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Economic and Fiscal Situation of Albania

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Abstract: ***This is a systematic review of reports and articles published in literature and web regarding economic and fiscal situation of Albania. The economic slowdown has only led to a marginal reduction of external imbalances. The current account deficit has narrowed slightly but remains above 10% of GDP, adding to a substantial accumulation of external liabilities over the years as reflected by a gross external debt amounting to some 52.5% of GDP. The current account deficit expanded rapidly during the first half of 2014. During first half of 2014, the current account deficit reached 12.3% of GDP, increasing by around 21.3% annually. The expansion of the trade deficit was the main factor behind the higher current account deficit.Net flows to the capital and financial accounts resulted in about EUR 488.6 million during the first six months of 2014, compared to EUR 403.6 million in 2013H1. As a ratio to GDP they were valued at around 9.7% from around 8.2% to GDP in 2013H1. In 2014H1, the capital account recoded a higher surplus in annual terms. The financial account showed a net increase in liabilities of around 15.8% annually.***

Keywords: fiscal policy, economic growth, macroeconomic forecast

1. Introduction

Albania's economic growth slowed down sharply in 2012. Following an average real GDP growth rate of 3.4% in the preceding three years, the Albanian authorities estimate that annual real GDP growth was 1.6% in 2012. The slowdown reflects low consumption growth and declining investment in the wake of weakening confidence and continued recession in Albania's main economic partner countries. While some pick-up of growth can be expected over the medium term, the quick re-acceleration of economic activity projected in the programme, driven by strong export growth and an upturn in private consumption, is likely to face several headwinds such as subdued external demand and tight credit conditions as the ratio of non-performing loans to total loans has risen sharply to 23% (1). The economic slowdown has only led to a marginal reduction of external imbalances. The current account deficit has narrowed slightly but remains above 10% of GDP, adding to a substantial accumulation of external liabilities over the years as reflected by a gross external debt amounting to some 52.5% of GDP. Looking forward, the heavy exposure in terms of exports and remittances to recession-hit Italy and Greece poses some risks to a sustained narrowing of the current account deficit, even if exports in 2012 held up rather well. External imbalances will remain a source of vulnerability, which has in recent years been mitigated by a relatively stable inflow of foreign direct investments financing most of the deficit. It will be a key challenge for the government to increase or even maintain the past level of FDI inflows. FDI inflows are not only crucial in terms of balance of payments but also essential for transferring knowledge, boosting productivity and diversifying the rather narrow production and export base that leaves the economy vulnerable to external shocks. Decisive and urgent action is required to increase the country's attractiveness as an investment destination by improving the business environment, the perception of which has recently deteriorated further due to the accumulation of arrears and the de facto renationalization of the energy distribution company (2,3).Beyond the limited on-going privatization attempts, economy-wide competitiveness would benefit from further improving the regulatory framework, accelerating the resolution of the long standing issue of property rights, and pushing ahead with product market reforms notably in the energy sector so as to ensure a reliable supply of electricity. Together with raising the quality of the education system and up-skilling the labour force, such reforms could contribute to alleviating the persistently high unemployment rate as well as supporting economic diversification. Public finances are characterized by pernicious imbalances. The general government deficit is stable at 3.5% of GDP which is too high to achieve debt sustainability and the statutory ceiling for public debt (60% of GDP) was breached in 2012. While the explicit aim of the 2013 budget is to stimulate economic growth which lifts the debt-to-GDP ratio to 63.8%, the stated priority for 2014-2015 is fiscal consolidation. This implies a narrowing of budget deficits that would initiate a reduction of public debt to 63.4% of GDP at the end of 2015 (4). Fiscal predictability, which has been a recurrent issue due to the overestimation of revenues as well as weak and uncertain tax collection in the past, is further threatened by the repeal of the statutory debt ceiling last year. Ensuring the credibility of the sustained but gradual effort of fiscal adjustment needed to embark on a path towards debt sustainability calls for the rapid adoption of an efficient anchor, such as a clear and transparent fiscalrule, which would also lower financing costs for both the public and the private sector. The composition of expenditures should also be guided by a pro-growth vision, avoiding the recent practice of compensating the downward trend in the revenue-to-GDP ratio with capital spending cuts and that the projected consolidation in 2014-2015 will be based exclusively on lower capital expenditure. Privatization receipts should also be used to reduce debt, repay accumulated arrears and create fiscal space to allow more growth-enhancing capital spending. Yet, the privatization process has recently slowed down, making future estimations of revenues uncertain. While the high public debt hampers macroeconomic stability and sustainable growth, it is also associated with high rolloverrisks since more than half of it is short term. Its management should be further oriented towards lengthening the outstanding debt profile and lowering the re-financing risks (5, 6).

Macroeconomic stability has continued to be enhanced by the monetary policy. Headline inflation has been low and relatively stable within the central bank's 2-4% target range for most of the period since 2006. Such performance was maintained last year when it benefited from the negative output gap, relatively low inflationary pressures from the external side, and well-anchored inflation expectations. In this context, the central bank has had room to support the slowing economy. By July 2012 it had cut the policy interest rate by a total of 125 basis points to 4%, which was further reduced to a historic low of 3.75% on 30 January 2013 (7,8). This monetary easing has been transmitted effectively to short-term interbank rates. However, monetary flexibility is constrained by the relatively high degree of euroisation of the financial system. Unhedged borrowers also pose an indirect market risk to the banking system in the event of currency depreciation. It is important that stability-oriented fiscal and monetary policies are complemented by well-designed and properly implemented structural reforms in order to boost growth prospects in the future (9). Efforts need to be stepped up to reinforce the legal system, strengthen the rule of law, fight corruption and enhance human capital as well as transport and energy infrastructure. The aim of the article is to give an overview of the economic and fiscal situation in Albania.

2. Material and Methods

This is a systematic review of reports and articles published in literature and web regarding economic and fiscal situation of Albania.

3. Results and Discussion

The Albanian economy has shown tentative signs of improvement during the first nine months of 2014. Value added in the economy recorded an annual increase by 1.3% during first nine months of 2014. The slight contraction which took place in Q2 was temporary, mostly linked to supply side shocks in specific sectors of the economy like construction, industry and transport contributing negatively to growth as well as base effects. On the other hand, the increase in value added in the services sector accounts for a positive contribution in the annual pace of the economic activity. The positive performance of services was led by activities in other services and trade branches. From an aggregate demand standpoint, the growth during 2014 was mostly generated by domestic demand, while foreign demand is assessed to have had a negative contribution. However, the economic slowdown which took place in Q2 was largely driven by the public sector. This reflected the consolidation stance of fiscal policy as well as the base effect of higher fiscal stimulus injected into the economy in the 2013Q2. On the other hand, private sector demandremained on a positive trajectory. Improved confidence and favorable financial conditions have supported the growth of private consumption and investment during the first half of the year. Private investment was positively affected by improved business confidence, increased utilization rate, the growth of new orders and the easing of credit conditions. Higher inflows of FDIs net off privatizations through foreign capital, especially in Q1, boosted investment growth. The recovery of the investment will depend on the sustainable growth of the consumer demand and the continued improvement of financial conditionsFor2015, growth is projected to be slightly higher than the previous year. This growth is expected to rely mainly on domestic demand. Economic and Fiscal Fiscal indicators area shown in table 1.The easing of monetary conditions, the correction of the public and private sector balances, and the improving the economic agents' confidence is expected to fuel domestic demand. The Albanian economy continues to operate below potential, which in turn is reflected in inflation below the target of the Bank of Albania. During January-September 2014, the annual inflation averaged 1.75%, slightly lower than in the same period of 2013. Based on inflation dynamics as well as on medium terms projections for inflation and economic growth, the monetary policy has remained strongly expansionary. It has aimed at supporting the domestic demand and at enabling the sustainable return of the inflation rate and inflation expectations to target. The key interest rate actually is at the historical low level of 2.25%. The Bank of Albania has continued to use forward guidance to steer the public and the financial markets expectations on the path for future monetary policy. Monetary indicators have shown a weak dynamic during 2014, reflecting low financing needs of the economy. The annual growth of M3 has been especially sluggish in the second quarter of the year, and stands at 1.0% in September. Bank finance to the public sector has been low while the contribution of credit to economy has turned positive only in the third quarter of the year. Credit to the private sector has registered positive annual growth in the third quarter of the year, following its contraction in the previous 12 months. However, this pick-up in credit remains fragile. Banks, businesses and households remain risk averse. Credit growth is segmented in terms of both banks activity in lending and also of sectors of the economy that are being financed. Credit growth has been driven by expansion of credit to private non-financial corporations. On the other hand, credit to households has been sluggish, registering near zero growth for the last 12 months. In 2014, credit growth continues to be supported by credit in domestic currency, while foreign currency credit continues to shrink. The Albanian Lek appreciated by 1.7% yearly in nominal terms3 during the first 10 months of 2014. Lek has appreciated by 2.6% yearly in real terms.The current account deficit expanded rapidly during the first half of 2014. During first half of 2014, the current account deficit reached 12.3% of GDP, increasing by around 21.3% annually. The expansion of the trade deficit was the main factor behind the higher current account deficit. Here, a general pickup in imports, the overturned net balance of the energy sector from net exporter last year to net importer this year and volatile oil prices in the international market were primary facets of trade developments. Concurrently, the terms of trade deteriorated on average by 3.3% points during the first half of the year. Net primary income registered a higher deficit linked to larger direct investment income outflows. Services performed better this year compared to the same period last year. After the 19.8% annual drop last year, secondary income inflows have increased only slightly this year. Remittances have stabilized at around 5% to GDP in 2014H1 and, following a continuous five quarter drop, increased slightly in 2014Q2. Latest evaluations project a higher current account deficit than last year’s forecasts for

2015 due to lower than expected goods exports and secondary income outflows and higher than expected services imports and primary income outflows. Macroeconomic developments and forecasts are shown in table 2. Net flows to the capital and financial accounts resulted in about EUR 488.6 million during the first six months of 2014, compared to EUR 403.6 million in 2013H1. As a ratio to GDP they were valued at around 9.7% from around 8.2% to GDP in 2013H1. In 2014H1, the capital account recoded a higher surplus in annual terms. The financial account showed a net increase in liabilities of around 15.8% annually. Net foreign direct investments decreased slightly, partly as a result of large FDI related public asset privatizations last year and partly as a result of higher direct investment abroad this year. Net portfolio investments and net financial derivatives (other than reserves) were lower this year compared to 2013H1. Net other investments fell by around 37% annually due to a sharp increase in currency and deposit assets in 2014H1 despite an increase in debt liabilities.

4. Conclusion

Reforms need to be accelerated to realize medium-term growth potential. In particular, further measures are needed to improve the business environment by strengthening the legal system and the enforceability of contracts, developing administration and addressing the issue of property rights. The informal economy and weak tax collection remain a challenge. It is imperative to improve infrastructure, especially in energy and transport, while persistently high unemployment and skills mismatches call for upgrading the skills of the labour force and enhancing the functioning of the labour market. The lack of diversification of the production base in terms of sectors and export markets leaves the economy vulnerable to external shocks. The EFP correctly identifies the broadobjectives, but concrete measures remain piecemeal and mostly backward looking; as such they fail to provide a comprehensive answer to the challenges facing the country (10).

*Measures to enhance the business climate are unambitious.*They include a further reduction of the administrative burden to start a business and the implementation of the European Charter for SMEs. A recently enacted law on administrative courts aims to ensure for citizens and businesses a due legal process within a reasonable timeframe, but its implementation is still pending. The fight against economic crime and corruption is seen as a strategic priority; however, no wide-ranging measures are proposed in the EFP to address the problem. The reform of public administration will involve, similarly to the proposal already made last year but not yet implemented, a link between civil servants' salary and their evaluation and training (11).

Energy is in the focus of several initiatives. This is welcome given the country's extensive reliance on hydropower whose output often fails to meet domestic demand. Steps are being taken to further liberalize the electricity market for consumers, scheduled to be completed by 2015. The electricity production market is also opening up, with concessions being granted to private operators and four hydro power plants being privatized. The planned construction of interconnection networks with neighbouring countries, especially the former Yugoslav Republic of Macedonia and Kosovo(5) would enhance energy exchange capacities and security of supply, but the EFP does not contain a clear timing or budget allocations in this respect. The recent forced nationalization of the electricity distributor risks undermining efforts to provide adequate electricity supplies deteriorates the investment climate and might constitute a drain on public resources. In order to ensure the long-term stability of the sector, the regulatory and legal framework governing the relations between key playersneeds to be reviewed (12,13).

Attracting FDI is crucial but gets limited attention. Promoting foreign direct investments would help finance the sizeable current account deficit and support technology transfer and innovation. Apart from mentioning limited on-going privatization attempts (of, among others, Albpetroland Albtelecom), recalling the relatively favourable framework conditions thanks to broad macroeconomic stability and the development of economic zones, the EFP gives relatively little consideration to this area. Against this background, the projected increase in FDI flows might turn out to be optimistic and is in any event not further explained.Banking system regulatory framework is set to strengthen. One of the most important projects still in course is the implementation of the Basel II requirements for risk assessment and management. Once the new capital adequacy regulation is approved, banks will be given the necessary time to adapt their internal system to the new requirements and build the indispensable human capacity.

*Furthering employment and improving the labour market remains a significant challenge.*The unemployment rate has been stubbornly high in recent years (exceeding 13 %), despite economic growth. The proportion of long term unemployed remains high, while the informal economy is still an important provider of jobs. Shortcomings in education and training are significant. The EFP falls short of addressing these challenges as it recalls to a large extent existing labour market services but fails to put forward major new initiatives, with the exception of plans to step up labour inspections to combat informal employment.

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Table 1: Economic and Fiscal Programmes.Fiscal indicators

	2010	2011	2012	2013	2014	2015	2016
Total revenue** (% of GDP)	3,3	3,8	3,1	1,5	3,1	3,9	4,1
Total expenditure** (% of GDP)	13	13,7	13,3	13,5	13,1	12,2	10,9
Government balance (% of GDP)	-15,3	-11,5	-12,1	-10,3	-9,5	-8,2	-7,1
Government gross debt (% of GDP)	2,3	3,6	3,5	2,0	3,0	3,0	3,0

Table 2: Macroeconomic developments and forecasts

	2012	2013	2014	2015	2016
Real GDP (% change)	1.3	0.7	2.1	3.3	4.2
Contributions:					
- Final domestic demand	-2.5	-1.5	0.1	2.5	3.9
- Change in inventories	0.0	0.0	0.0	0.0	0.0
- External balance of goods and services	3.8	2.2	2	0.8	0.3
Employment (% change)	0.0	0.0	0.0	0.0	0.0
Unemployment rate (%)	13.1	13	12.8	12.6	12.5
GDP deflator (% change)	2.1	1.7	2.3	2.5	2.7
CPI inflation (%)	2.0	1.9	2.7	2.8	3.0
Current account balance (% of GDP)	-10.7	710	88.2	-7.5	-7.3