

# Albania: Country Profile and Recent Economic Developments<sup>1</sup>

Anton Schautzer<sup>2</sup>

*This paper provides an overview of the transition process and recent economic developments in Albania. The Albanian economy has embarked on a dynamic catching-up process. Since 1998 real GDP growth has amounted to 7% on average, and registered unemployment has been decreasing continuously since 2000, now standing below the level of some of Albania's neighboring countries. Progress toward price stability, an important monetary policy objective, has also been substantial. The Albanian lek (ALL) has been appreciating against the euro in nominal as well as in real terms, and the deficit-to-GDP ratio has been decreasing. The trade balance, however, is a major weak spot. The deficit in the trade balance is mostly covered by transfers and, since 2000, by the beginning foreign direct investment (FDI) inflow. Gross foreign debt has been on a decreasing trend and currently amounts to about 20% of GDP. The fight against corruption, organized crime and the black economy remains a primary objective of the Albanian authorities. Progress in this area is crucial to finally open the door for a Stabilisation and Association Agreement (SAA) with the European Union.*

## 1 Introduction

### 1.1 Political and Institutional Framework

Albania entered the 1990s after several decades of extreme isolation. In March 1991 the country saw its first democratic elections, from which the Communist Party emerged victorious. However, persistent discontent with low living standards and bad living conditions led to mass emigration to Greece and Italy; as a consequence, the government resigned. Thus, in 1992, new elections were called and won by the Democratic Party under Sali Berisha. The Berisha government finally started the transition process toward a free market economy.

The first years of transition were characterized by high unemployment and widespread poverty. The political scene was clouded by conflicts between the two big political camps. In the elections that followed in 1996 the Democratic Party remained in power. In 1997, after some sluggish transition progress, the country was shaken by a severe financial crisis. About USD 1.2 billion, i.e. more than 50% of Albania's total GDP of 1996, were invested in highly speculative pyramid schemes. Toward the end of 1996, 12 of the existing 16 pyramid systems collapsed. Many private Albanian investors accused the government of having breached its supervisory duties and of having profited from the pyramid systems. The consequence was a severe economic, social and political crisis, which was accompanied by, partly violent, mass protests and riots. A military intervention by foreign troops under UN mandate helped to overcome the crisis and to gradually reestablish order.

In the subsequent elections of 1997 the Socialist Party won, and Fatos Nano became new prime minister. On November 28, 1998, a new constitution was confirmed by referendum, which strengthened the position of the prime minister and of parliament.

In 1999, during the Kosovo war, Albania proved to be a stable factor in the region. Although the Kosovo war and the conflicts in Macedonia affected national and ethnic interests, Albania did not interfere and thus contributed to preventing the expansion of the conflict. Moreover, Albania offered shelter

<sup>1</sup> This paper is a summary of the author's country profile of the Republic of Albania, which is available on request (in German only).

<sup>2</sup> Oesterreichische Nationalbank (OeNB), Cashier's Division and Branch Offices, Foreign Research Division, anton.schautzer@oenb.at. The author gratefully acknowledges comments by Thomas Reininger, Foreign Research Division (OeNB), and language advice by Jennifer Gredler. The standard disclaimer applies.

to about 460,000 war refugees. After the elections of 2001 a coalition cabinet led by the Socialist Party was established. The next elections will be held on July 3, 2005.

In January 2003 negotiations with the EU were initiated within the framework of the Stabilisation and Association process. These negotiations are aimed at reaching a Stabilisation and Association Agreement (SAA), which is to provide the contractual framework for the EU and Albania during the period leading up to Albania's EU accession. So far, such agreements have been concluded with Croatia and with the Former Yugoslav Republic of Macedonia. Negotiations with Bosnia and Herzegovina and with Serbia and Montenegro have not started yet. (However, in April 2005 the European Commission recommended opening negotiations with Serbia and Montenegro.) So far, only little progress has been made in the negotiations with Albania. The European Commission has called for greater commitment on the part of the Albanian authorities in fighting organized crime, human trafficking, money laundering and corruption, and for more adequate measures aimed at reducing the shadow economy.

### 1.2 Structural Reforms

The Albanian authorities are aware of the fact that further structural reforms are needed. One part of the reform agenda includes further privatizing public entities, improving infrastructure (especially local and international transport networks), resolving energy sector issues, supporting small and medium-sized enterprises and stimulating competition. The other part consists in taking anti-corruption measures, reforming legislation and administration as well as strengthening institutional and administrative capacities. Although the efficiency of the tax and customs administration has been improved, incentives for transforming illegal or semi-legal businesses into formal ones are still insufficient (IMF, 2005a).

### 1.3 IMF Facility

Within the framework of the IMF's Poverty Reduction and Growth Facility, a total amount of SDR 96.1 million was granted to Albania between July 1993 and December 2004. SDR 33.7 million have already been repaid. Albania's member's quota amounts to SDR 48.7 million. At the moment the IMF has no Stand-By Agreement with Albania.

## 2 Development of Real Economy Indicators

### 2.1 Economic Growth and the Average Level of Income

With a cumulative real economic growth of about 40% between 1990 and 2004, Albania ranks among the most successful transition economies. This successful development started from a rather low level, however. During the first transition phase between 1990 and 1992, GDP decreased by a total of 39%. The liberalization of prices and foreign trade, the privatization of agricultural land and a macroeconomic stabilization program directed at the reduction of monetary growth, the budget deficit and inflation laid the foundation for the high average growth rate of 9.3% in the following three years (1993–96). The agricultural sector, the service sector and, to a lesser extent, the construction sector contributed most significantly to economic growth. After a setback in 1997, when

GDP decreased by 7% because of the financial crisis, Albania was soon back on a growth track. In 1999 real GDP reached the level of 1990. In 2002 economic growth slowed down to 3.4%, which was attributable to a bottleneck in energy supply and unfavorable weather conditions for the agricultural sector. In 2003 and 2004, the real growth rate went up to 6% again.

The Albanian Ministry of Finance expects an average yearly economic growth of 6% until 2007 (Ministry of Finance of the Republic of Albania, 2004). The Vienna Institute for International Economic Studies (wiiw) projects a real growth rate of 6.2% for 2004 and 6.5% for 2005 (Holzner, 2004), whereas the IMF forecast amounts to 6.0% for 2005 (IMF, 2005b).

Chart 1

### Real GDP Growth Rates



Source: World Bank, Albanian Institute of Statistics (INSTAT).

GDP at market exchange rates amounted to EUR 5.4 billion in 2003, which corresponds to EUR 1,745 per capita and EUR 4,267 per capita at purchasing power parities (PPP), respectively. In PPP terms the Albanian per capita GDP appears to be clearly lower than in the other Southeastern European countries

Table 1

### GDP per Capita at PPP and at Exchange Rates

#### for Selected Countries of the Region

GDP per capita, EUR

	2000		2003	
	At PPP	At exchange rates	At PPP	At exchange rates
Albania	3,184	1,239	4,267	1,745
Bosnia and Herzegovina	4,940	1,359	5,670	1,611
Bulgaria	5,325	1,674	6,341	2,249
Croatia	8,111	4,502	9,720	5,747
FYR of Macedonia	5,169	1,921	5,401	2,041
Moldova	2,150	x	x	x
Romania	5,006	1,795	6,315	2,316
Serbia	4,186	3,106	5,130	1,949

Source: wiiw; Moldova: EBRD.

(SEECs), with the probable exception of Moldova. At market exchange rates, the Albanian per capita GDP deviates by far less from the levels in most other SEECs, as the ALL exchange rate is higher valued in terms of PPP than other SEEC currencies (except for the Croatian kuna).

## 2.2 GDP Developments: The Expenditure Side

The analysis of the development of GDP components on the demand side of the equation is severely limited by the lack of comprehensive up-to-date statistical information. A particular problem was that no data could be found on the real annual changes of these components. Instead, the analysis had to be based on the development of the shares of demand-side subaggregates in total nominal GDP.

Table 2

### GDP Components (Expenditure Side)

% of GDP

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Final consumption	101.9	109.4	107.3	96.3	95.2	91.2	96.4	99.8	97.5
of which: households	67.3	89.3	84.1	70.6	65.9	61.0	57.8	90.1	87.9
statistical discrepancy	24.8	9.3	13.5	16.5	20.4	20.7	28.6	0.0	0.0
households including statistical discrepancy	92.2	98.6	97.6	87.1	86.3	81.6	86.3	90.1	87.9
general government	9.7	10.8	9.8	9.2	8.9	9.5	10.1	9.7	9.6
Gross fixed capital formation	21.0	16.8	16.3	20.0	24.7	29.2	28.0	25.0	25.4
of which: statistical discrepancy	4.2	1.4	2.1	2.7	3.4	3.4	4.7	0.0	0.0
Domestic absorption	122.9	126.3	123.6	116.3	119.9	120.4	124.5	124.8	122.9
Exports of goods and services	12.3	10.5	10.8	15.7	17.6	18.3	19.4	20.4	21.7
Imports of goods and services	35.2	36.7	34.4	32.0	37.5	38.6	43.8	45.2	44.6
Net exports of goods and services	-22.9	-26.3	-23.6	-16.3	-19.9	-20.4	-24.5	-24.8	-22.9

Source: Author's calculations based on IMF, 2005c.

Note: The IMF, allocated the total statistical discrepancy contained in the national accounts up to 2002 to final consumption and investment according to the ratio observed in the national accounts excluding the discrepancy. Unexplained oscillations in this discrepancy introduced additional statistical uncertainty into the historical data. Data for 2003 and 2004 are estimates.

### 2.2.1 Private Consumption

In 1997 the share of private consumption (including the allocated part of total statistical discrepancy) in total nominal GDP increased significantly. However, this was only attributable to the fact that the annual average of consumer prices rose by about 33% (after a mere 13% in 1996), while CPI-deflated private consumption (including statistical discrepancy) fell markedly and by far more than real GDP. Moreover, from 1998 to 2001 CPI-deflated private consumption recovered by less than real GDP. As disinflation was more pronounced based on consumer prices than on the GDP deflator, the share of private consumption in total nominal GDP decreased significantly. After CPI-deflated private consumption had expanded by far more than real GDP in 2002 and 2003, its growth rate moderated to that of GDP in 2004 according to IMF estimates. Strong real consumption growth in these years was underpinned by significant real wage growth. While consumer price inflation was relatively low and stable in these three years (2002–04), the share of private consumption in total nominal GDP increased from about 82% in 2001 to close to 90% in 2004.

### 2.2.2 Public Consumption

From 1996 to 2004 the share of public consumption in total nominal GDP remained slightly below 10% most of the time, with only moderate fluctuations.

### 2.2.3 Gross Fixed Capital Formation (GFCF)

In 1997 the share of GFCF (including the allocated part of total statistical discrepancy) in total nominal GDP decreased significantly. However, this was mainly caused by the sharp increase of nominal GDP resulting from the upward jump in inflation. It is not clear whether GFCF fell by more or less than total real GDP that year. However, the continuous strong increase of the share in nominal GDP from 1998 to 2004, which peaked in 2001, suggests higher real growth in GFCF than in total GDP.

### 2.2.4 Imports and Exports

In 1997 the share of exports in total nominal GDP was only about 10%. This very low export-to-GDP ratio clearly reflects the isolation the Albanian economy had suffered for several decades. On the import side, the lack of competitive production units and the enormous demand for Western consumption goods by the Albanian population after decades of isolation also showed in a comparatively high share of imports in total nominal GDP. Thus, in 1997 Albania had negative net exports of about 26% of GDP.

However, from 1997 to 2004 Albania succeeded in more than doubling its export-to-GDP ratio, while at the same time containing net exports at lower levels than at the beginning of this period. Obviously, export growth has contributed significantly to real GDP growth in recent years. At the same time, the weight of exports is still relatively low by international comparison, a fact which suggests high growth potential for the future.

## 2.3 GDP Developments: The Production Side

### 2.3.1 Agriculture

Agriculture is one of the most important sectors of the Albanian economy, in particular in terms of its contribution to total employment. Before the beginning of the transition process, the Albanian industry used to outperform agriculture in terms of GDP. Estimates for 1983 show that agriculture had a share of about 34% in GDP, whereas industry accounted for more than 43% (World Bank, 2004a). The privatization of agricultural land was one of the first measures at the onset of the transition process. As industrial output collapsed at the same time, the share of agriculture in GDP reached 55% in 1993 (World Bank, 2004a). Since then, the primary sector has grown continuously but more slowly than the other main sectors of the economy.<sup>3</sup> As a consequence, it has lost weight, particularly in favor of services. According to the Albanian Institute of Statistics (INSTAT), the share of agriculture in nominal GDP declined from 33% in 1996 to 26% in 2002.

<sup>3</sup> The World Bank estimates the average annual growth in agriculture from 1993 to 2003 at 2.2%.

### 2.3.2 Industry

The industrial sector had been by far the most important sector in the Albanian economy for a long time. The lacking competitiveness of the state industry, which had been protected by the isolation of the country, caused a decrease in the industrial sector's share in GDP from about 43% in 1983 to 23% in 1993 (World Bank, 2004a). According to INSTAT, the share of industry in nominal GDP declined from 15.5% in 1996 to 10.5% in 2002. Simultaneously, the industrial sector underwent a far-reaching structural change. In parallel, the energy supply for industry improved markedly, inter alia through network improvements and consequently a reduction of supply interruptions, which enhanced the conditions for industrial production growth. Furthermore, domestic electricity production could be increased to cover about 80% of consumption, which substantially reduced the dependence on imports (IMF 2004b).

### 2.3.3 Construction

One of the most dynamic sectors of the Albanian economy is the construction sector. According to INSTAT, the share of construction in nominal GDP increased from 4.7% in 1996 to 7.8% in 2002. A depleted capital stock, with respect to both buildings and infrastructure, shows the high potential in construction in the years to come.

### 2.3.4 Services Sector

At the beginning of Albania's transition process the services sector played a rather small role, merely contributing around 23% to GDP in 1993 (World Bank, 2004a). As this sector grew quite dynamically, its share in GDP increased significantly. According to INSTAT, the share of services in nominal GDP increased from 47% in 1996 to 57% in 2002. Especially the subcategory "trade, hotels and restaurants" has considerable potential, as Albania has a long coastline and a rich cultural heritage, and tourism will probably become more important in the future.

## 2.4 Labor Market

### 2.4.1 Employment and Unemployment

After total employment had fallen continuously until 1999, it stagnated until the end of 2004, except for a small increase by 0.7% in 2003.<sup>4</sup>

In parallel, the unemployment rate (registered unemployment) had increased from 12.4% at the end of 1996 to 18.4% at the end of 1999. Its decline to 14.4% at the end of 2004 resulted primarily from a drop in the total labor force, as total employment remained nearly unchanged.

Apart from structural changes and reforms (e.g. in the regulations for unemployment registration) that can be considered typical for a transition process, the decrease in the total labor force can be explained by vast emigration.

Moreover, while the spreading of the shadow economy is not unusual during economic transition, the share of the informal sector in Albania seems to be particularly large. According to IMF estimates the informal sector accounts for

<sup>4</sup> Owing to a methodological break at the turn of the year 2000/2001, it is not possible to compute a rate of change for 2001.

30% to 60% of the total Albanian economy, whereas INSTAT estimates it to account for one-third of official GDP (IMF, 2003).

Even though employment in the agricultural sector has decreased substantially, it is still high. In 2003 about 58% of the employed population worked in the primary sector, 13% in the secondary sector and 29% in the tertiary sector. Higher employment in the services sector was attributable to substantial increases in trade and in the transportation and communication industries.

The government is trying to reduce unemployment, which is particularly high among women, by improving the efficiency of the employment service and by retraining unemployed persons.

#### 2.4.2 Labor Productivity and Wages

From 2001 to 2004 labor productivity in the whole economy advanced at an average annual rate of 5%, while average gross wages increased at an average rate of nearly 11%. The resulting rise in nominal unit labor costs during that period by 5.5% per annum was probably instrumental in raising the average price level in the economy (as measured by the GDP deflator) by about the same rate.

In the following, labor productivity and wage levels in Albania are assessed by means of an international comparison. Labor productivity (as measured by GDP per employed person at PPP) was low in Albania in 2004, not only compared to Austria or Poland, but also compared to SEECs, in particular the Former Yugoslav Republic of Macedonia and Bulgaria. The average wage level (measured in euro at the respective exchange rates) in Albania was, by contrast, not that much lower than in Macedonia, and it was even slightly higher than in Bulgaria. Thus, the unit labor cost level in Albania exceeded that of Macedonia and, to an even greater extent, that of Bulgaria. Higher unit labor costs in euro in Albania were mainly a result of the relatively high comparative price level, which stood at 45% in 2004 against about 37% in Macedonia and Bulgaria. This high comparative price level reflects the substantial real appreciation of the Albanian lek since 1997. Back in 1996, Albania's comparative price level had been much lower than that of Macedonia and only slightly higher than that of Bulgaria.

Table 3

#### Indicators of Macro-Competitiveness in 2004

EUR-based, annual average

	Labor productivity level (Austria = 100)	Wage level (EUR) (Austria = 100)	Unit labor cost level (Austria = 100)	Memorandum items	
				Comparative price level (euro area = 100)	
Albania	24.6	6.2	25.2		44.8
Bulgaria	29.2	6.0	20.4		36.8
Croatia	53.3	31.2	58.6		59.9
FYR of Macedonia	34.2	7.8	22.9		37.3
Poland	47.0	21.0	44.7		48.3

Source: Author's calculations based on data provided by INSTAT and wiw.

### 3 Inflation and Its Components

Inflation, as measured by the consumer price index (CPI), declined rapidly from an annual average of 33% in 1997 to close to zero in 1999. After having remained below the upper target limit of 4% in every month since December 2002, the yearly inflation rate slightly exceeded the 4% limit in February 2004, but then decreased again to 2.2% in November and December 2004. The average annual inflation rate for 2004 was 2.9%. Thus, Albania achieved its monetary policy inflation target in recent years.

Within total CPI, the position “food and non-alcoholic beverages” is the most important item in the basket with a weight of 42.6%. Annual average food price inflation fell from about 6% in 2002 to zero in 2004. This decline contributed significantly to reducing annual average inflation in 2003 and helped contain the inflationary impact stemming from the rise in international energy prices and hikes in administered prices in the communication industries in 2004.

It is important to note that the positions “clothes and footwear” and “furniture, households items and maintenance,” which are core inflation components in the goods sector, showed deflation throughout the period of 2002 to 2004, while the position “education,” which belongs to the service sector, recorded inflation rates far above average in these years.

Table 4

Selected Factors Influencing Inflation		1996	1997	1998	1999	2000	2001	2002	2003	2004
<b>Consumer prices</b>	December, year-on-year, %	17.4	42.1	8.7	-1.0	4.2	3.5	1.7	3.3	2.2
	Annual average, year-on-year, %	12.7	33.2	20.6	0.4	0.0	3.1	5.2	2.3	2.9
<b>Producer prices</b>	Annual average, year-on-year, %	..	..	..	2.2	4.9	-5.4	6.4	6.2	9.5
<b>GDP deflator</b>	Year-on-year, %	..	13.9	13.5	4.5	4.3	6.9	7.4	3.7	5.6
<b>Unit labor costs, whole economy</b>	Nominal, year-on-year, %	..	..	4.5	-0.8	3.0	..	7.9	3.0	5.8
<b>Nominal exchange rate</b>	ALL per EUR 1, December	128.6	163.9	164.3	136.8	130.8	122.0	137.9	133.7	126.7
	ALL per EUR 1, December, year-on-year, %	0.6	27.5	0.2	-16.8	-4.4	-6.7	13.0	-3.1	-5.2
	EUR per ALL 1, December, year-on-year, %	-0.6	-21.6	-0.2	20.1	4.6	7.2	-11.5	3.2	5.5
	ALL per EUR 1, annual average	135.9	168.9	168.7	147.0	132.6	128.5	132.4	137.5	127.6
	ALL per EUR 1, annual average, year-on-year, %	7.2	24.3	-0.1	-12.9	-9.8	-3.1	3.0	3.9	-7.2
	EUR per ALL 1, annual average, year-on-year, %	-6.8	-19.5	0.1	14.8	10.9	3.2	-2.9	-3.7	7.8
	<b>Real exchange rate</b>	EUR per ALL 1, annual average, year-on-year, %	..	5.4	19.4	13.9	8.6	4.0	-0.1	-3.5
	basis: CPI	..	..	..	17.9	10.6	-4.4	3.3	0.9	15.4
	basis: PPI	..	-8.2	12.3	17.9	14.1	7.7	1.6	-2.2	11.6
	basis: GDP deflator	..	..	..	..	..	..	..	..	..
<b>M2 (excluding foreign currency deposits)</b>	Nominal, annual average, year-on-year, %	46.1	36.6	28.9	20.9	13.7	13.1	12.2	7.6	8.2
<b>Broad money (including foreign currency deposits)</b>	Nominal, annual average, year-on-year, %	192.2	47.0	21.6	16.3	14.4	16.1	9.7	6.0	10.0
	Real (GDP deflator), annual average, year-on-year, %	..	29.0	7.1	11.3	9.6	8.6	2.2	2.3	4.2
	% of GDP	45.4	65.2	62.0	62.7	64.0	64.6	63.9	61.6	60.4
<b>Budget balance (including grants)</b>	% of GDP	-11.3	-13.0	-9.5	-9.0	-7.5	-6.6	-5.6	-4.2	-4.9
<b>Real GDP</b>	Year-on-year, %	9.1	-10.2	12.7	10.1	7.3	7.6	3.4	6.0	6.2

Source: INSTAT, Bank of Albania, World Bank, author's calculations.

The rise in industrial producer prices in recent years was not only driven by the rise in international energy prices but also by the adjustment in administered prices in the energy sector aimed at reaching cost coverage.

The marked disinflation from 1997 to 1999 and the fact that inflation has been relatively low since 1999 despite strong increases in international energy prices in 1999 and 2000 can be attributed in particular to the lek's strong nominal appreciation from 1998 to 2001. After a moderate corrective depreciation in 2002 and 2003, the nominal exchange rate appreciation in 2004 led to roughly the same nominal level as in 2001. In real terms, however, the currency further appreciated between 2001 and 2004. This contributed to a deflationary impact on the consumer prices of durable goods and thus helped contain the inflationary impact of energy prices, administered prices and unit labor costs in 2004.

In addition, the relatively low level of underlying inflation has probably been favored by the deceleration of real money growth to below real GDP growth in recent years.

## 4 Monetary Sector Developments

### 4.1 The Bank of Albania's Monetary and Exchange Rate Policy

Since the end of 1997 the Bank of Albania's most important objective has been to achieve and maintain price stability (Bank of Albania, 1997). During recent years, this objective has been specified as an annual inflation rate of between 2% and 4% at the end of the year. In order to attain this objective, the Bank of Albania attempts to control the money supply through an annual monetary program (Bank of Albania, 2003a). This program, which is updated quarterly, determines the annual growth rate of broad money in line with a certain level of inflation and projections of the potential output growth and money velocity (Luçi, 2005). Thus, monetary policy in Albania uses money growth as an important intermediate variable.

The Bank of Albania's most important monetary policy instrument is the repo rate, i.e. a fixed interest rate which is applied in (reverse) repurchase agreements with a maturity of one week on the basis of weekly auctions. The repo rate serves as a floor or ceiling rate if these auctions are held as variable price auctions. The purpose of these open market operations is to steer (short-term) market interest rates, manage the liquidity situation and signal the stance of monetary policy. The Bank of Albania uses repurchase agreements to withdraw liquidity via the temporary sale of treasury bills by the Bank of Albania (commercial banks' deposit placement with the central bank), while reverse repurchase agreements inject liquidity via the temporary purchase of treasury bills by the central bank (collateralized loans to commercial banks). In addition, the Bank of Albania buys and sells treasury bills outright on the market for structural purposes. These nonreversible operations of nonstandardized frequency have a permanent effect on liquidity.

The repo rate is the calculation basis for the interest rates of the standing facilities to which no limits apply under normal circumstances: overnight deposits (repo rate minus 3 percentage points), (collateralized) overnight loans (repo rate plus 2.5 percentage points) and lombard loans (repo rate plus 6 percentage points).

The required rate for minimum reserves has been 10% of the required reserve base since 1995 (Raiffeisen Zentralbank, 2005). The reserve base includes deposits with a maturity of up to two years denominated in domestic or foreign currency. The minimum reserve must be held at the Bank of Albania in Albanian lek, euro or U.S. dollar. Minimum reserves are remunerated with 70% of the repo rate, of EURIBOR or LIBOR depending on the currency (Bank of Albania, 2003b).

The Bank of Albania has established a loosely managed float as its exchange rate regime, which means that it intervenes to prevent strong fluctuations. In 2003 and 2004, interventions primarily aimed at containing the appreciation pressure in order to preserve external competitiveness. The Bank of Albania does not use a formal reference currency, but because of the close economic relations with the euro area (especially with Italy and Greece) euro exchange rate developments are closely observed.

#### 4.2 Interest Rates

Albania's interest rate policy responds to inflation and exchange rate developments. Accordingly, the Bank of Albania has cut the repo rate in several steps from 8.5% at end-2002 to 6.5% at end-2003. After further gradual cuts, the repo rate reached a new historical low of 5% on March 30, 2005. In addition, the central bank's rate for overnight deposits was cut at the beginning of 2004, from 2.5 to 3 percentage points below the repo rate. The interest rate channel proved effective, as the commercial banks cut interest rates on the lek deposit market, on the primary market for 3-, 6- and 12-month treasury bills and on the interbank market as well. The interest rate for overnight transactions in the interbank market reached 3.9% in December 2003, which was half of the level of the previous year. The 12-month treasury bill yield decreased from 13% in December 2002 to 8.1% in December 2004.

Nominal interest rates on 12-month deposits of nonbanks decreased continuously from 9.3% in December 2002 to 6% in December 2004. Taking into account year-on-year changes in CPI of around 2% in both periods, the real interest rate on these deposits declined in parallel, but remained clearly positive. Nominal interest rates on 6- to 12-month loans to nonbanks decreased from 16% in December 2002 to 10.5% in December 2003 and then increased again to 13.7% in December 2004. However, the rise in PPI inflation during these years had the effect that, for industrial companies, the real interest rate on these loans fell sharply in 2003, from about 9% to about 2.5%, and declined further to slightly above 1% at the end of 2004.

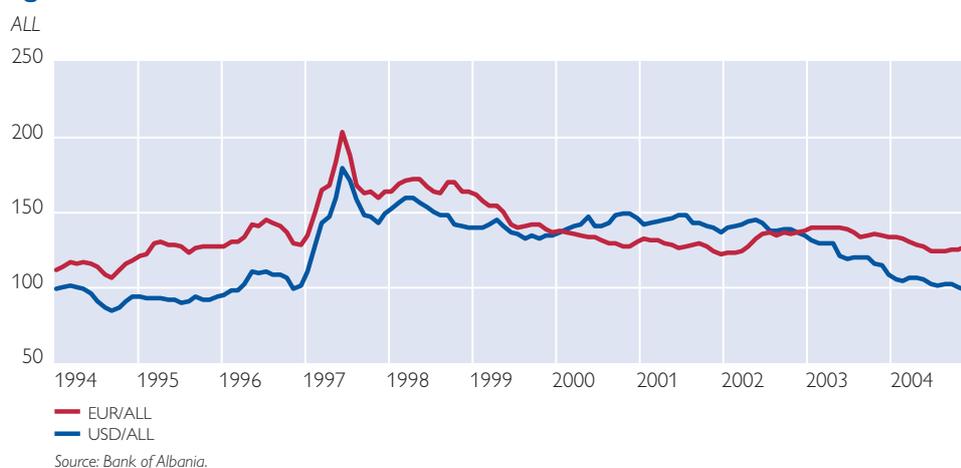
#### 4.3 Exchange Rate Developments

After the abrupt and overshooting depreciation of the Albanian lek during the financial crisis in the first half of 1997, the Albanian currency underwent a corrective appreciation in the second half of that year. Compared to the annual average of 1996, the nominal average value of the Albanian lek was 20% lower (in euro terms) in 1997. However, the lek's real average value did not change much in 1997, given the simultaneous upward jump in inflation. From 1997 to 2001, the Albanian lek appreciated against the euro in nominal terms by more than 30%, reaching a level which was 6% above that of 1996. In real terms, it

appreciated by 54% (based on CPI) and by about 60% (based on the GDP deflator). Between 2001 and 2004, the Albanian lek was broadly stable in nominal terms, although it depreciated by 6.5% until 2003 and appreciated again by 8% after that. However, in real terms, it further appreciated by 4.5% (based on CPI) and by about 11% (based on the GDP deflator). The weakening of the currency from February 2002 to May 2003 was related to the significant deterioration of the current account balance in 2002.

Chart 2

### Nominal Exchange Rate Development of the Albanian Lek (ALL) against the Euro and the U.S. Dollar



#### 4.4 Development of Monetary Aggregates and Their Counterparts

Regarding the components of broad money (the shares of currency outside banks, demand deposits, time deposits and foreign currency deposits in M3), substantial shifts took place between end-1996 and end-1998, mainly as a result of the financial crisis in the first half of 1997 and its immediate aftermath. During this period the share of demand deposits as well as that of currency outside banks went down, while the share of time deposits went up substantially from 20% to 45% of M3, reflecting the reestablished confidence in the banking system. It is interesting to note that the share of foreign currency deposits even went down slightly over this period. By 2004, these shares had not changed much compared to the end of 1998. The moderate rise in the share of foreign currency deposits from 24% (end-1998) to 32% (end-2001) – a level close to that of end-2004 (31%) – was most probably attributable to the depositing of holdings of euro-constituent currencies (mainly of Deutsche mark) by domestic residents prior to the euro cash changeover at the beginning of 2002.

Both domestic credit growth and net foreign assets (NFA) growth contributed significantly to the growth of broad money from 1999 to 2004. Only in 2002 and 2003, the growth of average annual NFA, converted into Albanian lek, was subdued – despite the nominal depreciation in these years. In 2004, however, it accelerated despite the nominal appreciation.

From end-1995 to end-2001, the Bank of Albania's NFA increased continuously in euro terms, implying a steady rise in the NFA of the total banking sys-

Table 5

Monetary Developments					
	2000	2001	2002	2003	2004
<i>Nominal year-on-year change of the annual average stock in %</i>					
<b>Broad money</b>	<b>14.4</b>	<b>16.1</b>	<b>9.7</b>	<b>6.0</b>	<b>10.0</b>
<i>Contributions to the nominal year-on-year change of broad money in percentage points</i>					
<b>Net foreign assets of the banking system</b>	<b>5.8</b>	<b>11.1</b>	<b>3.3</b>	<b>-0.4</b>	<b>3.9</b>
<b>Domestic credit (net) of the banking system</b>	<b>7.8</b>	<b>3.7</b>	<b>7.2</b>	<b>6.8</b>	<b>4.1</b>
<i>of which: claims on the private sector</i>	1.7	0.7	2.3	2.7	2.9
<i>claims on households</i>	1.5	-0.6	-0.5	0.9	1.6
<i>claims on enterprises</i>	0.2	1.3	2.8	1.8	1.3
<i>net claims on the public sector</i>	6.3	2.8	5.1	4.1	1.1
<b>Other domestic assets (net) of the banking system</b>	<b>0.8</b>	<b>1.2</b>	<b>-0.8</b>	<b>-0.4</b>	<b>2.0</b>

Source: Bank of Albania, author's calculations.

Note: Broad money is defined as the sum of net foreign assets, domestic credit and other domestic assets of the banking system.

tem. In 2002, however, NFA temporarily decreased as a result of the significant deterioration of the current account balance. The improvement in the external balance in 2003, and in particular in 2004, led to a sizeable and continuous buildup of NFA from mid-2003 onward, accompanied by significant appreciation pressures.

A significant part of the recent increases in NFA stemmed from interventions on the foreign exchange market by the Bank of Albania, which were aimed at containing the appreciation of the lek in order to preserve external competitiveness.

Table 6

Net Foreign Assets									
<i>EUR million, end of period</i>									
	1996	1997	1998	1999	2000	2001	2002	2003	2004
Total	420	419	508	739	987	1,313	1,157	1,191	1,480
Bank of Albania	156	192	219	346	542	712	678	732	926
Commercial banks	..	..	..	..	445	601	479	459	554

Source: Bank of Albania.

Note: Data refer to the end of period.

Within total domestic lending, net claims on the public sector made the largest contribution to credit growth until 2003, while claims on the private sector were more important in 2004. Net lending to the public sector constitutes the bulk of domestic lending. It is extended primarily via the purchase of government securities. The growth of net lending to the public sector slowed down from 9% in 2002 to 2% in 2004. In parallel, lending to enterprises slowed down from 67% to 17%, while lending to households expanded vigorously by about 75% each in 2003 and 2004 from a very low base level, after having decreased by nearly 30% in 2002. In 2004, the slowdown in the growth of lending to the government sector was pivotal in containing broad money growth.

At the same time, the sectoral composition of lending to nonfinancial companies changed rapidly. The share of loans to the trade sector, traditionally the most important debtor, decreased from about 40% in 2001 to 22.5% in 2004.

The agricultural sector has also received fewer loans in recent years, although gradual improvements of the banking infrastructure in rural areas are now contributing to better access to loans. Real estate lending, by contrast, has gained importance.

The share of long-term loans with a maturity of more than twelve months rose from 16% at end-2002 to 30% at end-2004.

An important characteristic of the Albanian banking sector's asset side is the large share of foreign currency loans (more than 80% at end-2004). Their share had increased sharply from 32% at end-1998 to more than 80% at end-2001. During those years the strong appreciation of the Albanian lek provided a rationale for foreign currency funding. In turn, the upward jump in foreign currency lending probably contributed to the lek's appreciation. The fact that the share of foreign currency lending remained at a high level until 2004 may reflect expectations of a further (real) appreciation of the lek.

## 5 Public Finance

Albania had high fiscal deficits in the 1990s, ranging from 10% to 16% of GDP. In the late 1990s, the country embarked on a consolidation course, and the deficit was reduced from 12% (9% when including grants) of GDP in 1999 to 4.6% (and 4.2%, respectively) of GDP in 2003. For 2004, the deficit-to-GDP ratio is estimated to have remained stable. For 2005, Albania's mid-term budgetary program targets a deficit of the same size as in 2003 and 2004, i.e. 4.6% of GDP. In 2006 and 2007 the deficit is supposed to be reduced to 4% and 3.8%, respectively (Ministry of Finance of the Republic of Albania, 2004).

Table A7

### Fiscal Revenues, Expenditures and Balance

% of GDP

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Revenues (excluding grants)	19.1	18.8	20.3	16.4	17.6	22.7	22.7	22.7	22.2	22.2	22.4	22.1
Revenues (including grants)	22.3	20.8	21.3	16.5	18.3	24.9	26.0	24.6	23.9	22.8	22.8	22.4
Expenditures	35.8	32.7	30.6	27.8	31.3	34.3	34.9	32.1	30.5	28.4	27.0	26.7
Balance (excluding grants)	-16.7	-13.9	-10.3	-11.4	-13.7	-11.7	-12.3	-9.4	-8.3	-6.2	-4.6	-4.6
Balance (including grants)	-13.5	-11.9	-9.3	-11.3	-13.0	-9.5	-9.0	-7.5	-6.6	-5.6	-4.2	-4.3

Source: Albanian Ministry of Finance, IMF.

### 5.1 Budget Revenues

The legal basis of the current tax system has been gradually created over the past ten years. Value-added tax was introduced in 1996 and stands at 20%. In December 1998, new income tax legislation entered into force, and in January 2001 the corporate tax was cut from 30% to 25%.

Tax collection in Albania is relatively weak. Sizeable potential revenues remain untapped as the black economy is pervasive. However, the significant and continuous increase in the ratio of direct tax revenues to GDP since 1998 may indicate that the fight against the black economy is starting to show first results. Indeed, the higher direct tax revenue-to-GDP ratio allowed the overall revenue-to-GDP ratio (excluding grants) to remain relatively stable from 1998 onward, despite decreasing revenues from customs duties and non-tax revenues.

Table 8

**Development of the Revenue Structure**

% of total revenues

	1993	1998	2003
<b>Total revenues</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Indirect taxes	19.0	30.8	30.3
Direct taxes	40.0	15.4	28.1
Customs duties	13.0	13.5	8.3
Local taxes	1.0	0.8	5.0
Social insurance contributions	12.0	16.9	17.2
Non-tax revenues	15.0	22.2	11.3

Source: Albanian Ministry of Finance.

**5.2 Budget Expenditures**

When comparing the development of revenue and expenditure ratios it becomes clear that the budget deficit reduction between 1999 and 2004 was solely achieved on the expenditure side.

A detailed analysis of the expenditure structure shows the following picture: In 1998 interest payments amounted to almost one quarter of total budget expenditures. This share was clearly reduced by 2003. While the share of public investment expenditure in total budgetary expenditures increased from 17% in 1998 to 23% in 2001 despite a higher overall expenditure-to-GDP ratio, it was cut to a mere 15% by 2003 and contributed to the further reduction of the overall ratio. Social insurance expenditures, however, increased substantially.

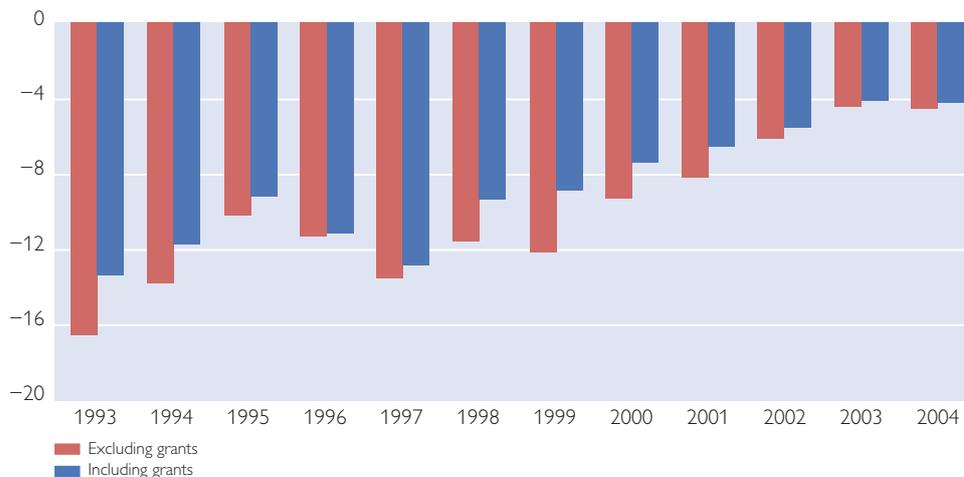
**5.3 Budget Deficit**

A relatively stable revenue ratio and the lower expenditure ratio helped reduce the budget deficit from 1999 to 2004.

Chart 3

**Total Public Budget Deficit**

% of GDP



Source: Albanian Ministry of Finance; 2004: IMF estimations.

The budget deficit has to a great extent been financed by domestic sources. In 2003, for example, about 70% of the budget deficit were financed by domestic sources; of these 70%, two-thirds stemmed from the purchase of government securities by commercial banks. Traditionally, treasury bills have been issued, with the share of treasury bills with a 12-month maturity increasing. In addition, two-year bonds have been issued since October 2002.

Table 9

### Financing Structure of the Budget Deficit

%	1993	1998	2003
Domestic financing	64.0	57.4	70.5
of which: by privatization (% of domestic financing)	4.0	0.5	3.8
Foreign financing	36.0	42.6	29.5

Source: Albanian Ministry of Finance.

Privatization played a subordinate role in budget deficit financing until 2003. In 2004, however, the privatization of the biggest Albanian bank, the Savings Bank (Banka e Kursimeve)<sup>5</sup> contributed significantly to deficit financing. These privatization proceeds implied that the growth of net lending to the public sector extended by commercial banks decreased significantly in 2004.

Further privatizations are planned (Emerging Europe Monitor, 2004b): Albtelekom (telecommunications), ARMO (refinery), KESH (power plant operator), INSIG (insurance company), ALBPETROL (oil production), Petro-limpex (operator of service station network).

#### 5.4 Public Debt

The public debt-to-GDP ratio rose from 35% in 1998 to a peak of 41% in 2000, and then declined continuously to 37.7% in 2003 according to wiiw (2005). IMF data also show a decline in recent years, but from much higher levels: After a peak of 85% in 1997, the ratio is assumed to have fallen continuously, reaching 55% in 2004 (IMF, 2005c).

## 6 Balance of Payments and External Debt

### 6.1 Regional Structure of Foreign Trade

The weight of the European Union in Albania's foreign trade is obvious. In 2003, more than 93% of all Albanian exports went to the EU, with Italy (74.9%) and Greece (12.9%) once more being the most important partners. Imports from EU member countries accounted for 68% of imports to Albania in 2003, with Italy and Greece again being the most important trading partners by far: 34% of Albanian imports came from Italy and almost 20% from Greece compared to 6.5% from Turkey and 5.7% from Germany.

Trade with other neighboring countries (Serbia and Montenegro, Macedonia) is surprisingly low. The predominant position of Greece and especially of Italy in Albania's foreign trade has several reasons. First, relations with

<sup>5</sup> The Savings Bank (Banka e Kursimeve) was purchased by the Austrian Raiffeisen Zentralbank in April 2004. In October 2004 it was renamed "Raiffeisen Bank Sh.a." This means that all Albanian banks are now privatized and foreign-owned.

Italy are strong and varied despite a burdened past. During the communist era the Albanian population could receive Italian television, and today many Albanians speak Italian. What is more, there is a large Albanian community in Italy. Second, trade activities among the countries of Southeastern Europe had already been rather limited before the 1990s (EBRD, 2004), as Albania chose isolation after it had discontinued its diplomatic relations to Yugoslavia (1948), the Soviet Union (1961) and finally the People's Republic of China (1978). Finally, the low level of interregional trade in Southeastern Europe is also a result of past tensions within the region.

However, an initiative intended to support trade among the SEECs has been developed within the framework of the EU's Stabilisation and Association process. A network of bilateral agreements, which is to enter into force in 2008, is supposed to create a free trade zone in the region (European Commission, 2004).

## 6.2 Current Account

Albania's trade balance displays a very large deficit, which points to the lacking competitiveness of many Albanian products on international markets. This trade deficit has been partly covered by a positive balance in current transfers. As many Albanians work abroad, remittances play an important role in the economy. The large trade deficit is to some extent a consequence of buoyant net current transfers.

The export-to-GDP ratio according to the balance of payment statistics does not show a clear longer-term upward trend. Thus, it does not confirm the rather encouraging findings on the basis of nominal data from the national accounts. Both strong real appreciation and the economic slowdown in the Italian export market after 2000 might provide some explanation for this relatively weak export performance. The import-to-GDP ratio changed more markedly. A significant decrease until 1999 may have resulted from the sharp decline in net current transfers. Then, up to 2001, it increased by roughly the same degree despite weaker GDP growth, probably driven by the previous sustained real appreciation. Further weakening GDP growth combined with a temporary

Table 10

Current Account									
	1996	1997	1998	1999	2000	2001	2002	2003	2004
<i>% of GDP</i>									
Exports of goods	8.3	7.3	7.5	8.0	6.9	7.2	6.8	7.3	7.4
Imports of goods	31.4	31.9	29.4	27.4	29.3	31.4	30.6	29.0	26.9
<b>Trade balance</b>	<b>-23.1</b>	<b>-24.6</b>	<b>-21.8</b>	<b>-19.4</b>	<b>-22.4</b>	<b>-24.2</b>	<b>-23.8</b>	<b>-21.7</b>	<b>-19.5</b>
Services balance	-0.5	-1.5	-1.5	3.0	0.3	2.1	-0.2	-1.3	-0.3
Current transfer balance	19.0	12.2	18.1	10.2	14.7	13.4	13.0	13.7	12.8
Income balance	2.4	2.3	2.8	2.2	2.9	3.5	2.6	2.8	2.1
<b>Current account balance</b>	<b>-2.1</b>	<b>-11.7</b>	<b>-2.5</b>	<b>-4.0</b>	<b>-4.5</b>	<b>-5.2</b>	<b>-8.3</b>	<b>-6.5</b>	<b>-4.9</b>
<i>Memorandum items</i>									
Real GDP growth (Albania)	9.1	-10.2	12.7	10.1	7.3	7.6	3.4	6.0	6.0
Real GDP growth (Italy)	1.1	2.0	1.8	1.7	3.0	1.8	0.4	0.3	1.2

Source: Bank of Albania, EUROSTAT.

interruption of appreciation may then have supported the decline of the import-to-GDP ratio and the resulting improvement in the trade balance by 2004, which was achieved despite the rising cost of energy imports.

As a result of the prominent role of net current transfers, the current account deficit doubled from 2% to 4% of GDP from 1996 to 1999 despite the improvement in the trade balance. However, higher net current transfers from abroad helped mitigate the impact of the rising trade and services deficit in the current account balance up to 2002. Then, a stable current transfer surplus allowed the recent improvement in the trade balance to fully translate into a lower current account deficit by 2004, when it amounted to 4.9% of GDP or EUR 322 million.

### 6.3 Capital and Financial Accounts

The sum of the capital account surplus and net FDI inflows covered a very large part of, or even exceeded, the current account deficit in the years following 1996, with the exception of 1997 and 2002. The capital account, for example, contained debt relief, inheritances, donations and investment subsidies provided by international organizations. In 2004, the higher level of net FDI inflows alone nearly sufficed to cover the lower current account deficit.

Table 11

#### Capital and Financial Accounts as Compared to the Current Account

% of GDP

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Current account balance	-2.1	-11.7	-2.5	-4.0	-4.5	-5.2	-8.3	-6.5	-4.9
Capital account balance	0.0	0.0	1.1	2.0	2.1	2.8	2.5	2.6	1.6
Financial account balance	1.7	7.0	1.0	1.7	5.5	2.6	4.5	3.3	4.9
of which: FDI	3.1	2.2	1.6	1.2	3.9	4.9	2.9	2.9	4.3
Net errors and omissions	1.9	6.5	2.5	3.8	0.4	3.2	2.5	2.4	x

Source: Bank of Albania.

Annual FDI inflows had oscillated around EUR 50 million from 1993 to 1995, before climbing to EUR 71 million or 3% of GDP in 1996. However, in the wake of the financial crisis of 1997 investment inflows dried up again. Since 2000 Albania seems to have become more attractive for foreign investors, and in 2001 FDI inflows peaked at EUR 231 million or 5% of GDP, partly as a result of significant privatization proceeds which amounted to about 43% of net FDI inflows. In 2002 and 2003 the share of privatization decreased to 2.5% and 4.2%, respectively; total FDI inflows were lower but still reached a level of 3% of GDP. The pickup of FDI inflows in 2004 to EUR 278 million or 4.3% of GDP may be attributed to the privatization of Albania's Savings Bank, which was sold to the Austrian banking group Raiffeisen Zentralbank yielding proceeds of about EUR 105 million.

The most important investors in Albania are Italy and Greece. About 82% of FDI stock stem from these two countries. Investment has been flowing into industry (42%), trade (27%) and construction (6%).

#### 6.4 Gross Foreign Debt

Gross foreign debt (in euro terms) fell from 42% of GDP at the end of 1997 to only about 16% at the end of 2004. This reflects the fact that most of the current account deficits were covered by non-debt inflows, thus minimizing new net borrowing. Moreover, strong real GDP growth and the strong real appreciation of the Albanian lek contributed to this decrease. At the same time, the structure of foreign debt changed significantly. While at the end of 1997 the bulk of foreign debt (54%) consisted in arrears, a quarter was owed to multilateral lenders and 21% to bilateral creditors (mainly the Paris Club), at the end of 2004, 60% of total foreign debt were owed to multilateral lenders (primarily to the International Development Association of the World Bank Group) and one third was owed to bilateral creditors, again mainly the Paris Club.

### 7 Conclusions

In the 1990s, Albania's transition process was characterized by efforts directed at overcoming its severe economic, social and political problems. After long years of isolation the country started its transition process from a very low level. Although broad reforms were initiated in 1992 (liberalization of prices and foreign trade, macroeconomic stabilization program, privatization of agricultural land), dynamic development was prevented by a difficult political environment, the weakness of market economy institutions and legal frameworks as well as massive emigration due to widespread poverty. In 1997 a severe financial crisis led to riots. However, after an intervention by foreign troops under UN command, political and economic stabilization was achieved and a dynamic growth process began. The following aspects of Albania's economic performance in recent years are particularly noteworthy:

1. Average economic growth of almost 7% from 1998 to 2004;
2. Drop in unemployment to below 15% in 2004;
3. Sustained nominal and real appreciation of the Albanian lek, except for a temporary interruption in 2002–03;
4. Decrease of annual average inflation to below 3% in 2004;
5. Reduction of the budget deficit to less than 5% of GDP in 2004; and
6. Increasingly successful fight against the shadow economy (increase of direct tax revenues).

A weak spot in the overall picture is the sizeable trade balance deficit, which seems to point at some weaknesses in the country's competitiveness. However, the buoyant remittances and other current transfers cover the large trade deficit to some extent. It is worth noting that in the period from 2002 to 2004 the trade deficit decreased due to lower imports, while net current transfers remained stable. Continued FDI, in particular in manufacturing and tourism, might help ameliorate Albania's competitive position over time. At present, the depleted infrastructure is an obstacle to more dynamic investment inflows.

In the financial sector, the beginning involvement of foreign players (especially Austrian banks) is a positive sign which could help promote sustainable economic development.

Albania has been given the perspective of EU membership (Council of the European Union, Thessaloniki, 2003), and in 2003 negotiations on a Stabilisation and Association Agreement started. To date, these negotiations are still at a

rather early stage, as the European Commission has called for greater commitment on the part of the Albanian authorities in fighting organized crime, human trafficking, money laundering and corruption, and in implementing more ambitious measures to reduce the shadow economy.

Cutoff date for data: May 31, 2005.

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