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GROWTH, INVESTMENT, SAVINGS IN ALBANIA DURING TRANSITION (1990-1998)

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DEDICATION

I wish to dedicate this study to:

My Parents Andromaqi and Filip – who have always encouraged me to research.

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CHAPTER 1
INTRODUCTION

1.1 THE MAIN OBJECTIVES

The main objective of this research paper is analysis of growth, investment, and savings in Albania, during the post communist transition up to date. This includes theoretical and less empirical components. My objective in this paper is not to speculate with scarce and poor quality data, but to explore and find the real causes behind that what has happen with growth, public investment and savings as financing investment. First objective will focus on the misjudgement on economic growth in Albania. The dubious GDP growth figures in 1993-1996 in the knowledge that the industrial sector had collapsed was a bad example of intellectual bad faith in the short history of Albania's economic transition. The Domar model will help in determination of required level of investment. After paper will concentrate on analysing of public investment's composition by keeping in consideration the role of public sector on crowding out the private investment. Last the paper will focus on the role of savings in financing the investment.

1.2 THE QUESTIONS OF THE RESEARCH

The transition reform from a command and planned economy to a market oriented economy is basically followed by drastic change on market orientation as well as institutional and legal framework. These changes can cause positive and negative effects.

In the case of Albania, the increasing of investments has impacts, determined by the proper composition, to the further question of financing these investments. In the current process of transition of Albania the questions of the research are:

(A) What is behind rapid GDP growth in Albania and what is the 'required investment' rate for a target growth rate?

(B) What was happened with public investment did crowding out the private investment?

(C) What was the role of savings in financing the investment?

1.3 METHODOLOGY AND DATA

This study will be carried out mainly through qualitative analysis. The data adopts theoretical and empirical approach. The empirical analysis will be of explanatory data type with considerable use being made of descriptive statistics. Data used in this paper are mainly from two sources.

First source is the national statistical. The provision of economic data in Albania has been poor, when it has existed at all. Given the limitations in the statistical documentation of the Albanian economy arising from weakness in the scope and methods of collecting, processing, interpreting and presenting data, the reliability of data have to be treated with caution. The statistical yearbooks appeared annually during the period of communism rule, became quinquennial and sparse in credible data in their later years. Although the attempt to improve the situation since the end of the communism the results are still mixed and reliable sources are scare.

Second the international statistical sources are used intensively. Reliable information, as far as it is obtainable at all, is best obtained from those international agencies of which Albania is member, and which have access to the available data. Here are included *Staff Country Report* of IMF and World Bank, also the annual *Transition Report* published by the European Bank for Reconstruction and Development.

1.4 LIMITATIONS OF THE STUDY

One of the main limitations of the paper is the lack of the dissaggregate data. The analysis will be done within the available data, which means a constrained one. Also the quality of existed macroeconomic data must be consider with caution. As the source for country data is mainly the government, obstacles to data recording can arise due to politics, budget constraints, definitions and expertise. The data have large errors and omission as the result of existing of informal market and special during the crisis in 1997 when the collection of reliable data has become even more difficult, and its publication at times irregular.

1.5 ORGANISATION OF STUDY

The rest of the research is organised in the following manner: Chapter 2 will present the analytical framework within which the study will be conducted and associated an overview of the literature surrounding. Chapter 3 presents the analysis of dubious figures of GDP growth and calculating the 'required' level of investment. Chapter 4 will deal with the investigating if the public investment crowding-out private investment. Chapter 5 will explore the role of savings in financing the investment. Chapter 6 will concludes the study.

1.6 SETTING OF ALBANIA

Albania lies in Southeast Europe, in the Balkan Peninsula and borders on Greece, Macedonian, Kosovo, Montenegro and the Adriatic and Ionian Sea. Population in 1996 is about 3.4 million, 60% of which lives in the rural areas. From 1960 to 1990, the Albanian population increased at a rate of 2 % per annum, which is five times above the European average. At 28 inhabitants per square kilometre in 1923, Albania now has the highest population density in the Balkans with about 111 in 1990. Albania is also the poorest European Country with about 550 $ per capita in 1994 (EBRD 1996).The post - communist transition process in Albania initiated since middle of 1991, with the support of IMF/WB, and has been aimed basically at liberalisation of economy, reducing the role of state and increasing the market regulation, price stabilisation, as well as reducing the budget deficit. The economic reform involved large institutional and legislative changes, including the reforms in juridical system. At its initial stages, this effort focused on re-establishing a degree of economic stability following the collapse of the communist system, while beginning the transition toward a market economy. According to IMF survey 'Albania experienced the highest commutative output growth following the collapse of the real output among transition economies' (1995). Real GDP grew more rapidly in Albania than in most other transition economies during 1993-1994, albeit from a very low base following the collapse of production in the state-owned agricultural and industrial sectors. Growth was estimated at 11.0 per cent in 1993, 8.3 per cent in 1994, 13.3 per cent in 1995 and 8.9 per cent 1996.

CHAPTER 2
THEORETICAL FRAMEWORK AND LITERATURE REVIEW

2.1 'REQUIRED INVESTMENT'

The aim in this section of the paper is to determine the 'required' investment rate for a target growth rate. For this we refer to the Domar's model. Domar's approach to growth became popular because it had a wonderfully simple prediction: GDP growth will be proportional to the share of investment spending in GDP. Domar assumed that output (Y) is proportional to machines (K) available at the beginning of the year. i.e. $Y(t) = \phi K(t-1)$. Then $Y(t) - Y(t-1) = \phi [K(t-1)-K(t-2)]$. The right–hand side is just last year's net investment $I(t-1)$ multiplied by ϕ. Divide both sides by last year's output. So GDP growth this year is just proportional to last year's investment/GDP ratio:

$(Y(t) - Y(t-1))/Y(t-1) = \phi I(t-1)/Y(t-1)$ (Easterly,W; 1997a, pp.3)

Early development economists used Domar's model (called the Harrod-Domar model because of an earlier contribution by Harrod) to calculate a financing gap that needed filling if an economy was going to develop. Like Domar they reasoned that binding constraint on production was insufficient physical capital, since they thought unskilled labour was in abundant supply. This led them, like Domar, to predict that growth will be proportional to the investment rate; specifically growth will be equal to the investment divided by the Incremental Capital Output ratio (ICOR) and thought it was somewhere between 2 and 5.The equation can be expressed

Growth rate = (Investment/GDP) / ICOR (1)

This model is used broadly by the international institutions to identify the needs of poor country stress the short-run necessity of both investment and aid for growth. These institutions are World Bank, International Monetary Fund (IMF), Inter-American Development Bank and European Bank for Reconstruction and Development (EBRD). The EBRD in 1995 has announced that it was using the "Harrod-Domar growth equation" to project investment requirements. This equation warned the ex-Communist countries that " investment finance of 20 percent or more of GDP will be required" to reach "growth rates of 5 percent" (here the ICOR is 4).

The financing gap was the gap between available financing for investment (such as domestic saving) and the required investment. Filling this gap with aid, the country would get the required investment, which in turn would yield the target growth rate.

2.2 PUBLIC INVESTMENT AND CROWDING OUT

The role of the public sector in the capital formation process, and more particularly on the issue of crowding out, has been focused almost exclusively on the developed countries. In the case of developing countries, however, there is an absence of a well-established theoretical framework for analysing investment and, apart from some isolated examples, remarkably little empirical work on the subject.

Crowding out, broadly defined to include both financial and real crowding out, occurs when the government pre-empts scarce financial and physical resources that would otherwise be available to the private sector (Blejer. M; Khan. M: 1985). This research will focus in the issue of real crowding out. The public investment involve both the development of infrastructure, which likely would be complementary with private investment, and other types of noninfrastructural investment which competes with private investment either through absorbing limited physical resources.

Policymakers and analysts in developing countries believed that public investment provides a significant stimulus to private investment and thereby serves as a powerful instrument and growth policy (Sundararajan V.; Thakur S.;1980;p814).

The public investment influences private investment through several channels. First, public investment competes with the private sector for scare physical and financial resources and thereby exerts a negative influence on private investment, at least in the short run. Second, to the extent that public investment facilitates production in the private sector by lowering the cost of producing private sector output. In other words, public investment provides some of the facilities (e.g. infrastructure) that the private sector would have to provide for itself in the absence of public investment. Hence, the private sector's capital requirements are lowered by public investment. Third, increased in short-run of public investment raises the demand for the output of the private sector; it thereby influences output expectations and investment requirements of the private sector. Finally, public investment raises aggregate output and savings, supplementing the economy's physical and financial resources, and thus offsets at least a part of any initial crowding-out effects on private investment. Private investment is influenced by output expectations, the resources available to the private sector, public infrastructure (which facilitates private investment) and the initial private sector capital. It is crucial to analyse the level of public investment. If the public investment has been taken place, the nature of private investment should be taken in account in order to point out that how public investment through channels above mentioned has crowding out private investment.

The empirical studies on investment behaviour in developing countries, done by Sundararajan and Thakur (1980), and Tun Wai and Wong (1982) have produced strong evidence to support the hypothesis of financial crowding out, and the results for real crowding out have been, to say the least, quite mixed.

Sundararajan and Thakur (1980) have made an empirical testing for India and Korea using a dynamic model of public investment, private investment, savings, and growth. They found that public investment exerts a short-term crowding-out effect on private investment; but it also raises the productivity of private capital stock and by creating demand for the output of the private sector. On the other hand it also raises aggregate output and savings, thereby offsetting part of the initial crowding-out effect.

Nazmi and Ramirez (1997) provide one empirical result in analysing the crowding-out in Mexico. They found that public investment has directly and positively impacts on output and it does so at expense of private investment. Current and past increases in overall public investment spending depress private investment directly but impact it positively through an accelerator effect.

Fisher, Sahay and Vegh in (1997) found that the key to rapid growth in the transition economies (East Europe and Soviet Union) is adopting policies that promote investment. They suggest that particular attention should be given to the quality of investment. While many of the transition economies have traditionally had high investment ratios, the efficiency of the capital stock has typically been low. Hence, policies should focus not only on increasing the level of investment, but also in improving its efficiency.

2.3 SAVING AS FINANCING OF INVESTMENT

Investment-Savings Gap

Goods and services that are put to use in an economy come from two sources, home production (Y) and imports of goods and services (M). These are used for consumption (C), investment (I) and exports of goods and services (X) where C and I include imported consumer goods and investment goods. Hence,

(i) $Y + M \equiv C + I + X$ or $Y \equiv C + I + X - M$

Domestic production (Y) gives rise to incomes which are identical to the total value of production and this income is spent on consumer goods (C) or saved (S) so that

(ii) $Y = C + S$

From (i) and (ii) it can conclude that C is common to both sides of the equation and the equation can be rearranged as

(iii) $I = S + M - X$

This indicated that $M - X$ is the excess of imports of goods and services over exports, or the deficit (or surplus) on the current account of a country's balance of payments. This must be identical with the net capital inflow (F), defined to include any net change in the external reserves of the economy. Thus

(iv) $M - X \equiv F$ when (iii) is rearranged we have $I - S \equiv M - X \equiv F$

It is clear that in the I-S gap the foreign borrowing must be sufficient to meet the shortfall of domestic saving below the level necessary to finance the investment that is needed to achieve the target rate of growth.

Sources of Financing

The financing gap should be 'filled' by two main resources: Domestic resources and Foreign Resources.

Domestic resources. First of all *saving* is seen necessary to fund investment. Without money or monetary assets, savings and investment will tend to be simultaneous acts, in the sense that saving and investment will be done by the same people, and saving will be invested in the sector in which the saving takes place. The financial system plays the role to 'redistribute' resources from savers to investors. The banking system with the power to create credit, investment can take place first without prior saving through the process of borrowing (in this case the savings funds investment but does not necessarily financed it) and second together with financial system by promoting and financing investment. The financial system is important for encouraging saving, financing investment and allocating savings in the most productive manner.

There are three broad groups in domestic society that save: the household sector, the business sector and the government. The households sector saves out of personal disposable income (personal saving), the business sector saves out of profit, and the government can save out of tax revenues if it spends less than it receives on current expenditure (that is, runs a budget surplus on current account). Households and business saving is sometimes referred to as private saving, also is called the voluntary savings. Government saving is public saving, also is called as involuntary savings.

Domestic savings for investment can also be supplemented also from abroad. Private foreign investment is a direct source of capital formations and provides a direct addition to domestic investment.

The encouragement to save and invest productively must come from the government and government agencies concerned with promoting economic development.

The foreign resources. The main forms of this type of resources are:

- Foreign direct investment;
- Remittance;
- Official flows from bilateral sources and multilateral sources (such as the World Bank and its two affiliates, the International development Association, IDA, and the International Finance Corporation, IFC) on concessional and non-concessional terms.

In East European countries under the classical socialist system the primary channel for transforming saving into investment was the government budget. Public and private financed are intertwined. Investment is financed not through a financial system that intermediates between businesses and households, but rather by the government as the owner of capital stock. The profits from state owned enterprises stay within the public sector. Since saving stay essentially within production sector, there is no need for financial institutions to channel saving from the ultimate savers, households, to the eventual users of the funds, enterprises.

The transition from a regime of central planning to a market economy has dramatic effects on the saving process. Ickes (1993) found that during transition there is a tendency of increasing savings by households under the transition. First this is offset by a decline in public-sector savings. Second as the state role in the economy recedes, the income from production will accrue to a new set of owners. Thus some increase in private savings is just a transfer that results from a change in the nature of ownership. He found also that there was a decline in capital accumulation, as consequences of weakening of central control in many East Europe countries and the former Soviet Union. The decline of savings ratio occurs that before the 1989 (the year of starting of transformation) suggests that this shift have more to do with the deterioration in performance than in effects of the transition.

2.4 CONCLUSION

In order to calculate the level of 'required' investment rate for a target growth rate it will be used the Domar model. This model has been used broadly by international organisation to identify the needs of poor country stress the short-run necessity of both investment and aid for growth. Here are includes the ex-communist countries.

Focusing on analysing investment's quality especially of infrastructure investment, rather by looking the public investment share of GDP will do the examination of crowding out issue. The level of investment should not be ignored, but is more important the quality of public investment and impacts of them to the private investment. For this will be used the qualitative analysis.

To analyse the role of savings in financing the investment the qualitative analyses of domestic and foreign resources will take place. A better picture will be reached by going in deep of the behaviour of savings. The examination adequacy of banking system will point out the role of banks attracting savings from population and provide credit for investments. In order to find the role of foreign savings in financing investment it will be examined the level and quality of foreign direct investment and aid.

CHAPTER 3

GROWTH DURING TRANSITION AND 'REQUIRED' IMVESTMENT FOR THE FUTURE

3.1 INTRODUCTION

In order to find that what is behind the rapid growth in Albania during transition it will be examined the methodology being used to calculate GDP growth. A better result will be arrived by concentrating on dubious GDP growth figures in 1993-96 in the knowledge that the industrial sector had collapsed badly. The determination of 'required' investment is necessary as a starting pointing to exam later crowding out.

Chapter 3 will proceed in the following way. First, rapid GDP growth in Albania, if it was real or not will be examined in section 3.2. Next, in section 3.3, 'required' investment rate for a target growth rate will be determined by Domar model. Then, section 3.4 will conclude with remarks about the real growth GDP and the value of 'required' investment in Albanian economy.

3.2 GROWTH IN ALBANIA DURING TRANSITION

Albania did have success in stabilising macroeconomic conditions, so by the end of 1992, Albania has register positive results. As shown in Table 3.1, the decline in GDP was stopped in 1993 and grew by about 9.6 per cent over the year as whole; GDP continued to increase, by 9.4 per cent in 1994 and by 8.9 per cent in 1995.(Until 1996, the GDP growth figures published in IMF and World Bank documents).The reduction of annual inflation rate from 226 percent in 1992 to 7.8 per cent in 1995 has been presented as one of the government's notable successes. The domestically financed budget deficit was reduced from 44 percent of GDP in 1991 to below 7 per cent in 1995. The external current account deficit from 61 per cent of GDP in 1992 to less than 8 per cent in 1995 and official reserves rose to USD 240 million in 1995 from zero in 1991.

GDP growth figures above all led most external expert to qualify the transition in Albania as a 'success story', and to explain it as the natural result of successful reforms implemented under the guidance of international monetary institutions. So IMF has expressed its opinion: "Albania has made impressive progress since the overthrow of Communism in 1991" (IMF, 1997, p.3); "[s]trong adjustment policies have been the key to Albania's success" (IMF, 1997,p.3); "Albania has made tremendous progress ... The three successive years of high economic growth attest the major progress made in stabilisation and structural adjustment" (World Bank, 1996b, p.iii). In this way these institutions has accepted their role in this progress.

Table 3.1-Main Economic Indicators, 1990-1996

	1990	1991	1992	1993	1994	1995	1996
Economy							
GDP*	-10.0	-28.0	-7.2	9.6	9.4	8.9	8.2
Industrial output*	-14.2	-42.0	-51.2	-10.0	-2.0	1.0	13.6
Agricultural output*	-5.4	-17.4	18.5	10.4	10.3	10.6	3.0
Inflation(end-of-year percentage)	0	104.1	236.6	30.9	15.8	6.0	17.4
Inflation (annual average in percentage terms)	0	36.0	226.0	85.0	22.6	7.8	12.7
Fiscal Sector							
Domestically financed deficit (% of GDP)	4.0	44.0	20.0	9.1	7.0	6.7	10.5
Overall government budget deficit (cash-based; % of GDP)	4.0	44.0	20.3	14.4	12.4	10.4	11.4
External Sector							
External current account balance (excluding official transfer; USD million)	-122.0	-213.0	-434.0	-365.0	-283.0	-181.0	-201.0
External current account balance (excluding official transfer;% of GDP)	-6.0	-26.0	-61.1	-29.7	-14.3	-7.5	-7.7
Trade balance(USD million)	-150.0	-308.0	-454.0	-490.0	-460.0	-474.0	-676.8
Trade balance(% of GDP)	-	-	-64.0	-39.9	-23.2	-19.6	-25.0
Gross international reserves (USD million)	-	11.0	72.0	147.0	204.0	240.0	280.0
Exchange Rate							
Lek/USD	8.9	24.2	75.0	102.1	94.7	92.8	104.5

*Percentages change over previous period at constant 1990 prices.
Note: Government figures for GDP in 1994, 1995, and 1996 were 8.3, 13.3 and 9.1 per cent.
Source: IMF (1994,1997)

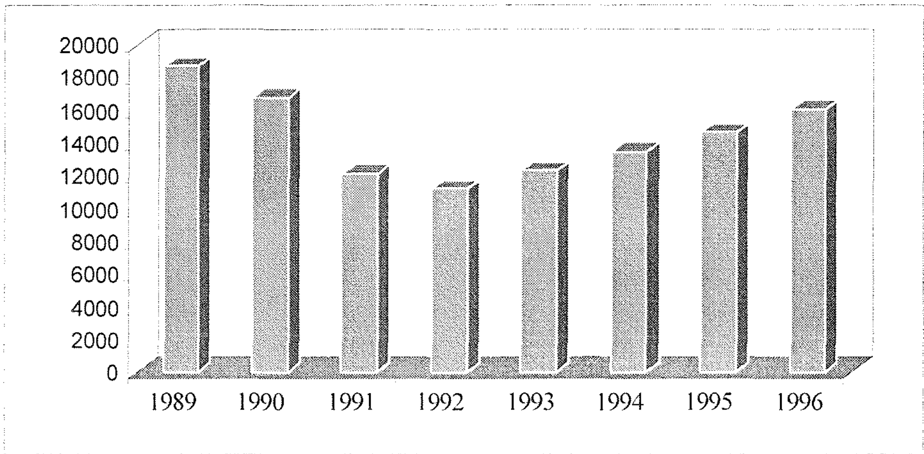
The European Bank For Reconstruction and Development (EBRD) in its 1995 *Transition Report,* also presented Albania on the basis of its GDP as the country with the highest growth in central and Eastern Europe, and place it without hesitation in the group of countries in which economic reform was being pursued most extensively and most rapidly. While Albania showed the signs of economic recovery between 1992 and 1995, it was not clear whether this growth was artificial or signalled a real improvement in the economy.

The crucial question was concerned the methodology being used to calculated GDP growth. The methodology was based only in the growth of GDP. For some, the methodology employed by the World Bank and the IMF was inappropriate because it calculated GDP growth on the basis of investment and income rather on real production, so leading to an overestimation of output growth. This method clearly did not take into account the collapse of industrial output. Even the World Bank itself recognises that there are possible sources of error in calculation of growth rate: "there is also a risk of overstating annual growth, due to improvements in data collection by Albania statistical agencies and government ministries, especially in categories such as private industry and services", concluding that "substantial scope for error remains, given still evolving data collection procedures in Albania" (IMF, 1997, p.6).

As the same GDP figures had to be recalculated, most of them downward (from 11 per cent in 1993 and 1995 to 9.5 and 8.9 per cent respectively), shows how this measures of GDP growth could have been only approximate. This systematic presentation of higher figures by the Government in 1995-1996 (13.3 and 9.1 per cent respectively) illustrates the political considerations that were behind the GDP figures. In the other hand in calculation of GDP growth has been totally ignored the real production, basing only on the income and investment, leading to an overestimation of output growth.

First of all, the very low starting base was followed by the collapse of production in the state owned agricultural and industrial sectors during the first years the country opened its borders (1989-1992). As already indicated in the transition economics literature (Fischer, Sahay and Vegh, 1997) the initial conditions are very important in determining the level of output growth. Growth tended to be higher in poorer countries such as Albania. This means that starting from very low base, where the economy is completely paralysed and extremely poor, any effort in making the economy move would give a positive result. It is also important that this result should be interpreted with more caution as the transition in Albania had started much later (in 1991-1992) than the rest of Central and Eastern Europe. Figure 3.1 is shown that the level of GDP remained below its pre-transition level: at the end of 1998, reordered still only 85 per cent of its 1989 level. It is still unclear that how Albania has been identify as one of the most successful transition economies, basis on the basis of GDP.

Figure 3.1-GDP, 1989-1996 (millions leks at 1990 constant prices)



Source : IMF (1994,1997,1999).

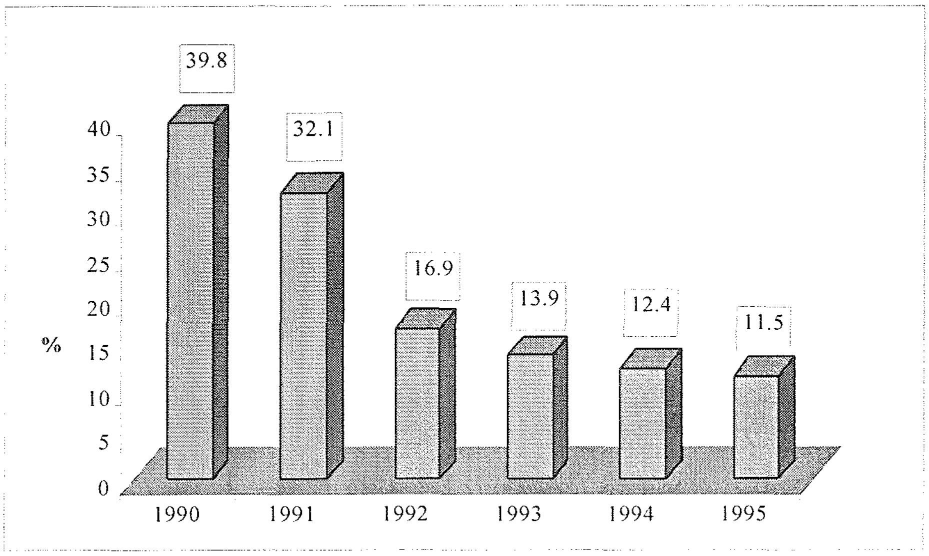
It is clear from figure 3.2 that industrial production (mostly- state owned) continued to decline over the period 1990 and 1992, which led that the industrial output did not contribute to GDP growth. This low industrial output has contributed mainly in worsening foreign trade deficit, which is clear by the Table 3.1.

For the experts of IMF, the recovery in Albania: "is largely attributable to continued strong growth in agriculture… Over 1991-1995 as a whole, agricultural output increased by 63 per cent"(IMF, 1997, p.5). This is clear by the Table 3.1.

Albanian emigrants supported their families and friends, providing an important source of disposable income, spending, and investment for the country as a whole.(the large exodus took place mainly in 1989-1992 and nearly 400,000 Albanians were working abroad. This amount represents about 12 per cent of the total population.

According to the IMF (1994, p.30), "The Albanian economy has been sustained throughout the difficult transition in part by large inflows of private remittances from expatriates." Because of poor banking system, these transfers are largely effected in cash and in kind (especially consumer durables and electronics). The IMF to amount to USD 200 million (IMF, 1994, p.30), around 20 per cent of GDP estimated emigrants' remittances in cash. Unofficial estimates suggest that the correct figure may be closer to USD 500 million and new calculation rise the figure to about 50 per cent of GDP. The funds from emigrants went particularly in the private sector: "[p]rivate trade and construction have been fuelled in part by transfers from abroad" (IMF, 1994, p.5); they have helped to create new businesses and stimulate investment project.

Figure 3.2-Industrial Output, 1990-1995 (share of total GDP at 1990 constant prices)



Source : IMF (1997), p.4

First, the remittances have a positive economic effect and they strongly confirm the absence of the internal growth and capital formation necessary to revitalise domestic production. Second, the most of these remittances came to be played in pyramid schemes offering high interest rates, rather in private activities (as mentioned by the IMF, 1997,p.22). So in 1996 emigrants sent USD 558 million into Albania and in 1997 (the year of the collapse of pyramid schemes) this fell by almost half, to USD 330 million.

The two above-mentioned facts show that the contribution of remittances in GDP growth remains unstable. This is supported also by the fact that in the long run these remittances are expected to decline, as emigrants links with the country during the time will decrease.

3.3 'REQUIRED' INVESTMENT RATE FOR A TARGET GROWTH

IMF in 1996 told the ex-communist countries in Europe that "raising investment rates to 30 percent of GDP" would "double projected growth rates"(Easterly, W, 1997, p.15). The IMF Institute in its training manual for developing countries suggests that investment requirements be calculated as "Target Growth *ICOR" (http://www.worldbank.org/html/prmg/grothweb/notes1.html). For calculation of the required investment is necessary the value of ICOR. In Table 3.2 are given some data for ICOR in selected countries. The Albanian figure for ICOR is too low, which means that efficiency is high. First, this result must be considered with caution due to the quality of data. Second, the collapse in production sphere makes unacceptable the found value of ICOR for Albania and it will be ignored in our calculation. The ICOR value for the ex-Communist countries group data of ICOR is four, therefore for Albania which belongs to this category of countries, it will be used the same value so ICOR equal to 4.

Table 3.2-ICOR in Selected Countries

Countries	ICOR
Latin America	4
Uganda	3
Ex-Communist Countries	4
Albania	1.90

Source: Easterly, W (1997, p.14) and for Albania Table A1 in the Annex Table.

By using the equation "Target Growth * ICOR" for Albania, the required investment finance should be of 20 per cent or more of GDP to reach the growth rates of 5 per cent.

Levine and Renelt (1992) found that the average share of investment in GDP for 15 transition economies in 1995 was 22 percent. The calculated figure for Albania is near this figure. The average share of investment in GDP for Albania in 1995 with 15.5 percent was low compared with the average of transition economies.

The growth rate in Albania as one of the highest among the transition economies has been associated with a low share of investment compared with the average of other transition economies. Keeping in consideration the formula 'Rate of Growth *ICOR =Rate of Investment', results that high level of growth rate and low share of investment can happen in case of efficient ICOR. On the other side in section 3.2 is shown that production sphere has collapsed, which makes unacceptable the efficiency of investment. In the case of Albania with share of investment of average 15.5 percent (average for

1992-1995), with collapsed production sphere and using 4 as the ICOR value 4 led to only 3.8 percent of growth rate (instead of growth rate declared as about 9 percent).

The last finding supports the existence of dubious figure of growth rate in Albania during the transition.

3.4 CONCLUSION

The reservations concerning the calculation method selected for GDP growth, the possible errors due to sometimes unreliable or badly reported data, an the reliability of GDP as a criterion of economic growth in Central and Eastern Europe should undoubtedly have led in the adoption of more caution in the interpretation of the figures by the analysts. So presented as a success economy as far as concern of growth rate, seems to have masked a reality in which apparent economic success depended in large part on remittance from foreign workers, large scale smuggling and money-laundering, and illusory short-term profit from pyramid schemes.

The determination of 'required' investment by 20 percent seems acceptable within the figure for transition economies. This reveals the finding that low share of investment and collapsed production sphere can lead to low growth rate, making again unacceptable the declared high growth rate in Albania.

CHAPTER 4
PUBLIC INVESTMENT AND CROWDING OUT

4.1 INTRODUCTION

Naturally Albania's transition to the market brought a large reduction in the weight of the government in the economy. With the advent of a private productive sector, there had also to be radical change in the means by which the state collected revenue. The task that the authorities face in these circumstances is to ensure that the government still has the resources to fulfil its essential public function. Albania's rapid rise in output after its revenue instruments had been put in place might have led to the expectation of a steadily rising capacity of the state to meet public needs. Yet this did not happen. And the prevalent judgement is that there has been a deterioration of the infrastructure of schools, roads, and hospitals, as public sector investment has settled at small, fraction of its late-1980s level.

In order to answer the second question risen in this paper that what was happened with public investment did crowding out the private investment; the qualitative analysis will be performed. Therefore, this chapter will unfold in the following manner: in section 4.2 the level of public investment will be explored. The analysis of quality of investment will be performed in section 4.3. Section 4.4 will present an analysis of private investment. The crowding–out will be identified in section 4.5. Finally, section 4.6 will conclude the findings of the chapter.

4.2 LEVEL OF PUBLIC INVESTMENT

Table 4.1 shows a sharp decline in public investment up to 1997 with the lowest value of 4 percent. In other side the private investment has been jumped to 9.3 percent in 1994 from only 3.7 percent in 1993, later it continues to increase more slowly and in 1997 reached the greatest value of 12 percent. In other words it is clear that level of public investment during the transition period up to 1998 has been decreased.

The reasons of shrinking of public investment are attributed first to changing size of the government sector, second because of the mass-privatisation program started in

1992, after the approbation by the Albanian parliament of first law on privatisation in August 1991 and third the low absorptive capacity.

Table 4.1-Public and Private Investment (as % of GDP), 1993-1998

	1993	1994	1995	1996	1997	1998
Public Investment	9.5	8.6	8.2	4.5	4.0	5.2
Private Investment	3.7	9.3	9.8	11.0	12.0	10.8
Total Investment	13.2	17.9	18.0	15.5	16.0	16.0

Source: IMF Albania*: Staff Report for the 1999 Article IV Consultation,* June 1998

IMF Albania*: Recent Economic Development,* April 1997.

Changing Size of Government Sector

In the transition of a command economy to the market we should expect government expenditure to fall in relation to national income. So it was in Albania, as appears in Table 4.2. Total government spending is given as 57% of GDP in 1989, rose to 62 in 1991 and 1992, fell sharply to 46% and 44% in 1992 and 1993, and then successively to 35%, 33%, and 31% in 1994, 1995 and 1996.

Table 4.2-Changing Size of Government Sector 1989-1996 (monetary figures in million leke*)*

	1989	1990	1991	1992	1993	1994	1995	1996
GDP nominal	18681	16813	16473	50700	11420	18830	22506	26620
GDP at 1990 prices	18681	16813	12156	11282	12363	13637	14932	16217
Implied GDP deflator	100.0	100.0	135.5	449.4	923.7	1380.8	1507.2	1641.5
Consumer Price index		100.0	136.0	443.4	820.2	1008.7	1089.6	1220.4
Gov't exp're nominal	10604	10449	10202	23405	49958	66317	74530	81763
Gov't exp're 1990 prices	10604	10449	7529	5208	5409	4803	4945	4981
As % of GDP : Gov't exp're	56.76	62.15	61.93	46.16	43.75	35.22	33.12	30.71
Gov't revenue	48.19	46.79	31.38	24.66	27.67	24.63	23.80	19.76
Deficit	8.57	15.36	30.56	21.51	16.08	10.59	9.32	10.97

Source: Mainly Ministry of Finance; EBRD, *Transition Report Update 1997*

It should be mentioned that is used GDP deflator for deriving the real (constant prices) spending and revenue aggregates. The approach here is to use the GDP deflator implied by the ratio between nominal and real estimates of GDP. From the *World*

Development Reports, it appears to be lower than in the Czech Republic, Romania and Bulgaria around 1993 and 1994, but higher than in Russia or the Baltics about the same time.

Most of the elements in the fall of expenditure relate clearly to the changes of fundamental policy: liberalization, privatisation, and the political opening to the outside world.

Mass Privatisation Programme

The privatisation process has influenced in declining of public investment and in the same time in increasing the private investment (changing only the ownership).

Agriculture was the first sector to be privatized, mainly through the dismantling of agricultural co-operatives. Prior to 1991, the majority of agricultural production took place within framework of state farms and co-operatives. Although, according to some, following the fall of the communist government, "farmers spontaneously dismantled agriculture co-operatives and distributed the land and livestock among themselves"(see IMF 19997,p.31), this process was clearly based on the government's decision to ban co-operatives in agriculture, which was implemented through the programme of land privatisation approved by the parliament in 1991 (Land Law No. 7501, 19 July 1991). Under this law, the land controlled by the co-operatives was allocated to families living in the villages of the co-operatives in accordance with a number of criteria. In 1992, the privatisation process was extended (under Decision 452 of 17 October 1992) to include land controlled by state farms. By the end of 1993, 92 percent of agricultural land had been privatised, including 93 percent of former co-operative land and 91 percent of former state farm land. (State farms accounted for 24.1 percent of the cultivated land and often possessed the best agricultural land).

Albania started its small-scale privatisation in the middle of 1991, with the Privatisation law of 10 august 1991. The National Agency for privatisation (NAP) was established in order to organise and monitor the process. The rapid privatisation of small-scale entities was implemented in transport, trade and services. The end of 1992 transferred 75 percent of the commercial network and services units to private ownership.

On the other side the privatisation of large-scale enterprises included state-owned enterprises with a value of more than USD 500,000 faced many difficulties. Around 300 enterprises came into this category, some of which could be split up and sold as small and medium-sized enterprises in accordance with Decree No.248. Most privatisation of small and medium-sized entities was carried out quickly and without proper payment being made, so depriving the state of much-needed revenue. The most difficult task of national importance is the privatisation of strategic sectors of the economy. Preliminary discussions commenced in 1994 concerning the selling-off of state-owned utilities, such as water, hydroelectric power generation, power distribution, and telecommunications, with a view to increasing their efficiency and eliminating shortages, but no concrete steps were taken. In other side the privatisation of the mining sector was also planned, but has met with strong opposition from trade unions because of the adverse social effects and unemployment that would result. (See "We Are against Privatisation of the Mines", in *Albanian Observer*, Vol.2 No. 2 (1996), p.40.

While in the course of 1991-93 agriculture and small and medium-sized enterprises had been privatised very rapidly, the process has failed on the privatization of strategic sectors of the economy.

The Low Absorptive Capacity

In particular, 1993 the Government drew up a first comprehensive Public Investment Programme (PIP) covering the period 1994-96, to identify and provide the investment necessary to support economic and social development. This programme was updated in 1995 for a new programme for 1995-97 and in 1998 for another programme for 1998-2001(See Public Investment Programme, 1998). It is difficult to finance such programmes against a background of overall budgetary restrictions, so the support of foreign donors has been a key component in this process. The performance of PIP has been very low which is reflected is inadequate level of public investment. The disbursement figures including both external and local financing show an annual decline in the total disbursement since 1993 up to 1997 by 10 percent.

Factors behind this performance are mainly attributed to:

- Over-optimistic assumptions about the time taken to identify negotiate and secure financing for externally funded projects. The more rigorous design and economic appraisal requirements coupled with the need to comply with aid agency procedures and timetables have meant that the time taken to secure project financing has often been longer than anticipated. As a result funding commitments have been less and project lead –in and mobilisation times longer than anticipated in either the 1994-95 and 1995-97 PIPs. Experience suggests that most agencies it take at least two years from initial discussions on project financing to the start of a significant implementation activity.
- Delays in project start-up due to the need to undertake prior policy, legislative and institutional reform measures. This is crucial by taking in account the slow reform in the institutional structure. Thus, the projects face difficulties with their implementation once they have been financed.

4.3 QUALITY OF PUBLIC INVESTMENT

In one survey designed by the World Bank and implemented by Albanian Center for Economic Research result that compared to other transition countries, experts perceive Albania as having first one of the highest rate of corruption, second the lowest rate of rule of law and last the lowest investment attractiveness index. By the same survey result that almost 90 percent of firms identify the poor quality of physical infrastructure[i] as an obstacle to their operations and about 60 percent list corruption a significant obstacle.

In reality the corruption is widespread in Albania and it has great costs for social and economic development. It undermines public confidence in the most important institutions in the country. It reduces the funds available for critical public services (World Bank, 1998,p.iii). Widespread corruption is a symptom of serious institutional weakness in government. This is reflected in the public procurement practices, which implicate systemic corruption, by the public administration. Such practices are very recent for Albania, and are completely different from the ones used under the centralized system. This system ensured that it was always the state itself that was buying and selling, while exports and imports were centralized and the prices strictly controlled and planned. The present system is based on the Public Procurement Law (July 1995), which addresses the procurement of goods, civil works and services with public funds. A Public Procurement Agency was established and is responsible for preparing standard documents to be used in public procurement, to advise the procuring entities and to inspect the documentation of procurement carried out by such entities. Despite such regulations, many irregularities are evident during the implementation of such procedures:

- in the pre-contracting period, there are cases when specifications are tailored to suit particular suppliers, information about contracting opportunities is restricted, urgency is claimed as an excuse to award a contract to a single or limited number of contractors without proper competition, and the confidentially of suppliers' offers is breached;
- during the evaluation of the bids, there are cases when senior staff intervene to influence the evaluating commissions or even to decide who is going to win the bid;
- following the award of the contract there is poor supervision, allowing contractors to provide lower quality products than originally offered, falsify quality or standard certificates and pay bribes to contracts supervisors; and
- insufficient information addressed to all parties, including officials who have the responsibility for procurement, suppliers and contractors seeking to compete for contracts, and the public large.

From these irregularities is evident that the procurement process of public investment has been more a process to enrich the individuals that work there (and the political influenced people that have supported them), rather to contribute in the true goal, this of the improvement of the quality of public investment.

The picture of level of infrastructure is as follow: during the 1990-92 crisis following the fall of communism, infrastructure in Albania was damaged with the destruction of state property; investment during that period fell from 26 per cent of output in 1989 to only 4 percent in 1992. As a consequence, the country's infrastructure became seriously deficient and rapidly worsened.

As far as concern the utilities such as gas, water, electricity and telecoms all suffer from public failure to pay bills (EBRD; Albania, 1999 Country Profile; April 1999, p.11). For example, bills have not been paid for a number of years by relatively large share of the public sector (not to mention the general public). In many cases, the termination or suspension of services to non-paying public sector entities and companies was forbidden, while legal action taken by the utility companies proved unsuccessful. The utility companies have requested that the Government make every effort to ensure that public sector pays its bills on time and that the regulations are properly enforced, while maintaining a certain level of protection for the most vulnerable sections of population.

Regarding the infrastructure, even before the transition, Albania's infrastructure was quite underdeveloped relative to other east European countries (see EBRD, p.22). The 18,000 kilometres of roads are constructed in accordance with the standards of the 1930s, and there is only one road for about 39 km, between Tirana and Durres, now being upgraded with loans from international organisations (up to 1999 after 2 years of working has finished only the first five km). There are two ports for maritime shipping: Durres, which also has ferry facilities, and Vlora, both needs modernising. Reconstruction work and an increase in the number of European connections have also improved Tirana's airport. Government has undertaken the infrastructure investment. Without competition, there can be a great deal of inefficiency and waste.

4.4 QUALITY OF PRIVATE INVESTMENT

Private investment can be divided in domestic and foreign. The limited data will constrain the analysis to be not completed.

Domestic Private Investment

The transition in Albania has led to rapid growth in the service sector, with very small enterprise playing a particularly important role. According to the IMF, "strong growth witnessed in construction, transportation, and other services, reflecting the continued development of shops and restaurants and the beginning of a tourist industry... There is no question that there was a significant increase in these sectors in 1995"(IMF, 1997, pp.6-7). The domestic private investment in Albania has been characterised by the growth of micro-enterprises or called 'kiosk economy'. The official statistics show that the number of small businesses increased enormously between 1992 and 1996. There were more 40,000 private enterprises outside the agricultural sector in 1996, officially employing more than 120,000 workers. This means that average private firm had 2.2 employees; only 3 percent of such firms employed more than 10 workers. Due to the lack of financial resources, most firms operate in less capital-intensive sectors, such as trade (51 percent of registered firms in 1996), or transport (15 percent) and other services (19 percent). In transport and services taken together, the number of registered businesses rose to about 17,000 (IMF, 1997), 10 percent of which are in manufacturing, 2 percent in construction, and 3 percent in agricultural processing. The statistical office has confirmed that in most businesses (90 percent) only one or two people are involved.

On the other side the majority of enterprises in services and trade are registered as physical entities (a total of 31,740 in the private sector in December 1996) rather than legal ones (9,094). In trade and cafés 97 percent of enterprises are registered as physical entities, and 91 percent of restaurants, with the legal form of Limited Liability Company. The growth of these small cafés or retail shops, often known as 'kiosks' were generally funded from emigrants remittances. Thus, it is clear the doubt about the ability of the Albanian service sector to generate real economic growth, grounded as it is on such simple activities. By looking the nature of domestic private investment, the lack of financial resources and infrastructure played important role as obstacles of them.

Foreign Direct Investment

Two main characteristics of foreign direct investment in Albania were the limited amount and narrow range of sectors. Among the factors that limited foreign investment, foreign investors often reported the lack of infrastructure.

The amount of foreign direct investment that Albania received has been modest by the standards of Central European transitional economies. So in 1996 cumulative foreign investment has reached USD 270 million or USD 85 per capita, which are very below the average in most Central and Eastern European countries, where for example

Hungary had reached USD 671 per capita in 1994 (EBRD, 1997, p.126). In Table 4.3 are shown the level of FDI during the transition.

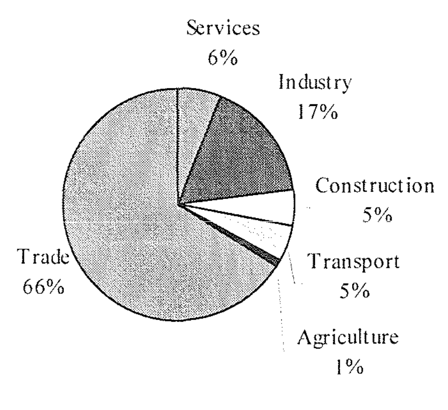
Table 4.3 - Foreign Direct Investment, 1991-1996 (in million USD)

	1991	1992	1993	1994	1995	1996
FDI per year	10	20	58	52	70	90
Cumulative FDI	10	30	88	140	210	270*
Per capita FDI	3	10	28	44	65	85

Note: *It is get by EBRD, 1997, p.126.
Source: INSTAT, 1997.

On the other side the foreign investment has been concentrated in a very limited number of sectors. Foreign investment more than 65 percent of enterprises with foreign investment up until 1996 were in trade, with less than 20 percent in industry, and only 6 percent in other services, particularly tourism (hotels and restaurants). This is shown in figure 4.1.

Figure 4.1. Distribution of Enterprises with Foreign Investment, by Sector, 1996.



Source: INSTAT (1997).

Merely of foreign investors that came in Albania were more attracted because of the low average wage. They invested in such sectors as trade and light industry more for quick profits rather for establish stable economic activities.[ii] The lack of infrastructure has been crucial on the low amount and a narrow range of sectors of foreign direct investment, hence has influenced on quality of them.

As the result insufficient public funds dedicated to infrastructure did not facilitate domestic and foreign private investment, influencing in the inadequate quality of them.

4.5 CROWDING - OUT

First the very low level of public investment indicates that in the competition for the physical and financial resources the public investment has had scare resource compare with the private investment. Thus the financial resources have been allocated to private investment. Second the quality of public investment was low; this ensues by the high corruption and reflected in the present miserable condition of infrastructure, facilities and etc. On the other side the public investment has failed in providing the facilities, which led that public investment has not contributing on lowering the cost of producing on private sector. Third, the lack of infrastructure has been indicated as major obstacle for the private sector. This has been indicated by the quality of domestic and foreign private investment, which has not been supported by the infrastructure, even the contrary happened.

The outcomes of the above-mentioned condition indicate that the public investment did not crowd-out the private investment.

4.6 CONCLUSION

The level of public investment is found to decline during the transition period and to be dependent upon different factors. In an attempt to discover some of contributing factors, the level of public investment was examined through the following factors first changing size of the government sector, second the mass-privatisation program started in 1992, and third the low absorptive capacity. These examinations indicated the role of these factors in explaining the causes of declining of public investment level.

In order to determine the quality of public investment the analysis of procurement process has pointed out the unfair selection and low quality level of public investment selected, both result from the high level of corruption on the government, as a symptom of serious institutional weaknesses in government. So public investment has not been allocated on what were the necessities. This has its own impacts, because the money did not go to the right investments.

On the other side the analysis of private investment constrained by the lack of data showed that the public investment has not contributed in facilitated them, on the contrary it was an obstacle. Taking in the considerations the conditions of crowding-out, it results that in Albania during the transition period the public investment did not crowd-out the private investment.

CHAPTER 5
ROLE OF SAVING FOR FINANCING INVESTMENTS

5.1 INTRODUCTION

The savings for financing investments are supplied by domestic and foreign resources. The domestic savings are composed by households sector, the business sector and the government. Data are available only as percentage of GDP for public and private savings. There are no data available for households sector which mean saves out of personal disposable income (personal saving) and for the business sector which mean saves out of profit. The analysis of privatisation and pyramid schemes will help to find where the Albanian savings have gone. The foreign savings consist on the foreign direct investment; remittance and official aid.

Chapter 5 will proceed in the following way. The analysis of public investment and changing the scale of revenue will be examined in section 5.2. Next, in section 5.3 the inadequacy of the banking system will be discussed. Then, section 5.4 will continue in analysing the informal market and pyramid schemes. Section 5.5 will discussed the role of savings in privatisation of urban housing of the remittances. Section 5.6 will discuss the role of foreign direct investment in Albania. In section 5.7 the role of official aid in financing the investment will be discussed. Section 5.8 will conclude the findings of the chapter.

5.2 PUBLIC SAVINGS AND CHANGING THE SCALE OF REVENUE

The government can save out of tax revenues if it spends less than it receives on current expenditure (that is, runs a budget surplus on current account). Government saving is public saving, also is called as involuntary savings. In Table5.1 is shown that the public savings has been decreased sharply after the 1990 and still has remained negative.

This can be explaining by examine fiscal deficit. In table 5.2 is shown a very high fiscal deficit as a proportion of GDP from 1990 to 1993(over 30 % in 1991); in other years (when it was between 8% and 11%), it would have regarded as high. On the other side the contribution of grant-aid to the government accounts reached its peak as a proportion of GDP in 1992, when it represented 5.80%, more than a fifth of what budget deficit would otherwise have been. Since there is no domestic bond market, domestic financing of the deficit has meant a combination of direct creation of base money by the Bank of Albania and, in latter years the sale of Treasury Bills, which have been bought largely by the state-owned banks and insurance company.

Table 5.1 - National Saving 1989-1998* (in percent of GDP)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998*
Foreign savings/2	3	7	22	61	33	14.3	9.7	11.5	14.3	8.3
National savings	27	10	-9	-55	-20	-15	8.3	4.0	1.7	7.7
Public/3	21	3	-27	-24	-13	-5.5	-6.7	-8.6	-10.8	-8.1
Private	6	7	18	-32	-7	-9.5	15	12.6	12.4	15.9

Source: IMF (1994), p.40; IMF (1997), p.43; IMF (1999), p.24 and World Development Report 1996,p.188-9, 208-13.

* Estimated data

/1 Excluding in percent of broad money stock at end of previous year.

/2 Current account excluding interest and official transfers.

3/ Excluding counterparts of food aid.

Table 5.2 - Budgetary aggregates - mainly revenue – 1989-1996

As % of GDP	1989	1990	1991	1992	1993	1994	1995	1996
Govern. Expenditure	56.76	62.15	61.93	46.16	43.75	35.22	33.12	30.71
Govern. Revenue	48.19	46.79	31.38	24.66	27.67	24.63	23.8	19.76
Deficit	8.57	15.36	30.56	21.51	16.08	10.59	9.32	10.97
Turnover tax/VAT	22.61	23.41	13.71	4.67	4.37	2.63	2.39	3.41
State enterp profit tax	10.57	7.57	2.92	2.63	3.49	1.46	1.10	1.28
Personal income + small business tax				0.42	0.59	0.74	0.68	0.52
Import+export tax			0.57	2.97	3.19	3.33	2.96	2.90
Excises				2.49	3.81	5.04	4.61	1.86
Soc.insurance Contribution (exl.health)	4.94	5.75	8.70	3.35	2.81	3.39	3.95	4.35
Fees				0.58	1.56	2.33	1.67	(1.09)
Privatisation receipt						1.17	0.14	0.21
Agr.co-operative tax	0.50	0.37	0.02					
At 1990 prices Government revenue total (in million leke)	9003	7866	3815	2782	3421	3359	3554	3205

Source: Ministry of Finance; EBRD, *Transition Report Update 1997*

The large reduction in government expenditure (see section 4.2) associated with transition to a market economy would naturally be accompanied by fall in government revenue. But the fall in revenue between 1989 and 1996 has been greater proportionally than the fall in expenditure (about 64% as against 53%); and its decline does not appear to have been a planned, orderly process. Part of it happened inevitably as a result of other major changes: the collapse of so many state enterprises meant that the turnover tax and direct enterprises tax they paid disappeared; similarly the dissolution of agricultural co-operatives (collective farms) ended the taxes that had been imposed on them. That revenue in real terms should have fallen drastically until 1992 and risen modestly in 1993 is not surprising. What is easy to explain is that, after the introduction of several new tax instruments, revenue increased very little in real terms from 1993 to 1995 and fell slightly in 1996, this due to fact that industrial output did not contribute to GDP growth as industrial production (mostly- state owned) continued to decline over the period 1990 and 1992. Much of the increase in output and real income came from agricultural, and farmers are not subject to any direct tax. On the other side the increase in domestic expenditure over the period from 1992 to 1996 as a whole was probably greater proportionately than the increase in income because of the rate of increase in emigrants' remittances; and expenditure is also a base for tax.

From Table 5.2 is evident a progressive failure in tax collection as the economy 'revived'. That difficulties in tax collection should be experienced in the transition period is not unexpected. The transition to the market meant for the government not only that new sources of revenue had to be found, but also that new problem of revenue collection had to be faced. Under the old regime tax payments to the government involved merely the internal transfer of funds within the public sector; up the hierarchy from enterprises to the central authorities. In a market system, the government has to raise taxes from independent private agents - a situation giving rise to much more complex administrative problems of assessment and compliance. In fact a completely new revenue service has to be created.

During transition in Albania has changed the pattern of revenue sources. In 1989 four sources accounted for about 90 percent of revenue. There were the turnover tax, the tax on state enterprises, transfers of amortisation funds from these enterprises, and social insurance contributions. The tax on state enterprises was changed into a profit tax on companies normally at 30 percent but at 50 percent for mining. In 1992 were introduced a personal income tax to be paid by employees, and a tax on small businesses other than family farms. Taxes on international trade came into existence in 1991 and excises in 1992. Various fees for such items as motor registration were introduced in 1992.

Again, from Table 5.2 is clear the poor performance of real tax yield over the period of "fast growth" 1994 to 1996 suggests that were low performance in the economy associated with a deterioration in the administration and enforcement of the number of taxes. Current level of revenue and modes of borrowing have meant low level of public savings which led in deteriorating infrastructure and at the same time a level of cash deficit that may not always be consistent with sound macroeconomic management.

5.3 THE INADEQUACY OF THE BANKING SYSTEM

Before the transition, Albania's banking system was typical of a centrally planned economy. The State Bank of Albania was in charge of both central banking and commercial banking tasks. The first step of bank reforms in 1991-1192 created a two-tier banking system with Central Bank of Albania governing three state-owned second-tier banks: National Commercial Bank (NBC), the Rural Credit Bank (RCB), and the Savings Bank (SB). Each of these second-tier banks was created with a view to become a universal bank and engaging in both deposits taking and lending to households and enterprises. Despite the progress made in one direction, the Albanians lack of experience of modern banking techniques turned out to be a serious handicap. At the end of 1996 there were still no private banks, and only two foreign banks had come on the scene to form joint ventures, the Arab Islamic Bank and the Italian Albanian bank, with an average foreign capital of 60 percent. The two joint venture banks at the end of 1996 served more as facility for the transfer of currency than for deposits and credits.

Rapid development of the private sector resulted in higher demand for credit. The creation of new small private enterprises required start-up capital and additional funds for necessary investment. At the same time, the privatisation of state-owned enterprises needed substantial investment in order to increase efficiency and renew their generally obsolete equipment and technology. Many people willing to start a new business were often blocked by the very tough conditions imposed by the banks, most of which required a downpayment on loans that most new businesses could not supply. The growing credit demand did not meet because of a voluntarily restrictive monetary policy. The Bank of Albania used direct instruments of monetary policies, in particular a tight credit policy through hard constraints, such as bank-by-bank credit ceilings imposed on commercial bank. Interest rate on loans and deposits were also indirectly set by the Central Bank. Quarterly distribution of the volume of credit has often led commercial banks to refuse customers requests for loans because they did not fit into their credit plan (Muco, 1997, p.4).

The bank-to-bank credit ceilings were imposed from mid-1992 on the direct advice of international monetary institutions in response to the banks' poor credit evaluation and stock of bad loans. According to the IMF (1997,p.30),"[t]hese ceilings have been set at levels well below what the banks would like and probably at levels insufficient to meet the demand for credit in the private sector at prevailing interest rate. The limitations of the banking system made these measures sensible, indeed necessary, but their combination led to the emergence of an informal market. Which provided alternative channels for the intermediation of savings."

As predicted, this strict monetary policy clearly reduced the ability of commercial banks to satisfy increasing demand for credit in 1992-96. Only a very small percentage of credit requests could be satisfied, directing the private sector to the informal credit market.

5.4 THE INFORMAL MARKET AND PYRAMID SCHEMES

The failure of the banking system to act as a proper financial intermediary and sever restrictions on credit policy led to the growth on the informal financial market. The informal sector started up in order to establish the financial market that the banking sector had singularly failed to provide.

The informal market consisted partly of foreign exchange dealers (some licensed, some not) and partly of a number of companies taking deposits and making loans (Jarvis, 1999,p.7). These companies were first informal because they did not become licensed to take deposits and at the same time they grew based mostly on private loans from migrant workers to friends and family. Large ones that managed to attract the major part of the population's savings followed these companies, so concentrating the informal market in a few hands. The pyramid schemes started in 1991-92 then during 1995 and early 1996 they consolidated and grew. The pyramid companies and others often repeated to legitimise their activities that the borrowing activities had their legal basis in the Albanian civil code that considered a mutual agreement entered into by a borrower and a lender as quite acceptable.[iii]

The interest rate offered by these companies quickly drew in an increasing number of people. Thousands of small kiosks with a cashier were opened over the country to collect people's savings, money inflow and outflow being regulated from the headquarters. Since the credibility of the whole system was essential to its survival, these funds ensured payment on time and in full. The apparent reliability of these investments, combined with very good interest rate, led to exponential growth in the number of depositors and the amount deposited. While some of them –those which were not based on any official economic activity or unofficial business- started to find it difficult to reimburse their depositors, other companies that had launched legal activities, or had access to money generated by illegal activities, became very powerful economic groups. Most regional funds expanded at the national level. By 1995, nearly every major city in the country had at least two such organisations operating in it.

These funds were able to survive, apart form their self-sustaining mode of functioning (earlier depositors being paid with the depositors of later ones), thanks to the existence of a range revenue sources: remittances from emigrants, personal savings, revenue from private legal activities, and also probably accounting for the major part-money laundering generated by criminal activities such as prostitution, the trafficking of illegal emigrants- mainly from Asia-across the Adriatic, and of drugs, weapons and goods to break the Yugoslav embargo.[iv]

In summer 1996, after the elections, when political reasons action against these funds seemed impossible and undesirable, a bitter struggle commenced among the pyramid schemes to attract depositors and to capture market share. They started to offer very high interest rates, 20 to 30 percent per month, and shortened the repayment period-for instance from six or seven months to three. They also sought to attract more medium-sized and large deposits. This increased demand for capital met with a huge supply response: emigrants began to send more money to their families with the express purpose of investing in the schemes, hoping for immediate returns.

According to observers, the capital inflow to each of these schemes increased from USD 500,000-600,000 per day in July to USD 3.5-4 million at the end of August.[v] The mass savings hysteria increased further in the following months, culminating at the end of autumn 1996. In October, the IMF insisted that the Albania Government intervene, causing the Minister of Finance to call the attention of the media to the uncertainty and danger of the pyramid companies and funds. Meanwhile, the government delayed taking legal steps. In November and December, the majority of schemes increasingly registered a negative daily net cash flow. Some of them during these months increased further the interest rate per month two up to 100 perfect on three-month deposit while one other up to 50 percent a month. In the end of December 1997 started the bankruptcy of the first scheme following by the others and in the early of January 1997 all the schemes were closed, closing the dream of Albanian to become rich immediately, and swallowing at the same time all savings and major part of remittance. The number of depositors was estimated at 400,000, which meant that at least half the families in Albania- but probably many more- had become involved in the pyramid schemes. The authorities also estimated the total net debt of the schemes towards their creditors at around USD 2 billion, that is, a sum equivalent to the annual national GDP.

The collapse of the investment schemes suddenly revealed the real character of the Albanian economy, based on pyramid schemes and the laundering of money from illegal activities rather than on real production growth.

5.5 PRIVATISATION AND REMITTANCES

Privatisation of urban housing alongside the privatisation of agriculture and industry discussed in section 4.2 has drawn a part of savings. Privatisation of urban housing proceed under a law in January 1993 and with great speed. By November 1993, the privatisation of 97 percent of urban apartment was complete and 230,000 dwellings had been transferred to their residents (Hashi&Xhillari, 1998,pp.14-15).

The role of remittance on economy has been discussed broadly in paper. In section 3.2 is showed the role in economy. The IMF to amount to USD 200 million (IMF, 1994, p.30), around 20 per cent of GDP estimated emigrants' remittances in cash. Unofficial estimates suggest that the correct figure may to about 50 per cent of GDP. After in section 4.4 is pointed out the role of remittance on financing the small sized enterprises. The funds from emigrants went particularly in the private sector: "[p]rivate trade and construction have been fuelled in part by transfers from abroad" (IMF, 1994, p.5); they have helped to create new businesses and stimulate investment project.

Also in section 5.4 has been discussed the role of remittance in supported the existence of pyramid schemes.

As the result the remittance played a crucial role as foreign financial resources. The weak point here is that after the collapse of pyramid schemes the amount of remittance decreased sharply. This is process that can be accelerating further till the political stability will return in the country.

5.6 FOREIGN DIRECT INVESTMENT (FDI)

The constitution that prohibited investment was changed and in 1993 the Parliament passed one of the most liberal laws on foreign investment in Central and Eastern Europe (Law 7764 on Foreign Investment, dated 10 November 1993). The Law on Foreign Investment awarded the foreign investors equal treatment with local investors, and protected him against expropriation and nationalisation. Also the government offered a package of incentives to foreign investors operating in Albania, particularly in manufacturing and tourism: a profit-tax exemption for period of four years for those investing in production; other tax facilities for those reinvesting their profits; and a five-tax holiday for companies operating in tourist development zones (According to Law No. 7665 of 21 January 1993 on priority Tourism Development Zones).

First, the amount of foreign direct (private) investment that Albania received has been discussed in section 4.4.Among the factors that limited foreign investment, foreign investors often reported the lack of infrastructure. Political stability and overall country risk also remained important discouraging factors. Bureaucratic obstacles were often mentioned, particularly during business registration and at customs office. The related fact of corrupted administrative has been discussed in section 4.3.

Second, the FDI has been characterised by a big number of joint-venture as shown in Table 5.3 and in same time associated with problems. In this kind of enterprise has been irregularities and corruption also on the part of foreign investors. The government failed to select the foreign partners on the basis of technical criteria, preferring subjectivity and spontaneity. This happened mainly in strategic sectors such as copper.

Table 5.3 - Companies Involving FDI, to 1995 (numbers)

Sector	Joint ventures	Wholly foreign owned	Total	% of total
Agriculture	26	7	33	1
Transport	64	48	112	4
Construction	71	53	124	5
Services	77	67	144	6
Industry	292	123	415	17
Trade	1002	592	1594	67
Total	**1532**	**890**	**2422**	**100**

Source: Albanian Center Foreign Investment Promotion, *A Guide to Business in Albania*, 1997, p.15

Third is the low level of foreign involvement. The Table 5.4 shows the size-distribution of firms. Starting from the right, we can term the five size-categories: big,

Table 5.4 - Average Size of Investing Firm and Foreign Capital per Firm, 1991 to 1995

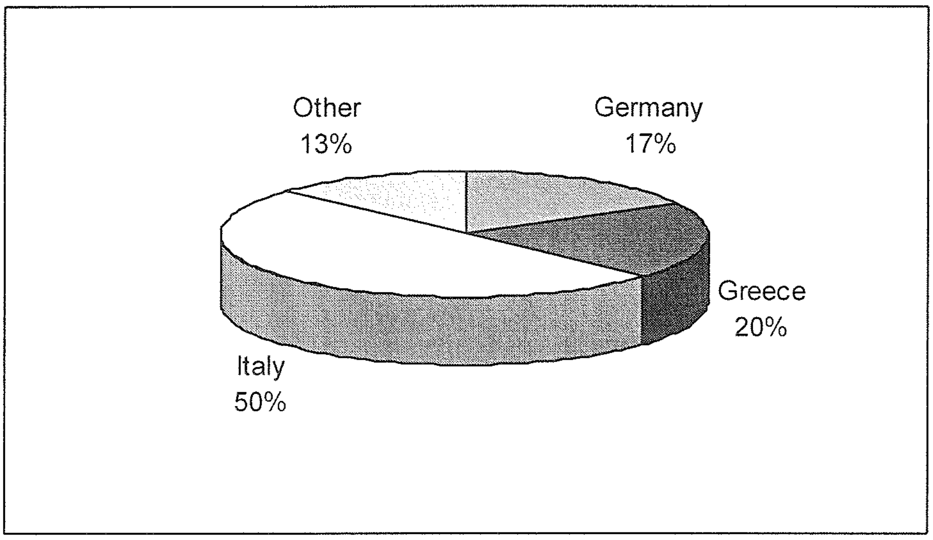
Year	Number of firms	Average size of firm: Capital in USD million	Average amount of foreign.cap USD million
1991	10	0.18	0.12
1992	62	1.16	0.08
1993	241	0.21	0.16
1994	422	0.07	0.05
1995	238	0.49	0.47

Source: District taxation Offices, as reported in Brumbulli&Dunlop (1997).

medium, small, very small and the smallest (at or below the present lower capital limit in leke). It is striking that as many as 1061 of the 1798 firms had initial capital at or below the minimum limit. These 1061 firms in total had initial foreign capital amounting to less than a million of dollars in productive sectors. While this small average size might have helped to revitalise the small-industry sector, it had no impact on the strategic industries or the physical infrastructure of the country.

Fourth, there were a limited number of partners. In figure 5.1 are shown the main concentration is Italian capital to 50 per cent of all FDI, followed by the Greece with 20 percent. According to the Italian Economic Centre, more than one-third of Italian businessmen were only attracted by quick profits and did not intend to establish stable economic activities.[vi]

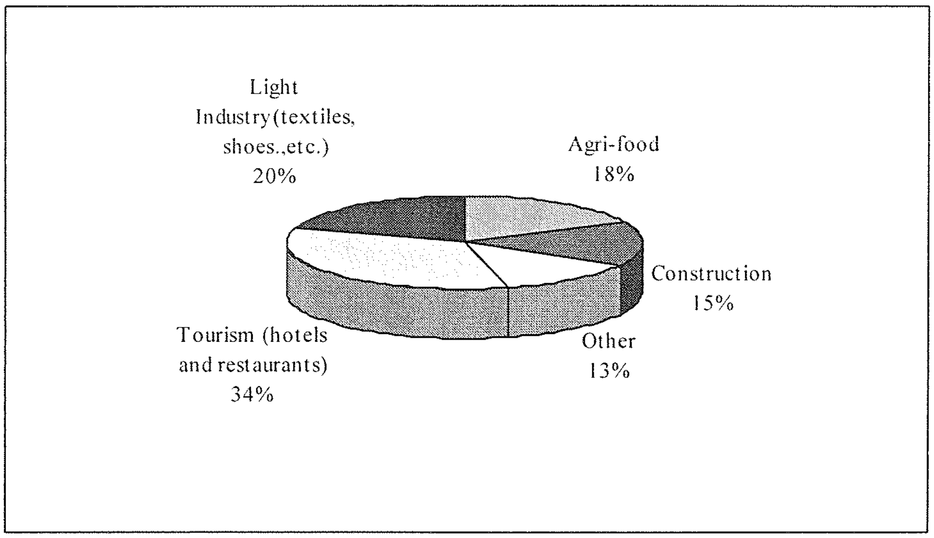
Figure 5.1 Foreign Direct Investment, by Country of Origin, 1996(%)



Source: INSTAT

Fifth has been a narrow range of sectors. This has been partly discussed in section 4.4. In figure 5.2 is shown the characteristic of foreign direct investment by sectors.

Figure 5.2 Distribution of Foreign Direct Investment, by Sector 1996



Source: INSTAT

From Figure 5.2 the distribution was with tourism in first place with 34 percent of foreign direct investment- in which large amounts are invested per project- then light industry (20 percent), agri-food (18 percent), construction (15 percent), and 6 percent are in transport (as part of others which accounted for 13 percent). These four sectors concentrated more than 80 percent of foreign capital flows in Albania. The relatively low amounts in trade render this sector marginal term of foreign investment flows, despite the large number of very small enterprises involved.

The very small percentage of foreign enterprises in agriculture is also worthy not. Although many were created in 1992-94, most went bankrupt. The very small farms (one hectare on average) turned out to be a major obstacle to foreign investment, particularly in respect of land privatisation, so undermining the future of Albanian agriculture.

Beside FDI, private foreign capital inflows included loans and portfolio movements. There are no figures for the aggregate amounts of these flows to Albania, but the consolidated presentation of inflows by the EBRD (1996, p.114) estimates that, for transition countries as a whole over 1991-95, these two categories of gross private inflows were between them more than twice as great as FDI.

There is doubt that, since the beginning of the transition, Albania has managed to attract foreign investment, so ending its long period of isolation. At the same time, direct investment flows remained well below what the Albanian economy would needed to revive its economy.

5.7 OFFICIAL AID

Official foreign aid committed to Albania was of the order of 15 per cent of GDP over each of the years 1994-1996; in 1992 and 1993 it was a considerably higher proportion than that. Though only a little over half the aid committed altogether over 1991-1996 was actually disbursed within the period, aid has formed a large part of the inward transfers and capital movements that have allowed the country since 1991 to consume and invest substantially more in value that it has produced. The pattern of aid changed over the period from high concentration in 1992 on food and commodity and 'balance-of-payments' categories to an overwhelming dominance in 1996 of flows described as for development and investment, bur since 1992 technical assistance has remained important throughout (see Table 5.5). Technical assistance itself has been described as becoming over the period less 'general' and more specific to particular projects and operations.

Table 5.5 - Aid Commitments Received, by Function, 1992-1996 (USD million in current prices)

	1991	1992	1993	1994	1995	1996	Tot 6yy	%
Balance of Payments	0	94.3	65.9	36.9	48.8	6.6	253	13
Technical Assistance	4.9	78.2	74.6	45.4	55.2	57.4	316	16
Humanitarian Food aid	175.4	0	24.0	9.5	0	0	209	10
Commodity Aid	26.8	81.7	2.6	1.1	0.4	0	113	6
Development Investments	0	58.8	82.0	165.7	261.7	324.6	893	44
Total	**220.7**	**449.3**	**322.5**	**271.0**	**366.2**	**388.6**	**2018**	**100**
Total disbursed	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**1076**	
GDP in Curr't $at 100 lek=$1	*	*	1142	1883	2251	2662	*	
Aid comm'd as % of GDP	*	*	28	14	16	15	*	

Source: Department for Economic Development and Co-ordination, Macroeconomic Unit.

Aid covers both grants and loans. If loans are to be counted as aid, they must be soft, that is charged at less than commercial rates. In 1991, 75 per cent of the aid received by Albania was in the form of grants. The proportion fell to 52 per cent in 1995 and 38 per cent in 1996. From the EBRD's table (1996,p.114) it seems that Albania's proportion of grants to loans for these years was higher than the average for the transition economies.

The changes in the proportions of the various categories of aid received, as shown in Table5.5, are not unexpected, for a country that was in very severe distress over 1991 and 1992, but made a fast recovery thereafter. "Long-term' categories (technical assistance and development/investment) take up about 60 percent of the aid in current dollars over the whole period, and virtually all of it in 1996. Some of the humanitarian, food and commodity aid (mostly in earlier years) provided items include in the state budget.

The characteristics of official aid is the low level of disbursement, in 1996 the total of disbursement was only 53 percent. This can be translated as 53 percent of available financial source for investments.

5.8 CONCLUSION

Role of the savings as financing the investment is found to be concentrated more on the foreign resources, rather than in domestic resources. In an attempt to discover some of the contributing elements of savings in investment the public savings, banking system, informal market, remittances, privatisation, domestic private investment, foreign direct investment and official aid were examined in separately. In the end the analysis indicated that public savings failed to play the role for financing the investment, because of the fiscal deficit. The inadequate banking system led to the growing of the informal market and pyramid schemes. The fact that most of remittance came to be placed in pyramid schemes , rather in new private economic activities, shows their unsuitability as a sustainable and permanent pillar of economic recovery.

Foreign investors, who represented the most likely sources of assets, fresh capital, new technologies, and access to foreign markets, continued to focus their attention and investment on a small number of sectors, such as trade and tourism, without bringing the expected higher returns. The experience pointed out that a favourable law in not enough to attract the foreign investment.

Although the share of official aid was high, but government failed to disburse only 53 percent of allocated aid.

CHAPTER 6
CONCLUSION AND POLICY RECOMMENDATION

6.1 CONCLUSION

The major objective of this study was to examine the growth, investment and savings in Albania during the transition period 1990-1997. This study is an attempt to analyse Albanian economy. Conclusion will be drawn along three lines of the hypothesis. First, examining of the dubious GDP growth figures in 1993-1996. Second to investigate if public investment has crowded-out the private investment. Third to explore the savings as source for financing investment taking in the consideration the variation of the sources.

The reservations concerning the calculation method selected for GDP growth, the possible errors due to sometimes unreliable or badly reported data and the reliability of GDP as a criterion of economic growth in Central and Eastern Europe should undoubtedly have led in the adoption of more caution in the interpretation of the figures by the analysts. The fact that Albania's GDP has still not recovered its 1989 level by 1996 is particular hazardous. The indicator related to industrial activities was showing a dramatic decline, reflecting the failure of real forces of production to take off. The willingness of the government in power (Berisha government) to implement reforms and to comply with IMF and World Bank requirements, coupled with the not unrelated willingness of external experts to present
Albania as a success story, seems to have masked a reality in which apparent economic success depended in large part on remittance from foreign workers, large scale smuggling and money-laundering, and illusory short-term profit from pyramid schemes.

The level of public investment is found to decline during the transition period and to be dependent upon different factors. The decreasing in size the government sector, remaining state-owned of the large enterprise, especially of the utilities and mining under the failure of mass-privatisation program started in 1992, and last the low absorptive capacity due to the low level of disbursement come from the overoptimistic goals led to the low level of public investments. At the same time high corruption in procurement process has led to the unfair selection and low quality level of public investment selected. The serious institutional weaknesses in government were also the reasons of high level of corruption on the government. On the other side the poor quality of public investment results to be an obstacle for private investment, rather to facilitate them. Thus, in Albania during the transition period the public investment did not crowd-out the private investment.

The role of savings to finance the investment seems to be majority by the foreign resources. The fact that the pyramid schemes were able to expand for years is evidence of the extraordinary amount of cash that Albanians had been able to amass in the four or five years after the fall of communism. This money could have been put to the service of the country's economic development if the banking system had been working efficiently and if an appropriate credit policy had been put place. The failure of the international monetary institutions to intervene until late 1996 and their systematic presentation of positive economic indicators - largely declared in the domestic and international press - also indirectly contributed to reinforcing the economic and political legitimacy of the schemes. The remittance played a crucial role as a foreign source. The weak point is the only a small part of it has been used for new investment, majority went toward the schemes. The foreign direct investment almost for small-industry sector and it has no impacts on the strategic industries.

6.2 POLICY RECOMMENDATION

The results of this study lay the foundation for followed main policy recommendations.

The high growth rate in Albania has been found dubious. The reasons behind this consideration are technical and political. Since this is found to be unacceptable figure by keeping in consideration the collapsed production sphere, a strong argument can be made that it is important to revive the production sphere in order to achieve the high growth rate. The government must not think politically, but should be aware of real figure of growth rate. The future of Albanian economy depends in great parts on the reconstruction of its industry. This requires that the government must design an overall industrial strategy (not just a privatisation programme) and support it with all appropriate policy instruments, fiscal, commercial, credit and others.

The public investment result to not crowd-out the private investment. Albania came to the transition process with low performances on establishing new public investment, maintaining and improving the existed one. This happened in the time that this kind of investment is crucial to facilitate the new private investment under the new market economy system. Therefore, government must undertake policies that encourage increasing level of public investment associated with successful implementation of a comprehensive program to combat corruption and reform of the public sector[vii].

As far as concern the role of public savings, the problem of budget and fiscal policy as support is clear that government expenditure could hardly is reduced, given the need to rehabilitate critical physical infrastructure both damaged and destroyed (especially during the crisis in 1997). Priority should be given to the revenue side: in particular the improvement of collection of revenues.

The results of tight credit policy provoked mainly the failure of the banking sector to play its proper role as intermediate financial agent. This led to the growth of informal market and further converged on pyramid schemes. Thus, more flexible the condition of credit policy must be asked from the IMF. Consequently, one could expect that policy that improves the banking sector would have a positive impact on increasing the role of banks as financial intermediaries.

The Albanian government seems to believe that opening the country up to foreign assistance and investment would generate most economic growth. Foreign investments led only to mixed results. Contrary to expectations, foreign investors did not bring an overall positive effect in the economy. For this is needed more diversified strategy from the government. In particular, there is a need to be more selective when choosing foreign investors. With improved infrastructure including roars, telephones, electricity, increased foreign investment is expected. The level of aid's disbursement is low. There is an urgent need to build local capacity and increase the use of local expertise as well as ensure that aid/development assistance meets needs identified at the local level. This policy will effect in increasing of amount of aid's disbursement and transforming it in efficient or necessary investment.

Annex Table

Table A1. Calculation of ICOR for 1989-1996

	GDP at Constant prices 1990	Gross Domestic Investm . at constant prices 1990	ICOR
1989	18681	5926	--
1990	16813	4927	-2.64
1991	12105	1007	-0.21
1992	11235	2792	-3.21
1993	12309	1625	1.51
1994	13466	2410	2.08
1995	14667	2640	2.20
1996	16050	2488	1.80
		Mean of ICOR	**1.90**

Note: ICOR = Δ K / Δ Y, where K is capital and Δ K is equal to Investment (I).
Also to calculate the Mean of ICOR, I have accounted only positive ICOR.
Source: IMF (1994,1997);

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THE END NOTES

[i] The lack of reliable services in transport, telecommunications, energy, and water have, from the start of reforms, constituted a major impediment to investment and sometimes generated rather primitive services. The lack of water remains one of the most acute daily problems of Albanians.

[ii] As reported in *Albanian Observer*, Vol.3 No. 1(1997), p.26.

[iii] The proof of deposit was the receipt (or bill) given to the lender by the registered company. These receipts displayed the principal sum, the date of agreement, the period, and the interest rate with final signatures of the lender and the cashier.

[iv] According to the Albanian economist Zef Preci, the Albanians- probably alongside the Italian Mafia-managed to earn USD 600,000 a day- one fifth of total national income-smuggling petrol and diesel into Montenegro. He believes that up to USD 1.3 billion from those revenues was placed in the pyramid schemes. See *Albanian Observer*, Vol.3, No.5 (1997), p.32.

[v] See A.Hoxha,"Why did it happen?", *Albanian Observer*, Vol3,No3-4(1997),pp.30-31.

[vi] As reported in *Albanian Observer*, Vol3, No.1 (1997), p.26.

[vii]The Decision of 'On the Approval of Anti-Corruption Action Plan' was taken on August 1998, pursuant to article 36 Law 7491, date 04/29/1998 on the 'Main Constitutional Provisions'. World Bank (1998), p.25.