

# ECONOMIC AND MONETARY DEVELOPMENTS DURING THE TRANSITION PERIOD IN ALBANIA. A DESCRIPTIVE APPROACH

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## Introduction

Albania represents a special case among the ex-communist countries. The Albanian economic model had three distinctive features:

- Complete reliance on centralized planning
- Elimination of all forms of private property
- The implementation of national self-reliance and economic autarchy.

During the last decade of communist regime Albanian's economic performance worsened sharply resulting in a stagnation of economic activity. The annual growth in GDP per capita fell to less than 1%, compared with 5% in the previous decade. The reasons which are hiding behind this situation can be summarized to: the worsening of external accounts, the depletion of foreign exchange reserves, the rapid increase of external debt, the accumulated structural problems and finally the resistance to undertake reforms as other socialist countries had. Albania was considered as the least developed country in Europe in 1990, with standards of living similar to third world countries.

## An Overview of Albanian Economy Transition Process

Since 1991, the beginning of the transition the pattern of development of Albanian economy has shown four different stages

*Table 1. Albania, Macroeconomic Indicators, 1991-2000 (Annual averages, percent)*

	1991-92	1993-96	1997	1998-2000
Real GDP growth	-17.6	9.3	-7.0	7.6
Inflation	170.5	17.5	42.1	3.8
Current account deficit (%GDP)	-61.1	-15.1	-12.1	-7.1
Fiscal deficit (%GDP)	-25.8	-11.4	-12.9	-11.0

Source: Ministry of Finance.

During the first stage (1991-92) Albania was the last eastern country started changes towards democracy and market economy. Table 2 presents some of the initial indicators in Albania, prior to the changes and implementation of the program. Compared to some other eastern European countries there was a large gap in standards of living between these countries and Albania.

This stage was characterized by huge reduction of real GDP and high inflation performances. During 1991 and 1992 there was a rapid increase in prices which were exacerbated by an initial monetary overhang of 0.576.

*Table 2. Albania: Selected Indicators at the start of Transition*

Indicators		
Population (1991, Annual Average) <sup>1</sup>	3,242,000	
GDP per capita (1991) <sup>2</sup>	\$340.0	
GDP Growth (Annual Average, Constant Prices) <sup>3</sup>	1970s: 5.0%	1980s: 0.8%
Administered Prices	100%	
State Ownership Economy -Wide		
Broad Money/GDP <sup>4</sup>	0.576	
External Debt/GDP (1991) <sup>5</sup>	0.573	

Sources:

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

This early stage also was characterized by a rapid growth of domestic credit, especially to government and state enterprises, leading to a large monetary expansion. The rapid increases in the money supply according with the large fiscal deficits and severe negative aggregate supply shocks, helped to fuel the high inflation leading to a decrease of GDP of about 40% in 1992.

The period 1993-96 (second stage) was characterized by a significant economic recovery. In real terms GDP increased by 9 percent, inflation fell substantially, and both the current account balance and the fiscal deficit improved significantly compared with 1991-92.

*Table 3. Albania: Selected Macroeconomic Indicators*

	1994	1995	1996	1997	1998	1999	2000
GDP growth in (%)	8.3	13.3	9.1	-7.0	8.0	7.3	7.8
Inflation in (%)	15.8	6.0	17.4	42.1	8.7	-1	4.2
Unemployment rate (%)	18.4	13.1	12.4	14.9	17.8	18.0	15.3
Budget Deficit/GDP (%)	9.0	10.2	12.8	12.9	10.4	9.5	9.1
Current account/GDP (%)	-14.3	-9.7	-11.5	-14.4	-8.2	-7.2	-7.0
Trade Balance/GDP (%)	-23.6	-19.2	-25.2	-23.3	-19.7	-18	-21.4
Exchange Rate	94.7	92.8	104.5	148.9	150.6	137.7	143.7
Debt/GDP (%)	52.5	55.5	59.9	71.4	59.4	62.2	70.7

Source: National Statistics, various issues.

This strong performance was mainly due to two factors: (i) policy of tight monetary and credit policy and cautious fiscal policy eased the pressure on prices, and (ii) the privatization of agriculture, and of retail and wholesale trade as well as small- and medium-size enterprises, spurred GDP growth.

The banking reforms started in July 1992 creating the Bank of Albania as a new Central Bank, and all commercial operations were transferred to the newly created National Bank of Albania. The Central Bank was awarded a degree of independence, which was essential for implementing the comprehensive stabilization program and in 1992, for the first time in Albania, Central Bank imposed a hard budget constraint to control money and credit growth. The rate of growth of broad money decreased from 182% between mid-1991 and mid-1992 to less than 100% for the following twelve-month period and further to 45% between mid-1993 and mid-1994 and 42% for the following twelve-month period. Table 4 presents the yearly growth rates of M1, M2, and M3 withdrawn from IMF country reports and EBRD's Transition reports for various years. However, the rate of growth of broad money increased between mid-1995 and mid-1996 to more than 50%. In addition the velocity of broad money initially increased, from 1.9 at the end of first quarter of 1993 to 2.6 at the end of second

quarter of 1994, and decreased further, to a value of 1.9 at the end of the fourth quarter of 1996 and it is a further indication that the expansion of the economy was accompanied by both a decline in inflationary expectations, and by increased credibility of the stabilization program. But, during 1996 the decrease in velocity can be accounted for the huge expanse of informal sector.

*Table 4. Growth Rates of Monetary Aggregates (year-on-year) and Money Velocity*

	1994	1995	1996	1997	1998	1999	2000
Base Money	34%	28%	14%	48%	-1%	22%	23%
M1 Aggregate	37%	53%	53%	1%	-9%	23%	26%
M2 Aggregate	44%	52%	38%	23%	23%	20%	13%
M3 Aggregate	41%	52%	44%	28%	21%	22%	13%
Money Velocity	2.6	2.1	1.9	2.1	2.1	1.8	1.8

Source: Bank of Albania

On the other hand, during the second stage in Albania, the deficit was kept under control by restraints on many forms of expenditure, including those on wages and social security. Real wages in the state sector fell initially and since the second half of 1993 to 1995 increased by 4.2% and public sector employment has fallen from 790,000 in 1992, to 296,000 by mid-1995. Thus, reducing considerably the government's wage bill and wage pressure, a low inflation can be succeeded.

In 1992, a new Unemployment Insurance system was introduced, which tightened the eligibility criteria by restricting unemployment benefits up to a maximum of one year.

The reduction of expenditure, along with the introduction of new tax laws which increased revenue lead to a reduction in budget deficit from 17.3% of GDP in 1992 to 9.6% in 1995, but it rose to 10.5% in 1996, (See Table 6). Total revenues as a percentage of GDP declined to 23.5 % in 1995, and 21.7 % in 1996, from 26.7 % in 1993 mainly due to a declining share of tax revenues in GDP. Total expenditures, as a percentage of GDP, also displayed a similar trend declined from 40.4 % in 1993 to 32 % in 1995 and 32.9 % in 1996.

*Table 5. Summary of Fiscal Accounts, 1995-2000, (% of GDP)*

	1995	1996	1997	1998	1999	2000
Revenues	23.4	18.4	16.6	20.3	21.2	22.6
Expenditures	33.6	31.2	29.5	30.7	32.7	32.2
Primary balance	-10.6	-11.1	-9.8	-6.2	-8.1	-6.1
Overall balance	-10.2	-12.8	-12.9	-10.4	-11.5	-9.6

Source: Budget Department, MoF.

However, during 1996, the new election resulted in a decrease of tax revenue and increase of fiscal deficit. A low pace accompanied these developments in reforming banking system and along with huge expanding pyramid investment schemes began to show early signs of a collapse.

The third stage of economic developments characterized by the collapse of the pyramid investment schemes pushing the country into a state of anarchy. GDP contracted by 7 percent, inflation was accelerated and the current account deficit widened by three percentage points compared with its 1996 level.

Revenue decreased by a further two percentage points of GDP and the fiscal deficit was largely financed by resource to domestic borrowing and the government had to reduce fiscal imbalances and the resulting inflationary pressure. The new government after 1997 accomplished this through a post-

crisis recovery program supported by the donor community. As a result of these measures, the fiscal deficit was contained at around 12 percent of GDP and inflation moderated towards the end of 1997.

The new government, through a recovery program, implemented structural measures especially in banking system, which was also blamed for financial crisis. A new banking law was passed which strengthened the independence of the Bank of Albania and a privatization strategy was developed, which allowed the privatization of medium and large enterprises as well as the sale of strategic enterprises (banks, etc.).

The period after the financial crisis of 1997 (fourth stage 1998-) were marked by macroeconomic stability and structural reforms. GDP rises by 7.5 percent and inflation reduced significantly. By the end of 1999, Albania had roughly regained its 1989 GDP level and the private sector accounted for over 75 percent of GDP. The current account deficit also improved being approximately 8.2 percent of GDP in 1998, 7.2 percent of GDP in 1999, and 7.0 percent of GDP in 2000.

*Table 6. Albania: GDP, Remittances, 1994-2000*

	1994	1995	1996	1997	1998	1999	2000
GDP, current prices (in billion of leks)	184.0	229.7	278.7	341.7	460.6	506.3	539.2
Remittances (in millions of Dollars)	379.1	384.7	476.0	235.7	437.7	188.4	438.0

Sources: 1. GDP: IMF Staff estimates

2. Remittances: Bank of Albania, Quarterly Statistical Bulletin.

Deepening the structural reforms stressed on banking system was considered of great importance to improve economic activity. The “well functioning” of the financial system was influenced significantly by the operation of some new private banks and the privatization of state-owned banks. Recently, the second biggest bank, National Commercial Bank was privatized while the biggest bank, a state-owned one, is preparing to be privatized announcing the tender by end June 2001. In order to reduce the dominant position of Savings Bank in time for privatization is suggested that pension offices should be transferred to Albapost.

The main monetary policy objective in this stage was to maintain inflation at a low level. In order to reach this objective, Bank of Albania controlled money growth adjusting interest rates and credit ceilings. As a result of a sharp decline in inflation (negative level) in 1999, Bank of Albania cut interest rates again and abolished both direct instruments, credit ceilings and the minimum interest rates for time deposits in lek. Since September 2000, only indirect instruments were used, mainly repo operations.

Achieving a below-target inflation and over-performance in official reserves created possibility to relax monetary conditions leading to a significant decline in T-bill rates.

The fiscal discipline during these years has been a key factor in improving macroeconomic performance (Table 1). The new government initially contained the fiscal deficit despite a plunge in revenues of roughly 7 percentage points of GDP between 1995-97. Expenditures were cut, particularly on public investment, by 4 percentage points of GDP during this period.

Despite the Government’s efforts to contain the budget deficit through expenditure compression, the decline in the availability of foreign financing that occurred in the aftermath of the pyramid scandals forced a reliance on domestic financing. The reliance on domestic financing resulted in a substantial increase of the inflationary pressures in the economy.

Since 1997 the authorities have accelerated its implementation of economic reforms. Revenues increased through tax policy measures and improvements in tax administration. The public expenditure

have also increased, although the quality of expenditures remains a problem as interest payments account for a much larger share of current expenditures. A measure of the government's adherence to a tight fiscal policy stance to support macroeconomic stabilization is the 5 percentage points of GDP reduction in the primary balance between 1996 and 2000.

While the Government has had good success in imposing fiscal discipline in the wake of the crisis in 1997, several priorities for fiscal management have become clear. First, on the fiscal policy side, there is a need to reduce the reliance on domestic financing of the budget deficit to keep inflation low and reduce the level of interest payments. This, in turn, requires improving the revenue base and reorienting expenditures toward the Government's objective of sustaining a high rate of economic growth and achieving durable poverty reduction. Second, achieving fiscal objectives cannot be accomplished by imposing fiscal discipline alone. As already mentioned the fiscal policy needs to be changed in order to improve the incentive structure and functioning of budgetary institutions so that they focus more effectively on the technical and allocative efficiency of public expenditures.

## **Exchange Rates and Remittances**

Stability in the nominal exchange rate is another key component of the stabilization program in Albania. Before 1991, Albania's exchange rate was fixed at the rate of 8 Leks to the Dollar.

Table 3 shows the yearly Lek/Dollar exchange rate from 1991-2000. Initially, the exchange rate depreciated to an official rate of 112.6 Leks to the Dollar and since 1992, the exchange rate has appreciated slightly in nominal terms, but overall has remained relatively stable.

The stability of the nominal exchange rate can be mainly attributed to private remittances from emigrants. In Table 6 we present the values of remittances for the period 1994-2000. These remittances provide Albania a source of foreign exchange reserves, and help it to finance an ongoing deficit in the trade balance. In contrast, shortages of foreign exchange reserves in Bulgaria and Romania led to very large exchange rate depreciations, contributing to high inflation. As a percentage of GDP, remittances were estimated to be more than 20% in 1992, since then, they remained above 15% of GDP in 1995. But after the collapse of ponzi schemes and investment fund companies these emigration flows declined rapidly in 235 million in 1997. However, after Kosovo crisis the level of remittances increased significantly reaching 437 million dollars in 1999 and 438 million dollars in 2000.

## **Conclusion**

Stabilization programs are based on a mixture of monetary, fiscal, and exchange rate/balance of payment policies. Tight control of government spending and money supply growth are important elements of anti-inflation programs, and, for a small open country like Albania, a stable exchange rate helps to keep the price of tradable goods in line with the foreign prices. In Albania exchange rate stability up to the end of 1996 and from 1988 to 2000 was enhanced by the flow of remittances. The increase of money demand because of declining inflationary expectations and rapid output growth helped to a low inflation.

Albania's stabilization program was multi-faced, combining the monetary, fiscal and external components. The tight control of the money supply and government expenditure played important roles in controlling the rapid inflation after price liberalization in 1991-92. However, external factors contributed considerably to an over-expansion of the economy. In addition, remittances from emigrants helped to bring about a stable nominal exchange rate in the stage two and four of the transition, which

in turn, led to lower inflationary expectations. As a result, from 1994 until 1996, and from 1988 to May 2001 Albanian's monthly inflation is similar to those of most EU countries. But unfortunately, during the end of 1996 and until the end of 1997, after the collapse of ponzi schemes and investment fund companies, and the deep political and economical crisis at early 1997, the exchange rate began to depreciate from 102.025 Leks to the Dollar at the end of 1996 to 179.069 Leks to the Dollar in June 1997, and the rate of inflation went up to 20% in the first four months of 1997. After the crisis, implementation of new stabilization program and structural reforms improved significantly the macroeconomic performance leading in a low inflation of -1% in 1999 and 4.2% in 2000.

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