

Conference—Albania: Opportunities and Challenges in the Move Towards Emerging Market Status

May 14, 2008

Discussion Points Raised During the Conference*

A. Panels I to III

1. Following the presentation of **Mr. Altin Tanku** (Director, Research Department, BoA) on *The challenges of Changing Monetary Policy Setup*—which discussed the Bank of Albania’s efforts to formally adopt an inflation targeting regime—Deputy Minister of Finance **Sherefedin Shehu** initiated a discussion of whether the current 3 ± 1 percent inflation band was an appropriate target level.

- **Mr. Tanku** replied that research and empirical evidence had shown that the 3 ± 1 target band did not hinder growth in any way.
- **Mr. Sokoler** (IMF monetary policy advisor by the BoA) replied that the current inflation objective had worked and saw no reason to change it. Given this success, Mr. Sokoler noted that changing it would require a very good argument.

2. **Ms. Gerta Picari** (formerly head of INSTAT) asked how the impact on headline inflation of tradable and non-tradable goods had changed in the new CPI basket that was introduced in 2008.

- **Mr. Oestreicher** (IMF) replied that the influence of traded goods had increased over the last six months, but mainly because of the rising price of food, rather than from changes in the CPI basket composition. He noted that underlying inflation (excluding food and energy) remained quite low.

3. A question was raised from the floor as to whether the pursuit of low inflation was responsible for low economic growth, and advanced the opinion that more inflation was an acceptable cost for higher growth.

- **Mr. Oestreicher** replied that Albania had attained both high growth and low inflation.
- **Mr. Sokoler** noted—using Israel as an example—that buying growth through higher inflation works at best only in the short run, if at all, and that the costs were such that this should not be attempted.

- **Mr. Bell** (IMF) said that, in earlier years, people believed that you can inflate yourself to prosperity, but not any more. He noted that the IMF program in Albania focused on both stability and growth.

4. **Mr. Sherefedin Shehu** provided comments on the government's experience and attitude towards fiscal rules following the presentation of **Mr. Jiri Jonas** (IMF) on this subject.

- He noted that, while the government of Albania does not have a formal fiscal rule, they have accepted and implemented a policy of reducing the deficit and debt in terms of GDP, as well as aiming to have a good ratio between external and domestic debt. It was true that in 2008 the fiscal deficit would increase, but this would be only temporary and was due mainly to the acceleration of foreign financing committed in earlier years. He noted that since 2005 the government has had a net operating surplus; and that expenditure was of good quality because most of it is being used for the Reshen-Kalimash road project.
- Mr. Shehu stated that the goal is to bring the debt to below 50 percent of GDP within 3-5 years. Some 10 percent of the debt is from inherited arrears and should be settled. Government guarantees, of which those to KESH were a large share, could possibly be reduced in the KESH privatization process. In addition, debt maturity was being extended. Moreover, the new organic budget law contains some rules related to the Maastricht criteria, of limiting debt to GDP to below 60 percent.
- He was not sure that strict rules should be enshrined in law. However, a fiscal rule should be formalized in policy documents, a step the authorities would consider in the future.

5. Commenting on **Ms. Alison Stuart's** (IMF) presentation *Debt Sustainability and Accessing International markets*, **Mr. Karl Landgraf** (US Treasury Advisor to the Ministry of Finance) noted:

- Commercial banks have always held about 70 percent of the public debt in Albania and insurance companies only 1.6-2.2 percent. This would only change when pension funds and life insurance develop.
- Pension reform would have a major effect on the financing of domestic debt.
- The yield curve in Albania is steep, but returns are high in emerging markets. The 5-year bond when first issued had a risk premium of 236 basis points, now it is 100 basis points. Risk premiums are coming down.

6. Commenting on **Mr. Mumtaz Hussain's** (IMF) presentation *Dealing with Macroeconomic Costs of Energy Shocks*, **Mr. Enno Bozdo** (Deputy Minister of Economy) noted that:

- the effective collection rate has improved recently and this is a positive trend;
- In 2007, difficult hydrology, led to lower domestic output and to increased imports at increased prices, which contributed to an increase in costs;
- Tariffs should be at cost recovery levels, but that the average cost recovery prices should be calculated based on the last three years—not just the last year, as 2007 was exceptional.
- He also noted that average tariffs in 2005-2006 remained unchanged, but household tariffs have increased and cross subsidies were corrected in 2006. While there was no tariff increase in 2007, an 18 percent tariff increase took place in 2008.
- Efforts were being made to increase generation capacities and to move forward with the privatization of the distribution arm of KESH.

B. Concluding Round Table Discussion

7. Mr. Bell asked the panel how Albania will effect the transition from consumer-based growth to investment- and export-based growth.

Mr. Genc Ruli (Minster of Economy) responded that the policies needed to effect such a transition are well known. The issue remains the quality of implementation of necessary reforms. What is needed is:

- Prudent fiscal and financial policies;
- Qualitative improvements in business climate;
- Coordinated strategy for attracting foreign direct investment;
- Further liberalization and trade openness;
- Export promotion;
- Continuing intensive investment in infrastructure. In this regards, Mr. Rule noted that poor logistics lead to higher transaction costs. For example, there is a need to improve communication given the low rate of mobile and fixed-line telephony penetration;
- An improved energy situation, which will require a regional approach; and
- Education, education, education!

Mr. Shehu observed that Albania used to be a self-sustained regime, but now cannot survive without imports.

- He expressed optimism for the future because he saw foreign interest in investing in Albania. The structure of imports shows that they are predominantly technology, which is investment that will create the means to repay itself and reduce the current account in later years; as well as increase productivity which will create incentives for additional high profile investment. He expressed support for promotion of businesses that use natural resources, such as tourism, agriculture, and mining.

Mr. Ardian Fullani (Governor of the Bank of Albania) noted that:

- Early in the transition process, Albania established a flexible exchange rate regime that continues to provide benefits to the country. This regime has smoothed inflationary pressures without damaging competitiveness. In fact most problems concerning competitiveness originate in the real sector;
- The consumption pattern observed today partly reflects consumption smoothing over the life cycle (permanent income assumption). However, the current account gaps created today are debts that the economy will need to repay in the future, necessitating higher output in the future.
- Higher productivity is therefore needed, and this requires the right mix between capital, labor and technology. Privatization will further this aim and is the right thing to do. Imagine the Savings Bank today still state-owned.
- However privatization is not everything. Reforms should be multidimensional. Revenue collection has strengthened, but expenditure needs to be well conceived.
- An important role of the government is to develop markets. With respect to the Money markets, these have been promoted by reducing the frequency of treasury bill auctions. The new law on repurchase and reverse repurchase agreements would allow banks to trade and give incentives for interbank trade.

8. **Mr. Bell noted the high level of remittances and the fact that labor was not a significant factor in Albania's growth over the last decade. He asked whether it would ever be, and what the prospects were for employment growth.**

Ms. Camille Nuamah (World Bank Country Manager for Albania) noted that World Bank research in this region about demographic and emigration shows Albania has a young population; and that there are differences between official statistics and the labor survey data. She observed that job creation in the formal sector generated by domestic and foreign investors was needed in areas other than the traditional job creating sectors. She examined the policies that could be pursued to attract employment-generating foreign direct investment:

- Albania still appears to have relatively low wages. But this is uncertain, because the effect of taxes and skills levels need to be taken into account during comparisons. What is needed is education, education, education.
- On productivity and labor competitiveness, she noted that the tax on labor is higher than on capital. There is potential to lower taxes with reform of the social security system. Currently, it is overpriced.
- Education system reform is needed to ensure Albanians have skills that are marketable. There is a need for more investment in education; and Albania's education system needs to become more market based and able to better meet the requirements of domestic and potential foreign investors.
- There is lots of investments in sectors with low productivity (restaurants and coffee shops). A climate that allows investors to take risks is needed.
- The education system is not the only form of education. Firms are providing training too.

Mr. Ruli noted:

- Albania both suffered from immigration and received benefits. This is ongoing despite the decline in population growth. Albania has a strong spirit of entrepreneurship, but he questioned whether the type of businesses being opened was optimal.
- Albania's labor market and labor legislation has some rigidities which, combined with migration and insufficient opportunities for education, has resulted a lower-skilled work force. The inspectorate of labor is not worth the investment. The question is how to increase efficiency.
- A low level of vocational training and a low participation of women in the labor force are problems. In Shkoder, in a new (textile) plant, people were not taking the jobs on offer. Also, labor skills have not been modernized enough. For example, there was once lot of vocational training in the mining sector, but now schools are closed and experienced miners are old. And younger people do not want to go and work in a pit. The market is not helping much and its signals are confusing. Something is missing.

9. Mr. Bell asked what should be done to improve the business environment and to deal with property rights, particularly massive illegal construction.

Mr. Daniel Berg (EBRD, Resident Representative) observed that the EBRD business environment survey of 2005 showed that the "time tax" in Albania, defined as time spent with government officials rather than at work, is the highest in the EBRD list, at 10-11 percent compared to an average of 6 percent for other SEE countries. The informal sector is

large. Only 75 percent of salaries are reported. But those who report, only report about 50 percent of their real salary. Contract enforcement is cumbersome, and infrastructure (electricity, phones, and water) is of poor quality. However, investments in cement, airport, ports are occurring, which shows reforms are happening.

Mr. Ruli. observed that the problems being faced are problems of the process of emancipation. These are more problems of a developing society. There are “trust societies”, where reform has happened and “non-trust societies”, where (except China and Japan) reform has not happened, and relations are based on trust or non-trust.

People in trust societies base their behavior on the trust they have for the institution. In Albania, however, behavior is based on personal relationships. This type of culture was inherited, and Albania cannot become an Ireland in just two decades. But movement towards this goal must proceed quicker, otherwise there will be no catch up.

- **Property rights** are difficult to solve. The legalization process, despite the discussion of whether it is good or bad, has started and it is important that it be completed. However, the claim cannot be made that it will be possible to fairly compensate former owners. There will be a cost and someone will have to pay.
- **Civil service.** Politicians are considered as soft criminals. Responsibility for this has to be accepted, but politicians nonetheless have the highest interest in obtaining good people. Only one third of staff are of medium quality and only one tenth is of good quality. The market is poor in skills. Quality is a problem of education and also of on-the-job-training. A training center exists (*the Institute of Training of the Department of the Public Administration*) but there has so far been no discernable impact.
- The **National Registration Centre (NRC)** was severely attacked by the media and businesses for six months because it did not provide business registration in one day. What they did not know is that what was received from the courts—who were previously responsible for registration—were sometimes only the covers of files with no content. Nothing was digitalized. Now the NCR is handling new registration.
- **Licensing** reform is being forced through by political will. The licenses affected have now been identified and the line ministries need to carry out the actual reform. But at least where resistance lies can now be seen.
- **Reform on inspectorates** is at a very early phase. The mentality of the past, where inspectorates were considered a kind of gendarmerie needs to be jettisoned. Some inspectorates still exist only on paper, others lack funding and staff. The quality of laws is improving. The aim should be for good laws, not perfect ones—and the emphasis should be on adapting, not adopting laws.

Ms. Nuamah observed that she too was from a non-trust country. The power has to come from earning your mandate by delivering services. The mandate should be about delivering

services. The question is what services you deliver. Institutions have to earn trust to get power.

- Property rights are still in transition. There is a need for a stable land registration system. Legislation and fundamentals are constantly changing. It's the problem of adapting, and it is a political process. The solution should be simple and [implantable.]
- Illegal construction is not only an Albanian problem. Italy, Turkey, Greece, Spain all have dealt with it.
- With respect to civil services, there is the law and there is the politicization. There are challenges. There is lots of capacity, but maybe not as much as is needed. A transition to a managerial style that meets the private and public needs is required.

10. Mr. Bell noted that IMF program support is scheduled to end in early 2009, and that Albania needs a replacement commitment device. He noted that markets trusted the IMF to put a seal of approval on Albanian economic policies. The question is how to maintain that level of trust without the Fund, and suggested this called for a credible fiscal rule.

Mr. Florion Mima (Deputy Minister of Finance) observed that a fiscal rule is indispensable. But which one to choose? He preferred the expenditure rule because it would not be dismantled by a rotation of power. An expenditure rule would also imply less pressure and harassing of businesses for taxes. If a deficit rule were adopted, he felt all things achieved so far would be at risk, as the next government could comply with the deficit rule, but by increasing both revenue and expenditure.

Mr. Shehu; expressed the belief that Albania was mature enough to survive without the IMF. He saw the challenge being the planned switch to market financing.

Mr. Fullani: said that monetary policy needed the support of prudent fiscal policy. He said the role of the IMF had anchored Albanian policy in the past; and applauded the authorities for their resolve to go on with reform. He noted that not all countries have been so welcoming of IMF advice. It was not easy, early in the transition process, to decide on such basics as liberalizing the price of bread or the exchange rate. Now the problems dealt with are more similar to those of Italy. He observed that, after having the IMF as an anchor many years, a fiscal rule was now needed, and that the Albanian authorities have the capacity to discuss this. Now, rather than later is the right time to implement a rule that could serve as a measure of performance, accountability, and efficiency for the government. It would help control inflation and also boost market confidence. He observed that no one would buy Albanian debt if inflation were high.

* Notes prepared by Linda Spahia, local economist at the IMF Resident Mission in Tirana