

The Albanian economy in the 25th year of its transition

Abstract

In the past 25 years, the Albanian economy has undergone a significant transformation. However, the task of building a full market economy has been difficult and protracted. Liberalisation of trade and prices came quickly, but institutional reforms have often faced opposition from vested interests. This article sets out the main features of the transition of the Albanian economy from the macroeconomic perspective. The transition's itinerary is analysed in three periods; the first phase discusses the pre-crisis developments in Albania; the second presents the problems faced by the Albanian economy during the crisis; and the third outlines the need to orient the economy toward a new strategy of growth and the steps that should be taken in order to create opportunities and challenges. The paper concludes that the current economic model cannot generate sustainable growth at the level of the pre-crisis period. New dynamics and prosperity in the 21st century require a smarter growth model and one that has in its substance regional co-operation.

Keywords: transition, sustainable growth, structural reforms, regional-operation

Introduction

Before the global financial crisis, the Albanian economy was experiencing sustained and rapid growth, accompanied by a low inflation rate, a consolidated fiscal position and a stable foreign exchange market. Sound fiscal and monetary policies, as well as low macroeconomic volatility, supported the impressive growth of the country. The main driver of growth was strong domestic demand, which reflected a rising trade deficit financed through remittance inflows, privatisation and FDI.

The crisis changed that situation, affecting several aspects of the Albanian economy. The first impact of the crisis was on the banking system, not as severe as in other emerging and developed economies; then economic growth slowed, as did credit and investments.

The aim of this article is to discuss several implications of the economy's pre-crisis growth model which, together with the financial crisis, revealed a number of domestic imbalances. The implications of these imbalances need to be considered in order to lay the basis for a new model of development. The main question raised in this article is whether the core pillars of growth that have sustained the Albanian economy from the beginning of the transition process until the present remain intact, and are able robustly to support sustainable growth over the medium-term. This

question motivates the discussion that follows concerning the future growth model for Albania.

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

The pre-crisis model – consumption-driven growth model and the production of non-tradable goods

1990 marked the start of the process of transition of the Albanian economy from centralised planned economy to a market one. In the early stage of the transition, between 1990 and 1992, Albania's real GDP decreased by a cumulative 39 per cent. With the introduction of macroeconomic stabilisation policies, and due to the gain of efficiency resulting from liberalisation measures, the Albanian economy experienced a sustained economic recovery, averaging an annual growth rate of 9.3% between 1993 and 1996. The desire for rapid wealth accumulation, coupled with the inability of the economy to absorb the available funds and financial illiteracy, led to the creation of informal financial institutions (pyramid schemes) that yielded extremely high returns in cash for short-term investments. The perception of rapid wealth accumulation over a short period of time resulted in a rapid increase of domestic demand fuelled by household consumption. The fall of these pyramid schemes was the first shock to the Albanian economy, which led to the crisis of 1997. This event proved to be very short-lived, as the annual growth rate of real GDP one year later reached 8.6 per cent. In the following years, the increase in GDP stabilised at around an average of 6 per cent until the onset of the financial crisis.

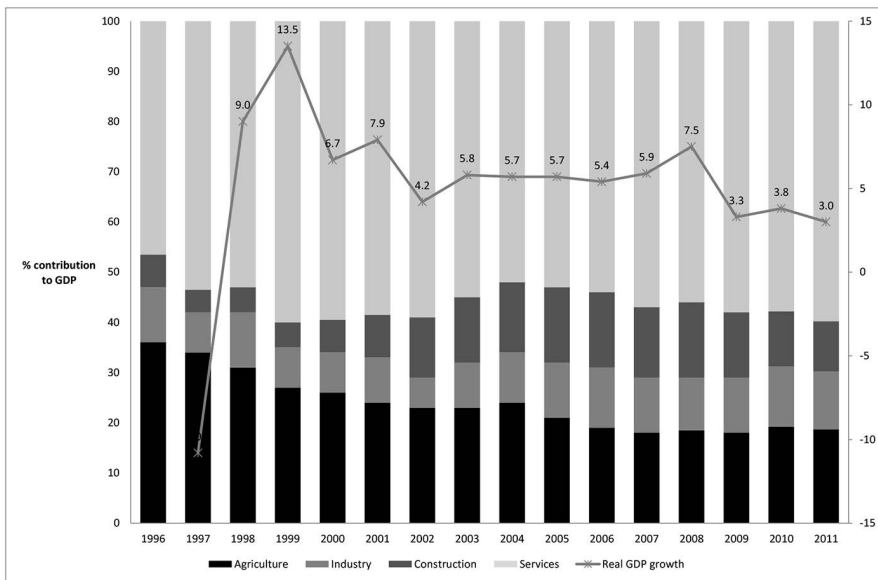
It is very interesting to establish the sources of such impressive economic growth in order better to understand the possible implications for the future. Like the other centrally-planned economies, resource allocation in Albania was made in line with the state's central planned priorities rather than market efficiency. The re-allocation process, together with improvements in the productivity of the factors of production, is what shaped the growth economic model, biasing growth towards some sectors of the economy at the expense of others.

One study (Kota, 2009) shows that the industry sector dropped to 7.6% of GDP in 2009, from 39 per cent at the beginning of the transition process, as a result of low levels of efficiency and a lack of market demand. In contrast, the construction sector expanded considerably, from about 3 per cent of GDP in 1990 to 14.5 per cent in 2009, due to high demand for residential housing, much-needed improvements in infrastructure and support for other sectors that placed demands on capital, land and the labour force. The largest expansion happened in the service sector, whose share increased from 33 per cent to 63 per cent during the 1990-2009 period. Agriculture

expanded from 23 to 32 per cent during 1990-1997, but it had shrunk to 19 per cent of GDP by 2009.

This composition of the economy's sectors initiated a re-allocation of the factors of production in line with market demand. The study by Kota (2009), based on the methodology of Khan (2004) suggests that only after 2000 did the capital stock play an important role in economic growth, with total factor productivity continuing to be an important determinant of economic growth. TFP fell dramatically during the sharp contraction of 1990-1992, but increased substantially during the recovery period of 1993-2003.

Chart 1 – Non-tradable sector – the key boost to economic growth



Source: World Development Indicators (WDI, INSTAT)

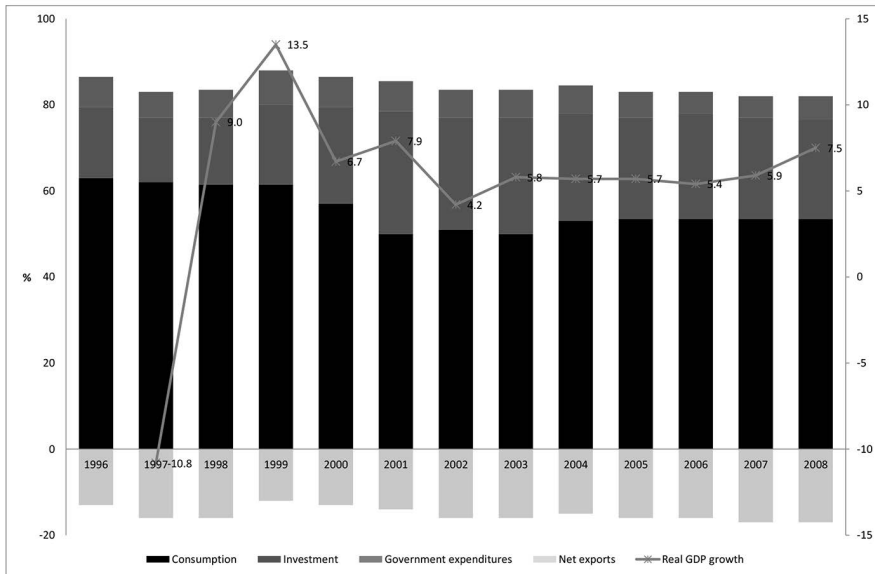
In line with theoretical observations and empirical evidence, the productivity gains from the rapid redistribution of the factors of production provided a decreasing contribution in the early stages of the transition. Domestic demand, in terms of elevated private consumption and investment, was increasing quickly, being the main driver of the sustained growth rate.

Developments in these important elements of domestic demand were also affected by the speed of financial intermediation in the country. Credit to the private sector has grown rapidly since then, with the bulk of credit and private investment going toward non-tradable sectors, mainly construction.

Furthermore, the size of the non-tradable sector, in comparison to the tradable sector, contributed to a rapid increase in trade and current account deficits, as the production of the agricultural and industrial sectors of the Albanian economy could

not match the increasing demand for consumption and investment. During the 2004-2010 period, consumption goods accounted for around 32 per cent of total imports, with 53 per cent being intermediate goods and only 14 per cent being capital goods.

Chart 2 – Consumption: the largest share of domestic demand



Source: INSTAT

Unlike other central and east European economies, the majority of credit was financed by domestic resources, bank deposits and capital rather than by foreign borrowed funds. However, more than two-thirds of loans were dominated in foreign currency.

The downside of this growth model is that the fast process of intermediation adversely affected the balance sheets of households and companies, while simultaneously contributing to a weakening of the economy's external positions since growth was supported by widening trade and current account deficits.

The financial crisis ended the favourable run

After a long period of substantial economic growth, the last quarter of 2008 marked a slowdown in the Albanian economy, a trend which has been maintained to the present day. Due to the moderate level of financial deepening in Albania, and its low integration in the international financial market (financial intermediation was mainly dependent on domestic resources rather than loans from parent banks), the financial crisis did not, in the first place, heavily affect the economy through direct channels. The economic growth rate continued to be positive, but at a low level.

The slowdown in the European economy caused the reduction of foreign currency inflows, mainly remittances. Meanwhile, the deterioration in household and private sector balance sheets, resulting from depreciation and a sharp slowdown in financial intermediation due to liquidity problems, caused by fears of contagion, supposed that the crisis could spread into the Albanian banking system as well. Both these factors had a negative impact on aggregate demand and economic activity.

The domestic sources of the financing of Albania's thus-far successful economic growth were seriously affected by the crisis. Credit growth shrank from an annual 53 per cent in 2007, to 25 per cent in 2009 and to 3 per cent in 2012. The result was that private consumption slowed and private investment contracted, ensuring that domestic demand provided no boost to economic growth. Due to the crisis, the economy could not use its resources efficiently, leading to unemployment pressures and lower capital formation. Later, economic activity was hit by the slowdown in domestic credit growth as well as a lack of financing for private investment.

The current situation of economic activity, chronic current account deficits and a weakening in household and private sector balance sheets were worrying signals that must be reversed in the long-run. The Albanian economy must identify new sources of sustainable growth, as existing ones are exhausted and have become, as a matter of fact, less sustainable. Increasing investment in the tradable sector, especially in exports, is crucial to balance the current account in the future and put the Albanian economy on a sustainable path of economic development.

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

Accordingly, there is a need to identify a new long-term economic growth pattern, capable of absorbing financial resources – particularly from abroad – in new and innovative ways and generating economic growth without producing the negative externalities of the old model. The crucial step in overcoming the problems of under-used capital, the slowing of credit growth, the high unemployment rate, unused agricultural rate, etc. is finding efficient ways to increase the productivity of the factors of production and to combine them more efficiently.

The first step in this regard is the identification of the competitive advantages that the Albanian economy generates and the acceleration of structural reforms in light of these priorities. An analysis of the competitiveness of the Albanian economy shows that the structural and institutional problems are greater obstacles than the economic ones.

Constrained by the circumstances of an economy that has just moved out of the transition to emerging market status, Albania requires political commitment and a broad level of social understanding, as well as continuous support for long-term de-

velopment from all economic agents. The following section presents the characteristics of a new growth model for Albania.

A new growth model for Albania

The positive experience of economic development thus far indicates that Albania has the right capacities to grow, but only if it succeeds in shifting to a new economic model – investing heavily in technology adoption, innovation and human capital, while achieving a re-orientation of its financial resources.

Economic developments in Albania, as in other emerging market economies, have confirmed that total factor productivity has been the main contributor to growth during the process of transition toward a market-oriented economy.

The several comparative advantages yielded by Albania's favourable geographic location, concerning tourism and agriculture, and by its endowments in natural resources relating to electricity, mining and associated industries, have yet to materialise or take off despite several attempts to make them attractive through special government-supported programmes. The lack, or low quality, of its physical and market infrastructure, along with slow structural reforms in markets as regards factors of production (land) and lacklustre foreign direct investment in these traditional sectors, have prevented an increase in employment and labour productivity and have failed to create economies of scale. The same is true with respect to the adoption of new technologies and the development of human capital. Competing with similar or more advanced economies, Albania has focused on factor-price competitiveness. Policies should develop particular economic programmes and proper capabilities to increase the productivity of its factors of production up to the point where they become economically profitable for the current price from the point of view of investors.

New growth models link the competitiveness of the economy to its ability to generate innovation and improve productivity through human capital. The competitiveness of a country is not related to its monetary wealth, but rather to the ability of its human capital to increase its productivity faster than its costs. In this context, it is worth emphasising the crucial importance of education as the key element of investment in the improvement of human capital. The history of economic development shows that countries that have invested in education are currently the most developed countries of the global economy.

This process is particularly important to the further improvement of labour productivity in Albania. Long-term economic growth should be based on the continuing enhancement of productivity, while the improvement of within-sector productivity growth is the new challenge for Albania. More emphasis should be put on investment in output-oriented sectors which have high productivity growth. Simply using human capital cannot be the only solution: boosting domestic production is crucial to the ability of the economy to support internal demand for investment and consumption. The ability to generate extra income depends on the size of the economy. In this respect, for a small open economy, exports are of imperative importance, while the tradable sector becomes the keystone of the future growth model. The efficient reallocation of economic resources will be reflected in the fine balance between domestic demand-driven growth and an export-driven model.

The re-orientation of the economy towards the export sector relies on the country's ability to improve its competitiveness. Exchange rate re-adjustment following the financial crisis has already occurred; the result is that the export sector should find other ways to enhance its profitability other than price differences. Greater focus should be placed on enhancing external competitiveness through an improved business environment and cost competitiveness. The above-mentioned reforms on human capital improvement and technology adoption are very relevant in boosting the export sector. Macroeconomic policies need to focus on improving the attractiveness of the economy for strategic long-term investors so that financial inflows and domestic lending are channelled to the tradable sector.

The banking sector and financial intermediation affect aggregate economic performance. An increase in bank capital may increase their loan volumes, thus triggering an increase in investment and GDP. During the international financial crisis, the significant slowdown in worldwide economy activity led to a rise in non-performing loans. Combined with a decrease in asset prices, this rendered banks more risk adverse, and thus less willing to lend to different sectors of the economy which, in turn, exacerbated the economic slowdown. The restructuring and resumption of lending activity cannot take place without first cleaning up non-performing loans. The investment and credit allocation process, the composition of credit portfolio and a landscape of economic growth must be achieved by pressing banks to improve their financial situations and increase their credit assessments and risk management capacities. Improving the business environment, market institutions and market efficiency will allow for the accurate pricing of opportunity costs and risks, improve the process of credit allocation in the economy and lead to the desired sustainable model of growth.

The future orientation of the Albanian economy must consider the regional perspective. A small economy, in terms of markets and demographics, with limited scope for economies of scale and clustering, Albania is located in a region dominated by similarly-endowed (in terms of markets and demographics) small, open economies which offer and promote similar comparative advantages and share the same political, social and economic goal of EU membership.

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

Regional co-operation calls for the identification of win-win strategies of country specialisation and trade in goods and services. These are characteristics that the region can offer on a much better basis than can its individual economies. In other words, this calls for economic structural co-operation, through the identification of country-level comparative advantages and industry-level competitive advantages based on a regional overview rather than one oriented to national points of view.

Conclusions

The growth model of the Albanian economy prior to the crisis has been a success story, with fast growth rates, welfare improvement and an upsurge in total factor productivity.

However, the recent financial crisis has revealed the many domestic imbalances that have emerged as a result of the transition growth model. The economy was oriented toward the production of non-tradable goods and services, which increases domestic demand much faster than aggregate supply. Remittances have been in strong support of the economy but, in this process, they have become dysfunctional, being oriented mainly towards consumption rather than investment.

The financial crisis hit the sources of this successful expansion, so the need to orient the economy towards a new strategy of growth is imperative. Technology adoption and innovation should be the new cornerstone of a new growth model. In this process, developing and accumulating human capital will be crucial, since a well-educated labour force will be able to use more advanced technology more effectively.

The banking system will have to play an important role in this new growth model. Its financial intermediation must support the development of new trades and industries away from the current focus on non-tradable activities. A new model of banking business should be founded on a closer relationship with business as well as stronger research, risk assessment and risk management capabilities.

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

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