the large difference between Albania and its neighbors. Governance problems remain a serious obstacle. For example, the EBRD's 2002 Transition Report showed that, whereas the percentage of firms decreased somewhat that relied on pecuniary "inducements," the average "bribe tax" that firms paid almost doubled during 1999–2002 to 3.3 percent of revenue (Table 3), placing Albania in the unflattering neighborhood of the Kyrgyz Republic, Azerbaijan, and Georgia. Not surprisingly, the generally

ineffective and—at times—arbitrary administration in the customs and tax departments has recently been identified by a comprehensive study on investment barriers as a principal deterrent to (foreign) investment. The combination of, in the regional context, average tax rates, low revenue collections, and high “tax bribes” is certainly consistent with a large shadow economy.

Further indications can be found when analyzing recent monetary data. Informal economic activities tend to be cash-based (cash is anonymous), and the demand for cash, relative to overall output, is frequently used to approximate developments in the informal sector of the economy—particularly if the demand for cash increases at a pace faster than considered justified by economic fundamentals. In this context, high per-capital cash holdings and particularly an increase in the demand for cash by 3 percentage points of GDP during 1998–2002 could be taken as an indicator of such development (Figure 5). However, further—and more in-depth—studies would have to (i) separate the demand for cash from the aftermath of, and the behavioral changes from, the collapse of the pyramid schemes in 1997 and the episode of heavy deposit withdrawals in early 2002; (ii) identify the relation of cash holdings and deposits in light of the large drop in real interest rates during this period; and (iii) include estimates of circulating foreign cash into the equation. Given Albania’s income level, together with the circulation of a considerable amount of foreign cash, the per capita amount of domestic cash, both over time and relative to neighboring countries, is very large and, a priori, would seem to support the supposition of an informal sector that is larger than the official estimate (and larger than those in neighboring countries).

These macro data allow for a very rough and preliminary approximation of the estimated size of Albania’s informal market. Assuming that the share of the informal sector relative to GDP in Bulgaria is approximately correct (see Table 1) and given an effective tax burden of around 50 percent,¹⁹ the 8½ percentage point difference in the tax collection rates between the two countries (see Figure 3) would imply that the majority of economic activities in Albania could, in fact, be informal. This is a hypothesis and, by no means, an estimate (or proof), based on the analysis of various indicators that, however, appear to be consistent with such a claim. This has to be confirmed (or refuted) by thorough empirical studies.

4. FORMALIZING THE SHADOW ECONOMY: RECOMMENDED MEASURES

Albania's informal sector represents a considerable share of economic activities, and it could easily jeopardize the realization of Albania's medium-term goals of socio-economic development and European integration. While budgetary revenues, relative to the performance of Albania's economy, is weak, formal private sector activities are discouraged by (i) strained taxpayer relations and poor public services; (ii) inadequate tax enforcement; (iii) excessive permit and licensing requirements; (iv) the existence of a competitive disadvantage relative to informal market participants; and (v) a weak public infrastructure.

To move Albania away from this "sub-optimal equilibrium" requires concerted efforts. The government's principal challenge, at this stage in Albania's development phase, lies in the adoption of measures aimed at improving "governance" and strengthening of public institutions, including customs and tax administrations. A successful strategy would have to stand on two pillars—viz., (i) providing better "public goods" (that is, improving governance, the quality of public services, and taxpayer relations, accelerating the implementation of NSSD investments, and ensuring progress with the SAA negotiations); and (ii) the development of a credible anti-evasion action plan.

In Albania's case, it is not high tax rates per se but, to a large extent, the ineffectual and discretionary application of tax laws and governmental regulations that has created the conditions under which the shadow economy is growing. Consequently, the government needs to find a way to raise public awareness of the government's increasing commitment to resolutely addressing fiscal evasion (which, in itself, should help to improve tax discipline) while enhancing taxpayer relations. The authorities could achieve this, for example, by hosting a series of workshops (or brainstorming sessions) charged with improving the comprehension of (i) the amount of foregone tax revenues; (ii) the main channels used to bypass the tax and customs directorates; and (iii) effectiveness of possible policy measures aimed at closing the loopholes. Undoubtedly, "fighting evasion" is a very broad and rather ambitious goal, with the public's expectation of actual improvements being low for as long as this publicly stated policy goal is not underpinned

by practical steps to address the issue commodity by commodity, tax by tax, and problem by problem. Apart from the finance ministry and the tax and customs departments, several other parties have strong interest in improving the situation, most important of which are the formal enterprises experiencing a distinct cost disadvantage in the marketplace vis-à-vis their informal competitors. Their advice should thus be actively sought in any discussion on a detailed anti-evasion strategy.

Whether one takes a particular excise commodity (cigarettes, fuel, coffee, or alcoholic beverages) or a specific tax, the formal enterprises that are active in these markets would, in all likelihood, respond very positively to an invitation to engage in a direct dialogue with the finance ministry and the tax and/or customs directorates to (i) identify the main source of leakages; (ii) discuss the related weaknesses in public administration; and (iii) propose policy measures to remedy the situation. Also, the banking system—together with the customs and tax directorates—could support efforts to identify ways to encourage payments through the banking system and to facilitate, particularly, cashless customs and tax payments, either through the use of direct deposits (say, directly at the point of entry at the border), bank-guaranteed checks, direct money transfers, or the increased use (and acceptance) of credit cards.

At the end of such a consultative process, the resulting policy proposals, together with a firm timetable, should be publicly presented as a comprehensive anti-evasion strategy, thereby (i) increasing public awareness of the government's commitment to address this problem in a serious, comprehensive, and forceful manner; (ii) bolstering efforts in securing both higher revenue levels; (iii) supporting the government's objective in implementing key medium-term policy goals as, for instance; identified in the NSSD; and (iv) starting to change the widespread perception of evasion being an "acceptable" way of doing business by communicating the costs to the country as a whole, including its effect on the prospect for eventual EU membership.

In devising such a "carrot and stick" strategy, the government can—and should—rely on every economic actor that will benefit from a situation characterized by a low degree of fiscal evasion and the provision of high-quality public goods. These include (i) those

government officials that have a genuine interest in securing and increasing the budget's revenue base to accelerate the implementation of priority investments (which will increase the popular appeal of those politicians overseeing such a reform); (ii) the large number of formal businesses that seek fairer competition, improved public services, and lower tax rates in the medium term; and (iii) the many households (voters) that would welcome better roads, schools, and hospitals and, more generally, a more responsive and effective government. One has to keep in mind though that there are also a large number of vested (private) interests both in the public and private sectors, who—at times, considerably—benefit from the status quo. These would have to be sacrificed for the sake of a public good. Not surprisingly, any proposal of this type tends to be unpopular and encounter active resistance.

However, by (i) fragmenting a big problem in a large number of smaller ones; (ii) sensitizing the public that there is indeed a serious and credible commitment by government to make substantial progress (which, in the context of the starting negotiations on an SAA, is a very convincing period of time to make such an announcement); and (iii) explicitly requesting private-sector input, the government should be able to build a momentum that, over the short to medium term, secures higher tax receipts while strengthening the government-business relationship. At the same time, firms will benefit from fairer competition, improved public services and, possibly, lower tax rates in the medium term, as will Albanian citizens from the realization of NSSD investments and a generally more responsive and effective government. The prospect for progress in the process of European integration alone should give the government and additional—and very important—impetus to underpin, with concrete actions, the efforts to increase governance and reduce the size of the informal market. The public needs to be convinced, with tangible measures, that Albania, like other transition countries before it, is indeed en route to becoming a modern, prosperous, and European economy. Principally, there is no reason why it should not be able to do so.

ENDNOTE

¹ Insightful comments by Hossein Samiei, Jan Kees Martijn, Ivanna Vladkova-Hollar, Karen Ongly, David Hamoodi, and participants of the Bank of Albania's 4th International Conference on the Albanian Economy: Performance and Policy Challenges, held in Saranda during September 11–12, 2003, have considerably improved this paper and are gratefully acknowledged. The views expressed in this article are those of the author and should not be attributed to the IMF. The standard disclaimer applies.

² See, e.g., IMF (2002, 2001a). The economic stabilization program was required to overcome the socio-economic crisis caused by the disastrous collapse of the pyramid schemes in 1997; see Bezemer (2001) and Jarvis (2000).

³ On October 21, 2002, the Council of Ministers of the European Union decided to invite Albania to start SAA negotiations; see EU (2002a,b). During the opening ceremonies of the SAA negotiations, the President of the European Commission, Romano Prodi, stressed that Albania—"a potential candidate" (Prodi 2003a)—was taking "first step down the road to Albania becoming a full member of the European Union," which implied that the government accepted "a major commitment" in a wide range of areas, including the "completion of a market economy" (Prodi 2003b).

⁴ See Government of Albania (2001) and, on the recent experiences in implementing the strategy's measures, Government of Albania (2003) and IMF (2003b).

⁵ For a survey of the corresponding literature, see, e.g., Schneider and Enste (2000a,b)

⁶ Johnson, Kaufmann, and Shleifer (1997) define the politicization of economic life as "the exercise by politicians of control rights over businesses. ... Typically, politicians use these rights to pursue their own interests, such as maintaining employment in certain firms, supporting politically friendly and punishing politically unfriendly entrepreneurs, and subsidizing their allies. Politicians also use these rights to enrich themselves by offering firms relief from regulation in exchange for bribes. Political control generally reduces the profitability of doing business, and therefore adversely influences entrepreneurial activity and economic growth" (pp. 159–60).

⁷ Notable exceptions include Cassel (1986, p. 93) or Gretschnann (1984, p. 120) who argue that informal markets represent, respectively, an "economic buffer" or a "stabilizer of last resort" that permits households and firms to more easily adjust to a deteriorating economic environment. In his empirical study, Bhattacharyya (1993) showed that the informal sector had positive effects on both consumption and investment expenditures for the U.K. during 1960–84, a point that Schneider (1998) supported analyzing German and Austrian data. Other authors, such as Asea (1996), argue that owners of informal firms tend to be greater risk-takers and, as a result, provide the economy with a higher degree of competition, thereby closely reflecting Schumpeter's (1942) ideal of an innovative and creative entrepreneur.

⁸ For a discussion on the various estimation techniques, see the various articles included in the June 1999 Economic Journal discussion on "Controversy: On the

Hidden Economy” as well as Schneider and Enste (2000b), Tanzi (1986), and Feige (1986) and the authors cited therein.

⁹ According to Schneider’s (2002) estimation method, the size of Albania’s informal sector is comparable to those in Lithuania (30.3 percent), Croatia (33.4 percent), Bosnia and Herzegovina (34.1 percent), Romania (34.4 percent), and Bulgaria (36.9 percent).

¹⁰ INSTAT’s estimate is based on a survey method analyzing the economic activities of small, medium, and large enterprises in different sectors of the economy.

¹¹ In its December 16, 2002 issue, the daily newspaper Dita, e.g., mentions on page 1 that 50–60 percent of the Albanian economy is informal, with smuggling of imported goods being the principal component (“Ekonomia, 60 përqind informale”).

¹² For an in-depth discussion on the benefits and limitations of alternative definitions, see, e.g., Schrage (1984) and Thomas (1992).

¹³ See also Altvater and Mahnkopf (2002) and Naylor (2002).

¹⁴ For example, how would one separate the fraction of private cash transfers that represent remittances in the narrower sense of the term from those that correspond to ill-begotten profits of crime?

¹⁵ See, e.g., Hofreither and Schneider (1989) or Chapter 9 in Schneider and Enste (2000).

¹⁶ Under ceteris paribus conditions, the participation in the informal market increases net wages and maximizes, subject to the household’s budget constraint, the consumption of private goods.

¹⁷ For a discussion on the indirect methods used to approximate the size of shadow economies, see, e.g., Feige (1989) and Schneider and Enste (2000a). Johnson, Kaufmann, and Shleifer (1997), Lackó (2000), and Schneider and Enste (2000b) provide estimates for other transition economies.

¹⁸ The very steep drop in tax revenue collection in 1991–92, by about 25 percentage points of GDP, was caused by the economic collapse and social anarchy following 48 years of communism and isolationism (for a comprehensive analysis of the particular challenges during early transition years, see, e.g., Blejer et al., 1992).

¹⁹ For households, the average income tax rate is about 18 percent, with employee contribution to the social security institute representing roughly 12 percent. If, of the remaining 70 percent, three-quarter is consumed, another 11 percent will be paid in VAT and, correspondingly, 7 percent for excise. The remaining 2 percent would reflect other taxes.

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COMMENTS ON "ALBANIAN INFORMAL MARKET"

Fatmir Mema

Zef Preçi

The issue of hidden economy is a major problem, though in practical terms it is a natural and spontaneous reaction towards the impossibility of formal economy to meet the necessities of a part of the members of the society. We should acknowledge that the contribution provided by the hidden economy in both the developing and transitional countries, is considerable for the economic growth; however, it is associated with a number of problems deserving to be treated carefully from the compilers and executors of economic policies.

Indeed, it's difficult to give a definition of hidden economy. It so happens not due to the lack of knowledge on how to measure and assess the size and spread of this sector; but because different experts view the problem from different viewpoints, thus giving similar definitions, yet different from each other.

Thus, the hidden economy (differently considered as grey economy, parallel economy, underground economy, informal economy) comprises small units engaged in the production of goods and services which are not registered as formal units; units that contribute to the production of goods and services, registered as formal units, but which declare only partly the capacity of their activity; production units or service units created on the basis of family business, which are not registered. The hidden economy

often comprises individual persons who exert their activity unlicensed and some others who perform criminal economic activities and activities banished by law. It would have been more clear-cut to say that hidden economy is that part of "lawful" economy (neither banished, nor criminal) which doesn't respect the enacted legal framework and which would be rateable in case of report to fiscal authorities. Depending on the development of the countries, the hidden economy usually occupies 10-50% of PBB; i.e. it is lower in developed countries and higher in developing countries and countries in transition.

A flourishing hidden economy makes the official statistics on unemployment, labour forces, income, consumption etc., sound incredible; consequently, the compiled programs and policies based on these statistics may be inappropriate for implementation. This is not the case of jumping to hasty conclusions, however, we might launch the hypothesis that the modest achievements with regard to the implementation of poverty reduction and economic development strategy noticed in the impossibility of converting the well known macro-economic achievements in regional and sectional development, among others, are also conditioned by the considerable weight of the hidden sector and the lack of instruments enabling its formalization without damaging it, which means trying to "lighten" it in favour to the sustainable development of our country.

Some elements of hidden activities such as:

- some public home services: TV and washing machine repair;
- human services: making medical visits and injections;
- foreign language courses;
- street retail-trading of agricultural products from villagers of nearby areas;
- day-labourers (members of cooperatives and agricultural enterprises departments) obtaining agricultural, farming products and different raw materials for family needs;

have existed even during centralized economy. The larger scale of hidden activities in Albania, primarily, came as a result of the collapse of the institutions of centralized economy, legal and institutional vacuum emerging soon after and of the initial weakness

of the state to establish adequate legal and fiscal institutions for the market economy. We shouldn't be neglectful towards the destructive effects of the crises our country has faced in the meantime, as well as the high and constant economic and social polarisation during the entire transitional period up to date. Here we must stress that this polarisation in some cases achieved through a doubtful manner, has brought the long debate regarding fiscal amnesty.

We are of the opinion that the major factors leading to the strengthening of hidden economy in this period are:

- the massive close-out of jobs in the first period of transition;
- the huge demographic displacements towards field areas, big cities and particularly towards Tirana;
- the high politicization of public administration and frequent interventions of politics in economic decision-making;
- the compilation of a new and improved legislation, yet, leaving room for a high level of hidden economy.

The main effects of hidden economy are on:

1. Monetary indicators: Hidden activities tend to be carried out in cash, thus increasing the need of money circulation.
2. Participation in the labour market and duration of working hours: If the number of employees and working hours in the hidden economy increase, the rate of employees and working hours in formal economy will decrease.
3. Official statistics of production: Growth of informal economy is associated with less credible statistics and lower figures compared to the official rate of the economic growth.
4. There are two opposite streamlines concerning the effect of informal economy on economic growth: 1. the decrease of hidden economy influences on the economic growth; it means an increase of income from taxes by leading to an increase of the public expenditures. 2. the hidden economy is more competing and efficient than the formal economy; in this way it stimulates the economic growth.
5. The need for public expenditure on the conditions of high-rate hidden economy leads to an increase of the hidden economy itself, and in a vicious circle, to an increase of taxes to meet the public expenditure needs.

6. Potential possibilities to transfer a part of hidden economy to criminal economy and in financial support of crime, especially organized economic crime.

7. Increase of corruption through bribing civil servants dealing with tax control and collection, by bringing as a consequence the corruption and deformation of the activity in the public administration operations. There are plenty of pressures in the Albanian official bodies for employment in tax and customs administration.

Hidden economy can be measured by:

A. Direct methods, through:

1. Questionnaires;
2. Tax-control by means of expenditure and income statistics of companies and individuals.

B. Indirect methods through:

1. Statistics of national accounts (incongruity between the income and expenditure statistics in national and individual accounts);
2. Statistics of employment rate (decrease of employment in formal economy by assuming that participation in work has a relatively constant rate of participation);
3. Transactions (the data of the quantity of monetary economic transaction to calculate the total and official PBB);
4. Money demand (increase of cash demand because the transactions of hidden economy are performed in cash);
5. Consumption of electrical power as it is the best physical indicator of the overall economic activity (the difference between the growth of PBB and the growth of the power consumption).

Keeping it under control and enabling the gradual formalization of the hidden economy, we should look into:

1. Its role in the country economy, the weight in employment and the dynamics in different sectors, and in the relaxation of the social consequences of transition, etc;
2. The legal framework which leaves room for the hidden economy;
3. Problems in the taxing system, state bureaucracy and social insurance;

4. Employment of minors in the hidden sector.

We also highlight that, though a lot of partial studies have been made by different researchers, primarily foreign ones, by the state institutions and media publications, a higher priority, with regard to the study of hidden economy, should be given to Albanian researchers, not for the mere fact that we have nowadays sufficient intellectual capacity graduated in the country or abroad, but also because of the features represented by the Albanian economy in this transitional period; this hinders its acknowledgment and consequently the implementation of given models for the assessment of the level and spread of the hidden economy. The most efficient way for complete studies that offer executable policy recommendations for this sector, would be the undertaking of common studies with the involvement of Albanian researchers, state institutions dealing with fiscal and employment matters as well as international institutions for expertise in this area.

In conclusion, here are some recommendations to reduce the hidden economy rate:

1. The low-tax countries tend to have a lower level of hidden economy, but we highlight that the reduction of taxes doesn't often reduce the rate of hidden economy; we, therefore, think that there is room for adjustments of the taxing system by making them simpler in content, logical for the citizens and executable in the conditions of Albanian economy. Establishing bridges between the contributions and profits from the fiscal system is viewed as the main way, which encourages the citizens and businesses to orient themselves towards the formal sector of economy.
2. The complicated state rules for licensing, market-labour and bureaucratic barriers increase the hidden economy. We, therefore, think that there are many cases, which require a relaxation of bureaucratic and exceeding barriers in the licensing documentation, etc.. A number of studies have been made in this area; what remains to do is their implementation in relevant fiscal packages.
3. Hidden economy is lower in countries where the state institutions are more powerful and efficient. The continuous strengthening of these institutions, the growth of public trust toward them remain the safest ways to enhance the formalization of economy and reduce its hidden sector.

4. The countries with a high corruption level have high-rate hidden economy. The fight against corruption, in term of the strengthening of institutions and state, the growth of civic consciousness and individual responsibility, as well as the strengthening and modernization of public administration remain premises for the reduction of this sector.

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ASSESSING MONETARY POLICY IN ALBANIA USING AN INTEREST RATE RULE¹

Hossein Samiei

I. INTRODUCTION

The conduct of monetary policy, in both industrialized and developing countries, has been significantly re-evaluated over the past two decades. First, there has been an increasing tendency toward central bank independence in order to enhance transparency and reduce political interference in monetary policy decisions. Second, the focus of monetary policy has shifted toward controlling inflation, with other factors—such as output—entering the decision making process primarily to the extent that they influence future inflation. Third, there has been a shift of emphasis from monetary aggregates toward interest rates as the main instruments of monetary policy. This has been accompanied by an increased stress on using rules, while acknowledging the need for a certain degree of discretion in practice.

Against this background, modeling central bank behavior using interest rate rules has attracted much attention. A simple rule, popularized by Taylor (1993), stipulates that the central bank sets its policy interest rate by reacting to the deviations of current inflation from a target rate and of output from its potential. Taylor suggested that this rule replicated closely monetary policy decisions in the U.S.. Other authors have shown that under certain assumptions, such a rule could also be optimal. While clearly no central bank

can be expected to follow such a rule strictly, extended versions of the Taylor rule have been used as a tool to appraise monetary policy decisions (see, for example, Orphanides (2002), and Gerlach and Schnabel (2000)).

In line with international trends, monetary policy in Albania has, since the beginning of transition, become increasingly more transparent, systematic, and market based. Despite the underdeveloped financial system, a banking system that is dominated by one bank, and very limited private sector credit in domestic currency—which limit the use of indirect instruments of policy—the Bank of Albania (BoA) has had success in strengthening policy making. The focus on inflation has increased—through adopting an informal inflation targeting framework in the context an independent central bank and a flexible exchange rate—supported by policies that target reserve money. In part as a result of this, but also owing to stabilization policies followed after the collapse of the pyramid schemes, inflation has been under control since 1998. Low inflation has also been supported by large official inflows and private remittances, which have contributed to a strong exchange rate.

The objective of this paper is to use Taylor-type rules to analyze whether, in setting policy interest rate, the BoA has responded systematically to relevant economic developments. The estimation results provide some support for this hypothesis, although they are only indicative, given the simple nature of the analytical framework, structural shifts in the Albanian economy over the past decade, and serious data deficiencies.

The paper is organized as follows. Section II discusses the basic Taylor Rule; Section III presents two backward-looking and forward-looking dynamic extensions of the formula for estimation purposes; Section IV highlights the data problems; Section V presents the estimation results; and Section VI concludes.

II. THE TAYLOR RULE

The simple Taylor rule stipulates that the policy interest rate deviates from its equilibrium level to the extent that inflation deviates from its target and output from its potential:

$$i = r^* + \pi + \alpha (\pi - \pi^*) + \beta (y - y^*)$$

where i is nominal policy interest rate, r^* equilibrium real interest rate, d and d^* , respectively, actual (or expected) and target inflation rates, and y and y^* , respectively, (logarithms of) actual and potential output. The term $(y - y^*)$, therefore, measures the output gap.

Taylor argued that this rule could replicate Fed's monetary policy for U and $V = 0.5$, or equivalently for response coefficients of 1.5 for inflation and 0.5 for the output gap. With these coefficients, a rise (fall) in inflation would provoke a more than proportional rise (fall) in nominal interest rates, implying a rise (fall) in the *real* interest rate, thus making it more likely for the rule to be stabilizing.

Taylor's original formulation, as a possible reaction function for monetary authorities, or as a means to assess monetary policy, is subject to a number of qualifications. First, it requires observations on expected inflation and the real interest rate, which are not readily available; and on the inflation target, which are available only in the presence of formal inflation targeting. In practice these have to be estimated or simplifying assumptions need to be made—for example that the real interest rate and the inflation target are unchanged over time, in which case they would be absorbed by the intercept term. In addition, the information available to the monetary authorities at the time decisions are made, may not be the same as the historical data used in estimation. Second, in practice, policy rates are likely to display some autoregression and to respond to economic developments with a lag. A dynamic formulation, therefore, would be more appropriate. Finally, other factors could influence policy interest rates, including the exchange rate, foreign interest rates, and money growth.

III. ESTIMATED EQUATIONS

We estimate dynamic formulations that include other variables that could influence decision making. Given the informational issues, we consider two types of behaviors on the part of policy makers: backward- and forward-looking. In the backward-looking case the central bank is assumed to respond to past values of inflation and the output gap, as well as exchange rate changes, monetary growth, and foreign interest rates (and their lags), which are jointly denoted by the vector z_t :

$$i_t = \delta + \rho i_{t-1} + \sum_{j=1}^k \alpha_j \pi_{t-j} + \sum_{j=1}^k \beta_j (y_{t-j} - y_{t-j}^*) + \gamma' z_t + u_t$$

The real interest rate and the inflation target are assumed constant and subsumed under the constant term λ_i and u_t is an error term, assumed to have the standard properties.

In the forward-looking specification the interest rate is assumed to react to expectations of inflation at time $t+k$ and output gap at time t —which are both unobserved at time t when the interest rate decision is made:

$$i_t = \delta + \rho i_{t-1} + \alpha \pi_{t+k}^e + \beta (y_t^e - y_t^*) + \gamma' z_t + u_t$$

This equation is estimated using instrumental variables for expected inflation and output gap, under the assumption that expectational errors are white noise.

IV. DATA PROBLEMS

Before discussing the estimation results, it is important to stress some of the numerous data problems that limit the scope for a meaningful empirical analysis. First and foremost, GDP data are extremely imprecise. For the period 1994-97, and again 2001-02, in the absence of national accounts, they are estimated based on scarce activity data. For the period 1998-2000, although national accounts are now available, the data suffer from inaccuracies resulting from extensive informal activity. Furthermore, quarterly GDP data are unavailable and, for the purpose of this exercise, they were estimated (using conversion by the quadratic match sum method). Finally, potential output is estimated using the HP filter. Given the very unreliable nature of the estimated quarterly GDP data, this measure of potential output is only meant to give an indication of the extent of pressure on the economy.

Second, the Bank of Albania switched to using indirect instruments of monetary policy in January 2001. The data used here for the policy interest rate are the BoA's refinance rates prior to that date, and the weekly repo rates since then. This could be a source of inconsistency and structural break, especially because it is reasonable to assume that interest rate policy took a more meaningful form following the switch to indirect instruments. Given the short length of the data it is not possible to address this problem in a satisfactory fashion.

Finally, while, in comparison with GDP, CPI inflation is relatively

accurately measured, the data are subject to a structural break in 2002 owing to a revision of the basket, and suffer from biases resulting from the outdated weighting system prior to 2002. However, for the purpose of assessing the BoA's approach to monetary policy (i.e. its response to measured inflation) this may not be an important source of inconsistency.

V. ESTIMATION RESULTS

The estimation results are presented in Tables 1 and 2. Other variables included in the equations (money, exchange rates, and foreign interest rates) ² turned out to have insignificant (or implausible) coefficients and are dropped from the regressions. The presented results, therefore, amount to testing for the Taylor rule in its original form, but allowing for dynamics and alternative assumptions about expectations formation. ³

They are, on the whole, surprisingly supportive of a Taylor-type reaction function. Specifically, 1-quarter lagged inflation and 3-quarter lagged output gap in the estimated backward-looking equation, and 4-quarter ahead inflation in the forward-looking equation appear to be significant determinants of policy interest rates. The output gap in the forward-looking equation is insignificant. The diagnostic tests indicate that the equations are broadly well specified (the assumption of normality in the backward-looking model, however, is rejected).

Based on these results, and subject to the provisos already made, the results appear to indicate that the BoA has been acting systematically in response to inflation and activity. In particular, in the backward-looking model, a 1 percentage point increase in past inflation average leads to 0.1 percentage point increase in nominal interest rate in the short run and about 1 percentage point over the longer run. In the forward-looking model, the effects of an increase in expected inflation on the interest rate are estimated to be larger.

While the results are encouraging, they are tentative, given the extensive data difficulties and the short length of the data, coupled with the presence of sharp movements in inflation, the output gap, and interest rates following the pyramid schemes. Furthermore, while there is support for the basic Taylor rule, the estimation results are not robust to including other variables, possibly due to the short length of the data or measurement errors.

VI. CONCLUDING REMARKS AND POLICY IMPLICATIONS

The results reported in this paper provide some evidence that the BoA has followed a systematic approach to monetary policy—although severe data problems reduce the reliability of the results. This approach has clearly played an important role in maintaining low inflation, although the paper does not examine this issue—low inflation has also been helped by the gradual fiscal consolidation and large inflows, which have maintained a strong exchange rate. A systematic and focused approach to monetary policy will be increasingly more important as the interest rate transmission mechanism becomes stronger.

The support for a Taylor Rule does not, of course, imply that the BoA should or could follow such simple policy rules—any more than any other central bank does. In practice, the BoA bases its monetary policy decisions on a variety of indicators, and a Taylor rule could be considered as summarizing these factors (for assessment and estimation purposes) in a compact form. The BoA should continue to develop its ability to analyze economic developments in setting monetary policy. Furthermore, the Taylor rule seems to be based on interest rate response to demand shocks, while inflation in Albania is significantly influenced by supply shocks, to which monetary policy may not react in the same manner. Finally, monetary policy in Albania is supported by targets on NIR and NDA. Given the weaknesses in interest rate transmission mechanisms, policy will need to continue, for the time being, to rely on both interest rates and monetary targeting.

Table 1. OLS Estimation of the Backward-Looking Interest Rate Reaction Function¹

Dependent variable is i_t		
34 observations used for estimation from 1994Q4 to 2003Q1		
Regressor	Coefficient	T-Ratio [Prob]
C	0.20	0.22 [0.83]
i_{t-1}	0.89	14.25 [0.00]
π_{t-1}	0.12	2.12 [0.04]
$y_{t-3} - y_{t-3}^*$	0.51	4.91 [0.00]
$R^2 =$	0.96	$\bar{R}^2 =$ 0.95
S.E. of Regression =	2.01	F-Stat. F(3, 30) = 231.10 [0.00]
DW-statistic =	2.68	Durbin's h-statistic -2.14 [0.03]
$\chi^2_{sc}(1) = 5.10$ [0.200] Test for serial correlation	$\chi^2_{ff}(1) = 3.52$ [0.061] Test for functional form	
$\chi^2_n(2) = 14.56$ [0.001] Test for normality	$\chi^2_{he}(1) = 2.05$ [0.152] Test for heteroscedasticity	

1/ Data is quarterly. i_t is the short-term policy interest rate; π_t is year-on-year inflation rate; y_t and y_t^* are (logs of) actual and potential GDP.

Table 2. IV Estimation of the Forward-Looking Interest Rate Reaction Function¹

Dependent variable is i_t		
30 observations used for estimation from 19 1994Q4 to 2002Q1		
Regressor	Coefficient	T-Ratio [Prob]
C	-0.57	-0.34 [0.74]
i_{t-1}	0.91	10.93 [0.00]
π_{t+4}	0.21	3.61 [0.00]
$y_t - y_t^*$	-0.12	-0.43 [0.67]
<hr/>		
$R^2 =$	0.94	$\bar{R}^2 =$ 0.93
S.E. of Regression =	2.37	F-Stat. F(3, 26) = 133.90 [0.00]
DW-statistic =	2.41	Sargan's CHSQ (3) 4.12 [0.25]
$\chi^2_{sc} (1) = 5.16 [0.27]$ Test for serial correlation	$\chi^2_{df} (1) = 0.01 [0.92]$ Test for functional	
$\chi^2_n (2) = 0.48 [0.79]$ Test for normality	$\chi^2_{het} (1) = 2.64 [0.10]$ Test for hetroscedasticity	

1/ Data is quarterly. i_t is the short-term policy interest rate; π_t is year-on-year inflation rate; and y_t and y_t^* are (logs of) actual and potential output. $\pi_{t-1}, \pi_{t-2}, \pi_{t-3}, y_{t-3} - y_{t-3}^*$, and $y_{t-4} - y_{t-4}^*$ are used as instruments.

ENDNOTE

¹ This paper has benefited from comments by participants at the Bank of Albania Conference in Saranda, September 10-12, as well by my colleagues at the International Monetary Fund.

² Both euro and dollar exchange rates and interest rates were tried.

³ All estimations are carried out by Microfit 4.0 (M. H. Pesaran and B. Pesaran (1997)).

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LUNCHEON SPEECH

FEW WORDS ABOUT THE DISTINGUISHED GUEST, MR. DERVISH

Shkëlqim Cani

Honorable Ladies and Gentlemen,

Before I give the floor to Mr. Kemal Dervis allow me to say a few words about this great friend of Albania and Albanians.

Kemal Dervis has become internationally renowned especially during the last year, for the precious assistance to the Turkish Government while it was facing the severest economic crisis of its modern history.

As one of the most credible policymakers of markets in transition, Mr. Dervis has held since 1998, the honorable position of a high official in the World Bank.

Of course, we, as Albanians, are very grateful to Mr. Dervis for the remarkable personal and institutional contribution, because, as we all know, World Bank has been one of the biggest donators and supporters of Albania during the 12 years of transition.

For the Turkish people and not only for it, Kemal Dervis is the inspirer of messages that call for European and global integration; he is the modern politician that has replaced the traditional ones, and, for the Turks, he is a breath of fresh air.

Being in possession of remarkable knowledge of the economic and political situation of the region, and in particular of the Albanian case, Kemal Dervis enjoys the indubitable sympathy of Albanians as one the main leaders of his country who has continuously and vigorously supported Albania, despite political fluctuations and changes.

It would take me a long time to speak of Kemal Dervis and his attributes but I am convinced that everybody is witness of his brilliant career in the World Bank , of his personal contribution in securing a vital package of 16 billion usd from the IMF that will help the revitalization of the Turkish economy, and will impact the economy of the whole region we live in.

COMPLEMENTARY SPEECH

Kemal Dervis

Thank you very much, Mr. Governor, Mr. Minister, dear friends, dear colleagues.

It's great to be back and you know time goes so fast in life, it's eight years in fact since I last visited Albania when I was responsible for the Eastern Europe and Balkan Department in the World Bank. I kept a little calendar and in three years 92 – 95, I came 28 times in Albania. That means definitely that Albania was my second home. Than different positions happen, different work and also the deep crises in Turkey; and while I thought so often of Albania, and of my friends here, of the progress the country was doing, I had not the opportunity to come. Thank you very much for inviting me, thank you for giving me this opportunity to be together with you again back in Albania. You know, I'm going to start with a little story, because it's good to tell a story after a nice lunch like this, and it's professor Mema who inspired me to tell this story when we talked about mentalities and how each country has its own spirit in all that. You know I'm Turkish, but I lived outside Turkey for many years so let me tell you a small story about economic reforms when I was a minister. It has to do a little bit with mentality because I think both Albanian and Turks share a strong built character, we are not easily pushed around, we want to impose our will. So, in Turkey, one of the many reforms we tried was to liberalize Turkish Airline Industry. Turkish Airlines is a very important airline but it was making losses, and part of the reason for the losses was the

low prices that the Ministry of Transport was imposing on Turkish airline. So it was important to have this big company become profitable and what I wanted to do was to liberalize the prices, but the Minister of Transport had no intention at all to cooperate with me on this matter. He was in charge for movement of prices and also for setting the time – tables, which is perfectly normal because you cannot allow the planes to take off whenever they want. So I prepared the prices liberalization law, I sent it to the Prime Ministry and after a while I got a call back from a colleague who was trying to help me. He said, let's make a change; why don't you add to the price liberalization also the liberalization of the departure and arrival times, let the planes leave and come whenever they want! I said 'It's crazy, everyone will think I'm crazy'. So, then we agreed to just send the cover memo with my name, because I was not going to sign that officially. He took it to the Minister of Transport and he said 'Look at this stupid Dervish. He wants to liberalize the departure times, so you take the red pen and cross it out, but as far the prices are concerned, ok let him do this!!!!'

So that way we both got our will, neither one dominated the other.

Let me take this time to share with you some basic lessons that I've learned in my work at the World Bank, as a minister, as a professor in the universities, as an economist etc. Let me just select a few, which I think are important and worth it.

The first lesson is to recognize the development as a really integrated process. It's not just about economics, it's about political economy, government, about social systems; it's really an integrated whole and it has to be looked in that way. If we see it in the narrow economic approach this leads to mistakes. This is not to say that economics is not important, it's very important, and particularly so the macroeconomic framework. We know a lot about monetary policy, fiscal policy, as we had excellent presentations this morning. Of course we have to be a good technical economist but to succeed I think we need sociologists, historians, psychologists, social scientists and what we really need is a good political process. I think this is what history teaches us; just to be an economist is not enough and particularly all of us are economists. I think we should all remember that, otherwise we would not get the success we want.

The second major I would like to propose is particularly for transitional economies. Oscar Lange, who was a very famous Marxist economist, who also taught during the War in the university of Chicago; many of you have surely heard about it; wrote a very interesting article about the computer and market which came out at the early 50's. There was a great misconception among Marxists in the 30's, 40's, 50's and this is a very interesting article about the computer and market. It was an old debate about markets and planning and he said, "but now we have computers, so forget the market, we can write computer programs, a thousand of equations, and then we can plan correctly a socialist economy". This was the misconception, such a very intelligent man talked about. Of course that type of quantitative planning was very old, very inefficient, very bureaucratic and could not possibly work. But the opposite extreme, which has happened in many countries, is that there is no strategic planning at all. There is a very little long-term thinking, and in fact what happens is that the annual budget has become the only economic framework that exists in many countries. I think this is also quite a mistake. I think what we need is a strategic planning framework, in fact not just economic but overall social planning, which looks at emigration, income distribution, at sources of growth, education, health, at all these things. This can help a lot to avoid a kind of crises and mistakes that we have seen in so many countries. I believe that somehow we have to rebalance a little bit, of course don't get me wrong, I'm not at all advocating any return to old style bureaucratic planning, but I do believe that a part of the Ministry of Finance's annual budget can be a seriously multi-year framework. It has to be looked at more seriously. I would say that in even an institutional context, such as a ministry is, a long term strategic planning is necessary. Markets are often very myopic and they also make mistakes, so what you need is to make the interaction between them and planning.

The third lesson I think we have all learned is the crucial importance of financial sector. I think that we have learned this lesson but this lesson hasn't been learned enough in international level.

I do believe that the same kind of attention that is given to the financial sector nationally, also needs to be developed at the international level. I think Albania has not yet experienced short-term large capital flows. The kind of foreign exchange market you have in Albania probably is made by remittances. You don't yet

have somebody in Citibank or in Deutsche Bank saying 'Ok, I'm going to buy Albanians bonds today'. This is a mixed blessing, let me tell you, because the day that the international banks attacked the Turkish lira on Feb. 19'th, The Citybank made 1 billion \$ in one day, in 24 hours. Ok, their business is to make money, but try to explain this to Turkish worker who just lost his job, because of the collapse. So this kind of excessive volatility in capital flows and excessive attacks on currency are very difficult to feature. I don't have a magic solution for it but I do believe that some supervision in that area is probably needed. I do support the IMF's work on orderly restructuring mechanisms in the international financing system. Let me also add to this, one more point and that's about the income distribution and poverty. When you look what happen to income distribution and poverty at time of crises, you'll always see that there is the poorest people who take the biggest hit, the rich somehow adjust.

The first duty of a policy maker is to avoid deep financial crises in his country; and the first duty of the international organizations is to build an international system that is not indifferent to crises, as the one we have had.

Now let me say a few words about the IMF, the banking world institutions and their interaction with the countries. I've spent 20 years at the World Bank, I enjoyed it, it was a good period, I learned a lot and I think we did some very useful things in Albania and in other countries. So, I am a supporter of the Banking world institutions and I think the world needs them.

At the same time I do believe that it's very important that economic programs emerge out of the true interaction between the advisers from liberty unities, institutions from IMF, world bank and the local government, bureaucracy, opinion makers, civil society etc. That interaction I think is absolutely necessary to generate good policy; even the best advisers from abroad cannot really understand fully all the details of the domestic system and I think time is needed to learn this by discussion, by interaction.

I believe that maybe IMF and the World Bank are trying to do this but even more effort is needed in that direction. I think there are some dangers in management practices. I mean why is it so difficult; for example when one appoints a resident representative from the World Bank or IMF; to have a planning period, when the old resident

representative is still there? The new one that has been appointed comes, they work together for six – nine months and then the old one moves away. Instead I think the personal planning procedures of institutions are still inefficient. I would say, there is not enough international planning on how this whole thing is managed and I think the country suffers from that. A good representative learns very fast, but to put somebody in the country with no experience of that country, I don't think it's a very good management practice. So, I think there are things one can do; practical steps, to improve the give-and-take between the international institutions and domestic economy, whether it is Albania, Turkey or Mexico or Argentina or else.

Finally, I want to make a last point. It's a very difficult point of course. Some problems unfortunately don't have a national solution. I mean some problems that developing countries are facing, really have to be solved at the international level. Let me give you one example when I was running for parliament. The cotton farmers in Turkey produce good, high quality cotton and the cost of producing is quite ok. The problem is, as the most of you know, that US is offering massive subsidies to its cotton farmers. So what could we do, we have a big budget problem, a big debt problem, there is no way that Turkey or Albania or even Brazil can subsidize the domestic cotton the same way as US does. So what can we do? Put a tariff for cotton? If we do this, then our cotton becomes more expensive than the world cotton and our textile (people producing shirts) will suffer from that. So what can we do? We only can watch the cotton farmer go down and disappear because the US is offering such huge subsidies to its farmers. This is not a problem that I as a Turkish policy maker can solve in Turkey. This is something we have to solve at the international level. I know it's a very timing thing to make this point. Those who preach free trade and competition in the world, don't; they turn around and pass a form of bill, of the kind that the US administration has passed a few months ago, of huge additional subsidies to the American farmers, not even to the poorest American farmer, but to the rich American farmer. And so, this makes tremendous damage to poor farmers in the developing world, in Africa, Eastern Europe, in Latin America and so on. For some of this problem we really have to fight internationally and the only way we can succeed is if main countries get together, negotiate together and show their strength. Because these are real problems and it's not true that all the mistakes made

or all the cost that people in developing countries have to bear, are domestic. Some of them are really made in Washington, Brazil and Tokyo, so we should also remember that. I believe that the IMF, The World Bank should help in that direction. Mr. Olters and Mr. Passacantando, both of them have been very strong outspoken of these issues and we should be grateful for that.

So finally let me say how did I find Albania, I haven't seen too much, but tomorrow we will see more driving back to Tirana. I think that there has been tremendous progress in Albania. The eight years is not that long period and I can see how much the country has changed. It has a tremendous development. If it hadn't been for the financial crises of 96 – 97 I guess Albania's per capita income would be another 500 US dollar higher. So this shows how important is to avoid crises. Many countries have run into this, people learn and sometimes these crises have one good thing also. The people learn from this mistake and don't do this again. I'm very optimistic; I can see a lot of progress. I was always very optimistic about Albania. I knew it would be one of the start performers of transition, I think if all of you contribute, you will be proud with the achievement. I also believe that together with our European friends, both Turkey and Albania will adopt in European Union actually faster than more people think now. This will finalize the whole transition process and it will also make Europe stronger and bigger, not concentrated. If you have this conference another eight years from now, I can't predict that you will be in the union but you will be very close to it. I do believe that Albania will catch up fast. I think that Turks and Albanians will help each other in this reach to have this friendly, peaceful South Eastern Europe.

Many, many thanks and I'm so happy to be here!

SECOND PANEL: "POTENTIAL
CHANNELS OF FOREIGN
EXCHANGE INFLOWS - FROM
UNCERTAINTY TO AN EXPORT -
ORIENTED ECONOMY"

SUSTAINABILITY OF CURRENT ACCOUNT BALANCE¹

Ahmet Mançellari

Selami Xhepa

ABSTRACT

The trade deficit and consequently, the current account deficit, are among the essential challenges the Albanian transition is facing. The level of 24,6% of the relative indicator of trade deficit in 2002 (in percentage of GDP), corresponds to the level of 9% of the relative indicator of current account deficit, approaching to the record level marked in 1997 (11.1%), surpassing the level of 2001 by 3,7 percentage points and being about two times higher than the level of 5%, which, in economic literature, is regarded as a “warning” level. The high levels of current account deficit raise the need to analyze the deficit sustainability, an analysis that constitutes even the aim of this paper.

Comparing the theoretical criteria and particularly the practical criteria of current account deficit sustainability with current account balance position in Albania, the conclusion is drawn that in Albania's case the current account deficit is chronic, and at very high levels. Nevertheless, given the overall considerations, current deficit may be estimated as relatively sustainable, but with a rather fragile and seriously threatened sustainability.

Given the current account deficit structure, it is concluded that the improvement of current account balance requires, first of all, the

trade balance improvement. In spite of the importance the substitution of imports has, this paper emphasizes the idea that the orientation of economy towards export growth stands in the basis of a sustainable and long-term trade balance improvement.

INTRODUCTION

The Albanian transition is presented, *inter alia*, as a process of Albania's exit from the isolation over some decades, and as a process of opening its economy to regional and global markets and developments. Economic opening in itself is a key factor to the restructuring of economy and increasing of its efficiency. However, the achievement and maintenance of internal macroeconomic equilibrium under conditions of economic opening constitutes a challenge, which in Albania's case has taken the view of high current account deficit levels and worrying trade deficit levels.

The level of 24,6 per cent of the relative indicator of trade deficit (in ratio to GDP) in 2002, corresponds to the level of 9 per cent of relative indicator of current account deficit, that comes close to the record level noted in 1997 (11.1 per cent), surpassing by 3,7 percentage points the level of 2001 being about twice higher than the level of 5 per cent, which in economic literature is regarded as a "warning" level. Such levels of current account deficit raise the question: Is current account deficit "sustainable" in Albania's case? Precisely that is the question we are going to try to answer through this paper.

Serving the above purpose, the paper is divided into three sections. Based on relevant literature, the **first section** deals with the possible meaning and criteria of assessing the current account deficit sustainability. Given that the current account deficit is identified with the difference between savings and investments of economy as a whole, to a certain extent it measures and reflects the strength of an emerging economy. But, on the other hand, the negative difference between the savings and investments may not be "sustainable" and may shake the external position of economy. Current account deficit sustainability, in substance, means sustainability of financing investments presented as a balance on national savings, under the conditions of (i) increasing imports, with rates comparable to those of real GDP growth; (ii) non-

reduction of normal flow of international payments; (iii) non-reduction of foreign reserve required.

Theoretically, in a synthetic view, the degree of ability of a country's economy to face international financial liabilities may serve as a "measurer" of current account deficit sustainability. However, on practical grounds, a number of criteria may be used, which spring from the above theoretical criterion, such as the foreign debt ratio to GDP; presence of external sector crises; ratio of investment growth rates to savings growth rates; structure of current account deficit; structure of capital inflows; dynamics of foreign reserve stock, compared to debt stock; position of the financial system and of the banking system in particular and the possibility of predictability of policies and of economic developments.

In the **second section** an effort is made to the implementation of the criteria discussed in the first section, for assessing the sustainability of current account deficit in Albania's case. The increasing need of economy for investments, especially under conditions of very low domestic savings rates, have made possible that the current account be featured by a chronic deficit, extended over the whole transition period. The analysis of indicators tests that the current account deficit is a consequence of increasing investments at a higher rate than the rate of increasing the domestic savings. The increase of investments, particularly of those of the private sector, has impacted on the growth of import volume, which has led to the deepening of trade deficit, whose very high levels constitute a threatening to the external equilibrium of economy.

The analysis of sources of financing economic transactions with the world and their expected tendencies, especially the export position and problems; the narrowing and marketing tendencies of support by international financial institutions; the tendencies for decline in mid-term and long-term periods of migrants' foreign currency inflows; the performance towards the narrowing and closing of illegal traffic paths, all highlight the fragility of current account deficit.

Effort is made to the **third part** to provide an answer to the question of how can sustainability of current account deficit be increased in Albania's case. Analyzing the structure of this deficit, it is concluded that current account deficit sustainability may be equivalent to the

sustainability and duration of import financing sources. Under these conditions, the question raised may be reduced into how can the trade balance be improved. The paper emphasizes that from a long-term viewpoint, the main way to trade balance improvement is the way of promoting exports, based on the increase of competitive abilities of the country's economy.

In the economic literature on the transition countries, attention is paid to macroeconomic state of competition, especially to the real exchange rate appreciation process, a phenomenon that has associated almost all the transition countries. The analysis of this factor in Albania's case testifies its weak impact on export performance. Other factors are underlined as having more effect, such as restructuring reforms performance, smoothing and preventing the administrative barriers to the private sector development, improving the overall investment climate, improving the business microenvironment.

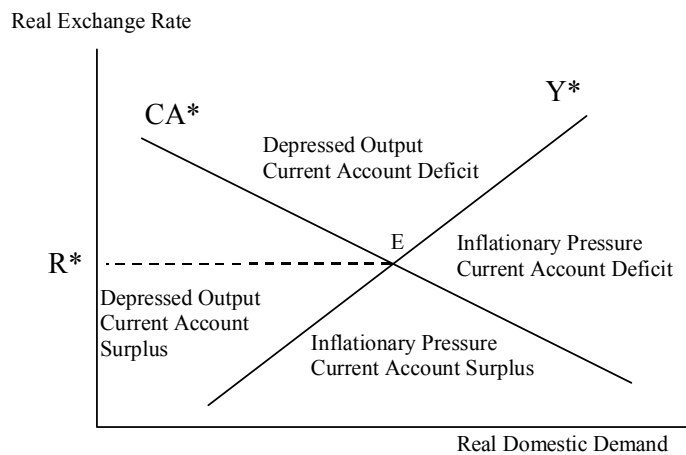
The end of the paper emphasizes that current account deficit in Albania's case is chronic, at very high levels. However, generally speaking, it may be estimated as relatively sustainable, but with a very fragile and seriously threatened sustainability.

1. MEANING AND CRITERIA OF ASSESSING THE SUSTAINABILITY OF CURRENT ACCOUNT DEFICIT

The instantaneous achievement of both the external and internal macroeconomic balance is regarded as an essential target of macroeconomic policies. The internal balance is defined as a situation, in which the real product is at its potential limits or close to them, and the inflation rate is low and not accelerating. The external balance is frequently defined as a certain level of current account, considered as sustainable.²

Both, the internal and external balance, are based on two essential variables: level of real domestic demand and real exchange rate. In turn, both variables reflect the macroeconomic conditions and policies. Current account deficit occurs when real exchange rate is appreciated too much, and/or there is an excessive real domestic demand. Figure 1³ reflects both the instantaneous internal and external equilibrium (shown by point E), and the various combinations of dis-equilibrium positions.

Figure 1: Macroeconomic equilibrium and real exchange rate.



In which situation presented in the Figure is Albania at present? The chronic deficit in current account balance places Albanian economy on the right of CA^* line (the line of external equilibrium). In spite of relatively high and constant economic growth rates, the presence of high rate unemployment, along with the low level of the credit to private sector/bank deposits ratio indicates GDP levels far from the potential one, mainly due to structural causes. This means that Albanian economy is at the same time on the left of Y^* line (internal equilibrium line). So, Albanian economy, characterized by a GDP below the potential one, and simultaneously by a current account deficit, is above point E of the instantaneous internal and external equilibrium, to which responds the R^* of real exchange rate level. However, the inflationary pressures deriving from emigrants' remittances and other foreign currency inflows and from structural factors, make it possible that the Albanian economy be predisposed towards disequilibrium levels on the right of E .

In this paper, we shall focus on external macroeconomic balance, meaning a "sustainable" current account balance. The current account balance, precisely the current account deficit, is an important indicator of the performance of a transition economy. The importance springs from the fact that current account balance, reflecting the savings-investments ratio, is closely related to the fiscal balance position and to that of the private savings, both very

important factors for the economic growth. The importance of current account balance (deficit) is linked even with the fact that it reflects the position of exchange rate and competitive ability in economy.

Given that the current account deficit is identified as the difference between savings and investments for the whole economy ($CA=S-I$), in a certain way it measures and reflects the power of an emerging economy. But, on the other hand, the negative difference between the savings and investments may not be “sustainable” and may shake the external position of economy. The shocks or the crisis of external position of economy may appear (i) as a foreign currency crisis, associated with a drastic depreciation of domestic currency or with drastic reduction of the country’s foreign reserve, (ii) as external debt crisis, in the form of insolvency of external debt and /or inability to receive new foreign loans. Even for transition economies, as emphasized by Roubini and Wachel, current account deficit reflects both sides noted above. On one hand, according to a point of view, the current account deficit reflects the success of structural changes, which have enabled capital inflows and investments and have opened the perspective of a rapid economic growth. On the other hand, according to another viewpoint, the current account deficit is a reflection of transition processes not always well managed, with unsustainable imbalances, potential sources of foreign currency or balance of payment crises (Roubin and Wachel, 1998).

Which side of current account deficit is more important? That is, which viewpoint is more convincing? The answer, as noted by the two abovementioned authors, is difficult. The difficulty relates to numerous factors and to not rare shocks, frequently unpredicted ones, which affect the current account balance position in transition countries, without excluding even the low quality of available data. Nevertheless, without neglecting the “positive” side of current account deficit, the paper will be focussed precisely on the other side, on treating the sustainability of this deficit.

Concept of “sustainability” needs clarification. When speaking about current account deficit sustainability, in its core, it does not mean “sustainability” for “maintaining “ the existing trade deficit levels. What should be understood is the sustainability of financing investments in excess of national savings; it is the sustainability

financing sources of this deficit, under the conditions of (i) increasing imports with rates comparable to those of GDP growth; (ii) non-declining of normal flow of international payments; (iii) non-declining of foreign reserve required. (Chrong-Huej Wong, 2000.)

So, the concept of trade balance sustainability is a complex concept. Under these conditions, it is impossible to find a simple rule to estimate whether a country's current account deficit is sustainable or not. However, the economic literature recommends a number of criteria that may be used to make such estimation. (Roubini and Wachel, 1998). Theoretically, the degree at which a country's economy can face the international financial liabilities serves as a "synthetic measurer" of current account deficit sustainability (economy solvency).

In which conditions an economy may be considered solvent and therefore its current account deficit "sustainable"? Economy solvency can be measured by a number of indicators which, at any case, relate to external debt and compare the ratio of real interest rate to economic growth rate; (real interest rate being higher than economic growth rate); real interest rate to debt increase rate (debt stock not increasing faster than real interest rate); the unrestricted amount of current account balances to original external debt (solvency means equality of two indicators) etc.

However, for practical reasons, a number of criteria may be used (precisely indicators) that spring from the above theoretical approach.

(i) One criterion of sustainability would be the *non-increasing ratio of foreign debt to GDP*.

(ii) Another practical criterion of sustainability, under the conditions of absence of external shocks, or fundamental changes of macroeconomic policies, would be the *non-occurrence of external sector crises*, in the form of foreign currency crisis or debt crisis.

(iii) Generally, it is accepted that a level over 5 per cent of the indicator of the ratio of current account deficit to GDP draw the attention to the need of estimating the sustainability, that is even to the possibility of current account deficit unsustainability. However, the estimation of sustainability is related to the analysis of deficit

sources. Under the conditions of a high ratio of deficit to GDP, the deficit is more likely to be sustainable, when caused more by the national investments increase than by the savings dropping, especially when *the national savings in turn, are low*. The high investment rates, particularly those of the private investments in productive capital, though they may produce current account deficit, are expected to be accompanied by increase of productive capacities and of income from export, hence even of increasing possibilities to serve the foreign debts. Increase of investments is consistent with high economic growth rates, therefore high current account deficits are more *sustainable under the conditions of high economic growth rates*. If we refer to decrease of savings, the reduction of national savings due to public savings reduction (budget deficit increase) is generally more problematic than the private savings reduction. This is so because the dropping of private savings is likely to be a transitory phenomenon, whereas the public saving reduction is a structural problem.

(iv) The current account deficit sustainability is impacted even by the deficit structure. If the current account deficit is caused to a great extent *by a high trade deficit*, thus reflecting structural problems relating to competitive ability of economy, its *sustainability would be more problematic*, as compared to cases when it is related mainly to the net factorial income. In this framework, the export share to GDP may serve as a criterion of current account deficit sustainability.

(v) The current account deficit is financed by foreign capital inflows. In the size of sustainability of this deficit, an important role is played even by the capital inflow structure. Generally, short-term inflows (*portfolio investments or otherwise called "hot" money*) and loans *are more risky to the current account deficit sustainability than the respective long-term inflows (foreign direct investments) and wealth investments*. In the framework of loans, in short-term periods, the loans from private creditors appear more problematic than the loans from official creditors and portfolio investments more problematic than the bank loans. Sticking to the loan portfolio frame, its foreign currency composition is of importance.

Even the size of foreign capital inflows is important for the sustainability of current account deficit. Foreign capital inflows in large sizes, especially in sizes greater than current account deficit,

in spite of the positive contribution in short-term periods, with the passing of time may be accompanied *with negative consequences in competitive ability of economy*, through the impact on domestic currency appreciation, notwithstanding whether sterilizing measures are taken or not (in the negative case, the money supply is increased, hence even the inflation, affecting on the real appreciation of domestic currency; in the positive case, the maintaining of high interest rates encourages the continuation of foreign capital inflows, affecting the nominal appreciation of domestic currency). However, interventions in the foreign currency market may smooth the situation, thus increasing even the foreign currency reserves.

Generally speaking, the current account deficit may *be less sustainable under the conditions of a real appreciation of domestic currency, in spite of what causes this appreciation*, as long as it affects negatively the competitive ability of economy.

(vi) The ability of a country to face the current account deficit is affected by the foreign reserve stock of that country. A higher ratio of the foreign reserve to the debt stock is an indicator of an even higher degree of the sustainability of current account deficit.

(vii) Finally, the sustainability of a high deficit of current account depends on the country's financial system position, especially in the banking system, and the political stability degree and the predictability of policies and the economic developments.

2. IS THE CURRENT ACCOUNT DEFICIT SUSTAINABLE IN ALBANIA?

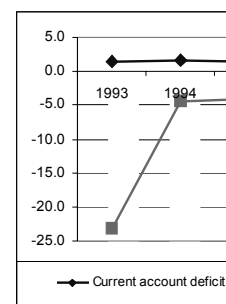
After a three-year period with a positive balance⁴, in 1996 the current account balance deteriorated, marking a deficit of 2.3 per cent ⁵ of GDP. During the crisis of 1997, the deficit level reached to 11.1 per cent of GDP, and normalized later below 5 per cent, along the entire period of 1996-2000. The deficit surpassed the critical value of 5 per cent of GDP in 2001, undergoing a very fast growth in 2002, to arrive at the level of 9 per cent of GDP. (Figure 2 and annex A, table 1.)

Figure 2: Current account balance in Albania for 1993-2002

Comparing the data on the current account balance in Albania with the respective data of other countries of the region that indicate similarity of structural problems in economy, it is noted that in general, even these countries feature high levels of the current deficit (annex A, table 3). In some of them, the deficit levels over 5 per cent of GDP have been present for a relatively long period of time, while there are not evidenced external sector crises. On the other hand, in countries having experienced economic and monetary crises, as Bulgaria's and Rumania's case, (in 1996-97), the high level of current account deficit has not served as a warning signal. Bulgaria, for example, at the crisis time (in 1997) had a positive balance of the current account of 4.2 per cent of GDP, compared to 0.2 per cent one year after the crisis. Under these conditions, we may state that for countries such as Albania, that is, generally even for the regional transition economies, which depend much on foreign aids, the limit of 5 per cent of GDP of current account deficit has not served as a warning signal of the external sector crises. The importance of this limit is presented somewhat vague, compared to countries with an established market economy.

However, to judge on the sustainability of current account deficit for Albania that from 2002 was twice as much as the warning signal, we should refer to the criteria discussed in the first section.

As long as the ability of a country to face the **external debt** stands in the core of sustainability of current account deficit, let us refer, above all, to the criteria that compares the dynamics of external debt stock, with the rates of GDP growth. At year-end 2002, net



external debt accumulated reached to about 1 billion dollars or 20.9 percent of GDP. The level of this indicator is relatively low, against the other countries of the region. Meanwhile, the external debt annual level (annual addition to the debt stock) has varied from 1,5 to 3 percent of GDP, while the annual average growth of GDP has been to about 7 percent. So, the external debt growth stands below the annual growth level of economy. From the viewpoint of this criterion, the current account deficit may be considered as sustainable. However, even from the viewpoint of this criterion, the sustainability appears as fragile. The ratio of external debt – exports (given the primary role of foreign currency income on exports for the service of external debt, in a long-term view) is presented as very high and with a fast growth (from 113 percent in 1993, to 296,5 percent in 2002). However, looking at the period under discussion, the service of external debt has been in modest levels, arriving on average to 6,5 per cent of total exports, much lower than the figure of 25 percent generally considered as a critic level. The country is not on the threshold of facing external debt insolvency. Also, excluding the negative developments of 1997, the country has not experienced any foreign currency crisis and has not shown any signs of any such crisis approaching to it. Thus, this reinforces the argument of sustainability of current account deficit.

However, for a better judgement on sustainability of current account deficit, as emphasized even in the first part of the paper, a more attentive consideration is needed on the causes, structure and financial sources of this deficit, referring to relevant criteria.

Let us first deal with current account deficit causes, referring to the deficit meaning as a difference of **savings – investments** and the relevant indicators (Annex A, table 2). At the start of (1992) current account deficit reached to 57 percent of GDP. The cause of such a deep imbalance was the domestic savings reduction (to minus 51,9 percent of GDP), while investments were at very modest levels, 5,2 percent of GDP. Later on, the picture changed. The subsequent ten-year period is featured by an increase in the savings level, contributed particularly by the increase in the public savings (the fiscal deficit reduction). From -15.5 percent of GDP in 1993, the government savings reached to -1.2 percent in 2001⁶, while the private savings became positive in 1994 (14,2 percent of GDP), and remained almost at the same level even at the end of 2001 (14.3 percent of GDP). On the other hand, investments were

increased from 13,2 percent of GDP in 1993, to 19,4 percent in 2001. Positive changes are noted considering the investment structure. The public investments weight has been declining from 9,5 percent of GDP in 1993, to 7,3 percent in 2001 and 6,5 percent in 2002). Private investments were increased from 3,7 per cent in 1993, to 12,1 percent in 2001 and 12,5 percent in 2002. So, for this period, the increase of investments, especially the private ones, has been the source of current account deficit. This fact, as noted in the first section, reinforces the conclusion on sustainability of current account deficit.

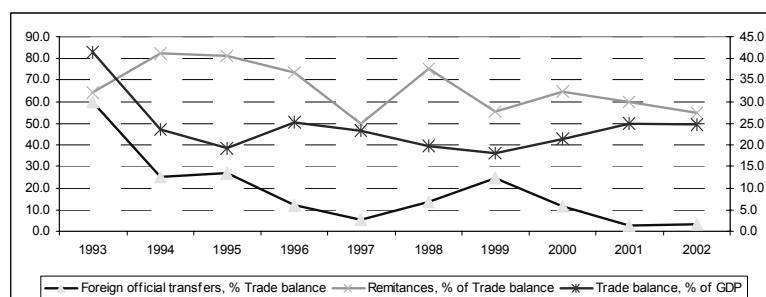
Let us pass now to the analysis of the structure or of the sources of current account deficit: trade balance, current transfers and the net factorial income.

The *net factorial income* has resulted positive since 1994 and its share in the current account has been increased. In absolute terms, it has been increased from 14,2 million dollars in 1994, to 126,3 million in 2002, unlike other transition countries, where the net factorial income is structured in the deficit account. The reasons relate to the low figures of external debt service and also to the investment of country's reserve abroad. Therefore, the net factorial income has impacted the smoothing of current account deficit level.

Official *transfers* have also played a positive role in the current account balance. The role of official transfers has been especially important in the first years of transition. If we excluded the effect of official transfers, the current account balance in 1992–1994 would result in deficit, reaching respectively to -23,2, -4,5 and -4 percent of GDP, from about +1,5 percent of GDP that results for this whole period. (See figure 2, figure 3 and Annex A, table 1.). Official transfers continue still to be an important source of financing current account. However, their role has been declining and it has shown an obvious trend to gradually change towards the use of commercial term credits. So, in 2002, the official transfers represented only 2,5 percent of the import volume.

The *remittances* have had the main share in the component of transfers. During the whole last decade, the migrants' remittances have financed more than the half of import of goods. (See: figure 3 and Annex A, table 1.)

Figure 3: Official transfers and migrants' remittances, in percentage to trade deficit



Trade deficit (in ratio to GDP) is shown on the right axle of the chart, whereas share of remittances and state transfers in financing the trade deficit is shown on the left axle of the chart.

According to balance of payments data (Annex A, table 1), the **trade deficit** of goods constitutes the most important component, which dominates the current account balance behavior. The relative indicator of trade deficit, in spite of declining compared to 1993 (from 41.4 percent of GDP in 1993, to 24.6 percent of GDP in 2002), remains at high levels. Meanwhile, in absolute terms, the trade deficit has increased in general, surpassing the figure of 1 billion dollars in 2002, being in a very high level if we take into account the overall level of overseas transactions. The dominating role of trade deficit in the current account deficit constitutes the main fragility of sustainability of the latter one and the main source of threatened sustainability.

Without making a detailed analysis of financing sources of current account deficit, we think that it is of importance to point out the significant share of informal sources (without saying straightforwardly the share of illegal traffic) of financing the commercial transactions. This fact increases further the fragility of sustainability of current account deficit and makes the external position of economy more threatened.

Another indicator of sustainability of current account deficit is even *the foreign reserve level*. The growth of foreign reserve level increases the economy's efficiency to meet debt obligations. In this case, the level of reserves to imports will serve as a measuring

indicator. During a decade, the foreign reserve level is tenfold, facing 4,5 months of commodity imports, a level that is considered optimal.

Finally, again without referring to details, we would like to emphasize that the problems currently presented by the banking system, and the financial system in general in Albania, and the oscillations and political instabilities the country experiences time after time, contribute to its fragility and threaten sustainability of current account deficit.

Concluding the analysis of this issue, we think that it is not merely the level of current account deficit over 5 per cent of GDP that should make us feel concerned. The maintaining of high levels of economic growth, under the conditions of current rates (modest ones) of domestic savings, would require even for a certain period of time, the mobilization of foreign and the current account balance will continue to be featured by negative balances. More troubling is the domination of this deficit by a deeply negative trade balance and the potential instability of other sources, excluding income on exports, of financing commercial transactions and current account deficit. The low levels of exports and foreign direct investments on one hand, and the high share of official transfers and remittances, as well as the still high levels of illegal traffics on the other hand, under the conditions of expecting reduction of the latter ones in the future, risk to exert pressure on the reduction of overseas commercial transactions volume. This may cause reduction of the rates of economy growth.

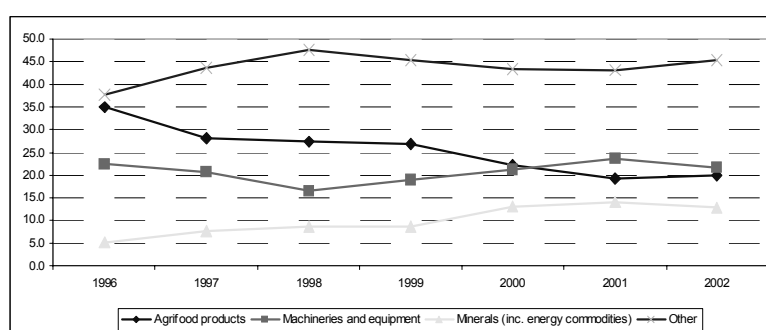
3. HOW CAN SUSTAINABILITY OF CURRENT ACCOUNT DEFICIT BE INCREASED IN ALBANIA'S CASE?

The above analysis of the criteria of current account deficit sustainability and of the factors determining this deficit highlights the critical importance of the trade balance. Under the Albania's conditions, the sustainability of current account deficit may be equivalent to the sustainability, duration of import financing sources. Also, the sustainability improvement of current account deficit, from a long-term viewpoint, may be identified with the improvement of trade balance.

How can the trade balance improvement be achieved? Not in the "short" way of reducing the imports. Undoubtedly the imports of

capital goods should be promoted and not reduced. Neither any effort to reduce consumption based on import goods would be fruitful. But, naturally, any effort to substitute imports with the domestic output at least of the same quality, would be useful. Figure 4 presents the dynamics of imports of main commodity group, where a generally increasing trend of import of machinery and equipment and raw materials is noticed⁷.

Figure 4: Dynamics of main commodity group of imports.



How can the substitution of imports be achieved? By placing obstacles to imports? By increasing these obstacles? In spite of existing spaces (but which are narrowing in the framework of regional and European integration of the country) to smooth the short-term protecting policies for certain products of the branches in recovery, yet, principally, the answer would be *no*. Not only would it be contrary to the liberalizing and integrating flows, especially because of the extended protectionist policies, but it would also hinder the efficient restructuring of economy, based on the market signals⁸. Therefore, a sustainable substitution of *imports* may be achieved only by restructuring the economy and by establishing a favorable climate of private investments.

The efforts to sustainable substitution of imports and to establishment of a favorable climate for the private business are consistent with the efforts to promote *exports*. **Export promotion may be considered, from a long-term viewpoint, as the primary way to improve trade balance⁹.** Yet, without neglecting the importance of export oriented policies, the main path towards their promotion passes through the efficient restructuring of economy,

based on the market principles. Only increasing the competitive abilities of economy the exports can increase.

How is the situation of Albanian economy competitive ability presented and how can it be improved?

The competitive ability of economy has on its basis the competitive ability of certain companies. The competitive ability of companies is based either on macroeconomic factors that determine the overall environment of their economic activity and the value of their product in terms of foreign currencies, or on microeconomic factors, which relate to the internal environment and conditions of the company. Microeconomic factors play a special role and the restructuring processes of economy are further enhancing this role. The campaigns undertaken recently for improving the internal environment of companies, so as to promote cooperation between companies and their competitive abilities through the climate of clusters¹⁰, are expected to provide positive effects in increasing the abilities.

Other very important factors for increasing the competitive ability of economy, and of certain companies, are the smoothing and preventing of administrative barriers and the improvement of the overall investment climate (FIAS, 2003).

Among macroeconomic factors, we highlight the *real exchange rate*. We think to refer in a more detailed way to the analysis of this factor, since it is presented simultaneously even as a determinant variable of instantaneous internal and external macroeconomic equilibrium. The real exchange rate is nothing else but the nominal rate, adjusted to relative inflation index, determined as the ratio of a foreign country's price index to the given country's price index:

$$RER = \frac{ErP^f}{P}, \quad (1)$$

Where RER is the real exchange rate, Er-is the nominal exchange rate, P^f is the price index in the foreign country and P-is the price index in a certain country.

The real effective exchange rate (REER) considers the basket of foreign currencies of the countries, with which a certain country

trades, as well as the basket of price index of these countries, thus setting up average weighted indicators.

Real exchange rate may be used even based on the price index of traded and non-traded goods:

$$RER = \frac{ErP_T^f}{P_N}, \quad (2)$$

Where, RER is the real exchange rate, E-is the nominal exchange rate, P_T^f is the traded good price index, defined in international markets and expressed in foreign currency and the P_N -is the non-traded good price index, expressed in domestic currency.

The increase of RER implies the real depreciation of domestic currency against the foreign currency. The real domestic currency depreciation implies domestic product price decrease in foreign currency, that is, increase of competitive ability of economy and promotion of exports. The RER decrease is associated with the increase of domestic product prices expressed in foreign currency, that is even with the reduction of competitive ability of economy and the restraining of exports. It is understandable that the impact on imports would be adverse.

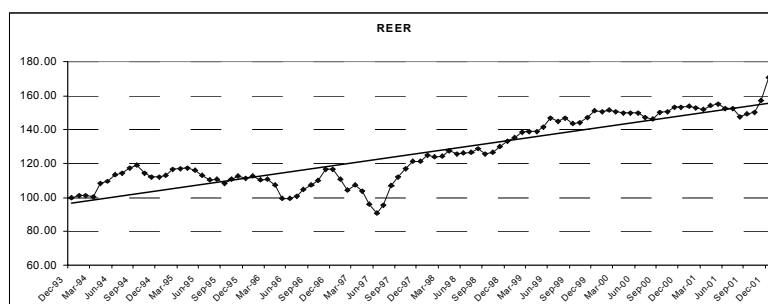
Under the assumption of the operation of One Price Law (based on the theory of Purchase Power Parity, PPP), we may state that $Er=P_T$, where P_T is price index of traded goods, expressed in domestic currency. Hence, the real exchange rate formulae would be transformed into:

$$RER = \frac{P_T}{P_N}. \quad (3)$$

According to formulae (3), the real exchange rate is expressed as a ratio of traded good price index to the non-traded good price index. The increase of the relative price of traded goods in relation to the non-traded good price is reflected as a RER increase, that is, as real domestic currency depreciation, and is associated with the respective allocative effects and competitive ability of economy.

However, in literature, to express the real domestic currency appreciation or depreciation more directly, the inverse of RER is calculated, which is frequently, again called RER (See: I. Hollar, 2003), which expresses the ratio of the price index in the given country to the foreign country price index. The increase of RER indicator calculated in this way expresses directly the real appreciation of the currency, whereas the decrease expresses its real depreciation.

Figure 5: Real effective exchange rate behavior, 1993-2001.



The performance of real exchange rate in Albania over the transition years demonstrates a relatively sharp trend of domestic currency real appreciation, Lek, as illustrated in Figure 5¹¹. Regarding this phenomenon, some questions may be raised. (i) Is this trend a deviation from the real optimal rate of equilibrium? (ii) What has impacted this trend? (iii) At what extent this trend may be regarded as responsible for the high trade deficit? (iv) May the foreign currency policies be expected to be effective for promoting exports? Let us try briefly to answer these questions.

(i) Given the Swan diagram (Figure 1), we see that a real exchange rate responds to the internal and external instantaneous macroeconomic equilibrium, which would be considered as real equilibrium rate or as optimal real equilibrium rate. However, the above diagram is more appropriate for stabilized market economy. Under the conditions of a transition economy, subject to massive structural changes, it would be very far to claim to determine a real equilibrium rate¹². (Jazbec, 2002, Hollar 2003.)

(ii) Going on with the second question, it would be required to take into account the main factors that affect the real exchange rates, that are contained straightly or implicitly in the formulas for their calculation. Since the complete analysis of determinant factors on real exchange is beyond the focus of this paper, we would be satisfied by referring quickly to the formulae presenting the real exchange rate as a ratio of non-traded good price index to traded good price index¹³. What causes the change of relative prices of traded goods? Liberalizing reforms would be a significant factor. These reforms, along with the prevention of a number of managed prices, are accompanied with increase of non-traded good prices, resulting to real domestic currency appreciation.

Another factor analyzed in the literature is the *Balassa-Samuelson effect*. Referring to this effect, real exchange rate increase has, again, on its basis the relative price increase of non-traded goods, which in turn is explained with a faster rising of productivity in the traded than in the non-traded good sector. (Drine and Rault, 2002.) Any effort made in Albania's case to analyze the price dynamics of traded and non-traded goods does not manage to prove a faster non-traded good price rise, as compared to traded good prices; Virtually, the adverse conclusion is drawn. (Josa, 2003.) However, this conclusion is probably related to the information inadequacy and the approach used.

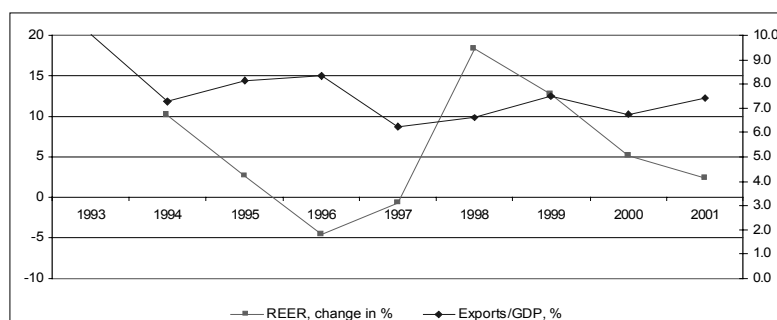
In other researches (Hollar, 2003), the Balassa-Samuelson effect is accepted in Albania's case, although the arguments are somewhat indirect and general, because of the absence of required data. According to Hollar, referring to the period of 1997, while the wage ratio in two sectors has remained more or less around the unit, the productivity ratio is increased in favor of the traded good sector. According to a study cited by the author (Halpern and Wyplosz, 2001), the analysis of data from 9 transition countries indicates that for every 10 per cent increase in traded good productivity (industrial goods), the relative price of non-traded goods to traded goods is increased 2,4 per cent in the short-term period and by 4,4 per cent in the long-term period.

Among other arguments used by the author to support the Balassa-Samuelson effect in Albania's case, valid even for other transition economies, are:

- Underdevelopment of the services sector in these countries during the period of centralized economy and increase of demand for products of this sector upon the income rise after the transition started
- The high financial inflow, especially in the form of formal and private (along with the loans and FDIs, whose share has been small). To the extent these inflows go for financing the expenses of the traded good sector, they, in the case of a small country, do not change the relative price of these goods. To the extent the expenses are increased in the non-traded good sector, the pressure for rising the prices of these goods, and even for domestic currency appreciation becomes evident. In Albania's case, the foreign financial inflows fluctuated within very high limits: 23-32 per cent of GDP. We should add here even the fact that official grants are oriented, to a great extent, to the public sector and to non-traded services.

(iii) However, leaving aside the reasons and taking for granted the real exchange rate "growth", that is the real appreciation of domestic currency, Lek, how much has this factor impacted the very low performance of exports? The analyses performed (Hollar, 2003), indicate that the impact is weak or insignificant. Relating to the weak correlation between these two variables, it is enough to refer to figure 6, which presents graphically the behavior of real exchange rate (always presented with the inverse formulae) and the export/GDP rate.

Figure 6: Variation in percentage of the REER and the export/GDP ratio.



Note: The export/GDP ratio is measured on the left axle, whereas the level of real exchange rate appreciation (depreciation) is measured on right axle of the chart.

The econometric estimation we tried to make on the relation between the real effective exchange rate and respectively imports and exports leads us to the same conclusion, being similar to other authors' findings (Hollar 2003; Mançellari, Mytkolli, Kola 1999). We have viewed the imports as a function of the real effective exchange rate (REER) and the synthetic indicators of domestic demand (GDP), whereas exports¹⁴ as a function of real effective exchange rate and the credit to private sector (DC).

The results presented in Table 1 (for more details, see Annex B) test that in long-term periods, the imports are more sensitive to the real effective exchange rate movements than exports, though in both cases, the values of *t-statistics* are insignificant.

Table 1: Conclusions of econometric analysis:

Export equation

A. Long run relationship

		Coefficient	T-stat.
Log(REER)	Included observations	-0.132976	-0.408839
Log(DC)		0.862866	5.833580
	Adjusted R-square		0,46

B. Error correction

DLEKS(-1)	-0.457352	-0.801504
DLEKS(-2)	-0.327939	-0.582690
DLDC(-1)	-0.752461	-0.386669
DLDC(-2)	0.075185	0.036420
DLREER(-1)	0.030704	0.075862
DLREER(-2)	-0.030242	-0.074660
Included observations	33,00	
Adjusted R-square	0,21	

Import equation

A. Long run relationship

	Coefficient	T-stat.
LREER	0.339469	1.302463
LGDP	1.012716	6.583608
Included observations:	32.00	
Adjusted R-square:	0.34	

B. Error correction

DLIMP(-1)	-0.569095	-4.387924
DLIMP(-2)	-0.225827	-1.716510
DLREER(-1)	0.105371	0.723912
DLREER(-2)	-0.067519	-0.470908
DLDGP(-1)	14.42594	5.900461
DLDGP(-2)	-13.14060	-5.180513
<hr/>		
Included observations:	29.00	
Adjusted R-square:	0.69	

In short-term periods, both imports and exports are insensitive to real exchange rate movements. The main explanatory factors are domestic demand in the case imports and credit to private sector (used as *proxy* for the investing activity) in the case of export performance.

(iv) The weak impact of real effective exchange rate on the export performance suggests that foreign currency policies would be less effective or ineffective in promoting exports. (See, also Mançellari, Mytkolli, Kola, 1999.)

CONCLUSIONS

Facing theoretical criteria, and especially the practical criteria of current account deficit sustainability vis-à-vis the current account balance position in Albania, the conclusion is drawn that current account deficit in Albania's case is chronic and at very high levels. In general, however, it may be estimated as being relatively sustainable, but with very fragile and seriously threatened sustainability. The fragility is related particularly to the dominating trade deficit weight in the current account balance and the expected unsustainability of financing sources of this deficit in medium and long-term periods.

Taking into account the current account deficit structure, we draw the conclusion that the current account balance improvement requires, above all, the trade balance improvement. In spite of the importance of substitution of imports, the paper emphasizes the idea that trying to orient the economy towards increase of exports, stands on the basis of a sustainable and long-term trade balance improvement.

Without neglecting the importance of supporting export policies, the main way to promote them is based on the efficient restructuring of economy, on the basis of market principles. The export growth is made possible only through increasing the competitive ability of economy. Important factors in increasing the competitive ability of the economy are the restructuring reform performance, the smoothing and prevention of administrative barriers, the improvement of the overall investment climate, the improvement of business micro-environment, including the increase of cooperation between companies, especially in the form of clusters. The real exchange rate appreciation is assessed as having a weak impact on exports in Albania's case. Therefore, even the possible foreign currency policies as instruments to improve the trade balance are considered to be ineffective.

ANNEXES

A. Table

Table 1: Main Balance of Payment data

millions of USD	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Current account	18.8	31.4	36.6	-62.3	-253.7	-65.0	-132.9	-163.1	-217.9	-420.8
Exports	123.1	141.8	201.4	224.4	143.6	202.7	275.7	258.9	304.9	330.4
Imports	418.4	554.8	648.4	933.1	644.4	823.5	943.0	1089.4	1337.5	1,506
Trade deficit	-295.3	-413.0	-447.0	-708.7	-500.8	-620.8	-667.3	-830.5	-1032.6	-1175.4
Foreign official transfers	303.9	117.1	128.5	83.4	29.0	82.6	165.0	94.4	28.1	38.2
Remittances from expatriates	325.8	377.9	384.6	499.6	266.9	452.3	368.1	530.8	614.9	631.5
Cumulative net foreign debt	139.4	186.9	250.3	298.8	332.2	460.4	550.1	617.0	697.7	979.6
Foreign debt service	0.6	17.5	4.7	8.9	11.2	15.6	13.6	15.4	16.4	41.4
Gross international reserves	72.0	147.0	204.0	240.0	275.0	306.0	384.0	485.0	608.0	737

Source: Bank of Albania, different statistical reports; Ministry of Finance, Fiscal Statistics, 2003

Table 2: Indicators of Current Account Sustainability

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Current account deficit, % of GDP	1.5	1.6	1.5	-2.3	-11.1	-2.1	-3.6	-4.3	-5.3	-9.0
Current account deficit, % of GDP, net of official transfers	-23.2	-4.5	-4.0	-5.9	-12.5	-5.0	-8.2	-6.8	-6.1	-9.8
Foreign official transfers, % Trade balance	59.7	25.5	27.1	12.3	5.4	13.7	24.9	11.5	2.7	3.3
Remittances, % of Trade balance	64.0	82.2	81.0	73.6	49.9	74.9	55.5	64.7	59.9	54.7
Trade balance, % of GDP	41.4	23.6	19.2	25.2	23.3	19.7	18.0	21.4	25.0	24.6
Exports/GDP, %	10.0	7.3	8.1	8.3	6.3	6.6	7.5	6.7	7.4	7.0
Foreign debt service/GDP, %	0.5	12.3	2.3	4.0	7.8	7.7	4.9	5.9	5.4	12.5
Foreign debt/exports, %	113.2	131.8	124.3	133.2	231.3	227.1	199.5	238.3	228.8	296.5
Foreign debt/GDP, %	11.4	9.6	10.1	11.1	14.5	15.1	15.0	16.1	17.0	20.9
Annual foreign debt/GDP, %	5.3	2.4	2.6	1.8	1.5	3.3	3.1	2.7	2.2	3.1
M2/Gross international reserves	4.1	2.7	3.0	3.9	4.2	3.6	3.4	3.6	3.0	2.9

Source: Fiscal Statistics of Government, quarterly, nr. 1/2003; ACIT (on foreign trade data)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Saving Investment Balance in per cent of GDP										
Foreign Saving(1)	57.1	28.7	14.3	9.7	9.1	12.1	6.1	7.2	7.0	6.3
Domestic Saving	-51.9	-15.5	3.6	8.3	6.4	3.9	9.9	9.6	12.0	13.1
Public(2)	-21.9	-14.1	-10.6	-8.7	-9.0	-8.6	-5.2	-5.8	-2.6	-1.2
Private	-30.0	-1.5	14.2	15.0	15.4	12.5	15.1	15.4	14.6	14.3
Investment	5.2	13.2	17.9	18.0	15.5	16.0	16.0	16.8	19.0	19.4
Public	4.0	9.5	8.6	8.2	4.5	4.0	5.2	7.4	6.5	7.3
Private	1.2	3.7	9.3	9.8	11.0	12.0	10.8	9.4	12.5	12.1

current account excluding net factor services and official transfers;

(2) revenues (excluding grants) minus current expenditures.

Source: Albania: Selected Issues and Statistical Appendix, IMF Country Report No 03/64; March 2003

Table 3: Current account, % of GDP for some countries

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Albania	1.2	1.6	1.5	-2.3	-11.1	-1.5	-3.4	-4.3	-5.3	-9.0
Bosnia Herzegovina		-9.0	-8.9	-27.3	-31.0	-28.2	-17.4	-27.4	na	na
Bulgaria	-10.2	-0.3	-0.2	0.2	4.2	-0.5	-5.5	-5.8	-6.2	-4.4
Croatia	5.7	5.9	-7.7	-5.5	-11.6	-7.0	-7.5	-2.8	na	na
Macedonia	0.5	-4.6	-5.2	-6.5	-7.4	-8.8	-3.9	-5.5	na	na
Rumania	-4.5	-1.4	-5.0	-7.3	-6.1	-7.2	-3.8	na	na	na
Ex- Yugoslavia				-8.0	-10.1	-6.4	-3.6	-4.6	na	na

Source: WIIW data base; national central banks data published on the web pages.

B. Regression Results

Dependent Variable: **LEKS**

Method: Least Squares

Date: 08/22/03 Time: 10:51

Sample: 1993:1 2001:4

Included observations: 36

Variable	Coefficient	Std. Error	t-Statistic	Prob.
LREER	-0.132976	0.325253	-0.408839	0.6852
LDC	0.862866	0.147914	5.833580	0.0000
R-squared	0.480785	Mean dependent var		8.578459
Adjusted R-squared	0.465514	S.D. dependent var		0.842092
S.E. of regression	0.615641	Akaike info criterion		1.921649
Sum squared resid	12.88649	Schwarz criterion		2.009622
Log likelihood	-32.58967	F-statistic		31.48348
Durbin-Watson stat	1.680474	Prob(F-statistic)		0.000003

Dependent Variable: **DLEKS**

Method: Least Squares

Date: 08/22/03 Time: 10:56

Sample(adjusted): 1993:4 2001:4

Included observations: 33 after adjusting endpoints

Variable	Coefficient	Std. Error	t-Statistic	Prob.
DLEKS(-1)	-0.457352	0.570618	-0.801504	0.4298
DLEKS(-2)	-0.327939	0.562802	-0.582690	0.5649
DLDC(-1)	-0.752461	1.946010	-0.386669	0.7020
DLDC(-2)	0.075185	2.064390	0.036420	0.9712
DLREER(-1)	0.030704	0.404740	0.075862	0.9401
DLREER(-2)	-0.030242	0.405064	-0.074660	0.9410
R-squared	0.332824	Mean dependent var		0.048812
Adjusted R-squared	0.209272	S.D. dependent var		1.051357
S.E. of regression	0.934896	Akaike info criterion		2.866203
Sum squared resid	23.59884	Schwarz criterion		3.138296
Log likelihood	-41.29236	F-statistic		2.693811
Durbin-Watson stat	2.118474	Prob(F-statistic)		0.042301

Dependent Variable: **LIMP**

Method: Least Squares

Date: 08/22/03 Time: 11:01

Sample(adjusted): 1994:1 2001:4

Included observations: 32 after adjusting endpoints

Variable	Coefficient	Std. Error	t-Statistic	Prob.
LREER	0.339469	0.260637	1.302463	0.2027
LGDP	1.012716	0.153824	6.583608	0.0000
R-squared	0.362790	Mean dependent var		10.07065
Adjusted R-squared	0.341550	S.D. dependent var		0.612162
S.E. of regression	0.496739	Akaike info criterion		1.498956
Sum squared resid	7.402480	Schwarz criterion		1.590565
Log likelihood	-21.98330	F-statistic		17.08026
Durbin-Watson stat	1.456314	Prob(F-statistic)		0.000265

Dependent Variable: **DLIMP**

Method: Least Squares

Date: 08/22/03 Time: 11:02

Sample(adjusted): 1994:4 2001:4

Included observations: 29 after adjusting endpoints

Variable	Coefficient	Std. Error	t-Statistic	Prob.
DLIMP(-1)	-0.569095	0.129696	-4.387924	0.0002
DLIMP(-2)	-0.225827	0.131562	-1.716510	0.0995
DLREER(-1)	0.105371	0.145558	0.723912	0.4764
DLREER(-2)	-0.067519	0.143380	-0.470908	0.6421
DLGDP(-1)	14.42594	2.444883	5.900461	0.0000
DLGDP(-2)	-13.14060	2.536544	-5.180513	0.0000
R-squared	0.752312	Mean dependent var		0.049747
Adjusted R-squared	0.698467	S.D. dependent var		0.602765
S.E. of regression	0.330991	Akaike info criterion		0.808540
Sum squared resid	2.519765	Schwarz criterion		1.091429
Log likelihood	-5.723831	F-statistic		13.97174
Durbin-Watson stat	2.557537	Prob(F-statistic)		0.000002

ENDNOTE

¹ Paper presented at the Conference organized by the Bank of Albania and Faculty of Economics, TU, Sarande, September 11-13, 2003.

² For a detailed analysis, see Chorng-Huey Wong, 2000.

³ Figure is known as the Swan diagram, taking the name after the author that has used it for the first time. (see Swan, 1963).

⁴ The positive current account balance for the first period of transition is dedicated mainly to the foreign official transfers. Figure 2 highlights this role of foreign official transfers.

⁵ It should be emphasized right from the beginning that the data quality and availability are a problem, and a serious one, which affects the accuracy of the data extracted. This becomes obvious by the significant breaking of the statistical series, which may result even due to methodological changes in measuring the indicators, by the high levels of the item "Mistakes and Omissions" of balance of payments, etc.

⁶ Calculated as deduction of current expenses (excluding grants) from income.

⁷ For more details, see Mançellari and Xhepa, 2002.

⁸ Idem.

⁹ Idem.

¹⁰ For more information regarding this incentive and the clusters, see Xhepa dhe Mançellari, 2003 and Tanku, Begaj, Skreli dhe Civici, 2003.

¹¹ In Albania's case, the dynamics of real domestic currency appreciation appear better in the indicator of real exchange rate, calculated on the basis of consumer price index (CPI). The presence and weight of managed prices make the real exchange rate indicator, calculated on the basis of relative traded good prices, less reliable. (Hollar, 2003.)

¹² In the debate on revaluation tendency prevailing in transition economies regarding the real exchange rate, two viewpoints are noted. One viewpoint, called the equilibrium factor viewpoint, considers the variations in the real exchange rate as a reflection of the real equilibrium factor variation, which is, in turn, reflected in the variation of the saving and investment balance, that is to say even as a return to the long-term exchange rate equilibrium. The other viewpoint, called the viewpoint deviations from the equilibrium levels, and considered as exchange rate revaluation, causes the loss of competitive ability of economy. (Roubini and Watchel, 1998.)

¹³ The real exchange rate is defined according to the formulae that actually calculates its inverse. (See Hollar, 2003)

¹⁴ In absence of the foreign effective demand series, a simulation is carried out, using only the domestic demand of Italy, which constitutes the main market of Albanian exports. Though the results are not reported in this material, the exports would not be sensitive to changes in foreign market demand. This may be understood in the context of very low levels of our exports to the size of foreign market demand.

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COMMENTS ON: "THE SUSTAINABILITY OF CURRENT ACCOUNT DEFICIT"

Erjon Luçi

Evelina Çeliku

Something like 6 months ago I did participate on a working party in Poland organised by BIS and Bank of Poland. I was asked in one of the session what was my opinion about the large size of Albanian current account deficit. I should admit, that question got me by surprise because at that time I was not quite up to date with the all the latest development of current account deficit. My quick answer was that, despite its large size as far as there was a closed circle going from the foreign remittances to imports, for the current account deficit it wouldn't make much difference if the remittances eventually declined, hence the possibility of 'hitting the wall' (meaning currency crisis) was still small for Albania. Ever since I tried to figure out better the scenarios of a possible crisis and of any flaw in my idea.

Although Albania has been characterised by large current account deficit throughout most of the transition period, only recently its size has become a matter of concern of many domestic and international institutions. While the main worry stems from its relatively large size, a thorough analysis is required to decide whether this is an unsustainable situation, which could lead to a currency crisis, or simply a reflection of the structural developments the country is undergoing. From this perspective we welcome the effort by Dr. Mancellari and Dr. Xhepa to shed some light on this important topic.

From the presentation of Mr. Mançellari we saw that the assessment of current account deficit is a complex issue which makes its

analysis very difficult to come out with clear answers. The authors have used several indicators to assess the sustainability of the current account deficit, which generally point out at the fragility of preserving its actual sustainability. One potential source of problems with authors' results is the reliability of the benchmarks used to judge sustainability. However the authors have been very careful to emphasise a number of caveats and weaknesses of these benchmarks, especially those related to structural changes which are important aspects of Albanian and other transition economies.

We tend to agree with the main conclusion of the discussion that the actual current account deficit in Albania is relatively sustainable despite its worrying size. The other consideration about this situation as being fragile needs to be treated more carefully because, apparently, it seems to contradict the main conclusion. The fragility of current account deficit could be classified as a case of unsustainability. **As Milesi-Ferretti and Razin (1996) put it: If the continuation of the current policy stance and/or of the present private sector behaviour entails the need for a “drastic” policy shift, or lead to a “crisis” there is a case of unsustainability.**

So, we think that a more proper conclusion based on the given evidence is that while the actual policy stance in Albania could be considered as being sustainable in the short run, in the long run it could generate some problems if certain measures, such as those proposed, correctly, by the authors, are not undertaken. However, concerns have been expressed that several shocks might trigger unsustainability in the short-run as well, on which we want to bring particular attention.

One of those developments which is the most feared to cause problems is the decline in foreign remittances as families of emigrants join them abroad, a view supported by the forthcoming presentation of Mr. Gedeshi and Mrs. Uruçi. It is often argued in several studies (Muço et al. 1999) that remittances from abroad, so far, have played an important role in maintaining the stability of exchange rate in Albania and in financing a significant share of imports. However, it is not so clear how the decline in the foreign remittances would lead to a situation of current account unsustainability and/or currency crises.

Referring again to the forthcoming study of Gedeshi and Uruçi, a large part of foreign remittances goes for consumption and quite a

few for investment purposes. Therefore, a reduction in foreign remittances would lead to a reduction in consumption. If we make the realistic assumption that a large part of this consumption comes from imports, it follows that a decline in foreign remittances will be associated by a similar decline in imports, hence would leave the current account deficit more or less unaffected. Regarding the exchange rate market, based on the above assumptions, it seems to exist a closed circle too, which makes currency crisis difficult to arise. If for example, the families of emigrants cease exchanging remittances in the market the possible impact of this reduction in foreign currency supply will be counteracted by a similar reduction of demand, as far as the importers would reduce the need for foreign currency by the same amount.

It could be argued that a time mismatch might exist between the decline of supply and that of demand, because importers might not be sure whether the decline in the demand for imports is temporary or permanent. So, a quick depreciation of currency could follow. However, we retain that this is an unrealistic situation. The movement of emigrants' families abroad will hardly occur at the same time. This means that even if there is a time inconsistency in importers' reaction to the change of demand the impact need not be large enough to generate a currency crisis. Also the experience so far has shown that significant emigrants' movement in the summer time have been manageable. There is no reason to believe that the *gradual* movement of their families would have such a disruptive effect.

Another development which could have a more significant impact on current account deficit and a higher risk of a sudden decline in the inflow of foreign currency in the exchange rate market, is the reduction in the income coming from the informal (illegal) activities as the rule of law improves. The evidence on informal market, as Mr. Olters revealed in his speech, are very poor, and any judgement on the degree that it is used to finance imports and on how much goes through the exchange rate market, remain open to speculation. Nevertheless, independently from its size, even in this case the impact need not be necessarily large enough to trigger a case of unsustainability. For the informal but legal activities the income won't be lost as they switch from the informal to formal economy. Regarding illegal activities, let alone the fact that a large part of it may not flow through markets, the experience with the tightening of illegal emigration through the sea (which might have

had an important impact on reducing illegal revenues) has shown not to have been associated with any particular deterioration. On the other side a reduction in illegal activities will give a strong signal to foreign investors that the rule of law has begun to work in Albania. Thus, that part of current account deficit could that used to be financed through illegal activities income may now be financed through FDI. However, even in this case attention should be paid to the time mismatch, so an intervention by the BoA on the exchange rate market could be justified if there are signs of currency run, until the FDI start boosting.

Political instability could be another important source of deterioration of current account deficit as the 1997 experience in Albania has shown. Although, Albania in these recent years could be classified as relatively stable country, politically-wise, as mentioned earlier the investor confidence may delay to come. In these situations of bad equilibriums an external a positive shock might be needed. Measures such as, the set up of insurance structure to foreign investors against the political and economic risk in Albania in 1997 by World Bank are very useful solution. It is important to consider their viability in the future as solution that can boost FDI and improve the sustainability of current account deficit and also solve the above problem of time mismatch.

Nonetheless, the need for further structural reforms to improve the competitiveness of Albanian economy is indispensable to ensure the long run sustainability of the current account deficit. We are not getting into the discussion of ways to accelerate exports since this will be elaborated more extensively on the following presentation by Mr. Çeku. However, we want to make a couple of comments on the issue of the real exchange rate appreciation. Leaving for the moment the ambiguity about the degree of real exchange appreciation, which depends on the method used to calculate it (Hollar, 2003), we think that econometric technique at this stage might be insufficient to give conclusive results on whether the real appreciation of lek played or nor any role in the competitiveness of Albanian economy. Considering that exports as ratio to GDP have changed very little from the outset of transition it is difficult to find any relationship with the exchange rate which has been much more variable for many reasons. However, there is always a possibility that this appreciation has increased its pressure on keeping the foreign competitiveness and exports down.

We do not want to assert that this is necessary the case, but unless this situation is compared against a situation where exports are more variable it would be difficult to come to a clear conclusion. So, further investigation is needed on deciding whether this appreciation is misalignment or a reflection of structural changes

To close the discussion with a positive note, it should be mentioned that future sustainability of current account deficit may also enhance by the expected privatisation of Savings Bank, Telecom, KESH, INSIG which most probably will be privatised via foreign strategic investors. Nonetheless, we should always keep an eye open to potential destabilisation shocks that could lead to a situation of unsustainability and/or any currency crisis. As a matter of fact, the Bank of Albania is planning to push this discussion further by investigating in more detail the problems related to the sustainability of current account deficit.

(in millions US\$)

	1994	1995	1996	1997	1998	1999	2000	2001	2002
CURRENT ACCOUNT	31.4	36.6	-62.3	-253.7	-65.0	-132.9	-163.1	-217.9	-406.8
Exports of goods fob	141.4	204.8	243.7	158.6	208.0	275.1	255.4	304.6	330.2
Imports of goods fob	-601.0	-679.8	-922.0	-693.5	-811.7	-937.9	-1,076.4	-1,331.6	-1,485.4
Trade balance	-459.6	-475.0	-678.3	-534.9	-603.6	-662.8	-821.0	-1,027.0	-1,155.1
Services: Credit	83.1	98.2	127.3	67.9	86.6	266.7	448.1	533.5	585.0
Services: Debit	-97.5	-106.3	-142.3	-101.1	-129.3	-165.4	-430.0	-444.2	-589.5
Income: Credit	55.6	70.8	83.5	61.6	86.1	85.6	115.9	162.5	148.3
Income: Debit	-41.4	-28.5	-12.0	-11.9	-8.7	-10.3	-9.1	-13.4	-20.6
Transfers - private	374.1	348.9	476.0	235.7	421.3	188.4	438.6	542.6	586.9
Transfers - official	117.1	128.5	83.4	29.0	82.6	165.0	94.4	28.1	38.2
Capital Account	21.6	389.5	4.9	2.1	31.1	67.5	78.2	117.8	121.2
Financial Account	24.2	-414.5	49.6	140.7	16.0	36.8	182.5	109.0	206.2
Direct investment	53.0	70.0	90.1	47.5	45.0	41.2	143.0	207.3	135.0
Portfolio investment	0.0	0.0	0.0	0.0	0.0	0.0	-25.0	-23.4	-36.8
Capital transfers (others)	-28.7	-484.5	-40.5	93.2	-29.0	-4.4	64.5	-86.9	102.7
Errors and omissions	-44.5	7.9	54.8	142.5	69.4	131.3	15.0	136.1	108.0
Overall balance	54.9	30.6	47.0	43.8	59.4	123.5	131.9	145.0	28.6
Under attention									
Change in reserves	-54.8	-30.6	-39.5	-28.3	-75.9	-97.4	-130.5	-116.2	-109.9
Foreign exchange effect	7.3	5.1	-7.3	-15.5	12.6	-26.2	-3.5	1.5	65.0

ROLE OF REMITTANCES IN THE SOCIAL ECONOMIC DEVELOPMENT OF THE COUNTRY

Esmeralda Uruçi

Ilir Gedeshi

Aristide Zolberg, a well-known researcher of international migration, wrote in 1989 that if all the world countries were constituted of Albania on one hand and Japan on the other, there would be no need to study international migration¹. Almost one year later, as for irony, consecutive massive streams of international migration, frequently illegal and chaotic, would make Albania one of the world countries mostly affected by this phenomenon, so much that Russell King defines it as “a type of laboratory on studying new migrating processes”.² This phenomenon, present in all the territory of the country, has accompanied all the stages of Albanian transition, with different intensity. Almost 10 years after the start of transition, about 1/5 of Albanians or over 600.000 persons, mainly young ones,³ have migrated abroad, especially in Greece and Italy, whereas the domestic migration has involved hundreds and thousands of others. Two of the most important aspects of this phenomenon having a large socio-economic impact are “brain migration”⁴ and remittances⁵.

This paper is a result of a research on remittances, realized through known quantitative and qualitative techniques, with 1500 Albanian short-term and long-term, legal and illegal international emigrants at year-start 2003. It analyses remittance behaviour and their phenomenon in three main aspects:

In relation to macro-economic indicators, to show their importance
In relation to poverty, and

In relation to the role they play for socio-economic development of the country.

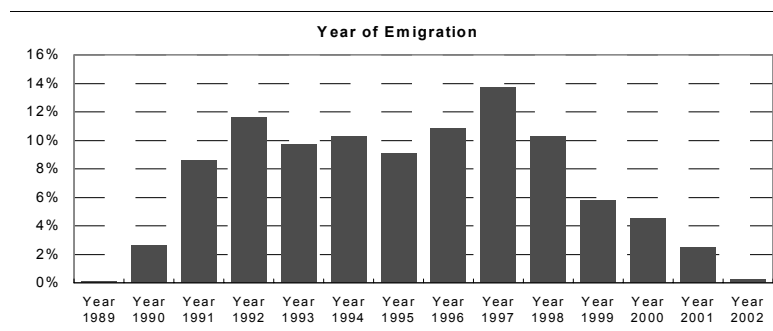
SOME FEATURES OF MIGRATING FLOWS DURING TRANSITION

The immediate opening of the country to the world, accompanied by a deep social, economic and political crisis were the main factors urging the first flows of international migration from Albania. The massive migration was favoured even by vigorous demographic processes that had happened during 1945 – 1989, when the country's population was increased at about three times. Albanian population at the end of this period was characterized by a young age having relatively high level of education.

International migration from Albania has streamed in waves since the second half of 1990. Until end of 1992, economic transformations of transition led to an underlined reduction of agricultural and industrial output, increase of unemployment and reduction of real wages, being reflected in the further deepening of poverty, thus urging recurrent migrations.

A relative improvement of some macroeconomic indicators was noticed after this year, being reflected even in migration rate reduction. But, since the end of 1996, and especially along 1997, the deterioration of macroeconomic indicators and the collapse of pyramid schemes caused a socio-political chaos, urging a new massive migration wave. Even the survey carried out with 1180 international migrants reflects clearly the migration curve during 1990 – 2002.

Chart 1.



Source: Survey on foreign currency remittances of long-term legal emigrants, January 2003

Albanian international migration is spread in Greece, Italy, England, Germany, France, Switzerland, Belgium, U.S.A., Canada, etc., but Greece and Italy are two main countries, where it is widely focused.

According to official statistics taken from the process of legalizing migration in 1998, there were 241.561 Albanians in Greece whereas in the legalization process of 2001, it was estimated that there might have been about 500.000 legalized and non-legalized Albanians⁶. Albanian migrants to Greece are focused to most economic developed regions and to the regions that are close to Albanian borders⁷. About 30 per cent of them work in construction and public work, 19 per cent work in other mundane works outside the construction sector, 29 per cent in house services, 11 per cent of them work in mechanic repairing and maintenance, 6 per cent work in restaurants and hotels, and 5 per cent in other jobs⁸. Based on these data, King estimates that all those working in house services and a part of those working in restaurants and hotels, or 1/3 of Albanian migrants employed, are of female sex⁹.

The number of Albanian migrants to Italy that have a “permit – to – stay”, at year-end 2001 reached to 144.120 persons¹⁰. According to official Italian statistics for 1992 and 1999, it is noticed that the

Table 1. Demographic structure of Albanians to Italy, compared with other migrant groups, 1992 and 1999 (as of June 30, 1999)

	% female legal migrants		% married in 1999		% with children	
	1992	1999	1992	1999	1992	1999
Albanians	17.8	34.0	32.0	54.4	9.3	18.7
Maroccans	15.3	27.9	43.0	49.8	7.8	16.7
Tunisians	17.4	22.1	26.6	33.1	11.5	15.3
All immigrants	17.5	29.2	34.9	49.3	10.3	13.3

Source: Bonifazi, 2001

REMITTANCE FLOWS

Relying on the classification of S. Wahba¹¹, who makes reference to Giudici¹² (1998), we can distinguish four types of remittance:

1. Potential remittances, which represent the total savings of the emigrant. This can be calculated by subtracting the personal necessary expenditures incurred in the country of emigration from the incomes.
2. Constant remittances, which imply the minimum income that the emigrant sends to his family in the country of birth, intended to cover the cost of daily necessities.
3. Additional remittances, which represent extra income over the regular amount sent by the emigrant. This is not used to meet the most acute needs of the family, but for investments in factual or financial undertakings.
4. The spared remittances, representing the amount of savings that the emigrant doesn't intend to make as a remittance, but prefers to invest in the country of emigration.

Having marked with:

Y = the income of the emigrant in the country of emigration

C = the indispensable consumption of the emigrant

c = the daily necessities of the emigrant's family

S = emigrant's savings

We can write: $Y = C + c + S$

We can sum up the different types of remittances as follows:

$$R = c + aS + (1 - a)S = c + S$$

R = potential remittances

c = constant remittances

a = emigrant's tendency to send the savings

aS = additional remittances

$(c + aS)$ = dispatched remittances, and $(1 - a)S$ = spared remittances

The amount of dispatched remittances from the emigrants to the country of origin, is determined by a group of factors like:

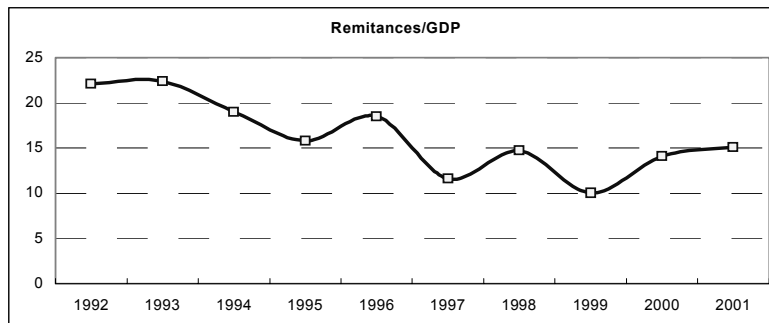
1. Number of employees that have emigrated and are working abroad.
2. The structure of emigrants according to age, civil status and family unification, scale of qualification, neighbourhood with the country of emigration, legalization, etc.

3. Labour conditions also have a strong impact on remittances. The key elements that exert influence in this case are the wage level, which changes according to the country of emigration, type of work, facilities created by the local employers for the emigrants, etc.
4. The amount of remittances depends also on the security, speed and ease of transferring money to the homeland.
5. Political, economic and social changes occurring in the country of origin and destination have also a great impact on the quantity of remittances transferred.

IMPORTANCE OF REMITTANCES TO ALBANIA

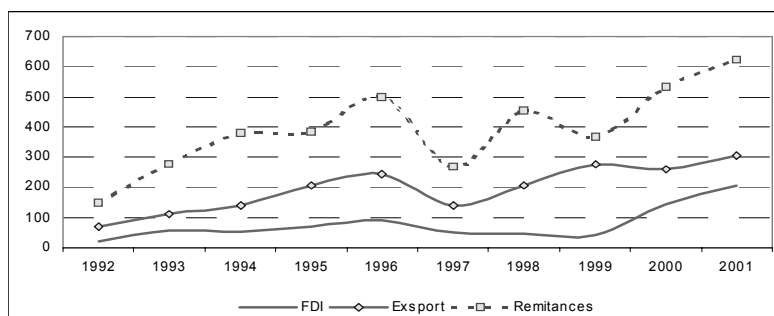
During the period of 1991-2000, emigrant remittances have been increasing and have represented about 10-22 per cent of GDP respectively. Pursuant to Bank of Albania estimates, they reached to about USD 620 million in 2001, or about 15 per cent of GDP¹³, from USD 150 million or about 22 percent of GDP they were in 1992.

Chart 2



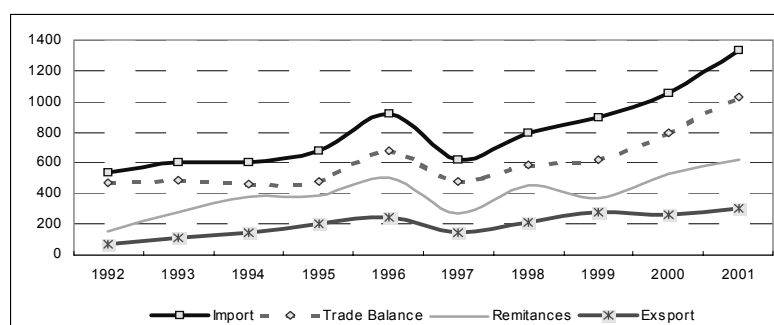
Another indicator that reflects the importance of remittances is the ratio of remittances to foreign direct investments and to foreign aid. During 1992 – 2001 the accumulated foreign direct investments were USD 774.7 million, whereas accumulated remittances were USD 3924.2 million or about 5 times higher. They have also been more than the foreign aids Albania receives annually from abroad. In 2001, foreign aids have been about 180 million dollars, while the remittances of this year were about 3.4 times higher.

Chart 3. Dynamics of remittances, exports and foreign direct investments during 1992 - 2001



Another indicator to assess the importance of remittances is also that of their ratio to merchandise export. In 2001, remittances were about twice higher than foreign currency income on exports, whereas the amount of remittances per capita of population was about USD 200 in 2001. Remittances have also played a primary importance in financing imports and covering the trade deficit. Important was their role even for maintaining the domestic currency exchange rate and for fast development of the sectors of services and construction. Thus, they have positively impacted on the macroeconomic stability of the country.

Chart 4. Dynamics of remittances, imports, exports and trade deficit during 1992 - 2001



Therefore, the remittances have been a key factor in determining one of the characteristics of Albanian transition, extroversion of economy (*extroversion*¹⁴), which means that the local consumption is higher than the national product.

Migrant's remittance behaviour

At the end of December 2002 and the beginning of January 2003, a survey was organized with 1.180 legalised Albanian migrants in different countries. It was held in the territorial border areas of Kapshtica and Kakavija, in the ports of Durres and Vlora, as well as in Rinas Airport. There was chosen just this period for survey because it represents the optimal time-period of international migrant flows into and from Albania on the occasion of the end-year celebrations

The selected areas represented migrant's flows from the whole Albanian territory. 57.1 per cent of the surveyed emigrants lived in Greece, 36.6 per cent were in Italy and the rest of them, and 6.4 per cent were coming back from other countries.

This survey aimed at studying the international migrant's behaviour in relation to remittances. It did not include illegal migrants and short-term ones.

Socio-demographic migrant's characteristics

According to the survey, it results that 93 per cent of migrants are of Albanian nationality, 3.7 per cent are of Greek nationality, 2.3 per cent are Vlachs and only 1 per cent are Romanies and Egyptians. 86.8 per cent of surveyed are male and 13.2 per cent are female. From the viewpoint of marital status, 68.4 per cent are married, 29.5 per cent are single, while 2.2 per cent are divorced or widowers.

Most of them or 58.3 per cent are with high education, 28.7 per cent are with primary education and 12.1 per cent are with higher education. Most of them or 67 per cent belong to the group-age up to 35 years old. These data show that most of international migrants questioned are young males, with high education and married.

Socio-economic migrants' characteristics in the country of migration

Main factors that stimulated Albanians to migrate, based on the survey, are "unemployment" (53.2 per cent) and "insufficient incomes" (14.9 per cent), reflecting poverty level, as well as "lack of perspective to improve economic situation"(10.2 per cent).

Other secondary reasons, stimulating migration relate to “unsatisfying social life” in Albania (10.4 per cent) and “the perspective to ensure a better future for children”(9.6 per cent), as well as “political and economic uncertainty” in the country (9.4 per cent).

According to the survey, 58 per cent of international migrants live in the country of migration with the family or with part of it. Migrants have an average staying time in migration, to about 7 years. Most of them (86.8 per cent) rent a house and 89.6 per cent of them are insured.

From the professional viewpoint, evidence shows that they passed from low-level jobs to promoted ones. These migrants represent that part of Albanians wanting to become part of the society where they live.

Actually, most of Albanian migrants, especially those living in Greece, want to turn back to the homeland. According to the survey, 66 per cent of migrants want to turn back to the homeland, 19.7 per cent declared that they would not, and 14.3 per cent declared that they hadn't decided yet whether to come back or not.

Table 2. Do you think to return to Albania?

No.	Do you think to return to Albania?	Answers (in percentage)
1.	YES	66
2.	NO	19.7
3.	I don't know	14.3
4.	TOTAL	100.0

Source: Questionnaire for remittances of long-term legalized migrants, January 2003

PRODUCTION, TRANSFERS AND USE OF REMITTANCES

The main factor urging Albanians to migrate is to save part of earnings from working in the migration country, and to money back to the homeland.

According to the survey, the average monthly wages are Euro 1567. Most of these incomes are ensured from the work of the head of the household, while the rest from the work of the other family members. The migrant's family saves part of these incomes.

According to the survey, the migrant's families save on average about Euro 4285. Most of these families (68.6 per cent) deposit these amounts with the banking system of the migration country.

Based on annual migrant's savings and their time of staying in migration, we would state that their saving deposits reach the level of some USD billions.

In 1992, or two years after the massive migration, Albanian migrants in Greece, deposited about USD 80 millions¹⁵ with Greek banks. Furthermore, the English researcher James Korovilas, in his article, estimates that every Albanian migrant employed in Greece, should save at least USD 2340 per year¹⁶.

In this estimation he is based also on the studies of other Greek researchers, Lianos, Sarris and Katseli (1997). According to them, the average daily wage of migrants is USD 30 and about 1/3 of it is saved¹⁷.

As a consequence, he estimates that annual savings of an Albanian migrant are equal to the number of workdays in Greece during a year, times daily savings (234 workdays *USD 10 daily savings = USD 2340 yearly).

According to the questionnaire, 82.1 % of the international migrant send their savings to the homeland. During 2002, they have sent on average Euro 2159. The remittance transfer is performed through formal and informal channels. Choosing the kind of channel for the remittance transfer depends on a number of factors, such as legal and illegal status of the international migrants in the host country, short-term or long-term international migration, banking system situation in the homeland, transfer cost, exchange rates in the banking sector compared to informal market, etc. In 2001, nearly 39% of remittances or USD 243,8 million were transferred through formal channels, against 7,5% or USD 28,3 million that were transferred in 1994. The majority of remittances sent through formal channels are carried out by Western Union international agency. But informal channel remains the main channel for transferring the remittances. According to data provided by the Bank of Albania, nearly 61% of remittances have entered into Albania through informal channels. These channels include mainly the remittance behaviour of international migrants when they come back in their homeland or the ones sent by means of their kinship and friends.

However, the survey data show that the majority of international migrants (76,5%) bring their money on their own, 23,5% send it by courier through their friends and only 15,2% remit by formal channels. The difference noted between official data and survey one can be explained by two principal factors. First, the survey is performed with legal international migrants and mainly in the countries near Albania (Greece, Italy.) These international migrants have come back 3.8 times during the last two years and have brought their money on their own or through friends. The second factor is related to the amount of money, which is to be transferred. In this case, for large amounts of money, international migrants make use of formal channels.

The majority of international migrants surveyed, send their money to their “parents” (71,3 %) and the minority send them to their “brothers and sisters” (13,3%). Whereas the international migrants, who have not attained the family unification at the country of the international migration (27,1 %), send their money to “wife and children”. The questionnaire demonstrates that the amount of money that the international migrants send to “wife and children” is higher than that sent to “parents” or “brothers and sisters”. In such circumstances, we can conclude that the tendency toward family unification in the country of international unification would cause the decrease of remittance amount.

Table 3. To whom do you send the money?

No	To whom do you send the money?	No. of people
1.	Wife and children	27.1
2.	Parents	71.3
3.	Brothers and sisters	13.3
4.	Relatives	4.2
5.	Friends	0.6
6.	Others	2.2

Source: Questionnaire on foreign currency remittances of long-term legal immigrants.

More than half of international migrants (59%) sends the money to the homeland because of the moral obligation toward the family, and this is explained by economic difficulties during the transition period and the Albanian family traditions.

Table 4. Why do you send money in Albania?

No	I send money because	No. of people
1.	I have a moral obligation toward family/parents	59
2.	I wish to	28
3.	Family needs	13
4.	TOTAL	100.0

Source: Questionnaire on foreign currency remittances of long-term legal immigrants, January 2003.

The majority of the international migrants (69,7 %) send their money in order to meet “the essential needs of the family” and in this case we have to do with the constant remittance, used completely for consumption. Whereas the additional remittances related to “the furnishing of the house” are sent only by 29,9% of international migrants, 9.4 per cent of migrants send remittances for investment in their homeland, and only 18% of migrants send remittances for the “purchase and construction of a house”.

Table 5. The aim of sending money.

No	The aim of sending money.	No. of people
1.	To meet the essential needs of the family	69.7
2.	To furnish the house	29.9
3.	To invest in the homeland	9.4
4.	To deposit in the bank	6.4
5.	To purchase or construct a house	18
6.	Others	4

Source: Questionnaire on the foreign currency remittances of long-term legal immigrants, January 2003.

The remittances sent for investments by the majority of international migrants are destined to the purchasing of real estate (40,4%). Others send the remittances to utilize them for the service sector (trade, transport, tourism, etc.), whereas a small number of international migrants send remittances for investments in the production sectors such as agriculture, industry and construction. These data, also, prove the conclusion that the majority of international migrants send their remittances for the families' everyday life consumption. This model of remittance utilization does not favour the opening of new workplaces.

Compared to previous years, during 2001 only 32,9% of the surveyed persons have sent more remittances in Albania, 25,2% have sent the same amount and 42% have sent less. The immigrants, who have sent more money in Albania are those who have sent the remittances to “wife and children” and “parents”.

Table 6. Remittances sent during 2001 compared to previous years

No	The remittances sent during 2001 compared to previous years.	In %
1.	More	32.9
2.	The same amount	25.2
3.	Less	42
	TOTAL	100.0

Source: Questionnaire on foreign currency remittances of long-term legal immigrants, January 2003.

Even during 2002, as compared to 2001, the same tendency is noticed, because 46% of international migrants say that they have sent more remittances. Whereas, in the short-term prospective, only 22,1% say that they will send more remittances. Based on these data, we admit that in the mid-run, the remittance trend to Albania is much probable to be at the current level, rather than tending towards increase.

Table 7. Remittances sent during 2002 compared to year 2001

No	Compared to 2001, during 2002 you have sent:	In %
1.	More	23.3
2.	The same amount	30.7
3.	Less	46
	TOTAL	100.0

Source: Questionnaire on foreign currency remittances of long-term legal immigrants, January 2003.

Table 8. Remittances probably to be sent during the 2-3 coming years

No	What are your intentions for the 2-3 coming years?	In %
1.	More	22.1
2.	The same amount	17.1
3.	Less	18.7
4.	Nothing	4.4
5.	I don't know	37.7
	TOTAL	100.0

Source: Questionnaire on foreign currency remittances of long-term legal immigrants, January 2003.

This assertion is the outcome of the interaction of a number of economic, political and social factors, which operate in different directions. The group of factors influencing on the increase of remittance flow includes: the rise-up in immigrants' number, their legalization, the remittances increase and the immigrants' motivation and their willingness to share part of the savings with the family in the homeland, the time-length of their staying in the country of international migration, etc. Whereas the factors influencing on the reduction of the remittance amount include the family unification and the weakening of the immigrants' relations with their relatives in the homeland.

Even the factor of length of the staying period will positively impact on a short-term period. According to Reyneri' s research (1976), remittances constitute a parabolic function of making the migration cycle longer, reaching the maximum somehow between the 10

and 14 years of international migration time, whereas for shorter or longer periods of time, they are at a lower level. If we judge that during the first years of international migration, the expenditures for being established with a residence impede the remittances, which increase progressively with the passing of time, this can explain the trajectory. But after 10 or 14 years of international migration, there is an important turning point, since it marks the time of deciding if the international migrants will return to the homeland or will settle permanently in the destination country. In both cases, the remittance flows are destined to exhaust or reduce¹⁸. The key factor encouraging large international migration, legal and illegal, is poverty, in the broad sense¹⁹, along which it ensures its not turning to poverty²⁰. In most cases, a non-poor family is distinguished from a poor one from the fact whether it has or has not one of its members in migration. The used remittance pattern is related first of all, to the very survival of the family, then to the improvement of the standard of living, and finally, to the extending, constructing or purchasing of a new house. This mutual relation between poverty and international migration is obviously distinct in Albania. But the problem laid out is the relation between international migration and socio-economic development. Stated more simply, would remittances and the returning of a part of international migrants, along with their financial savings and human capital they have accumulated in the migration country, lead to reduction of migrant flow? Notwithstanding any optimistic assessment²¹ made on this problem, other researches indicate that Albanian international migration remittances so far have not been, and will not likely be even in the near future, a determinant factor for a fast and sustainable socio-economic development of the country. Meanwhile, the desire for international migration or potential migration, in spite of reductions following 1998, continues to be relatively high in Albania.²²

The increasing role of remittances in Albanian economy requires the establishment of certain economic conditions and the strengthening of political stability in the country, aiming at reaching a significant change by using remittances, passing gradually from prevalence of consumption destination to investments in the socio-economic development. The accomplishment of this strategic change must be accompanied with a number of complex measures in the field of economic, financial, banking, legislative policies, etc., including all the stages the remittances undergo from production to consumption.

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²⁰ GEDESHI I., MARA H., PRENI XH., Economic activities and employment opportunities in rural areas within the pilot communes of Korça Clean and Green Project, UNDP, 2003

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COMMENTS ON: "ROLE OF REMITTANCES IN THE SOCIAL ECONOMIC DEVELOPMENT OF ALBANIA"

Kliti Ceca

THE IMPORTANCE OF IMMIGRANTS REMITTANCES IN THE ECONOMIC DEVELOPMENT.

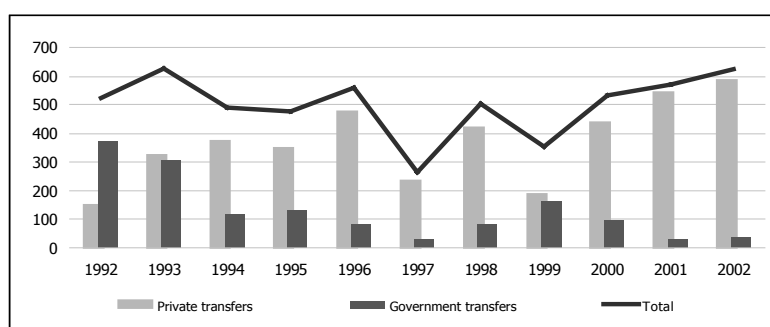
In the report "Global Development Finance 2003" of World Bank, of April 2003, it is stated that the foreign direct investments (FDI) and remittances are transformed into the most important financial resources for the developing countries, and they have proved even more important than private lending. Just like FDI-s, remittances are considered to be more stable as capital resources and in this way they contribute to a stable growth of the developing countries.

In a worldwide range, the flow of remittances surpasses the USD 100 billion per year, and more than 60% of this amount goes to the developing countries. Therefore, they constitute an important mechanism for the transfer of resources from developed countries into developing countries.

A FEW WORDS ON THE TREND OF REMITTANCES IN ALBANIA.

By the mid 1990s, Albania experienced the phenomenon of massive exodus, which with the passing of time would become a key factor in the external financing. Since 1992, perhaps even earlier, the remittances from expatriates started to become increasingly present in the Albanian economy.

In principle, the increase in inflows should be influenced by the expectancies for development in the Albanian economy. Inflation forecasts and expectations for exchange rate depreciation, which would be followed by higher interest rates of the Lek (AL), would cause an upsurge in the remittances brought into the country by workers working abroad. Between 1994-1996 a considerable part of the foreign exchange brought in the country in the form of remittances was converted into leks and invested in the pyramid schemes, which reached their peak in 1996. In 1997 and 1999 remittances went down reflecting the 1997-year crisis which marked the fall of the pyramid schemes and the Kosovo's crisis.



The short experience of transition shows us that the financing of the high trade deficits in Albania is done not only through capital inflows, which have undoubtedly played a significant role, but also through immigrants remittances. From 1994 to 2000, nearly USD 4,4 billion have entered the country in the shape of current transfers kind, and nearly USD 3,6 billion were made up of remittances from Albanians working abroad. The remittances for year 2002 are estimated at USD 632 million or at 13% of GDP.

THESIS AND RECOMMENDATIONS FOR REMITTANCES MANAGEMENT POLICY.

The nature, amount, frequency and impact of the remittances at the social and economic dimension of the country are of special importance and have attracted the specialists' attention all around the world. Migrants' inflows exert a strong influence on the incomes and wealth distribution in the beneficiary country, (Taylor and Wyatt,

1996). In the studies and empirical measurement performed, the world literature concludes that at "the first phase" of the migration, the remittances are used at a great extent as a means of subsistence for the beneficiary families, such as food, clothes and health needs (Massey and Parrodo, 1994; Massey et al., 1987; Rhoades, 1978). By meeting these means of subsistence, the improvement of the living conditions and the increase of the living standard result as priorities in expending these inflows. At a later phase, a significant part of these remittances is utilized for useful investments, especially for the business set-up, which comes out to have a positive effect in the country's economic development, influencing at the same time employment and the decline of the pressures for immigration. However, a similar phenomenon in Albania is trifling. All the more so, with the passing of time, as immigrants and their offspring become naturalized in the host country. Consequently their relations with the country of their origin will gradually grow weaker.

As it is was explained in the previous speech, Albanian migration remittances are getting closer to this climax.

The actual emergency stands in creating a good management and in securing a continuity of these inflows. The exchange assets generated by the immigrants' work must, at all costs, be faced with a smart domestic policy. This policy, besides aiming to channel the private current transfers towards consumer investments, must tend to create the appropriate mechanisms to absorb the foreign exchange means generated by the immigrants' work (despite the fact that they can enter in Albania as transfers or be invested as saving deposits in the countries where the immigrants live) in order to realize stable investments.

Our recommendations for the remittances development and management policy are listed below. It is worth mentioning that the recommendations are made under the assumption and belief that the remittances have a positive net effect in the Albanian economy. In the actual state, we are aware that this condition applies in Albania.

- *Reduction of transfers cost.*

The strengthening of competitiveness or the increase in the number of the actors in this sector, would reduce the cost of these transfers. A low price paid for each transfer would cause the transfers level

to increase. On the other hand, the reduction of the corresponding taxes would lead to an increase in the volume of these transfers.

By setting up a price transparency model, the government must encourage competition in this sector. This competition will lead not only to a fall in prices, but also to encouraging many migrants. The price transparency on its own will not bring about price fall in a monopolist market just like the Albanian one. The government must make use of the incentives in setting up new companies, reducing taxes, etc.

- *The creation of the development funds.*

The development funds will serve as institutions that will collect immigrant remittances in order to realize exceeding investments. Let's refer to the example of the Savings – Credit Agencies, developed in Albania during the last few years. On the other hand, it is believed that, if the money is managed in this way, it will have an effect on the economy and on the financial system. It is worth stressing that the positive trend and set-up at the beginning of these funds is thought to have a positive effect after the initial success (after the immigrants become convinced for the funds' efficiency, they may invest more in these funds). South Chorea makes a good example of this situation.

- *The co-operations among the governments.*

Relying on other countries' experience, Albania must and it can take steps forward for the cooperation between its government and the governments of the countries from which remittances flow, in order to set the official structures that will help the immigrants (not only for their social problems such as legalization, education etc.), for an efficient usage of their savings toward their own country. The governments of host countries and home countries must undertake effective measures in order to facilitate the flow of remittances (for example: micro-credits, training, the facilitating of the bureaucratic procedures, fiscal facilitations, etc.). Worth mentioning is the case of Maly that has a considerable immigration in France. The structures set up through the governmental agreements have assisted in the development of Maly's economy.

- *The increase of the size of credit to economy from the banking system.*

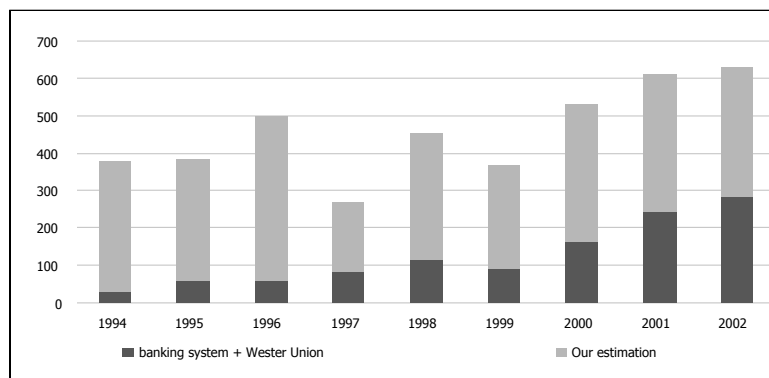
It is thought that the expansion of credit extended to economy by

the banking system will be accompanied by a geographical expansion of the banks' branches and subsidiaries across the country. As a result, the banking system and other financial institutions could become more significant as channels used for the transfer of remittances.

REMITTANCES MEASUREMENT

Bank of Albania estimates the flow of remittances by means of a methodology that is based on the theory of the parallel markets. This is done because in Albania, a considerable part of the transactions is carried out in these markets. The methodology is based on measuring the foreign exchange outflows from the parallel market, because the remittances through the banking system are easily measurable. In this way, this methodology constitutes in setting up a matrix of exchange flows, which presents the outflows and inflows of the foreign exchange moving in the parallel market. We must point out that in this big "sack" of "remittances", besides remittances, are included foreign currency assets generated by unclear activities, which in Albania are represented by illegal activities – all providing cash in Albania.

In the previous years, due to the development of the banking system and the people's increasing awareness of the advantages of the usage of the banking system, remittances through the banking system have increased.



METHODOLOGICAL CONSIDERATIONS

Regarding the methodology that could be used in the future assessment of remittances, we believe that the way suggested by Mr. Gedeshi and Mrs. Uruçi in their article/essay should be followed. Hence, we consider that the data collected by institutions, which have conducted surveys, are very important.

Consequently, we think that periodical surveys should be conducted in order to collect information on remittances (as well as on other economic-social data) for a certain period of time. Based on this ground the compilers could set up a mathematic-statistical model. Then, this model could serve in further time series simulations (there are various methods that can be suggested, like Box&Jenkins, Monte – Carlo, AR(p), MA, ARMA, ARIMA, etc.). Other periodical surveys (less frequent) should be made for potential corrections of the model in keeping the real trends. In order to achieve quantitative evaluations of the indicators, we suggest these surveys be made in host countries.

CONSTRUCTING THE PATH OF THE ALBANIAN EXPORTS FOR THE FUTURE

Bardhyl Ceku

INTRODUCTION

Albania underwent a difficult period during its 12 years of transition marked by the efforts to establish an economic system geared towards the free market. Despite the difficulties of the transition process, the economic and social crisis of 1997, and the Kosovo crisis of 1999, Albania made progress in establishing the macro-economic stability and carrying out structural reforms.

Although in the recent years, Albania has experienced economic growth (for 2002 the economy's yearly growth rate was 4.7 %¹), Albania is the poorest country in Europe with only 1521 USD GDP per capita, with a considerable trade deficit, and lacking basic infrastructure, with a financial system that cannot meet the needs of the business community, with private and public institutions unprepared to take over responsibility for a new economic system that we have agreed to construct.

Albania is now faced with a new challenge: it aims to extend and to improve the competitive capacities in the international market with the intention to join the European Union. As known, an important factor influencing the improvement of economic growth of the country and reflecting the improvement of competitive capacities is the foreign market. In 2002, Albania has registered the highest level of goods trade - 12 % more than in 2001. The import of goods was about 1.5

billion USD and the export 330 million USD or 8 % more than 2001².

Those data show that the economy of our country is import-oriented, and imports represent 82 % of the foreign trade volume. The faster growth of imports compared to that of exports has caused the further deepening of the trade deficit, which is linked to the insufficient development of competitive capacities in the domestic production.

1. What is the current import – export situation?

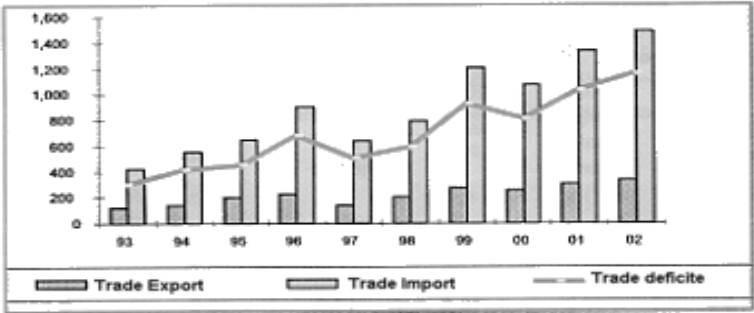
With the market economy opening up and with the freeing of the movement of commercial goods and services, the flow of imports into Albania grew rapidly as a result of the scarcity in the market, of the flourishing domestic demand and of the incapability of domestic production to meet these needs. Despite improvements in the performance of exports during this period, the trade deficit continued to deepen during the years, as shown in the table below:

Table 1.Trade balance (in millions USD)

YEAR
Import (in millions USD)
Export (in millions USD)
Trade Balance (in millions USD)

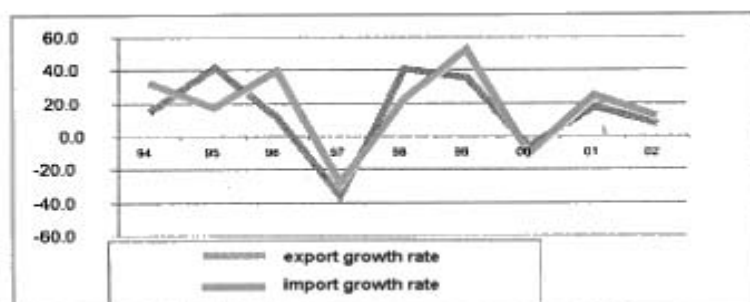
The export-import ratio worsened between 2000 and 2002 going from 23.8 percent to 22.8 and then to 22.2 percent .

Chart 1.Trade balance in Albania (on millions USD)



Export level in terms of GDP is very low and during the last 12 last years it has varied between 6-7,5 per cent, which means that in fact, the Albanian economy does not have sufficient production in certain segments of the economy, that can be destined to export.

Chart 2. The progress of exports and imports in the last decade (on percentage)



Albanian exports have been dominated by re-exports or exports from active processing since 1996.

During 2002, the increase of exports, to a considerable extent, was a result of the increase in re-exports, (active processing exports), with 9.2 percent compared to 2001. Below is presented the performance of total exports and its two sections for the period 1999-2002.

Table 2. Composition of exports.

YEAR	Exports from domestic production (1)	Exports from active processing (2)	Total exports (3) = (1)+ (2)
1999	10704	20698	31402
	34 per cent	66 per cent	100 per cent
2000	9312	21697	30991
	30 per cent	70 per cent	100 per cent
2001	9392	21599	36209
	27 per cent	73 per cent	100 per cent
2002	9556	27614	37170
	26 per cent	74 per cent	100 per cent

Obviously, exports from active processing continue to represent the bigger fraction of Albanian exports, standing at about 74 percent of their total volume. The growth of re-exports was accompanied

by a rise in imports of raw materials for textile industry and leather processing, which are respectively 11 percent and 3,6 percent of imports volume. Certainly, both these figures and the imports of machinery and equipment, which constitute about 20 percent of total imports, reflect the development of the productive sector of the Albanian economy³.

At the same time, exports from domestic production are rising, although the increase in volume is not so evident. Exports from domestic production are represented by agricultural products (medicinal herbs, tobacco), metals (ferrochromium, aluminium), leather, wood materials and mineral products (fuel). Industrial exports became smaller and smaller as state-owned enterprises went bankrupt one after the other.

As mentioned above, the exports structure is dominated by active processing products (textiles and shoes), destined for the EU markets.

The structure of imports and exports is presented as below⁴:

Table 3. Structure of Imports & Exports.

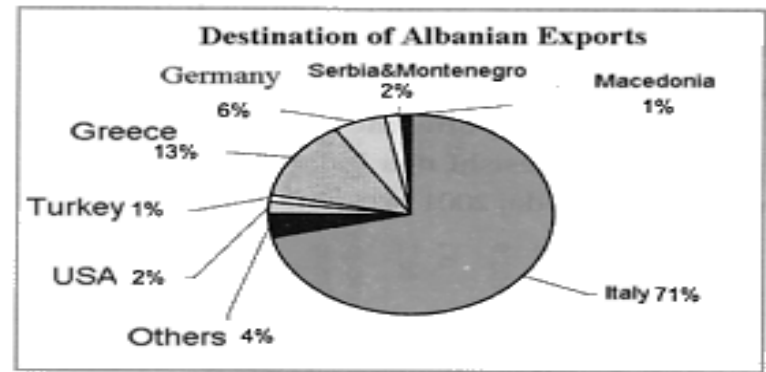
Nr.	IMPORTS STRUCTURE	1996	2002
1	Meat, meat products	5,0	3,0
2	Vegetable Products	17,5	6,8
3	Oils and animals or vegetable fats	2,9	1,4
4	Conserved foods, beverages, tobacco	9,5	8,8
5	Mineral Products	5,2	12,9
6	Chemical industry products	4,8	5,8
7	Plastics; rubber and their products	2,3	3,0
8	Leathers and their products	2,1	2,5
9	Woods their products	0,8	1,1
10	Papers, their articles	1,4	2,0
11	Textile and textile products	9,0	10,9
12	Head and foot wears, umbrellas	6,3	3,7
13	Products by stone, cement, ceramic, glass etc.	2,4	3,9
14	Pearls; jewellery; coins	0,1	0,0
15	Basis metals and their products	4,8	9,0
16	Mechanical and electrical equipments	16,2	16,2
17	Vehicles	6,1	5,4
18	Optical and musical instruments, watches etc.	1,3	1,0
19	Guns, munitions and their spare parts	0,1	0,0
20	Different articles	2,1	2,5
21	Art works, pieces from antiques	0,0	0,0
	TOTAL	100,0	100,0

Nr.	EXPORTS STRUCTURE	1996	2002
1	Meat, meat products	3,1	0,6
2	Vegetable Products	7,1	4,0
3	Oils and animals or vegetable fats	2,2	0,0
4	Conserved foods, beverages, tobacco	4,1	2,2
5	Mineral Products	10,3	2,8
6	Chemical industry products	1,2	0,5
7	Plastics; rubber and their products	0,5	0,2
8	Leathers and their products	4,5	4,5
9	Woods their products	2,8	2,6
10	Papers, their articles	1,4	0,9
11	Textile and textile products	24,4	37,7
12	Head and foot wears, umbrellas	23,4	28,9
13	Products by stone, cement, ceramic, glass etc.	0,2	0,6
14	Pearls; jewellery; coins	0,0	0,1
15	Basis metals and their products	11,3	9,3
16	Mechanical and electrical equipments	1,7	2,5
17	Vehicles	0,1	0,3
18	Optical and musical instruments, watches etc.	0,1	0,1
19	Guns, munitions and their spare parts	0,3	0,2

Hence, as we can see, there is an improvement of the exports structure for textiles and related articles as well as the head and foot wear and umbrellas, and also an increase in imports of mineral products and chemical industry products.

The Albanian exports and imports geography is as below:

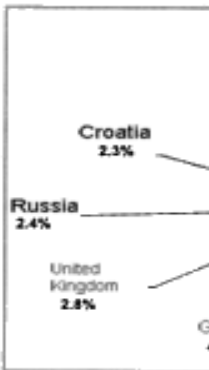
Graph 3. Exports by origin.



This chart shows that exports are oriented mainly to EU countries, mostly to Italy and Greece.

The asymmetric trade regime of Albania and some other country of the region to EU, during 2002, has been exploited at a low level and mainly for items like: anchovy, tomatoes at 33 percent of quota, sweet pepper at 9 percent, watermelon at 43 percent etc.

Graph 4. Imports by origin.



The situation is the same if we look at the origin of imports. Italy and Greece are the two bigger exporters to Albania.

The Albanian exports to signatory countries of the memorandum⁵ of trade liberalization stand at a low level, although the tendency during the last three years is upwards. From these countries, the exports to boarding country consist mainly of consumption products, construction raw materials, petroleum etc. Kosovo draws a considerable amount of exports from Albania- about 90% of the above-mentioned exports (it is presented with Yugoslavia for statistical reasons). In the first semester of 2003 Albania exported to Kosovo products valued at 871178 US dollars, mainly food products and construction raw materials.

Table 4. Free trade agreements.

NR	COUNTRIES	2000		2001		2002	
		000 /USD	%	000 /USD	%	000 /USD	%
1	Bosnia - Herzegovina	0	0	7,7	0,05	74,2	0,6
2	Bulgaria	78	0,7	94,7	0,66	97,8	0,8
3	Serbia, Montenegro and Kosovo	7088,4	64,2	9503,3	66,1	7457	58,3
4	Croatia	1385,3	12,6	49,7	0,35	158,4	1,2
5	Macedonia	2479,6	22,5	4719	32,83	4867,7	38,7
6	Romania	4,03	0,04	0	0	57,9	0,5
A	Memorandum's Countries	11035,3	4,25	14374,6	4,7	12713,6	3,76
B	Other Countries	24964,8	22,5	29387,3	20,9	33812,8	26,4
	Exports Total	260578	100	293873	100	338124	100

2. Which are the reasons for this situation?

The Albanian trade balance continues to be negative because of the low level of exports mentioned above, the domestic production export represents a small percentage of the total exports and consists mainly of agriculture products. Industrial exports are much smaller than they used to be when state-owned enterprises functioned properly.

This development is clearly reflected in the mineral industry. The minerals traditionally produced in Albania are chromium, cooper, ferrochromium, iron-nickel and some other products from the petroleum refinery that until the middle of '90 have been dominant components on the revenues from foreign exchanges.

Therefore, in the years of the centralized economy, mainly by the end of 1970s until 1990, Albania was the second country in the world concerning the chromium export (after South Africa) and the third for its production (after South Africa and Soviet Union). By the 1999 the chromium production dropped markedly. The production of 1999 was only 47 percent of the production of 1998. The crisis of the chromium industry resulted from continued strikes of the chromium industry workers, which had a negative impact even on the realization of chromium exports in the following years⁶.

By analysing the cooper industry, we see that cooper production was at its maximum level by the end of '80. In 1999, the cooper ore production dropped by nearly 37 percent compared to 1998. The refined cooper production fell sharply (by 70 percent) and the cable cooper production continued to decline, preserving the trend it started to exhibit since 1993.

In the past, the abundant production of electricity, natural gas and oil, as well as the low consumption of fuels in the country, turned Albania into an exporter of energy.

The reduction of electricity production, as a result of some years of dryness, the drop in oil production, and the increasing domestic need for energy lost Albania its good reputation as an energy exporter. The drastic fall of mineral exports is deemed as the most important factor that influenced the reduction in the domestic production export volume, causing at the same time the change of export structure. There is an evident drop in the weight of the category of "unprocessed materials" represented by mineral exports and category "fuel" where the export of electricity is included.

The low levels of exports from domestic production show that economic potentials to export are not being used as they should. One of the many reasons is the standstill of the mineral industry which is expected to be privatised. This industry has had a very significant share on Albanian exports.

Currently, there are many other factors affecting the low level of exports. Some of them are:

- The predominance of very small agriculture production units, many of which bring very limited production to the market. These units have difficulties in getting credits that could be used for enlargement or to purchase equipments necessary to intensify the land utilization or its modernization.
- The predominance of small workshops, mainly with old equipment, which cover only local or regional needs and cannot meet the quality and hygiene standards of the European markets.
- The lack of products standardization and production label.
- Insufficiency of infrastructure for raw material supply, products marketing and their eventual pre-processing.
- The difficulty of small producers in getting organized to collect the adequate quantities of products in order to process them for market and to profitably export them.
- The destruction of many existing structures and of production capacities, except for those in the textile, clothing and shoes industry.
- The lack of infrastructure and weak marketing to improve the image for tourism development.
- The lack of capital that can be invested in modern equipment and the lack of information on the sources of suitable technological supply.
- Many managers do not possess adequate knowledge on the modern methods of management. They are simply focused on production and lack contemporary expertise especially in the field of marketing.
- The production levels are lower than those of the destination countries, so the international competitiveness is low for these phases of production, which are easily automated.
- The lack of contacts between the business community and potential partners in foreign markets and the difficulties that managers encounter in order to travel to the countries intended for foreign trade.

From the above factors, the tendencies of consumption the development of potential aimed markets are unknown (such as movement to comfort products). In the meantime there are many conditions (i.e. hygienic standards, product presentation, supply continuity) to be fulfilled by all the suppliers, aiming to get the control a part of these markets.

3. What should be done to increase exports?

Even though Albania has been exporting a certain range of products, there is evidence to make us believe that the potential for exports is larger than the one we are currently exploiting. Albania could, in the near future, build a basis that could help widen and improve the country's exports.

The Albanian economy has not exploited the domestic capacities adequately. One of the reasons for the underexploitation of domestic resources has been the energy crisis, which has had a significant impact on the profitability of all the economic sectors.

Judging from the last few years' exports situation, the economy's growth rates, the performance in some economic segments, imports of agriculture and other economic sector equipments, public investments and many reforms currently in practice; from the opening and enlargement of regional market, especially to Macedonia and from the intensification of trade relationships with Kosovo, we could say that there is a good prospective for Albania to develop its competitiveness in exports from a regional perspective.

Below, we present a projection for exports (divided into domestic production and active processing exports) in millions of USD⁷.

Table 5. Export projections 2005, in millions of USD

YEAR	Exports from domestic production (1)	Exports from active processing(2)	Total exports (3) = (1)+ (2)
2003	112,3	286,1	398,4
	28,2 percent	72,8 percent	100 percent
2004	151,6	306,6	458,2
	33,1 percent	66,9 percent	100 percent
2005	212,2	314,7	526,9
	40,3 percent	59,7 percent	100 percent

As regards the performance of exports in the forthcoming years, we estimate that total exports will exhibit an annual growth rate of 18.3 percent; exports from domestic production will grow at 30 per cent and exports from active processing will grow at 10.4 percent.

In exports from domestic production, we expect a larger growth in the following products:

- vegetable products, medicinal, spices and fresh vegetables,
- animal products like: meat, dairy, fish etc.,
- foods, beverages, tobacco,
- construction raw materials (cement, lime),
- several minerals and metals (chromium, copper etc.),
- leather,
- woods and wood products,
- in the sectors of textiles and shoes, the growth will come from active processing of imported raw materials.

We foresee a larger growth in exports from domestic production, as compared to exports from active processing, because of the projected growth in workers' incomes, which will make active processing production less profitable than nowadays.

These projections have been debated since, we all know that these developments will be affected by many factors such as a thorough knowledge of exports and relevant factors from specialized institutions.

Naturally, the main impulses for economic growth will come from the private sector, as was the case during the first years of transition and during the economic recovery after the 1997 crisis. But, because of the abovementioned problems, the private sector is not yet able to use the competitive advantages of Albania, despite the possibilities that the liberalization of the state control system is offering in practice.

In the agriculture sector, it is necessary to affect the quantity and qualitative improvement of agriculture production. To achieve that, the production methods in agriculture should be modernized and new methods of organic agriculture should be introduced. This calls for concentration on such activities, that would increase the possibility of land operations. Also, the above would facilitate investments in agriculture, with the aim of intensifying the use and productivity of the land, and it would improve the knowledge and

skills of farmers to create contractual relationships or to form groups for marketing or raw materials supply. In this context, it is necessary to improve the communication system and road infrastructure.

Investments in non-agriculture sectors should be promoted and the aim should be the modernization of production units. It is necessary to update the technical and marketing knowledge through a special strategy. An appropriate infrastructure should be established that can facilitate and make possible the improvement of services.

The relative isolation of Albanian producers and managers from the target markets is one of the factors that have impeded the development of all economic sectors. For this reason the state should support those activities that pave the way for the Albanian producers and managers to enter foreign markets. They need to have sufficient information on these markets' conditions and to create an image of Albania as a supplier or exporter in specific sectors.

The fact that the revenues for 2002 from tourism were 47 percent higher than the Albanian exports means that tourism development should be one of the most prevalent issues of national development strategy. Despite the tough competition from countries of the region (Greece, Montenegro, Croatia), the sector of tourism has a potential to become a powerful engine of economic growth.

From a general point of view, and based on several factors affecting directly or indirectly the growth of goods export level, the perspective seems optimistic. Some of these factors are presented below:

1. The general economic development policies and the commitments for a liberal trade policy in the region.
2. The existence of an export promotion strategy and relevant structures to be implemented.
3. The improvement of financial and banking system as well as the expansion of credit to economy.
4. The rise of public investments in road, railway, water supply and telecommunication infrastructure.
5. The continuous increasing of foreign and domestic investments in the economy, especially in the industry of food and minerals.

6. Government commitments to facilitate and cut off the administrative barriers that impede the business development.
7. Government commitments to solve the ownership problem, which may lead to huge investments in the economy.

Likewise, an important factor affecting the export growth is the production standardization as per international standards. This would improve the image of Albania as a potential exporter.

CONCLUSIONS

- Exports from domestic production during the first years of last decade have been dominated by stock products and production units inherited from the centralized economic system, whereas in the following years the economic production evidently diminished, especially on export products, as results of reforms, privatization and need to restructuring the economy.
- During these years the trade deficit has continued to expand. Exports as a share of GDP has continued to decline over the years. The current trade deficit confirms the problems encountered by the country's balance of payments. The deficit means that the country should sell some of its assets or explore the possibility of receiving financial grants from other countries. Albania may attempt to close the gap between exports and imports by: promoting export and domestic production of some products that are currently imported;
- Exports of domestically produced products such as construction materials, leather, medicinal herbs, minerals etc. to a number of countries such as: Yugoslavia (+Kosovo), Turkey, USA, Switzerland etc. are going up.
- The exports/imports ratio represents a problem since, for the time being, other sectors such as tourism, financial services and other services can not compensate for the trade deficit. At the same time, the Albanian economy can not rely on selling its assets, since this too has a limit. The remittances from expatriates, which are the main financing item of the current account, are moving downwards. Hence, from this point of view, if the trade deficit becomes larger, it would be a barrier for the further development of economy as whole. After 2005, economists might need to deal with ways and methods intended to reduce the trade deficit.

- Export promotion, is a significant aspect of structural adjustments, and it should have a big impact on the balance of payments. Within the framework of economic policy in Albania, export development is considered a key factor in improving macro-economic indicators, especially the balance of payments, and in contributing to the creation of new jobs.
- FDI promotion could be a rational way to develop existing export potentials, to build new export capacities, to quickly access the market and to establish dynamic competitive advantages. FDI-s could play an important role in supporting the production intended for export. Also, the approval of Middle-term SME Development Strategy is decisive to improve the Albanian industry competitive skills, since SME make up 95 percent of the industrial sector.
- In order to attract more foreign investments and modernise production units of exports the country should apply some incentives, improve tax policy on investment for equipments for the production sector, cut off or reduce VAT on equipment, activities of companies operating in the production sector etc.
- In the agriculture sector, the immediate target is the quantitative and qualitative improvement of the agriculture production. To achieve this, the farmers' methods should be modernised and the organic production should be increased. In the European markets the "bio" products are very well-received. The above improvements need concrete actions such as: investments facilitation in order to enhance the land productivity, improvement of farmers' knowledge and skills, and the incentive to form groups oriented towards marketing and raw materials supply.

The main issues related to export promotion are:

- Identification of competitive advantages and their development;
- Promotion of FDI;
- Development of the production base in the country

Albania, with its geographical position, natural sources, climate and a relatively small domestic market, has all the possibilities to be a potential exporter to European markets.

The improvement of the energy situation through sectoral policies will have a positive effect on the economic development and in the reduction of the undesirable developments such as the large imports of electro-mechanical equipments, i.e. generators, electro-motors etc.

Likewise, the substitution of processed fuels with crude oil to be processed in country by the processing industry could help the reduction of the trade deficit. In the meantime, supporting policies for these sectors are essential.

An effective cooperation between the state institutions dealing with sectoral policies and with policies that affect developments in the exchange rates, which both constitute the backbones of an export strategy, will create a favourable environment for the balance of payments developments.

Agriculture and agro-industry are two sectors of the Albanian economy with such potential that could help improve the trade deficit, in terms of replacing imported products with domestically produced products. In this context, the extension of credits to these sectors could facilitate the overall strategy of improving the trade deficit.

In order to improve the export – import ratio, in addition to sustainable long-term objectives, we must pay attention to short-run solutions as well:

- One attempt could be the establishing of collecting centres on a regional basis. In these centres goods will be marketed, modified, standardized, and packed.
- Coming up with initiatives, which would make possible the use of other energy sources, especially the solar one, drawing from the positive results of other countries such as Greece, France, Spain etc.
- Promoting the imports of crude oil, because of the considerable refining capacities in the country, in order to minimize the trade deficit and reduce the unit production cost.

- Supporting construction materials production sector, because of the huge demand in the domestic market, and the because of the big export potential it represents especially in the region.
- Establishing criteria and norms in the construction of buildings regarding the central heating, which will reduce imports of such items as air conditioners, boilers, heaters etc.
- An improvement the management of water supply would help reduce imports of categories such as: dams, deposits, water pumps etc.

Further more, to improve the trade balance, many governmental structures should:

- Obtain on a regular basis analytical data for every product intended for export;
- Identify producers and wholesalers dealing with the exportation of different domestic products;
- Identify products that are potential exports but have not yet found the channels to access foreign markets;
- Identify domestic products and producers that need temporary protection from same imported products.
- Identify products, that can be produced in the country using existing sources and capacities;
- Establish an information system on agriculture and light and food industry products, which are tasty and biologically pure, and for which there is a high demand in foreign markets.
- Receive information and data on prices, demands, companies and regulations of foreign markets.

The further development of Albanian industry oriented to exports will depend on successful political, institutional, technical and managerial capacity-building.

The Albanian Export Promotion is supported by the competitive capability, based on the principles of sustainable private – public partnership in an integrated position where all of the following are included:

- The production and logistics oriented towards the market (business community role),

- Services oriented by business (public and private organizations role),
- Legislative and administrative framework oriented by business (government role).

The strategic statement regarding export promotion aims to include and to secure a closer cooperation among all the actors in order to benefit from complementary statements and synergy effects. Hence, the functional relations among public and private organizations, business community and donors, as well as government contribution will be essential to the success of Albanian Export Promotion.

The main issues regarding the incentive attitude are:

- The official integration of export promotion strategy into the general economic development strategy;
- The institutionalisation of public – private partnership to the strategy planning, implementation, monitoring and improvement.
- The establishment of an export promotion institution, which will coordinate its activities with the activity of the implementing agencies network;
- Improvement of the legal framework and concentration of administrative procedures;
- The promotion of Albanian industry for an integrated position that will begin with an improvement of the competitive capabilities and will proceed towards export promotion.

In order to stimulate the Albanian general economic development, we must make use of complimentary statements and synergy effects. Priority should be given to effective cooperation among all the actors and efficient coordination of donors' contributions. The substitution of imports by exports will play an important role in the Albanian future general economic development because of the competitive advantages of Albania, represented mainly by low costs and an educated working force, proximity to European markets, re-emergence of regional markets, abundant natural sources, liberal trade policies and the unexploited potentials of agriculture, food processing, mining, light industry and services.

ENDNOTE

¹ 2002 Annual Report of the Bank of Albania, page 58

² 2002 Annual Report of the Bank of Albania, page 59

³ 2002 Annual Report of Foreign Trade, ACIT

⁴ 2002 Annual Report of the Bank of Albania, page 59

⁵ Data taken from Ministry of Economy

⁶ Source: Ministry of Industry and Energy

⁷ Data taken from Ministry of Economy

COMMENTS ON: "CONSTRUCTING THE FUTURE PATH FOR EXPORTS"

Sokol Qeraxhiu

Dear participants of the conference,

Exports' growth should be considered as a part of overall economic development and growth of Albania. Excluding some temporary distributions the exports cannot be increased in an isolated environment and independently from the overall development of Albanian economy and infrastructure, but still, the growth of exports needs to be considered as one of the Albanian development priorities.

Considering this, the paper of Mr. Ceku covered quite a wide area and issues. In the paper he reconfirmed the fact that Albanian exports are concentrated on sectors like tourism, agriculture, food processing and mining and listing a number of factors and possible measures for promoting and helping the Albanian export-growth.

In order to be more productive and focused on the recommended measures, the paper identifies some primary areas on which development should be oriented. The time and sectoral analysis presented in the paper aim to identify (reconfirm) existing competitive advantages as well as some primary sectors of economy. As mentioned in the paper, this identification is done more in support of advantageous sectors already discussed before – Agriculture and Tourism.

The conclusions of the paper point out that we need to maintain a "strategic approach to the growth of exports", as well as try to

engage all potential actors in this process. The main role belongs to the Albanian government. Following the principles of this “strategic approach” through an all-inclusive process, the government should build development strategies for various areas and at the same time it should ensure maximum coordination.

In my comments I would like to draw your attention on some issues, which I consider also important and trying to avoiding repeating what you already have in the Mr. Ceku paper.

WHY IS THE EXPORT GROWTH IMPORTANT?

Globalization and the need for economic integration

Worldwide economic globalization and the aim of Albania to move towards European integration are factors, which lead to a more open market and less barriers. Latest “free trade” agreements signed with other countries in the region seems to be only the beginning of the integration process. In this context, the import/exports between countries are more and more less controlled by the governments and are leading to a higher level of free competition among producers of goods and services.

In order to survive this coming reality, the Albanian producers should be efficient and make continuous use of the competitive advantages of their own country of origin.

The level of export is an economic development & integration readiness indicator

As mentioned above, the growth of export should be supported only by an economic growth. More exports will be mainly as a result of more internationally attractive products, higher quality and standard of internal products/services and more efficient production process.

Therefore, the level of export and its change over time can be used as an indicator of level of success of internal economical reforms and level of readiness of Albanian producers of goods and services to positively compete in an international market. In the European Union integration process, Albanian decision-makers should carefully consider the use this indicator.

Another important indicator of development of the Albanian economy can be the change in the structure of the export.

PROBLEMS AND REASONS FOR THE ACTUAL PURE EXPORT LEVEL

Some of the difficulties and problems faced by the Albanian exports are as follows. They are listed according to my personal importance/ impact.

Lack of management experience

This lack of management experience and knowledge is present in both government and private entities. The change of Albanian economy from a planned to a free market economy will be always in a transitory phase until we are familiar with the free market economy, development mechanism.

Again, under the new globalization and integration area, the management, should be driven by a global thinking. This looks to be a very challenging change considering the last 40 years Albanian experience.

Over the last 10 years, a lot of changes have happen in this direction, but still more need to be done.

Capital Insufficiency and difficulties in planning.

Business in Albania keeps developing based on relatively small investments with small production capacities. Those investments are of a spontaneous character and mostly arise from the joint capital of a small number of individuals.

For this reason, it is difficult to concentrate a considerable capital in one enterprise. The number of enterprises technology-oriented is very limited and in general the quantity and quality of products and the respective production efficiency is hardly comparable to those of the region.

On the other side, the businesses in Albania lack a clear planning. These investments are carried out gradually and in distinct steps. The main factor that has affected this absence of vision, apart from limited capital, is the difficulty in planning and coordination of business individual development with the general development of the Albanian society and economy.

PROBLEM IN THE EXPORTS STRUCTURE

Lack of export diversity

The most obvious problem of our exports, as mentioned in the publications of Bank of Albania, is the lack of diversification of the export basket. I believe that the continuing diversification of exports would have, among other things, direct advantages in the sustainability of exports and increase of employment rate.

Textile articles and foot wear account for 50 per cent of total exports, while re-exports account for 70 per cent. Such rate of concentration in exports will have the following negative impacts:

- Fluctuations in exports due to movements of international prices of these articles, which compared to prices of other articles are more volatile in general;
- Re-exports, with emphasize on the export of labor, are in inverse relationship with the economic development and welfare.

Forecasts from the Ministry of Economy are very optimistic as re-exports are expected to go down to 54 per cent of total exports by 2005. However, I believe that this figure should be considered more a result of reforms and changes in this area rather than a downward trend of weight of re-exports.

IMPROVEMENTS AND INITIATIVES

At the end I would like also to mention some initiatives and potential improvements towards the promotion of Albanian exports.

The main initiatives in this direction should come from the Albanian government, as it should keep developing strategies on promoting exports. This not only would prove the commitment of the Albanian government but would also provide an overall sound strategy, which would ensure the coordination and transparency of the means to implement the strategy.

Last, I would like to point out that it is very important not only to formulate these strategies but more so to successfully implement

those. Therefore, there is need to monitor them on ongoing bases, with transparency and open to all interested parties. Also, they should be reviewed on periodical bases assessing the progress made so far.

Thank you for your attention.

COMMENTS ON: "FOREIGN TRADE AGREEMENTS: THE BENEFITS AND DRAWBACKS"

Sherif Bundo

Beshir Ciceri

The conference organized by the Bank of Albania and the Economics Faculty – University of Tirana, is a great event at a scientific level as well as at the perspective and constructive extent. First, let us express our thanks to the organizing institutions and their directors for the fact that now, not only is the organization of yearly conferences of this kind becoming a tradition, but conferences with co-organizers are becoming a tradition, too.

Discussing about the same subject matter soon after a full-time and well-presented report, as it was the case with just finished report, is rather difficult. It is difficult for the exigent audience; it is difficult to the disputants. Nevertheless, the interest and curiosity is exactly here.

The “free trade” agreements have become the subject matter of the day for all the economic, political, mediatic and administrative opinion of our country. These terms are also widely discussed in rest of the Balkan. In the morphological viewpoint these have been called “Free trade Agreements”, when actually they are “duty-free trade agreements” or agreements with reduced custom duty. They are not and could never ever be “free trade” in the real meaning of the word. Free trade, as used in the real meaning of the concept used by Adam Smith, can’t be employed in the nowadays circumstances between two countries, especially in Balkan, where

apart from the many impediments and tax duties, there are also many administrative, legal, boundary impediments and procedures, restrictions on people's movement, etc. The regional citizens have not yet been able to travel freely from one country to another, let alone exercise free economic activities or free trade. This is more than true and many examples could be brought forth; however, we are not going to spend more time on this as there are other elements, clearly more important, to evolve a discussion.

Following, we are bringing to your attention some useful elements to the today's conference.

1. Free trade agreements are, beyond any doubt, an achievement to be appreciated in the region. They have changed and are still changing day after day the commercial communication climate throughout countries. These agreements have been the first big step towards the liberalization and facilitation of trade among the regional countries. Our country is among the most advanced ones regarding these agreements. This represents a positive premise. Important for us is the promotion of products for export, so that we could be buyers as well as sellers under the free trade agreements. Agreements already exist. The object is missing; there is no surplus production in the country. Under these circumstances, we believe that the commitment of the state structures is that big and advantageous in promoting the domestic production, particularly that for export. The Turkish, Polish, Hungarian, Bulgarian, Slovenian, etc., experiences are successful because their economic and growth solution clue is the domestic production. These experiences also show that there can't be real poverty reduction or export stimulation strategies without giving incentives to and stimulating the domestic production. I am not aware of any law or incentive favoring and stimulating the domestic export productions to the extent, for instance that construction firms and construction volume were justly stimulated from the lack of taxation and VAT, for a relatively long period of time. The expansion of the Albanian market through the reduction and lift of customs duty tariffs after 2008 is a great advantage, though a potential one only. Free exchanges are typical of relatively developed countries, the economies of which exchange products, reciprocally, freely as liquids flow freely in their communicating vessels. On the perspective development track, the Balkan countries, too, do have what to produce, exchange and communicate to each other. Now

it is time to strongly urge incentives and investment in those sectors of the Albanian economy that bear the advantages of regional economic growth and development. Even within the European Community, the joint market used to expand the boundaries by reducing political restrictions and at the same time when the economies of the Market member countries were growing. Moving from the Rome Treaty to the Customs free Trade took nearly 45 years. In this perspective, we think it is time to focus on intensified investment in branches favoring the new dimensions of the regional market. It is time to turn our attention towards the production and export of certain traditional products in agriculture, handicraft, and tourism towards the North of the Region.

2. Is there reciprocity in the free regional trade of our country? Do we have equal trade?

This question is rather difficult. It is somehow known that we may have equal trade conditions with the regional countries, but however, we can never have equal trade. This conclusion has been already discussed. We would like to emphasize the impact of free trade agreements on the Albanian economy reconstruction, better to say on a new structural orientation. Our country went through a very difficult transition, during which many production capacities, which could be rehabilitated and become effective to the present market, have been destroyed. This is similar more or less to what happened in the rest of the region. In this perspective, our economy today finds itself without the necessary manufactories or vegetable conservation, preserves, fish, animal products, processing factories, etc. Meanwhile, the regional countries have made effective the ex-production capacities of 15-20 years ago. Under these circumstances, we surely do not feel ourselves under equal trade, but only under equal trade conditions. Not wanting to touch upon the object of another subject matter, the most significant fact of this conclusion is both the continuous and notable growth of import volume and the continuous deepening of the trade deficit. One of the most important values of our economy, appreciated also by the foreigners under the tourism conditions, is gastronomy and culinary art in general. This significant economic and promotional element of tourism, is grounded in two main elements: in the originality and in the values of agriculture and animal productions on one side, and in the tradition of the Albanian cuisine, where one can find elements of the Turkish, Italian and Greek cuisine altogether, which are regarded as the most appreciated cuisines. This fact bears a

comparative advantage itself in the region and beyond. This comparative advantage should be encouraged, promoted, supported and developed. We should turn this comparative advantage into a productive and exporting capacity at a near future. It is the right place to state that even the banking system can strongly influence in this aspect through the crediting system giving priority to the agriculture and animal farming industry investment.

It is necessary to conclude that the free trade agreements of our country with the other countries in the region should be associated with encouraging packets and policies aiming the development and utilization of the domestic sources. Considering the present trend of the rapid growth of imports, reduction or standstill situation of exports, daily deepening of the foreign trade balance, deepening or difficulties in the foreign current accounts, we think that our economy will be faced with huge obstacles in the future.

3. When speaking about free trade agreement, we always keep in mind that apart from the economic aspect, the countries parties in the agreement do have another framework - political, strategic, institutional framework and integration framework or preparations towards the integration in European structures. Without making any more comments - in the political aspect - agreements are incentives and encouraging actions. We believe that they are regarded as such by everyone. However, agreements should not always remain framework documents, political garniture. Apart from customs duties arrangements, the application of the agreement would also require other arrangements in the economic regimes of our country and those of other countries, either active or passive ones. If the agricultural and farming sectors, for instance, have a favorable climate in the fiscal field within the country, they do not enjoy any facilities in export. If agro-industrial products were exported, then they would benefit only from the free trade agreement facilities, but meanwhile they would equally come under constraints to pay VAT, excises, service charges, etc. It is quite logical to discuss for example the reduction of VAT for the agro-industrial export products, handcraft and traditional products, etc.

Saranda - September 11, 2003

"CAPITAL ACCOUNT LIBERALIZATION - WHAT SHOULD ALBANIA DO?"

Shkëlqim Cani

Diana Shtylla

LIBERALIZING CAPITAL ACCOUNT IN ALBANIA: WHY, WHEN AND HOW?

1. What is capital account liberalization: the pros, cons and a brief history of capital controls.
2. How liberalized is Albania's capital account: theoretical approach and empirical evidence.
3. Why do we advocate capital account liberalization?
4. Conditions for capital account liberalization and the current situation in Albania.
5. Suggested steps of liberalization in Albania.

ABSTRACT

Capital account liberalization is one of the processes Albania will have to undertake in the near future. Restrictions on movements of capital are no novelty. They have been prevalent in many countries around the world especially during times of turbulence such as wars or economic depressions. The last two decades have been characterized by a continuous easing of controls on capital movement, and many countries have completely opened up their capital accounts.

However there is a number of countries, Albania included, that are

not yet liberalized. While Albania imposes no restrictions or controls on capital inflows, it maintains controls on most capital outflows. The reasons behind the need for capital account opening are linked to the benefits stemming from this process such as higher economic growth, increased diversification opportunities, financial development, fulfillment of the requirements set by the Albanian authorities in collaboration with the WTO and the European Union, reduction of the informal economy, stable and low inflation etc..

Capital account liberalization requires the fulfillment of certain conditions such as: a sound macroeconomic framework; strong institutional and regulatory regime especially in the financial sector and appropriateness of the exchange rate regime. Therefore we stress the importance of preserving and improving current macroeconomic indicators such as GDP growth and inflation, the importance of the continuation of structural reforms, the importance of carefully monitoring the levels of total and especially foreign debt, and the immediate necessity to develop a foreign exchange-generating strategy that will enable Albania to maintain a sound balance of payments position.

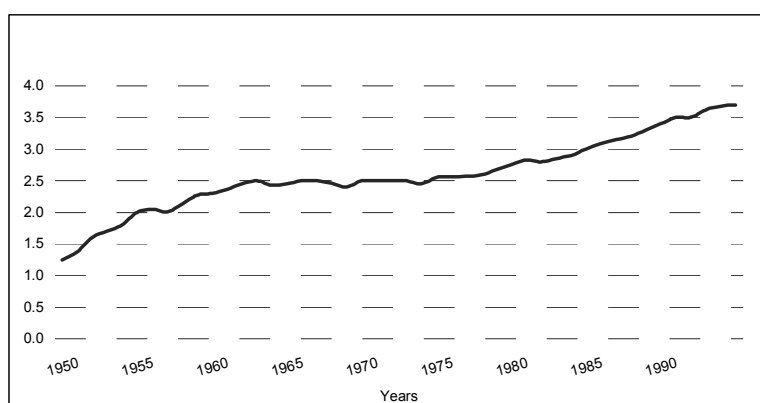
As far as the liberalization steps are concerned, in line with theory and recorded evidence so far, we suggest that a careful approach be taken as Albania opens its capital account. The sequencing of the liberalization steps is very important. Sequencing stands for an ordering and a combination of structural and macroeconomic reforms with steps towards the opening of the capital account.

1. WHAT IS CAPITAL ACCOUNT LIBERALIZATION: THE PROS, CONS AND A BRIEF HISTORY.

Capital account liberalization means complete removal of controls and restrictions on movements of capital from and to a country. The word 'restriction' is used not only for outright legal prohibition, i.e. in cases when the law completely prohibits a certain transaction, but also when quantitative restrictions are imposed, and even in the cases when, for a given transaction, approval from an authority such as the central bank is required. At this point it is necessary to underline the distinction between the obligation to receive an approval (authorization, permission) and the declaration required at the point of entry or exit of the capital. Some countries apply the system of the declaration of the quantities of capital that leave the

country for mere statistical reasons or tax-related concerns. These declarations do not constitute restrictions or controls on the movement of capital because they do not impede or decelerate this movement. Because controls and restrictions on the movement of capital are both of quantitative and qualitative nature it is difficult to determine whether a country has a liberalized capital account or not. Quinn and Inclán (1997) measured capital account openness in a number of countries by coding measures limiting international capital mobility according to their degree of restrictiveness.

Graph 1: Degree of openness¹



It is clear that in the second half of the last century the degree of capital account liberalization has been increasing especially in the last decade.

Brief overview of controls on the movement of capital.

Capital has been moving from one country to another long before sophisticated financial and capital markets were in place. However, the movement of capital has, to various extents been subject to controls, the size and scope of which differed from one economic and political era to another. It is wrong to assume that controls on the movement of capital have been gradually lifted over the decades. There have been periods when capital has moved from one country to another with a greater freedom than it does today. Such was the gold standard period during which capital was transferred and invested in huge quantities, while interest rates

of different countries were closer than they had ever been before. The fixed exchange rate regime, the gold standard, was regarded by many countries as a reliable and stable one. Short-term capital helped finance many new economic activities in many countries. The gold period was followed by the war period which included the two world wars and the interwar period – the Great Depression (1914-1945). This period was characterized by an increasing nationalistic feeling and anti-cooperational policies. Trust in the gold standard eroded after the breakup of WWI and monetary policy focused on the solution of domestic problems and mostly on the financing of war-related deficits. Capital controls were imposed in countries all around the world as means that could protect them from currency depreciation and help keep the gold in their possession. The world economy shifted from a developed stage of globalization to almost full autarchy within a few decades. Capital movement was almost inexistent, international investment was viewed with suspicion and international prices and interest rates stopped moving in tandem. Global capital and international investment was even considered as the main cause of the depression in the 30s.

The third period - the Bretton Woods period (1945-1971) - was an attempt to reconstruct the world economy. Trade transactions flourished and economic growth was more prominent than ever. Despite the remarkable growth fears related to the movement of capital had not been appeased. IMF initially sanctioned controls on the movement of capital as a means to prevent currency crises. These controls granted the governments some independency to pursue active monetary policies. The philosophy advocating capital controls, was not abandoned until the end of the 60s when it became visible that global capital could not be contained. Capital markets were regenerated during the controls era, while fixed exchange rate regime was the common feature of many developed economies.

In the fourth and final period-the post Bretton Woods or the flexible exchange rate period- the trend was different. Although some countries were hesitant to replace the fixed exchange rate with the flexible one, between 1970-1990 capital movement has been quite remarkable. The governments of developed countries did not regard capital controls as necessary, as fixed exchange rates were not their priority any more. Since a flexible exchange rate could accommodate developments in the capital market, controls could

be lifted without causing problems. The removal of controls encouraged the movement of capital in and out of many countries. In the peripheral countries economic reforms reduced transaction costs and direct investment risks. As a result, capital flew into these countries at least until the end of the 90s, when foreign investors became aware of the problems that could arise from the fixed exchange rate regimes that were still widespread among developing countries.

Arguments for the Capital Account Liberalization

The classical theory² suggests that international movement of capital allows countries with limited savings to attract financing for investment projects in the country, enables investors to diversify their portfolios, spreads investment risk and promotes intertemporal trade-the trading of goods today for goods in the future.

If capital is free to move from one country to another, then individuals, firms and countries can consume as much as they want to by borrowing from abroad when their income is not sufficient. Borrowing from abroad, helps smooth business cycles and allows domestic firms and individuals to keep consuming and investing even when domestic production and income are at low levels.

Capital account opening has been found to raise credibility in the monetary authorities. According to William McGruben and Darryl McLeod who compared inflation performance of countries that liberalized their capital account during the 90s with that of countries that did not do this, the continuous lifting of controls can bring down the yearly rate of inflation by up to 3 per cent. A similar conclusion has been reached by Eichengreen, Rose and Wyplosz (1996b). They studied the record of macroeconomic variables in countries that underwent crises, while some of the countries selected had liberalized their capital account and others had not. The authors found that inflation, money growth and trade imbalances are higher in crises occurring in the presence of controls. In another study done by Alesina, Grilli and Milesi-Ferreti (1994), it is made clear that countries imposing controls tend to have higher inflation and greater seigniorage revenue but lower real interest rates.

Johnston and others (1998) find that the intensity of capital controls is negatively correlated with economic development and positively

correlated with the level of tariff barriers, the black market premium and the volatility of the exchange rate.

Arguments against Capital Account Liberalization

A number of economists around the world bring forth several arguments against full liberalization or the manner in which it was conducted in certain countries. Some of these arguments follow: In the first place it is hard to measure the net benefits that a country would reap from CAL, because, under normal conditions it is impossible to predict the losses that the country might incur in the face of a capital crisis. In a proper analysis a country must estimate the probability of a crisis as well as the potential losses that the crisis could bring about.

One opponent of the CAL, Sebastian Edwards, has found that capital movements do not always help total factor productivity growth. He separated countries into distinct groups according to their level of development, and found that financially sophisticated countries have much more to gain than financially underdeveloped countries. In other words, Edwards concluded that, a country can benefit from CAL only after having reached a certain level of economic development. In the same line of thought, it has been argued that developing countries suffer much more than developed countries in periods of crises.

In the private sector, CAL raises the question of access to credit especially for individuals and medium-sized companies. Small borrowers benefit less from foreign capital, and are more severely hit by swift capital flights because of their limited ability to transfer their assets abroad and limited access to financial services.

A number of economists while not being fully against liberalization, suggest that this process should be carried out cautiously and gradually. They argue that going back from a liberalized state to a controlled one, in case of crises, might be very costly and detrimental to the economy.

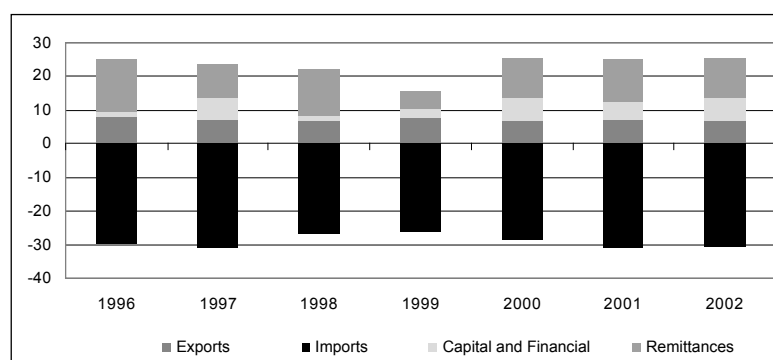
2. THE DEGREE OF LIBERALIZATION OF ALBANIA'S CAPITAL ACCOUNT AND REASONS BEHIND THE MODEST INFLOWS.

Albania is regarded as a country with low barriers to foreign capital and direct investment. An index of Economic Freedom constructed

by Wall Street Journal ranks Albania higher than countries such as Japan, Canada, France, Slovenia, Bulgaria, Malta, Cyprus and all the ex-USSR countries. The reason behind this is because according to Albania's Regulation on Foreign Exchange Activities³, there is no approval process, and no sectors are closed to foreign investment. In the same way, repatriation of initially-invested foreign capital as well as the earnings stemming from these investments, face no obstacles in leaving the country. According to this evaluation 'Foreign and domestic firms are treated equally under the law in Albania and are guaranteed safety from expropriation or nationalization.' There is only one (accidental) case in which foreign investors are not treated in the same way as residents of Albania. Foreign investors who invest in Albanian Treasury Bills must pay a 15 per cent tax on their profits as opposed to a 10 per cent tax imposed on Albanian residents.

The movement of capital to and from Albania is regulated by the Regulation on Foreign Exchange Activities (FEA) amended in 30.7.2003. As mentioned above foreign capital entering the country is not subject to any restrictions or controls. Despite the lack of controls, inflows of capital in Albania are very modest and we feel the need to analyze some factors that might have limited the incoming capital to Albania.

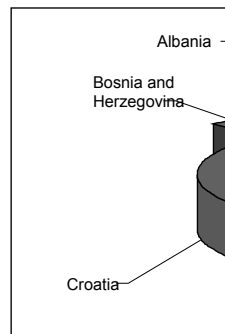
Graph 2: Imports, exports, capital + financial flows and remittances (% of GDP)



Most of the capital comes to Albania in the form of FDI and capital transfers (credit) to the government. There are no portfolio investments from abroad whereas in the past three years domestic

banks have purchased, in very limited amounts, foreign debt securities. Although we are aware of the benefits stemming from the diversification of incoming capital, we would like to investigate some of the reasons that have held back foreign direct investment (FDI) in the past few years. Inward direct investment is particularly beneficial for the host country. In a widely-held view, foreign direct investors are believed to increase domestic capital formation, to augment host country stocks of technology and managerial know-how, and to improve access to export markets. Foreign direct investments are considered as a comparatively stable source of external financing. On the other hand FDI is typically regarded as less responsive to adverse macroeconomic developments. It is associated with fixed investment which can only be liquidated at a substantial loss. (Lehmann 2002). Albania seems to have been less of an attraction for foreign investors than other southeastern European countries, even compared to the ones of similar size such as FYR Macedonia or Croatia.

Graph 3: Distribution of FDI among southeastern European countries for 2001 (total 100 %).

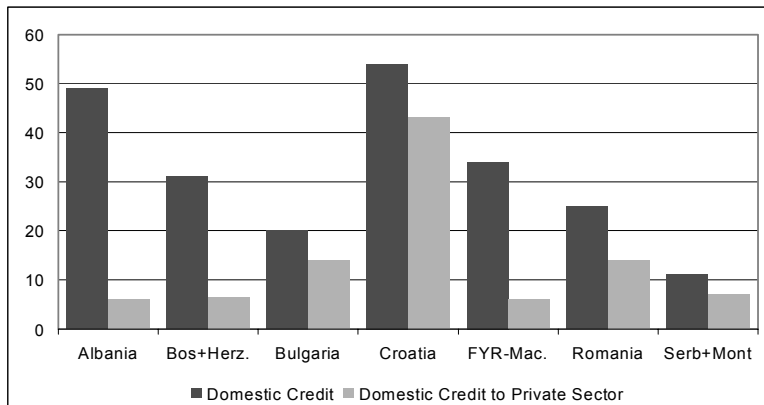


Reasons behind investors' reluctance to invest in Albania can be related to:

1. Technological factors which may result in differences in production between the investing and the host country. Although Albania lags behind other developing countries, it is making progress in terms of attracting new technology. In the last two years imports of machinery and equipment, mostly related to investment in telecommunications made up 16-18 per cent of total imports.

2. Institutional factors that determine the perceived risk of confiscatory taxation, the presence of informal economy, unclear property rights and uneven application of laws and contracts. All these phenomena are observed and are still present in the Albanian business environment. Despite recent improvements, cases of arbitrary decisions, evasion and preferential treatment of specific subjects have been observed. Unclear property rights, which often result in dual ownership of an asset, corruption, delays, gaps and irregularities in the enforcement of law make it difficult for foreign investors to purchase or construct buildings, to acquire technology and to normally engage in a business activity in Albania. In addition to the overall improvement of investment conditions in the future, we believe that, the liberalization of the buying and selling of land may also aid foreign investors to conduct their business in Albania.
3. Financial system flaws and credit market constraints which have confined the development of the private sector. Albania is one of the SEE countries with the lowest level of domestic credit to private sector⁴. SMEs, for a number of reasons, are still having difficulties in attracting financing from domestic banks.

Graph 4: Bank intermediation in SEE in 2001 (in percent of GDP)



Under these conditions it is obvious that well-developed financial system is required as an intermediary between foreign capital and SMEs in the country.

4. Lack of information and insufficient marketing which have also impeded foreign capital from entering the country.

5. Increasing concerns about repayment which are related to the current account balance situation. It is said that current account deficits are regarded as warning indicators of a crisis and higher account deficits tend to be associated with higher required risk premia. (Lipschitz, Lane and Mourmouras, 2002). As the current account deficit of Albania (as percent of GDP) has been growing continuously during the last 4 years, until it stopped at 8.3 % of GDP in 2002, concerns about the ability of the country to repay its external debt must have grown accordingly.

After scrutinizing the reasons behind shallow FDI-s in the last decade in Albania, we must mention the undeniable fact that FDI-s, like the majority of statistics in Albania, are subject to some erroneous registrations, estimations, misspecifications etc.. The Albanian balance of payments has been constantly registering positive large errors and omissions and this is a sign of underestimated inflows. Based on these observations and other information, we might conclude that incoming capital and especially FDI-s might be higher than those registered and presented in the balance of payments.

Outflows of capital, on the other hand, are still subject to restrictions. No approval is required for outgoing cash transfers from the territory of the Republic of Albania, when the amount transferred for investment purposes in Albania from a foreign bank has not been used; and for outgoing transfers from the territory of the Republic of Albania, for an amount up to the total of paid-in capital and earnings resulted from such capital investment, if this is supported by the appropriate documentation (Law no. 7764 dated 02.11.1993, "On Foreign Investments"). Commercial credits given abroad also need no approval, as long as their maturity is shorter than one year. Immigrants who are not residents of Albania can also transfer foreign exchange obtained through their occupation abroad, or the selling or investments of their wealth. In order to be able to transfer capital abroad, physical and judicial persons as well as individuals, residents of Albania, need to receive the approval of licensed subjects (commercial banks). The ceiling on the amount that could be transferred abroad by a single individual was raised from 20,000 usd to 3.5 million leks (currently 28,000 usd) or the equivalent in foreign exchange. Although the FEA Regulation does not allow residents to carry out direct investment abroad, investment in foreign securities, lending to non-residents etc., we believe that

Albanian residents have transferred and continue to transfer capital out of the country both through legal and illegal channels. In sum we conclude that the capital account of Albania is completely liberalized on the side of inflows and more liberalized than suggested by legislation on the side of outflows.

3. WHY DO WE ADVOCATE CAL?

We are of the opinion that Albania should not ask whether to liberalize or not, but rather, when and how to conduct the liberalization process. For various reasons that will be presented in the paper, it seems that liberalization is unavoidable, and what we must take care of is the ordering of the steps and the preparation of a smooth liberalization process that will yield the desired benefits and diminish the drawbacks. Below are presented some points that support the liberalization thesis in Albania.

- (a) Fictitious controls; large informal economy; evidence that controls on outflows are being circumvented; theoretical support that controls on outflows are less efficient than controls on inflows of capital;
 - (b) Empirical evidence that capital account liberalization promotes economic growth in developed and especially developing countries;
 - (c) Long term prospect to become more integrated with the international financial system;
 - (d) Short –to- medium term commitment to meet the requirements of EU, WTO and other international organizations;
- a) There is good reason to believe that the size of the informal sector in SEE, as a percentage of the formal sector, is large compared both to advanced industrial economies and to transition economies in central eastern Europe and the Baltic states. Informal activities thrive in weak states where enforcement of the rule of law is patchy and barriers to entry are large. (Falcetti, Sanfey, Taci, 2003). Although Albania is not ranked among the countries with the highest share of informal sector/GNP (only 33.4 vs. 45.1 in Moldova and FYR-Macedonia) there is evidence that the share of informal sector is underestimated due to the method of estimation being used. Muent, Pissarides and Sanfey (2001) report evidence from a survey of legal enterprises in Albania that competition from the informal sector is the biggest obstacle they

face in doing business, outweighing even access to finance or taxes. It is clear that in an economy where illegal and unregistered activities play an important role, unrecorded flows of capital both in and out of the country are present. Illegal activities are generally financed from sources outside of the banking system, such as revenue from other illegal activities carried out in the country or abroad. Most of the transactions in this fraction of the economy are conducted in cash, which is easy to transfer either through customs or through other channels. To illustrate this fact, we can refer to the low percentage of imports and exports that are paid for via banks. The figures for 2002 were 40 and 44 per cent whereas for the first six months of 2003 they were 34 for imports and 32 per cent for exports.

If we consider legal ways of transferring the money abroad, we conclude that a standard 5-member family can transfer abroad through commercial banks around 130-140 thousand usd a year. If one manages to trick the interbank information system, which should not be very difficult in the current conditions, then one can transfer more than the allotted amount under the same name or using different identifications. There are sufficient reasons for us, as central bankers, to believe that Albanian residents can and do get around restrictions on capital movement. They tend to do this when political and economic conditions in the country deteriorate, when they suspect that their savings in foreign currency are not safe in the domestic banks (as was the case in March-April 2002), or for reasons related to illegal activities.

Referring to theory, in addition to the points made above, we must mention quite a number of studies which have found that controls in general and controls on outflows in particular are far from being effective in restricting the movement of capital between countries. It has been found that controls have to large extent failed to inhibit portfolio capital flows, especially when a devaluation was anticipated. Evidence from a number of countries and a number of studies shows that only the most comprehensive and repressive controls on outflows have had at best limited effects.⁵

In conclusion, keeping in mind the size of the informal sector in Albania, the significance of cash in the economy, the continuous tendency of residents to circumvent controls, and the evidence that controls on outflows, even in the best cases, have resulted less efficient than controls on inflows, we might say that controls

on the movement of capital in Albania are to a large extent ineffective and at the same time impossible to maintain.

b) Albanian economy has a strong need for foreign financing as it develops. Foreign capital is needed both for the privatization of existing entities, as well as for greenfield projects which are crucial to the overall economic development of the country. Theory suggests that a country that has liberalized outflows is more attractive to foreign investors, as the fear of being stuck with their capital in the country at a moment of crises is much smaller than otherwise. The scheme is simple. Less or no controls on outflows encourage inflows and more inflows help the country to efficiently allocate resources, to provide opportunities for risk diversification, to develop its financial system and to attract better technology and know-how from the investors. Many studies and surveys have concluded that developing countries that have liberalized their capital accounts have experienced economic growth at higher rates than under closed capital account.

Quinn's empirical estimates (1997) suggest that the change in capital account liberalization has a strongly significant effect on the growth in real GDP per capita in his cross section of 58 countries over the period 1960-1989. Bekaert, Harvey and Lundblad (2001) find that financial liberalization leads to a 1 percent increase in annual per capita GDP growth over a five year period and that this effect is statistically significant. Along with these studies, there is a number of other studies which have found no correlation between liberalization and growth or which have found that this correlation is inexistent for developing countries (Arteta, Eichengreen and Wyplosz, 2001, and Klein and Olivei, 2000). Because we are faced with a choice here, we prefer to regard capital account liberalization as beneficial to the economy.

c) As we proceed towards a more open capital account, we will also enhance the chances that the Albanian capital and financial market become more integrated with the international market. The more markets are integrated, the better aligned the interest rates are and the easier it is to make educated choices about investments at home or abroad. Albania's integration with international financial markets will be a gradual process and maybe it will some time, before we actually witness the outcomes.

d) Albania is committed to liberalize its capital account and it has agreed to do so within a certain timelimit. In the Report of the Working Party on the Accession of Albania to the World Trade Organization⁶, removal of capital controls is one of the horizontal commitments. The report states that: 'the Bank of Albania reserves the right to maintain capital controls which will apply on national treatment basis. The regime currently in place will be removed no latter than 2010'⁷. At the same time Albania is preparing to sign the Stability and Association Agreement, which is a first step towards integration in the EU. This agreement will impose on Albania certain conditions regarding the sequencing of CAL and it will set, similarly to the commitments signed with WTO, a time limit after which the capital account of Albania will be fully liberalized. This limit will depend on the time when the SAA will be signed. However, based on the SAA already signed with Macedonia and Croatia, we believe that this limit will not fall beyond year 2010. As shown above, Albania does not have only the good will, but also the official commitment to open its capital account within a relatively short period of time.

4. CONDITIONS FOR CAL AND THE SITUATION IN ALBANIA

In this section of the paper will be presented several generally-acknowledged conditions that countries should meet before they decide to open their capital accounts. Transition economies that open themselves up to free capital flows are vulnerable. Global capital markets are huge relative to the size of these economies, so small portfolio shifts can exert an overwhelming influence on capital flows and domestic financial conditions. Policies should be set so as consciously to reduce vulnerabilities (Lipschitz, Lane, Mourmouras, 2002). As each condition is presented, the current situation of Albania is described along with some proposals for the immediate future.

- a) Sound macroeconomic framework and continued restructuring of the economy;
- b) Strong institutional and regulatory regime in the financial sector;
- c) Ability to use fiscal policy to offset the effects of large capital inflows or outflows;
- d) Access to information; policy transparency and data dissemination;
- e) Appropriateness of the exchange rate regime;

a) Not all countries have opened their capital account while they were at the peak of their economic performance. However, according to the conventional view, macroeconomic stability is a key precondition for the liberalization of the capital account. Economic instability may deepen the weaknesses of the financial sector and the liberalization of capital account under these conditions may make matters worse. Sound macroeconomic policies are essential to the neutralization of this mutual relationship. In Albania's case we must once again stress the importance of preserving macroeconomic stability; current rates of GDP growth; inflation at low levels; maintaining external debt at sustainable levels; and, as we speak of capital account liberalization, the importance of designing foreign-exchange generating strategies.

Albania has a low export/imports ratio, while remittances from immigrants working abroad are almost twice the amount of exports. We could say that the real export of Albania is not that of goods but that of labor. Capital inflows are much lower than both exports and remittances. Since some of the sources of foreign exchange in Albania (remittances, foreign aid and revenues from illegal activities) are expected to pour less foreign exchange in the medium-term, we have to think of other long-term sources through which Albania can finance its current account. Good tourism, export-promoting or import-substitution strategies can help reduce the current account deficit, while strategies designed to attract foreign direct investment can help increase financial inflows.

b) Opening the capital account exposes the domestic financial system to foreign competition. Hence, most developing countries have attempted to implement financial sector reforms before fully liberalizing capital account. These reforms typically include freeing interest rates on loans and deposits, developing indirect monetary instruments etc.. Viewed from this perspective, the financial sector in Albania has done good progress in terms of preparing for liberalization. Interest rates on loans and deposits were liberalized in 2000 whereas credit ceilings had been abolished already. Bank of Albania is now relying on indirect instruments to conduct its monetary policy. From above we might conclude that the financial system in Albania is not unfit for CAL. Despite this fact, the financial system in Albania is still narrow and relatively underdeveloped. The banking system comprises the biggest fraction of the financial system. Banking supervision has done quite a progress towards

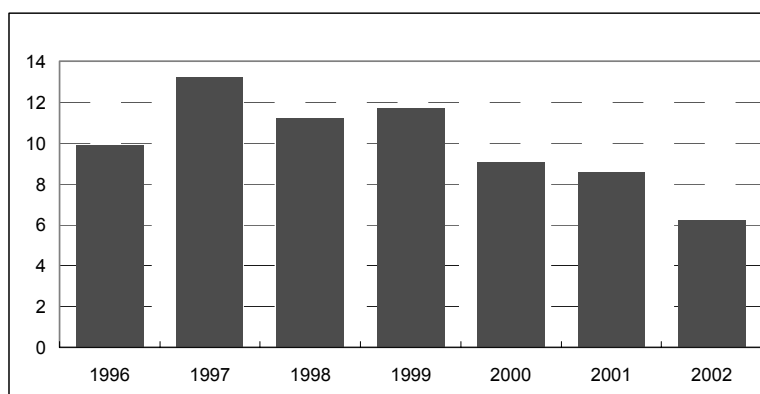
international standards, whereas supervision of other financial institutions such as those of insurance requires essential reform.

Apart from the need to improve and strengthen prudential supervision, we must emphasize the necessity to improve the enforcement of law, especially regarding money laundering. The issue of money laundering is of crucial importance in the case of Albania for reasons related to the large informal sector and especially to the illegal and/or criminal activities that take place in this fraction of the economy. The fight against money laundering in Albania is a result of the combined efforts of the Ministry of Finance, Ministry of Public Order, Bank of Albania, General Prosecution Office and the National Informative Service. These institutions have signed a memorandum of understanding in 2002, with the purpose of designing a general action plan and of creating a representative group that would engage in the 'Interinstitutional Cooperation in the Fight against Money Laundering'. The law 'For the prevention of money laundering' has been approved in 2000 and recently (2003) amended by the Albanian Parliament. Bank of Albania has also contributed to the anti-laundering campaign with a regulation dating 1997. Supervision inspectors from the Bank of Albania pay special attention to the forms filled for cash transactions, for quantities above 2 million lek or the foreign exchange equivalent. The authority in charge –the agency at the MoF- receives a special report filled by commercial banks and inspected by BOA inspectors, for each transaction above 70 million leks or its equivalent. The fight against money laundering is becoming more important with every report published by international organizations in which organized crime, smuggling, illegal activities etc.. are cited among the major problems of Albania.

c) Openness to global capital markets reduces the possible range of action for monetary policy. The fiscal stance becomes, therefore, *the* preeminent tool of stabilization policy. But there are practical limitations to the ability of fiscal policy either to offset the expansionary impact of a large capital inflow or to provide support for economic activity in the event that these flows are reversed (Lipschitz, Lane and Mourmouras 2002). It follows that a country must be able to adapt its fiscal policy to the changes in the quantities and the direction of capital flows. It is suggested that a country uses contractionary fiscal policy if faced with large capital inflows and that it does the opposite when capital flies out of the country. If

a country decides to use its fiscal policy as a flexible tool to stabilize capital flows, it must enjoy a strong fiscal position. Albania's fiscal position is a relatively stable one despite the high fiscal deficit. However, we should be aware of the fact that the use of fiscal policy is limited by multi-year governmental obligations and programs and is subject to parliamentary debate and approval. The message here is that Albania should be very careful about how it manages its fiscal policy if it decides to open up its capital account.

Graph 5: Fiscal Deficit of Albania in % of GDP.



d) Access to information, policy transparency and data dissemination are important when liberalizing. When information on a country is restricted, the large throng of relatively uninformed investors follows the few who are deemed to have special access to information. This makes for runs and panics. Easy access to information allows investors to assess risk independently and is likely to militate against herd behavior. Therefore policy transparency and data dissemination should be seen as essential elements of economic management. Two of the biggest weaknesses in Albania are insufficient and erroneous information and poor dissemination and there is a lot to be done to improve the information system, to enlarge the body of users of this information, to raise the quality and usability of information and so on. The responsibility falls on all the institutions that produce, collect, use and publish information such as INSTAT, all ministries, Bank of Albania etc.. Policy transparency is at a somewhat higher level but, in this direction also, there is room for improvement.

e) The impossible trinity theory says that a country can not have an open capital account while it pursues an independent monetary policy and maintains a fixed exchange rate. Although both types of exchange rate regimes have their drawbacks in the face of capital flows, there is evidence that the floating exchange rate regime is less vulnerable than the pegged regime. Domestic borrowers in a country with a long –lived pegged regime may feel safe and may decide to assume more risk than necessary while borrowing. Albania's regime of floating exchange rate, and its commitment to this type of regime smooth the progress of CAL.

5) SUGGESTED STEPS OF LIBERALIZATION IN ALBANIA

No matter how much or how little they support CAL, most economists tend to agree on one thing: the importance of the sequencing of CAL. Sequencing stands for an ordering and a combination of structural and macroeconomic reforms with steps towards the opening of the capital account. On one side, as already explained above, a country must undertake reforms that will improve the overall situation and will facilitate the process of liberalization. Controls on capital movement can not replace sound macroeconomic, financial and structural policies. Therefore, before we begin to lift controls, we must identify the flaws of other policies, that these controls are intended to correct. The pacing, the timing and the sequencing of liberalization must take account of the political and regional situation. The commitment of authorities to engage in the liberalization process and their interest in reforms should be considered. It may be the case that, political considerations hold back the enforcement of an optimal reform program in the financial sector. For such reasons it is imperative that the authorities be cooperative, cautious and transparent as reforms are designed and implemented.

The improvement and strengthening of banking supervision is very important as liberalization is discussed. Complete restructuring of banks may require a long time. However it is recommended to follow through with liberalization after the necessary prudential measures are in place. Accounting practices are very important in this respect. Some of the practices that require special attention are related to the assessment of assets, the classification, provisioning and the amortization of loans etc..

Drawing from other countries' experience, economic theory and 'the recipe' for capital account liberalization outlined in the Stability and Association Agreement signed by Croatia (assuming that the one that will be signed by Albania will be similar in content) we have come up with a general framework for liberalization and some suggestions regarding other processes that might facilitate CAL. We have to clarify that, from here on, every time we mention a control or the liberalization of a certain item of the capital account, we refer to an outward movement of capital or a control on outflows, since, as explained before, Albania imposes no controls on capital inflows.

- We first propose that the 15 per cent tax on the yield of Treasury Bills to which non-residents are subjected, be lowered to the level of 10 per cent. If this change is made, there will be no discrimination versus non-residents and non-discriminatory practices are very important when liberalization is concerned.
- As a rule, a country begins to liberalize outflows by lifting controls on direct investments abroad. We suggest that Albania remove controls on outward direct investments gradually. Given the present condition of business and economy in Albania, we believe that the risk of capital flight, if outward investments are liberalized, is low. As the Albanian economy becomes more competitive, domestic investors will be more willing and encouraged to explore investment opportunities in the country rather than export capital abroad. At this point it is appropriate to emphasize the importance of improving the overall investment climate in Albania. The controls on outward investments can be abolished by raising the ceiling of the amount that can be transferred abroad (for investment) and by finally eliminating the ceiling altogether. This process may take a few years but not more than 3 or 4. One way to monitor outward direct investment can be through the Ministry of Finance. The MoF can initially issue authorization for outward investments after the resident entity presents proof that it has paid its fiscal obligations and has generated profit for a certain period of time. This would provide for 'clean' and controlled capital. After a certain period of time, requirement for authorization from the MoF can be lifted and residents may be allowed to invest freely, while still reporting the capital they export, for statistical purposes. There are certain processes that could facilitate direct investments from Albanian residents abroad. One regards the visa procedures. It is a well-known fact that visas to and out of Albania are a hindrance to investors. There have been cases when non-residents have

encountered difficulties in acquiring an Albanian visa, not to speak of the long and painful application process that Albanian residents have to go through in order to obtain visa for almost every foreign country they visit. We believe that, if the movement of people in and out of the country is made easier, foreign and resident investors will be able to better assess investment opportunities in the country or abroad. We encourage foreign and domestic authorities to give this matter special attention in the immediate future.

- In the first stages of the liberalization process, we may start considering the possibility of allowing the issuance of commercial credits of a maturity longer than one year to non-residents along with financial loans of the same maturity. The maturities of these types of credits are normally considered as a protection against crises. The liberalization of both outward direct investment and long-term commercial and financial loans should be accompanied by:

- review of the financial legal framework;
- improvement of statistics and standard accounting procedures;
- strengthening of general agreements on liquidity and accompanying monetary operations as well as those regarding the exchange rate.

- In the last stage of liberalization, we propose the liberalization of portfolio investments as well as that of financial credits and loans with maturities shorter than one year. The lifting of controls on these capital transactions is recommended after the following requirements are met:

- Strengthening of the legislation; of supervision and risk administration;
- Financial sector and corporate reforms;
- Development of capital markets including pension funds.

All the above recommendations are based on the ordering of the liberalization steps that have generally been agreed upon. We must say that, when capital account liberalization is discussed, as is the case with macroeconomic, fiscal and monetary policies that countries choose, there is no single recipe that would yield the

desired results at any time and in any place. For this reason, the need for a thorough analysis of the economy arises. This analysis would identify the specific conditions of the country, the relationship among various sectors of the economy, the sensitivity of each sector to external developments etc.. This analysis should be conducted not only at the beginning of liberalization, but at each liberalization phase since, domestic and external conditions are subject to constant and, often unpredictable, change.

ENDNOTE

¹ Degree of openness measured in accordance with Quinn and Inclán index. Values close to 4 indicates maximum degree of liberalization.

² "Liberalizing Capital Movements", Economic Issues 17, IMF.

³ The Regulation of FEA, approved by Supervisory Council Decision no. 64, dated 30.07.2003, is published in the Official Bulletin of the Bank of Albania, no. 12, July 2003.

⁴ Reference to Falcetti, Sanfey and Taçi 2002.

⁵ "Capital Account Liberalization- Theoretical and Practical Aspects" , Occasional Paper 172, IMF.

⁶ Albania is a member of WTO since October 2000.

⁷ Source: Report of the Working Party on the Accession of Albania to the World Trade Organization; Schedule GATS – Albania, WT/ACC/ALB/51/Add.2, 13 July 2000.

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THIRD PANEL: "ECONOMICS OF
TRANSITION"

ALBANIA: THE FUTURE PATH TO SUSTAINABLE DEVELOPMENT

Geoff Nicol

Luiza Jano

Ardian Harri

I. EXECUTIVE SUMMARY

The approach we have taken to examining the prime requirements for sustainable development can be summarised as:

- Examining Albania's development since transition, to identify the key factors which have driven its performance since then;
- Examining 'best practice' in relation to developing a framework for sustainable development, according to both academic and practical considerations, on a world wide basis;
- We then examined where Albania stands in relation to these. This allowed us to identify key priorities for sustainable development;
- We have included a separate section on the respective roles of government and the private sector in a free market economy, since we feel that it is vital that necessary measures are taken to ensure that both sectors carry out their appropriate roles;
- Finally, we summarise our conclusions and recommendations, and give an illustration of what has been done in other small countries through implementing appropriate measures.

As noted above, considerable attention was given to an analysis of Albania's performance since the commencement of transition, analysing evidence in relation to the key factors behind sustainable development elsewhere, and Albania's situation in relation to these. Findings in relation to these are summarised in the main paper, but fuller accounts of our conclusions are given in Appendices 1,2, and 3, attached.

The paper commences with a brief analysis of Albania's growth since transition, and lists some of the factors that we consider to have been particularly important during this period. It notes that:

- Although growth rates in recent years have been quite high, the overall growth rate since transition is more modest. In fact much of the growth has been recovery from downturns (in other words, we are not in any position to conclude that Albania has any high 'natural' long-term growth trend);
- Key factors behind the growth have been the very high remittance inflow, and more recently the growth of tourism and export industries. These key factors, combined with an increased level of domestic flows through new investments and businesses, have generated the economic growth that has helped to finance growth in government expenditure;
- By comparison with other countries with similar standards of living, Albania's domestic economy is rather fragile, with low (and unsophisticated) export market development, a massive trade deficit, a high cost structure and high unemployment. The high (and persistent) level of unemployment is a major weakness in the economy.

The paper then notes some of the findings of recent studies that have examined factors behind sustained economic growth. It notes that:

- There is general agreement that sustained economic growth is due to sustained technological progress¹.
- There is general agreement that the policy framework, or "getting the basics" right, is essential²;
- The importance of initial conditions prevailing is of interest, mainly from a theoretical point of view;
- In recent years the importance of institutions (which can be summarised as the presence of clear property rights,

the rule of law, and a business friendly bureaucracy) have been recognised as being of overriding importance.

We then examine Albania's situation, and future prospects, from different points of view³, namely:

- geography (including climate, location, and natural resources);
- integration (including participation, and impediments to participation in the world economy);
- policies, and
- institutions.

We concluded that, from the point of view of future sustainable economic development, Albania has strengths in relation to geography, it is 'on course' in relation to integration, and the policy framework generally (with one or two reservations⁴), but has problems in relation to the latter factor, namely, institutions⁵. This is troubling since all the indications are that the institutional framework (or 'institutional quality') is of paramount importance.

The study goes through the list of items that make up a 'government accountability index'⁶. These include voice and accountability, political stability and the absence of violence, government effectiveness, regulatory burden, rule of law, freedom from graft, and 'business friendly bureaucracy – other'.

Drawing largely on the findings of the recent (March 2003) report of Foreign Investment Advisory Service (FIAS), the paper notes that Albania has problems in relation to the last four issues, which are related to two critical areas, namely property rights and a business friendly bureaucracy. It notes measures specified in the NSSD to deal with the issues, but considers that these areas, nevertheless, pose the critical areas to be addressed for sustained economic growth.

The paper then looks at the respective roles of government and the private sector. It notes that whereas, in a command economy, government owns or controls the factors of production and makes the business decisions, in a market economy individuals own the means of production (either directly, or through various forms of business organisation), while it is the private sector that must make the business decisions.

In the transition from a command economy to a market economy the role of the government and private sector needs to be redefined. First of all, as a precondition, it is critical that government realize that its role is now completely transformed. The challenge facing transition governments is to, first, understand their new role, and understand it properly, and second, put in place the institutions, the policies, and the attitudes under which a market economy will function effectively.

It concludes that “...understanding the new role of government and putting in place the institutions, policies, and attitudes to allow the market economy to function properly is (still) the outstanding challenge.”

The paper closes by looking at Albania’s strengths and weaknesses.

The strengths include:

- a good geographical location, a good climate, and natural resources;
- openness to trade;
- openness to foreign investment;
- low tax structure, with generally low marginal tax rates;
- active pursuit of privatisation;
- competitive cost structure, by comparison with EU member states;
- an entrepreneurial population, and
- a high inflow of funds from Albanians abroad for various purposes, including investment

The weaknesses include:

- unclear property rights;
- a business environment and bureaucracy which is far from ‘business friendly’, while corruption is widespread;
- high social security taxes at low levels of income;
- a minimum wage which is set by administrative decision rather than market forces;
- a high cost structure, by international standards.

It notes that these are serious disadvantages, which will work to slow down future growth in Albania.

It further notes that “..unless the issues are tackled urgently and with conviction, we see a major danger that the “free market” approach will be transformed into “crony capitalism”, where those with the connections get the benefits, while others lose out. As so clearly brought out in so many studies, this is not an option for sustained development.”

It notes that Albania has been in a “transition” mode for over 10 years, and it is still very much in “transition mode”. It argues that a major effort is required to get all involved into a “free market” mindset, and away from the “central command” mindset. This includes transparency in the application of all regulatory measures, reduction of scope for decision taking on specific matters by either officials or politicians, and clear rights of appeal.

The overriding concern, we believe, must be to complete the reforms necessary for full transition. In addition to changes to the relevant laws and regulations, this will require a change in the attitudes and mindset of administrative officials from a “central command and control” mentality to a “facilitation” mentality.

From the perspective of “getting the basics right” measures which governments need to implement, we believe, to ensure high and sustained growth include:

- a high-level political commitment to private property reforms, with a clear and coherent strategy to accelerate their implementation;
- promoting a business friendly bureaucracy;
- review of the financing of social security and health insurance, with a view to reducing the very high costs incurred at low levels of income; and
- allowing the market to determine remuneration levels and conditions, including minimum wages.

The first two measures are related to institutional quality, and are fundamental for broad based economic growth. The latter two measures are policy related, aimed at removing barriers to employment growth.

The paper closes with an illustration of what can be done when market forces are allowed to operate freely in a business friendly environment, in small countries like Albania.

II. INTRODUCTION AND APPROACH

The approach we have taken to examining the prime requirements for sustainable development can be very simply summarised as examining best practice, according to both academic and practical considerations, on a worldwide basis. We then examined where Albania stands in relation to these. This allowed us to identify key priorities for sustainable development.

The paper commences with a brief analysis of Albania's growth since transition, and lists some of the factors, which we consider to have been particularly important during this period.

It then notes some of the findings of recent studies that have examined factors behind sustained economic growth.

We then examine Albania's current situation, and future prospects, from different points of view⁷, namely:

- geography (including climate, location, and natural resources);
- integration (including participation, and impediments to participation in the world economy);
- policies, and
- institutions.

We concluded that, from the point of view of future sustainable economic development, Albania has strengths in relation to geography, it is 'on course' in relation to integration, and the policy framework generally, but has problems in relation to the latter factor, namely, institutions.

We note that the Government is attempting to cover a wide range of measures in a wide range of fields, as is documented in the NSSD. We appreciate that there is a wide range of pressing needs, and in these cases determining priorities can be difficult.

However, we feel that, in the circumstances, the overriding requirement is to establish a clear set of priorities at an overall level, based on the most critical issues at each stage. The priorities are not "set in stone" (in that they are not set for an indefinite period), they are not set out as the only priorities that matter, but are they

set out as those which should be emphasised as giving the highest returns at this point in time⁸.

Over time, we would expect priorities to change as relevant measures are implemented, and as the economic framework changes.

III. BACKGROUND

Appendix 1 examines Albania's economic performance since independence, and the factors behind realised growth. It then goes on to compare some key characteristics of the Albanian economy relative to both other lower-middle income economies of the world, and lower and middle income economies of Europe and Central Asia, in particular.

The main conclusions are:

- While real growth has averaged 6.6 per cent a year from 1993 onwards, from 1990 the real average rate of growth has been 2.1 per cent annually. Much of Albania's so-called "high growth" has been recovery rather than real growth;

The main factors behind the growth have been:

- the high inflow of expatriate remittances;
- the growth in tourism income in recent years; and
- growth of exports;

These key factors, combined with an increased level of domestic flows through new investments and businesses, have generated the economic growth that has helped to finance growth in government expenditure;

By comparison with other countries which have similar standards of living, Albania has:

- a very small export base, and consequently a huge trade deficit;
- relatively unsophisticated export market development;
- very high levels of overseas development assistance (ODA) on a per capita basis;
- a high cost structure;

- fairly high rates of taxation; and
- very high rates of unemployment.

The high dependence on expatriate remittances, the large trade deficit, high dependence on aid, and very high rates of unemployment, are indications of a relatively weak domestic economy. Economic growth in any year, and the flow-ons from economic growth, are dependant on outside factors. The high (and persistent) level of unemployment is a major weakness in the economy.

IV. EMPIRICAL EVIDENCE ON ECONOMIC GROWTH

There has been a long running debate over the nature of growth: whether it is just an accumulation of manpower and machinery, or is it the result of the latest technology? What are the roles of government, compared to investment and exports, and what is the importance of economic conditions prevailing at the very beginning of periods of extended growth? Finally, what is the relative importance of the institutional framework in economic growth? The answers to these questions are paramount to those countries wishing to embark on periods of extended growth, including Albania. We now look at the conclusions drawn from examinations of empirical evidence in relation to the factors determining economic growth. We note that there are overlaps, in particular between classifications of certain factors as either 'policy-related' or 'institution-related', in the studies. This does not, however, detract from conclusions reached.

IV a) Manpower, machinery and technology

We turn first to the role of manpower, machinery and technology in economic growth.

Looked at from an accounting perspective, there are three elements that determine production of goods and services: labour, capital, and technology. Labour and capital, the factors of production, refer to the workforce and the capital goods (buildings, machines, vehicles) that the workforce uses in manufacturing some product or providing some service. Technology refers to all the methods employed by capital and labour to produce a good and depends on the development or acquisition of practical skills to get the job done more quickly and more efficiently.

It is now agreed that only by significant and sustained technological progress is it possible to achieve a sustainable rate of economic growth. This is because there are limits to how much labour participation rates can be increased, while increasing capital more than labour will eventually lead to diminishing returns to capital, leading to a fall in the growth rate even if capital continues to grow at a constant rate. Studies continually show the importance of technological progress (or innovation) as the overriding factor in advanced economies.

We would note that this issue is not particularly relevant to Albania at the present stage of its growth. Albania is at an early stage in capital accumulation, and it has ample labour resources, so the issue of whether growth is factor led (implying that once the increased supply of factors runs out, growth rates will fall) or productivity led is largely irrelevant.

IV b) Economic Policies

Turning now to the role of economic policies, where government's set "the economic policy framework for economic growth", it should be noted that different studies come to different conclusions, depending on the viewpoint of the authors.

It is generally acknowledged that the major policy-related measures required for high growth are:

- high savings;
- prudent monetary and fiscal policies;
- low taxes;
- openness to trade; and
- a strong commitment to education.

However, there have been disputes over the relative role of government in the economy. The 'neoclassical liberal' school emphasises the primacy of free markets. According to this school, the role of government should be to "get the basics right".

"Getting the basics right" means creating an environment which will encourage economic growth through:

- ensuring stable and low inflation;
- promoting the integrity of the financial and banking system
- providing for open markets; and
- striving for stable and realistic exchange rates;

in respect to the macroeconomic environment.

On the microeconomic side, it requires government to ensure property rights, law and order, and adequate provision of public goods. Government should avoid high tax rates, price controls, and other distortions of relative prices.

The 'revisionist' school embraces the view that government should get the basics right, but additionally asserts that since markets work imperfectly in poorer countries, selective interventionist policies should also be followed. This would allow the use of selective intervention in credit policies, tax policies, and other assistance to specific industries that are seen as having economic potential. The World Bank report on the high growing economies of east and southeast Asia in 1993, for instance, conceded that measures such as directed credit and export subsidies had sometimes been helpful, but concluded that industrial policies to promote specific industries did not work⁹.

Problems associated with the East Asian financial crisis of 1997/98 tend to support the former (neoclassical liberal) approach, since many of the problems that emerged were associated with government interference in the economy. This refers, in particular, to the problems associated with 'crony capitalism', whereby selective interventions favoured specific producers on the basis of connections rather than efficiency.

In respect of Albania's circumstances, the principle of "getting the basics right" are undoubtedly essential. In general would argue that while government might 'facilitate' industrial development (for instance through promotion of identified opportunities, provision of serviced industrial sites, general promotion of exports, or locally produced goods), it should not become directly involved in favouring particular interests or producers through such measures as direction of credit, or granting of specific assistance to single producers or types of producers.

IV c) Initial Conditions

Turning now to an examination of initial conditions for growth, we can note that a study tracing average growth of income per person in 41 countries during 1960-85 back to initial conditions in 1960 showed that countries that were poorer, but had good primary education systems, less inequality of income and land distribution, high life expectancy, and low fertility rates grew faster than others during the following period¹⁰. However, some caution is recommended in analysing the results, due to problems with data reliability and small number of observations, and since it is not clear what the practical implications of the findings are for policy purposes.

IV d) Institutional Framework

In recent years attention has shifted to more long-term analysis of factors underlying sustained growth over longer-term time frames. In particular, attention has concentrated on the particular roles of geography, integration in the world economy, and institutions in economic growth.

The key findings are given in a review of recent literature in Appendix 2. Key findings include:

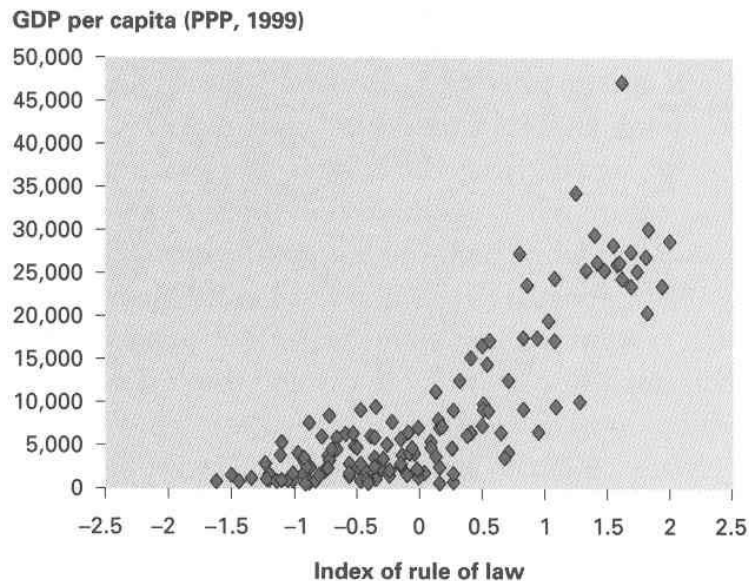
1) The primacy of institutional quality¹¹.

Findings here include:

- if Middle East countries strengthened the quality of their institutions to all-country average, there would be a 150% increase in per capita incomes.
- If Bolivia would raise its level of institutional quality to that of Korea, its per capita GDP would be close to \$18,000 rather than its current level of \$2,700¹².

The World Development Report for 2003¹³ illustrates the connection between institutional quality and national income in the following graph:

The relationship between institutional quality and national income



PPP = Purchasing power parity.

Note: As a measure of institutional quality, the rule of law includes considerations such as the security of property rights, or the confidence with which a group or individual can find tomorrow the fruits of what is planted or conserved today.

2) Institutions that are geared to protecting property rights, placing constraints on elites and politicians, and allowing the accumulation of human capital, the spread of entrepreneurship, and the creation of a mass market are of paramount importance.

Examples here relate to different colonisation strategies, in particular the comparative development of the US, Canada, Australia and New Zealand, where laws, institutions and policies provided the population with the ability to invest, accumulate human capital, and participate in commercial activity. This compared to countries where there were resources to be extracted (e.g. Africa,

India, Caribbean, Latin America, Mexico etc.) where institutions neither protected the property rights of regular citizens nor constrained the power of elites. It notes that these “..institutions inhibited the accumulation of human capital, the spread of entrepreneurship, and the creation of a mass market – factors viewed as important in economic development”.

Further examples relate to the importance of property rights, in particular, in allowing sustained economic growth. The World Development Report 2003¹⁴ (World Bank) also states that “...if not properly protected, assets cannot thrive and contribute to growth or human well-being.” The report notes that among the six transition economies where property rights were least secure, income (GDP) fell in the decade of transition - by 40 percent or more.

In conclusion, economies with high inequality in the ownership of assets tend to generate institutions that placed restrictions on individuals' opportunities for future economic advancement, and this ties these economies into low growth paths.

We now try to evaluate Albania's position in relation to the most recent criteria identified, as well as its policy framework, to examine where it stands in relation to the requirements for long term sustained growth.

V. EVALUATION OF ALBANIA'S SITUATION

Our summary of the situation is that Albania's position appears very satisfactory from the viewpoints of geography and integration with the world economy. In respect of the policy framework, we believe that most elements of a sound policy framework are in place, but adjustment is required in some areas. It is in the field on institutional development, however, where we feel Albania needs to take bold steps to set an environment for sustainable long-term economic growth.

We note that there are necessarily some overlaps between the different characteristics we have specified (geography, integration, policies, and institutions), and note that this is unavoidable in the circumstances.

V a) Geography

In respect of geography, we note that Albania has advantages in location and climate. Advantages include:

- Its proximity to the large EU market;
- A climate, coastline, and mountains that give it a huge tourist potential;
- A climate that is favourable for the production of 'niche' market fruit and vegetables; and
- Good natural resources, including chrome, copper, nickel, coal, marble, oil and liquid petroleum gas (LPG).

V b) Integration

In respect of integration with the world economy, we would note that:

- Albania has been a member of the WTO since 2000 and is in the process of implementing its obligations under the WTO;
- It benefits from the 'asymmetric regime' with the European Union (combined with the asymmetric regime accorded to some countries in the region);
- It has, or is in the process of forming free trade agreements, with Macedonia (in force July 2002), Croatia (in force July 2003), as well as Bosnia and Herzegovina, Montenegro and Serbia, Romania, Bulgaria (agreements signed by relevant Ministers), Moldova, and Kosovo and Turkey;
- It has a generally liberal foreign investment regime, whereby local and foreign businesses are given equal treatment in most respects.

V c) Policy Framework

Albania, we note, is generally 'on track' in relation to the policy environment. While it does not have high domestic savings, it is noted that high savings are generally associated with higher standards of living, in later rather than earlier periods of growth¹⁵. While deficits are still high, these have been reduced progressively. In the circumstances, it is probably fair to say that prudent monetary and fiscal policies are generally followed, with attention being

focussed on controlling the domestically financed deficit. Marginal tax rates are generally low by international comparison (though there are, we believe, some problems relating to social security levies). As noted above, openness to trade is increasing, and there is a strong commitment to education.

In respect of the basics, a policy of pursuing low and stable inflation is being followed; measures have been, and are being put into place to promote the integrity of the financial and banking system¹⁶; and the exchange rate is market determined. We believe that there is room to reduce interest rates, and encourage greater development of the use of the banking system by the private sector, and we understand measures are being put into place in this regard. We note that there are no direct price controls other than the minimum wage rate, and regulated prices for local monopoly suppliers. Privatisation has been actively pursued.

The low rates of employment growth in recent years, we believe, reflect weaknesses in the policy environment. High social security taxes¹⁷, which become operational at low rates of pay, combined with an administered minimum wage, do not encourage the growth of small and medium size enterprises. The relatively high economic growth of recent years should have encouraged employment growth, particularly in the non-farm private sector, where most of the economic growth has occurred. This does not appear to have happened to any significant degree. We would urge that these two policy fields be re-examined to make them more economic growth and employment growth orientated.

V d) Institutional Framework

Albania's position in relation to the institutional framework is examined more fully in Appendix 3. While it is noted that quality of institutions can be measured in different ways¹⁸, the analysis uses a broad based measure called the 'aggregate governance index', though it adjusts this to suit Albania's circumstances¹⁹.

The findings on the six measures are:

1. Voice and accountability

This covers the extent to which citizens choose their government,

have political rights, civil liberties, and an independent press. Albania has gone a long way in this field but we consider that there is room for improvement in specific areas.

2. *Political stability and absence of violence*

The main issue in this area is the frequent changes of government and ministerial portfolio, which works to slow down the effectiveness of government initiatives.

3. *Government effectiveness*

This covers the quality of public service delivery, the competence and political independence of government employees.

The National Strategy for Social and Economic Development (NSSD) notes that improving the quality of public service delivery “.. is presently a problem area”, and lists a series of measures being implemented.

4. *Regulatory burden*

We consider this a particular problem area. The Foreign Investment Advisory Service (FIAS) recently commented:

“.. Ten years after the initial transition to a monetary economy, the present administrative system in Albania is still burdened with many outdated regulatory requirements. These are rooted in a mentality of state planning and control, and micro-management of the economy by the Government”²⁰.

The NSSD acknowledges problems in government administration and refers to reform of the services and appeal procedures. The objective is to reduce the number of licenses, streamline similar units and functions and create a “one stop shop”.

It is probably fair to comment that this area still requires much further attention, but it appears to be in the process of being recognised, with identification of initial measures to improve the situation.

5. Rule of law

This refers to the protection of persons and property, independent and effective judges, and contract enforcement. Contract enforcement, in turn, requires a strong and enforceable judicial system, relative absence of corruption, and transparent dispute resolving mechanisms.

This is an area, which needs particular attention. The NSSD recognises problems in relation to the problems of crime, and the judiciary, and notes measures being taken.

In our opinion, resolution of property rights is perhaps the greatest single challenge facing Albania at this point in time. The FIAS study continually draws attention to the need for a sound and viable land market for the following key requirements:

- to allow further development, and to prevent strategic investors being deterred;
- to complete the requirements for transition to a full market economy;
- to encourage genuine investment;
- to prevent illegal construction and the negative effects on investors and the public associated with it.

The study notes “ ..Albania needs to encourage investment of strategic benefits to its long-term national economic development. Such investments require an adequate legal and institutional framework providing strong protection for property rights, clear guidance for land use and construction requirements, and equal and predictable treatment when dealing with regulatory agencies at the national and local levels.”

The case for establishing sound property rights as a precondition for sustained economic growth is soundly established in virtually all analyses of sustainable growth, as is the negative impact of not having such rights.

6. Freedom from graft

In other words public power is not abused for private gain or corruption.

Economic literature emphasizes that corruption has a high economic cost. A study of corruption in the former CIS countries, for instance, gave its effects as:

- worsening distortions in resource allocation;
- raising costs and reducing incentives to invest, and deterring foreign investors;
- affecting small and medium sized enterprises particularly adversely; and
- reducing domestic savings and investment and stimulating capital flight.

It concluded that corruption “is one of the most important forces inhibiting investment and growth and thereby lowering living standards in many of the transition economies reviewed”²¹.

The NSSD notes that “...The fight against corruption is a cross-cutting issue of all reforms ... The fight against corruption will continue to be a priority ...”.

The FIAS study notes that “...a recent study based on surveys conducted in seven countries in the South East European (SEE) region ... revealed that Albania was the worst among all countries in the region in terms of perceived corruption, and that its performance is getting worse with time”²². The report further notes that “...flaws in the operation of the administrative regulatory system, such as the exercise of too much discretion and a lack of transparency and accountability, provides fertile opportunities for the practice of corruption”.

7. Business friendly bureaucracy – other

The four final issues relating to institutions, namely government effectiveness, regulatory burden, rule of law (certain components) and freedom from graft are sometimes treated jointly under the issue of ‘business friendly bureaucracy’. The FIAS study notes that there are four major problems in this area:

- there is a systematic lack of implementing regulations and operational guidelines. They note that new laws are not supported by necessary procedures, criteria and responsibilities, so permitting a high degree of administrative discretion by agencies and officials;

- there is a systematic lack of effective institutional structures, with no clear designation of responsibility or accountability, or inter-agency cooperation;
- legal and regulatory enforcement is chronically lacking, with dispute settling mechanisms not working effectively; and
- administration is further weakened by a lack of development of the appropriate mindset and skills of officials at all levels. The study notes that “..in general, regulatory officials seem not to trust businesses. Many appear to see themselves as policemen, not service providers..”

The study notes that “...while these features are not unusual among transition economies in the region, their severity is remarkable when benchmarked against comparable country results”.

It is noted that a special group has been established, under the Chairmanship of the Minister of the Economy, to work out and implement an action plan to remove the barriers identified in the FIAS report.

VI. THE ROLE OF GOVERNMENT AND THE PRIVATE SECTOR

Albania is still in the process of transition to a market economy from the command economy. As the FIAS report stresses: “the economic transition is far from complete, with many laws and regulations introduced but not effectively implemented.”

Expressed in a more theoretical context, two criteria critically distinguish between the central command and the market economy systems. These are:

- who owns the factors of production – land, capital, and labour? and
- who makes the business decisions?

Under the command economy, not only did government effectively own or control the factors of production, but they also took the business decisions. As noted by Balcerowicz²³ “..the peculiarity of the communist party-state consisted in the attempt to have *total control over the individual’s activities* – in other words, in the radical curtailment of individual liberties.” From the economic perspective,

two of these exceptionally extensive state controls are of importance:

- the banning of the private entrepreneurship, which, together with the initial nationalisations, resulted in a monopoly by the state sector;
- central planning on state-owned enterprises, which included output commands, rationing of inputs, foreign exchange, price controls and directed foreign trade.

Under a market economy, individuals (either directly, or through companies or other forms of business organisation) own and control the means of production, and businesses themselves make the business decisions. Government's role is to set the framework within which businesses operate, in a clear and transparent manner, so that the market forces lead businesses to generate growth in a competitive environment.

This is a completely different role for government to that in which it operated previously. As Balcerowicz also states, "...the legal framework and the judicial system criminalized private economic activity and independent political activity, and were ill suited to the market economy, rule of law and free society."

In the transition from a command economy to a market economy the role of the government and private sector needs to be redefined. First of all, as a precondition, it is critical that government realize that its role is now completely transformed. The challenge facing transition governments is to, first, understand their new role, and second, put in place the institutions, the policies, and the attitudes under which a market economy will function effectively.

It is in this area, we feel, that Albania has its biggest shortcomings, in setting a path to sustainable development. As the FIAS report states "...Ten years after the initial transition to a monetary economy, the present administrative system in Albania is still burdened with many outdated regulatory requirements. These are rooted in a mentality of state planning and control, and micro-management of the economy by the Government".

Returning to the questions asked above, i.e.

- who owns the factors of production – land, capital, and

labour? and
· who makes the business decisions?

We would stress that it is individuals that own the means of production (either directly, or through various forms of business organisation), while it is the private sector, which must make the business decisions. It must be very clearly understood that it is the role of the private sector to use the factors of production to create incomes in an efficient and competitive manner, within an appropriate institutional framework set by the state.

Government, for its part, needs to realize that it no longer needs to make the everyday microeconomic business decisions. That role is better left to the private sector, in other words, to the businesses that have to survive through taking the right decisions. Government's role is to create the proper institutional framework which will encourage economic growth.

Government should use the criteria that separate two types of economic systems as a basis to determine priorities that need to be tackled first and, at the same time, identify which measures will give the greatest returns in moving towards the Government's goal of achieving "private sector led growth and development".

Looked at from this point of view, understanding the new role of government and putting in place the institutions, policies, and attitudes to allow the market economy to function properly is (still) the outstanding challenge.

We are well aware that this cannot be implemented without a major effort to get everyone into "free market" mindset, and away from the "central command" mindset. At an administrative and regulatory level, it requires transparency in the application of all regulatory measures, reduction of scope for decision-taking on specific matters by either officials or politicians (including both committees of officials and politicians), and clear rights of appeal. We know that resolving these issues will be far from easy. We believe that special outside assistance may be essential to assist the Albanian Government in these areas, and we would urge donors to give these areas a very high priority.

We would stress that the evidence overwhelmingly shows high returns from completing the reforms associated with the transition process²⁴.

VII. CONCLUSIONS AND RECOMMENDATIONS

The Albanian economy has many strengths. These include:

- a good geographical location, a good climate, and natural resources;
- openness to trade;
- openness to foreign investment;
- low tax structure, with generally low marginal tax rates;
- active pursuit of privatisation;
- competitive cost structure, by comparison with EU member states;
- and entrepreneurial population, and
- a high inflow of funds from Albanians abroad for various purposes, including investment.

These have allowed the economy to grow at over 6 per cent, in real terms, since 1993.

At the same time, it has a number of weaknesses that will work to slow future growth, the most critical of which are associated with an incomplete reform agenda. Specifically, the main weaknesses, we believe, include:

- unclear property rights;
- a business environment and bureaucracy which is far from 'business friendly', while corruption is widespread. This includes a continuing "central command" mindset in the bureaucracy.
- high social security taxes at low levels of income;
- a minimum wage which is set by administrative decision rather than market forces;
- a high cost structure, by international standards.

These are serious disadvantages. Unclear property rights will deter strategic investors from locating in Albania. The "business unfriendly bureaucracy" and in particular the "central command mindset" associated with it slows, frustrates, and deters businesses, and appears to nullify much of the advantages of Albania's openness to trade and foreign investment. Corruption raises costs, worsens resource allocation, and skews distribution of income and wealth. High social security taxes (particularly combined with minimum wages set by administrative decisions rather than market conditions) will work against the development of small and medium

sized businesses, as well as reducing employment growth. The high cost structure, by international and regional standards, effectively reduces Albania's attractiveness to foreign investors.

These factors will work to slow down future growth in Albania.

Unless the issues are tackled urgently and with conviction, we see a major danger that the "free market" approach will be transformed into "crony capitalism", where those with the connections get the benefits, while others lose out²⁵. As so clearly brought out in so many studies, this is not an option for sustained development. We further believe the problems are more urgent than is generally realised. Albania's long-term growth trend, since 1990, has been 2.3 per cent per annum. Much of the so-called "high" growth has really been recovery from previous decline. Once the "catch-up" phase is excluded, Albania's long-term growth trend is much less favourable. The dangers of reverting to such a trend should not be dismissed out of hand. We believe that Government needs to allocate clear priorities to its development strategy, based on identifying those reforms that will give the greatest return at specific points in time. At this point in time, we would emphasise that understanding the new role of government and putting in place the institutions, policies, and attitudes to allow the market economy to function properly remains the outstanding challenge.

The overriding concern, we believe, must be to complete the reforms necessary for full transition (refer Box 1 below). In addition to changes to the relevant laws and regulations, this will require a change in the attitudes and mindset of administrative officials from a "central command and control" mentality to a "facilitation" mentality.

Box 1. Reforms and Growth" .. The experience accumulated in the past decade, whether viewed informally or with the help of data, charts and regressions, provides support for the view that the most successful transition economies are those that have both stabilised and undertaken comprehensive reforms, and that more and faster reform is better than less and slower reform". (Fischer, Stanley and Ratna Sahay, 2000, "Transition Economies after Ten Years" IMF Working Paper No. 30, Washington, D.C.)

From the perspective of “getting the basics right” measures which governments need to implement, we believe, to ensure high and sustained growth include:

- a high-level political commitment to private property reforms, with a clear and coherent strategy to accelerate their implementation;
- promoting a business friendly bureaucracy;
- review of the financing of social security and health insurance, with a view to reducing the very high costs incurred at low levels of income; and
- allowing the market to determine remuneration levels and conditions, including minimum wages.

The first two measures are related to institutional quality, and are fundamental for broad based economic growth. The latter two measures are policy related, aimed at removing barriers to employment growth.

The merits of having a thoroughly sound and business friendly environment, in an economy like Albania, cannot be overstated (refer Box 2 below). The potential advantages of completing the transition are great. The costs of delaying action, or giving low priority to fundamental measures, are potentially very high. We would urge that the measures needed to complete the transition from a control, to a free enterprise economy, need to be implemented in a prioritised manner with the greatest possible urgency.

Box 2. Foreign Investment and Growth “So what did the Irish get right, and can others repeat the trick? One reason that the Irish have managed such rapid growth in income per head is that there are not very many of them. In a country with a population of just over 3 million, high levels of foreign investment can have a dramatic effect. In the past decade in particular, foreign investment in Ireland has surged. In this respect, Ireland’s story resembles that of Singapore or Hong Kong, which have also managed to use a business friendly environment to attract high levels of foreign investment, particularly in technology. Like Ireland, they have small populations that were made rapidly richer by a surge of foreign investment.” (‘The Wealth Effect’, *The Economist*, May 19th 2001)

ANNEX 1

(Extract from FIAS Report of March 2003)

TABLE II-3: CORRUPTION PRESSURE INDICATOR*								
(Relative share of those who have had contacts with the respective group and have been asked for cash, gifts or favours.)								
	Customs officer		Municipal official		Judge		Tax official	
Country	2001	2002	2001	2002	2001	2002	2001	2002
Albania	55.60	54.88	52.50	50.67	53.10	44.31	56.80	50.43
Bosnia and Herzegovina	19.90	16.50	14.10	12.50	8.30	9.15	8.80	12.19
Bulgaria	15.80	18.55	10.30	9.96	9.10	60.80	8.30	5.29
Romania	21.80	25.32	11.90	19.67	13.70	59.53	8.90	24.08
Macedonia	20.50	29.68	16.90	19.70	16.60	41.70	10.60	7.98
Croatia	10.50	7.36	11.30	8.27	5.80	41.97	6.60	3.45
Serbia	42.80	52.68	27.20	25.12	19.30	32.24	22.00	23.49
Montenegro	21.60	29.67	19.30	20.79	7.00	30.65	13.30	17.24
Bulgaria	Source: "Corruption Indexes," Regional Corruption Monitoring, Centre for the Study of Democracy and the International Legal Development Institute, Rome, April 2002 35.1							
Macedonia	Source: "Corruption Indexes," Regional Corruption Monitoring, Centre for the Study of Democracy and the International Legal Development Institute, Rome, April 2002 35.1							

APPENDIX 1.

Economic background

Albania's economy is estimated to have grown at a real average rate of 2.1 per cent per annum since 1990. Looked at from this point of view growth cannot be considered impressive, but when viewed from the aspect of setbacks that the economy suffered during this time, and subsequent recovery from them, the overall picture is more encouraging.

In looking at Albania's development since transition, we propose to:

- first consider economic developments during the period;
- examine some factors which we believe have been the underlying forces behind progress, and
- consider some key features of the Albanian economy in the light of international comparisons, since this provides a framework against which to measure Albania's economic characteristics.

a) Economic Developments during the period

Since the beginning of the transition in 1991, the Albanian economy has gone through four distinct phases. The early years of transition (1991-92) were dominated by a contraction of real GDP as a result of social and economic disruption, and high inflation, driven by pressure for higher wages, food shortages, and currency devaluation. By the end of 1992, output in real terms had fallen to two thirds of its 1989 level and inflation had risen to over 220 per cent. The trade deficit had risen to over two-thirds of GDP and the fiscal deficit amounted to almost 14 per cent of GDP.

The period 1993-96 was characterised by a significant economic recovery. GDP grew by over 10 per cent annually in real terms, inflation was brought down substantially, and both the trade and fiscal deficit improved. Cautious monetary and fiscal policies resulted in easing of pressure on prices, while the privatisation of agriculture, and of retail and wholesale and retail trade as well as small and medium size enterprises resulted in strong growth in the agricultural, transport, construction and service sectors. Although economic growth remained buoyant during 1996, with the slippage

of stabilisation policies the economy began to show some early signs of a collapse. Revenue collection decreased significantly and the fiscal deficit began to widen.

In early 1997, large pyramid investment schemes, which had been building up since 1993, collapsed, bringing the country to a state of anarchy. The resulting turmoil brought economic activity almost to a standstill. As a result, real GDP contracted by over 10 per cent, inflation increased from 13 to 42 per cent, the current account deficit quadrupled²⁶, the value of the currency depreciated by 42 per cent against the US dollar.

The new Government that came to power implemented a post-crisis recovery programme supported by the donor community. The recovery programme also intensified the implementation of structural measures. A new banking law was passed which strengthened the independence and controlling powers of the Bank of Albania. A privatisation strategy was developed that allowed the privatisation of medium and large enterprises as well as the sale of strategic enterprises to investors. Steps were taken to support the institutional and governance reforms needed to build a more responsive, accountable, and transparent state.

Since 1998 growth has recommenced. In spite of some signs of a slowdown during 2002, annual real economic growth averaged 7 per cent a year during the period from 1998 to 2002²⁷. Revenue growth has been buoyant, with overall revenues increasing at 13.8 per cent a year, and the budget deficit, while still large, having fallen from previous levels. The average CPI increase has been kept to 3.5 per cent, in spite of a supply-induced increase in 2002.

b) Factors associated with Albania's growth since transition

It can be noted that the history of Albania's growth since transition has been one of GDP contraction, often associated with economic and social disruption, and subsequent recovery. But the factors underlying the growth trend, we believe, include:

- the high inflow of transfers from emigrants, supplemented by incomes earned by residents working overseas temporarily;
- a relatively high inflow of official transfers, particularly at critical periods;

- the growth in tourism income in recent years;
- growth of exports;
- growth in government expenditures;
- foreign investment, and
- an increasing level of domestic income flows through new investments and businesses.

A summary of the growth, and levels, of these factors relative to GDP during 1993 to 2003 is given in Table 1 below.

Table 1: Features of Albania's Economic Growth, 1993-2002		
	Average Annual	Percentage
	Growth Rate	of GDP
	(%)	(average)
Growth at Constant Prices	6.6	
Nominal Growth Rate	20.6	
Consumer Price Index at end year	12.3	
Commodity Exports	16.9	7.3
Service Exports	29.7	8.2
Income Credits	13.6	3.1
Private Transfers	13.9	13.3
Public Transfers	-16.5	3.2
Foreign Direct Investment	11.7	3.0
Total Government Expenditure	16.3	31.5

Sources: Bank of Albania, INSTAT, and Ministry of Finance.

The high inflow of transfers from emigrants (supplemented by incomes earned by residents working overseas temporarily²⁸) has, we believe, played a crucial role in raising domestic consumption and investment. The flow-on effects from these inflows have further raised taxation revenues and financed government expenditure. Over the period 1993 to 2002 these flows averaged over 14 per cent of GDP, and grew at an average rate of 14 per cent per annum. Official transfers, by contrast, have averaged just over 3 per cent of GDP during this period, though their value has fallen from the high levels of the early transition years, and now averages less than 1 per cent. Their value tends to increase after economic and social crises²⁹, and have contributed directly to stabilisation efforts.

The overall level of transfers, plus incomes brought into the country by residents working abroad temporarily, we would note, have

contributed immensely to increasing levels of economic growth, in addition to balancing the net outflow from trade³⁰. At the same time, we would note that such high inflows have undoubtedly resulted in appreciation of the currency, and therefore reduced international competitiveness.

Similar comments can be made regarding the development of tourist inflows in recent years. Service imports, which are dominated by tourism, averaged 8.2 per cent of GDP over the period 1993-2002, and grew by almost 30 per cent per annum. While tourism outflows reduce the net contribution of tourism (most of which is ethnic Albanians resident overseas returning for holidays) to generation of economic activity and government revenue should not be ignored.

Although exports, which averaged 7.3 per cent of GDP over 1993-2002, are small by international standards, and by comparison with the level of imports, they have still played a significant role in generating GDP growth over the period. Exports increased at an average rate of 16.9 per cent annually between 1993 and 2002.

Government expenditure has averaged 31.5 per cent of GDP since 1993, and it has grown at an average rate of nearly 24 per cent. While much of this expenditure is not directly recorded in GDP (such as interest, and social security and health transfers), most expenditure other than overseas debt payments is important in stimulating economic activity. As such, the level of government expenditure must be included as one of the key determinants of economic activity. At the same time, the dangers of 'crowding out' of private sector activity, particularly through running large budget deficits, must be borne in mind given the critical role of the private sector in economic growth³¹.

In contrast to the importance of current flows, in relation to remittances and tourism, the major benefit of foreign investment is the economic activity flowing from the investment³². Government has maintained an 'open door' approach to foreign investment, and this has resulted in foreign investment inflows, mainly in the trade sector, but with investment also occurring in the industry, services, construction and transport sectors³³. Foreign investment in the manufacturing sector, in particular, has been instrumental in generating exports of manufactured goods. We note that direct investment inflows, which were growing significantly between 1992

and 1996, fell dramatically for the next three years, before starting to rise again in 2000. A significant portion of the direct investment inflow has been associated with privatisation.

The final key source of growth noted, namely “..an increasing level of domestic income flows through new investments and businesses”, refers to the increasing numbers of new enterprises in new fields, often established by returning emigrants. These contribute to increasing domestic circulation of currency (or, in macroeconomic terms, raising the ‘multiplier’ effects of exogenous expenditures). The high growth rate of nominal GDP (almost 21 per cent per annum) relative to most exogenous variables noted above, during 1993 to 2002, is largely attributable to this factor.

c) Key features of the Albanian economy in the light of international comparisons

Table 2: Some International Comparisons			
Feature	Albania	Lower Middle-Income Economies	Europe and Central Asia Low & Middle Income
Gross National Income (GNI)/ capita 2001 (US dollars - market exchange rates)	1,230	1,240	1,960
Gross National Income / capita 2001 (US dollars - purchasing power parity)	3,880	5,020	6,990
Relative Price Ratio to US, 2001 (%)	0.32	0.25	0.28
Per Capita GDP Growth, 2000-01	5.5	3.3	2.4
Foreign Direct Investment / GDP, 2000 (%)	3.5	2.3	2.9
Investment (GCF) / GDP, 2001 (%)	19	27	21
Exports / GDP, 2001 (%)	6.8	25.8	35.0
Imports / GDP, 2001 (%)	29.4	24.2	35.1
Trade Bal / GDP, 2001 (%)	-22.6	1.6	-0.2
Current Account / GDP, 2001 (%)	-6.0	3.4	4.9
High Technology Exports (% of Manuf Exports, 2000)	1	13	10
Overseas Development Assistance/Capita (US dollars, 2000)	93	7	23
Current Revenues / GDP, 2000 (%)	19.3	16.6	27.6
Total Expenditures / GDP, 2000 (%)	29.8	20.7	30.5
Budget Bal (inc grants) / GDP, 2000 (%)	-8.5	-3.8	-1.3
External Debt, 2000 (% of GNI)	13	33.3	53.7
Domestic Credit by Banking Sector, 2001 (% of GDP)	46.5	91.3	37.8
Unemployment as per cent of labour force		4.3	11.1

Source: World Development Report, 2003, and 2003 World Development Indicators, The World Bank, 2003

Some key features of Albania's economy, by comparison with other lower middle-income countries, and lower and middle-income countries in Europe and Central Asia, are given in Table 2 below. The purpose of this comparison is to give some perspective on where Albania stands by international standards.

Key features which emerge from the table include:

- Albania's gross national income per capita is similar to the world average for low and middle-income economies, but less than two-thirds of the European and Central Asian Low and Middle Income Economies (these include all of the former European Socialist Regimes plus the Asian former members of the USSR, plus Turkey and the Isle of Man).
- After adjustment for the cost of living (based on surveys conducted by International Comparison Programme, a joint programme of the World Bank and the regional economic commissions of the United Nations), Albania's standard of living is less than 80 per cent of world lower middle income country average, and slightly above half of the European and Central Asian Low and Middle Income Economies.
- The cost of living is 28 per cent more in Albania than in the world lower middle-income countries, and 13 per cent more than in the European and Central Asian Low and Middle Income Economies.
- GDP growth in 2001 and 2002 was significantly higher than in both the world lower middle-income countries, and the European and Central Asian Low and Middle Income Economies.
- Foreign direct investment inflows, and investment in capital goods, are broadly similar in Albania and the other categories of country.
- While the ratio of imports to GDP is broadly similar in Albania to the other countries, the ratio of exports to GDP is much lower in Albania (less than one-third the level of exports to GDP of world lower middle income countries, and one fifth of the level of the European and Central Asian low and middle income economies).
- Albania consequently has a huge trade deficit, of almost 23 per cent of GDP, compared to negligible trade deficits in the other groups of economies.
- However, after taking into account other current flows (in

Albania's case mainly remittances) Albania's current account deficit is much smaller than its trade deficit, at about 6 per cent of GDP. The other groups of countries have positive current account balances.

- High technology exports are a much smaller proportion of Albania's manufactured goods exports, implying a much lower level in the development of the export market.
- Overseas development assistance for Albania (which we noted above has fallen considerably in recent years), at US \$93 per capita, is still far above levels for both other groups.
- Albania's revenue, expenditure and deficit (after deducting grant assistance) are considerably higher than for world lower middle-income countries. European and Central Asian low and middle-income economies have significantly higher revenues, and lower deficits, while expenditure levels in relation to GDP are similar.
- Albania's levels of overseas debt are very considerably lower than for both other groups of countries, while domestic credit by the banking sector is considerably lower than for world lower middle income countries, but above that for European and Central Asian low and middle income economies.
- While unemployment data for Albania is not given, it can be noted that both groups of countries have unemployment rates, which are well below the recorded unemployment rate for Albania for the same period of 16.9 per cent⁴³⁴.

In conclusion, we would observe Albania shows all the classic features of a 'high remittance' economy, including:

- growth being based on domestic demand rather than exports, so there is a massive negative trade balance;
- a high cost structure by international standards, for a country with lower middle income level; and
- a low level of employment, which is concentrated in government and official entities, with relatively little private sector non-farm employment.

In Albania, to a much greater extent than most other European transition economies, the transition process exacerbated difficulties in an economy that was already beleaguered in many respects, resulting in a massive increase in the unemployment rate.

The huge outward migration that followed has resulted in migrants obtaining skills and incomes that they would not have obtained at home, while the remittances have helped to alleviate poverty, and generate economic growth. Returning migrants establish businesses which help develop the economy.

At the same time, the particularly high level of remittances in Albania has also contributed to raising the exchange rate, and consequently reducing competitiveness. It has led to a 'dual economy' in many respects, with standards of living and costs varying immensely for different segments of the population. A high dependence on remittances for longer-term growth should be of some concern, since remittances tend to be 'generation related'³⁵.

The slow growth of employment, in the face of relatively high GDP growth in recent years, should be, we believe, a major concern. The non-agricultural private sector is estimated to account for about 55 per cent of total GDP³⁶, yet it only accounts for some 29 per cent of total employment³⁷, and just 7.9 per cent of the workforce. Yet this is the sector which, according to official statistics, is growing most rapidly and therefore should be experiencing increased employment.

APPENDIX 2.

Empirical Evidence on Economic Growth relating to the Institutional Framework

In recent years attention has shifted to long-term analysis of factors underlying sustained growth over longer-term time frames. In particular, attention has concentrated on the particular roles of geography, integration in the world economy, and institutions in economic growth.

The key findings are:

1) The primacy of institutional quality.

Some examples from one particular study (Edison, Hali) suggest³⁸:

- a) there would be a 150% increase in per capita incomes in Middle East countries if their institutions are strengthened to the all-country average institutional quality: the income gains are much larger if institutional quality rises to the level of advanced economies;
- b) annual growth in per capita GDP in the Middle East countries would increase by 1 percentage point if countries there had institutions as good as the average quality for the entire sample: the increase would be 3.2 percentage points if these countries raised their institutional quality to the level of advanced economies;
- c) if institutions in the Middle East countries were as good as those in the average country in the sample, countries in that region would experience a 12% reduction in economic volatility (i.e. instability): if there institutions were brought to the level of the advanced economies, economic volatility would be reduced by more than 50%.

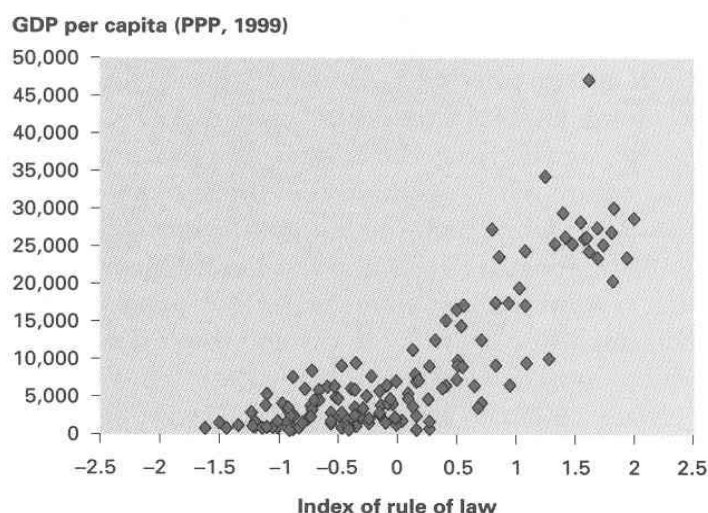
In another study, it is noted that: "...the quality of institutions is the only positive and significant determinant of income levels." According to their estimates an increase in the quality of institutions can produce large increases in income per capita. For example, the difference between the quality of institutions in Bolivia and Korea is equivalent to one standard deviation (in statistical terms) or a 6.4 fold difference. Therefore, if Bolivia would raise its level of

institutional quality to that of Korea, its per capita GDP would be close to \$18,000 rather than its current level of \$2,700".

Further, the World Development Report for 2003³⁹ states that "...a large body of theoretical and empirical studies concludes that there are strong casual effects from good institutions, measured by such variables as rule of law, to higher incomes per capita (refer graph below). According to one study⁴⁰, better voice and accountability would raise national income per capita by a factor of 2.5.

The World Development Report, 2003, plots the relationship between institutional quality, based on rule of law index, and national income as shown in the chart below.

The relationship between institutional quality and national income



PPP = Purchasing power parity.

Note: As a measure of institutional quality, the rule of law includes considerations such as the security of property rights, or the confidence with which a group or individual can find tomorrow the fruits of what is planted or conserved today.

2) Institutions that are geared at protecting property rights, placing constraints on elites and politicians, and allowing the accumulation of human capital, the spread of

entrepreneurship, and the creation of a mass market are of paramount importance.

a) Acemoglu⁴¹ looked at the two types of colonization strategies (and their associated institutions) followed by the Europeans and their effect on economic prosperity. In countries where there were resources to be extracted (e.g. Africa, India, Caribbean, Latin America, Mexico, etc.), Europeans pursued the strategy of setting up extractive institutions. These institutions neither protected the property rights of regular citizens nor constrained the power of elites (Europeans themselves and their allies). On the other hand, Europeans created a number of colonies where they replicated – and often improved – the European form of institutions protecting private property and placing significant constraints on elites and politicians. Primary examples include Australia, Canada, New Zealand, and the United States.

It is this difference in institutions that explains the reversal of fortune in economic prosperity between the two types of colonies. The second group of the former European colonies, that are relatively rich today were poor before the Europeans arrived. However, the type of institutions set up in these colonies were much more conducive to investment and economic growth, producing as a consequence this reversal of fortune.

A second example comes from the World Bank publication “World Development Report 2003” that compares per capita incomes of several Latin American countries with those in Canada and the United States. In the 16th and 17th centuries, the GDP per capita of several Latin American countries like Argentina, Barbados, Cuba, etc. was similar (or higher, by more than 50%) than the US GDP per capita⁴². However, once industrialization began in North America in the 19th century, the United States and Canadian economies diverged sharply from the rest of the hemisphere. One key to early industrialization was the ability of the broad population to invest, accumulate human capital, and participate in commercial activity. The United States and Canada provided the laws, institutions, and government policies to make such investment and participation available.

On the other hand, conditions in the Latin American countries, made possible a high inequality in income, wealth, and human capital, which in effect influenced the development of institutions. The

emerging institutions blocked effective access to opportunities for economic and social advancement for a broad cross-section of the population. These institutions “..inhibited the accumulation of human capital, the spread of entrepreneurship, and the creation of a mass market – factors viewed as important in industrial development”.

b) The World Development Report 2003 (World Bank) also states that “...If not properly protected, assets cannot thrive and contribute to growth or human well-being.” Further the Report states: “...with insecure property rights, incomes and well-being collapse....A staggering 75 percent of firms in the Kyrgyz Republic, Moldova, the Russian Federation, and Ukraine were not confident that the legal system would uphold my contract and property rights in business disputes. Among the six economies where property rights were least secure, income (GDP) fell in the decade of transition-by 40 percent or more. Many countries with contractions in GDP also had large increases in death rates.”

The Report also states that “..Without commitments to law and property, well-managed exploitation is unlikely. Insecure property rights also hurt natural and environmental assets: fish populations are threatened, and trees are cut prematurely. Because people are not sure that they will be able to harvest tomorrow, they take what they can today - initiating a race for property rights... “For a cross-section of countries, the insecurity of property rights reduces investment in human-made capital and increases deforestation. Forests would benefit from reforms that strengthen the commitment to law and property. There are good reasons to believe that benefits will extend to other natural and environmental assets as well.”

Another study⁴³ suggests that per capita incomes would grow at least 2 percent per year in all countries if they would only protect property rights (public and private) and pursue more competitive market policies.

Additional studies⁴⁴ provide evidence that natural assets decline when protective institutions are weak. Poor institutions contribute to a poor investment climate and to the depletion of natural resources. Moreover “..countries with high rates of depletion of natural resources also tend to be countries with low stocks of physical capital”⁴⁵.

In conclusion, economies with high inequality in the ownership of assets tend to generate institutions that placed restrictions on individuals' opportunities for future economic advancement, and this ties these economies into low growth paths.

We now try to evaluate Albania's position in relation to the most recent criteria identified, as well as its policy framework, to examine where it stands in relation to the requirements for long term sustained growth.

APPENDIX 3.

Evaluation of Albania's Situation relating to the Institutional Framework

Institutional quality can be measured using different indices. One of these relates purely to *property rights*, another to *constraints on the executive*, relating to institutional and other limits placed on political leaders (on the grounds that the more constraints there are, the more sustainable are the policies implemented). Another measure, the *aggregate governance index*, is the average of six measures of institutions, including (1) voice and accountability (2) political stability and the absence of violence (3) government effectiveness (4) regulatory burden (5) rule of law, and (6) freedom from graft.

In assessing quality and effectiveness of the institutional development we have examined the measures included in the aggregate government index, and finally included a 'business friendly bureaucracy - other' measure to capture issues which do not fall neatly into one category or another⁴⁶.

Going through these, in turn:

1. Voice and accountability

This covers the extent to which citizens choose their government, have political rights, civil liberties, and an independent press. Albania has gone a long way in this field but we consider that there is room for improvement in specific areas.

2. Political stability and absence of violence

The main issue in this area is the frequent changes of government and ministerial portfolio, which works to slow down the effectiveness of government initiatives.

3. Government effectiveness

This covers the quality of public service delivery, the competence and political independence of government employees.

The National Strategy for Social and Economic Development (NSSED) notes that improving the quality of public service delivery “.. is presently a problem area”. Measures that are underway to improve public service delivery, competence and political independence, include:

- implementation of the civil service status among public servants;
- more transparent recruitment procedures;
- definition of the role of the general secretary as the link between the political and administrative level in ministries and other institutions;
- improved job specification, evaluation, and training procedures;
- the ability to appeal to the Civil Service Commission.

We would note that improvement in the quality of public service delivery is necessarily tied to the following issue relating to the role of government.

4. *Regulatory burden*

Commenting on government regulation the Foreign Investment Advisory Service (FIAS), a joint service of the International Finance Corporation and the World Bank, commented:

“...Ten years after the initial transition to a monetary economy, the present administrative system in Albania is still burdened with many outdated regulatory requirements. These are rooted in a mentality of state planning and control, and micro-management of the economy by the Government”⁴⁷.

The NSSED refers to a study on the “the Public Service in the Central Administration” carried out by the Anti-corruption Unit. It notes that “..the purpose of this study was to promote the simplification, normalization, unification of all of the procedures and technical criteria with regards to the delivery of all public services offered by central administrative institutions as well as the reform of the services and appeal procedures. The objective is to reduce the number of license, streamline similar units and functions and create a “one stop shop”.

It is probably fair to comment that this area still requires much further attention, but it appears to be in the process of being recognised, with identification of initial measures to improve the situation.

5. Rule of law

This refers to the protection of persons and property, independent and effective judges, and contract enforcement.

This is an area which needs particular attention.

In respect of the independence and effectiveness of the judiciary, the NSSD notes that “..While the independence of the judiciary has increased, its efficiency and fairness remain problematic”. It identifies a series of steps to increase the independence and effectiveness of the judiciary, including “...continued reforms ... aimed at strengthening the institutions of judicial autonomy, building capacity, increasing transparency and enhancing access to justice by vulnerable social groups”.

In respect of law and order generally, the NSSD comments that “...The reduction of serious crime, increased crime detection and public order in general are being strengthened through reforms to prosecuting institutions. This includes some initial success in the fight against illegal trafficking and organized crime. The strengthening of public order and the fight against the international organized crime and money laundering in particular needs more international support.”

Contract enforcement requires a strong and enforceable judicial system, relative absence of corruption, and transparent dispute resolving mechanisms.

Resolution of property rights is perhaps the greatest single challenge facing Albania at this point in time.

The FIAS study continually notes the problems with property rights, as follows:

- *In relation to the need for a sound and viable land market for future development*

The report states:

“...However, there is a wider concern in relation to broader issues of land, property, and construction rights, characterised by numerous land tenure disputes, illegal occupancy, and chaotic construction activity. Many pointed out that the weak legal and regulatory framework further weakened by corruption, has encouraged rampant development based on short term and speculative motivations at the cost of long term and strategic investments. If allowed to continue, such developments will undermine the Government’s efforts to develop a sound and viable land market based on private ownership, consistent with the public interest, and supporting future development.”

They go on to recommend that “..the Government act quickly to review and implement the World Bank recommendations. Further delay can only exacerbate the problems and deter strategic investors..”

· *In respect of the requirements for transition to a full market economy:*

“...weak, and often conflicting, property rights, have seriously hampered these private transactions. They are the result of errors and inconsistencies arising from the multiple privatisation and restitution programs, as well as from chaotic construction activity. While a problem across the country, it has been particularly acutely felt in the urban areas where the commercial demand for land is high...

“...many decisions made by the Restitution Commission created overlapping claims over the same land and housing properties, and forced current and historical owners to enter into difficult processes in pursuit of sale, lease or co-ownership agreements.”

· In relation to the adverse impact on genuine investment:

“For a prolonged period, municipal authorities granted construction permits haphazardly without always following title search requirements. Frequently, at the time of construction, the investor was not fully aware of any tenure controversy concerning the development site. Subsequent restitution of the site, following

completion of construction, legally required the investor to enter negotiation with the ex-owner(s) of the site for a lease or sale deal, something he had not had reason to expect...

“ ..on the other hand, there were also speculators who took advantage of the weak system and deliberately obtained construction rights without tenure-rights, knowing that, once the development was completed, eviction was going to be difficult.”

· Referring to the impact of illegal construction:

“..Finally, some property disputes were caused by illegal construction, that is, construction undertaken with neither property nor construction rights. Although the law does not accord illegal developers the same status as those who build with construction permits, eviction is practically difficult and costly. In some cases, it becomes impossible as the developer has already sold the development to a third party and disappeared with the large profits from the transaction.”

· Referring to the negative effect on investors and the public:

“...First Registration has been achieved in most rural areas. In urban areas, however, the process has stagnated due to the complexity of tenure controversies, noted above. It is also hindered by the lack of information about land and properties that remain in state-ownership and are believed to be significant in urban areas...”⁴⁸

“ ..Ultimately, all are caught up in and suffer the negative consequences of this vicious circle, which impedes strategic investors whose need for land with secured property rights is essential...

“ ..Investors are increasingly concerned about rampant and effectively uncontrolled construction activity. It leads not only to vexatious and costly property right disputes, but also creates physical disorder in the built environment...

“ ..The lack of law enforcement and proliferation of corruption enabled speculative developers to build and sell properties opportunistically and very profitably, leaving innocent buyers and the general public to cope with the adverse consequences.”

- *The Report goes on to recommend specific measures, in particular the need for a clear and unambiguous commitment by Government:*

“ ..Most importantly, the Government must demonstrate a high-level political commitment to these reforms and develop a coherent strategy to accelerate their implementation. Many past efforts failed due to a fragmented approach with non existent or weak linkages between the various programs and responsible institutions.”

- The necessity for such an approach:

“Albania needs to encourage investment of strategic benefits to its long-term national economic development. Such investments require an adequate legal and institutional framework providing strong protection for property rights, clear guidance for land use and construction requirements, and equal and predictable treatment when dealing with regulatory agencies at the national and local levels.”

The case for establishing sound property rights as a precondition for sustained economic growth is soundly established in virtually all analyses of sustainable growth, as is the negative impact of not having such rights⁴⁹.

The NSSD recognises the need for the further strengthening of the rule of law and resolution of property rights, noting that it is expected to have a positive effect on the economy. Measures to be put into place in regard to property rights include:

- completion of the inventory and registration of state assets by 2006;
- improving their administration and increasing the transparency of their disposition and sale.

In relation to urban land, measures include:

- appropriate settlement of the rights of private property, joint ownership in dwellings, public ownership; and
- the adoption of the instruments for their implementation and protection, including appropriate forms of compensation;

Measures to be implemented in relation to the rural land market include the development of the land market and consolidation of ownership.

6. Freedom from graft

In other words public power is not abused for private gain or corruption.

Economic literature emphasizes that corruption has a high economic cost. It emphasises the links between governance and corruption, and emphasises that poor governance creates opportunities and incentives for corruption, can lead to a skewed distribution of income and wealth, and negatively affects growth and living standards. A study of corruption in the former CIS countries, for instance, gave its effects as:

- worsening distortions in resource allocation;
- raising costs and reducing incentives to invest, and deterring foreign investors;
- affecting small and medium sized enterprises particularly adversely; and
- reducing domestic savings and investment and stimulating capital flight.

It concluded that corruption “is one of the most important forces inhibiting investment and growth and thereby lowering living standards in many of the transition economies reviewed”⁵⁰.

The NSSD notes that “..The fight against corruption is a cross-cutting issue of all reforms. It has been waged both towards narrowing the spaces for corruption through increased transparency as well as through the adoption of anti-corruption incentives which have mainly medium-term and long-term impacts. Measures have also been taken towards enhancing control and prosecuting corruption cases. As a result, the index of perceived corruption has fallen. The fight against corruption will continue to be a priority and it will be fought according to these two aforementioned approaches”.

The FIAS study notes that “..a recent study based on surveys conducted in seven countries in the South East European (SEE) region by the Centre for the Study of Democracy and the

International Legal Development Institute,⁵¹ revealed that Albania was the worst among all countries in the region in terms of perceived corruption, and that its performance is getting worse with time". Tables produced in the FIAS report are attached in Annex 1.

The report notes that "...flaws in the operation of the administrative regulatory system, such as the exercise of too much discretion and a lack of transparency and accountability, provides fertile opportunities for the practice of corruption. Governments that are serious about combating corruption must endeavor to simplify investment regulatory procedures and eliminate the exercise of unnecessary administrative discretion". It notes measures that are already underway led by a Special Committee in the Prime Ministers Office, and urges the addition of a further specific term of reference addressed at the removal of administrative barriers to investment in order to remove opportunities for corruption and improve transparency.

7. *Business friendly bureaucracy – other*

The four final issues relating to institutions, namely government effectiveness, regulatory burden, rule of law (certain components) and freedom from graft are sometimes treated jointly under the issue of 'business friendly bureaucracy'. The FIAS study notes that there are four major problems in this area:

- there is a systematic lack of implementing regulations and operational guidelines. They note that new laws are not supported by necessary procedures, criteria and responsibilities, so permitting a high degree of administrative discretion by agencies and officials;
- there is a systematic lack of effective institutional structures, with no clear designation of responsibility or accountability, or inter-agency cooperation;
- legal and regulatory enforcement is chronically lacking, with dispute settling mechanisms not working effectively; and
- administration is further weakened by a lack of development of the appropriate mindset and skills of officials at all levels. The study notes that "...in general, regulatory officials seem not to trust businesses. Many appear to see themselves as policemen, not service providers.."

The study notes that "...while these features are not unusual among transition economies in the region, their severity is remarkable when benchmarked against comparable country results". Problems that the study noted related mainly to taxation and customs matters.

A special group has been established, under the Chairmanship of the Minister of the Economy, to work out and implement an action plan to remove the barriers identified in the FIAS report.

TABLE OF CONTENTS

I.	Executive summary
II.	introduction and approach
III.	background
IV.	empirical evidence on economic growth
IV. a)	manpower, machinery and technology
IV. b)	economic policies
IV. c)	initial conditions
IV. d)	institutional framework
V.	evAluation of albania's situation
V. a)	geography
V. b)	integration
V. c)	policy framework
V. d)	institutional framework
VI.	the role of gOvernment and the private sector
VII.	cONclusions and recommendations
VIII.	references
IX.	Annex 1: extract from FIAS report of march 2003
X.	Appendix 1: economic background
XI.	Appendix 2: Empirical Evidence on Economic Growth relating to the Institutional Framework
XII.	Appendix 3: Evaluation of Albania's Situation relating to the Institutional Framework

LIST OF ABBREVIATIONS

EU	European Union
FIAS	Foreign Investment Advisory Service
GCF	Gross Capital Formation
GDP	Gross Domestic Product
GNI	Gross National Income
IMF	International Monetary Fund
INSTAT	National Institute of Statistics, Albania
LPG	Liquid Petroleum Gas
NSSD	National Strategy for Social and Economic Development
ODA	Overseas Development Assistance
SEE	South East European
WTO	World Trade Organization

ENDNOTE

¹ This issue is not, however, particularly relevant to Albania which is at an early stage in capital accumulation, and which has ample labour resources;

² "Getting the basics right" includes a macroeconomic aspect which encourages economic growth through ensuring stable and low inflation, promoting the integrity of the financial and banking system, providing for open markets, and striving for stable and realistic exchange rates. On the microeconomic side, it requires government to ensure property rights, law and order, and adequate provision of public goods. Government should avoid high tax rates, price controls, and other distortions of relative prices.

³ A significant amount of academic literature has recently examined economic growth from these angles, which are currently considered as alternative determining factors in economic growth.

⁴ These relate to the high social security and health insurance taxes levied at low rates of income, and the setting of the minimum wage by administrative decision rather than market forces.

⁵ For the purpose of this paper, the term "institutions" refers broadly to the rule of law, including property rights, and a business friendly bureaucracy. Another definition, by Acemoglu, defines institutions as behavioural norms and rules of human interaction in a society, particularly those relating to enforcement of property rights; constraints on the actions of elites, politicians, and other powerful groups; and a degree of equal opportunity for broad segments of society.

⁶ These have been slightly modified to suit the overall method of analysis applied in this paper.

⁷ A significant amount of academic literature has recently examined economic growth from these angles, which are currently considered as alternative determining factors in economic growth (e.g. Acemoglu, Daron, Simon Johnson and James A. Robinson, 2001, "The Colonial Origins of Comparative Development: An Empirical Investigation", *American Economic Review*, Vol 91 (December); Jeffrey D. Sachs "Institutions Matter, but Not for Everything", *Finance & Development*, June 2003, or Hali Edison "Testing the Links", also *Finance & Development*, June 2003)

⁸ We would point out that implementing measures that give the highest rates of return, at any point in time, will also lead to the highest provision of revenues for implementing of other priorities.

⁹ The World Bank, "The East Asian Miracle" 1993.

¹⁰ Rodrik, Dani "King Kong Meets Godzilla: The World Bank and the East Asian Miracle". Chapter 1 in "Miracle or Design? Lessons from the East Experience" ed. by Albert Fishlow and others (Washington: Overseas Development Council, 1994)

¹¹ For the purpose of this paper, institutions are broadly defined as behavioural norms and rules of human interaction in a society, particularly those relating to:

- (i) enforcement of property rights, so that a variety of individuals have incentives to invest and participate in economic life;
- (ii) constraints on the actions of elites, politicians, and other powerful groups, so that these people cannot expropriate the incomes and investments of others or create a highly uneven playing field;
- (iii) a degree of equal opportunity for broad segments of society, so that individuals can make investments, especially in human capital, and participate in productive economics activities (Acemoglu¹¹).

¹² Rodrik, Dani. and Subramanian, Arvind. The Primacy of Institutions (and what this does and does not mean). Finance & Development June 2003, p. 32.

¹³ World Development Report, 2003. World Bank, Washington, D.C. Figure 3.3.

¹⁴ The report refers, in particular, to the following studies: Bohn, Henning, and Robert, T. Deacon. "Ownership, Risk, Investment, and the Use of Natural Resources." American Economic Review, 2000, 90(3):526-49.
Hellman, Joel S., Geraint Jones, and Daniel Kaufman. "Seize the State, Seize the Day": State Capture, Corruption, and Influence in Transition." World Bank Policy Research Working Paper 2444, 2000. Washington, D.C. Hoff, Karla, and Joseph Stiglitz. "After the Big Bang? Obstacles to the Emergence of the Rule of Law in Post-Communist Societies." World Bank, 2002. Washington, D.C. Processed.
EBRD (European Bank for Reconstruction and Development). 2002. Transition Report 2000. London.

¹⁵ Carroll, Christopher D., and David N. Weil "Saving and Growth: A reinterpretation", Carnegie-Rochester Conference Series on Public Policy, Vol 40 (1994), pp 133-92.

¹⁶ We would note that the banking and financial system needs far more development, but understand measures are underway to facilitate this.

¹⁷ For instance, the IMF Country Report No. 01/118, July 2001, states "...contribution rates in the urban (pension) scheme are high". The Report further states "considering other transition economies, only the contribution rates in Bulgaria (39 percent) and the Kyrgyz Republic (36 percent) are higher than the Albanian one."

¹⁸ These include one measure which relates purely to property rights, and another to constraints on the executive, in addition to the aggregate governance index.

¹⁹ This includes adding another measure, 'business friendly bureaucracy - other' measure to capture issues which do not fall neatly into one category or another. In addition, we have re-interpreted the fourth measure, regulatory burden, away from policy related measures since these, in our analysis, are considered policy related. Instead, we have focussed on problems in government regulations and the use of those regulations more generally.

²⁰ FIAS, "Albania Removing Administrative Barriers to Investment: A Critical Component of the National Development Strategy" March 2003.

²¹ Refer Thomas Wolf and Emine Gurgen "Improving Governance and Fighting Corruption in the Baltic and CIS Countries, Economic Issues No 21, International Monetary Fund, July 2000.

²² "Corruption Indexes", Regional Corruption Monitoring, Centre for the Study of Democracy and the International Legal Development Institute, Rome, April 2002. Tables produced in the FIAS report are attached in Annex 1.

²³ Balcerowicz, Leszek, "Post-Communist Transition: Some Lessons", The Institute of Economic Affairs, London, 2002.

²⁴ For instance, refer Box 1 in the following section.

²⁵ Balcerowicz notes that " .. Non-radical programmes, which typically feature less liberalisation and correspondingly more state intervention, also give rise to new economic inequalities, with the winners being those who can successfully lobby government. In practice, this means members of the old communist elite, who are more experienced, better organised and better connected than others. The inequalities generated by their lobbying are less justified by economic performance than those that stem from the radical reform programmes and rankle with the 'losers' even more. Finally, by channelling entrepreneurship and managerial energies into rent-seeking and corruption rather than into the search for greater efficiency, non-radical programmes that avoid liberalisation destroy the prospects for economic development. Anyone willing to take the longer view should then realise that the discontent and drawbacks associated with non-radical reform outweigh the problems brought by sustained and radical efforts towards comprehensive liberalisation, stabilisation and institutional building". Balcerowicz, Leszek, "Post-Communist Transition: Some Lessons", The Institute of Economic Affairs, London, 2002.

²⁶ This was mainly as a result of a decrease in the private remittance inflow, from (US dollars) 476 million to 236 million. Official transfers also fell by two-thirds to 29 million. The trade balance actually decreased as a result of imports falling by more than exports, in dollar values.

²⁷ GDP per capita is estimated to have surpassed its 1989 level in 1999.

²⁸ Inflows from residents working overseas temporarily are referred to as 'compensation of employees' in the balance of payments statistics, and are recorded as an income flow.

²⁹ In 1992, according to the Balance of Payments statistics, such inflows reached 55 per cent of GDP, and in 1993 were equivalent to 23 per cent of GDP. It has since fallen progressively, except from an increase from 1.3 per cent in 1997 and 2.9 per cent in 1998 to 4.6 per cent in 1999.

³⁰ Over the period 1993 – 2003 these averaged about 18 per cent of GDP. In fact, much of the net outflow from trade can be directly related to the influence of the inward transfers in stimulating economic activity and imports.

³¹ In Albania, it is noted, bank lending to the private sector is minimal.

³² The critical role of foreign investment in growth is brought out in the following comment taken from the Economist's Economic Focus: "...The point about foreign direct investment is that it is far more than mere 'capital': it is a uniquely potent bundle of capital, contacts, and managerial and technical knowledge. It is the cutting edge of globalisation..." (from The Cutting Edge, Economics Focus, The Economist, January 24th 2001)

³³ Actual percentages are trade sector (67 per cent), industry (17 per cent), services (6 per cent), construction (5 per cent), transport (4.7 per cent) and agriculture (1.3 per cent). Source: An Investors Guide to Albania, Ministry of Economy, March 2003.

³⁴ The Bank's notes to the table state that "...no data are given in the table for economies for which unemployment data are not consistently available or are deemed unreliable". The recorded unemployment rate used for Albania is generally considered an underestimate of unemployment since it excludes discouraged persons and those who do not register.

³⁵ Findings in remittance economies in the South Pacific, for example, are that second generation remits about one-third of the original migrants, and it virtually ceases after that.

³⁶ This is based on year 2000 figures for agriculture (28 per cent of GDP), public administration (7 per cent of GDP), and an allowance of 10 per cent for non-budget public sector institutions in other sectors.

³⁷ This is based on contributors to the Social Security Institute in 2001. Non-farm private sector employment includes 72,089 employees and 26507 self employed, compared to 342,318 non-rural contributors.

³⁸ Edison, Hali. Testing the Links. How strong are the links between institutional quality and economic performance? Finance & Development June 2003, p35-37.

³⁹ World Development Report, 2003. World Bank, Washington, D.C.

⁴⁰ Kaufman, Daniel, Aart Kraay, and Pablo Zoido-Lobaton. "Governance Matters." World Bank Policy Research Working Paper 2196, 1999. Washington, D.C.

⁴¹ Acemoglu, Daron. Root Causes. A historical approach to assessing the role of institutions in economics development. Finance & Development June 2003, p. 28-29.

⁴² World Development Report 2003, World Bank, p. 34.

⁴³ Sachs, Jeffrey D., and Andrew M. Warner. "Economic Convergence and Economic Policies." National Bureau of Economic Research Working Paper 5039, 1995. Cambridge, Mass.

⁴⁴ Acemoglu, Daron, Simon Johnson and James A. Robinson, 2001, "Reversal of Fortune: Geography and Institutions in the Making of the Modern World Income Distribution", National Bureau of Economic Research Working Paper 8460. Cambridge, Mass.

⁴⁵ Source: World Development Report, 2003, Box 3.3.

⁴⁶ In addition, we have re-interpreted the fourth measure, regulatory burden, away from policy related measures such as government restrictions on goods markets, international trade and banking systems since these, in our analysis, are considered policy related. Instead, we have focussed on problems in government regulations and the use of those regulations more generally.

⁴⁷ FIAS, "Albania Removing Administrative Barriers to Investment: A Critical Component of the National Development Strategy" March 2003.

⁴⁸ State-owned land and properties can be in the hands of the national and municipal governments, as well as state owned enterprises. Although statistics of state owned land and properties are extremely deficient, some study estimated that they made up about 50% of the total urban land and close to 40% of urban commercial land by the end of 1998. See "City Made By People," p. 53, Vol. 2, 2000, Centre for Habitat Development, Tirana.

⁴⁹ Some analyses of institutional quality focus exclusively on property rights. Refer Edison, Hali. "Testing the Links. How strong are the links between institutional quality and economic performance?" Finance & Development June 2003, p35-37

⁵⁰ Refer Thomas Wolf and Emine Gurgen "Improving Governance and Fighting Corruption in the Baltic and CIS Countries, Economic Issues No 21, International Monetary Fund, July 2000.

⁵¹ "Regional Corruption Monitoring," the Centre for the Study of Democracy and the International Legal Development Institute, Rome, under its South East European Region Legal Development Initiative (SELDI), 2002.

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COMMENTS ON: "ALBANIA: THE FUTURE PATH FOR SUSTAINABLE GROWTH"

Sybi Hida

This paper could just as easily have been entitled "The role of institutions on the prosperity of Albania". The authors come up with a number of strengths and weaknesses for sustainable economic development in Albania. I agree. Our country, fortunately, has a favourable geographic position and abundant natural resources. In these conditions what it needs are management skills and commitment to strong institutions in order to achieve a higher living standard. Over the ten years of transition, both pessimism and optimism for the future have emerged. However, some positive shifts in the economy and society have created the belief, that the basis for future sustainable development is going to be formed. One of the more creative definitions of sustainable development builds on three kinds of capital: economic, physical, and social/human. From this perspective, which is used by the World Bank, sustainable development entails passing on to future generations an equal or preferable enhanced stock of economic, social and human capital. This definition is a derivate of Brundtland Commission 1997 definition – "Development that meets the needs of the present without compromising the ability of future generations to meet their own needs". Thus, the role of institutions achieving this goal is of paramount importance.

Albania, as a country that during these transition years implemented policies according to the "Washington Consensus" theory requires more attention for the role of government in economic development.

‘What connected these policies was a belief that governments had played an overactive role in promoting development, taking on tasks best left to the private sector, and abusing powers best left unused. Widespread government intervention was not only unnecessary to promote growth, it was the chief barrier to achieving that growth’. Being part of this philosophy, the first years of transition in Albania towards the market economy have been associated with the wrong conception of the “freedom to do everything besides respecting the rules”. The role of state has been misunderstood, influencing the quality and effectiveness of the institutional development, as the authors have explained.

What we have to know is if the current institutions in our country is in such stance that will help economic development. The authors have shown a clear picture about the role of institutions in economic development using academic literature and experiences in other countries with similar living standards as those of Albania. The authors, referring to the National Strategy for Social and Economic Development (NSSD), note that there is enough work to be done for institution building in Albania. We have to admit that Albania is already in the right path by having first identified and specified in writing its weaknesses and measures.

The importance of the institutions quality on economic development can be summarised by using Douglas North definition “It is the mixture of formal and informal rules and enforcement characteristics that shape a society’s incentive structure”. The NSSD, MTF and other development documents undertaken by Albania institutions are the first sign for a sustainable economic growth. The ability of institutions to design policies for a medium term period can be seen as a measure of institutions quality.

As authors note, the fiscal policy has played an important role on economic growth. Its implications on economic growth are derived from tax reforms and expenditure reforms. The allocation and the quality of government expenditure will be an important factor in pursuing economic growth. Increasing the level of investment on priority sectors and reducing the level of financing the budget deficit by household savings will foster economic growth.

Because of the short time period, it is difficult to measure the impact of fiscal policy on economic growth in Albania. According to the

growth theory, we are in the opinion that growth rate will continue to be satisfactory in the future. The Harrod-Domar model posited a concrete and linear relationship between investment and growth rates worldwide. The data on investment growth rates support this relationship; the level of investment in Albania will continue to be higher. The Solow-Swan neoclassical growth model predicted that growth rates were dependent, not on investment, but on the rate of technological change. Lucas' (1988) formal model argued that human capital was the significant factor determining growth rates worldwide, while Rebelo (1990) suggested that, if countries invested in labour-augmenting human capital, returns on physical capital would not diminish, allowing growth to continue forever. This model has emphasized the importance of education.

The authors note that two of the main factors behind the economic growth over transition period have been the high inflows of expatriate remittances and the growth in tourism income. What, in my opinion the authors do not point out sufficiently, is whether these factors will remain important to foster economic growth in the future. I conclude with a brief analysis of why the current tourism situation is unlikely to guarantee a sustainable economic growth and what policies are needed to maintain the other key drivers of growth, such as the large expatriate remittances.

Albania faces regional competition in tourism from, for example Greece, Croatia, Turkey and Montenegro all of which have much more developed infrastructure for tourism and similar natural beauty to Albania. Therefore tourism is unlikely to be an important source of growth over the short run and medium run. Another interesting finding during this year is that the number of Albanian tourists going abroad has increased. To my mind the key problem is the lack of infrastructure, both in physical and human capital. The role of government should be to improve this infrastructure not through the level of public expenditure but also through working closely with the private sector in improving the quality of service. This will be important for the longer term development of tourism.

Maintaining the high inflow of expatriate remittances as a main factor for economic growth is expected to be a problem in the future. It is clear that this factor has been playing an important role for economic development in Albania, and nobody wants it to lose this

role. The behaviour of different generations within expatriate families shows that, with other things unchanged, the level of expatriate remittances will decline in the future. All other things equal, this conclusion means that the economic development will suffer. Hence, what can we do to maintain the high level of remittances?

As emigrants are creating their own families in their host countries the level of remittances will decline. There are two ways to avoid this negative development: one is to encourage emigrants to come back to Albania and to benefit from their financial, human and social capital and the second is to actively promote the continued exportation of human capital. My suggestion is that we have to promote the second one and the first one will be a result. Reducing youth unemployment through emigration will reduce social problems in short run and as some of these individuals return with improved human and social capital, they will help economic development in the long run. It is important to remember that the export of human capital, as is the case with other goods, is faced with competition in the world market. Thus, the first step should be to create an appropriate education policy in Albania to optimise the use of emigration for Albania's economic and social development. This conclusion brings out again the importance of education.

The education system seems to be the Archimede's Lever for socio-economic development. One issue to address is: what level of education are we going to focus on? Are we going to emphasise pre-university or university education? Irish experience in promoting university education and postgraduate studies is a good example. The Irish Government provided a level of education, which prepared many of its citizens to emigrate successfully into an overseas labour market and also to be able to benefit from overseas graduate and post-graduate facilities. This was a key factor influencing economic growth in this country. In Albania, the number of students studying abroad and returning is still low, but it is important to note that in the last year their numbers has been higher than in the previous years.

Also, it is important to know the weaknesses and strengths of our education system and after that to formulate the necessary policies. It may be more beneficial to focus on pre-university education, or

in professional education, for example in learning foreign languages or become specialised in tourism services. It means that the government has to increase the amount of money spent in the education sector, but this requires the development of an education strategy with clear objectives. The education system in these years has been treated with priority, but more work has to be done.

As an indication of priority, in the Medium Budget Program 2004-06, it is stated that: spending on education is projected to increase from 3.0% of GDP in 2004 to 3.1% of GDP in 2006. The scope for increasing investment in education is expected to be quite limited since the level of donor financing to the sector is projected to fall as a number of major projects are completed. This approach to the education sector is seen as a fulfilling task highlighted on NSSD.

The MTBP 2004-2006 continues as follows:

“The strategy under NSSD of targeting higher wagebill increases for health and education will be continued. Salaries in these sectors are therefore due to increase proportionately faster than in other sectors over these two years. In all public services additional funds will be made available to support pay restructuring.”

The aim of Public Expenditure Management Reform in Albania is three fold: (i) to achieve fiscal stability – that is successfully achieved; (ii) to ensure strategic reallocation of resources – education spending as a percentage of GDP, compared with the countries in the region, is too low. This is changing as illustrated in the above two paragraphs and shows government commitments to this; and (iii) to increase efficiency and effectiveness of expenditures – this is the current challenge of the Albanian Government. This will require, for example, development of a clear education strategy which will address such issues as optimising Albania’s benefits from emigration as a source of growth.

Thus, it is clear that the Government is trying to design appropriate policies for the education sector. Apart from the Government policies in the last years, the young generation is considering with much interest investment in human capital. This conclusion is derived by an increasing number of students applying to universities, by a considerable number of students studying abroad and by increasing numbers in our universities.

Finally, the authors note that Albania is 'on course' in relation to integration but it would be interesting to analyse its implications on economic development. Of course, the integration process is seen with much interest from Albania but in the meantime it poses major challenges. The main challenge will be the creation of competitiveness in the integration market.

THE SIZE OF THE PUBLIC SECTOR¹

Dhori Kule

Heinz-Dieter Wenzel

1. INTRODUCTION

The World Development Report 1997 was devoted to the role and the effectiveness of the state. What the state should do, how it should do it, and how it can do its tasks better in a rapidly changing world – those were the central aspects in this annual World Bank publication six years ago.² What were the reasons for this particular focus on the aspect of public sector activity? After the Cold War and the collapse of command-and-control economies, most transition countries – in a first wave of enthusiasm about the liberation from the chains of oppressive patronage by the state – had as a motto: the smaller the public sector, the better. In many of those countries it was hardly understood that the state plays an important role even in competition-based market economies. It took and still takes quite a lot of powers of persuasion to make this evident.

Many people in the transition countries of Central and Eastern Europe were surprised to notice that the Western countries were mixed economies and not pure market economies. However, it remains to be seen whether in the transition countries a ratio of government expenditures to gross national product (a typical measure of state influence) of far more than 40 percent (and partially more than 50 percent), as it is the rule in the EU member states is

an example worth following. Moreover, it is questionable whether Europe should not orient itself by the far lower ratio of government expenditures to GDP of the USA (currently at about 32 percent).

This paper aims at questioning in a general way the role of the state from a theoretical perspective. Thereafter, particular attention is turned to how traditional justifications for public sector activity have to be adapted in the light of the ongoing globalisation of markets and the integration of political systems.

In this paper we use the terms „state“, „public“ and „government“ colloquially as it is often done in discussion and writing. And we regard state as consisting of the three distinct powers of legislature, executive and judiciary.

From a Public Economist's perspective three public sector activities which can be derived from that are of particular interest: government spending, government taxation and governmental regulation of private market activities.

A fourth, equally important public sector activity must not be forgotten: debt financing, i.e. the state's borrowing powers. Even if those borrowing powers do not belong to the state's coercive powers (as government bonds are normally purchased on a voluntary basis), they have the same effect on future generations as a tax, and that is because of the transmission of the interest burden.³

Hence, if in this paper we talk about the „size of the public sector“, we understand „size“ as measured by the four public sector activities mentioned above.

Before we attempt to measure the „size“, we want to investigate the reasons for public sector involvement, as size and scope have to be derived from an analysis of the justifications of public activities.

Hence, in the second part of this paper, we aim at investigating the factors that make public sector involvement necessary in market economies. The goal of allocative efficiency and the First Fundamental Theorem of Welfare Theory play a central role in this context. We demonstrate that conflicts of rationality and distributional objectives are the causes for public sector involvement.

The third part is explicitly dedicated to the respective areas of public sector activity. We show in detail how real-life economic policy internalises market failure and realises distributional objectives.

The fourth part deals with the question of measurability and the measurement of the size of the public sector. We show that from an economic perspective, this question can only be answered if it is known to what extent public sector activity ties down economic resources. Measurements of the expenditure side as well as of the revenue side do not adequately take account of this claim, as hidden costs are not considered.

In the fifth part, we investigate, on the basis of available data, how the Albanian public sector has evolved during the 1990s with respect to the public sectors of other Western Balkan countries.

The paper concludes with a short bottom line on economic principles of “good public sector policy”.

2. WHY PUBLIC SECTOR ACTIVITY?

There are several reasons that justify the role of the public sector even in a competition-based market economy. Those reasons result from the fact that the constituting principles of a market economy can either not be implemented or only be implemented incompletely. By “constituting principles” we understand, according to Walter Eucken (1952),

- a private property order,
- free price formation and perfect competition,
- freedom to conclude agreements,
- functioning sanctioning mechanisms of the market
- the predictability of economic policy.

A central result of welfare theory shows that so-called competitive equilibria, which grow out of the aforementioned principles, are Pareto efficient. This is a strong argument in favour of the superiority of free-enterprise competition systems. Indeed, with functioning markets the ensuing market results cannot be improved if they are Pareto efficient. However, Pareto efficiency doesn't tell us whether the resulting income and wealth distribution can be considered fair and socially acceptable.

Summing up, in two respects there is a case for involvement of an external player with coercive power – the state. Firstly, in case of an allocative inefficiency arising from a mismatch of the individual rationality of market participants on the one hand and the collective rationality (which means most advantageous for the economy as a whole) on the other. We call this a rationality conflict. Secondly, if the allocative efficiency doesn't lead to a desirable and "fair" distributional outcome. We call this a distributional conflict.

In Public Finance literature it is undeniable that the efficiency goal as well as the distribution goal are cornerstones of the justification of public sector activity in competition-based market economies, and hence they legitimate the very existence of a public sector. It is more disputable whether a third goal, the stability goal formulated by Richard A. Musgrave (1959), is of equal importance. There are extreme opinions, which allege that the public sector's macroeconomic control mechanisms even generate the business cycles they intend to fight.

Leaving aside this aspect for now, we want to look closer at the two first-mentioned goals. If those were to put into an order for real-life economic and budgetary policy, then the efficiency goal would be, without any doubt, more important from a welfare perspective. Figuratively speaking, allocative efficiency is necessary to make a pie as big as possible. The fair distribution of a smaller pie's slices (if there is no allocative efficiency) isn't helpful to anybody.

Hence, if an efficient resource allocation is the first goal of a competition-based market economy, we still have to ask which situations are typically for rationality conflicts in real-life economic activity and thus call for public sector involvement.

Indeed, there are many of such situations. In many markets for example, there is generally an underprovision of public goods, as non-rivalry in consumption combined with non-excludability from consumption makes private users with individual rationality behave as free-riders and disguise their preferences. But very often private goods, too, cannot be efficiently allocated through the market. This happens when markets fail to internalise spillover effects generated by private goods. In case of negative externalities, this leads to an overprovision of such goods, in case of positive externalities we can observe an underprovision.

A lack of individual private property rights can very often cause inefficient allocations, too. The recent past, whether in the former German Democratic Republic or in other post-socialist states, has alarmingly shown that the case of common property rights was an essential cause of the systematic overexploitation of economic resources. The combination of the two last-mentioned causes of market failure is known in Economics under the name as Tragedy of the Commons (Allmende Problem in German). Even today, this kind of rationality conflict is still typical for many efficiency problems. Especially in economies in transition, the problem of market power and asymmetric or insufficient information is very often a cause of economic welfare losses. The same is true for an imprudent privatisation of production structures that are characterized by economies of scale.

This enumeration could be continued, but already at this point we can note that due to the multitude of allocative inefficiencies the markets should not be “completely left to their own devices”.

In the following chapter we want to illustrate with examples in which fields and in which way government activity is necessary for welfare improvements.

3. WHERE PUBLIC SECTOR ACTIVITY AND OF WHICH KIND?

In principle, the state has three possibilities of intervention: through revenue policy, expenditure policy and regulation policy (i.e. laws, directives etc.). Each of these instruments should be primarily used to control the economy. The basic principle should be to change the framework conditions for private decisions in a way that makes individual rationality and collective rationality mutually compatible, and not to remove market failures through orders, bans or other forms of direct coercive measures. Clearly, especially a tax doesn't meet these requirements. That's why tax policy on the one hand is such an easy instrument for the state, and yet on the other a good tax policy is so difficult to reach. Taxes, too, should be primarily used to control the economy. The fiscal goal of taxation exists only insofar as necessary expenditures have to be financed. Hence, the secret of a good tax policy is to avoid as much as possible the distortion of price structures that developed in the markets.

In the following, we want to illustrate with some examples how allocative inefficiencies can be removed through the use of the aforementioned types of instruments. It ought to be kept in mind that transfers or subsidies are nothing but negative taxes, and public debt is a particular source of revenue.

3.1 Public Goods

Examples for public goods are the legal system, the national defence, the judiciary branch, law and order in a country, the protection of natural resources and the infrastructure. Those goods are useful to everybody, but due to the non-rivalry in consumption and the non-excludability from consumption they wouldn't be offered by private agents. The state can produce these goods on its own or have them produced by others. In any case production involves costs. The costs have to be financed through the budget, because free-rider behaviour makes a market-based allocation impossible. As there is no market price for public goods, their value is normally calculated through the costs of production. In this context, we speak of public consumption expenditure.

In Germany expenditures of these kind account for approximately 20 percent of GDP, and that ratio has been relatively stable over the years. With a ratio of government expenditure to GDP⁴ of around 50 percent, public consumption expenditure accounts for no less than 40 percent of the entire public expenditure. As public consumption expenditure is a non-attributable item, there is a strong case for financing these costs from the current budget. The same is true for the use of the existing infrastructure up to the level of economic depreciation. An increase of the capital stock beyond that would be equivalent to net public investment, which generates intertemporal utility and would have to be financed from the capital budget⁵.

3.2 Spillovers

The separation between public goods and externalities is sometimes not very clear. Why do we mention the fields of education, universities, research and development and health in this paragraph and not in the last one? This is because these goods are characterized by dynamic and intertemporal spillovers. Public education expenditure (schools, High schools, Universities) alone

amounts to a relatively constant 4 percent of GDP in Germany each year (or 8 percent of total government expenditure). There is a strong argument for education vouchers, which would allow for price formation in the education market, instead of financing the education sector via taxes. This is not socially unfair if needy people who are talented are financed through supporting education subsidies.

These education vouchers should be valid in all fields of education. This would allow for a neutral allocation, which cannot be reached if Higher Education is largely subsidised and access free (as is the case in many European countries).

The question is a completely different one for externalities in the field of environment. Theory shows that negative externalities can be internalised through taxation as well as subsidisation of the responsible party. Concerning allocative effects, both ways are equivalent. However, a subsidisation of the pollution reduction creates budgetary problems and, at the same time, wrong incentives for potential newcomers. It's the internalisation of negative externalities that shows most clearly the control character of a so-called Pigouvian tax. In this context, a good tax is a tax that renders itself superfluous.

3.3 Private Ownership

Without any doubt, this field concerns one of the main tasks of the public sector: to create and to ensure private ownership. The costs related to these tasks are to be found in the financing of law and order and the legal system in a country. In the transition process, these expenditures have a revenue counterpart: the proceeds of privatisation. In practice, things often look quite different. The reason is that the sales of enterprises are often related to social or labour market policy requirements. In Germany in the 1990s, this practice has led to tremendous losses of the Treuhandanstalt, which was responsible for the privatisation of public enterprises of the former German Democratic Republic. Apart from that, this strategy showed us that private-enterprise development was slowed down, too. Until today, Germany has to bear the consequences of this unsuccessful privatisation, as the need to transfer funds from the West to the East still amounts to approximately 80 billion Euros every year. More than half of the German deficit to GDP ratio, which today exceeds the 3 percent limit imposed by the EU's Stability and

Growth Pact, can be attributed to the unsuccessful public property privatisation.

A general lesson from this is: a fast privatisation without labour market policy requirements saves costs and creates wealth. To tie together privatisation and social policy targets, however, leads to the contrary.

3.4 The Problem of the Commons

The problem of the commons is rooted in a lack of private property rights, which leads to a lack of incentives to use resources in an efficient way. If the respective goods are scarce, there is a problem. Let's take the example of the free usage of water and energy by the population. In real-life economic policy, such practices are often sold as "social". The contrary is true. If market prices were charged that reflect production costs, and if needy customers were given income transfers, there would be welfare gains for all, as the theory of public finance shows. Hence, in two ways there is a necessity to act for the government. On the one hand, it has to ensure the provision of such goods through the market – if necessary by privatising the supply of these goods – and on the other, it has to make sure – through adequate income transfers – that all households can finance their basic needs.

Environment is another important example. For the use of environmental resources there are no rights of use. Overexploitation through environmental pollution is the consequence. This reflects individual rationality, but it is detrimental to the overall economy objectives. Let's look at the example of tourism development. Here, opportunity costs due to missed development possibilities can lead to net welfare losses for all (even the polluters) through damages to the environment. Evidently, there is a need for regulatory restrictions of government in this case.

3.5 Asymmetric Information and Incomplete Markets

Symmetric information on both sides of the market are the most important condition for efficient allocations. The famous lemon-market example of George Akerlof (1970) vividly illustrates this. What can the public sector do in this case? As typically consumers are disadvantaged by imperfect information, a public sector strategy

close to the market consists of subsidising institutions that take care of consumer information about quality and prices of supplied goods.

However, there can also be inefficient allocations if, as with intertemporal contracts, both sides of the market cannot exchange their products on an equal footing. The role of the state in the field of pension systems is an important example. Here, the state acts to guarantee the inter-generation compact which involves three generations: the old, the young and those not yet born. In the pay-as-you-go-system all the generations are parties to the contract. If the public sector didn't ensure the performance of the contract by the third generation, there wouldn't be any insurance contract, but only individual provisions. This would be individually rational, but not optimal. The example of Germany shows that in practice, the state can be part of the inter-generation compact in two ways. Firstly, if it acts to guarantee the solvency of the Social Security Fund (Gesetzliche Rentenversicherung, GRV), which yearly effects expenditures amounting to approximately the volume of the central government budget.⁶ Secondly, the state finances, through the central government budget, roughly one third of all GRV-related expenditures.⁷ This high co-financing ratio also is a consequence of the unsuccessful economic reunification of Germany, which put too great a strain on the inter-generation compact. This becomes far more evident when looking at the German social security budget, which covers the big life risks such as ageing, illnesses, unemployment and accidents. In 2002, social welfare expenditure amounted to roughly a third of GDP. 50 percent of that were financed by the public sector, 20 percent by private companies and only 30 percent by the insured parties themselves. This example shows two things. On the one hand, the public sector has a role as contracting party in the inter-generation compact. On the other hand however, it must not become the main financier of the big private life risks.

3.6 Market Power and Increasing Returns to Scale

Welfare losses in situations with market power (monopoly or oligopoly etc.) result from the fact that producers charge prices that are much higher compared to a situation of perfect competition, and the quantity supplied is too low. In the case of ordinary monopolies such a situation doesn't necessarily call for government

intervention. There are two reasons for this. Firstly, monopoly profits can be the reward for innovative Schumpeterian entrepreneurs – in this case, public sector absorption of the profits would be – from an efficiency perspective – as detrimental as e.g. the abolition of patent protection. Monopolies are only problematic when they persist. However, the theory of monopolistic competition shows that this doesn't have to be expected in the case of ordinary monopolies. In this context, the mission of the state is to prevent cartels and price fixing so that monopoly profits can be taken away by competitors. There are examples of monopolistic competition in the beverage industry. Birra Tirana for example is the only supplier of Albanian beer, but there is no reason to fight this monopolistic position, as there is competition of substitute goods.

The situation in the telecommunications sector is different. This sector is a natural monopoly, and thus characterized by increasing returns to scale. There are economies of scale, and there is no monopolistic competition. In such a situation, through regulatory restrictions the state has to prevent that competitors are squeezed out of the market. For this very reason, in Germany a regulation agency has been founded in order to monitor the market and to set price ceilings for tele- and communication services. At the moment German Government provides the legal base to include in the agency's responsibility the energy- and gas- regulation, too.

3.7 Redistribution and Economic Development Promotion

In the discussion up to now, public sector activities have mainly been justified on efficiency grounds. A big part of public expenditure in EU Member States however goes to households in the form of transfers and to companies in the form of subsidies.⁸ Transfers to households serve distribution purposes. Subsidies to companies however are part of economic development promotion. In real-life budgetary policy, expenditures for economic development promotion are by far the biggest group. This contradicts the logic of a market economy. If at all, measures to spur the economy can be taken temporarily only, and they serve their purpose if they can be abolished soon. If such measures are persistently taken, they maintain structures that are economically not competitive and induce high welfare losses. The EU's Common Agricultural Policy is surely a warning example in this context. Roughly 50 percent of the yearly EU budget of around 100 billion Euros are used to

subsidise European agricultural products, i.e. to bring their cost prices down to world market level. This long-term “promotion of competitiveness” of European agricultural producers is, without any doubt, an immense distortion of free market competition, which induces huge welfare losses European consumers

Other examples of economically ridiculous subsidisations are the tobacco production in Europe or the hard coal output in Germany. The former is even more contradictory insofar as the state simultaneously aims at preventing tobacco consumption through high tax rates. The latter is ecologically highly counter-productive. Both examples have in common that a discontinuance of the production subsidies by directing those payments directly to households engaged in the production process are budgetary neutral, but amount to higher-than-average yearly household incomes⁹. At the same time, this solution would create welfare gains by removing price distortions

Those few examples make clear that especially public expenditure for economic development promotion has to be watched like a hawk. However, there is another, “invisible” expenditure category: the tax breaks. In this context, we talk of tax expenditures, as tax breaks are nothing but a renouncement of tax revenues. In Germany, federal tax expenditures amounted to approximately 6.4 percent of federal tax revenues in 2002.

Table 1 illustrates with the example of the German federal budget for the budget year 2002 that in many fields expenditure directed to transfers and subsidies characterizes the overall expenditure.

4. HOW TO MEASURE THE SIZE OF THE PUBLIC SECTOR?

The size of the public sector can be measured in terms of the expenditures of the state. These expenditures can be classified either according to the scope of functions of the state as is indicated in Table 1 for the case of the German federal budget or according to the type of expenditures. Both classifications, however, lead to

Table 1: The magnitude of the federal budget Budget year 2002 in Billion Euro
Social Security
hereof:
1. Social Insurance Contributions
2. Labour Market
3. Family Benefits
4. Residential Payments
5. War Victims' Support
6. Social Policy Measures in the area of
7. Other Social Policy Expenditures
Defense
Consumer Protection, Food and Agriculture
1. Community Tasks (Federal Government)
2. Other Expenditure for Agriculture
Economic Development Program
1. Energy
2. Other sectoral promotion
3. Small and Medium-Sized Enterprises
4. Regional Economic Development
5. Warranties etc.
Transport
hereof:
1. Railways
2. Highways
3. Transport Facilities in Municipalities
4. Waterways
Construction
1. Housebuilding and Urban Development
2. Relocation of Parliament
Research, Education and Science
1. Science, Research and Development
2. Universities
3. Promotion of Apprenticeship
4. Professional Education and Training
5. Cultural Affairs
Environment Protection, Health and Consumer Protection
Internal Security
Economic Cooperation and Development
General Public Expenditure
hereof:
1. Interest Payments
2. Retirement Payments
Total Expenditure
Source: BMF (2002) and own calculations

the same result if all public budgets are integrated in a unified budget. Such a budget contains the expenditures of the federal government, of the states and the local authorities (after internal consolidation). There are also considerations in favour of integrating the social security budget into the unified budget. When setting the total of public sector expenditures in relation to the GDP this will result in the government expenditure ratio which indicates the percentage of total expenditures of an economy that is realized in state responsibility per year. As mentioned at the beginning, this government expenditure ratio is with around 50 percent, astonishingly high in most European states. When eliminating the social security from total expenditures and considering these payments rather as “social security contribution” than as “social security tax” this will result in a “narrow” government expenditure ratio of 30 percent for Germany instead of 50 percent. In the international context, this narrow ratio is much more representative as there are huge differences in the financing and the level of coverage of the social security systems in different countries. When regarding the narrow government expenditure ratio it is possible to judge independently from demographic influences, whether a public sector has expanded or decreased over the years. The example of Germany shows that the actual amount is around the same level as it was in 1965. Nevertheless, there have been substantial increases and decreases in the last decades. These movements correlate with different governments and their specific preferences for market or non-market activities.

Unfortunately, conventional budget expenditures can convey a misleading impression of the extent to which a society’s resources are under government control. There are at least two reasons for this, the existence of off-budget items and hidden costs of government¹⁰.

The aspect of off-budget items contains all state-owned companies and participations in private companies held by the state. The second aspect of hidden costs of government contains all those regulatory activities of the state which do not directly affect state expenditures, but which result nevertheless in high costs for those who have to adapt to the regulations. So, over-regulation and an extensive bureaucracy for example lead to hidden costs because growth is hampered and at the same time private resources are bound inefficiently. These two examples illustrate that the question

of the size of the public sector can easily be answered when considering formal or fiscal criteria only. An economically satisfying answer though would need to integrate into the government expenditure ratio the share of economic resources the private sector can not dispose of. Without going into the details of this question here, we can assume that the use of such a government expenditure ratio would enlarge the difference in the comparison between Europe and the USA even more.

If one tried to measure the size of the public sector by the number of state employees this would be misleading as well. In the transition process the number of state employees might be a useful indicator for the success of the restructuring process towards a market economy. Nevertheless, the real role of the public sector could only be measured if the resources bound in publicly used labour were weighted by their productivity. The actual number of government employees as well as their remuneration need not be a sufficient indicator for this.

So far, we have referred to the public expenditure side for measuring the size of the public sector. Of course, we could also consider public revenues as a basis for this measurement.

Table 2 shows the structure of the German Unified Budgets of the year 2002 in aggregated form. The (fiscal) size of the public sector can also be measured as the sum of the ratio of tax revenues to GDP, the ratio of the social tax to GDP, the ratio of special revenues (e.g. revenues from privatisations, profit of the Bundesbank) to GDP and the ratio of the deficit to GDP.

Table 2: Structure of the German Unified Budget for 2002 in percent of GDP (and rounded values)			
Expenditures	Percentage to GDP	Revenues	Percentage to GDP
Federal, States, and Local Budgets	30	Taxes	20
Social Security	20	Social Security	20
		Capital Budget, and others	7
		Deficit	3
Σ	50	Σ	50

Source: Own calculations

From the viewpoint of the revenue side the financing problems of public budgets can be outlined. The German ratio of tax revenues to GDP in 2002 is one of the lowest since 1949 and in 2002 it was the lowest in the whole of Europe as well. Consequently, the ratio of the deficit to GDP still was 3 percent although there has been a very high ratio of special revenues to GDP of 7 percent. This example makes clear that a low ratio of tax revenues to GDP does not at all give an indication of the burden levied on the private sector or of the degree of the role of the state in the economy. Essential for the determination of this burden are the hidden costs which are caused by growth hampering regulations. And it is this hidden costs problem which is responsible for the situation that Germany has the lowest rate of economic growth in Europe at the moment. Consequently, an economic policy which aims at reducing the size of the public sector by tax breaks only will therefore have no impact on the origins of the growth problems.

There are two conclusions we can derive when summing up this chapter's results. On the one hand, the size of the public sector implies in economic terms the degree to which the state claims economic resources. On the other hand, this degree can certainly not be measured by regarding the total revenues of the state. When measuring this degree by regarding the expenditure side, it is essential to integrate all off-budget items to attain a more realistic result.

5. PUBLIC SECTOR DEVELOPMENTS IN WESTERN BALKAN COUNTRIES

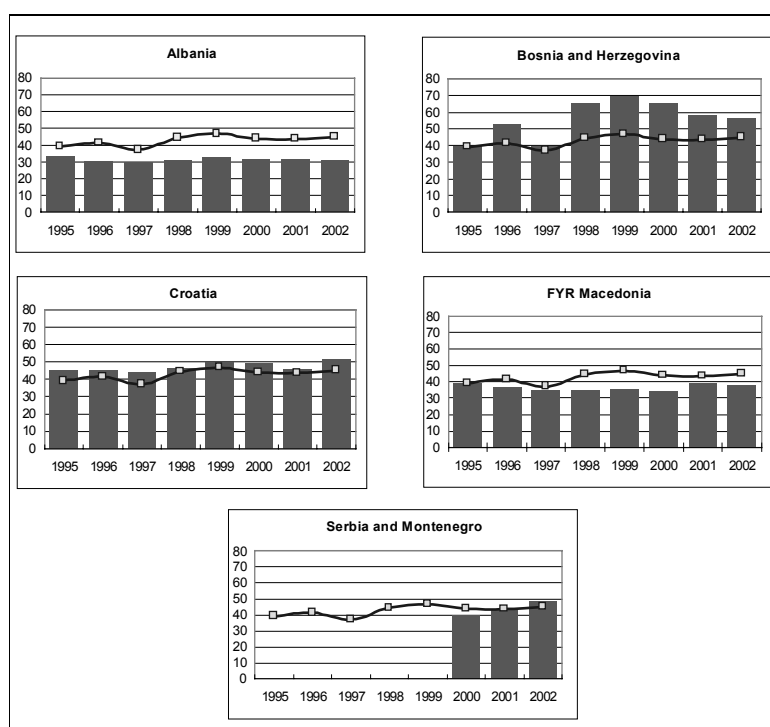
In Albania general government expenditure (which includes the state, municipalities and extra budgetary funds) in the time bracket from 1995 to 2002 is comparable to the German case if measured by the definition of the narrow government expenditure ratio to GDP as table 3 shows. Moreover, this relationship is a relatively stable one in the whole time period, and at the same time the lowest in comparison to Bosnia and Herzegovina, former Yugoslavian Republic of Macedonia, and even Croatia.

As table 4 shows, the fiscal deficit before grants, however, is with 7 to 8 percent more than average. This can be explained by a poor situation in receiving own revenue by taxation and privatisation proceeds. Compared to the beginning of the transformation process the situation has improved a lot, but in comparison with other Western Balkan countries the Albanian fiscal deficit problem is the worst.

Interpreting this point in the light of output growth of the Albanian economy, which slowed down from 6.5 per cent in 2001 to 4.7 per cent in 2002 – but was and still is the highest one compared to other Western Balkan Countries – the bad performance of the general government fiscal deficit shows even more that the problem originates from a badly functioning tax system.

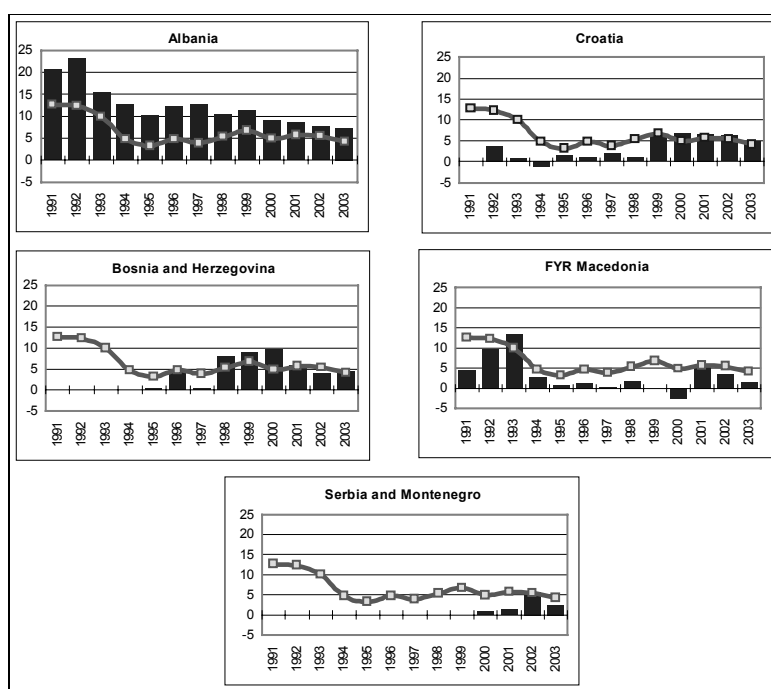
Fiscal deficits add to general government debt and as we see from table 5 in 2002 Albania has a debt ratio to GDP of nearly 65 per cent which is higher than the Croatian one which is around 57.5 per cent in 2002. This is the bad interpretation of the data compared. The good one is, that, where the debt ratio in Croatia steadily increased, the Albanian one remains relatively constant.

Table 3: General Government Expenditure in Western Balkan Countries and (unweighted) arithmetic mean 1995 – 2002 (in per cent of GDP) ¹¹



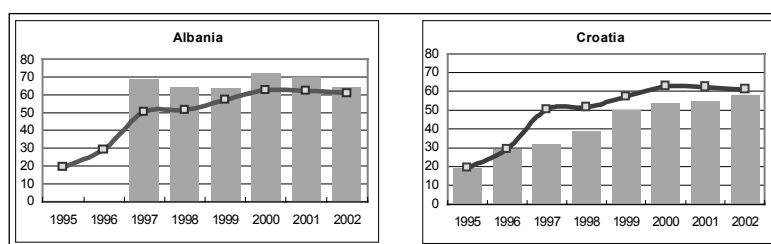
Source: EBRD (2003), Transition Report Update May

Table 4: Fiscal Deficit before grants in Western Balkan Countries and (unweighted) arithmetic mean 1991 – 2003 (in per cent of GDP)¹²



Source: EBRD (2003), Transition Report Update May

Table 5: General Government Debt in Albania and Croatia and (unweighted) arithmetic mean 1995 – 2002 (in per cent of GDP) ¹³



Source: EBRD (2003), Transition Report Update May

6. CONCLUDING REMARKS

Economists know that government expenditures and the share of GDP governments spend are not the right criteria to judge whether the public sector in a certain country is too small or too big. The deciding factor is to compare the benefits of government expenditures and the cost of financing that spending, including the deadweight losses associated with the method of financing that spending.¹⁴

Tax financing involves two burdens, the burden of the tax itself and the excess burden resulting from tax distortions. The first burden cannot be avoided, and the second one can only be reduced through an intelligent taxation with wide tax base and low marginal tax rates. Debt financing by contrast doesn't involve the first burden, but only the second one by limiting future taxpayers' options to choose. As costs arising from that can be transferred to the future, governments are typically tempted to act in a myopic way. That's the reason why this way of financing is normally limited by regulatory restrictions.

Apart from the costs of financing and the utility of expenditure programmes there is a third category: the hidden costs of government that arise from regulation. Those hidden costs are difficult to measure, but one can assume that they are considerable.

Hence, what is the essence of a good public sector policy? It is to limit public expenditure to the core areas of public activity, i.e. financing public activities with low tax rates and wide tax bases, borrowing only to the extent of public investment expenditure and a rigorous reduction of restrictive regulations.

ENDNOTE

¹ The authors thank Jörg Lackenbauer, Björn Saß, and Julia Bersch for helpful comments and research assistance.

² World Bank (1997, p. III).

³ As public sector debt financing is done without limiting the sovereignty of those who purchase bonds, one could conclude that debt financing is the most adequate instrument in market economies. This however is not the case, because (long-term) public bond financing contracts are entered into without taking account of third parties affected (i.e. future generations).

⁴ The expenditures of all territorial authorities including the social insurance systems accounted for 48.6 percent in Germany in 2002.

⁵ In Germany, the yearly expenditure for public investment is calculated to meet the requirements of Article 115 of the German Grundgesetz, which prescribes that yearly net borrowing must not exceed the expenditures for public investment.

⁶ In 2002, GRV's expenditures amounted to approximately 230 billion Euros, i.e. around 13 percent of GDP.

⁷ For 2003, general government payments to GRV of 77 billions Euros are already put aside.

⁸ In Germany in 2001 the total volume of transfers and subsidies amounted to approximately 6 percent of GDP, see BMF (2001).

⁹ In 2000, the subsidisation of German hard coal output amounted to approximately 70.000 Euros per employed person (!).

¹⁰ For this aspect see for example Rosen (1992).

¹¹ The data for 2002 are estimates. The development of the general government expenditures for each country is represented by the columns and the arithmetic mean by the bold line.

¹² The data are estimates for 2002 and projections for 2003. The development of the fiscal deficit before grants for each country is represented by the columns and the arithmetic mean by the bold line.

¹³ The data for 2002 are estimates. The development of the general government debt for each country is represented by the columns and the arithmetic mean by the bold line.

¹⁴ See Feldstein (1996).

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WHEN IS TRANSITION OVER? THEORY VERSUS REALITY IN ALBANIAN CASE

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Auron Pasha

Note

Doing a presentation with such a title is not an easy thing. The theme is very broad and actually has to do with every aspect of the reforms in Transition. As such it is impossible to cover those aspects in one presentation. Our aim with this presentation is to open a debate in this distinguished forum about the Question “When is Transition Over?”. In this regard we will try to discuss some aspects of the reforms in transition, by adopting a somewhat defined framework.

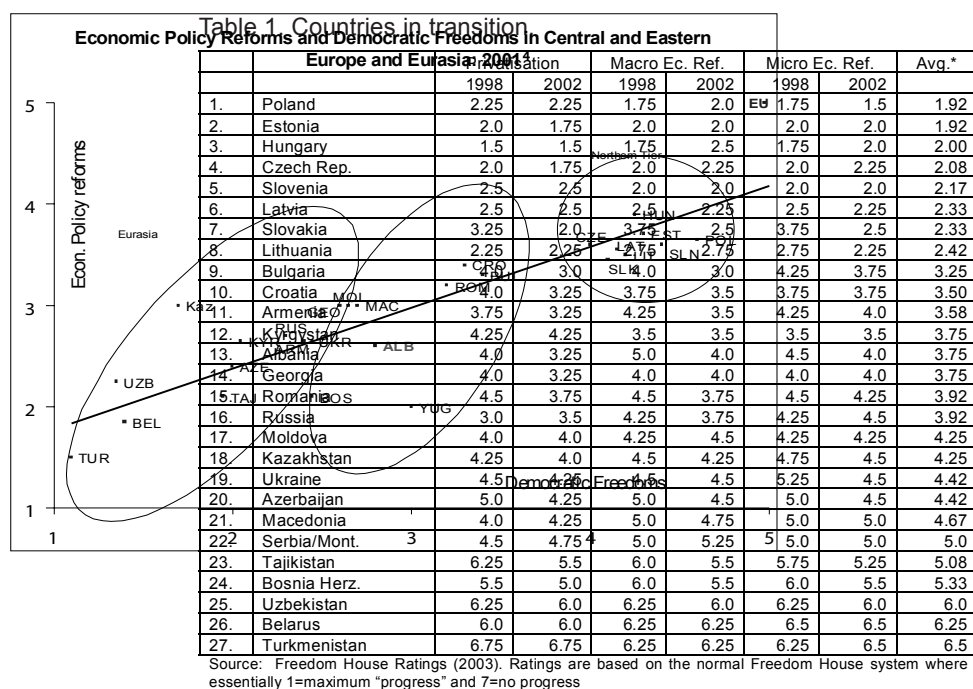
CAN THE QUESTION BE ANSWERED?

One of the famous economist of our times Joe Stiglitz wrote that Transition from socialist regimes to market economies is one big experiment. Considering it such, means that something is being tested. Apparently in this experiment what is being tested are the methods and the ways to get to the result while the result is known—full-fledged market economy. So the debate is actually about the ways to get to the result. After more than a decade of changes and reforms in transition countries, an obvious question arises. When is transition over? Transition – as the name suggest is meant to end at some point in time. Is it any more transition or development?

Many researchers have asked the question of “end of Transition” and tried to give answers. Sometimes their answers just added to the confusion about what the end of transition is exactly defined by. What is the end of transition measured by? Many efforts have been directed to build indicators, which will define the status of the development in transition. Some of these indicators are qualitative and some others are quantitative. The use of these indicators is important on judging about the progress and problems but we should also state that sometimes these indicators just confirm what you can easily “see without the need of a guide”¹. Sometimes anecdotal indicators can tell you much better where a country stands. Such an indicator that fits Albania is the time to pass the immigration counter at the airport². If we translate this indicator for the purpose of this presentation we can say – the shorter the time the closer a country is to the end of transition. And we can say that there is quite a reduction of time to pass the immigration counter in Rinas Airport in the last years.

In order to measure transition progress EBRD has a rating scheme of transition indicators. Based on this scheme the economic reform indicators are grouped into stages. The first stage reforms consist of liberalization of prices, trade liberalization, small-scale privatisation and the establishment of key commercial laws. In the second stage³ the reforms are bit more complicated. Large scale privatisation, enterprise restructuring, competition policy, financial sector reforms (including banking and capital markets), infrastructure and the effectiveness of key commercial laws. The idea of these indicators is to measure the progress of reforms but also in way that can be compared with a market economy benchmark.

Freedom House also has a rating scheme for three dimensions of economic reforms in transition countries (Privatisation, Macroeconomic reforms and Microeconomic reforms)



There are also popular models that try to estimate the time the countries of Central and Eastern Europe need to catch up with Western European development levels by using a standard growth regression framework, according to which GDP growth depends on factors that have proved to be significantly related to economic growth in a number of cross-country studies (e.g. school enrolment, investment to GDP ratios, initial GDP)⁵. However as rightly pointed out by several economists these models assume that developed market economies and transition economies have the same response to signals (meaning that markets are structurally the same). This is in fact the question related with the end of transition.

Others assess the “distance” of the CEECs from Western market economies in terms of macroeconomic variables such as inflation and budget deficits. These indicators are, however, usually not the ones that unambiguously characterize a market economy. Again others examine the difference between CEECs and EU member countries with regard to several more fundamental indicators such as infrastructure.

In order to answer the Question “Is transition over” perhaps we should answer the question “Has central planning under communist rule left a legacy that, even after more than a decade of changes, distinguishes post-communist economies (in this case Albania) from other countries in the world with a comparable income per capita?” (M.Suhrcke)

EU INTEGRATION PROCESS ... MEASURING THE END

We will try to approach the “end of the transition” problem by adopting a certain framework. And in this case such a framework seems to be EU Integration process. The answer to the question “When is Transition over” would be – When Albania becomes a member of EU. It sounds easy but still without any detail of the process. We will elaborate further down what does this imply for Albania.

Before we get into the details of the process there is one issue to clarify. Does the entry of Albania to EU mark the end of transition? From theoretical point of view a country may be a market economy and still not a member of EU. So the end of transition may arrive earlier than the accession but the idea is that once you are a

member of EU the question is not any more relevant. A country that is a member of EU can hardly still be a transition economy.

EU Accession Candidates must fulfill (referred to as “Copenhagen Criteria” include the following:

- Political – The achievement of Stability of institutions guarantying democracy, the rule of law, human rights and respect for the protection of minorities:
- Economic – The existence of a functioning market economy, and the capacity to cope with competitive pressure and market forces within EU
- Administrative – the ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union.

For the sake of this presentation we will group these criteria into two groups Economic, and Governance (Political and Administrative).

ECONOMIC CRITERIA

What does it mean to have a functioning market economy in place? According to these criteria as set in Agenda 2000 the existence of a functioning market economy requires that prices, as well as trade, are liberalized and that an enforceable legal system, including property right is in place. The performance of a market economy is enhanced by the consensus about economic policies and by the macroeconomic stability. A well-developed financial sector and the absence of any significant barriers to market entry and exit improve the efficiency of the economy.

- Price liberalization – Albania has achieved a high degree of liberalization. The only issues to be cover in this area are those related with number of infrastructure utilities products such as energy, water, telecommunication etc. Some of these prices are being decentralized (such as water) but full liberalization of prices of utilities need careful treating.
- Trade Liberalization - Albania is now a member of WTO which suggest that trade liberalization is a matter “passed exam”. However the Trade liberalization has as objective

to provide a solid ground for more economic growth fuelled by export growth.

When trade liberalization is not followed by export supply this does not mean that TL is ineffective. Often it means that TL has only partly been implemented. (Export promotion actions are often absent or limited). The work on this area has already started.

Also trade liberalization forces the economy to concentrate on those sectors with competitive potential. From the point of view of the question posed in the beginning of the presentation we can also say that an economy where the organization of production has not yet reached long-term market equilibrium is still in transition. (Annette N. Brown, 1999). It does not mean that the organization of production stops changing, but that the structure of production only slowly changes with the evolution of economy. The economy is still in transition when the industries are still significantly reshaping themselves. Signs of consolidation of the structure are seen during the last years but there is still some way to go.

• **Macroeconomic Stability**

Albania has reached a satisfactory stage of macroeconomic stability. Growth performance has been strong during the last years. (It should be said though that growth estimates are not very reliable since official national accounts do not exist yet, and the official growth estimates cover only inadequately private and informal sector). Remarkably inflation has been declining and reached a end-figure of 2,1 % in 2002. (Average inflation was 5,4%⁶) The question here how sustainable is this macroeconomic stability. There are several challenges in this regard. An energy problem has appeared to be lately another problematic issue that impedes sustainable growth. The first effects of the energy crises were seen in the lower growth rates for 2002. Apparently there are improvements in this area during this year but the problem has not yet been fully resolved. Low level of investments, the tendency for the decreasing of the remittances and foreign financial support are also challenging factors. On the other hand the level of GDP per capita remains one of the lowest in the region (reaching the level of 1521 USD per capita in 2002). All these are issue to be faced in the process of integration to EU.

- **Property rights**

Property rights in place are crucial elements of a functioning market economy. The enforcement of property rights in Albania remains still difficult. Although there is improvement in judicial reforms still the confidence of people to judiciary, as a guarantor of reliable enforcement is weak. Intellectual property rights unfortunately remain largely unknown in Albania. Problems are related with legislation but also as always with enforcement. Apparently the most clearly defined market seems to be the housing market although even here there are still problem with registration offices. However it seems that this market is working well. While land market is something that still needs intervention. This market is not working properly especially that related with agriculture land because the property rights are not yet clearly defined. The restitution or compensation process has not finished and until then this market will be stuck. Land registration system is not yet finalized. This is considered a serious impediment to increasing productivity in agriculture.

- **Privatisation**

Albania is considered a country that has finished small-scale privatisation. The challenge for the moment is continuation of the strategic privatisation process with AlbTelecom, INSIG and Savings Bank, Oil industry, energy sector, water sector etc. There is still a pending issue that relates with the Mass Privatisation program though, with the voucher scheme. This scheme can be considered a failure⁷ and this issue is still unresolved. (We can here remember the slogan for the enterprise privatisation which came from IFIs– let the market decide the value” while THERE WAS NO MARKET in place).

- **Financial Sector Development**

Banking sector has made quite some progress during the last years. However the development has been mainly quantitative. It is easy to have sound banks, banks that do not loose money because of bad loans – Simply require them to invest in Treasury bills. The challenge is not to create sound banks but sound banks that provide credit for growth.

For the last year in Albania the credit to economy was only 7,2 percent of GDP as opposed to 40% average of East and Central Europe⁸.

In an interesting EBRD paper prepared by Steven Fries and Anita Tacit it is calculated the ratio of Total Private Sector credit to GDP and the Market economy benchmark which means this ratio for a country with market economy and similar level of development measured by GNP per capita (on PPP basis)⁹

Table 2. Market economy benchmark

	1994			1999		
	Ratio of Total Private sector credit to GDP	Market Economy Benchmark	Distance from the Benchmark	Ratio of Total Private sector credit to GDP	Market Economy Benchmark	Distance from the Benchmark
Croatia	31.5	39.4	7.9	38.5	46.9	8.4
Czech Republic	76.6	58.1	-18.5	61.4	63.5	2.1
Estonia	15.4	39.5	24.1	35.8	48.7	12.9
Hungary	26.2	49.6	23.4	25.7	56.8	31.1
Latvia	18.4	35.6	17.2	16.5	42.0	25.5
Lithuania	20.0	36.7	16.7	13.9	43.8	29.9
Poland	18.6	44.9	26.3	28.8	54.2	25.4
Slovakia	43.3	49.4	6.1	56.5	58.1	1.6
Slovenia	23.3	61.1	37.8	37.0	69.1	32.1
Albania	5.7	25.0	19.3	3.9	30.7	26.8
Bulgaria	49.3	41.7	-7.6	17.9	42.1	24.2
FYR Macedonia	45.3	34.2	-11.1	22.7	36.2	13.5
Romania	19.1	38.9	19.8	10.7	40.4	29.7

Source: Paper "Banking Reform and Development in Transition Economies" by S. Fries and Anita Tacit.

COMPETITION POLICY

The benefits of private sector development are linked with the role of improving allocative and productive efficiency. Having this in mind, economic reforms such as trade and financial liberalization, privatisation etc. have been always considered as tools of stimulating competition and promoting greater economic efficiency.

The competition policy is much more than Competition legislation. Competition policy is a set of measures and instruments where privatisation, restructuring, deregulation, liberalisation, foreign direct investments, are included as well.

Although efforts have been undertaken recently on preparing the competition legislation, harmonised with the European legislation in the field (the new law "On the Protection of Competition" has

been approved by the Albanian Parliament on 28 July 2003), the enforcement of competition policy in Albania still needs to be improved. The new law lays the foundation for establishment of an Independent Competition Authority. Now, the main objective is to make this structure fully functional and operational. (Coordination of this structure with other regulatory bodies is indispensable for introducing pro-competitive policies in the regulated sectors)

Market entry has improved significantly, but still there are issues, such as licensing procedures or other administrative barriers, which need to be addressed. While market exit is not functioning properly. There is only a negligible number of firms that have declared bankruptcy, even though a law according to international standards "On bankruptcy" has been approved last year. Insolvency procedures need to be improved and judicial system needs to seriously cover the issues in this area.

Another issue related with competition is Informal Economy. The issue is very complex and cannot be seen only from one angle but we are all aware that informality has negative impacts from the competition point of view with formal private sector development. Informality in the economy on the other side is a proxy measure of the efficiency of state structures. Although we lack the data for measuring informal economy (better said we still lack the consensus about an accepted methodology) the figures from different institutions show that informal economy is around 30% (INSTAT) to 60 percent (IFIs assessment). This is apparently a challenge to be faced in the coming years.

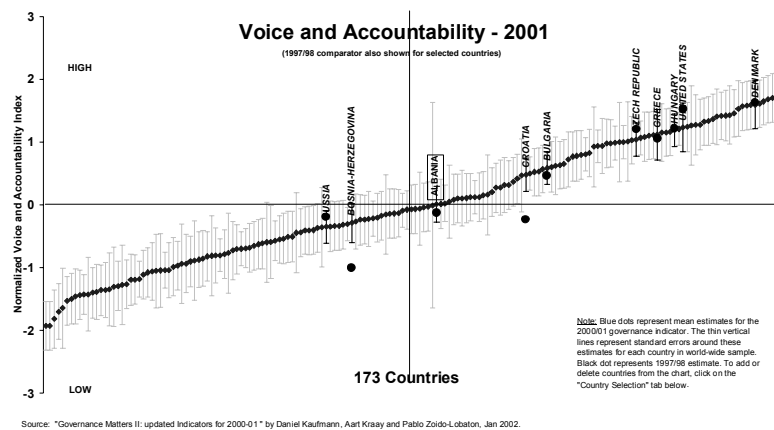
GOVERNANCE CRITERIA

Effective economic reforms are very closely linked with good Governance. Plenty of indicators have been built about the governance issues. However we can still say that the efficiency of state institutions is not easily measured.

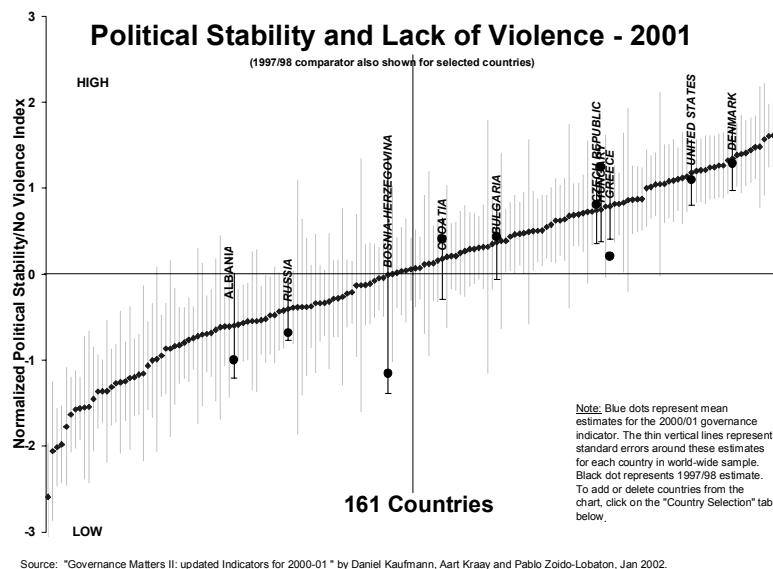
To illustrate the issue of governance for Albania we would like to present here some governance indicators (Albania included) which were constructed in a research Project¹⁰, of Daniel Kaufmann, Aart Kraay and Pablo Zoido-Lobaton. Their work consists in building aggregate indexes of governance for six broad concepts of governance¹¹ divided in three groups.

The first group of aggregated indicators aims at evaluating the process by which those in authority are selected and replaced. Two indicators comprise it:

1. **“Voice and Accountability”**¹² – which includes a number of sub indicators measuring various aspects of political process, civil liberties and political rights. All these indicators measure the extent to which citizens of a country are able to participate in the selection of governments. In this category are also included indicators measuring the independence of media, which has an important role in monitoring those in authority and holding them accountable for their actions.



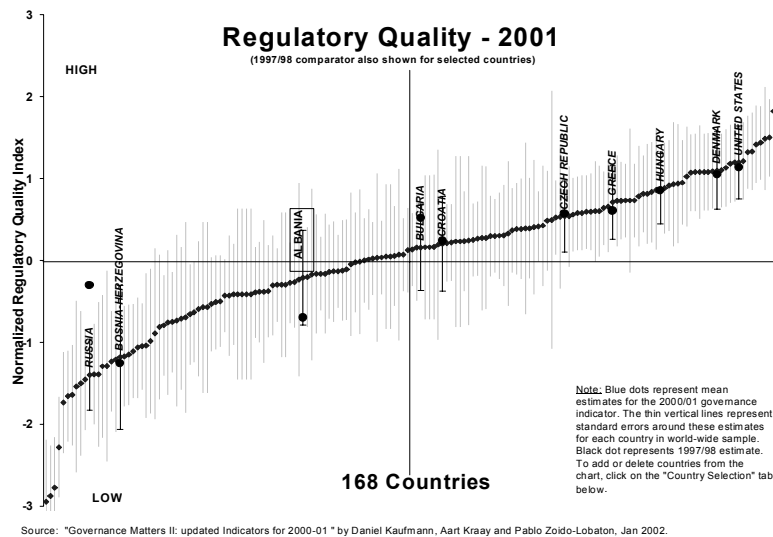
2. **“Political Stability”**. In this index are combined different indicators, which measure perceptions of the likelihood that the government in power will be destabilized or overthrown by violent or unconstitutional means. This index captures the idea that the quality of governance in the country is compromised by the likelihood of violent changes in the government, which not only has a direct effect on the continuity of policies, but also a deeper level undermines the ability of all citizens to peacefully select and replace.



The second group of indexes is comprised by several indicators, which measure the ability of the government to formulate and implement sound and effective policies.

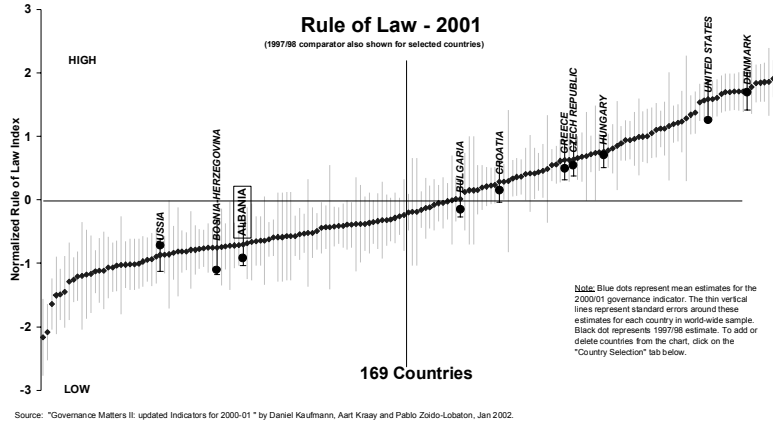
3. **"Government Effectiveness"**. In this index are combined the perceptions of the quality of public service provision, the quality of the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures, and the credibility of the government's commitment to policies into a single grouping.

4. **"Regulatory Quality"** is more focused on the policies themselves. It includes measures of the incidence of market-unfriendly policies such as price-controls or inadequate bank supervision as well as perceptions of the burdens imposed by excessive regulations in areas such as foreign trade and business development.

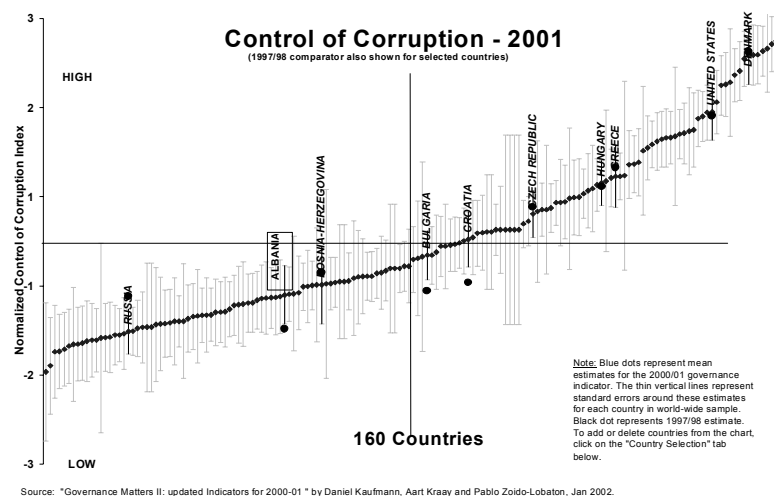


The last group summarizes in general terms the respect of citizens and the state for the institutions, which govern their interactions.

5. **Rule of Law.** In this index are included several indicators which measure the extent to which agents have confidence in and abide by the rules of the society. These include perceptions of the incidence of both violent and non-violent crime, the effectiveness and predictability of the judiciary, and the enforceability of contracts. In a single sentence this index reflects the success of a society in creating and environment in which the fair and predictable rules of the society form the basis on economic and social interaction.



6. **Control of Corruption.** This index measures the perception on corruption, which conventionally it is defined as exercising public authority for private gains. Existence of Corruption manifests a lack of respect from both the corruptors and the corrupted towards laws and rules and hence represent a failure of governance.



Perception versus reality.

In the issue of "end of transition" we cannot neglect the issue of perception. How are we perceived for the progress of reforms? Perception changes slower than the reality. The best example we would like to bring here is the Index of Economic Freedom from Heritage Foundation/Wall Street Journal indicators. The Index measures how well 161 countries score on a list of 50 independent variables divided into 10 broad factors of economic freedom. The higher the score on a factor, the greater the level of government interference in the economy and the less economic freedom a country enjoys. These 50 variables are grouped into the following categories:

- Trade policy
- Fiscal burden of government
- Government intervention in the economy

- Monetary policy
- Capital flows and foreign investment
- Banking and finance
- Wages and prices
- Property prices
- Regulation
- Black market (2003)

Each factor is scored according to a grading scale that is unique for that factor. The scales run from 1 to 5: A score of 1 signifies an institutional or consistent set of policies that are most conducive to economic freedom, while a score of 5 signifies a set of policies that are at least conducive. The four broad categories of economic freedom in the Index are:

- **Free** – countries with an average overall score of 1.95 or less
- **Mostly Free** – countries with an average overall score of 2.00 to 2.95;
- **Mostly Unfree** – countries with an average overall score of 3.00 to 3.95; and
- **Repressed** – countries with an average overall score of 4.00 or higher.

Table 3. Individual factors.

Individual factors	Score
Trade Policy	5
Fiscal Burden of Government	3.5
Government Intervention	3
Monetary Policy	2
Foreign Investment	2
Banking and Finance	3
Wages and Prices	2
Property Rights	4
Regulation	4
Black Market	5

Taking into account the fact that with the initiative of Bush Administration for the Millennium Challenge account this index will be one of the measures to decide how good a country is doing in implementing reforms, this is certainly an important index to look at. Most of the indicators here seem to accurate but we have our

reserves for several of them. Especially for the indicators referring to the trade policy. Due to the index Trade Policy in Albania is rated at scale 5 meaning – Very High Level of protectionism. The measurement is mainly based at average tariff rates and than adding the evaluation about Non-tariff rates. Based on this methodology the conclusion of this index is wrong. Albania is a member of WTO and as such is subject to tariff rules this organization imposes on its members. Also based on the methodology and the data the average tariff rules for 2000 and 2001 are respectively 10,4% and 7,87%¹³. As a consequence Albania should get a score of 3 for 2000 (moderate level) and 2 for 2001 (low barriers. If we count NTB than maximum Albania would get is 3 for 2001.

This is just an example to show that sometimes indicators are not correct and they have impact on the perceptions for the progress of the country.

CONCLUSION

This presentation was not an exhaustive list of all actions that Albania needs to take in order to “end transition”. Rather it was picture of major reforms based on a framework that to our opinion fits best the aims of Albania for the future. The objective of this presentation was to present the EU integration process as a “measurement process “ of progress of the reforms that define the stage of a country in transition.

Coming back to the question of transition end we believe that this question should be answered – ONCE ALBANIA IS PART OF EU. The issue is not that it defines the end of transition but once a member of EU the issue of “end of transition” is no more relevant. A country may be a market economy and still not be a member of EU, but a member of EU is definitely a market economy.

The question about the end of transition should be linked with the question if the socialist past has left still any legacies that make Albania differ from other countries with comparable income per capita.

If we divide the factors into two groups (Economic and Governance) it is clear that there are still uncompleted reforms in both areas. Their completion is closely linked with the progress towards EU integration.

ENDNOTE

¹ The village that can be seen does not need a guide – Albanian proverb

² Jak Jabes – On the (F)utility of Governance Indicators – ADB 2002

³ There is broad agreement that the second stage is more problematic because the institutional capacity required to implement those reforms is much higher than for the first stage. The second stage of reforms actually has to do with building the capacity of governments to govern. However apparently something that was not said quite often before is being now more loudly mentioned. And this is - the way the reforms were implemented in the first phase (although the phase may be almost completed) had impact in the implementation of the reforms in the second stage. It either accelerated these reforms or delayed them.

⁴ Explanatory notes for the graph. Taken from Monitoring Country Progress – USAID-E&E. Ratings of democratic freedoms are from Freedom House, Nations in Transit 2002 (2002), and cover events through December 31, 2001. Economic policy reform ratings are from EBRD, Transition Report 2001 (November 2001), and cover events through September 2001. Economic policy reforms include price liberalization, trade and foreign exchange, privatisation, legal, banking and capital markets, enterprise restructuring (credit and subsidy policy), and infrastructure reforms. Democratic freedoms include political rights (free and fair elections; governance and public administration) and civil liberties (free media and judiciary; freedom to develop NGOs and trade unions; equality of opportunity and freedom from corruption). Ratings are based on a 1 to 5 scale, with 5 representing most advanced.

⁵ Marc Suhrcke. (intereconomics)

⁶ According to Central Bank of Albania Annual report 2002

⁷ This process was not successful even in other countries of CEE where parameters of the markets were more developed.

⁸ According to Central Bank of Albania. Annual report 2002.

⁹ The authors have calculated the market economy benchmark based on a nonlinear regression of GNP per capita (\$PPP) on ratio of private sector of GDP for a pool of 122 developing and industrialized countries.

¹⁰ "Governance Matters II: Updated Indicators for 2000/01"

¹¹ All six indexes are measured with units that vary from -2.5 to 2.5 where -2.5 is a very low level of the index and 2.5 is a very high level. However it should be said that the error margin of the indexes is relatively large and this is shown in the graphs by vertical lines. These indexes are still subject to further research and improvement but however they show a tendency that is valuable for assessing different policies and reforms in a certain country.

¹² Graphs build by an interactive data interface (selected graphs to be presented)

¹³ INSTAT – General Custom data

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COMMENTS ON: WHEN IS THE TRANSITION OVER? THEORY VERSUS REALITY IN THE ALBANIAN CASE

Genc Ruli

That the transition from communism is largely over, can be seen in the fact that the great debate on its historical interpretation has already begun

However this is a general observation because different countries 12 years after transition beginning are in different distances from the end point.

The denomination “countries in transition” is not used anymore for countries like Poland, the Czech Republic, Hungary and Slovenia, using “countries in post-transition” instead. Some countries like the Baltic States are considered “countries of successful transition”; others like Russia and some former Soviet Union republics are considered countries of “failed”, transition, while Balkan countries are considered of “difficult”, “late” or “interrupted” transition.

Starting from the mid-nineties many transition countries (especially those of the Central and Southeastern Europe) were faced with a new historical perspective: that of joining the European Union. In the later years which were characterized by the European Union enlargement towards the post-communist world, the transition agenda was mixed with that of integration, often the latter becoming more of a priority and desirable for these countries. Different countries are now classified according to the progress they have

achieved towards the European Union integration rather than their transitional stage. The transition countries that are expected to join the European Union in 2004 were recently accorded the status of "functioning market economies". Therefore it is accepted that these countries have successfully completed the package of transforming reforms of the post-communist transition.

Should we think under these new circumstances that the transition process would be over when a country becomes a European Union candidate member or a full member? These two processes only coincide in time but are not reciprocally tied, other than the fact that a European Union member status cannot be given to a country that has not ended the post-communist transition yet. The strategy of the accession into the European Union is not fully attuned with the strategies of transition and development, in a series of issues they lack complementarities, and in some cases they even antagonize each other.

Theoretically, transition is defined as the historical process during which former communist societies undertake radical transformations of the political and economical socialist regime into that of pluralist democracy and market economy. Therefore in the economic aspect during transition the economy is no longer socialist, but not yet fully capitalist.

European Union integration is political and economic membership in the most developed countries group, those of Western Europe that are distinct for their high level of liberal democracy and the largely functional markets and highly competitive economies.

Theoretically and practically the transition process ends when the economic system ceases to transform (from one system to the other) and finally "freezes" into the projected model. After this moment the economic system of the country is no longer in a "transition" system but becomes a "normal" free market system. The ensuing economic policies are no longer transition policies but development and modernization ones.

At the beginning of the nineties researchers and analysts predicted an optimal deadline of ten years for the completion of the economic transformations and about four-five years for the political transformations.

In practice the transition resulted in an extremely complex process characterized by large variations in different countries' performances. Transition results and progress were greatly affected by the specific initial conditions of each country as well as the model followed and the consistency in implementing the reforms.

In many countries the transition process was mixed with events of non-transitional nature such as civil wars, interethnic conflicts or nation-state building.

While transitional countries cannot be considered poor, in too many aspects, many of them (including the Balkan countries therefore Albania) faced the type of problems that are poor countries' characteristics such as weak institutions, increasing inequality, and an incompetent political elite.

Therefore the symptoms of underdevelopment appearing during the transition have brought about a "de-modernization" of our societies which is expressed in the following traits:

- De-industrialization (re-agrarization) of national economies
- Significant presence of informal institutions (pre-modern)
- The weakening of social capital (deepened polarization of wealth, wild urbanization, high corruption, marginalization of social groups, and crime rates rise)
- Impoverishment of the human capital (the deterioration of the educational system, the worsening of the health services and social safety net, "brain-drain" etc.)

The policies that need to be undertaken to face these problems are pure development policies and not transitional ones. Therefore countries like ours must face a dauntingly complex process rather than simply a transition process.

* * *

What is Albania's present transition stage?

Judging from the entire transition reforms' progress indicators, it could be said that Albania has an average progress level (compared with the whole group of transitional countries). The macro-economic situation has been stable for long periods of time; the economy's

privatization scale is high, over 75 percent of the market is almost fully liberalized; the growth rates over the last ten years have been generally high; the economy's trade openness has shown positive trends; the building of the market institutions is partially completed.

It is generally accepted that the transition process goes through three reform stages:

The first stage involves macroeconomic stabilization policies and also many systemic reforms that mark the beginning of passage towards the market economy.

The second stage is the transition's consolidation and management, with an emphasis on institutional and legal reforms that strengthen the market economy's foundations. This phase necessarily requires a competent administration and a strong government.

The third stage in the future will aim at rapid growth and convergence ("catching up").

Today Albania lies somewhere in the middle of the processes of the second stage. Considering the year 1995 as the passage year from the first phase to the second, we note a prolonged stay at this stage and a slow and spasmodic progress in its reforms.

Thus if we agree to accept that Albania has today a market economy, we could not assert that our market economy is "functional." Important weaknesses such as the lack of financial discipline, low transparency and stability of the regulatory framework, inadequate implementation of market rules, an inefficient public administration, an unacceptable judicial system are some the indicators that steer us to this conclusion.

The Albanian economy is still vulnerable, unsustainable and characterized by:

- Unstable external deficit
- High fiscal deficit and soon to be unaffordable
- Problematic agricultural sector
- High unemployment levels and an inflexible labor market
- Insufficient credibility of the banking sector and a generally weak and undeveloped financial market
- Slow and inefficient privatization
- Weak social safety net

The marginal cost of delays the structural and institutional reforms rises with time. Therefore the challenge of expediting the reforms today is many times bigger nowadays than a few years ago.

An important issue contributing to the Albanian transition debate that I would have liked to touch upon is that of economic growth and expected trends.

The high growth rate is an important factor in supporting and facilitating transition reforms but especially during the third stage to ensure the country's economy modernization and convergence ("catching up").

As such the economic growth must be reform-generated, sustainable and long term.

Which are some of the traits that had characterized the Albanian economic growth:

- Our economy's growth rates have been especially high (over 8 percent during the period 1993-1996 and 1999-2000).
- But part of this growth is not the direct effect of reforms, but of the large gap created by the drastic production falls during 1988-1992 and again during 1997-1998.
- This growth is also partially due to external financial flows (which may have affected the GDP by 20 percent)
- At least up to two years ago the high growth dynamics came from a specific advantage of Albania: being an agrarian country (in economic development theory this is called the "advantage of backwardness"). The agricultural sector was developed fast during the last decade promoted only by its liberalization and privatization. The effects of this advantage today have worn out, so much so that the agrarian sector may soon become an impeding factor to the country's growth if it does not go through a deep land reform and is not affected by important investments in technology.
- The economic growth during transition was generally achieved by the "de novo" private sector rather than the inherited state sector (private sector contributes to 70 percent of the GDP). It must be said that the new private

- sector, albeit dynamic, is being developed through an atomized structure (small and very small enterprises) and with a strong informal component, which renders the capital accumulation and market institutionalization difficult.
- The domestic savings and investments rates are still low and coupled with inefficient and non-productive capital allocations. We are far from the optimal capital accumulation standards and especially in the capital and labor productivity.

Therefore it is not difficult to understand that the economic growth achieved during these transitional years, independent of its high rates, is far from being a sustainable long-term growth. Achieving that requires significant increases in capital goods, introduction of new modern technologies, re-industrialization of the national economy and investments in human capital.

If the country will not achieve sustainable growth in a mid-term (five-seven years) it risks remaining imprisoned in the bad path dependency and fall prey to chronic underdevelopment crises.

It must be accepted that at this point the Albanian economy (and all regional economies) lack the necessary sufficient potential to ensure rapid growth and achieve convergence (“catching up”) with Western Europe.

Good economic policies (often lacking) are a fundamental precondition for future success, but not the only sufficient factor. Concrete integration perspective in the European Union and a substantial financial assistance are determinant. The goal of integration in the European Union is more important than the entry itself.

FOURTH PANEL: "MONETARY
POLICIES IN THE REGION"

INFLATION, EXCHANGE RATES AND THE ROLE OF MONETARY POLICY IN ALBANIA

Marta Muço

Peter Sanfey

Anita Taci

ABSTRACT

This paper examines the conduct of monetary policy in Albania during the transition period. We identify various channels through which monetary policy can affect prices and output and we assess their relative importance. Estimates from a vector autoregression model (VAR) of key macroeconomic variables demonstrate the weak link between money supply and inflation up to mid-2000. However, the move during 2000 from direct to indirect instruments of monetary control has helped to strengthen the predictability of the transmission link from money supply to inflation. We conclude by arguing that a move to formal inflation targeting could help promote the transparency and credibility of monetary policy, but that such a move should be introduced only when the country is ready for it.

JEL Classification: E52, P24

Keywords: monetary policy, inflation, Albania

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The views in this paper are those of the authors only and not of the Anteon Corporation or of the EBRD.

1. INTRODUCTION

The performance of the Albanian economy throughout the transition period has been a pleasant surprise to many people.¹ Starting from a very low base in 1991/92, Albania quickly entered on a path of high GDP growth and falling inflation, in conjunction with the first moves towards serious market reforms. These achievements were jeopardised but not permanently reversed by a period of turmoil and near-anarchy in early-1997, when several large pyramid schemes, into which much of the population had put their savings, collapsed.² Since then, the Albanian economy has again enjoyed high annual growth rates and low inflation. This combination has been achieved in an environment where financial sector development is still at an early stage and informal markets are flourishing. Therefore, the role of monetary policy in influencing inflation and growth is inherently limited. Nevertheless, increasing attention is being paid in Albania to the role of monetary policy, and especially to the costs and benefits of introducing new instruments and of moving to more explicit inflation targeting.

This paper has three main purposes. The first is to assess the conduct of monetary policy in Albania during the transition and the extent to which the familiar transmission mechanisms from nominal to real variables have worked in this period. The second is to examine systematically, using time-series econometric techniques, the interactions between several key variables, and the effect that the shift in recent years towards indirect instruments of monetary control has had on these interactions. Finally, the paper assesses whether a move to inflation targeting in Albania is either feasible or desirable.

Section 2 of the paper examines the relevance of four different channels through which changes in nominal variables can affect the real economy: interest rates; exchange rates; credit rationing; and inflation expectations. The influence of some of these channels on prices and output has been limited. The main reason is that financial institutions in Albania are still at an early stage of development and have not been able to play the role that they do in advanced western economies. Indeed throughout most of the period, there is only a weak correlation, or none at all, between monetary aggregates and either inflation or output. Interestingly however, the correlation between money supply and inflation is

much higher from 2000, when the central bank switched from direct to indirect instruments of monetary control. Exchange rate stability and price stability continue to be closely related, suggesting that the exchange rate remains a key indicator for inflationary expectations.

Section 3 explores the correlations among several variables – money supply, inflation, exchange rate, trade balance and migrants' remittances – by estimating a vector autoregression model (VAR). The results point to the stabilising role of remittances on the exchange rate and hence on inflation in Albania.³ They also help to quantify the extent to which shocks to the money supply can explain the variance in inflation after mid-2000, when monetary policy shifted from direct to indirect instruments.

Section 4 explores the merits of having the monetary authorities adopt formal inflation targeting. We argue that such a move could help promote the transparency and credibility of monetary policy, in an environment where financial institutions are becoming more sophisticated. Nevertheless, there are considerable obstacles to the smooth introduction of this policy, not least the lack of reliable statistics and information on current indicators. Section 5 concludes the paper.

2. MONETARY POLICY IN ALBANIA

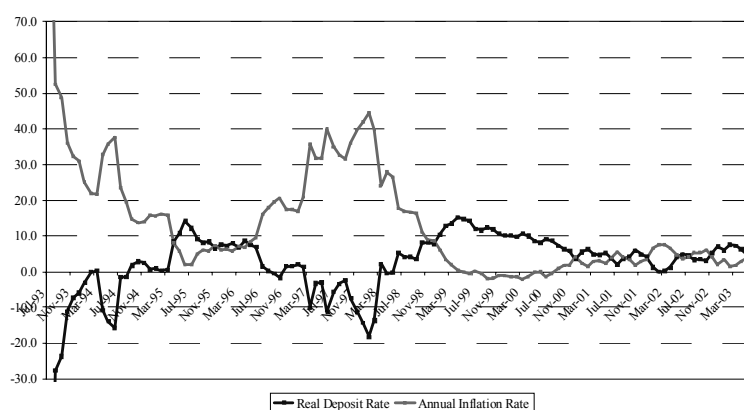
2.1 Background

The collapse of communism in Albania occurred in late-1990 and early-1991, and was followed by a year of economic collapse, social disorder and widespread emigration. The turnaround began in 1992; stabilisation measures were introduced through a one-year reform programme that started in mid-1992. Under this programme, the reduction of annual inflation, which at one point (in Autumn 1992) was running at over 300 per cent, to below 20 per cent was a key objective. Money growth was designed to be the principal nominal anchor of the programme, supported, first, by a fiscal policy that had as a central objective the elimination of monetary deficit financing by mid-1993, and second, by a tight credit policy. A two-tier banking system was also introduced around this time.

Under this programme, which was supported by the IMF and other international institutions, monetary policy was based on direct

instruments of monetary control. This decision was dictated by the poor state of the banking system, the external debt situation and the need to finance the large budget deficit. At the beginning of 1996 some licenses on private banking activity were issued to several foreign banks, paving the way for a real market in that field. It is only recently that the consolidation of the banking system has allowed indirect instruments of monetary control, including the establishment of required reserves, a refinancing window and a liquidity requirement, to replace direct instruments. New private banks have played a key role in encouraging the use of indirect instruments of monetary control and inter-bank competition.

Chart 1: Real deposit rate and annual inflation



Source: Bank of Albania.

The control of interest rates was an important part of Albanian stabilisation policy during the transition. Real interest rates turned positive in the third quarter of 1994 (see chart 1) when inflation declined but they remained under central bank control until the banking system began consolidating and monetary policy moved gradually towards the use of indirect instruments. The Bank of Albania started to eliminate direct control over interest rates at the beginning of 2000. Within a year the three controlled interest rates on 3 months, 6 month and 12 months deposits were removed and replaced with indirect instruments of monetary policy. The effects of these changes are explored in detail below.

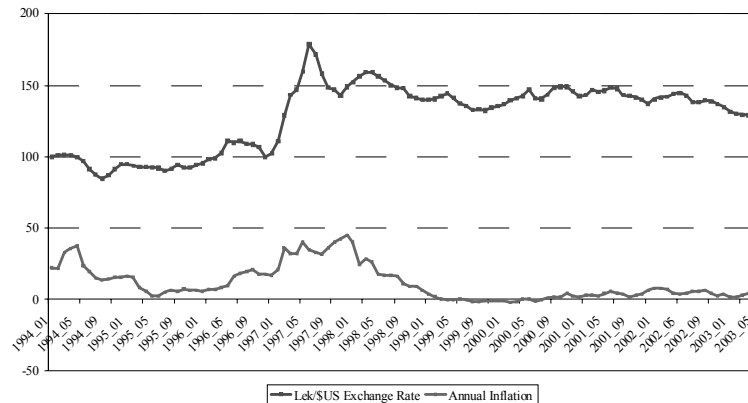
2.2 The transmission mechanism

There are a number of ways in which monetary policy can affect the real economy. Four channels that operate in market economies are through: interest rates; credit ceilings; exchange rate; and inflation expectations. The list is far from complete, but in the Albanian case other channels such as equity prices or housing market are less relevant, at least for now. It should also be noted that the effects can overlap to some extent, as explained more fully below.

As noted earlier, interest rates were under the direct control of the central bank until August 2000. An important indirect effect of interest rates on inflation may have occurred through the effect of high deposit rates on the demand for domestic currency deposits, which in turn helped to maintain or even appreciate the value of the domestic currency, thereby reducing import costs and prices. However, even though banks typically had large excess reserves, the main bank in the country, the Savings Bank, was prohibited from new lending throughout this period. Therefore, the amount of new credit issued in the economy was small and the direct influence of interest rates and credit allocation decisions on the real economy was correspondingly negligible.

The exchange rate channel is perhaps the most promising route for explaining inflationary developments in Albania. Exchange rate stability has in turn been aided by the substantial inflows of remittances throughout the transition period.⁴ As chart 2 shows, there is a clear and strong link between exchange rate stability and inflation.

Chart 2: Correlations between annual inflation and Lek/USD exchange rate



Source: Bank of Albania.

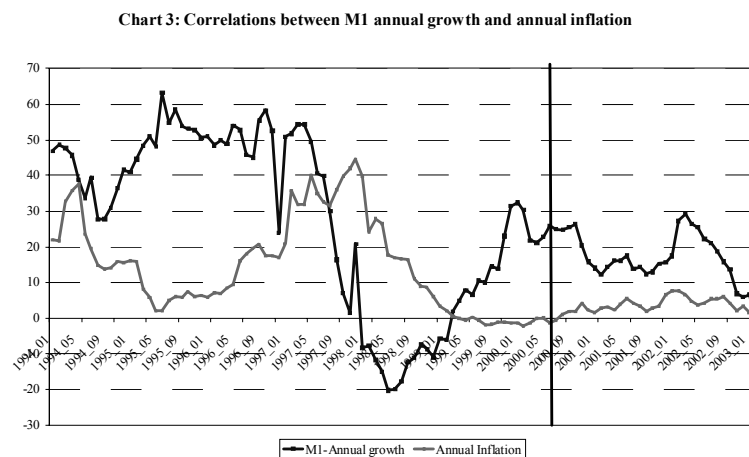
This link is seen most clearly during the anarchic period of early 1997, when both the exchange rate and the inflation rate jumped sharply, only to fall rapidly once the security situation was under control. The extent of the correlation is unsurprising in a relatively open economy like Albania where foreign currency circulates widely, both because of high inflow of remittances from Albanian working abroad and from smuggling and contraband. In fact, empirical evidence in Haderi et al. (1999) and Muço et al. (1999) showed that, for the early transition years (1993-96), the exchange rate and remittances explained much more of the variation in inflation than changes in the money supply do. We test below whether this result still holds true.

The stable exchange rate has undoubtedly played a key role in anchoring inflationary expectations, the fourth channel mentioned earlier. Since 1998, the central bank has been announcing at the start of each year a clear quantitative target for annual inflation, usually within a fairly narrow band (e.g. 2-4 per cent). This increased transparency has also helped monetary policy, especially in light of the relatively successful performance to date by the central bank in achieving this target.

Turning to the relation between changes in money supply and inflation, Chart 3 shows the co-movement between the two variables

from 1994 to 2003. It is clear that there is virtually no correlation up to 2000; during that time, changes in money supply were driven by demand shifts. Sometimes they move in opposite direction, for example in 1994/95, when money growth was robust while annual inflation was falling rapidly to single-digit levels, or in 1997 when money growth declined while inflation rose sharply in the wake of the pyramid scheme crisis.

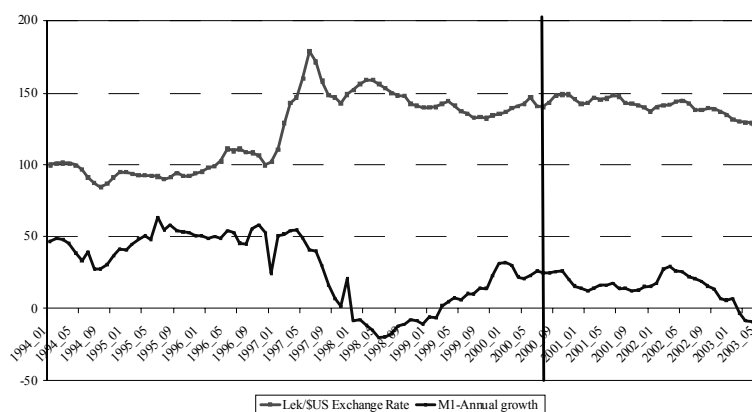
Note: Vertical line indicates September 2000, the time when the Bank of Albania shifted to the use of indirect instruments of monetary policy.



Source: Bank of Albania.

However, a positive correlation emerges after the introduction of indirect instruments of monetary control in September 2000, as Chart 3 shows clearly. This change, which is associated with the shift from direct to indirect instruments, is brought out by the econometric results below. It is also consistent with Chart 4, which demonstrates that there is a clear correlation between the annual growth of M1 and the Lek/USD exchange rate after the introduction of the indirect instruments of monetary policy.

Chart 4: Correlations between M1 annual growth and Lek/USD exchange rate



Note: Vertical line indicates September 2000, the time when the Bank of Albania shifted to the use of indirect instruments of monetary policy.
Source: Bank of Albania.

The relation between nominal and real variables in Albania is difficult to assess, because the main measure of economic activity – gross domestic product (GDP) – is estimated with a high degree of inaccuracy. The statistical coverage of the new, emerging private sector is inadequate, and there exists a large informal sector that probably accounts for at least one-third of GDP.⁵ In addition, GDP is estimated annually only, whereas monetary aggregates such as inflation and exchange rates are available at greater frequency. For these reasons, it would be useful for policy-makers to have available a good proxy for GDP, so that one could get a better sense of the inter-relations among nominal and real variables.

Charts 5-7 show the correlations between real GDP growth and three variables: import of machinery, energy consumption, and net exports. Because of data limitations we correlate data series of different frequencies: annual data on real GDP growth with monthly data on real growth of import of machinery and net exports, and quarterly data on real growth of energy consumption. Charts 5-6 indicate that there is a fairly close correlation between real growth in both import of machinery and energy consumption, and real GDP growth.⁶

Chart 5: Correlations between GDP real growth and import of machinery

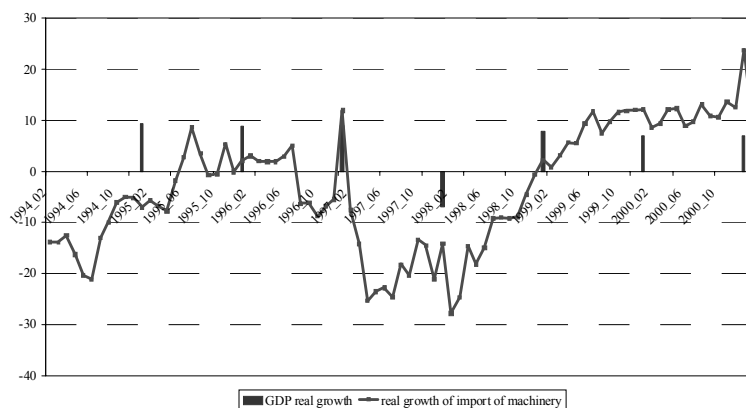
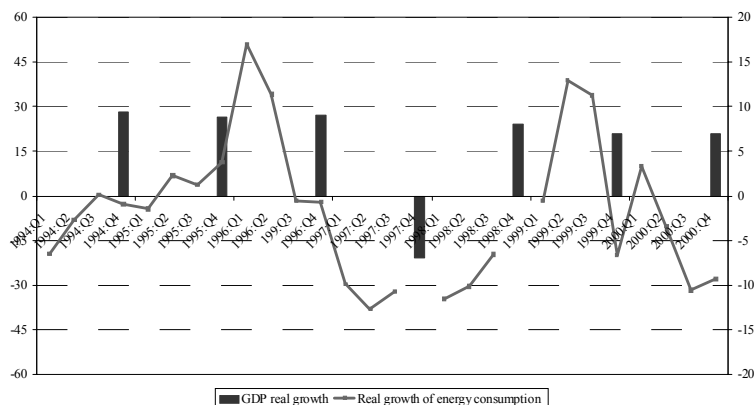
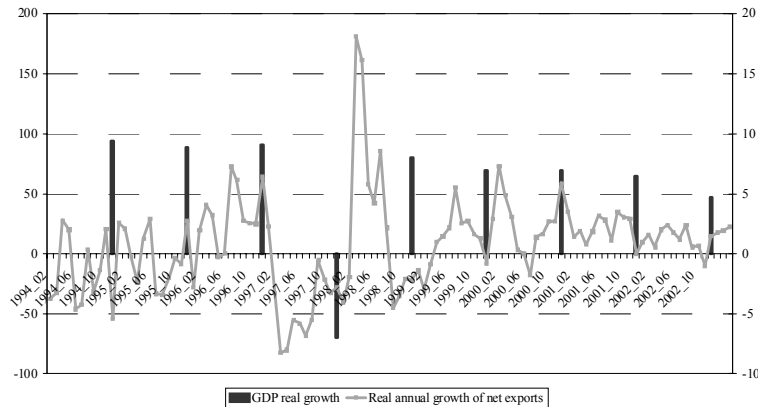


Chart 6: Correlations between GDP real growth and energy consumption



Finally, we examine the correlation of GDP with net exports (see Chart 7). Over the whole period, there appears to be significant co-movement between to two variables. Since, we have a longer data series for net exports compared to import of machinery and energy consumption, and in the absence of a better alternative, we use net exports as a proxy for GDP in our econometric analysis.

Chart 7: Correlations between GDP real growth and net exports



3. ECONOMETRIC RESULTS

While the charts and correlations reported above are useful for highlighting the main trends, one would like to know more about the interactions among key variables in the economy, specifically about how shocks to one variable affect subsequent developments in others, and whether the explanatory power of monetary variables has been increased by the shift to indirect instruments. Few studies have been made in Albania on the correlation between monetary policy decisions and export/import reactions through the exchange rate response.⁷ It is also interesting to test whether the exchange rate channel operates in Albania and how the effectiveness of this channel has changed with the introduction of indirect monetary instruments.

To answer these questions, we estimate a vector autoregression (VAR) model among the following variables: money growth, inflation, exchange rate, remittances and the trade balance. VARs are a flexible approach to summarising the interactions among macroeconomic variables without imposing unrealistic exogeneity assumptions. However, they should be seen as a descriptive device only, and their explanatory power is limited, especially when the time series are rather short.

The estimation period is January 1994 through May 2003, for which we use monthly data on all relevant series. To investigate whether the explanatory power of monetary variables has been increased by the shift to indirect instruments in September 2000 we also divide the sample period into two: the period when direct instruments of monetary policy were in place, from January 1994 to August 2000, and the period when indirect instruments of monetary policy were used, from September 2000 to May 2003.

The five variables used are as follows: the monthly rate of growth of M3, monthly inflation, the Lek/USD exchange rate in logarithm form, remittances in US dollars in logarithm form and monthly rate of growth of trade balance. The first three variables – money growth, inflation and exchange rate – are included in order to examine whether the exchange rate channel explains inflationary developments in Albania. However, since exchange rate stability has in turn been aided by the substantial inflows of remittances throughout the period, we include also the remittances in the VAR analysis. Net exports are included to examine the exchange rate channel as a monetary transmission mechanism into the real economy.

Estimation of a VAR requires the imposition of some ordering restrictions. As in Haderi et al. (1999), we argue that the most appropriate ordering is: Remittances → money growth → exchange rate → inflation → trade balance. Remittances affect directly both the money supply and the exchange rate. Money growth also affects exchange rate and both money growth and exchange rate are expected to affect the rate of inflation. Finally, inflation or the change in relative export import prices associated with a change in exchange rate, which in turn is affected by money growth would affect the trade balance (change in relative demand for export imports). The change in trade balance would then cause a change in output.

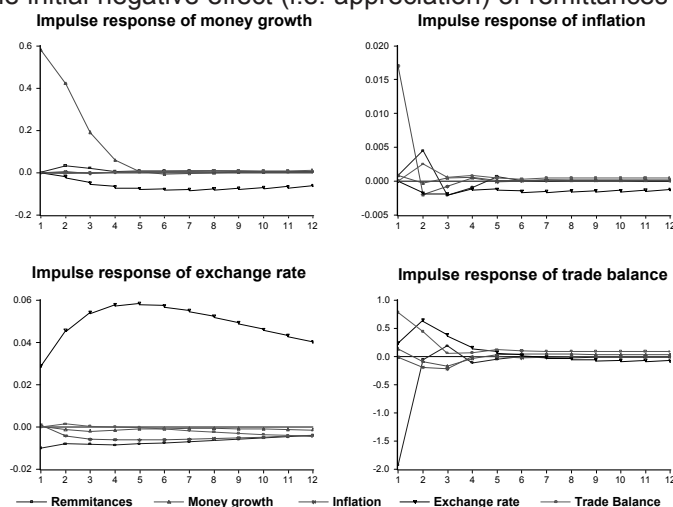
Given the short time series, the system was estimated using just two lags for each variable. Moreover, higher order lags were rejected according to Schwarz-Bayes Information Criterion. Charts 8-9 show the derived impulse response functions of four variables – money growth, inflation, exchange rate and trade balance.⁸ Separate impulse response functions were derived for the period of direct instruments of monetary policy and indirect instruments of

monetary policy respectively.⁹ For each variable, the figures illustrate the response of that variable to a shock to itself and to each of the remaining variables.

We focus first on whether shocks to money growth are associated with the subsequent path of inflation. For the period of direct instruments of monetary policy (up to August 2000) it is clear from the impulse response function that shocks to money supply do not appear to be related to inflation. Remittances and the trade balance have an expected positive effect on inflation that peaks after about two months but the effect dies out quickly after three to four months. The small negative effect of an exchange rate shock on inflation is persistent over a period of 12 months.

Chart 8: VAR analysis for the period of direct instruments of monetary policy (1994:01-2000:08)

The initial negative effect (i.e. appreciation) of remittances on the



Source: Authors' calculations, using data from Bank of Albania.

exchange rate is persistent and dies out only gradually after 12 months. The trade balance also does not appear to be affected by money growth. The positive relation between shocks to the exchange rate and the subsequent path of the trade balance peaks after two months and gradually dies out after four or five months. The effect of remittance however, is smaller and dies out after about four months.

These results are complemented by the variance decomposition analysis presented in Table 1. For each variable at different time horizons the variance decomposition analysis shows the percentage of forecast error variance caused by shocks to that variable and by shocks to other variables. The table show the variance decomposition for one-, six- and 12-month horizons.

The third block of rows in Table 1 shows that most of the forecast error variance in inflation is explained by its own shocks. Shocks to remittances explain up to 7.9 per cent – and shocks to exchange rate up to 6.4 per cent – of forecast error variance in inflation, indicating that remittances and the exchange rate together play a significant role in determining inflationary expectations. Money growth explains only up to 0.4 per cent of forecast error variance in inflation, confirming that movements in inflation cannot be explained by money supply changes during this period.

The last block of rows in Table 1 shows that most of the forecast

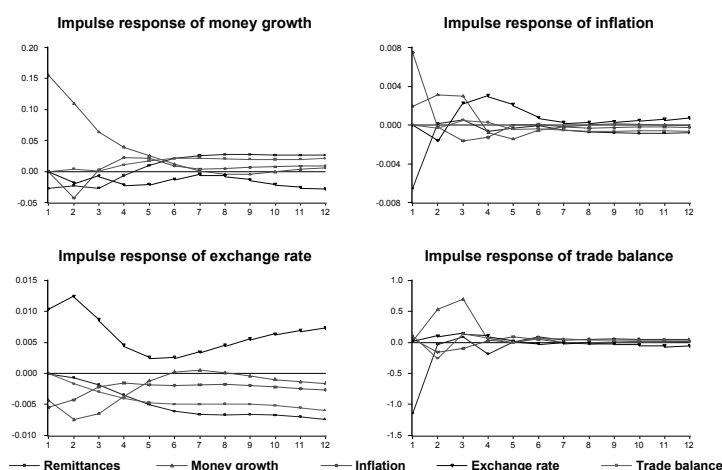
Table 1: Variance Decomposition (VAR 1994:01-2000:08)

	Months	Remittances	M3	Inflation	Exchange rate	Trade Balance
Remittances	1	100	0	0	0	0
	6	36.8	5.8	1.2	24.3	31.8
	12	23.9	5.3	1.6	33.3	36
Money growth	1	0	100	0	0	0
	6	0.3	96.5	0	3.2	0
	12	0.3	91.5	0.1	8	0.1
Inflation	1	0.2	0.2	99.5	0	0
	6	7.9	0.4	86.1	3.3	2.3
	12	7.6	0.4	83.1	6.4	2.5
Exchange rate	1	10.6	0	0.1	89.3	0
	6	2.5	0.1	1	96.4	0
	12	1.9	0	1	96.8	0.2
Trade balance	1	84.4	0.4	0	1.3	13.9
	6	69.5	1.1	1.5	12.3	15.5
Remittances	12	68.6	1.3	1.5	12.5	16.2

Source: Authors' calculations, using data from Bank of Albania.

error variance in the trade balance is explained by shocks to remittances (nearly 70 per cent at a 12-month horizon). Its own shocks explain up to 16.2 per cent and shocks to exchange rate explain up to 12.5 per cent of forecast error variance in trade balance. Shocks to money supply explain only up to 1.3 per cent.

Chart 9: VAR analysis for the period of indirect instruments of monetary policy (2000:09-2003:05)



Source: Authors' calculations, using data from Bank of Albania.

For the period of indirect instruments of monetary policy, however, the impulse response functions in Chart 9 show that the money growth does have a positive effect on inflation which peaks after three months and gradually subsides after four to five months. This indicates a clear relation between money supply and inflation. The positive effect of the exchange rate is also evident, peaking after about four months and subsiding after six months.

Shocks to money growth explain a significant part of the variance in trade balance as well. The biggest effect occurs after about three months and subsides quickly afterwards. The clear negative effect of money growth in exchange rate is also evident with the largest

effect occurring after two months and dies out gradually after four to five months. Shocks to remittances and inflation have a persistent negative effect on subsequent exchange rate movements. This analysis suggests that the explanatory power of monetary variables has been increased by the shift to indirect instruments.

Again, the way shocks to one variable affect subsequent developments in other variables under consideration becomes clearer with a variance decomposition analysis presented in Table 2.

Table 2 : Variance Decomposition (VAR 2000:09-2003:05)

	Period	Remittances	M3	Inflation	Exchange rate	Trade Balance
IRemittances	1	100	0	0	0	0
	6	58.9	31.3	2.3	2.8	4.7
	12	57.6	30.1	2.4	4.5	5.3
IMoney growth	1	3.1	96.9	0	0	0
	6	5.1	84.6	5.8	2.8	1.7
	12	11.3	71.9	5.4	5.9	5.5
IInflation	1	41.9	3.6	54.5	0	0
	6	28.8	16.6	39.6	14.6	0.5
	12	29.6	15.8	37.9	14.7	1.9
IExchange rate	1	0	12.1	19.2	68.7	0
	6	10.9	18.4	8.7	51.6	10.4
	12	25.6	9.8	6.4	41	17.2
ITrade balance	1	98.8	0	0.2	0	0.9
	6	58.6	33	2	1.9	4.5
	12	58.4	32.5	2.1	2.2	4.8

Source: Authors' calculations, using data from Bank of Albania.

Looking at the variance decomposition for inflation during this period, we see that, after 12 months, shocks to money growth now explain nearly 16 per cent of the forecast error variance in inflation compared to a mere 0.4 percent during the direct monetary instruments period. This suggests that movements in inflation are explained to a much greater extent than before (when direct instruments of monetary control were in force) by money supply changes during this period. Its own shocks still explain the majority of the forecast error variance in inflation. Shocks to remittances explain nearly 30 per cent and shock to exchange rate explain up to 14.7 per cent of forecast error variance in inflation at a 12-month horizon, indicating that remittances and the exchange rate are still a good indicator of inflationary expectations.

Also the variance decomposition for the trade balance shows that money growth explains up to 33 per cent of the forecast error variance in trade balance. Remittances explain nearly 60 per cent of the forecast error variance in trade balance over a 12-month horizon. These results suggest that the exchange rate transmission channel is present during the period of use of the indirect monetary policy instruments.

We also tested the robustness of our results with respect to changes in ordering of the variables used. In particular, we tested if exchange rate anticipates the money growth and remittances, as the Bank of Albania actively monitors exchange rate and takes it into consideration in the monetary projections. That is, we test whether exchange rate should be prior in the VAR. We also test whether the level of remittances is determined by the interest rate, which in turn is affected by the money growth, thus putting remittances after money growth in the VAR. We found that the ordering of variables is not the crucial determinant of our results, since changing the ordering of variables gave us similar results in terms of impulse response functions.

4. INFLATION TARGETING: AN OPTION?

In recent years, the central bank has considered moving from announcing an inflation band within which it intends to operate to explicit inflation targeting.¹⁰ Such a policy allows flexibility when facing real domestic (aggregate demand) and external shocks. In addition, inflation targeting uses a forward-looking approach that allows the central bank to avoid policies that are contrary to the target. Being a forward-looking policy this is likely to have a stabilising effect over financial markets. The Czech Republic was the first transition country that started to adopt this alternative to the monetary policy.¹¹

This strategy may also be attractive for Albania. The existing free float exchange rate regime makes easier the replacement of monetary control with targeting of inflation. It may also help strengthen the independence of the central bank. However, there are several reasons why Albania may not yet be ready to fully adopt such a policy.

First, as the analysis above makes clear, the transmission mechanism is not yet well defined in Albania, and therefore the

uncertainty about the effects of any change in monetary policy is high. Not only is there a large informal sector, but also securities markets are rudimentary and still need time for monitoring the impacts and effects that they may have on the economy. Indirect instruments of monetary policy are still relatively new and not fully tested.

Second, inflation forecasting techniques are not well-developed in Albania. There is considerable scope for further improvement towards more accuracy. Indeed, the main index used in calculating inflation – the CPI – has been criticised on the grounds that it does not seem to be representative of consumption patterns. Alternative indices are not in place yet and statistics on national accounts are not reliable.

Third, the transparency and accountability of monetary policy decisions are not yet well understood by the public. The Bank of Albania has significantly increased the amount of public education in an effort to influence inflation expectations, but more needs to be done. Furthermore, monetary policy affects real variables sometimes with long and unpredictable lags, making the education process more difficult.

For almost three years the Bank of Albania, on the suggestion of the IMF, has set the annual inflation target as a band of 2-4 per cent. It is not clear that this is the optimal range of inflation in the case of Albania, or indeed whether it should be a band or a point? So far the band has generally been achieved and been a good discipline for the Albanian authorities. Nevertheless, external events such as political instability, elections, and shortages of key goods such as electricity can hinder implementation of the target. Speculative attacks, like the one that caused a liquidity problem in the Albanian banking system in spring 2002, would complicate considerably the introduction of inflation targeting. All of these considerations suggest that the appropriate time for the adoption of inflation targeting in Albania may be some way off.

5. CONCLUSION

There are three main conclusions from this analysis of monetary policy in Albania. First, external influences, by contributing to exchange rate stability, have played an important part in keeping

inflation low for most of the transition period. Second, the range of instruments of monetary policy available to the authorities has widened in recent years, leading to more stability and predictability concerning the link between changes in money supply and changes in the price level. Also, the introduction of indirect instruments of monetary policy appears to have contributed to the effectiveness of exchange rate transmission mechanism of monetary policy into the real economy. Finally, the policy of aiming at an inflation band has worked quite well so far, but moving to inflation targeting may carry short-term risks and is not something that should be rushed into.

One of the biggest difficulties facing policy-makers in Albania is the poor quality of data on the real sector. As the quality improves, the link between monetary and real variables will become more transparent. While this may ease the task of the Bank of Albania in formulating monetary policy, it is clear that the scope for an activist monetary policy that tries to influence output and employment will remain extremely limited. The Albanian economy has moved over the last 13 years from almost complete isolation to relative openness, and is therefore more and more dependant on developments beyond its borders. However, the Bank of Albania can continue to play a stabilising role in the economy through the continuation of prudent monetary policies and occasional exchange rate management to smooth out shocks. Over time, the introduction of formal inflation targeting should be feasible, and would help contribute to stability in the economy.

ENDNOTE

¹ Aspects of the Albanian economy during transition are discussed in Mançellari et al. (1996), Vaughan-Whitehead (1999) and Clunies-Ross and Sudar (1999, eds.).

² The pyramid scheme crisis and its implications for the Albanian economy are discussed in Jarvis (1998) and Kovrilas (1999).

³ Previous papers that demonstrate this link in Albania are Haderi et al. (1999) and Muço et al. (1999).

⁴ See Haderi et al. (1999).

⁵ This estimate of informal sector activity in Albania is from IMF (2003), which cautions that it is likely to be an under-estimate.

⁶ Real growth for all series is calculated using the CPI.

⁷ See Kunst and Luniku (1998) and Kalra (1998).

⁸ For brevity, we omit the impulse response function of remittances in charts 8 and 9.

⁹ We also estimate a VAR for the whole time period. The results, not shown here, are similar to the results of VAR analysis for the period of direct instruments of monetary policy. This is partly explained by the fact that our time period of indirect monetary policy instrument is much shorter than the period of direct instruments of monetary policy.

¹⁰ See for a detailed explanation and comparative experience Blejer et al. (eds.) 2000 and Svensson 2000.

¹¹ However, several publications show an increasing interest from Poland. See for instance Orlowski, 1998 and Dabrowski, 1999.

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COMMENTS ON: "INFLATION, EXCHANGE RATES AND THE ROLE OF MONETARY POLICY IN ALBANIA"

Lavdosha Zaho

Erald Themeli

At first, we would like to thank the authors of the paper for their clear insights on the interactions between real economic indicators as well as the dynamic role of monetary policy in this process.

In our discussion, we would like to bring forward three points:

- The relationship between economic growth and economic stability;
- Monetary policy in Albania;
- The challenges of establishing an IT regime in Albania.

(I) THE RELATIONSHIP BETWEEN ECONOMIC GROWTH AND ECONOMIC STABILITY.

Albanian economy has been expanding rapidly during the last decade, averaging 6.3% in real terms during the 1993-2002¹ period. We would like to argue that macroeconomic stability, while being a key contributor to GDP growth, has not been the driving factor of growth in Albania. On the other side, our experience shows that the lack of macroeconomic stability has a negative effect on GDP growth, as 1997 and, to some extent, 2002 events have shown.

Before assessing the factors behind Albania's high economic growth, we need to put it into perspective: it is worth noting that the

Albanian economy started the transition period from a very low base. National income was estimated to be around 800 USD per capita in 1989. It is obvious that you can expect high growth rates starting from a low base. Nevertheless, average income almost doubled during the transition period. National income is estimated to be around 1600 USD per capita in 2002.

The main engine of economic growth has been private sector development. It is estimated that the private sector contributes 75% of GDP in 2001². Public economy and public contribution in the wealth-creating process has been decreasing steadily, reflecting the shift towards a market economy. Therefore, the main factors behind this growth appear to have been:

- Domestic demand. A “hidden” demand, unfulfilled during the centralized economy, served as a catalyst for the economic development. It started with consumer goods and continued with housing later. This contributed to the development of trade at the beginning and to the development of the construction and transport industries later;
- Private remittances from migration, which have been a steady source of income, have fueled domestic demand. Official estimates put them close to 13% of GDP in 2002. They have helped to sustain the aggregate demand and to finance private infrastructure investments. The role of this remittances in driving domestic demand can be better assessed if we note that FDI-s have averaged at round 3.8% of GDP² during 1999-2001, lower than most EU accession countries.
- Informal economy and illegal activities on a regional basis have contributed to the national income. Different estimates put the “gray economy” close to 30% of GDP.

Macroeconomic stability has been a key contributor but not the driving force in these developments. The development of the economy is financed mainly through remittances or by their own means, as in the case of enterprises. Private sector credit of the banking system, though growing at very high rates (around 25 annually during the last two years) is just 6.6% of GDP³. The credits of the banking sector or international capital inflows have had a limited role. Nevertheless, the role of macroeconomic stability, and

the inherent place monetary policy has within it, is due to increase in the future. It will provide the basis for a normal functioning of the economy, of its financing from the banking sector and in helping to attract FDI.

(II) MONETARY POLICY IN ALBANIA.

A. Evaluating effectiveness.

There are several indicators to judge the effectiveness of monetary policy. We would like to keep it simple: monetary policy has been successful in Albania in so far it has made possible relatively rapid disinflations (1991-1995 and 1997-1998) of the economy and a satisfactory price stability in the last 5 years. Of course, there are other factors contributing to price stability, but you can't negate the primary role of monetary policy.

B. The development of the transmission mechanism.

The development of the transmission mechanism is a process that concerns many factors in the country. Broadly speaking, the transmission mechanism can be split in two parts: The first part starts with BoA and ends in the financial system, the second one comprises the links and dynamics between the financial system and the real sector of the economy. The first part of the transmission mechanism in Albania can be defined as functional, or, at least, acceptable for the stage of development of our financial market. BoA interest rate decisions are being timely transmitted to financial market interest rates. The second part of the transmission mechanism is largely unknown. The ties between the financial sector and the real sector are hampered by informal economy, the degree of competitiveness of the financial sector, etc.

C. Monetary policy framework in Albania.

BoA has a monetary targeting framework. As a theoretical background, it looks at money supply as the prime determinant of price level in the economy. There are several comments we would like to make:

- The role of monetary aggregates in the economy is important for the price level. Regression analysis done at

BoA suggests that broad money influences prices with a lag of 5 to 6 months. The withdrawal of the deposits in 2002 is a good indicator of the effects liquidity has on prices in Albania.

- Targeting broad money (M3) implicitly covers exchange rate developments, as exchange rate level is included in Fx deposits.

D. Transmission channels of monetary policy.

We would like to focus on the two main channels:

- Interest rate channel.

Interest rates affect economic activity in three directions in Albania:

- The effect it has on credits to the economy;
This seems to be limited in Albania because lending in domestic currency is relatively small, SB is not allowed to lend to the economy.

- The impact it has on the savings-consumption ratio, as well as in deciding the asset portfolio of savings (cash vs. deposits).

The increase in interest rates has had an important role in bringing back the liquidity withdrawn from the banking system in 2002.

- Exchange rate channel.

BoA has a free-floating exchange rate. We agree and support the conclusion of the paper that exchange rate is very important for price stability. Exchange rate effects prices through the imported inflation. On the other hand, it is an important input in the price-setting mechanism in Albania.

(III) NEXT STEP. IMPLEMENTING THE IT REGIME IN ALBANIA.

BoA has made it clear that it intends to adopt the IT regime in the medium term, as its monetary policy regime.

According to McNees, monetary policy framework comprises “the institutional arrangements under which monetary policy decisions are made and executed”.

Therefore, the choice of a monetary policy regime requires an

analysis that extends beyond the central bank. BoA fulfills several preconditions necessary for the implementation of IT framework. It has:

- a clear mandate to achieve and maintain price stability, as its overriding objective;
- legal independence in two aspects, both goal independence and instrument independence;
- made a rapid progress in its analytical capabilities during the past 2 years.

The implementation of the IT regime in Albania needs to address several issues:

1. The development of financial markets;

There is no clear theoretical consensus of what represents the necessary degree of development of financial markets. Nevertheless, we can identify to areas where Albanian financial markets are inappropriate at the moment for supporting an IT regime:

- the deepness of financial markets - (Albanian financial market is practically equivalent to the banking sector, there are no long term financial assets to support IT, as a forward-looking policy arrangement)
- the transmission of BoA interest rates decisions in the financial markets is subject to some time and size uncertainties (a more competitive financial market would address this issue).

2. The identification and refinement of the transmission mechanism;

This issue is highly correlated to the first issue. It also requires the development of the real sector of the economy: the improvement of its ties with the financial sector and the correction of some structural weaknesses such informal markets, cash transactions and the monopolies.

3. The development of the necessary analytical capabilities requires quality data on all sectors of the economy;

The dissemination of SNA is a first step in this process. Furthermore, the data needs to be timely and reliable.

4. The clear support of all relevant economic policy-making actors in adopting and implementing an IT regime.

The theoretical benefits of IT regime are well known. As Mr. Hossein has rightly pointed in his paper, BoA has used discretion in its monetary policy decisions, though they appear to be close to the predictions of a Taylor rule. This has had a positive effect on the credibility of the BoA. The adoption of IT as a monetary policy regime does not affect the flexibility of BoA. Theoretical work suggests there is no trade-off between credibility and flexibility (Fry, M. Key issues in the choice of a monetary framework. 2000). "By imposing a conceptual structure and its inherent discipline on the central bank, but without eliminating all flexibility, IT combines some of the advantages traditionally ascribed to rules with those to discretion". (Bernanke, Laubach, Mishkin and Posen, 1999).

ENDNOTE

¹ Excluding the contraction of the Albanian economy during 1997, which was a result of a general socio-economic crisis, Albanian GDP growth during this period averaged 7.9 per cent.

² Source: EBRD, Transition Report 2002.

³ The data are for end August 2003.

MONETARY POLICY IN GREECE ON THE ROAD TO EMU

George S. Tavlas
Theodoros Papaspyrou

The views expressed are those of the authors and should not be interpreted as those of the Bank of Greece.

Let me begin my story in 1994, because that is when Greece's adjustment effort began. Here are some facts.

1. In 1994, Greece's inflation rate was almost 11 per cent. The EU average was less than 3 per cent.
2. Greece's deficit-to-GDP ratio was about 10 per cent. The average EU ratio was about 5 ½ per cent.

The next six years saw an enormous convergence of the Greek economy toward the remainder of the EU. Inflation was reduced from around 11 in 1994 to around 3 per cent by the year 2000 while economic growth accelerated.

How was this done? In Greece, a significant tightening of monetary policy had taken place in 1994 which led down the foundation of disinflation of 1995 and beyond¹. Beginning in 1995, in an effort to focus market expectations, the Bank adopted a "hard drachma policy", under which the exchange rate was used as a nominal anchor. For the first time, the Bank announced a specific exchange rate target. The idea underlying this strategy is that if the exchange rate commitment is credible, so that it is really believed by economic agents, then the output costs of tight monetary policies will be reduced.

The hard drachma policy was an overwhelming success. During the years 1995-97, the Bank kept real interest rates in the range of 5 to 6 per cent. In those 3 years, inflation was more than halved, while real GDP growth accelerated, averaging about 3% compared with about 1% during 1991-94.

Why did real growth accelerate during a period when inflation fell from a high level to the single digits? Although the credibility gain is difficult to quantify, the hard-drachma policy provided an unambiguous target for monetary policy, exerting a measure of self-discipline and serving to tie down inflation expectations. Other factors that strengthened credibility included the following.

- Substantial fiscal adjustment occurred. The fiscal deficit fell from about 10 per cent of GDP in 1995 to around 4 per cent in 1997.
- Beginning in the mid-1980s, steps were taken to liberalise the financial system, and by 1995, it had been completely deregulated, while Community prudential rules in banking and capital markets were adopted. With the deregulation of the financial system, the Bank of Greece was increasingly able to use market-based instruments of monetary control.
- The Greek Parliament approved central bank independence and provided the Bank of Greece with a mandate to achieve price stability.

In economics, there is no such thing as a free lunch. Our world is that of the second best, one in which there are both benefits and costs associated with any particular policy. The hard drachma policy was immensely successful in reducing inflation and allowing growth to accelerate. Yet, it presented difficulties.

1. The relatively high Greek interest rates, coupled with the increasingly credible exchange rate peg, led to a capital inflows problem. If the inflows had not been sterilized, they would have increased the monetary base and pushed down nominal interest rates. This would have meant an easing of monetary conditions, contrary to the tight monetary policy stance needed to disinflate.
2. A response by the Bank of Greece to the inflows was to undertake sterilization operations. Sterilization, however, was costly, as the Bank had to pay a high interest rate to borrow the funds.

3. A fundamental problem confronting nominal-anchor exchange rate pegs is that the currency of the high-inflation country can become overvalued during the move to a low inflation regime. In the case of Greece, an appreciation of the real exchange rate contributed to a widening of the current account deficit to about 4 percent of GDP in 1997, from near balance in 1994.

The widening current account deficit fed market expectations of drachma overvaluation and provided a fertile ground for contagion from Asia, which commenced with the devaluation of the Thai baht in July 1997. The sharp rise in interest rates required to support the drachma increasingly undermined growth and fiscal targets. As a result, by late 1997 and early 1998 Greece was confronted with a classic case of abrupt and sharp reversals of capital flows; a full-fledged speculative attack, was under way.

Consequently, by early 1998 the Government's objective of joining EMU in early 2001 was in jeopardy. In response, in March 1998 the drachma was devalued by about 12 per cent and the currency entered the ERM. There was no further speculative attack. There was no ensuing financial crisis. The drachma's exit from its central parity was one of the few orderly exchange-rate exits of the 1990s. What made it so successful? A literature has recently been developed on how to attain orderly exchange rate exit strategies. Here is a checklist as applied to the drachma.

- The literature strongly advises that following the exit from a central rate, the country in question should establish low inflation as a key objective and grant operational independence to the central bank. A reduction of inflation had been the main goal of the Bank of Greece for several years, and, following the granting of independence, the Bank's mandate was to achieve price stability.
- The devaluation of the drachma was both backward looking and forward looking. The magnitude of the devaluation took account of both past inflation differentials between Greece and other EU countries and prospective differentials in the period leading up to Greece's expected entry in EMU.
- Third, the drachma exited a unilateral peg and entered the ERM systems' arrangement within which it benefited from the availability of the mutual support facilities and wide \pm

15 per cent exchange rate bands.²

- The literature recommends implementation of prudential regulation of foreign exchange exposure prior to the exit. Prudential regulation had been implemented in Greece, and banks had effectively no net foreign exchange exposure at the time of the devaluation.
- The exit strategy literature recommends that fiscal policy be tightened following the exit. Fiscal tightening had already been in process in Greece in the years leading up to the drachma's devaluation, and it continued following the devaluation.

Crucially, the Bank did not ease monetary conditions; it made clear that it would use its independence to ensure that the Maastricht inflation criterion was attained. The wide, ERM bands facilitated the disinflation strategy, allowing the Bank to maintain high interest rates and to let the exchange rate appreciate relative to its central rate.

The rest, as they say, is history. Convergence continued for the next several years and on January 1, 2001 Greece became the 12th member to adopt the euro. The main lessons are as follows: The success of the Greek disinflation effort underscores the critical role of the credibility of policies. It is essential that the government's commitment to deliver its policy goals is believed. Credibility, however, cannot be achieved overnight, particularly if there is a history of failed stabilisation attempts. In such a situation, credibility can be fostered by a change in policy regime; in the case of Greece, the hard drachma policy constituted such a regime change. While an exchange rate target can help establish credibility by providing a clear and transparent nominal anchor, it runs the risk that it may become unsustainable in the absence of supportive fiscal policy. Important factors reinforcing the credibility of the exchange rate nominal anchor were continued fiscal adjustment, the legislation providing independence to the Bank of Greece, and the entry of the drachma into the ERM. The wide ERM exchange rate bands permitted the Bank to continue its tight monetary policy in the period prior to entry into Monetary Union.

For Greece, entry into the EMU marked the end of one long road. It also represented the beginning of another road, bringing new challenges. For Greece not only wants to survive in the euro zone, it wants to thrive in the euro zone. Still another road? That is another story for another time.

ENDNOTE

¹ The monetary policy was part of a re-orientation of economic and monetary policy specified in a revised convergence programme of Greece, 1994-99.

² The operation of the ERM itself had been improved following its reform in 1993 and the widening of exchange rate bands and its credibility enhanced as the EMU project was well on track in early 1998.

TURKISH ECONOMY AND MONETARY POLICY FRAMEWORK

Yusuf Bora Enhos

It is a great pleasure for me to join this conference and to share my views on Turkish Economy and Monetary Policy with such a distinguished audience. I would also like to thank to the Central Bank of Albania for this opportunity.

In my presentation, first, I will shortly touch upon the period before the real stabilization efforts started, then I will talk about the 2000 and 2002-2004 stabilization programs and in the last part, I will be talking on our achievements under the latest stabilization program. Going back to 1970's, Governments pursued inward looking import substitution policies and Turkey's monetary policy had been mainly based on the fixed exchange rate, managed interest rate system. When we came to 1980s, import substitution and restrictive foreign trade policies were replaced by liberal policies. Besides liberalizing the foreign trade during 1980s; the money, foreign exchange and securities markets were established. During 1980s, Central Bank conducted a monetary policy, which basically supported the export led growth strategy, through controlling both the exchange and interest rates.

In 1990s, capital movements became more and more liberal and gained momentum. This led to sudden capital inflows and outflows that resulted in crises, especially in emerging countries. During this decade, Central Bank of Turkey monitored financial system and tried to smooth out financial fluctuations caused by huge and

sudden capital inflows and outflows. In other words, Central Bank adopted a middle way under the fixed-but-adjustable exchange rate and freely market determined interest rates system. When we reached to the end of 1990s, despite all the efforts to stabilize the economy, what we had were increased inflation, volatile growth rates, soared public sector deficit, deteriorated current account balance and a highly dollarized economy.

Looking at the developments of the last twenty to thirty years, we had realized the fact that Turkey needed a comprehensive program to stabilize the economy. In this respect, Turkey launched an IMF supported stabilization program in 2000 to provide a stable macroeconomic environment by decreasing both the inflation and real interest rates so as to improve the long term growth potential of the Turkish Economy.

2000 program was an exchange rate based stabilization program. In an economy where pass through from foreign exchange to inflation is high, exchange rate based stabilization program with its front loaded credibility seemed to be a viable solution to inflation problem. In this respect, exchange rate basket was announced on a daily basis, covering one year period. This was the main policy tool to break the inflationary inertia and to provide a long-term perspective to the economic agents. Besides this, conduct of monetary policy was guided by a rule. According to this rule, the base money can only be created by changes in the net foreign assets of the Central Bank.

One other central component of the program was fiscal discipline. Performance targets were set for the primary surplus of the consolidated government sector.

Incomes policy, in line with the targeted inflation, was another pillar of the program. Public wages and administrated prices were set in line with the inflation target and in order to lessen the costs of disinflation process, structural reforms were designed in a way to increase the efficiency in public sector.

At the beginning, the program produced very good results. Interest rates sharply came down as a result of the removal of exchange rate uncertainty, confidence to the program was gained and expectations turned into positive. Later on, banks started to increase

their foreign exchange open positions and also increased their Turkish Lira denominated assets with relatively longer maturities in the form of consumer credits and government securities. This structure left the domestic banking system fully exposed to potential shocks.

Higher than expected inflation, mainly caused by boosted domestic demand and higher oil prices led to appreciation of pegged Turkish Lira. Appreciation of domestic currency in real terms together with increased consumer credits further amplified the domestic demand and as a result current account deficit widened to around US dollar 10 billion, which was about 5 percent of GNP and all these raised the concerns about the sustainability of the peg. In addition, delays in structural reforms were perceived by market participants as weakening government's commitment to the program. These developments affected the expectations negatively and the movement of market participants in unity led to increased interest rates and this, in turn, deteriorated the banks' financial conditions, which in turn resulted in loss of confidence. After experiencing two subsequent crises, credibility was lost and government had to abandon the crawling peg regime on 22nd of February 2001.

During the period between February 2001 and January 2002, the transitional program was implemented under the floating exchange rate regime. The main focus of this program was on reinforcing the structural elements of the previous program. Starting from January 2002, Turkey embarked on a new IMF supported program. The main aims of the program are almost the same with year 2000 stabilization program, but the design is totally different.

In the new program, ambitious primary surplus targets were set and the structural transformation process, started with the 2000 program was accelerated. In order to establish more transparent and healthy banking system we started to implement a restructuring program and imposed new regulations on banking system.

Under this new environment, where the exchange rate is freely floating, Central Bank takes a more activist monetary policy strategy. Inflation, itself, was set as a new anchor. Today, Central Bank makes its all decisions by considering the future inflation with the aim of achieving price stability and the short-term interest rates are used as the main tool to this end. By managing short-term interest rates,

we are aiming to shape the market expectations. This is very important for decreasing risk premiums resulting from uncertainty. As economic units gain more confidence, real interest rates will come down to a reasonable levels in harmony with the economic fundamentals, and the decrease in the cost of using capital will assist us in achieving sustainable growth.

Under the current monetary policy, we have been implementing implicit inflation targeting until the adoption of full fledged inflation targeting. In this sense, inflation target was set as 20 percent for the year 2003. In addition, our medium term target is single digit inflation. Floating exchange rate is a corner stone of our monetary policy. Under this new regime, a new anchor is needed since foreign exchange is no longer the anchor. As I said before, inflation itself is the new anchor, but we also set periodic targets on the base money aggregates to function as an additional anchor. Despite some of its disadvantages, the base money has been chosen because it is an aggregate that can put the monetary program on the right track in the transition period to explicit inflation targeting. Under the current monetary program, the base money target has been set to be consistent with the real GNP growth and the targeted inflation rate.

We have also quantitative conditionalities on Net Domestic Assets (NDA) and Net International Reserves (NIR) within the framework of IMF supported program. These conditionalities' primary focus is to ensure that the program maintains or leads to external viability rather than to impose tight control over inflation. In this context, a floor on NIR is set to indicate whether a program is likely to achieve its external objective that is repayment of external obligations and a ceiling on NDA is set as an additional protection, since it seeks to ensure that the external objective is not jeopardized by excessive credit expansion.

At this point, I want to talk about our achievements in respect of program objectives. On the inflation front, we undershoot the 2002 CPI target. The CPI inflation dropped to 29.7 percent as of end 2002, which is well below our 2002 target of 35 percent.

In the first quarter of 2003, external developments mainly determined the trend of inflation, as the war in Iraq created uncertainties, we saw volatility in oil prices and exchange rates.

The downward trend in inflation is disturbed by the rise in costs due to oil price increases and exchange rate depreciation. Besides these cost-push factors, rapid increase in agricultural and food prices as well as the public price adjustments played an important role in the rise of inflation in the first quarter. In this period, inflation expectations were also on an increasing trend.

Starting from May, cost-push effects began to diminish with the ongoing appreciation of the Turkish Lira and the increase in productivity. The CPI was realized as 24.9 percent y-o-y in August and expectations continue to converge our year-end inflation target. According to latest survey year-end CPI expectation decreased to 22.4 percent.

Despite some risks, the year-end inflation target of 20 percent is well within reach as long as strict commitment to the economic program is sustained. The structural reform process and measures for the budget discipline also reinforces our hopeful vision for the future trend of inflation.

Turkish economy started to recover in the first quarter of 2002, after 9.6 percent contraction in 2001. Indeed, at the beginning of 2002, growth rate was estimated as 3 percent in the program but then it was revised to 6.5 percent due to favorable developments in economic activity. However, GNP posted a robust expansion of 7.8 percent in 2002.

Our 2003 GNP growth forecast was 5 percent at the beginning of the year, however, in the first quarter of 2003, GNP growth was realized as 7.4 percent, which is above the expectations and growth performance of the economy was robust in the second and third quarter of the year as well. Strong export performance and slight improvement in domestic demand were the main drivers of the growth performance and 5 percent growth rate is within reach for 2003.

As I said before, one of the main objectives of our economic program is the achievement of viable debt position. In 2001 and onwards, Net Debt Stock/GNP ratio increased substantially due to the cost of banking sector restructuring, new IMF lending and higher borrowing costs. As a result of strict implementation of the program, this ratio has been on a downward trend. Decreasing borrowing

cost and higher than estimated growth rate of the economy has been supporting the decreasing trend of net debt stock. This is especially crucial for the success of economic program since concerns about government refinancing and debt rollover issues have been the main determinants of market expectations.

In conclusion, our experiences proved that prudent fiscal and monetary policies as well as structural reforms are indispensable for stabilization policies. By implementing the new program coherently, today, Turkey is well placed on the road of sustained non-inflationary growth. Today, we are more resilient to external shocks and less vulnerable to crisis.

MONETARY POLICY IN CROATIA - THE CHALLENGE OF SLOWING DOWN THE LENDING BOOM

Vedran Šošić

MONETARY POLICY FRAMEWORK IN CROATIA

Despite a prolonged period of macroeconomic stability (during the last decade, average inflation rate was kept below 2.5%), high unofficial “euroization” remains one of the most striking features of the monetary policy environment in Croatia. Foreign currency deposits in Croatia comprise close to 90% of total deposits, while two-thirds of broad money is denominated in foreign currency. The “euroization” phenomenon is the most important single factor affecting the choice of the monetary policy framework. Due to implied adverse impact of large swings in exchange rate arising from such high “euroization”, the central bank puts high emphasis on the goal of exchange rate stability¹. However, there is no pre-commitment on behalf of the central bank to defend certain exchange rate level and therefore movements that are believed to be in accordance with “fundamentals” are tolerated. The main channel of the money creation is foreign exchange intervention. Intervention needed in order to stabilize the exchange rate often results in excess liquidity due to the magnitude of capital inflows. The resulting excess liquidity in the banking system is usually sterilized with the issuance of CNB bills. This type of policy is sometimes referred to as “quasi-currency-board”. Exchange rate is managed, but without an explicit band, while international reserves are kept at a higher level than money supply (currently

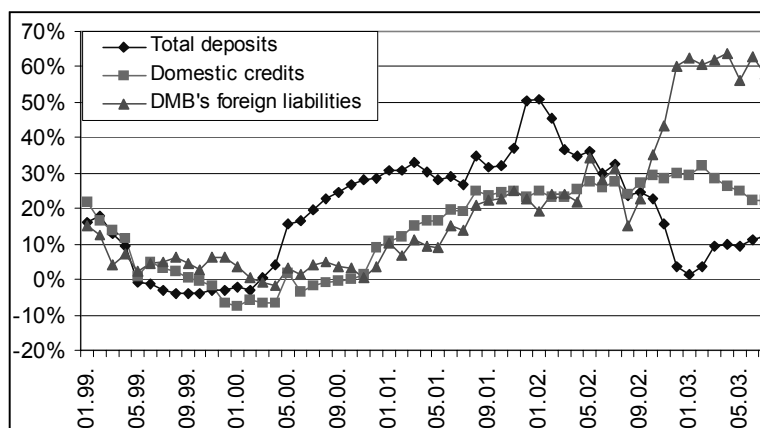
approximately 30%) – an attempt to use both credibility arising from the exchange rate stability and flexibility by accommodating certain exchange rate fluctuations.

CURRENT MONETARY POLICY CHALLENGES

Commercial banks initiated lending boom during 2001. This lending boom boosted consumption and investment, but it also significantly increased imports so current account deficit almost doubled in 2002 (reaching 7.1% of GDP) compared to 2001. The use of foreign sources of capital for financing domestic lending increased external debt, which reached 68% of GDP at the end of 2002, an increase of about 10 percentage points over the previous year. Finally, although the share of non-performing loans is still low, it is extremely hard to determine the real quality of the banking assets during the period of the lending boom.

There were several causes of the lending boom. The lending expansion was first initiated by the strong inflow of foreign currency deposits into the banking system after the end of the 1998/99 banking crises. The deposit inflow culminated in the last quarter of 2001, during the euro-changeover period, when foreign currency deposits grew by almost 2 billion euros. After the changeover, deposit inflows dried-up, but commercial banks didn't want to give up the fighting for market shares. In order to be able to continue strong lending activity, many commercial banks turned to foreign financing. Since in 1999/2000 some of the major foreign players entered Croatian banking market, they had no trouble finding sources of finance abroad.

Graph 1: Deposit and lending dynamics (% yoy change)



Source: Croatian National Bank

IMPLEMENTED POLICY MEASURES

First round of policy measures implemented consisted of direct measures as well as prudential measure. These measures included credit restrictions and minimum liquidity restrictions. Banks whose risk assets grew “excessively”, defined as more than 4% per quarter, are required to purchase low-yield CNB bills (0.5% interest rate) twice the amount of excess growth. This instrument directly aims at slowing down the lending boom. The second measure introduced required banks to hold liquid foreign exchange assets equal to at least 35% of their total foreign exchange liabilities. The goal of this measure was to make foreign borrowing more difficult. In addition to these macroeconomic measures, there was an additional prudential measure requiring fast-growing banks (growth rate above 20%) to form additional reserves (0,1% of risk assets).

It seems that measures implemented by the national bank managed to somewhat slow down the lending boom. However, external debt still keeps rising. Also, the one additional reason to be wary of the economic developments is the question of monetary statistics reliability. In addition to the first attempts of commercial banks to sell parts of their assets and thereby decrease their growth rate, which were quickly sanctioned, they soon started to use additional channels to extend loans (e.g. leasing companies they own). This

banking strategy helps development of other financial intermediaries, but it distorts the real picture of the lending dynamics.

Because of the above-mentioned reasons, the central bank decided to implement an additional measure. This measure pertains to increase of the domestic currency share of the required reserve from 25% to 35%. It is expected of that measure to mop-up the excess liquidity in the banking system and further decelerate lending growth.

In case all these measures do not contribute significantly to slowing down the lending growth and growth of external indebtedness, central bank is considering tightening the monetary policy stance even further. This will be brought about by increase of the rate of required reserves. Also, an introduction of capital controls is being considered.

Although IMF suggested central bank to raise interest rates, there are several reasons why central bank decided not to do so. The first reason pertains to the monetary transmission mechanism, which is based on the foreign exchange market. In the environment of the structural excess liquidity in the banking system, which is the net creditor of the central bank, commercial banks use central bank facilities mostly to manage their excess liquidity. Therefore, it is unclear whether increase of the interest rates on CNB bills would make sources of finance more expensive and feed into other interest rates. Secondly, since the rate on CNB bills is around 2.5%, while lending rates are still within the 8-10% range, the rate should probably be increased substantially in order to make banks switch from lending to private sector into the CNB bills. Moreover, increasing the interest rates, while interest rates around the world remain depressed, might trigger even more capital inflows. Finally, raising the interest rates would increase the costs of servicing debt for the Ministry of finance.

ENDNOTE

¹ Primary goal of monetary policy is price stability. Due to highly “euroized” environment and implied relationship between exchange rate and prices, this goal feeds into the task of keeping the exchange rate stable. Although recent research shows that spillover effects from exchange rate fluctuations into price movements are weak in Croatia, this might be precisely because of the policy success, or narrow range within which the exchange rate has been kept.

MONETARY POLICY EFFICIENCY AND CURRENCY SUBSTITUTION UNDER A CURRENCY BOARD ARRANGEMENT IN BOSNIA AND HERZEGOVINA

Dragan Kovacevic

INTRODUCTION

BiH is a small country which suffered dramatically from war and faced three major concurrent transition processes:

- the transition from war to peace
- the transition from a socialist command economy dominated by the state to a market-oriented private sector economy; and
- the transition from being a part of a large nation to become an independent country with its own domestic and administrative institutions

Only one of these transition processes is extremely challenging on its own. At an early stage of the reform process BH state had to provide some anchors or areas of economic stability. One such anchor, for which the experience of BH shows, that can be attended successfully and relatively quickly, is a stable currency.

MONETARY POLICY – CURRENCY BOARD ARRANGEMENT (CBA) IN BiH

The framework of monetary policy has been defined as Currency Board arrangement under the Dayton Peace Agreement for BiH in 1995.

The institutional and regulatory framework of this monetary system has been defined under the Law on the Central Bank of Bosnia and Herzegovina, which was adopted by the BiH Parliament.

The Law has defined that the Central Bank cannot get involved in any operations in the money and capital markets and that it cannot extend credits to any sector, including banking and governmental sectors.

The CBBH management body is the Governing Board, consisting of 4 members. 3 members are from the nations living in BiH (Serb, Croat, Bosniak) and the foreigner is the Head of the Governing Board. It has been defined that the Governing Board is to have such structure in the first 6 years of the CBBH operations. From August this year we have five domestic Governing Board members. The law ensures the independence of the CBBH. The Central Bank of BiH commenced its operations on 11 August 1997.

MONETARY POLICY PRINCIPLES

Currency Board Arrangement in BiH provides:

- The full coverage of the CBBH monetary liabilities by its net foreign exchange reserves;
- Firm foreign exchange rate in relation to the peg currency, the Deutsche Mark (1 KM = 1 DEM) ;

Since 1 January 2002, KM has been tied to EURO under the exchange rate 1 EUR = 1,955830 KM, i.e. 1KM = 0,511292 EUR.

- unlimited convertibility of the Convertible Mark - KM into the peg currency, under the fixed exchange rate.

MONETARY POLICY EFFECTS

Since the beginning of operations of the Central Bank of Bosnia and Herzegovina, the defined legal framework for the implementation of monetary policy is completely adhered:

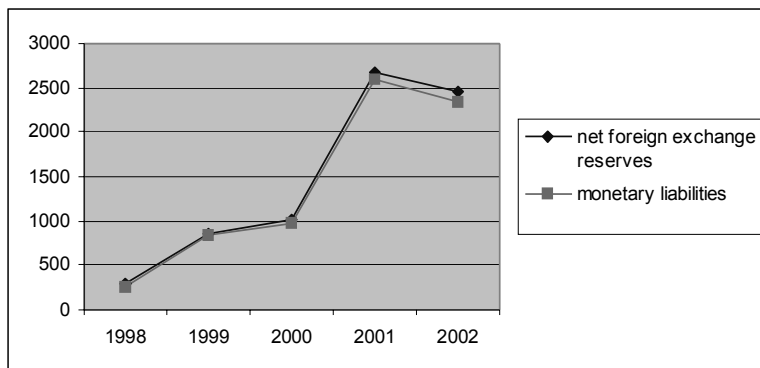
- Currency Board principle has been fully respected;
- Stability of the local currency has been provided;
- The local currency is exchanged against the peg currency without restrictions;

- Foreign exchange reserves are growing;
- Full presence of KM in domestic payment transactions;
- Low inflation rate...

The results and effects of monetary policy can be seen in the following surveys and analyses.

CBBH assets continuously grew in the whole period from the beginning of operations. At the end of 2002, they amounted KM 2,465 billion (at the beginning of the CBBH operations, they were KM 132 million) while net free reserves (differences between net foreign reserves and the monetary liabilities of the CBBH) were over KM 118 million.

Diagram 1. Net Foreign Exchange Reserves



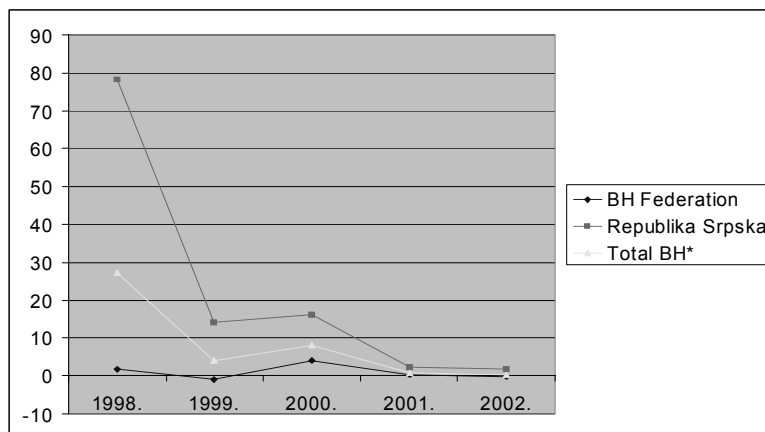
the currency board, considerable downward trend, and was below 1 percent in 2001 and 2002 (table 1 and diagram 2).

Table 1. Inflation trends in BiH

Inflation rate	1998	1999	2000	2001	2002
Federation of BiH	1.8	-1.0	4.0	0.3	-0.2
Republika Srpska	78.1	14.0	16.1	2.2	1.7
Total BiH*	27.2	4.0	8.0	0.9	0.4

* Inflation estimated by the scope

Diagram 2. Inflation rate in BiH



KM SELLING AND BUYING

Convertible mark is being traded without restrictions;

At the beginning of the CBBH operations, in 1997, four currencies were used in BiH: KM, DEM, Croatian Kuna and Yugoslavian dinar. Deutsche Mark, Croatian Kuna and Yugoslavian Dinar stayed in the payment system until 1999. These currencies were excluded from the payment system in the fourth quarter of 1999. In the end of 1999, 14,5 million of DEM, 1,4 million of Croatian Kunas and 2,4 million of Yugoslavian Dinars were in the payment system, the amounts are calculated in KM.

The share of these four currencies in the total payment transactions in the end of 1999 amounted to 25,5%. The use of Croatian Kuna and DEM actually ceased in 2000 in the Federation of BiH, and Yugoslavian Dinar was actually withdrawn from use in Republika Srpska in June 2000, as well as DEM.

The growth of confidence in KM and the increase of its use is shown in the following data:

In 2002, KM selling reached the level of KM 10,4 billion, and buying reached KM 8,3 billion; (diagram 3). The KM buying and selling is

possible today , along in BiH , in Austria, Switzerland, Germany, Czech Republic, Croatia, Hungary, Slovakia, Slovenia , and Serbia and Monte Negro. Trading balance amounted to KM 2,1 billion;

In the entire period the level of the KM use in BH payments system was growing (Diagram 4).

Diagram 3. KM Trading

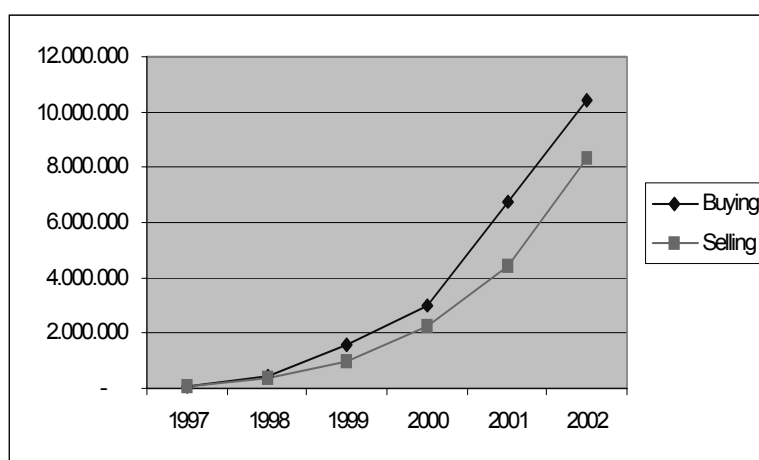
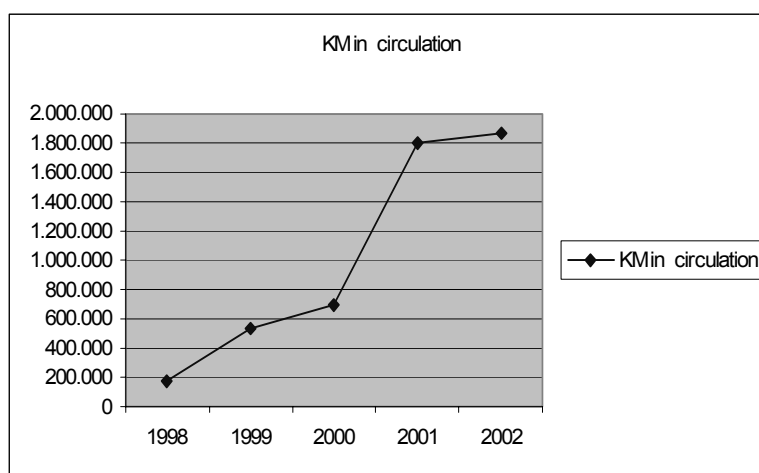


Diagram 4. KM in circulation



Stability in a country's exchange rate and inflation rate represent extremely important economic benefits for:

- attracting foreign investors
- development of the financial sector

Stability in a country's exchange rate and inflation rate allow people to plan their economic decisions ahead of time with more confidence. This is particularly important for investments as the economic return from any investment is spread over many years. This benefit applies to both local and foreign investors.

Stability in inflation and the exchange rate are also extremely important for the development of the financial sector. Currently, the main risk that banks need to focus on is the credit risk of their borrowers. This is still a major problem in BiH, particularly in the business sector. This is the principal reason why banks are currently lending more to the household sector than to the business sector.

But as credit risk is now the main area of financial risk for bank lending in BiH, it is possible for the authorities, banks and the business sector to work together to develop policies to progressively reduce it. The banking sector in BiH has made enormous progress over the last three years. The quality of the banks has improved and most of their balance sheets are in better shape. The range of services they are offering has increased and interest rates on loans have declined significantly.

BiH is a small country, it has a large balance of trade deficit; and it has enormous development needs in order to improve the living standards of its citizens. All these characteristics mean that BiH need substantial investments, including private foreign investments. There is still a considerable degree of political and business risk in investing in BiH. The fact that the CBA has delivered exchange rate stability and low inflation are the most positive factors BiH currently has, for persuading potential foreign investors to bring their capital to BiH.

Stability of domestic currency and the transparency of monetary policy within the Currency Board arrangement in BiH, have greatly contributed to the development of the banking sector and the return of confidence in banking. This is manifested through the

decrease in number of banks (curtailing of banking sector) and the change of structure of the ownership in banks. (Table 2 and 3).

At the end of 2002, 40 banks operated in BiH, 8 banks fewer than in 2001. In 1999, there were 61 banks operating in BiH. The number of banks, given the ownership structure, is tabled below.

State-owned banks	19	12	6
Private banks	36	36	34
Total number of banks	55	48	40
	31.12.2000	31.12.2001	31.12.2002

THE OWNERSHIP STRUCTURE IN BANKS

The structure of capital stock is presented in the following table:

STRUCTURE OF CAPITAL STOCK IN BANKS

Table 3. In millions of KM

	31.12.00	31.12.00	31.12.01	31.12.01	31.12.02	31.12.02
	Amount	Share	Amount	Share	Amount	Share
Total stock capital	658	100%	627	100%	745	100%
State capital	307	47%	119	19%	72	10%
Private capital	351	53%	505	81%	671	90%
Of which						
Foreign capital	135	38	346	68	494	74
Local capital	216	62	159	32	177	26
	351	100%	505	100%	671	100%

Participation of the foreign capital in the total stock capital is 66%, while the foreign capital participates with 74% in the private one.

Loans

- the total loans extended in 2002 amounted to KM 3.213 million and 3 percent higher than 2001 year end.
- Given the structure of loans by sectors, 41 percent were given as loans to private companies, 44 percent to citizens, 11 percent to the public enterprises and 4 percent to other sectors.
- Loans to citizens recorded a significant increase of 118 percent, those of private companies increased by 32 percent and those to public enterprises by 3 percent.

Table 4. Structure of loans.

	31.12.00	31.12.00	31.12.01	31.12.01	31.12.02	31.12.02
	Amount	Share	Amount	Share	Amount	Share
Total loans	1652	100%	2101	100%	3213	100%
Private	833	50%	988	47%	1304	41%
Public	322	20%	350	16%	361	11%
Citizens	375	23%	647	31%	1415	44%
Other sectors	122	7%	116	6%	133	4%

Only the Central Bank of BiH with its Currency Board arrangement can use required reserves as the monetary instrument.

The balance sheet of the CBBH is:

Assets	Liabilities
Net foreign assets	Cash in Circulation Required bank reserves

OTHER FUNCTIONS OF CBBH

The CBBH also plays additional roles in the BiH financial sector:

- We operate the clearing and settlement system for domestic non-cash payment system. It has the potential to expand its clearing and settlement role as the BiH financial system further develops
- We provide banking services for the state of BiH and for international financial institutions; some other levels of government have also decided to use some CBBH banking services
- The CBBH plays a coordinating role in banking supervision

The CBA in BiH in the future

- The main reason that the CBA should be retained as the monetary policy of BiH is that it is producing real economic and social benefits. The BH citizens are able to see this.
- A second reason for retaining the CB approach to monetary policy is that most countries in the region now have a high degree of exchange rate stability against the Euro.

- A third important reason why the CB needs to be retained in BH is that there is no sensible alternative, given the present state of the BiH economy and its institutions.
- The final reason why the CB should be retained is that the long – term goal of BH policy is to take the economy closer to and eventually into Europe.

CONCLUSION

The Currency Board approach to monetary policy has achieved the objective, set forth in advance, which is: financial stability in BiH. This has brought considerable economic and social benefits to the economy and the citizens of BiH.

The Currency Board should continue its role as it is important that financial sector stability is retained. Financial stability is not a goal that you can achieve once and then move on to some other objective. Stability in the financial sector has to be maintained through a consistent application of monetary policy.

In addition, it is possible for a Central Bank that operates as a Currency Board to carry out other financial sector roles that will help economic development – with the strong provision that the other policies must never be able to put the Currency Board Arrangement at risk. The CBBH already does this in the payments system and in banking. We will continue to expand our roles in the BiH financial sector while always remembering that our main goal is to maintain financial stability by operating as a Currency Board.

SHOULD BANK OF ALBANIA ADOPT THE IT REGIME?

Sulo Hadëri

Gramoz Kolasi

ABSTRACT

Even in light of the problems and restrictions inherited from the past economic events, the monetary policy of the last 10-12 years has been considered relatively successful. Initially using direct control means and later through money market operations, the monetary policy has been able to control money supply most of the time.

Attempts have been made to develop further the monetary policy framework, especially with regards to its operational aspect, which at the current state can be considered relatively advanced. Nevertheless, it cannot be acknowledged that Bank of Albania's monetary policy has either been or is perfect. It still exhibits some weak areas, which substantially diminish the transmission of policy decisions onto economy. At the same time, the sample of empirical analyses available is very small and the conclusions drawn from that are, for many reasons, of little use.

Therefore, it has been some time that the debate on reviewing the overall monetary policy frame has initiated, trying to answer the question: which monetary policy regime is most suitable for Albania, the current one or the Inflation Targeting regime (IT)? This question still remains open to discussions although, lately, the official stance of Bank of Albania is showing support to the idea that the future policy regime over the medium term will be that of IT.

The following paper, which is divided in two parts, will first try to present a brief overview of the monetary policy over the last years, pointing out the political and operational framework attended by the Bank of Albania. The second part will try to present different views and arguments related to policy regimes of the future, or stated differently, it will answer the question: Should Bank of Albania adopt the IT regime?

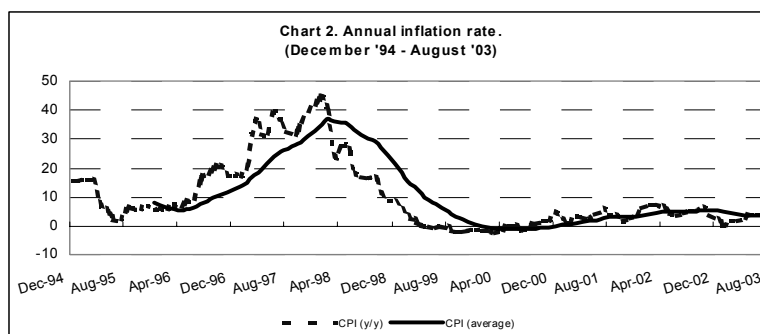
AN OVERVIEW ON THE LAST DECADE

Final Objective of the Monetary Policy

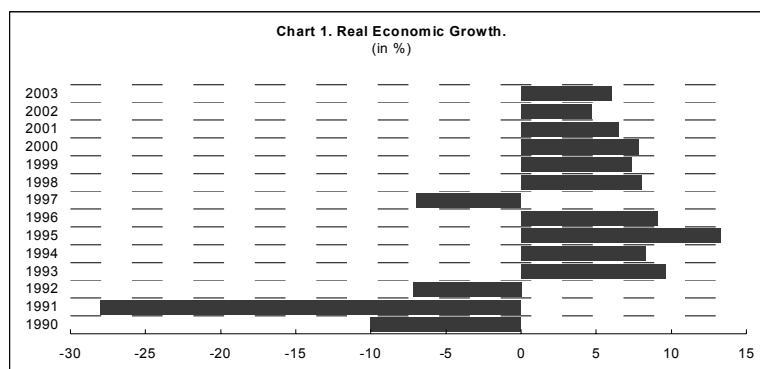
The actual law on “Bank of Albania” clearly states that the final objective of Bank of Albania is to achieve and maintain price stability, while all other objectives take a secondary role backing the final objective. Such an unambiguous expression of the objectives of the central bank has not been offered at the beginnings of modern central banking activity in Albania. According to the first law on Bank of Albania, approved in 1992, the main objective of the central bank was to maintain the value of the domestic currency, Lek.¹ Although it was not confirmed publicly, during the first years of transition, the objective of Bank of Albania to maintain the value of domestic currency was associated with attempts to maintain a certain monthly inflation rate. Later, the notion of aiming a monthly rate changed into a quarterly rate and by 1995 into a yearly rate. Given the hyperinflation rates in 1992 and 1993, it did not make sense to set an objective on yearly bases. Due to the implementation of tight monetary policies and budget deficit control, inflation rate came down until it reached a figure of single digit by end 1995. Now, it was reasonable to think of aiming inflation rates over longer time periods.

Yet, positive changes were identified after 1998 and on. During the last years, it has been continuously stated publicly that the objective of Bank of Albania is the annual inflation rate at the end of the year, set as a band between 2-4 per cent.

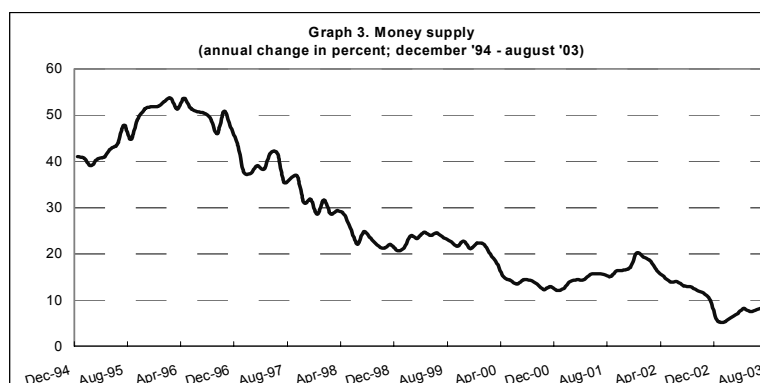
It must be said that Bank of Albania did not doubt when choosing to have price stability as its main objective. This decision is in line with the overall academic theories and the opinions of other central banks, which confirm that keeping inflation under control is the best contribution a central bank can offer.



Nowadays, or maybe even earlier starting since late '80s, the academic and professional beliefs are converging to the point that low inflation means higher economic growth and higher employment rate. Many theoretical arguments in favor or against the presence of inflationary pressures in economy have been brought forth, providing room for different interpretations, such as the one that an expansionary monetary policy can generate higher growth and higher employment. However, it should be noted that this does not hold true over long time periods, since the empirical evidences show that inflation and economic growth are negatively correlated, i.e. the higher the inflation rate, the lower the economic growth (Barro 1995, De Gregorio 1994, Fischer 1994).



Having a look at the case of Albania, one of the most appreciated achievements during the last eleven years has been the control that the monetary authority of the country, i.e. Bank of Albania has exerted on inflation. The process has been a long and continuous one, with ups and downs, but in general it can be assessed as a successful attempt.



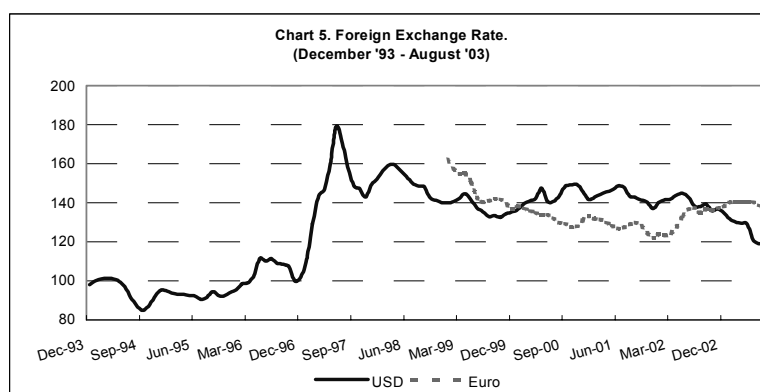
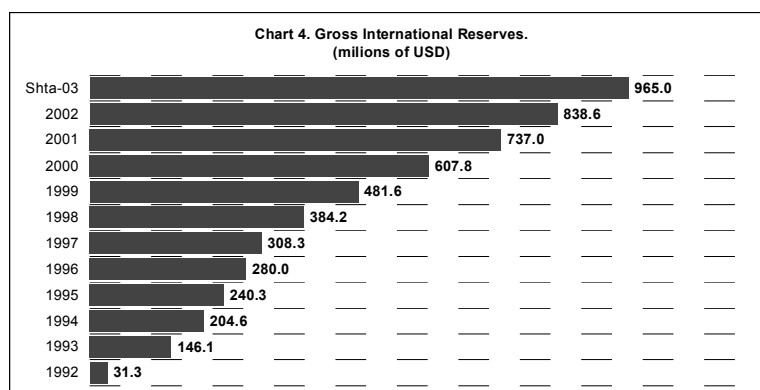
The statistical data for the last years indicate low inflation rates which most of the time fluctuate within the aforementioned interval (2-4 per cent). Even though during the last years there have been changes in the basket items as well as important domestic or foreign political events, including armed conflicts in the region, a careful monetary policy combined with a controlled budget deficit have contributed to aggregate demand keeping inflation pressures at reasonable levels.

Monetary Policy Regime

In determining the monetary policy regime, Bank of Albania has been, first of all, confined by the economic environment and the functioning of the transmission mechanism at early '90s.

Although the 1992 law gives Bank of Albania the rights to formulate and implement the foreign exchange policy of the country, the circumstances hinted that priority be given to the monetary policy regime, where the intermediate objective was and still is, the M3 aggregate or money supply.

Choosing between the two alternatives, money supply or exchange rate, in favour of the first one was conditioned by the fact that it was impossible to support a fixed exchange rate regime. Even though the results would have become noted faster in case the fixed exchange rate regime was adopted (in addition this regime was easier to implement), at that time the international reserves of Bank of Albania were at very low levels and moreover, the balance of payments deficit was increasing rapidly.



Now, years after we made this choice, it can be concluded that we took the right decision. Experience pointed out that many countries, including transition countries, at certain moment found themselves unprepared when they had to give up the exchange rate regime for various reasons. As mentioned by Crockett² “For as long as exchange rate regime functions, policy makers find no reason to replace it. When the domestic currency is under attack, the authorities do not like to believe that the fixed rate regime has failed already.”

Given a poor inheritance of institutions and market infrastructure in the country, in its initial phases, Bank of Albania could not adopt operational objectives based on free market principles. For this reason, monetary control was carried out through direct operational

means. This implied that the assets of the system and those of Bank of Albania should meet some quantitative limits. Hence, the control of the intermediate target, M3 aggregate would be achieved via direct control over foreign assets of Bank of Albania and over domestic assets of banking system, including net credit to government and to economy. In a way, *de facto* these limitations assume the status of intermediate criteria and even today, performance criteria³ serve to measure the accountability in reporting monetary policy efficiency in the economy.

Briefly, not spending too much time on the definition of these criteria, I would like to explain the logic behind having them:

- **Net foreign assets⁴** of Bank of Albania, relate to the performance of balance of payment and represent the sustainability of international position of the country. These reserves serve to hedge the exchange rate of Lek (Albanian domestic currency) from short-time speculations. In these cases, Bank of Albania deems it necessary to intervene in the foreign market. In addition, international reserves are considered as the last resort to finance expenditures or consumption of an economy, in emergency cases, and for this reason they are measured in months of imports. The target set for the international reserves is supported by this line of reasoning.
- **Domestic credit to government** serves as another precautionary measure to control budget expenditures. Hence, Bank of Albania is involved in controlling the credit to government by the banking system, keeping an eye on the domestic debt and furthermore, indirectly trying to control government expenditures that might create inflationary pressures in the economy. Since this objective relates to the behavior of three actors, Ministry of Finance, Bank of Albania and commercial banks, Bank of Albania cannot have full control of it and therefore, it is not responsible if limitations are not met.
- **Net domestic assets of Bank of Albania** represent part of the liquidity generated by Bank of Albania in the system. Changes in net domestic assets come mainly from transactions between Bank of Albania with commercial banks and government. The liquidity generated by these transactions accounts for most of the liquidity in the whole economy and thus has an impact on inflation performance.

Operational frame of Bank of Albania

As mentioned above, monetary supervision was initially exerted through direct means, applying some administrative measures on banks through some instruments such as the required reserve and credit limitations. Maybe it is not necessary to go back in details, but it is worth emphasizing that controlling the market through the administrative interest rate⁵ and the credit limit became more and more difficult. The addition of new private banks, while the Savings Bank was withheld from lending and the level of risk in the market was high, was followed by a considerable decrease of the credit to the economy. On the other hand, the impact of the limitation on the rates that state owned banks used to pay on long term deposits in Lek, diminished noticeably, especially after 1999, when the market was not following anymore the continuous reduction of the administrative rate by the Bank of Albania. Under such circumstances, a new conception of the overall operational frame was taken in consideration as well as the decision that the monetary policy of Bank of Albania was to be based only on the implementation of market instruments. More concretely, it was decided that the basis rate of the economy would be the rate of interest of the repurchase agreements (REPO), which would take place in standard weekly auctions⁶, held by the Bank of Albania. As shown in picture 1, the main instrument of the monetary policy of Bank of Albania is the fix rate of REPO. Depending on the message it wants to give to the market, Bank of Albania organizes two kinds of auctions. In the first one, when the intention is to give signals of neutrality, the amount accepted is unlimited, whereas it is demanded or offered against a fixed price formerly announced, which is the rate for the repurchase agreements of one week maturity established by the Supervisory Council of Bank of Albania. In the second case, when Bank of Albania's purpose is to give to the market the signal of more tightened or more expanded monetary conditions, it organizes auctions where the amount accepted is fixed and the announced price is limited (it is still the rate for the repurchase agreements of one week maturity).

Independent on the type of the auction, the only intention is the supervision of the liquidity in the system, aiming to keep it in optimal levels in order to enable the maximum efficiency of the transmission device. It is obvious that the fix rate of REPO serves as reference for other rates, not only for crediting facilities that Bank of Albania

offers to the banking system, but also for other market rates in general.

Besides interventions in the open money market, at present, Bank of Albania offers other facilities to regulate its relationship with the banking system:

- **Outright transactions**

The outright transactions can be used when trying to obtain a constant sterilization of the market. Practically, the instruments being used now to perform these transactions are treasury bills with one year maturity, whose maturity date does not expire less than 14 days from sale⁷.

- **Interventions in the exchange market**

Even though Bank of Albania has adopted a totally flexible regime of foreign exchange, it has been constantly present in the market, mostly to avoid speculations with Lek. The transactions of foreign exchange can be outright transactions or swaps.

- **Crediting facilities**

Lombard credit. The crediting facility of Lombard has been offered relatively early, but it should be mentioned that it has been used very rarely⁸. It is clear its classic goal of assisting banks in their temporary liquidity⁹ problems, and it is considered as the last source of credit when all other possibilities have been exploited. Actually, it is the highest rate the Bank of Albania is offering to the system. The price of Lombard¹⁰ is determined adding to the REPO rate a penalty of 6 percent.

- **Overnight credit.** This facility was offered to the banking system the last year, and aims at supplying the banks with overnight liquidity. The name suggests that it should be paid back the next day. Its interest rate¹¹ is based on the REPO rate plus a penalty of 2.5 per cent. Overnight credit has been used very rarely¹².

- **Required reserves**

The required reserve is one of the few instruments of indirect supervision, which has been used since July 1992, maintaining the same rate of 10 percent. The required reserve is calculated on the total of deposits¹³ (liabilities of commercial banks) in Lek as

well as in foreign currency. A recent innovation, dating October 2000 relates to the remuneration rate that Bank of Albania offers for these reserves in order to lower the financial intermediation cost in the system. Initially, the remuneration rate was 1/3 of market rate, but starting from the first quarter of 2001, in light of the desire to see the effects sooner, the remuneration rate changed to 1/2 of the market rates.

POLITICAL VISION OF BANK OF ALBANIA OVER THE MEDIUM TERM

In view of the overall low inflation rate in the country, the current policy framework of Bank of Albania can be assessed as successful. Yet, many economists are not convinced about the suitability of having monetary objectives when it comes to transition countries. These doubts rise from the fact that the demand for money in this countries is inevitably unstable (Wagner 1998). Also, since transparency, accountability and credibility are the most important conditions for the success of stabilizing policies, targeting money supply does not offer the best means to reduce inflation. The objectives on domestic assets (credit to government, credit to non financial state and private enterprises) are not very transparent, because even if they were to be published, they do not offer the public a clear message on the expected inflation rate. Furthermore, tight monetary objectives have usually high costs as they cause contractions in economy (although short lasting) and the rise of real interest rates (Sahay dhe Vegh, 1995). These costs might harm credibility, leading to expectations that soon policy will change to being expansionary.

Although there are not many empirical analyses¹⁴, yet over the years there have been attempts to study what determines inflation rate in Albania. Some authors¹⁵ have reached the conclusion that the correlation between money and inflation is weak.

No matter the differences of opinions, all agree that at a considerable extend, inflation depends from other macro variables, which are beyond the control of Bank of Albania or are not part of policy making issues. One of the most talked about factors is exchange rate, which in view of large imports is an important factor in creating inflationary pressures in the economy. (Hadëri et. al 1999). Also, the fiscal burden, in a way shadows the monetary policy efficiency vis-à-vis inflation.

Based on all the above mentioned reasons, it is logical that measuring all the factors that influence inflation has become a necessity, and maybe it is time that Bank of Albania moves from having money supply as its intermediate objective to targeting inflation. In this context, Bank of Albania has publicly stated that it will change its policy regime to Inflation Targeting in the medium term. In its policy document "The plan for medium term development of Bank of Albania (2003-2005)" it is mentioned¹⁶ that "... a suitable regime for our policy is that of Inflation Targeting...."

In practice, Inflation Targeting has revealed a successful strategy if on one hand it is supported by a sound macroeconomic and institutional environment and on the other hand it addresses an audience (economic agents, individuals, public overall) that understands and welcomes it.

What favors the fast implementation of Inflation Targeting?

Literature suggests that the successful adoption of IT regime requires a period of at least 2-3 years of **stable inflation** rate. It is not necessary to explain the notion of a stable inflation rate, yet, we would like to stress out the fact that during the last 5-6 years, Albanian economy has recorded inflation rates that can be considered low. On average, annual inflation rate for the period December '98 – August '03 varies around 2.4 per cent, a bit above the lower limit set by the Bank of Albania. However, the most important aspect of this is the public commitment of Bank of Albania to control inflation within a fixed band in the future. Currently, the official stance of the Bank is to keep annual inflation rate at the end of the year not higher than 4 per cent and not lower than 2 per cent. At this point, we would conclude that this fact is a strong point in favor of successful adoption of IT regime.

Another precondition for IT regime is the implementation of **flexible exchange rate** regime. This condition is met by Albania, thus supporting the fast implementation of IT. Since mid '92 and ongoing, Bank of Albania chose a flexible exchange rate regime where price is market determined. Eleven years later, it can be noticed that our domestic currency has been stable in general, except for the "unfair" attack of 1997. At present, the exchange policy of Bank of Albania assumes that interventions will be carried out only to eliminate

market speculations and to avoid large deviations from the historic trend of exchange rate of Lek.

Successful implementation of Inflation Targeting regime implies also the **consolidation of budget deficit** and in general the **commitment of fiscal authorities** not to compromise the monetary policy. The last years have marked progress in this respect although the fiscal burden in the economy is still large. Nevertheless, Albania's long term goal to join EU highlights the need for the commitment of institutions *de facto* to reduce the negative effects of fiscal burden in the economy. Two important conditions part of the convergence criteria: central bank is legally prohibited from financing budget deficit; and the budget deficit should be kept lower than 3 per cent of GDP, will be hopefully met during the 3-4 years ahead, coinciding with the Bank of Albania's goal to adopt inflation targeting in the next 2-3 years time.

Another argument favoring Bank of Albania to implement Inflation Targeting relates to the **overall legal and institutional context** of the Bank. Current law on Bank of Albania ensures a high legal, operational and economic independence. According to Albanian scholars, "...if we study the current law on the Bank of Albania, it can be concluded that the institution has a considerable legal independence¹⁷" (Cani, Baleta 1999). The same conclusion has been drawn with regards to the operational and economic independence. At present, Bank of Albania has managed to build a relatively modern operational setting to control money market, while she enjoys the legal rights to chose those instruments it deems appropriate. However, the authors we are referring to are skeptical when assessing the real independence of the central bank. They bring forth several arguments which create the impression that in everyday life, situation is a bit different and that from this point of view, there are many challenges to face. Stressing the same issue, it would be of interest to briefly elaborate on other institutional aspects, which have a vast impact in the successful implementation of the Inflation Targeting regime.

During the last years, Bank of Albania has greatly improved the level of transparency in every possible way. Its objective has been that of complying with the Code of Good Practices on Transparency of Monetary Policy of the Central Bank issued by IMF. Even though the number of publications, channels of communications with the

public, etc. has increased considerably, Bank of Albania cannot be considered a very transparent institution and that is partly due to the lack of its capacities to fully explain its policy decisions. Nevertheless, the positive developments of the last years create premises to be optimistic for the future.

Increasing transparency has, on one hand, led to improving the image of the Bank of Albania in public and on the other hand it has obliged the central bank to be more accountable for its actions. Different surveys, increasing interest in Bank of Albania's publications, assessments from international institutions, etc. suggest that the credibility of the Bank of Albania has risen continuously, being a positive factor in favor of Inflation Targeting regime. Also, the accountability of the Bank of Albania is based on contemporary principles focusing more on explaining the role of monetary policy and the role of Bank of Albania as a supervising authority by publishing its financial accounts and audit reports. However, there is still room to improve on both aspects especially in terms of explaining more professionally the policy making and administration process of the institution.

What hinders the adoption of an Inflation Targeting regime?

Albania still constitutes an economy of ongoing reform, with frequent structural changes, which, in a way, have their impact on the main economic indicators. Likewise, its immunity system vis-à-vis domestic and foreign crisis is far from perfect, which increases its fragility. Due to all these reasons and other ones mentioned in previous paragraphs, the Bank of Albania lacks a clear understanding of the manner how¹⁸ its political decisions are transferred onto economy. Cani in his presentation¹⁹ at the Third Conference of the Bank of Albania has stressed "... that the effect of monetary policy is sensitively decreased due to the presence of certain factors, such as: (i) the monopolistic position of the Savings Bank in the market of lek deposits; (ii) the limited role of crediting in lek; (iii) the relatively large difference between deposit and credit interest rates; (iv) the limited activity of interbank market, which is concentrated in extremely short-term instruments; (v) the remittances; (vi) the large possessions of *cash* in lek and foreign money by the Albanian people, etc."

This statement of the Governor of the Bank of Albania brings out

that in the event of a potential implementation of the Inflation Targeting regime, the Bank would necessarily need to address such issues as the low efficiency of the markets, the problems with competition and domination of the Savings Bank, the still low degree of financial intermediation, the lack of clarity that characterizes the mechanism of monetary transmission, the dimensions and impact that originate from shadow economy as well as the scale of dollarization, the familiar problems with macroeconomic statistics, the limited abilities of the Bank of Albania in the techniques of patterning and forecasting, etc.. All these issues, conjoined with the need for an improvement of the real independence of the Bank of Albania, constitute substantial obstacles for an adoption of the Inflation Targeting regime.

Obviously, it is not the case to draw a balance of the factors that are for and of those that are against the adoption of the Inflation Targeting regime. Of course, there is room for improvement in both directions. More specifically, it cannot be said that inflation in the recent years has been low and this is sufficient. The same way, the fact that there has been a decrease in the market domination by the Savings Bank in the last two years cannot be denied. The main conclusion that can be drawn out is related to the fact that the institutional engagement of the Bank of Albania to adopt in a medium-term period the Inflation Target regime as a political framework, requests a greater commitment by the Bank itself and by the other institutions in the country. There is no doubt that there is room for more macroeconomic stability, more economic growth, more new work places, greater stability of prices, greater rapidity in the implementation of structural reforms, etc.

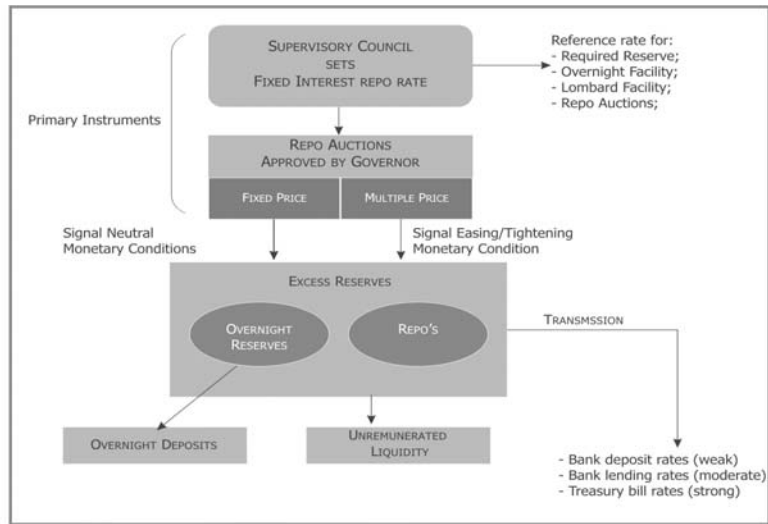


Diagram 1. Current Monetary Policy Framework

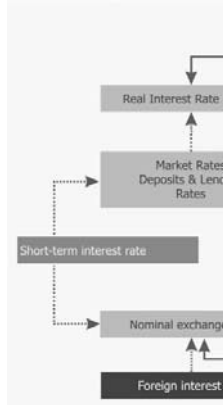


Diagram 2. Transmission Mechanism

ENDNOTE

¹ However, never has the final objective of the Bank of Albania been the combination of several indicators. Not in any case, have indicators such as domestic production, employment rate, etc. been part of final objectives pursued by Bank of Albania.

² Andrew Crockett, "Monetary policy objectives in light of Asian crises", Monetary Policy Frameworks in a Global Context, pg 224.

³ Quantitative criteria (performance criteria) are in existence even today, though their definition differs from that of early '90s.

⁴ The notion of net foreign reserves of Bank of Albania used in the monetary program is a little bit different from the term used very often "foreign reserves of Bank of Albania" or "foreign assets of Bank of Albania".

⁵ Floor interest rate for time deposits in Lek placed with second-tier state owned banks.

⁶ Depending on the policy of Bank of Albania, auctions could be: (i) repurchase agreements
– to draw liquidity, or (ii) inverse repurchase agreements
– to inject liquidity in the market.

⁷ During 2001, only two outright of TB have occurred for the total amount of 8 billion lek. In both cases, the buyer was the Savings Bank.

⁸ It was never used during 2000-2001.

⁹ It can have a maturity of up to three months and it can be obtained only once in three months.

¹⁰ At present, this rate is 13 per cent.

¹¹ At present this rate is 9.5 per cent.

¹² Until October 2001.

¹³ Except for interbank deposits.

¹⁴ Mc.Neilly Schiesser (1998); Helbirt & Domac (1998); Karla (1999); Mytkolli & Haderi (1999); (Hadëri et al. 1999); Kolasi (2000); Rother (2000), Kolasi, Çeliku & Hashorva (2001); Sanfey, Muço & Luçi (2001); Hledik (2001) etc..

¹⁵ Hadëri & Mytkolli; Kunst & Luniku (1998); Kolasi, Çeliku & Hashorva, 2001.

¹⁶ The plan for medium term development of Bank of Albania (2003 – 2005), pg 27.

¹⁷ Shkëlqim Cani, Teuta Baleta, "Central Bank independence. Bank of Albania: How independent is it?", Working Paper 1/99, September 1999, Bank of Albania.

¹⁸ Figure 2 reflects a potential scheme of the monetary transmission mechanism in Albania.

¹⁹ Shkëlqim Cani, Monetary Policy: an analytic view on the past and its vision on the future, Presentation in the Third Conference of the Bank of Albania, December 2002.

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COMMENTS ON: "AN APPROACH ON MONETARY POLICY: SELECTIVE BALKAN'S COUNTRIES EXPERIENCES"

Marian Gjermeni

With the understanding that the real life is the right appraiser to assess the effectiveness of the monetary policy which is followed by the countries that have the possibility to speak in this conference, I am going to skip my opinions about it and to organize my comments just for two topics:

Lessons learned from monetary policy implementation,
Possible future monetary policy framework.

A - LESSONS LEARNED FROM MONETARY POLICY IMPLEMENTATION:

- a- Government' s should publicly state their own objectives through their own programs or agreements signed with international financial institutions. This programs should serve like as a future benchmark for their economic activity,
- b- Get the public understanding and support to avoid any internally loss of confidence (credibility),
- c- If it's a need for policy adjustment make it transparent to the public but bear in mind that all adjustments should be consistent with previous policies,
- d- With the understanding that the majority of the countries in the region, which are participating in this conference, fall in transition economies, we need to be aware of the necessity for the structural reforms either in real or financial sector,

- e- Keep under control fiscal deficit and does not tolerate it especially through loosening monetary policy,
- f- Work to build up and to protect an independent central bank,
- g- Respecting the rules of the game and fulfilling continuously the targets will help to build up and increase the credibility and at the same time will create conditions to avoid any speculative attack,
- h- Work hard to create a sound banking system through strictly enforcing prudential regulations, monitoring carefully the development in credit activity, monitoring and why not avoiding any mismatch position either at banks or bank's clients balance sheet,
- i- Be aware about any inflow of foreign currency and formulate policies which will deal with them not only when they are coming but also when they are stopped or went out.

B - POSSIBLE FUTURE MONETARY POLICY FRAMEWORK

Supposing that the main objective of the monetary policy is going to be the price stability and not expanded or replaced by other objectives as promoting growth of output, employment or competitiveness, allow me to say first which are the two broad strategies which central banks adopt:

- a- Indirect policy based on an intermediate target such as: growth in monetary aggregate, interest rate or exchange rate. It is implicitly assumed that there is a predictable relationship between the intermediate target and future inflation along the line suggested by the quantity theory of money.
- b- Direct policy based on an explicit final target for inflation. A target is set usually for future inflation, in order to allow for the time lag between changes in monetary policy and its impact in inflation. Here policy is changed on the basis of multiple intermediate variable on both the demand and supply side of the economy.

In this case we can have three scenarios :

- 1 - The " strict constructionist" – Interest rate should respond

- to the exchange rate only when it affects actual or forecasted inflation (otherwise it could confuse the public regarding the ultimate objective),
- 2 - The “flexible inflation target” – the exchange rate can also be a legitimate policy objective, alongside inflation (in this case use monetary policy to respond to the exchange rate only when inflation remains comfortable within target),
 - 3 - “Singaporean view” – pass through is sufficiently high and stabilizing inflation requires close management of the effective exchange rate.

After we did a short description of the possible monetary strategies and after reminding to you the monetary policy framework used by country represented here: Greece no monetary policy, Turkey before crises exchange rate anchor and now explicit monetary target implicit inflation targeting, Croatia explicit monetary target but implicit exchange rate anchor, Bosnia Herzegovina currency board, Albania implicit inflation target, explicit monetary targeting I can say something about future possible monetary framework.

Greece like it is now,
Turkey - “strict constructionist”,
Croatia - “Singaporean view”,
Bosnia Herzegovina - “Singaporean view”,
Albania - “flexible inflation target”,

CONCLUSIONS

The central aim of the transition process has been to transform entirely the system of centrally planned economy toward a system of decentralised decision making of market economy and to reach and preserve macroeconomic equilibriums. The experience, so far has shown that achieving this aim requires more than just liberalising the markets. The institutions that support the new market economy need to be more established and consolidated as well. The institutional reforms in transition economies, however, have proved to be more complex and time consuming than anticipated. This slow progress of the institutional reforms seems to be responsible for the inadequate development of many economic sectors discussed in this conference.

The scale of informal economy in Albania has reached levels of becoming an obstacle to economic development by seriously restricting the role of government through its fiscal policy. The process of transformation of informal economy toward the formal economy according to Mr. Olters requires the provision of better “public goods” and development of a credible anti-evasion action plan. On the other hand, the sustainability of current account deficit is threatened if structural reforms aimed at increasing Albanian foreign competitiveness and the substitution of imports with domestic production are not implemented.

From the analysis of Mr. Nicols although Albania has strengths in relation to geography, integration and the policy framework it has problems in relation to institutions, and in particular with the property rights and business friendly bureaucracy. He urges that unless, these issues are tackled urgently and with conviction, there is a major danger that the “free market” approach will be transformed into “crony capitalism”, where those with connections get the benefits, while others lose out, which is not an option for sustained development.

So, as emerges from these discussions the institutional consolidation is the main challenge Albania and other transition economies face at this stage of transition. This is not to say that other policy areas such as monetary policy and financial development have less of importance at this stage of transition. Despite the macroeconomic stability achieved in Albania, several challenges stand ahead in order to increase the effectiveness and the role of monetary policy, as it was argued in the presentation of the last session. Also the experiences of other countries, discussed today in the last session, have revealed several difficulties in achieving the macroeconomic stability through tough monetary policy regimes without jeopardizing other foreign and domestic equilibriums.

This conference suggests several policy conclusions. Five major themes for future policy directions may be identified.

First, an economic policy and philosophy is needed that view the relationship between the government and markets as complementary both working in partnership, and recognised that while markets are at the centre of the economy, there is an important, although limited, role of government to play.

Second, the government has an important role to play in creating and maintaining the economic growth. The time has come to really understand the crucial role of public sector, especially in depression periods and in presence of market failures.

Third, the business environment in Albania needs further improvement to promote exports and FDI which in turn are necessary to maintain foreign equilibrium and a sustainable economic growth.

Forth, business community should commit itself in respecting the rules of the market economy and fair competition, as well as, the rules of law. They should increase the transparency of their activities and understand that their partnership with the authorities is the key to overcome the many problems the economy is currently facing.

Fifth, the Banks of Albania should continue to develop its ability to analyse economic developments in setting monetary policy in order to maintain the macroeconomic and financial stability without hampering the economic development.

Sixth, financial system being at the hart of market economy requires particular attention in order to boost the much needed credit for the development of small and medium enterprises.

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