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## **Albania: on the verge of the inflation target**

The Bank of Albania is committed to maintaining the inflation rate at 3%, with a tolerance band of  $\pm 1$  percentage point. By the end of April 2008, inflation stood at 4.4%. Throughout the year inflation is expected to fluctuate around the upper limit of the target, surpassing it on average. The increases in international energy and food prices are the main cause. Though risks have grown, Albania is likely to maintain its medium-term potential growth path of 6% in the years to come. This is given continued strong domestic consumer demand and increased public investment in infrastructure.

### **Fighting effects of inflation**

The inflation rate has been accelerating recently, though at a slower pace than in other countries in the region. Items exhibiting the biggest price increases in April 2008 as compared to December 2007 were: fuels, edible oils, fruits, bread and vegetables. Growing food import bills widen the trade deficit. The government announced some support for the farmers, such as fuel oil subsidies for greenhouse heating. Though the government was called upon to decrease taxes on bread, wheat and flour, the Albanian ministry of finance wants to take other measures: public sector wages and pensions should be raised in July 2008 in order to compensate for food price increases.

### **Fighting causes of inflation**

A recent IMF mission to Albania was strictly opposing these plans. The Bank of Albania, too, warned about wage-push inflation. Both argued for some support for the very poor, though. The IMF officials were able to persuade the government to cut the planned spending by 2.7% of GDP. Now the targeted budget deficit for 2008 stands at 5.2% only. However, this is in conflict with the promised wage increase and the government has not decided yet what to do. On its own account, in 2007 the Bank of Albania raised three times the interest rate by 25 basis points in order to fight inflation. In the first quarter of 2008 the key interest rate remained unchanged at 6.25% as the growth of construction costs is decreasing and the growth of monetary supply is slowing down.

### **Credit boom and stagnant remittances**

Still, credit to the economy grew by 47% in the first quarter of 2008. Though this could be seen as a sign of potential overheating, it should be noted that the credit volume grows from very low levels. Credit growth is rather an indicator of the development of the financial system. This is very important as a traditional source of financing is starting to dry up: Growth of remittances from Albanian migrants, mainly working in Greece and Italy, stagnated in 2007 at about EUR 950 million. At the

beginning of the decade annual growth rates of remittances had been at about 25%. Throughout the past ten years remittances were central to economic growth of Albania, fuelling the booming construction sector and private consumption. So far about half of the trade deficit has been covered by remittances. Given that the average migrant sends home remittances for about a decade and a half, and given the slowdown in emigration, it is fair to assume that the peak of the remittances flow has been reached. Domestic sources of finance as well as FDI inflows will have to gradually take over the role previously played by remittances.

### **FDI targets the energy sector**

There are also benefits from rising energy prices. The energy sector is increasingly becoming a target for FDI. After foreign investment in Albanian oil fields and hydropower, a US-Swiss consortium offered the best bid of EUR 125 million for the sale of an 85% stake in the state-owned ARMO oil company. The consortium plans to invest another EUR 240 million in ARMO's facilities. ARMO runs two refineries and a small network of filling stations. It controls about a quarter of the market. Moreover, the government launched the privatization of the distribution business of the state electricity company KESH. Between 51% and 76% of the company's distribution arm are to be sold to a strategic investor via an open international tender. In other news Prime Minister Sali Berisha invited the Italian electricity company Enel to build a nuclear power station. Italy held a referendum the year after the 1986 Chernobyl disaster, deciding to shut down its four nuclear power plants. Since then a moratorium on the construction of new plants is in effect. Enel officials declared to be ready to assess the feasibility of a project in Albania once the governments of Albania and Italy have reached the respective agreement. With the new Italian government of Prime Minister Silvio Berlusconi fancying the reintroduction of nuclear power generation, this plan gains in likelihood.

### **Favourable growth prospects despite increasing risks**

The overall growth prospects of the Albanian economy appear to be rather favourable given the expected investment in infrastructure. Strong domestic demand growth fuelled by remittances from Albanians working abroad is still at the core of the country's economic performance. However, an improved business climate and a more developed financial sector should be conducive to larger FDI in the export sector, making this sector an engine of economic growth. Rising inflation and decelerating growth in the construction sector as well as in loans to the economy pose certain risks to continued high growth. Still, our forecasts for GDP growth in 2008, 2009 and 2010 are at 5.8%, 6.0% and 6.1%, respectively. Compared to our previous assessment, growth forecasts for 2009 and 2010 have been reduced by a symbolic 0.1 percentage point reflecting the judgement on the rise in potential risks.

Table AL

## Albania: Selected Economic Indicators

	2004	2005	2006	2007 <sup>1)</sup>	2007 1st quarter	2008	2008 Forecast	2009	2010
Population, th pers., end of period	3135	3149	3150	3150	.	.	.	.	.
Gross domestic product, ALL bn, nom.	751.0	817.4	893.0	982.2	.	.	1060	1160	1270
annual change in % (real)	5.7	5.8	5.5	6.0	.	.	5.8	6.0	6.1
GDP/capita (EUR at exchange rate)	1881	2095	2304	2522	.	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	4210	4530	4950	5390	.	.	.	.	.
Gross industrial production									
annual change in % (real) <sup>2)</sup>	14.1	2.5	7.3	8.0	.	.	8	9	9
Gross agricultural production									
annual change in % (real) <sup>2)</sup>	6.3	0.9	3.2	1.5	.	.	3	2	2
Construction output total									
annual change in % (real) <sup>2)</sup>	7.9	11.9	6.9	6	.	.	9	10	11
Consumption of households, ALL bn, nom.	586.2	621.4	668.1	728.8	.	.	.	.	.
annual change in % (real)	9.4	3.9	5.0	6.0	.	.	5	6	6
Gross fixed capital form., ALL bn, nom.	279.4	296.9	320.0	380.2	.	.	.	.	.
annual change in % (real)	2.7	11.2	7.0	8.0	.	.	10	10	11
Reg. employment total, th pers., end of per. <sup>3)</sup>	931.2	932.1	935.1	934.0	932.8	.	.	.	.
annual change in %	0.5	0.1	0.3	-0.1	0.2	.	.	.	.
Reg. employm.in industry, th pers., end of per. <sup>3)</sup>	75.6	74.8	73.9	.	.	.	.	.	.
annual change in %	12.8	-1.1	-1.2	.	.	.	.	.	.
Reg. unemployed, th pers., end of period	157.0	153.0	147.7	143.0	147.7	.	.	.	.
Reg. unemployment rate in %, end of period	14.4	14.1	13.6	14.0	13.6	.	13	12	11
Average gross monthly wages, ALL <sup>3)</sup>	24393	26808	28822	34200	31850	.	.	.	.
annual change in % (real, gross) <sup>3)</sup>	11.2	7.3	4.9	15.0	13.4	.	.	.	.
Consumer prices, % p.a.	3.0	2.4	2.4	2.9	2.8	3.7	4.1	3.1	3.0
Producer prices in manufacturing ind., % p.a.	12.2	4.9	0.7	7.3	14.4	6.8	9	.	.
General governm.budget, nat.def., % GDP									
Revenues	24.5	25.0	25.3	25.6	.	.	.	.	.
Expenditures	29.6	28.4	28.5	29.0	.	.	.	.	.
Deficit (-) / surplus (+), % GDP	-5.1	-3.5	-3.2	-3.4	.	.	-7	-5	-4
Public debt in % of GDP <sup>4)</sup>	57.7	57.8	55.9	54.0	.	.	.	.	.
Refinancing base rate, % p.a., end of period	5.3	5.0	5.5	6.3	5.0	6.3	.	.	.
Current account, EUR mn	-287.8	-492.0	-471.0	-831.5	-176.6	-289.2	-850	-950	-1130
Current account in % of GDP	-4.9	-7.5	-6.5	-10.5	.	.	-9.8	-10.1	-10.8
Gross reserves of BoA incl. gold, EUR mn <sup>5)</sup>	1005.2	1201.6	1362.6	1455.3	1372.2	1393.9	.	.	.
Gross external debt, EUR mn	1224.0	1373.5	1445.4	1572.1	.	.	.	.	.
Gross external debt in % of GDP	20.6	20.6	20.0	19.5	.	.	.	.	.
FDI inflow, EUR mn	278.4	224.2	258.6	476.7	93.6	119.3	600	.	.
FDI outflow, EUR mn	9.0	1.7	8.2	11.0	2.1	-5.4	10	.	.
Exports of goods, BOP, EUR mn	485.6	530.2	630.6	786.3	182.3	205.2	900	1000	1100
annual growth rate in %	23.0	9.2	18.9	24.7	26.2	12.6	14	11	10
Imports of goods, BOP, EUR mn	1762.3	2006.9	2289.6	2890.4	625.1	736.6	3300	3700	4000
annual growth rate in %	12.1	13.9	14.1	26.2	22.9	17.8	14	12	8
Exports of services, BOP, EUR mn	807.6	967.3	1156.6	1415.1	265.2	295.8	1500	1800	2000
annual growth rate in %	27.6	19.8	19.6	22.3	-1.4	11.5	6	20	11
Imports of services, BOP, EUR mn	848.1	1107.7	1188.0	1402.3	292.7	325.5	1500	1600	1800
annual growth rate in %	20.3	30.6	7.2	18.0	-0.7	11.2	7	7	13
Average exchange rate ALL/USD	102.8	99.9	98.1	90.4	95.7	82.5	.	.	.
Average exchange rate ALL/EUR (ECU)	127.7	124.2	123.1	123.6	125.3	123.6	122	123	121
Purchasing power parity ALL/USD <sup>6)</sup>	48.0	48.6	48.2	48.8	.	.	.	.	.
Purchasing power parity ALL/EUR <sup>6)</sup>	57.1	57.4	57.3	57.9	.	.	.	.	.

1) Preliminary and wiiw estimates. - 2) According to gross value added. - 3) Public sector only. - 4) Based on IMF data. - 5) Refer to total foreign assets of Bank of Albania. - 6) Benchmark results 2005 from Eurostat and wiiw estimates.

Source: wiiw Database incorporating national statistics; wiiw forecasts.