Eurozone Debt Crisis and Albania

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Abstract

Albania as part of the Western Balkans was affected by the consequences of the financial crisis in 2009 followed by the EU debt crisis. However, as a result of external factors, the slowdown in economic growth began to feel in 2008.

Despite the fact that the economic growth in the country was the largest in the Western Balkans region and remained at positive levels even during the crisis, some of the economic and financial indicators had significant impact. Also, high increase in public spending in the infrastructure area was noticed, which accompanied the pre-crisis period and further deteriorated by its impact.

Looking at these up rising data of the budget deficit and the public debt to cover the latter, IMF proposed two fiscal rules in order to contribute strengthening fiscal sustainability:

1- The debt rule, which directly allows the full functioning of automatic stabilizers and keeps government under control;

2- The expenditure rule aiming at debt brake, which allows a close connection between the operational goal and the fiscal sustainability objective (IMF Country Report No. 10/206: July 2010).

Focus of this paper is particularly on the most important economic and financial indicators in Albania to better understand the extent of the impact of this crisis in the country and the measures taken as well. Through the comparisons of the situation before and after the crisis will be reached on the conclusions on the main instruments used by the government to cope with the crisis or avoid its consequences.

Keywords: EU debt crisis, Albania, impact, public debt, response to the crisis

1. Introduction

This article presents the economic and financial situation of Albania before, during and after the EU debt crisis. The focus will be on the most important indicators affected by the crisis and the measures taken by the government and Bank of Albania (and sugestions by IMF) in order to mitigate the effects of the crisis. The observations during this period show that almost all the macroeconomic and financial indicators were affected by the crisis, despite in different levels. Therefore, the main impact was on economic growth, current account deficit, the deterioration of fiscal indicators etc. In order to face these effects there was an immediate reaction of the monetary and fiscal policies.

As part of the Western Balkans, with strong and strategic connections with EU and Eurozone countries, the impact of the crisis in the Region has spurred interest among researchers. In these circumstances, Cocozza, Colabella and Spadafora (2011) have presented a detailed analysis of the situation of the countries in the region, including Albania, during the debt crisis and the corresponding measures taken in response. In his work Sanfey (2010), *inter alia*, points out that the region will have to get used to a period of lower growth in years after the crisis (which is evident from GDP growth datas in Albania). IMF has analised the economic transition of the Western Balkans, also Albania, and stressed out the problematic areas of the Region. Unemployment was one of them and one of the main reasons is the gap of skills. Nelson and Phelps (1966) stress out the importance of education. This line of research has been further developed by Redding (1996), which point out the importance of investing in human capital and in Research and Development and their implications in economic growth. Also there are some other relevant empirical studies presented by Bartel and Lichtenberg (1987), Benhabib and Spiegel (1994, 2005), Krueger and Lindhal (2001), Hall and Jones (1999). Lloyd-Ellis and Roberts (2002) demonstrate the interaction between skills and technology and their importance and implications to growth.

The paper is prepared based on descriptive and comparative analysis of concrete data as well as on abovementioned studies. Expectations consist on finding the real effects of the debt crisis in Albania, the undertaken measures by the respective institutions to smoothe the effects and their effectiveness.

2. Albania before and during the crisis

2.1 Impact on GDP growth

During 2008, the Albanian economy managed to withstand the shocking wave of global crisis, performing very well (IMF: 2008). Unlike many developing countries, during 2008, the main feature of Albanian economy development was supporting rapid growth of domestic demand. This demand marked an increase in all of its components: consumption, investment and government spending, while, even though growing, external demand in the form of Albanian exports had a proportionally lower impact on economic growth.

Likewise, economic activity in the country was essentially supported by domestic sources of finance, combined with a rapid credit growth for the economy, while the role of foreign financing in the form of credit lines or portfolio investments has not been a priority. (Bank of Albania; 2008). However, despite the satisfactory figures, meeting the annual projections and an annual GDP growth (7.5 per cent) greater than the value 2007 (Table 1), a slight slowdown occurred in economic activity as a result of the overall economic situation.

Table 1: Real GDP growth during 2007-2017

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017*[15]
5.9	7.5	3.7	3.71	2.55	1.42	1	1.8	2.23	3.37	3.93

Source: Bank of Albania

This slowdown was felt even more during 2009 in regards to lower growth rates. There was a significant decline of about 50 per cent in relation to the previous year, but still remained positive if compared to economic growth decline in other Western Balkan countries.

Statistics for aggregate demand in the country suggest that the slowdown in private consumption, accompanied by the decline in investment, have been the main contributors to the slowdown in demand growth rates in the country. The sustainability of consumer demand and the fiscal stimulus, which in addition to easing monetary conditions, supported the economy in generating positive growth rates, although at lower rates than in the previous years. Under these conditions, the slowdown of demand and economic activity led to a slight increase in unemployment. Clear evidence of the weakness in the region's and Albanian economic model can be found in the high unemployment rates even before the EU debt crisis. During 2007-2012 the values of unemployment remained at 12.7-13.8 per cent levels and went beyond these values after 2013.

Table 2: Unemployment rate in Albania during 2007-2017[16]

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017[17]
13.2	13.8	14.2	14.3	13.9	15.9	17.5	17.1	15.2	13.9

Source: Bank of Albania

Unemployment and, in particular, long-term unemployment remain a serious problem of an emerging economy. Beyond the social problems, high and stable rates of unemployment rate give signals for structural problems of the economy, which may limit the pace of economic growth in the long run (Bank of Albania; 2008: 50). According to available evidence, one of the reasons for these unemployment data in the Western Balkans is skill gap which

[15] Third trimester data

[16] Unemployment rate according to the Labour Force Survey, INSTAT

[17] Third trimester data

has been particularly severe in this Region (IMF; Western Balkans: 15 years of economic transition: 2015:13). Nelson and Phelps (1966) stress out the importance of education. The later enhances one's ability to receive, decode and understand information and that information processing and intrepretation is important for performing or learning many jobs. This research was developed by Redding (1996), who present in his paper a model of endogenous growth in which workers invest in human capital, meanwhile firms in Research and Development. These incentives determine the economy's growth rate and multiple equilibra exist for intermediate parameter values. There are some other relevant studies introduced by Bartel and Lichtenberg (1987), Hall and Jones (1999) and authors that have studied the impact of schooling on income and GDP growth (Krueger and Lindhal (2001), the role of human capital in economic development evidence from aggregate cross-country data (Benhabib, J., Spiegel, M., M., 1994; 2005) etc. In this framework, Lloyd-Ellis and Roberts (2002) develop a growth model in which they conclude that skills and technology as equal eartners in balanced growth are twin engines of growth.

2.2 Impact on Current Account Deficit

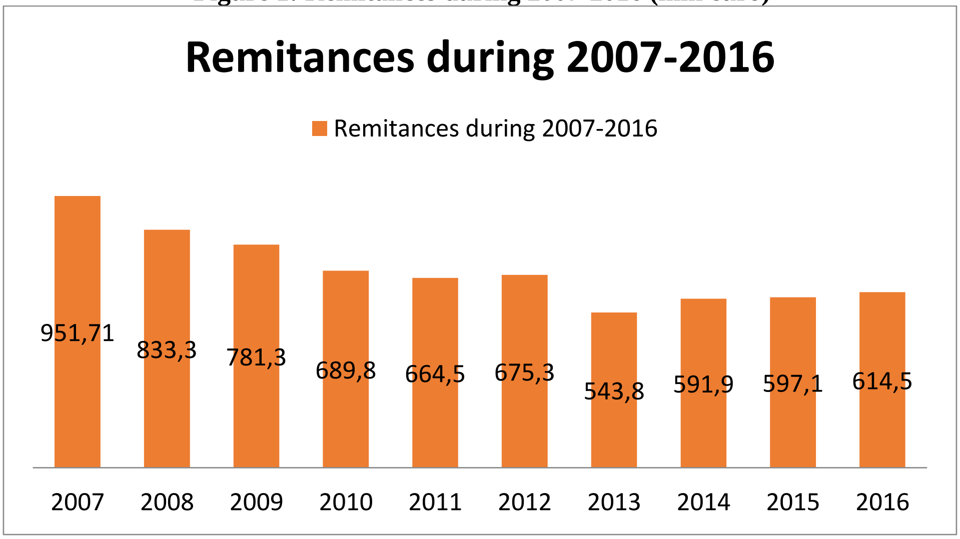
During 2008, domestic demand was also reflected in the growth of trade deficit and current account deficit. Thus, the current account deficit reached 14.9 per cent of GDP, mainly driven by the rapid growth of imports and the slowdown of remittances throughout the second half of the year. This was as a reflection of economic crisis strengthening effects on the economies of neighboring countries. But the widening of the deficit for this account was also influenced by the high prices of basic commodities imported and the temporary expansion of the budget deficit as a result of increase of public investments for the Durres-Kukes road project. In absence of these factors, the current account deficit would mark a lower value.

In macroeconomic terms, the high trade account deficit indicates high levels of consumption and investment in the economy, which are funded by foreign savings in the form of capital inflows. Foreign exchange inflows have been enough to close the balance of payments in positive terms. In longer-term analysis, Albania's current account deficit is a natural phenomenon considering the country's development level. Particularly positive is the fact that most of the country's imports are in the form of machinery and equipment, as well as import of intermediate goods in terms of consumption.

2.3 Impact on Remittances

The effects of crisis would be evident and tangible even in the remittances. This is due to the fact that the vast majority of Albanian emigrants are concentrated in neighboring countries such as Italy and Greece, which were "core countries" of the debt crisis in the EU. Thus, the decline of remittances was noted at the end of 2008. This impact was felt immediately in the total net of current transfers, which until 2007 financed the current account deficit completely, whereas during 2008 and 2009 managed to cover it partially. Remittances recorded an annual decline of about 6.5 per cent in 2009. Remittances ratio to GDP was 9 per cent, while the level of trade deficit financing from remittances was about twice lower than the same level for 2004. The decline in remittances continued in 2010 and 2011 but experienced a slight increase in 2012. In 2013 was marked the lowest remittances levels from abroad in the last 15 years. However, the growth of these flows continued and reached the level of 614.5 million Euros in 2016.

Figure 1: Remitances during 2007-2016 (mln euro)



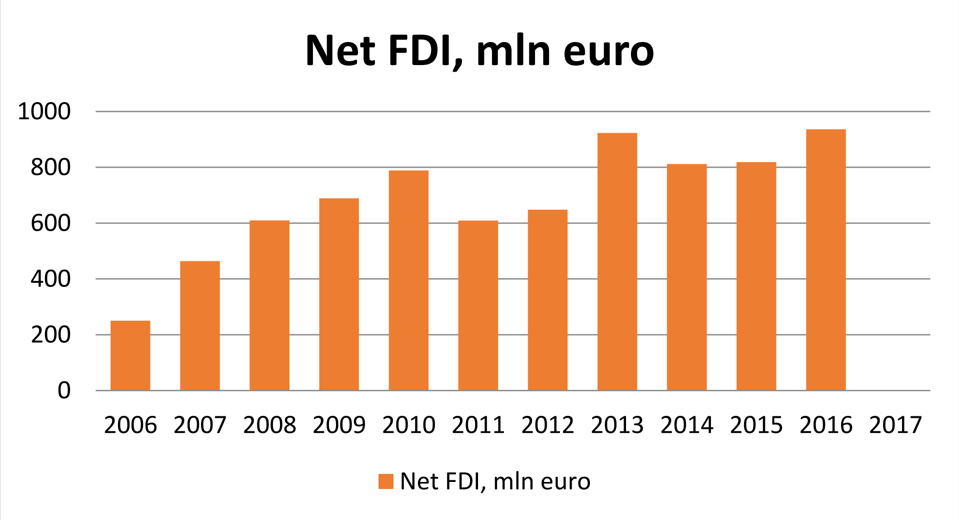
Source: Bank of Albania

2.4 Impact on Foreign Direct Investments

The great wave of FDI in the Western Balkans, particularly after 2006, was mainly driven by the economic recovery, a better business climate, and the start of accession negotiations with the European Union in 2005. In addition, the free labor cost, the accessibility with European markets and the privatization of state-owned enterprises gave a big boost to FDI flows. (WIR, 2013: 66).

Under these conditions, 2007 was also characterized by a significant increase of FDI by about 85 per cent compared to the previous year (Figure 2), and the main contribution for this was the successful privatization of Albtelekom.

Figure 2: Net FDI during 2006-2016



Source: Bank of Albania

Meanwhile, in 2008, the rising trend of foreign direct foreign investments continued, but at a lower rate than a year earlier (about 32 per cent). Their relative indicator to GDP is estimated at 7.6 per cent, against the 6 per cent estimated at the previous year.

In 2009, Albania overcame the declining trend of the Region, mainly due to the friendly environment toward business and the opportunities created by the privatization of state-owned enterprises. During 2010, FDI inflows increased by 14.4 per cent, reflecting more new investments on exploration and drilling for oil and gas and new concessions in the energy sector.

During 2011, as seen from the data in the table above, net FDI flows were hit by another decline and their value got 23 per cent lower than a year earlier. This decline came exactly as a result of the unstable global economic conditions, the difficulties in neighboring economies and the repatriation of capital that corresponded with the fragile political climate in the country at the beginning of the year. This decrease caused FDI flows to cover only 65 per cent of the current account deficit, compared to 78 per cent of the previous year. (European Commission, Progress Report 2012: 25).

Net inflow of foreign direct investment (FDI) grew slightly during 2012 (by 6.4 per cent) and financed around 70 per cent of the current account deficit compared to 60 per cent in 2011. Generally, the current account deficit narrowed, but remained a source of vulnerability, particularly in regards to the potential negative impact of the unsustainable external environment on FDI inflows and remittances of migrant workers (European Commission, Progress Report 2013: 13).

Since 2013, considering any possible fluctuations, the net inflows of FDI have increased year-by-year. The increase in net FDI flows in the 2016 was double of its value in 2006 and this increase was mainly driven by investment and privatization in the hydro power sector.

Although during the privatization periods, Albania has attracted high inflows of foreign direct investment, their relative indicator to GDP remains low. However, what is noticed is that the share of Foreign Direct Investment in Gross Domestic Product has increased.

2.5 Impact on Financial and Banking Sector

In 2008, with the privatization of the United Bank of Albania (40 per cent of its shares were owned by the government), banking sector in Albania was totally privatized. The banking sector's foreign borrowing stood at 8.6 per cent at the end of 2008 to grow further in the first half of 2009. Meanwhile, private sector lending grew in 34.4 per cent in 2008 GDP, marking again low values of financial intermediation. (European Commission, 2009: 22)

The average 12-month treasury bills' performance at end-2008 was 8.8 per cent, from 8.4 per cent a year earlier and continued to grow to 9.24 per cent by the end of June 2009, an increase that led to the crowding-out effect on investments .

Also profitability indicators, having remained solid throughout 2008, came down markedly during the first quarter of 2009. Finally, in April, the banking sector, taken as a whole, recorded its first net financial loss in several years. *Overall*, the banking sector remained wellcapitalised and liquid. However, in the first half of 2009, as the international economic crisis started showing effects, profitability suffered as non-performing loans increased, and banks started to tighten criteria for awarding credit thus dampening credit growth. (European Commision, 2009: 23)

Apart from the above, in the banking / financial system was noticed the uncertainty surrounding the shock of the global financial system, which was reflected in the withdrawal of part of the deposits from the system during the last quarter of 2008. These withdrawals brought liquidity problems in the system and were accompanied by tendencies to increase interest rates during this period.

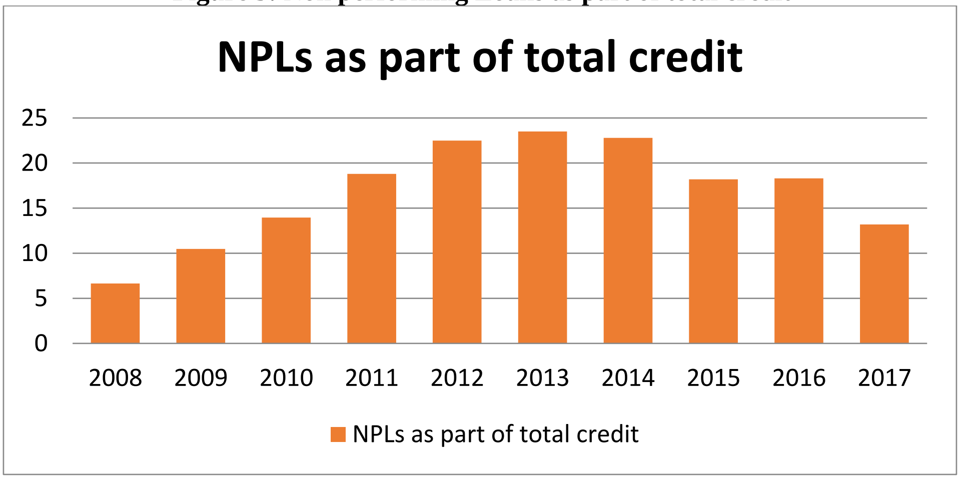
On the other side, this situation naturally affected the reduction of the system's readiness to credit the economy and consequently the slowdown in lending rates over the last quarter. This development, accompanied with the reduction of remittances during this period, had an impact on the slowdown of economic activity during the fourth quarter of 2008 (Bank of Albania, 2008: 39-40). In addition to the withdrawal of deposits from the banking system, with the onset of the effects of the international financial crisis in the export sector, the share of non performing loans rose sharply from 4 per cent in March

2008 to 7.5 per cent in the first quarter of 2009. Most problematic were loans to businesses rather than consumer ones, marking an increase more than double at 7.6 per cent at the end of 2008, from 3.6 per cent at the end of 2007.

The increase in these indicators continued in the following years. Financial sector developments have reflected the dynamics of the real sector of the economy and include a slowdown in demand for money and credit growth at its historical minimum. Influencing factors include, on the one hand, the lack of healthy demand for business and individuals, and on the other one, the banking sector's high sensitivity to the risk of non-return on credit.

Credit portfolio quality starting in 2008 continued to deteriorate, as evidenced by the increase in the share of non-performing loans in total. Thus, while in 2008 this indicator amounted 6.64 per cent of total credit, in 2009 reached 10.48 per cent, and to progressively increase year-on-year. In 2013 it reached the maximum value at 23.5 per cent of the total credit that after this year began to decline. In December 2017, this indicator reached 13.2 per cent from 18.2 per cent in 2016, reflecting the implementation of the plan for measures to reduce non-performing loans (Bank of Albania, 2017; 11).

Figure 3: Non performing Loans as part of total credit



Source: Bank of Albania, Annual Reports 2008-2017

As a result of good macroeconomic policy coordination, Albania's inflation and output fluctuations were at the lowest levels in the region for the period 2000-2009. Monetary policy has been successful in meeting its main target 3±1 per cent (average annual inflation for 2009 was 2.7 per cent), helping to create a favorable economic environment for the private sector to make consumer and investment decisions, which could support a sustainable economic growth (Bank of Albania, 2009: 27). Meanwhile, in the years to come, inflation remained almost within this interval (values for 2014 and 2016 were below the limit of 2 per cent), meeting the Bank of Albania's main objective.

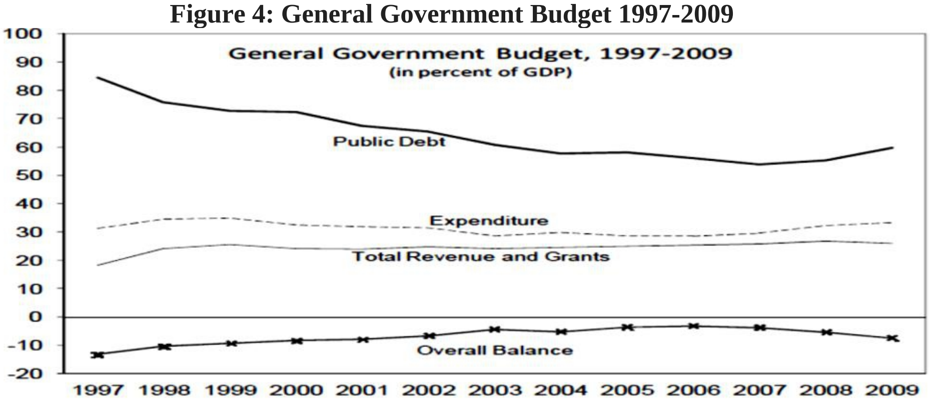
2.6 Fiscal policy developments in Albania

Fiscal policy, in 2008, was expansive which was reflected in the expansion of public investments and the budget deficit during 2008. Progress in the field of fiscal administration and growth within the parameters of the domestic economy enabled growth of budget revenues and control of fiscal deficit at acceptable levels, but without holding the debt at the levels of the previous year. In these circumstances, public debt amounted to 55.9 per cent of GDP from 52.8 per cent in the previous year. (Bank of Albania; 2008: 37). Expenditures for the large Durres-Kukës road project consumed 3.5 per cent of GDP in 2008 and 2009, pushing government spending even more than its long-term trend. Moreover, the global economic downturn put additional pressure on the 2009 budget by collecting lower revenues (IMF; Albania: Selected Issues, 2010).

Even, during 2009, fiscal policy continued to be an expansionist one, which, alongside the monetary stimulus, helped the economy in generating positive growth rates. This fiscal policy behavior was materialized in a budget deficit around 7 per cent of GDP at the end of 2009, an increase that reflects both actions of automatic stabilizers, in the form of revenue cuts, and countercyclical character of fiscal policy through increased wages and capital expenditures. Aside from revenue decrease, public spending has maintained high growth rates. Thus, at the end of the year, budget revenues and public expenditures amounted to ALL 299 billion and ALL 379 billion, respectively, accounting for 26.2 and 33.2 per cent respectively of GDP. (Bank of Albania, 2009: 50).

Given this performance, the debt ratio was projected to remain high, given ambitious spending plans. According to the IMF, this would make Albania leave behind the progress done in last ten years of continuous decline of public debt, making the country vulnerable to unfavorable shocks.(IMF; Albania:Selected Issues, 2010)

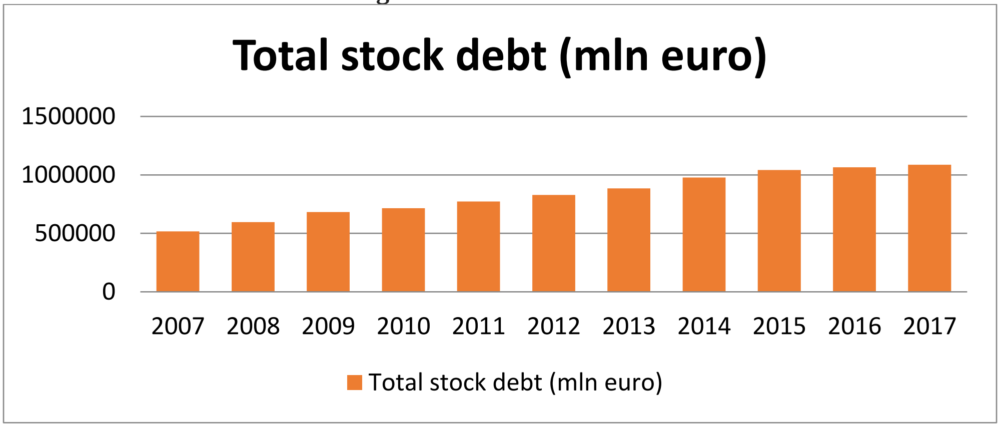
Figure 4: General Government Budget 1997-2009



Source: IMF

What was declared by the IMF in 2010 was confirmed by the debt data for the years to come, as shown in the chart below. Thus, the growth that this indicator has experienced year after year has been almost uniform and in 2017 doubled the values of government debt in 2007.

Figure 5 :Total debt stock



Source: Ministry of Finances and Economy

This increase in total central government debt stock data was a result of growth in its two components: Foreign Debt Stock and Internal Debt Stock, where the latter has recorded the largest increase. Meanwhile, appart from above, is noted the growth of state-guaranteed debt on both of its components.

3. Response to the crisis

In Albania, the authorities were able to use a mix of economic policies to mitigate the impact of the crisis, building on an overall prudent fiscal stance, a flexible monetary policy framework, and substantial foreign exchange reserves. In fact, despite having larger deficit and debt-to-GDP ratios than other countries in the Region in 2007, Albania standed out as the only country that implemented a non-negligible discretionary countercyclical fiscal stimulus in 2009, in part financed by privatization receipts and a syndicated loan. The country also benefited from having the lowest external debt and debt service ratios in the group. As a result, Albania weathered the turmoil better than most other regional countries (Cocozza, E., Colabella, A., Spadafora, F., 2011: 41).

Government of Albania revised in May 2008 the medium-term macroeconomic and fiscal framework in order to update the external assumptions and better reflect the impact of the global economic crisis. In this document estimation of growth for 2009 was revised downwards. The programme reflected an improved budget and project planning capacity, as well as better availability of statistics. (European Commission; Progress Report 2009: 19)

From the fiscal side, Albania was the only country in Western Balkan where the authorities were able to ensure an important fiscal stimulus (and partly discret). In the first place, automatic stabilizers on the revenue side were given full play, and an additional fiscal boost was provided through cuts in social security contributions and strong expansionary measures prior to the mid-2009 elections. (Cocozza, E., Colabella, A., Spadafora, F., 2011:46).

Looking at rising data of the budget deficit[18] and the public debt to cover the latter, IMF proposed two fiscal rules in order to contribute strengthening fiscal sustainability:

1- The debt rule, which directly allows the full functioning of automatic stabilizers and keeps government under control;

2- The expenditure rule aiming at debt brake, which allows a close connection between the operational goal and the fiscal sustainability objective (IMF Country Report Nr. 10/206: July 2010).

Restarting fiscal consolidation was the key near- and medium-term priority in Albania, given the need to address the sizable public debt and financing requirements. To this end, the Fiscal Framework 2011-2013 targeted a reduction in the overall deficit to 4 per cent of GDP in 2010 and to about 3 per cent over the medium term, with the aim of reducing public debt to about 50 per cent of GDP in 2013. Expansionary budgets for both 2010 and 2011 were predicated on over-optimistic revenue assumptions. In the event, the 2010 budget deficit was held at 3.7 per cent of GDP only after significant mid-year budget cuts, about half of which were achieved through reductions in budgeted capital spending (IMF, 2011i). Public debt has drifted up and is approaching the 60 per cent of GDP statutory limit, heightening near-term rollover risk and constraining budgetary flexibility.

Facing a considerable underperformance of the 2011 budget because of lower-than-expected revenue, the authorities adopted cuts in a mid-year budget review in July, so as to keep the budget deficit close to the original 3.5 per cent of GDP target and to avoid breaching the legal limit on public debt of 60 per cent of GDP (Cocozza, E., Colabella, A., Spadafora, F., 2011:62).

From monetary side, Albania was able to ease monetary policy (with different degree of effectiveness) and benefited from a large nominal depreciation of its currency because the monetary and exchange rate framework in place worked as a shock absorber in the unstable conditions of the post-Lehman Brothers bankruptcy (Cocozza, E., Colabella, A., Spadafora, F., 2011:49).

In Albania, monetary easing complemented the fiscal stimulus and the use of liquidity buffers in the countercyclical response to the crisis. Monetary

[18] Also, as we have mentioned, during 2008-2009, the deepening of budget deficit was a result of increase of public investments for the Durres-Kukes road project

conditions were initially loosened by means of quantitative easing in late 2008 (via direct liquidity injections by the BoA); interest rate cuts by 50 basis points each followed in January and October 2009.

Meanwhile the *lek* depreciated by a cumulative 14 per cent (IMF, 2010h). Inflation remained mostly in line with the target of 3±1 per cent, though depreciation pass-through and higher electricity prices at times lifted inflation above 4 per cent. These developments prompted the BoA to adopt a relatively prudent stance when compared to many other central banks in the region, in order to keep inflation expectations well anchored. (Cocozza, E., Colabella, A., Spadafora, F., 2011:50)

4. Conclusion

During 2008, the Albanian economy managed to withstand the shocking wave of the global debt crisis, performing very well (IMF: 2008; Concluding Statement of the IMF Mission for Albania). Despite the fact that during this year the economic activity generally developed in line with the forecasts of the beginning of the year, both in terms of economic growth and in the direction of maintaining macroeconomic balances, again felt the decline of the growth rate. This is due to the global and European shocks from the financial crisis.

Effects would be inevitable, despite the measures taken, due to several external factors, but not only. Thus, Albania is part of the Western Balkans, a key geopolitical point of entry into the Adriatic. In 2006, Albania signed the Stabilization and Association Agreement with the EU in the framework of its European perspective. Almost all services were privatized, while the financial / banking sector was privatized in 2008.

The decrease in the growth rate accompanied Albania in the period of the crisis, coupled with negative effects in trade, FDI and remittances deteriorating in these circumstances the Current Account Deficit. Meanwhile, the fiscal side “entered the crisis” with inappropriate position because of the budget deficit values during 2008 and 2009 and that continued to deteriorate during the crisis. For stabilizing these values of budget and deficit IMF proposed to Albania two “golden rules” to be taken into consideration.

Albania was the only country in the Western Balkans that was able to provide a non-negligible discretionary fiscal stimulus (partly financed through privatization receipts) that complemented automatic stabilizers in supporting the economy. On the contrary, and setting aside the financial and currency risks potentially associated with sharp movements of the exchange rate in a highly-euroized financial environment, the exchange rate regime worked as a shock absorber in Albania and allowed a countercyclical monetary easing. (Cocozza, E., Colabella, A., Spadafora, F., 2011:50)

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