

# Evolution of Public Debt in Albania during 1990-2017 and its impact on the Economic Growth

Amarda Cano

## Abstract

Public debt is one of the most important macroeconomic indicators due to its impact on the economy of each country. Literature suggests that the effect varies in each country depending on the level of economic development and situation. Public debt will have a direct impact on a country's economic growth, but there are contrasting opinions amongst economists regarding the use of public debt, particularly in situations of distress and in developing countries. Albania is a country that would be in need of a decrease of the debt/GDP ratio. This can be done through a stimulation of the economy rather than a decrease of the public debt. The empirical analysis shows that the increase on real public debt can negatively influence the GDP, yet, we do not observe a specific level above which the effects worsened. Instead, we notice that whenever the public debt was increasing, the cost of debt would sometimes decrease because the governments substitutes the debt borrowed from second tier banks with debt borrowed from the IMF.

**Keywords:** evolution, public, debt, Albania, 1990-2017, impact, economic, growth

## Introduction

Public debt is one of the most important macroeconomic indicators due to its impact on the economy of each country. Literature suggests that the effect varies in each country depending on the level of economic development and situation. Public debt will have a direct impact on a country's economic growth, but there are contrasting opinions amongst economists regarding the use of public debt, particularly in situations of distress and in developing countries. The two main lines of thought are: the theory of debt neutrality and conventional theory, which will be explained in detail in the following chapters.

Stiglitz (2007) argues that it is crucial for developing countries such as the Balkans to recognize that besides posing a huge burden on the economy, public debt can cause an economic downturn leading up to the bankruptcy of a country (case of Moldova and Argentina).

However, according to him, this situation is attributed to not only the economic conditions, but also to the irresponsible lenders that fail to accurately analyze a country's solvency and the quality of the investments for which the debt has been used. It is sometimes the lenders themselves who encourage the policy makers to borrow more than what they can handle. Consequently, there is more room for the policymakers to undertake corrupt activities by abusing the borrowed funds. Typical cases are the use of debt for road infrastructure or other major works. Generally, the sizeable funds that support the policies stimulating the economic development encourage corrupt behavior of public officials (Acconcia & Cantabene, 2008).

The underlying hypothesis is that debt has a negative economic consequence in a country and austerity policies have more effect on countries with consolidated finances, while in developing countries such as Albania often bring an even higher growth of public debt.

### Literature Review

Throughout the economic transition, Albania has had a tradition of using public policies for stimulating economic growth and social cohesion. These policies have been generally based on large infrastructure investment funds. However, because of the lack of laws, absent procedures, unskilled administration and increasing corruption, these funds have not always been efficient in increasing the economic growth rate and developing the country to the required level. A similar situation can be observed amongst the other Balkan countries.

Tirole (1996) explores the implications of the interaction between the reputation of a group and its members. Individuals who belong to a group with bad reputation for being corrupt will therefore have a strong incentive to be corrupt too. This perpetuates corruption as a group. Expansion of corruption not only increases investments' costs and decreases their quality, but it also causes distortions in fiscal payments and a rise of the informal economy (Friedman et al., 2000). This creates a situation where investments are discouraged, FDIs are reduced (Abed & Davoodi 2002), the funds used for education and health are restrained (Mauro, 1998), income redistribution gets aggravated (Olken, 2006), productivity is limited (Lambsdorff & Kyklos, 2003), economic growth is weakened, public spending increases and, consequently, a higher use of public debt is incentivized (Tanzi & Davoodi, 2002).

According to Kaufmann (2010), politicians tend to stimulate large investments in infrastructure. This is achieved with an increase in public spending and debt growth. He demonstrates that corruption brings an increase in debt stock and as a consequence increases the costs for debt repayment in the future. All of this can often lead to a vicious circle of corruption and public debt.

In recent years, there has been a significant increase in debt attributed to the reconstruction of city centers in Albania. This initiative has not had an impact on employment or economic growth, yet, according to policymakers, it has strongly affected the social welfare of citizens.

### Data Analysis

The IMF for developing countries considers that the optimal public debt to GDP should be 45%, while the maximum is 60%. In the last six years in Albania, public debt has gone from 59.4% to 71%, exceeding its maximum level, and at the same time the average economic growth was 2.7%.

As the public debt has grown larger, there has been a considerable increase in the cost of debt. This has happened regardless of the recent continuous efforts of the Albanian government to borrow only from IMF and WB at low cost. This is due to the fact that during the period of 2009 to 2012, Albania has been borrowing from second-tier banks with relatively high interest rates, almost three times more than the interests negotiated for the 1 billion-euro debt from the IMF in 2013.

**Tabela 2.1** GDP and Public Debt in Albania

Year	2010	2011	2012	2013	2014	2015	2016	2017*
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Debt in billion \$	5.37	6.31	7.16	7.81	8.39	8.27	8.41	8.65
GDP in billion \$	10.36	10.73	10.76	10.82	11.04	11.39	11.79	12.23
Debt/GDP in %	52%	59%	67%	72%	76%	73%	71%	70.7%
GDP Growth	3.7%	2.6%	1.4%	1.1%	1.8%	2.6%	3.5%	3.8%
Public Debt cost in billion \$	0.379	0.48	0.54	0.552	0.682	0.912	1.02	n.d

Source: World Bank, 2017

If we refer to Table 2.1, we will see that the public debt from 2011 to 2016 has gone from 6.31 billion to 8.41 billion, an increase of 2.1 billion dollars. While in the same period of time GDP has risen in real terms to just 1.06 billion, so debt in the last five years is almost double the real GDP growth. While debt cost has increased by \$ 540 million. This cost is an important indicator for a country like Albania where the budget for planned investments in the recent years is almost similar to the cost value of the abovementioned debt.

Usually, the effects of the debt in GDP are not immediate and can be 1-5 years late. However, the table helps us realize that the public debt in Albania has not shown instantaneous effects on the economic growth of the country.

Over the last two decades, the Albanian economy has undergone a number of important structural changes, which have primarily aimed at creating a sustainable economic growth and an increase in the living standards in Albania.

During the aforementioned period, our country has somewhat maintained a positive economic growth with an average of around 4% a year in the last 20 years, which is still not compliant with the requirements of a country that is trying to obtain membership in the EU. According to a simple calculation, if we take into account the economic growth of Albania and average EU growth during 2009-2014, we are left with a result of 74 years that Albania will need in order to reach this average (Muço, 2015).

However, the Albanian government has been trying to get closer to the EU economy by undertaking several liberalization reforms promoting economic growth. The latter have stimulated the economic growth, yet often these reforms expose the financial sector to internal and external risks, do not sufficiently improve the business climate and thus have served an anti-stimulus for economic growth.

During the period of 2000-2010, there has been a shift of labor from sectors with low productivity, where we can mention agriculture and underdeveloped industries, towards those with high productivity, such as construction. This shift along with fiscal consolidation and the higher incentives towards foreign investments has contributed to the the average annual economic growth of 4.8% (WB, 2010). We have started our analysis from year 2000 and onwards in order to avoid the beginning of the 90s and the period of 1997-1998 where the structural breakdown happened.

According to the Bank of Albania (2011), economic growth has come as a result of the significant improvement of the business environment, energy, financial sector, tax administration and public finance management. These policies combined with the

acceleration of public investment had a very positive impact on the country's economic development.

During the years of 2000-2008, the average economic growth of Albania was about 6% a year with the highest recorded growth being an annual growth of 6.85% in 2008. This year coincides with the introduction of a flat rate of 10%, which gave rise to a formalization of the economy and brought a significant increase in FDI. Additionally, there was a growth of 64% of public investments during this year accounting for \$ 0.8 billion.

As the global economic crisis started to settle in, the Albanian economic growth felt a slowdown from 3.3% in 2009 to about 1.1% in 2013. This decline came also as a result of three main factors. One of them was the significant drop in remittances coming from emigrants that were largely used for private consumption and investment. The second factor includes the decline in public investment and finally, the economic crisis that hit Greece and Italy, strongly affected Albania as they were the two strategic economic partners of the country.

The public investments hit a high of \$ 0.815 billion in 2009, but have since continued to shrink down to a new low of about \$ 0.4 billion in 2016.

### **Evolution of Public Debt throughout 1990-2017 and its impact on the Economic Growth**

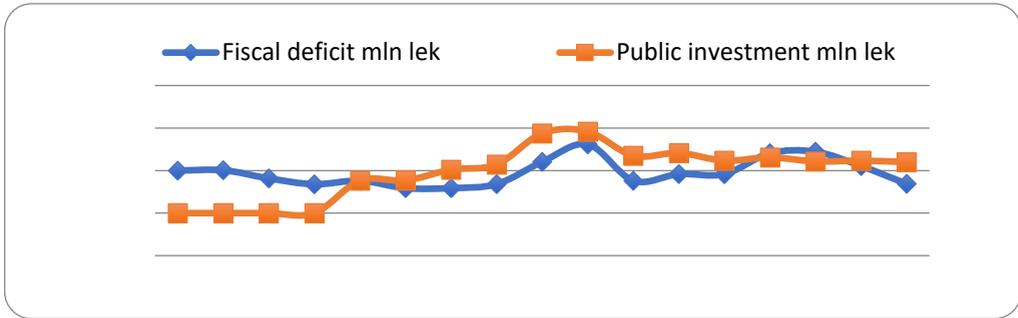
During the 1990s and throughout the transition period, Albania has been constantly helped by various international financial institutions and donors through soft grants and loans, with the purpose of constructing and restructuring the economy, while transitioning from a centralized economy to a market economy. As Albania was taking more steps towards development these generous donations started to decline. Albanian governments have been constantly relying on domestic and foreign financial markets, which have helped them collect the necessary funds for public investments. The budget of the state has always resulted in a deficit that was usually financed by borrowing, and consequently led to a public debt that reached high levels compared to the 60% ceiling set by the IMF.

If we take into consideration the recent years, the deficit has been constantly growing from 2005, 29 billion ALL, which accounts for 3.6% of the GDP, to 80.8 billion ALL, accounting for 7% of the GDP. During this period, the government tried to avoid the crisis effects from neighboring countries by significantly increasing the public investments. The government's increased borrowing to keep up with the public investments lead to the abovementioned increase in the deficit.

Starting from 2010, the government undertook a series of measures to improve fiscal indicators, particularly the fiscal deficit by reducing it by 53% compared to 2009, bringing it to 3.11% of GDP.

During 2011 to 2015, there was a round of upward fluctuations in the budget deficit. However, in the last two years, the government has worked hard towards reducing it through the increase of fiscal consolidation and the addition of new taxes. The local economy experts have judged these austerity policies to be negative because they will curb consumption, whereas according to the IMF they will be effective by reducing the public debt as well as the budget deficit which has kept a constant level of 2% during 2016 and 2017.

**Graph 2.1:** Fiscal deficit and public debt

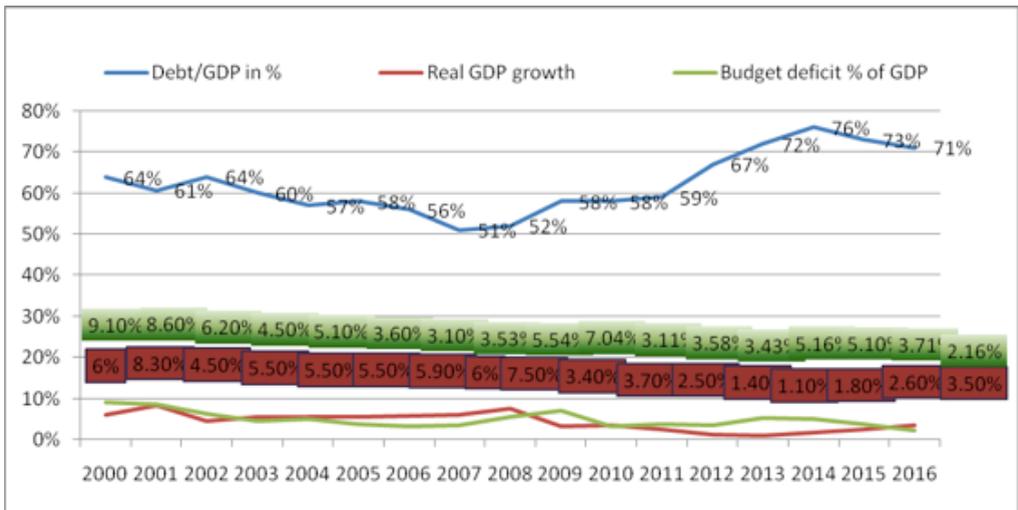


Source: World Bank, IMF, MF, 2017

As far as it regards the way the debt is structured, it is safe to say that during the 7 year period between 2000 to 2007, domestic and foreign debt have dominated (Initially it was distributed 70% domestic and 30% external). The growth rate of the domestic public debt has been more stable if we compare it to the rate of public external debt. Particularly, after 2007 the rate of the external public debt After 2007, the growth rate of the external public debt ascended much higher than the one of the domestic public debt.

GDP has increased at an average rate of 2-3% yearly, whereas the external debt has had an average of 18% (reaching a ratio of 52% of it being internal and 48% external). On one side this growth has been viewed negatively because it can affect the country's financial stability through a higher exposure to changed in the global financial markets and exchange rate risk. On the other side, this debt has a relatively cheaper because it is borrowed from the IMF. Additionally, the highest share in the public debt of Albania is occupied from the euro currency whose devaluation recently has decreased the cost of debt even more.

**Graph 2.2:** Real GDP growth and the budget deficit as a % of GDP



Source: World Bank, IMF, 2017

As far as it regards the performance of public debt in Albania throughout the years, we could say that 2016 marks the reduction of debt with regards to the previous year for the first time since 2010. The debt has had a real increase of 1.2% per year since 2000 to 2010. The years 2009 and 2013 mark the highest growth in real terms with 4.5% and 8.3% respectively.

According to the Ministry of Finance report (2016) from 2005-2013 for every x amount of debt, investments have increased by  $1.04^*x$ , and recently the latter has risen by  $1.74^*x$ . Nevertheless, this hike in investment due to debt has not been reflected in the GDP growth.

Whereas, the debt structure has now reached an equilibrium between external and domestic debt being 48% and 52% respectively. According to currency, about 50% is denominated in Albanian lek, 34.9% in euros, and 9.9% in dollars.

Keeping half of the debt in local currency is a positive thing, because it demonstrates direct confidence in the currency and the economy, which is very important for the reduction of the risks that investors have to take in the Albanian economy.

If we look at the Western Balkan countries, they have all had the tendency to make mass privatizations. Given that the state rarely manages its own businesses, they have opted for denationalization in order to improve the management of the assets and thus, transform them into enterprises that provide profitable services. Additionally, it has also been one of the demands of IMF for these countries to privatize the state-owned enterprises, and consequently reduce the public debt.

## **Conclusion**

Albania is a country that would be in need of a decrease of the debt/GDP ratio. This can be done through a stimulation of the economy rather than a decrease of the public debt. The empirical analysis showed that the increase on real public debt can negatively influence the GDP, yet, we did not observe a specific level above which the effects worsened. Instead, we noticed that whenever the public debt was increasing, the cost of debt would sometimes decrease because the governments would substitute the debt borrowed from second tier banks with debt borrowed from the IMF.

Investing in sectors such as agriculture, which would set the country for more competitive products during a time when the neighbouring countries have already lost some of their competitive advantages because of the current economic crisis. Therefore, if the government were to borrow with the goal to invest in the technology in agriculture or training to increase human capital productivity, this debt would definitely increase the overall productivity of a country, wages, and later on would positively affect the consumption and economic growth.

The risk is higher when public policies are used for major investments in infrastructure to stimulate growth. This encourages corrupt behavior, which widens easily as a group (Tirole, 1996). The expansive corruption has negative effects on the cost and quality of investments and supports distortions in fiscal payments and growth of an informal economy (Friedman et al., 2000; Kaufmann, 2010). This later leads to the vicious circle explained in Chapter 2.1.

According to Skidmore (1996) one of the many forms corruption becomes present is nepotism in the state administration, which touches even public hospitals where directors choose their own people or friends.

Similarly, in Albania it is quite often to see the majority of the public administration overflowed with unskilled people purely because they are paying, are militants or close relatives of policymakers.

Friedman et al. (2000) demonstrates that corruption is accompanied by a rise of informal activities and inefficiencies in tax collection, reducing thus, the fiscal revenues, due to fiscal evasion. It is usually the least corrupt governments the ones that tend to hold a high fiscal pressure.

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