

## Albanian Economic Transition and Role of Capital

*Ermelinda Gjika Xhaja*

*(University of Tirana, Albania)*

**Abstract:** Economic development in Albania has experienced its ups and downs from the post-communism period. The transition from a planned economy to the market economy has been more difficult than expected. Albania as a country striving toward European Union (EU) membership is still stuck in transition. Although the country has made some progress on the investment climate, the competitiveness of the economy within the Western Balkans and also with EU region, still it operates under economic potential. Albania has a number of advantages and unexploited resources to stimulate further investments and growth. The aim of this paper is to provide an overview of the Albania development indicators and explore the contribution of the capital to such growth. The paper is part of a deeper study on the Albanian convergence model toward Western Balkans and EU. The methodology of the paper makes use of time series data for a set of indicators such as GDP growth, transition indicators, fixed capital formation, investments. Comparisons are made also with other Western Balkans countries in some indicators. A calculation of the marginal product of capital is made in the paper to catch the contribution of capital to growth. The paper concludes that the contribution of capital has been essential in the growth but its efficiency and productivity has been put into question during the transition period. The model of Albanian economy model seems still at early transition stages and efforts are needed to improve the enabling environment for attracting more innovative and capital-intensive investments to make the country more competitive versus the region and EU.

**Key words:** economic growth; capital investments; transition economies

**JEL codes:** O16, O40, P20

### 1. Introduction

The transition of Albania from a planned economy to a market economy has proved more difficult and longer than foreseen. The Albanian economy has begun the economic growth in 1998 with 9% growth. Whilst in the period 2000-2009 the average economic growth was 6% and the GDP per capita accounted from 1082 USD in 1996 at about 4000 USD in 2015. Among the main activities promoting growth have been trade, services, and construction, mostly in dwellings with less impact on agriculture, manufacturing and other sectors of traditional exports such as minerals and electricity. Especially positive effect on poverty reduction has been stirred by the remittances, contributing to averagely 10.5% of GDP for 2000-2015. The weight of the public sector in the economy has varied in levels 25-30% of GDP, while public investment largest contribution is recorded in 2008 at 8.6% of GDP. However, there are repeated expressed concerns from Bank of Albania regarding under capacity

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Ermelinda Gjika Xhaja, Ph.D. Candidate in Faculty of Economy, Economic Expert for the Investment Council in Albania; research areas/interests: development economics, European integration. E-mail: ermegjika@outlook.com.

utilization of resources and economic opportunities in particular for the private activity. Improving the productivity of investments and human capital remains a major challenge to the Albanian economy to make it competitive in the region and beyond. Promotion of new technologies and sectors where comparative advantages are high will give to the economy some relief and chances for higher growth.

The influx of foreign investment in the country has been relatively low compared with other countries in the region of Central and Eastern Europe. FDI's contribution to the formation of new capital has averaged only 10% over the period 1996-2008. Although the maximum level reached 9.7% of GDP in 2010, the entry of certain groups except for banking sector the largest foreign investment was due to privatizations and concessions in strategic sectors permits exploiting the country's natural resources with a low added value for the gross domestic product of the country.

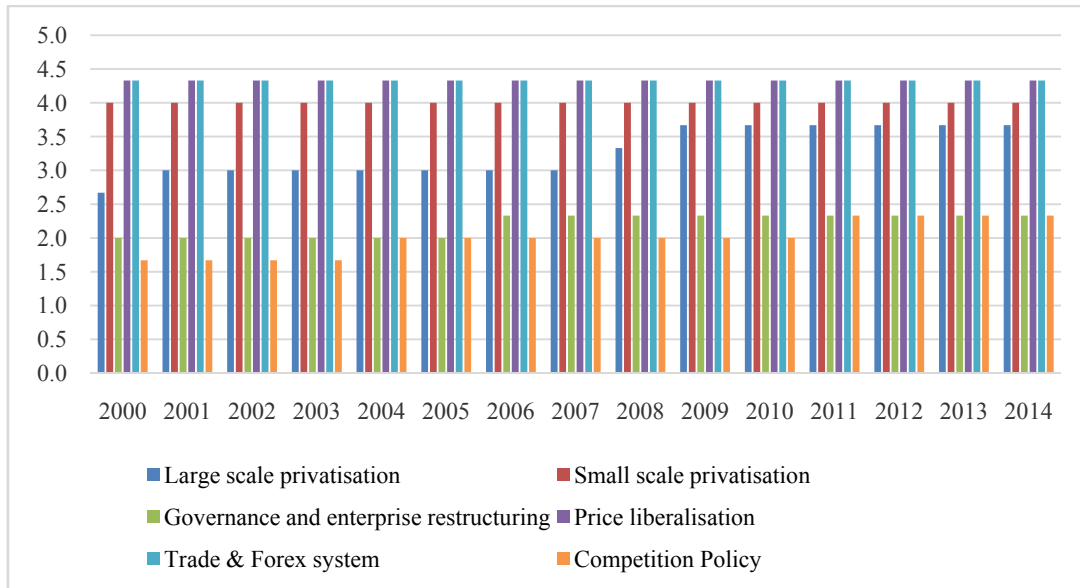
The global financial crisis that hit the financial markets of developed countries was not felt in the wake of its first wave in Albania due to the isolation of the financial markets and the capital of our country. But the consequences of the crisis impacted the economic growth started in Albania in 2009 were reflected in the decline of domestic demand, private investments, remittances, fiscal revenues, the increase of non-performing loans, so in its entirety presented signs of an economic crisis that deepened in the coming years. The lowest figure of economic growth for 2000-2015 was registered in 2013 by only 1%.

The aim of the paper is to introduce the dynamics of economic indicators during the transition period and moderately assess the role of capital accumulation in this process. For the purpose of the analysis, a range of indicators is used such as EBRD transition indicators, GDP real growth, fixed capital formation, FDI inflow. The paper provides an overview of the progress of transition indicators, the correlation with economic growth and continues with an assessment of the impact of capital accumulation on growth. The paper concludes by emphasizing the importance of effective orientation of capital toward productive investments, that makes better use of comparative advantages of the country and provide more stable growth.

## 2. Economic Transition Context

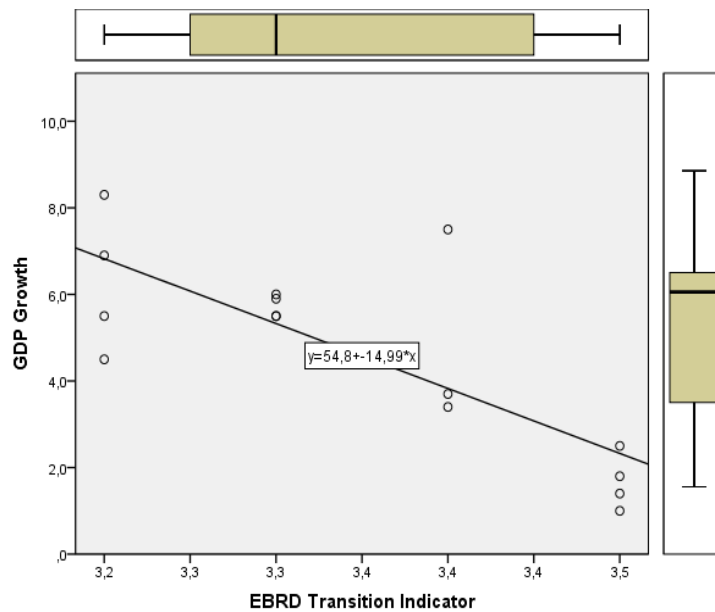
Albania together with the Western Balkans region are still stuck in transition as per 2013 Transition Report of the European Bank for Reconstruction and Development (EBRD) (see Figure 1). The country has made good progress on the reform path in terms of trade system, privatization and liberalization of prices, but a lot of efforts are still to be done in terms of competitiveness and restructuring of corporate governance. Countries in the region seem comparable between them in the stages of transition and also in the specific rating indicators. It is noted that the region is lagging behind in competition policy efforts that will enable their economies to enter the European markets.

The regression analysis of the average scoring of EBRD transition indicators and real economic growth for Albania, see Figure 2, shows a positive correlation ( $R^2 = 0.685$ ). The dataset corresponds to the period 2000-2014. The pace of reform has impacted positively the economic growth for a certain period, but afterward, the progress has stopped, reflected in the stagnancy of indicators for the last four years associated with a notable decline of growth rate.



**Figure 1 Transition Indicators for Albania**

Source: European Bank for Reconstruction and Development (EBRD)



**Figure 2 Regression of the Average Transition Scores for EBRD and GDP Economic Growth 2000-2014**

Source: Author's calculations as per EBRD data and IMF World Economic Outlook

Some of the reforms undertaken have affected the business climate as per evaluations made by various international reports (see Table 1). Concrete measures have been achieved for facilitating business registration, tax declaration procedures, licensing, inspections, investors' protection and more recently the online application for building permits. But the country is lagging behind in regard to competitiveness, the relevant infrastructure for promoting trade, education working skills, research and development, expansion of technology and innovation. Corruption remains a concern for business in relations with the administration as well as the judiciary. Whereas, the fifth EBRD and World Bank Business Environment and Enterprise Performance Survey (BEEPS V) conducted in 2013-2014 highlighted as key business problems in Albania, electricity supply, the informal sector and

corruption mainly for large firms. Relations with the tax administration and access to land and its ownership are two key constraints mentioned for new businesses in Albania that are under survey.

**Table 1 Ranking of Albania Related to Competitiveness and Business Climate**

Index/ Report	Organisation	2014/2015	2015/2016	2016/2017
Corruption Perception Index	Transparency International	110	88	83
Doing Business	World Bank	62	97	58
Global Competitiveness Index	World Economic Forum	97	93	80

Source: World Bank, World Economic Forum, Transparency International.

### **3. Role of Capital in Albanian Growth**

#### **3.1 The Capital Performance during Transition**

Robert Solow was a pioneer of the early attempts to quantify the contribution of each factor such as the accumulation of capital, the accumulation of work, productivity that impacts the product growth and thus the economic growth. This approach attempts to answer about what fractions of recorded growth may be generated by the growth of the stock of capital, labour force and changes in the overall productivity. It begins with a standard production function with respect to the contribution of labour and capital to the aggregate production, then adds a term to capture the total factor productivity (TFP).

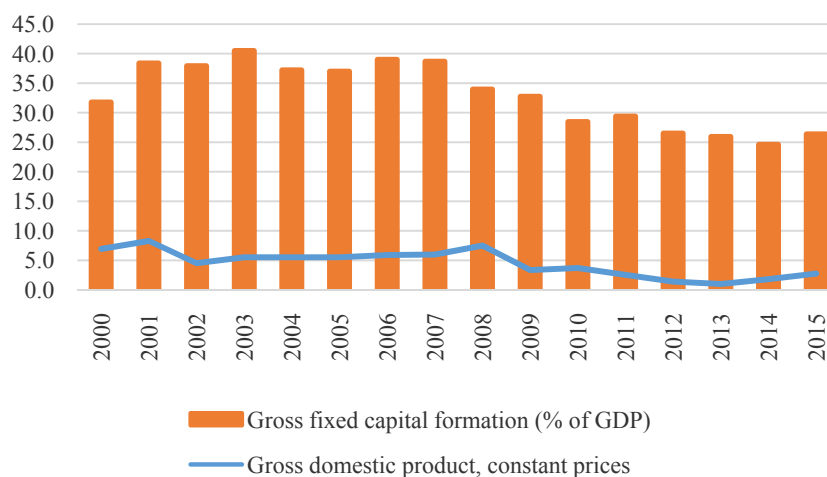
According to Borys et al. (2008), the growth of TFP is one of the main contributors to economic growth in the Western Balkans during 1997-2006. Being an economy in transition, countries are more likely to show an increase in TFP in the form of a more efficient use of inputs in the production and management of assets. Structural reforms like privatization deregulation and labour markets, trade facilitation and opening toward foreign investment, transfer of technology has led to the TFP growth. The calculations on the TFP value for Albania, are missing, making difficult to judge properly the contribution to growth. Whereas the contribution of labour has been negative mainly due to the high informality in the economy and undeclared employment. According to Schneider et al. (2010), informal sector in Albania for 1997-2007 totals about 34.3% of GDP.

Besides TFP, according to Borys et al. (2008) an important factor in promoting economic growth has been the accumulation of capital. Herein, it will be provided with an assessment of the effect of capital as one of the key inputs to economic growth.

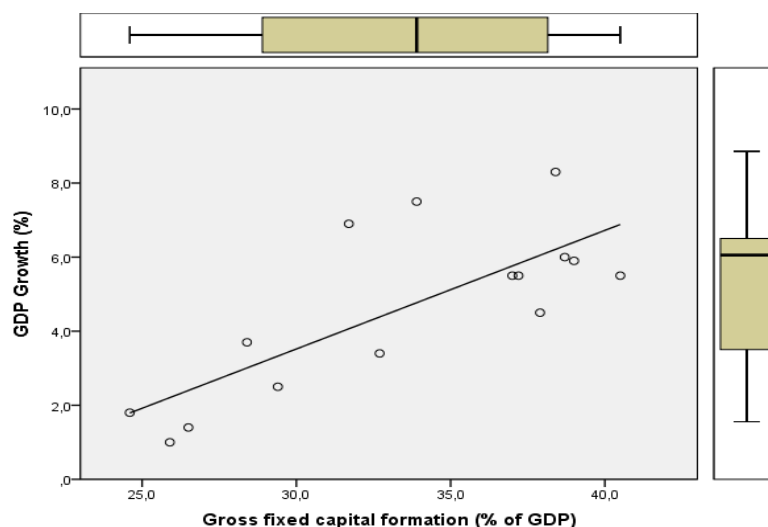
The capital accumulation has seen a substantial growth during the higher growth rates of the country showing signs of decline before the decline of growth pace (see Figure 3). The regression scatterplot as Figure 4 shows the existence of a relation between variables ( $R^2 = 0.588$  and significance 0.001) confirming the importance of the capital accumulation. According to Albanian official statistics, the total level of investments has accounted about 32% of GDP during 2000-2016.

Meanwhile, the country has experienced a substantial influx of foreign investment, especially after 2008, ranking second in the region in both contributions to GDP after Montenegro as well as in the nominal value flow, after Serbia. Referring to the Bank of Albania (BoA), the stock of FDI in Albania, at the end of 2014 is mainly concentrated on Transport and Communications with 27% of the total, financial services by about 17%, and the extractive industry with about 15%. The BoA data for 2015 estimated an inflow of FDI at EUR 881 million from EUR 869 million in 2014. In the recent years, the influx of foreign investment is oriented toward extractive industry, energy, telecommunications and financial intermediation. Meanwhile, in the region, the picture of FDIs

distribution per sectors appears different. In Serbia, the main FDI sectors are the financial sector and manufacturing industry as automotive, electrical, food and textiles. In Macedonia, in recent years FDIs have supported the automotive industry; in Bosnia and Herzegovina, the sectors with the highest inflow have been industry, banking and telecommunications, in Montenegro, the dominant sector is tourism. A good part of the FDI flow in the region is dedicated to the privatization of state assets, which has already been exhausted as an opportunity to attract more foreign investment.



**Figure 3 Capital Accumulation and Economic Growth in Albania**  
 Source: World Development Indicators and World Economic Outlook



**Figure 4 Regression Scatterplot of Fixed Capital Formation and GDP Growth**  
 Calculations of the author

### 3.2 Effective Use of Capital

In order to roughly assess the impact of the capital to GDP growth, and thus evaluate the potential productivity of the capital, it is calculated the marginal product of capital (MPK) and the expected contribution to GDP growth. The marginal product of capital shows how much the gross domestic product changes against the change of capital of which part of the economic growth is due to the capital growth. Thus, for every unit invested how many units in additional output will be generated. The literature shows that the efficiency of which the capital

can be used is far more important for growth than the size of the investment itself.

Table 2 presents the highlights in five years period of the calculations for MPK and the expected growth in GDP for the entire period from 1998 to 2015. As seen, the capital investments have played a key role in economic growth, to such extent that in certain years the effect of capital should have produced a higher economic growth. These results leave room to conclude that investments in Albanian economy have not always been productive and sometimes even counterproductive. According to the Bank of Albania, the economy is growing though remains below its potential. The signals coming from the market point out unused production capacity. The historical rate of capacity utilization is calculated by the Bank of Albania at 73%, with the lowest rate recorded in manufacturing sectors.

**Table 2 GDP Growth Due to Investments in the Albanian Economy as per MPK Calculations**

Years	2000	2005	2010	2015
MPK for total investments	0.55	0.24	0.26	0.12
Ratio of investments to GDP in percentage	32%	38%	28%	26%
Expected growth of nominal GDP from capital contribution	17%	9%	6%	3%
Effective nominal GDP growth	13%	9%	8%	3%

Calculations of the author, source of data Ministry of Finance. The calculation of expected GDP growth per year is made from MPK and investment ration of the previous year, when it is expected to be felt the impact on GDP.

The Albanian economic model is service oriented (62% of GDP) and mainly driven by micro and small enterprises, approximately 90% of enterprises have from one to four employees. Agriculture has a considerable share of GDP compared to the region (20%) while industry and production sector, in general, remain at relatively modest levels with a low capitalization of their technology. This is evidenced in the exports variety where 90% of manufactured goods exported by the level of technology (Sanfey, Milatovic, Kresic, 2016), are mainly based on labour and natural resources, in comparison to the 50% average of manufactured exported goods in other Western Balkan countries.

The data reflect the fact that Albania, as well as the Balkan region (OECD, 2013), are not well integrated into European supply chains. So, Albania has attracted so far sectors that rely on low labour costs and minimum qualifications as extractive industries and garments industries using the advantage of proximity to European markets. However, concerns remain on the reliability of resources for supporting further economic growth. This poses a challenge to the competitiveness of the economy toward the region and beyond to attract industries with a higher level of technology, skills, and know-how, thus to improve the added value of products and services traded in domestic and international markets.

#### **4. Conclusion**

This paper examines some of the macroeconomic indicators of Albania toward its transition phase and attempted to explore the impact of the capital factor to the economic growth. The Albanian economy has started from a very low level of capital at the early stage of the transition period but has recorded high growth rates till 2009, benefiting thus, as per Solow's growth theory (1956), from the backward advantages. Despite that, the country was hit by the global crisis and apparently is still stuck in transition. Private investments have been the engine of the economic growth during the transition but the expected outcome of capital accumulation and commitment has been not at optimum level. The country needs to adjust to such challenges and multiply the

efforts toward structural reforms that improve the grounds for attracting productive investments in the economy. The aspirations to further trade and infrastructure integration with the Western Balkans as well as with EU markets will make the country more favourable to investors by better using its comparative advantages.

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