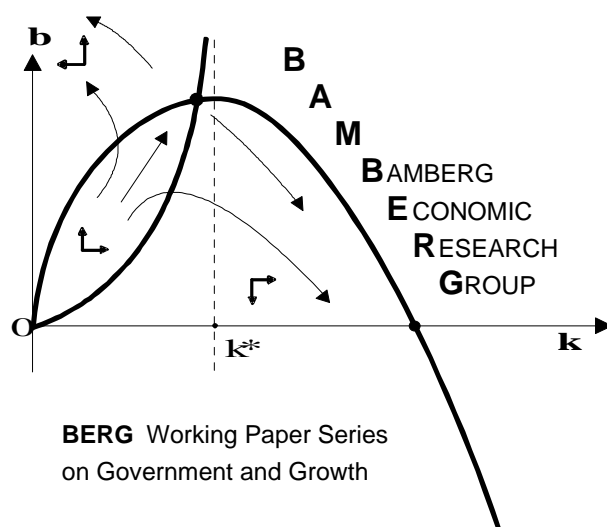


**SEMINAR VOLUME
OF THE
SECOND EUROPEAN DOCTORAL SEMINAR (EDS)**

**Heinz-Dieter Wenzel
Stefan Hopp
(Editors)**

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Edited by Heinz-Dieter Wenzel and Stefan Hopp

Preface

The European Doctoral Seminar (EDS) has been established in 2001 as an institution to facilitate and promote the academic exchange among young economics scholars from Bamberg, Tirana, Budapest and Sarajevo. Since its inception, seminars have been conducted in Budapest (September 2001) and in Bamberg (June 2002). In 2003, the Universities in Tirana and Sarajevo will be the hosts of the third and fourth European Doctoral Seminar, respectively.

For the participants, each seminar provides a unique opportunity to discuss one's scientific work with peers from three other nations. This diversity of social and academic backgrounds may provide a fertile breeding ground for the eventual advancement of our science, a prospect that crucially depends upon the intellectual curiosity and integrity of each individual current and future economist.

The EDS volume, like the present one, provides a medium to communicate some of the ideas presented throughout the seminar to a wider audience. Though the contributions in this volume include comments and suggestions made at the seminar, they ought to be considered as preliminary results of the ongoing research processes of the respective participants. Therefore, further comments and suggestions on the scope, nature and method of the subject matter will certainly be welcome by everyone. A complete list of all seminar participants, including email-addresses and academic affiliations, is included in this volume.

The contributions for the present volume have been divided in three sections. Section one contains a theoretical paper from the field of development economics that scrutinizes circular flow systems for underdeveloped nations. Applied papers on selected aspects of the Albanian economy are presented in Section two. The topics here range from an analysis of the monetary transmission mechanisms, and an evaluation of selected IMF programs to the policy implications of the variability of the Albanian exchange rate. The third section encompasses one paper on home financing in Hungary and two papers on the economic system in Bosnia-Herzegovina.

The editors would like to thank the EDS organizer, Dr. Volker Treier, for preserving through all the setbacks one normally encounters when responsibly organizing such a seminar. Last, but not least, we would like to express our thanks to the German Academic Exchange Service (DAAD) for the pecuniary support of the EDS.

Bamberg, February 2003

Prof. Dr. H.-D. Wenzel
Head of the Bamberg Economic Research Group (BERG)

Stefan Hopp

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Part I:

Development Economics

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The Macroeconomic Structure of Less Developed Countries

1. Introduction

All modern macroeconomic analysis is based on the study of circular flows. In the middle of the 18th century the French court physician François Quesnay introduced the circular flow idea (*tableau économique*) into economic theory, in analogy to the conception of blood circulation which had been detected more than 100 years earlier. Using the circular flow scheme enables us to arrange the numerous economic proceedings by focusing only on those flows of goods and services which take place between a few aggregate categories (sectors, classes) within a certain period. The circular flow theory states that nothing “falls out” of the whole system, or in Quesnay’s words: “all that is bought is sold, and all that is sold is bought.”¹ While the Physiocrats, under Quesnay’s leadership, split the economy into an agricultural and a non-agricultural sector, it is hard to find this basic scheme for industrial countries within modern macroeconomics today. Usually, the production of agricultural and non-agricultural goods is aggregated within one single production sector. Though, some models permit the production of various goods,² the basic separation between an agricultural and a non-agricultural sector with its respective household-sectors is no longer required in a macro-model for a modern industrialized economy.³

The attempt to analyze the macroeconomic structure of less developed countries (LDC) *in general* turns out to be rather difficult: this group of countries is too heterogeneous regarding its size, historical background, endowment of resources and factors, significance of the governmental sector, type and importance of the industrial sector, etc...⁴ Nevertheless some *common structural features* may be identified for LDC. Usually, the process of economic development starts with the emergence of a non-agricultural sector within a large agricultural economy. *Basically*, the appearance of a new sector is enabled by increases in agricultural productivity or by building an “industrial bridgehead”, organized by foreigners (e.g. colonizers). For the large majority of today’s LDC the contribution of foreigners - although they did not need to appear necessarily in form of colonizers - to the formation of their industrial sector has been rather significant.

In general, the new creating non-agricultural or industrial sector does *not* follow the same organization and production scheme prevailing in the agricultural sector. The diversity of the sectors is demonstrated on the one hand by different *types* of the

¹ The quotation is taken from Blaug, M. (1985), p. 28. This statement is principally valid in a barter economy or if we consider money as a pure medium of exchange. Furthermore, admitting intertemporal trade with debt claims and liabilities would not change the assertion.

² Examples for models with various goods are:

- “Two-sector-models” of Shinkay, Y. (1960) and Uzawa, H. (1962), which distinguish between the production of consumption and investment goods.
- Models which differentiate between tradable and non-tradable goods (so called “Australian”-, Scandinavian”- or “dependent-economy”-model); an overview gives Dornbusch, R. (1980), ch. 6, pp. 93-116. These types of models are sometimes employed by development economists; cf. Agénor, P.-R./Montiel, P.J. (1996), pp. 48 ff.

³ One possible reason for this may be that similar production technologies are employed in both sectors.

⁴ Cf. e.g. Todaro, M.P. (2000), p. 33.

produced goods: one sector produces food, the other sector raw materials or other industrial commodities, called manufactures. This asymmetric production structure frequently led to the suggestion that the manufacturing sector *depends on* the food producing sector. On the other hand, both sectors are characterized by institutional differences, e.g. concerning the determination of factor payments or the structure of factor inputs. Consequently, we usually find some limitations regarding intersectoral factor *mobility*. A huge discrepancy in the productivity of labour might be regarded as a symptom of sectoral heterogeneity (cf. table 1):

Table 1: Agricultural Production and Employment in LDC, 1995.

| <i>Region</i> | <i>Percentage of Employees in Agriculture</i> | <i>Percentage of Agricultural Production in Total Production (GDP)</i> |
|------------------------------------|---|--|
| <i>South Asia</i> | 64 | 30 |
| <i>East Asia (including China)</i> | 70 | 18 |
| <i>Latin America</i> | 25 | 10 |
| <i>Africa</i> | 68 | 20 |

Source: World Bank, World Development Report 1997: The State in a Changing World, annex, tabs. 4 and 12, adopted from Todaro, M.P. (2000), S. 366.

Although a substantial part of population in LDC is employed within the agricultural sector (particularly in Africa and Asia), the output share of that sector is much smaller. Furthermore, considering that one part of the agricultural production, like export-oriented plantations, is produced by relatively capital-intensive methods, we find an even lower productivity for the remaining traditional producing small-scale peasant farmers.

Hence, from the macroeconomic point of view, the disaggregation of LDC into two sectors may be justified by the demonstrated sectoral heterogeneity. Depending on the related problem we distinguish the sectors according to the *goods* they produce (agricultural/non-agricultural) or according to the production *method* they apply (traditional/modern). For example, if we are interested in questions about the industrial sector's dependency on the agricultural sector's food production, a distinction according to the respective produced goods seems to be meaningful. On the other hand, problems related with the limitations of factor mobility require a framework which differentiates between the organization and production methods applied. In the present context I want to proceed on the assumption that the kind of goods and the kind of production method correspond to each other: usually, agricultural goods will be produced by traditional labour-intensive methods, non-agricultural goods, particularly industrial goods, by modern methods (capital-intensive).⁵ Moreover, I suppose that services occur only within the industrial sector and will be produced by the same production methods like industrial goods.⁶

The paper at hand presents two macroeconomic circular flow schemes which take into account as well the *sectoral heterogeneity* as the relations between LDC and *foreign*

⁵ Although there might be examples demonstrating the opposite. However, the very low labour-productivity in agriculture shows that agricultural goods are produced until today with very low amounts of capital employed.

⁶ Later, during the course of development, there has been frequently emerged a huge service sector within large agglomerations where labour-intensive production methods predominate. The so called *informal sector* should be considered separately. Cf. Gupta, M.R. (1997), p. 409 for modelling the informal sector and the given literature there.

countries. The first circular flow describes an agrarian structured (subsistence-)economy which is complemented by an industrial organized exporting-sector. This sector has been induced by foreigners. In accordance with Fei and Ranis I would like to entitle this type of economy *open agrarian economy*.⁷ One special feature of the *open agrarian economy* is the fact that the domestic residents do *not save* at all. This implies that the industrial sector, using capital inputs for production, can only build up by *foreign savings*. This assumption may be justified particularly for LDC which are just passing through a very early state of the development process.

The second circular flow scheme also describes a two-sector-economy, connected to the rest of the world, the so called *open dual economy*. Like the *open agrarian economy* the second type is also characterized by the existence of two different organized production sectors (agricultural/non-agricultural). The main difference regarding the first type might be the abandonment of the restrictive assumption that residents are not able to save. Consequently, residents obtain possession of shares of the capital stock; now the other extreme case would be feasible: financing the industrial sector wholly by domestic foreign savers.

Both circular flows are expressed in physical terms, respectively in food units; monetary flows are ruled out here.

2. The early phase of the development process: *The open agrarian economy*

The following chapter presents a typical circular flow scheme of an economy that gets in touch with “modern” production methods induced by foreigners. Those foreigners come from industrializing or industrialized countries and appear initially as traders. They intend to export goods into their home countries that cannot be produced there or at very high costs. Those goods represent both: raw materials serving as inputs in their home country’s industry and exotic consumption goods enjoying great popularity there, like bananas, tea or coffee. The high demand in their home countries motivate the traders to change their profession and they become entrepreneurs extending and promoting not only the export but also the production of the requested goods, employing their own (modern) production methods.

The situation outlined describes the colonial phase of many African and Asian LDC during the 19th and early 20th century in order that we could talk about the circular flow of a “colonial economy”. Nevertheless, I prefer the expression *open agrarian economy* (OAE) because the present scheme is not confined to colonies but considers typical structures of all countries getting into contact by foreigners with external trade and modern production methods.⁸

The new economic actor in the OAE is the foreign entrepreneur. For production he needs domestic labour and a capital stock, changing by the way the structure of the agrarian oriented economy. In the following sections I will present each sector and their actors. The circular flow scheme (figure 1) reflects both sectors of the economy explicitly and considers as well the familiar macroeconomic accounts⁹ as the factor endowments of the related economic units. The direction of the arrows in figure 1 corresponds to the direction of real flows of goods and services.

⁷ Cf. Fei, J.C.H./Ranis, G. (1997).

⁸ In Latin America the colonial phase was over at the beginning of the 19th century. Some African and Asian countries (Ethiopia, Afghanistan, Nepal, large parts of China) have never been governed by colonizers.

⁹ The following accounts belong to the usual accounts of a national accounting system: product account, income account, saving and investment account and the rest-of-the-world account.

2.1. The rural sector

In the beginning of the development process rural communities form the only economic sector. Within these village communities almost all production capacities are concentrated on foodstuff cultivated by rather low productivity. Besides, a modest non-agricultural production sector with small scale craft business or services and an administrative or religious leadership may coexist, surviving from and depending in size on the farmer's food production surpluses. In the present framework I will neglect those non-agricultural activities within the rural sector in order to keep the circular flow scheme less complex.¹⁰ Furthermore, no distinction will be made between landlords and farm-workers or tenants. Subsequently we need not care about the numerous feasible contractual relations or lease agreements that prevail between the landlords and the rest of the rural population.

The **protagonist** of the rural sector is a *representative rural family farm* appearing as the owner of both production factors: it possesses not only the arable land but also supplies the labour necessary for food cultivation. Before the exporting sector comes into sight, family farms turn out to be wholly autarkic. They can be regarded as "producing households" making their production and consumption decisions simultaneously. By means of the **production factors labour** (L) and **land** (T) agricultural goods, particularly food, will be produced (Q_A).¹¹ Capital inputs are not of great importance; instead human (and animal) labour force is employed together with natural fertilizers and traditional cultivated seeds. Let us symbolize that part of the **labour** force that is engaged in *rural-sector*-production with L_A . The rest of the country's whole labour endowment (L_E) is employed within the exporting sector. A distinction between skilled and unskilled labour is not made here. Hence, aggregate labour which is constant in the short run can be expressed as the sum of both sectoral labour inputs:

$$(2.1) \quad L \equiv \bar{L} = L_A + L_E .$$

The second rural production factor **land** should also be considered as constant in the short run, meaning that all available arable land has already been cultivated; it is used exclusively inside the rural sector:

$$(2.2) \quad T = \bar{T} .$$

This assumption implies a rather low marginal productivity of labour in case of high density of population applying the law of diminishing returns.¹²

The rural sector **production technique** may be described by a linear homogenous neo-classical production function¹³ (F_A) (e.g. Cobb-Douglas-style):

¹⁰ The circular flows of a pre-industrialized (European) economy are described in detail by Jánossy, F. (1979).

¹¹ Capital letters are symbolizing aggregates.

¹² Diminishing returns in case of high population pressure is the central idea of the „labour-surplus economy“, firstly formulated by Lewis, A. (1954) in his path breaking article. Labour-surplus-models reflect particularly the circumstances in Asia, while the situation of some African countries may be better described by “land-surplus-models”.

$$(2.3) \quad Q_A = F_A(L_A, \bar{T})$$

Farmers produce a homogeneous agricultural good (foodstuff) that is neither sold nor bartered to a large extent and is used mainly for personal consumption (C_S) (subsistence economy). Further, a possible surplus of production may be sold or paid over to the new industrial sector; according to Fei and Ranis I am going to call this surplus *total agricultural surplus* (TAS)¹⁴. The following equation reflects the real output of the rural sector:

$$(2.4) \quad Q_A = C_S + TAS$$

The output-level and the family farmer's real income (Y_A) are identical if we neglect intersectoral intermediate trade and transfers:

$$(2.5) \quad Y_A = Q_A.$$

The output can be distributed totally among both production factors (L_A and \bar{T}):

$$(2.6) \quad Q_A = \underbrace{w_A L_A + r r_T \bar{T}}_{Y_A}$$

There is no need to determine the exact amount of wage w_A and land rate $r r_T$ here, since we do not differentiate between *landowner* and *farm worker*.¹⁵ The *representative* family farms receive the whole composite of factor payments; the per-capita income should be close to the subsistence level.

The family farmer's **income spending** is described in the following way: If we assume that due to the low income level no savings are generated, the entire income is consumed. As mentioned above, the lion's share of output (or income) is produced (or spent) for personal consumption. Within this macroeconomic context, personal consumption can be interpreted in a somewhat broader sense: it does not necessarily refer to the single family farms but to all family farms as a whole, meaning that one part of their production is consumed by themselves and another part may be bartered for similar food stuff produced by their neighbours. Of course, from the macroeconomic point of view such transactions are netted out.

Next, the remaining surplus of production (TAS) is supplied and exchanged for non-agricultural products on an (intersectoral) commodity market.¹⁶ Thus, we are able to

¹³ A linear-homogeneous production function means a production function with the degree of homogeneity of one.

¹⁴ Concerning the emergence of a TAS within a *labour-surplus-economy* see Fei, J. H. C./Ranis, G. (1964).

¹⁵ Generally, the two-sector-models of the labour-surplus-economy suggest that the wage rate is determined by average productivity since the marginal productivity of labour is zero or close to zero which would be below the subsistence level. However, more recent studies about sharecropping arrangements yield opposite results: wage rates frequently stay behind their marginal products. Cf. e.g. Rosenzweig, M.R. (1988) or Todaro, M. P. (2000), an overview about sharecropping is given by Singh, N. (1992).

¹⁶ Assuming that the TAS is not taxed by an authority like in pre-industrial feudal systems; concerning this point cf. Jánosy, F. (1979).

divide the application of income into personal consumption of family farmers and consumption of a non-agricultural good. As we will see below, this non-agricultural or industrial good (C_M)¹⁷ at the price P_M refers to a commodity imported from the rest of the world. But only the part γ (with $0 < \gamma < 1$) of the total import value is consumed by rural family farmers, the remaining part is consumed by the households of the second sector. Choosing the price of food P_A as numéraire and applying the relative price $p_M = \frac{P_M}{P_A}$, income spending or *absorption* of the rural family farms may be expressed by the following equation:

$$(2.7) \quad Y_A = C_S + \gamma p_M C_M$$

Some agricultural goods (TAS) are sold to the new sector while the family farmers receive various commodities in return ($\gamma p_M C_M$). We will call this kind of trade *intersectoral trade*, consisting in a way of intersectoral im- and exports, and express the correspondent **intersectoral trade account** (TA_A) - from the point of view of the rural sector - by the following equation:

$$(2.8) \quad TA_A = TAS - \gamma p_M C_M$$

From equations (2.4), (2.5) and (2.7) follow that the value of goods sold to the new sector and the value of goods received by the new sector must be equivalent. In analogy to the macroeconomic standard-identity of savings and investment we derive a similar accounting identity in form of a “balanced” intersectoral trade-balance:

$$(2.9) \quad TAS \equiv Y_A - C_S \equiv \gamma p_M C_M, \quad \text{or}$$

$$(2.9a) \quad TAS - \gamma p_M C_M = 0.$$

All economic activities of the rural sector are summarized by the following *basic sectoral identity*:

$$(2.10) \quad C_S + TAS \equiv Q_A \equiv Y_A \equiv \underbrace{C_S + \gamma p_M C_M}_{\substack{\text{absorption of the rural sector} \\ (\hat{=} \text{income spending})}} + \underbrace{TAS - \gamma p_M C_M}_{TA_A}$$

On the left hand of equation (2.10) we find the rural sector’s output which is equivalent to sectoral income. Again, sectoral income is expressed by the sum of the family farmer’s total demand (rural sector absorption) and the net-demand of the non-agricultural sector (intersectoral trade account). As a consequence of the **lacking of savings** we are able to derive two specific features: On the one side the absorption coincides with the application of income, on the other side the intersectoral trade account is (ex-post) balanced.

¹⁷ From now on, the terms *non-agricultural* and *industrial* are considered as synonyms.

2.2. The exporting sector

The exporting sector represents the new, foreign influenced sector. The name exporting sector reflects the assumption that the whole sectoral output will be exported to the rest of the world.¹⁸ One representative example for production is the exploitation of raw materials used as inputs in the growing manufacturing plants of the (recently) industrialized countries. In this case the whole production *must* be exported inevitably, since manufacturing plants within the OAE still do not exist. Moreover, let us assume that the predominant production methods are basically different from those employed in the rural sector.¹⁹ On the one hand exporters may use the well-known technology of their home countries. On the other hand, capital is the second employed production factor in addition to labour, while land use plays a minor role; that is why it is neglected in the exporting sector.

The **protagonist** responsible for the emergence and building-up of the new sector is the *foreign entrepreneur*. While I am going to consider the export *firm* as *domestic*, it should be emphasized that the *entrepreneur* is regarded as a *foreigner*, meaning that he stays basically in his home country, spending his income there. In other words, his income is not part of the national income of the OAE. The foreign entrepreneur provides and owns the required real capital stock (K), considered as constant during the relevant period:

$$(2.11) \quad K = \bar{K}$$

In addition to capital the entrepreneur uses the available domestic production factor **labour** (L_E), i.e. that part of labour not employed in the rural sector (cf. equation (2.1)). The labour force employed in the exporting sector has been recruited originally from the rural sector, but now a new economic unit has established: the household of the exporting sector (HH_E). We may assume that it is only endowed with one factor: labour (L_E).

Similar to the rural sector, the applied production technology may be described by a linear-homogeneous neo-classical production function (F_E):

$$(2.12) \quad Q_E = F_E(L_E, \bar{K})$$

A homogeneous good is produced and sold completely to the rest of the world at the price P_E . We express the output of the exporting sector in food units - and herewith the whole export (X) of the OAE - if we multiply the produced quantity by the relative

price $p_E = \frac{P_E}{P_A}$:

$$(2.13) \quad p_E Q_E = p_E X$$

¹⁸ As we will see below, within the new sector not only exports take place but also imports; this may be in contrast with the rural sector where we do not find any direct international trade activities; thus the new sector may be called the *international sector* as well.

¹⁹ Though, in reality, this has not been always the case. In South East Asia, e.g., export-oriented rice-production has been realized by methods of *traditional* rice cultivation.

Applying the adding-up theorem implies that the output can be decomposed in the sum of the product of the respective inputs L_E and \bar{K} and their partial marginal productivities $\left(w_E = \frac{\partial Q_E}{\partial L_E}\right)$ and $\left(rr_K = \frac{\partial Q_E}{\partial \bar{K}}\right)$. Thus, for the real wage share (W) we may write $p_E w_E L_E$, the real share of the rental rate (for capital) (R) may be expressed by $p_E rr_K \bar{K}$:

$$(2.14) \quad p_E Q_E = p_E (w_E L_E + rr_K \bar{K}), \quad \text{or}$$

$$(2.14a) \quad p_E Q_E = W + R$$

Within the exporting sector it seems to be rather plausible that factor payments are determined according to the rules of profit maximization and, hence, correspond to their marginal productivities.

The foreign entrepreneur receives the whole rental share and transfers it into his home country, by the way pushing into deficit the balance on factor payments (BF):

$$(2.15) \quad BF = -R = -p_E rr_K \bar{K}$$

On the other hand, the whole wage share is accrued by domestic households,²⁰ implying that the exporting sector's **income** ($p_E Y_E$) is nothing else than the wage share of its employed workers:

$$(2.16) \quad p_E Y_E = p_E Q_E - R = W \equiv p_E w_E L_E$$

Thus, the workers claim a part of the export production due to their labour input, but the *entire* production of that sector will be exported. Let us assume that the entrepreneur, trying to pay his workers, will import consumption goods to the amount of the wage share. If we further take for granted that the rural sector production of foodstuff is sufficient to provide the whole economy adequately, those imported consumption commodities may be completely of industrial character. Only if this is not the case the entrepreneur needs not only to import industrial commodities but also the required quantity of food. In the present framework I will presume that exclusively industrial goods will be imported, i.e. goods which have never been before within the described economy. Thus, we can state that the value of the wage share ($W \equiv p_E w_E L_E$) coincides with the value of the imported (industrial) consumption goods ($p_M C_M$):

$$(2.17) \quad W \equiv p_E w_E L_E = p_M C_M \quad ^{21}$$

Moreover, the foreign entrepreneur has the opportunity to enlarge his capital stock, dependent on his profit prospects. For this reason he needs to import investment goods from abroad as well since these types of goods are not manufactured within the OAE.

²⁰ We assume that the foreign entrepreneur himself is *not* working.

²¹ Expressing the price of the industrial import good (P_M), in terms of food yields $p_M = \frac{P_M}{P_A}$.

The imported investment good (I_M) may not be different from the imported consumption good, resulting that both goods have the same price (P_M). Hence, total import ($p_M M$) is given by:

$$(2.18) \quad p_M M = \underbrace{p_M C_M}_W + p_M I_M$$

Before aggregating all external economic relations in a rest-of-the-world account I will have a look at **income spending** of the exporting sector's households. From equations (2.16) and (2.17) follows:

$$(2.19) \quad p_E Y_E = p_M C_M$$

Assuming that per-capita income of the domestic exporting sector households is rather low, the *classical saving rule* may be applied, i.e. wage earners do not save. Consequently, while family farmers do not save as well, the entire domestic residents will not save at all. Since the whole income of exporting sector households consists of industrial consumption goods they have to barter a part of these commodities for the rural sector food surplus (TAS) to ensure their own survival. For this reason they act as traders while the rural family farmers acquire some of the imported industrial consumption goods (cf. equation (2.8)) and the remaining part ($1 - \gamma$) is consumed by themselves. The sectoral application of income is expressed as follows:

$$(2.20) \quad p_E Y_E = (1 - \gamma) p_M C_M + TAS.$$

To depict the intersectoral trade from the exporting sectors' point of view we have to change the sign of equation (2.8). As was shown above, the intersectoral trade account has to be (ex-post) balanced:

$$(2.21) \quad TA_E = -TA_A = \gamma p_M C_M - TAS = 0$$

Now, the **rest-of-the-world (current) account** of the OAE is described in the subsequent manner. The (international) **trade account** can be derived by equations (2.13) and (2.18):

$$(2.22) \quad TA \equiv p_E X - p_M M = p_E Q_E - \left(\underbrace{p_M C_M}_W + p_M I_M \right)$$

The balance of factor payments (BF) shows a deficit reflecting the outflow of the foreign entrepreneur's capital income:

$$(2.23) \quad BF = -R$$

Finally, the current account ($CA \equiv TA + BF$) is expressed by the sum of equations (2.22) and (2.23):

$$(2.24) \quad CA \equiv TA + BF = p_E X - p_M M - R = \underbrace{p_E Q_E}_{W+R} - \left(\underbrace{p_M C_M}_W + p_M I_M \right) - \underbrace{R}_R$$

Equation (2.24) shows that the current account must be in a negative position if the foreign entrepreneur imports investment goods, so if $p_M I_M > 0$. It is well-known that a current account deficit corresponds to an identical capital import ($Kim \equiv S_F$), so that we can state $S_F = p_M I_M$.²² This results from the assumption that domestic residents do not save; thus, the investment financing has to be realized by capital imports alone, i.e. by foreign savings (S_F). Let us summarize the described relations with the help of the rest-of-the-world account (table 2):

Table 2: The rest-of-the-world account of an open agrarian economy

| rest-of-the-world account (current account) | | | | | |
|---|--|---|--|---|---------------------------------------|
| $p_E Q_E$ (commodity exports) | <table style="border-collapse: collapse; width: 100%;"> <tr> <td style="border-right: 1px solid black; padding: 5px;">W</td> <td style="padding: 5px;"> $p_M C_M$ (imported consumption goods) </td> </tr> <tr> <td style="border-right: 1px solid black; padding: 5px;">R</td> <td style="padding: 5px;">R (payments for imported capital use)</td> </tr> </table> | W | $p_M C_M$ (imported consumption goods) | R | R (payments for imported capital use) |
| W | $p_M C_M$ (imported consumption goods) | | | | |
| R | R (payments for imported capital use) | | | | |
| current account deficit (= $Kim \equiv S_F$) | $p_M I_M$ | | | | |
| | | | | | |

In accordance with equation (2.10) we formulate the *basic sectoral identity* for the exporting sector:

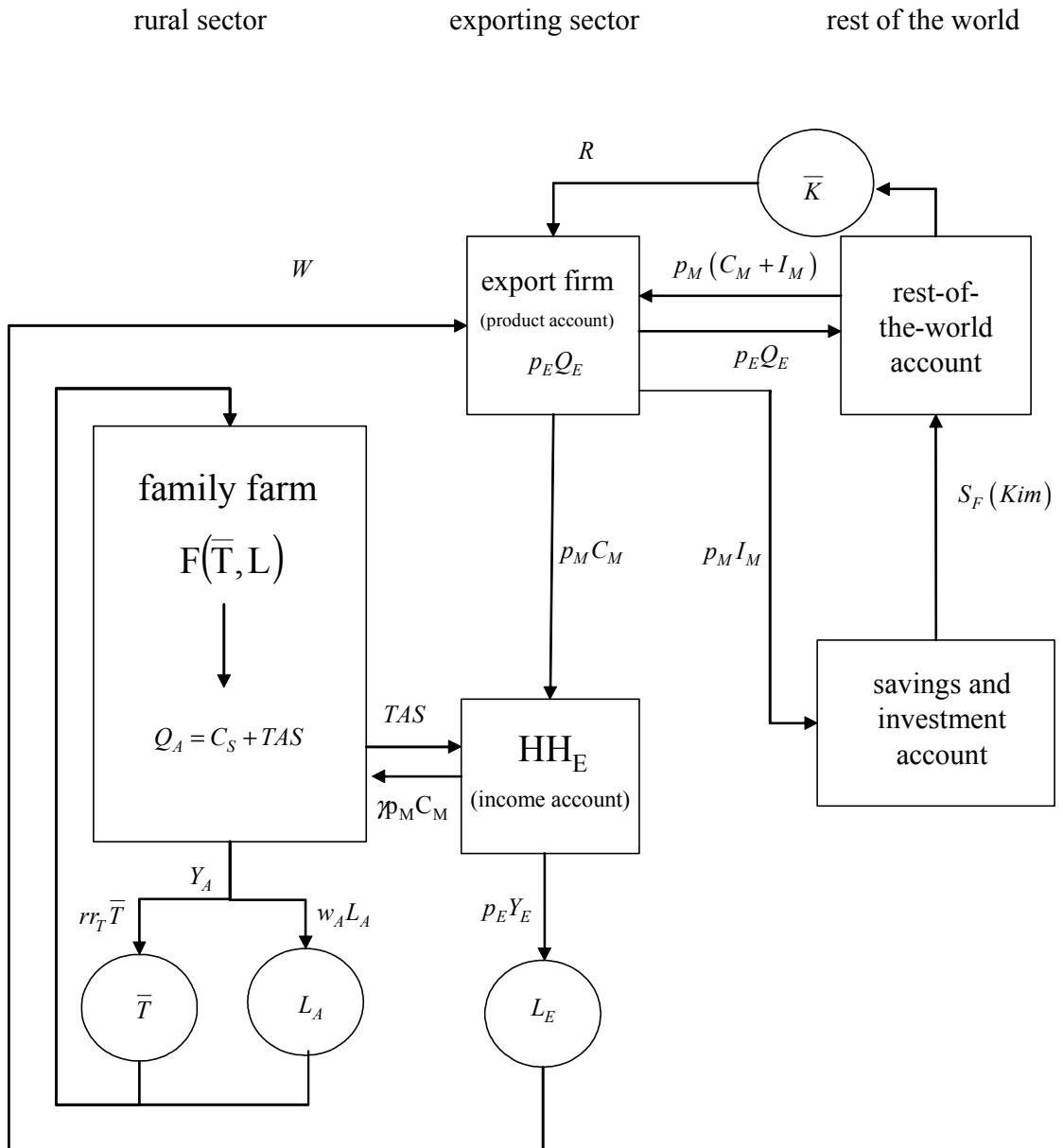
(2.25)

$$\begin{aligned}
 \underbrace{p_E Q_E}_{W+R} - R &= \underbrace{p_E Y_E}_W = \underbrace{p_M (C_M + I_M)}_{\text{absorption of the exporting sector}} + \underbrace{p_E Q_E - p_M (C_M + I_M) - R}_{CA} \\
 &= p_E Y_E = \underbrace{(1-\gamma) p_M C_M + TAS}_{\text{absorption of exporting sector households}} + \underbrace{\gamma p_M C_M - TAS}_{TA_E} + \underbrace{p_M I_M}_{\text{absorption of the (domestic) export firm}} - \underbrace{p_E Q_E - p_M (C_M + I_M) - R}_{CA}
 \end{aligned}$$

The left side of equation (2.25) shows the income of the exporting sector expressed by the difference between output and the rental payments flowing abroad. The right side demonstrates that income corresponds to the sum of absorption and the current account. Since the absorption is larger than income ($W + p_M I_M > W$) it follows that the current account is in a deficit position at the same level ($p_M I_M$). The second line of equation (2.25) is more differentiated and reveals not only *international* relations but also *intersectoral* relations from the view of the exporting sector.

²² In a national accounting system this transaction enters on the “savings and investment account” (cf. figure 1); the capital import deteriorates the OAE’s external position (creating a debt position).

Figure 1: The circular flow of an *open agrarian economy*



2.3. The entire open agrarian economy

Adding-up both sectoral outputs yields the OAE's real **net domestic product** (NDP). From equations (2.4) and (2.13) we get:

$$(2.26) \quad NDP = Q_A + p_E Q_E = C_S + TAS + p_E X$$

Further, output is portrayed by the sum of both sector's demand (absorption) and the net demand of the rest of the world (trade account):

$$(2.27) \quad NDP = \underbrace{C_S + \gamma p_M C_M}_{\text{absorption of the rural sector}} + \underbrace{(1-\gamma) p_M C_M + TAS + p_M I_M}_{\text{absorption of the exporting sector}} + \underbrace{p_E X - p_M (C_M + I_M)}_{\text{trade account}}$$

In the same way, **national income** (NNP) is given by the sum of both sectoral incomes (cf. equations (2.5) and (2.16)):

$$(2.28) \quad NNP = Y_A + p_E Y_E = Q_A + p_E Q_E - R = NDP - R$$

Equation (2.28) demonstrates that national income coincides with domestic income net the out flowing rental payments. In analogy with equation (2.27) national income may be expressed by the sum of absorption and current account:

$$(2.29) \quad NNP = NDP - R = \underbrace{C_S + \gamma p_M C_M}_{\text{absorption of the rural sector}} + \underbrace{(1-\gamma) p_M C_M + TAS + p_M I_M}_{\text{absorption of the exporting sector}} + \underbrace{p_E X - p_M (C_M + I_M) - R}_{\text{CA}}$$

3. The open dual economy

After establishing a new capital using sector, a transition process started in many LDC, characterized by two extreme forms of production: traditional agriculture and modern industrial manufacturing. During a successful development process, the size and importance of the agricultural sector with respect to output and employment will be diminished in favour to the industrial sector.

Those countries which just pass through the described phase of the development may be best analysed by the huge variety of *dual economy models* found in economic literature.²³ All these models have in common that the depicted economy includes two sectors: An "agricultural" or "traditional" or "backward" sector and an "industrial" or "modern" or "advanced" sector. Beyond this basic common feature dual economy models are rather heterogeneous and emphasize different sectoral asymmetries. Frequently, the analysis is focused on intersectoral interdependencies while external relations mostly do not play a key role.²⁴

²³ Cf. e.g. Jorgenson, D.W. (1961), Fei, J.C.H./Ranis, G. (1964), Higgins, B. (1956), Harris, J.R./Todaro, M.P. (1970), Taylor, L. (1983). An excellent though not very actual overview of dual economy models is provided by Dixit, A. (1973) or Kanbur, S.M.R./McIntosh, J. (1987).

²⁴ Regarding open dual economy models see Findlay, R. (1984), p. 218 and quoted literature there.

Neglecting further details of the specific models, I intend to present a circular flow that depicts the basic structure of a large variety of the wide-ranged dual economy types. The following flow system of an *open dual economy* (ODE) is characterized by:

- (1) The economy has *external* relations: The industrial product is international tradable and can be exported. Besides, another foreign good is imported. Moreover, foreigner's ownership of the domestic capital stock may be allowed. This last assumption follows the OAE framework where the whole domestic capital stock has been possessed by foreigners.
- (2) Three commodities are produced worldwide: two domestic (food and manufactures) and one foreign (another manufacture); now, we will not assume anymore that the domestic manufacturing is entirely exported.
- (3) Savings are generated within *both* domestic production sectors. This implies that as well rural as industrial households claim their share of capital payments.
- (4) (Real) Capital is used exclusively within the industrial sector, land only within the rural sector, hence, both production factors are *sector-specific*.²⁵

Now, let me present the single sectors and their actors. Figure 2 again shows the graphical version of the present circular flow.

3.1. The rural sector

The situation of the rural sector has not changed a lot compared with its position in the OAE. The **protagonist** of this sector remains the *representative family farm*, producing foodstuff (Q_A) by means of **labour** (L) and **land** (T). That part of labour employed in the rural sector L_A represents a part of the whole economy's labour endowment; the remaining part (L_I) is used for industrial production, so we may write:

$$(3.1) \quad L \equiv \bar{L} = L_A + L_I$$

All available arable land for food production has already been cultivated and cannot be augmented in the short run:

$$(3.2) \quad T = \bar{T}$$

Like in the OAE the applied production technology is given by a linear-homogenous neo-classical production function (F_A):

$$(3.3) \quad Q_A = F_A(L_A, \bar{T})$$

Again, the produced agricultural good is used principally for personal consumption (C_S), the remaining surplus (TAS) will be sold to the households of the industrial sector:

$$(3.4) \quad Q_A = C_S + TAS$$

²⁵ At this point, the structure differs from the Harris-Todaro framework where both sectors employ labour and capital (cf. Harris, J.R./Todaro, M.P. [1970]).

The rural sector production generates a factor income at the same level, accrued entirely by the representative family farmers. Thus, it is not necessary to determine the respective wage w_A and rental rate rr_T here:

$$(3.5) \quad Q_A = \underbrace{w_A L_A + rr_T \bar{T}}_{\text{factor income as a result of rural sector production}}$$

In contrast to the OAE framework we assume now that the family farmers will save a certain amount of their income. Their **savings** contribute to the finance of the industrial sector's capital accumulation and let the farmers claim an according share of capital payments. A necessary condition for that is the existence of a formal or informal capital market, bringing together and balancing the supply and demand of financial resources. For a moment it does not seem very plausible that rural families put forward the capitalization of the industrial sector. But we have to take into account that we consider a *representative* family farm which may be split into a landowner and a farm worker household. The suggestion that at least the landowner makes his contribution to the industrial sector's capital accumulation seems to be more reasonable.²⁶ Among others, Fei and Ranis have emphasized this rural contribution and considered it as essential for a successful development course. In the context of a *closed* economy it would be conclusive that during the first stages of the development process the start-up finance comes from the rural sector. Considering this, I now suggest to integrate the rural sector's *possibility* to take part in the capital formation process. Thus, the total rural sector's **income** is expressed by the sum of their production and that part of the rent of the industrial sector's capital stock received by the farmers (R_A):

$$(3.6) \quad Y_A = Q_A + R_A$$

The income will be **used** for personal consumption, for intersectoral traded consumption goods (γC) and for (real) savings (S_A):

$$(3.7) \quad Y_A = C_S + \gamma C + S_A$$

The intersectoral traded consumption goods (C) could have been produced domestically (C_I) or imported from the rest of the world (C_M). Thus, we have two different goods with different prices, expressing them in food units by their respective relative prices $p_I = \frac{P_I}{P_A}$ and $p_M = \frac{P_M}{P_A}$:

$$(3.8) \quad C = p_I C_I + p_M C_M$$

In the present ODE context, we do not only find pure commodity trade but also trade in factor services, resulting in intersectoral income flows. The **intersectoral trade**

²⁶ Particularly in Asia, the colonizer's legal system has changed the rural ownership structures decisively, strengthening the indigenous landlord's position. Cf. Todaro, M.P. (2000), p. 376.

account (TA_A) and the **intersectoral current account** (CA_A) (from the rural sector's view) are given by the following equations:

$$(3.9) \quad TA_A = TAS - \gamma C$$

$$(3.10) \quad CA_A = TAS - \gamma C + R_A$$

From equations (3.4), (3.6) and (3.7) follow that rural savings are equivalent to the sum of the intersectoral trade account and the capital incomes:

$$(3.11) \quad S_A = \underbrace{TAS - \gamma C}_{TA_A} + R_A$$

$$\underbrace{\hspace{10em}}_{CA_A}$$

In analogy with the *domestic* and the *national concept*, we may distinguish between the *production* (equation (3.12)) and the *income concept* (equation (3.13)) of the rural sector and formulate two *basic sectoral identities*, summarizing by the way the rural economic activities:

$$(3.12) \quad C_S + TAS = Q_A = \underbrace{C_S + \gamma C}_{\text{absorption of the rural sector}} + \underbrace{TAS - \gamma C}_{TA_A}$$

$$(3.13) \quad C_S + TAS + R_A = Y_A = \underbrace{C_S + \gamma C}_{\text{absorption of the rural sector}} + \underbrace{TAS - \gamma C + R_A}_{CA_A}$$

The production corresponds to the sum of absorption and (intersectoral) trade account, the income corresponds to the sum of absorption and (intersectoral) current account. If absorption is smaller than production (income), the trade account (current account) must be in a surplus position. This surplus corresponds to an intersectoral capital export at the same level, in other words: rural savings finance a part of the investment projects, realized in the industrial sector.

3.2. The industrial sector

Within the dual economy, the industrial sector may be regarded as the engine of economic growth and development. Like the OAE's exporting sector, the industrial sector uses capital and labour and can be considered as its "successor". By strengthening capital accumulation, output growth increases and rural sector's (surplus) labour might be absorbed. It should be emphasized, however, that the rural sector is essential for the industrial sector's expansion providing foodstuff and savings. Let me now present the actors of the industrial sector. In contrast to the OAE, now a notable quantity of domestic entrepreneurs exists, possessing a share of the capital stock. As usual, we assume a constant capital stock during the relevant period:

$$(3.14) \quad K = \bar{K}$$

The remaining part of labour (L_I) is used along with capital. Let us assume that workers' and entrepreneurial households together form the industrial sector's *representative household* (HH_I).

Once more, production is given by a linear-homogeneous neo-classical production function:

$$(3.15) \quad F_I = Q_I(L_I, \bar{K})$$

The produced good is sold by the price P_I , or, in food units, by $p_I = \frac{P_I}{P_A}$. Until now we

have not already determined what happens with the merchandise. According to more specific models, it might be completely exported, used at home or something in-between. At any rate, the merchandise is a non-agricultural, industrial good with dual use for (domestic) consumption (C_I), and (domestic) investment (I_I); moreover, demanded by the rest of the world (X). If we consider a small country and the law of one price holds, its price P_I is given exogenously by the world market.

Furthermore, industrial sector's enterprises import *another* non-agricultural good from abroad. It may be also used as consumption or investment good and is supplied at the

(international) price P_M , respectively $p_M = \frac{P_M}{P_A}$. Hence, industrial consumption goods

(C), investment goods (I), import goods (M), and total production of the industrial sector (Q_I) are expressed by the following equations:

$$(3.16) \quad C = p_I C_I + p_M C_M$$

$$(3.17) \quad I = p_I I_I + p_M I_M$$

$$(3.18) \quad p_M M = p_M (C_M + I_M)$$

$$(3.19) \quad p_I Q_I = C + I + p_I X - p_M M$$

The whole output can be split into the wage share ($W = p_I w_I L_I$) and the capital share ($R = p_I r r_K \bar{K}$):

$$(3.20) \quad p_I Q_I = W + R$$

In the industrial sector we assume again that factors are paid according to their marginal products. The capital payments are earned by the capital owners which may reside in both domestic sectors or abroad. Hence, all capital payments can be divided into their respective sectoral shares:

$$(3.21) \quad R = R_A + R_I + R_M$$

The foreign capital owner transfers his share back into his home country, charging the current account; similarly, the rural capital owner transfers his share into the rural sector, charging the intersectoral current account. However, the whole wage income remains within the industrial sector and constitutes along with the payments of the industrial sector's capital owner the sectoral income (Y_I):

$$(3.22) \quad p_I Y_I = p_I Q_I - (R_A + R_M) = W + R_M$$

The representative households **spend** their income on the remaining part $(1-\gamma)$ of industrial consumption goods, not demanded by family farmers, on rural foodstuff and on savings (S_I):

$$(3.23) \quad p_I Y_I = (1-\gamma)C + TAS + S_I$$

In contrast to the OAE, households do no longer act as traders here; instead, enterprises sell their commodities on markets to the households of both sectors and the rest of the world. The **intersectoral trade account** (TA_I) (**current account**(CA_I)) from the industrial sector's view corresponds to the negative intersectoral trade account (TA_A) (**current account**(CA_A)) from the rural sector's view (cf. equations (3.9) and (3.10)):

$$(3.24) \quad TA_I = -TA_A = \gamma C - TAS$$

$$(3.25) \quad CA_I = -CA_A = \gamma C - TAS - R_A$$

We derive the following relation between the industrial sector's investment and savings account (left side of the equation), the intersectoral current account and the (international) current account from the calculations of output (3.19), income (3.22) and income spending (3.23):

$$(3.26) \quad p_I S_I = \underbrace{\gamma C - TAS}_{\substack{TA_I \\ CA_I}} - R_A + \underbrace{p_I X - p_M M}_{\substack{TA \\ CA}} - R_M$$

If industrial sector's savings are not sufficient to match investment demand, the sum of both current accounts must be negative, i.e a capital import (from the rural sector or from abroad) occurs.

Finally, the *basic sectoral identity* of the industrial sector is expressed by (cf. equation (2.25)):

$$(3.27) \quad p_I Q_I - (R_A + R_M) = p_I Y_I = \underbrace{(1-\gamma)C + TAS + I}_{\text{absorption of the industrial sector}} + \underbrace{\gamma C - TAS}_{\substack{TA_I \\ CA_I}} - R_A + \underbrace{p_I X - p_M M}_{\substack{TA \\ CA}} - R_M$$

The left side corresponds to the income and reveals its relation to the output. Again, the income (the output) coincides with the industrial sector's demand or its absorption plus

the sum of intersectoral and international current account (trade account). If the absorption is larger than income (output), the sum of both current account (trade account) balances is in a deficit position.

3.3. The entire open dual economy

Corresponding to section 2.3 we will put the economy together and determine the levels of national production, income and spending. Summing up the sectoral output levels yield the ODE's **net domestic product** (NDP) (cf. equations (3.4) and (3.19)):

$$(3.28) \quad NDP = Q_A + p_I Q_I = C_S + TAS + C + I + p_I X - p_M M$$

Also, NDP may be expressed by the sum of both sector's (domestic) demand (absorption) plus net demand of foreigners (trade account):

$$(3.29) \quad NDP = \underbrace{C_S + \gamma C}_{\text{absorption of the agricultural sector}} + \underbrace{(1-\gamma)C + I + TAS}_{\text{absorption of the industrial sector}} + \underbrace{p_I X - p_M M}_{\text{TA}}$$

In the same way, we get the **national income** or net national product (NNP), adding up the sectoral incomes (cf. equation (3.6) and (3.22)):

$$(3.30) \quad NNP = Q_A + p_I Q_I - R_M = NDP - R_M$$

Also, we formulate the NNP as the sum of absorption(s) and current account:

$$(3.31) \quad NNP = NDP - R_M = \underbrace{C_S + \gamma C}_{\text{absorption of the rural sector}} + \underbrace{(1-\gamma)C + I + TAS}_{\text{absorption of the industrial sector}} + \underbrace{p_I X - p_M M - R_M}_{\substack{\text{TA} \\ \text{CA}}}$$

National wide **income spending** corresponds to consumption plus savings (cf. equations (3.7) and (3.23)):

$$(3.32) \quad NNP = C_S + TAS + C + S_A + S_I$$

Equalizing (3.31) and (3.32) yields the well-known (ex-post) identity of net financial investment and current account balance:

$$(3.33) \quad \underbrace{S_A + S_I - I}_{\text{net financial investment}} = \underbrace{p_I X - p_M M - R_M}_{\substack{\text{TA} \\ \text{CA}}}$$

If domestic savings are not sufficient to finance the domestic demand of investment, the remaining part has been financed by foreign savings (S_F), i.e. net capital imports (Nkim).

4. Conclusion and preview

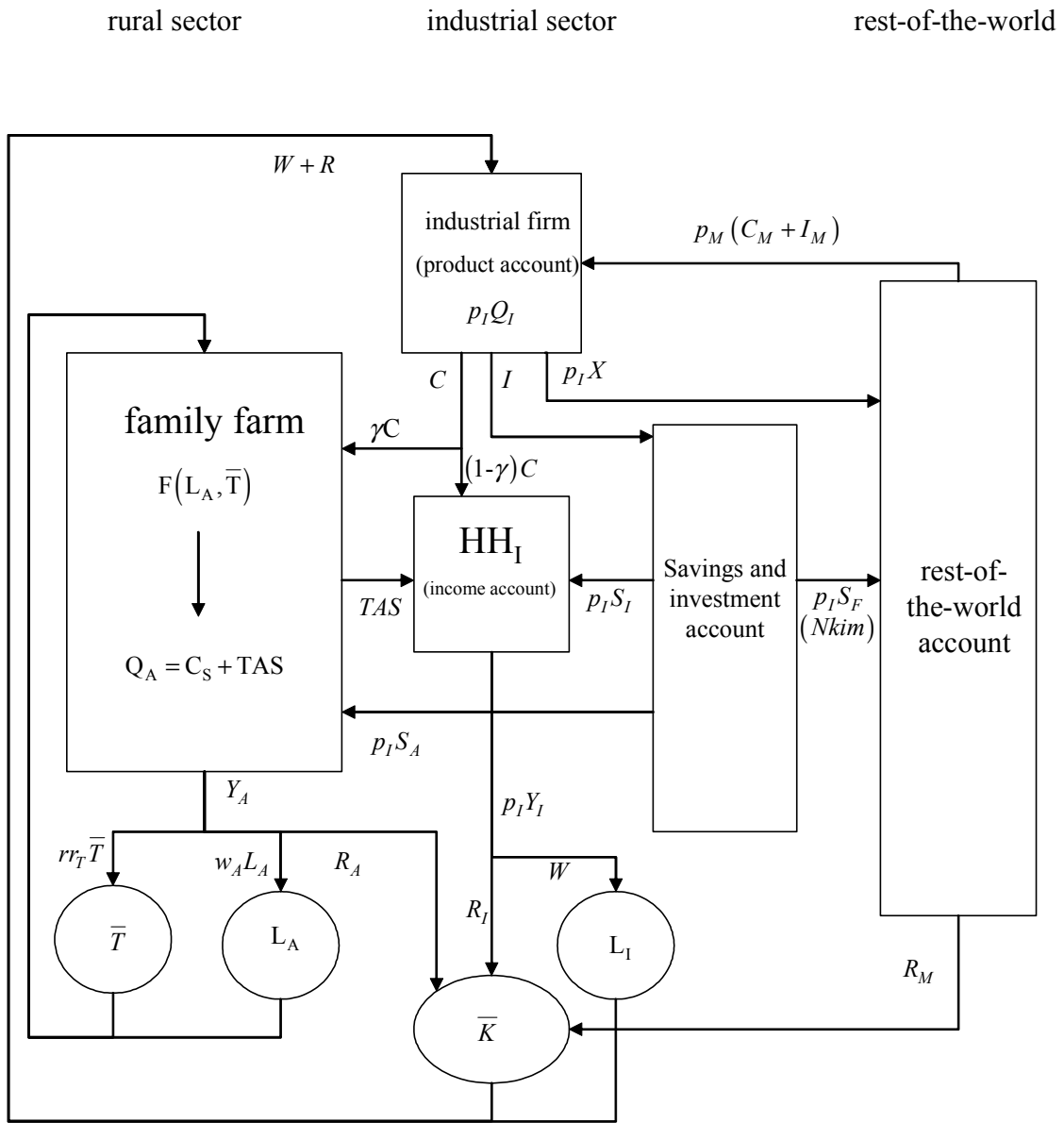
The present paper has dealt with the construction of two related circular flow systems²⁷ in an open LDC-context, including two completed domestic sectors. Differences between both frameworks are found according to their saving assumptions and the industrial sector's product type. Since in the OAE-context domestic residents do not save at all, in the ODE-context they save in both sectors. Furthermore, within the OAE-framework, the whole industrial production is exported, while the latter case suggests that at least one part of industrial home production is demanded by domestic residents as well.

Beyond these two frameworks, other variations seem to be reasonable, for instance the assumption that only industrial sector's households are able to generate savings.

The resulting basic equations may be used as the foundation for more sophisticated macroeconomic LDC-models, concerning intersectoral and international questions.

²⁷ Both circular flow systems are broadly founded on Fei, J.C.H./Ranis, G. (1997) and Ranis, G. (1988).

Figure 2: Circular flow of an open dual economy



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Part II:

Research on the Albanian Economy

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Albania and its Monetary Transmission Mechanism.

Introduction

In theory are mentioned different monetary transmission channels through which monetary policy can affect economy. Let's try to understand if any of the theoretical monetary transmission mechanism channels is the right channel that permitted Albania to achieve low inflation.

By the beginning of 1996 Albania was one of the countries of Eastern Europe that had the lowest inflation, and after the crisis of 1997 and Kosovo crisis it achieved again low inflation.

In the conditions of an undeveloped financial market, some monetary transmission channels can't influence the economy. For example lending bank channel can't be studied because in Albania during the period 1992-november 1999 BoA implemented the accreditation of upper limited loans for secondary level banks. Knowing these conditions in this paper will be studied only two channels that can fit very well to the Albanian economy. These are **interest rate channel** and **exchange rate channel**. [Bank of Albania]¹

1 Interest rate channel.

The interest rate is one of the instruments through which Bank of Albania (BoA) can affect the economy and actually in Albania it fixes the interest rate through weekly or daily auctions of repo (repurchasing public offers) that are repurchasing agreements between BoA and secondary level banks for the treasury bonds. Three main effects compose the interest rate channel: [Bank of Albania]²

- 1.1 Housing and other consumer expenditures effects.
- 1.2 Business investment effects.
- 1.3 Liquidity effects.

1.1 Housing and other consumer expenditures effects.

In other economies this effect is reported to be very important. Interest rates channel affects housing and other consumers' expenditures. What is going on in Albania?

Actually in Albania residential investments and consumer durable expenditures have a real boom. Demographic movement, the desire for a more comfortable life, the increase of the individual incomes, are main factors that caused this situation.

In Albania banks don't credit households for buying houses or they apply a very high interest rate. It is known that interest rate normally is the cost of buying a house. From 1992 when the interest rates were very high till 1996 when the interest rates decreased gradually, residential investments grew up very quickly. During the period 1996-1997, when pyramidal schemes were very strong we saw a very strange phenomena happening

¹ Source: Economic Bulletin, Bank of Albania

² Bank of Albania

in our country. A lot of people sold their houses and put their money in these schemes that offered fantastic interest rates. During this period, Bank of Albania was quite cutted out. Secondary level banks increased their interest rates till 32% but people didn't put their money in the banks. The factors that influenced the action of the people were very high interest rates offered by pyramidal schemes (60-100%), the absence of an economic education of the people in general, political and social situation etc.

After the crisis of 1997 the demand for houses increased again and BoA followed a constant and gradual policy of decreasing the interest rates. During 2000 residential investments were still very high.

The above description of the situation is only a partial one because Albania has very specific conditions. BoA, during the period 1992-november 1999 has implemented the accreditation of upper limited loans for secondary level banks and in the period 1997-november 1999 has forbidden to the state owned banks to credit the economy through any kind of loan or mortgage. So, where did the Albanian found the money?

The biggest sources of this money are emigrants because they are nearly 20% of our population. Their annually remittances are very high and this big amount of currency that enter in Albania gives to the emigrants families the possibility to improve their standard of life. Another sources of money are unknown incomes that come from underground economy. This happens because many people that are registered as unemployed in realty are employed and don't pay social insurance, which means that they are part of the informal labour market.

As you can see the conclusion is that the effects of housing and other consumer expenditures are irrelevant for the interest rate channel of the monetary transmission mechanism.

1.2 Business investments effects

Businesses finance their investments through borrowing money from banks or other financial institutions. Banks are the main source of funds especially for small and medium size businesses, which compose 90% of Albanian businesses. As table 1 shows the credit rate is very high. In the table we have annually maturity date credit rates given in % and foreign direct investments given in million US dollars.

Table 1: Credit rates and direct investments in Albania

| YEAR | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|--------------------|------|------|------|------|------|------|------|------|
| Credit rate (%) | 30 | 20 | 21 | 28.8 | 43 | 25 | 25.8 | 23.7 |
| Direct investments | 58 | 52.9 | 70 | 90.1 | 47.5 | 45 | 41.2 | 143 |

Source: INSTAT (Institute of Statistics of Albania)

Foreign direct investments increased in the period 1994-1996 and then decreased during the period 1997-1999. By the end of 2000 foreign direct investments increased immediately due to the privatisation of part of the public sector. There are no data for private domestic investments, which are related with the domestic credit rate that is given in table 1. Foreign direct investments have no connection with the Albanian credit rate.

As a conclusion we may say that in Albania business investment effects on GDP and inflation can't be measured because there are no data for private domestic investments.

1.3 Liquidity effects

These effects are connected with the creation of household's portfolio. In Albania cash money is the main financial asset that compose households portfolio and only few of the households are affected from actions that have to do with liquidity. For example: When inflation increases households should maintain fewer assets that can be affected from inflation and should maintain more assets like: land, durable items (automobiles or houses). So in Albania there are no conditions to create a portfolio like theory says because:

- Albania still doesn't have private financial assets that are assets issued from private enterprises with the aim to finance their investments.
- Treasury bonds issued to finance the budget deficit are the only financial assets and Savings Bank, which is the biggest bank in Albania (still state owned) is a monopoly in the treasury bonds market because it purchases quite 70% of this assets in the auctions organised by Bank of Albania.
- Secondary market isn't developed. To purchase and sell treasury bonds people have to go to any of the secondary level banks and to ask how to do it. This is an additive cost because of the non-availability of the information that has to do with the treasury bonds.
- After the bad experience of 1996-1997, many people have lost their trust on banks and other financial institutions.
- Only cash composes portfolio of the major part of the population.

Interest rate channel effects in the monetary transmission mechanism aren't very clear. To study this effects completely is needed to be fulfilled some conditions like:

- The widespread of secondary level banks in all the territory of Albania. This will encourage the further increase of the transactions.
- Creation and development of other financial institutions.
- The development of stock exchange market.
- The increase of the amount of information related to the banking system. This must be done because many people are unclear or don't have information at all about the way they can put their money in banks.

So liquidity effects are quite inexistent because in Albania don't exist the conditions that can permit to households the creation of a portfolio with different financial assets.

2 Exchange rate channel.

In Albania exchange rate channel is very important in determining the inflation because it has both a direct explicit effect on CPI (the big amount of goods imported) and another strong implicit effect on CPI that is caused from the big amount of currency used in everyday transactions. Judging from the structure of our economy, the exchange

rate affects short and long run inflation. One of the factors that make the exchange rate so important is that banks prefer to credit the economy only in foreign currency. The exchange rate influences both production (real exchange rate channel) and inflation (import prices channel).

Most of businesses and households prefer to convert their savings of lek (Albanian currency) in foreign currency. In this way they avoid the exchange rate risk. Knowing this fact can be said that monetary policy has a very weak effect on both direct channels of exchange rates (import prices channel and real exchange rate channel).

To forecast inflation in Albania is used exchange rates, monetary aggregates and dummy variables.

Nominal exchange rate is more effective in influencing inflation and production because:

- ❖ Exchange rate affects import prices and it has a very strong effect because Albanian imports are 30% of GDP. This fact shows that exchange rate affects directly CPI (Consumer Prices Index) and affecting CPI it influences inflation directly.
- ❖ Deutchmark (when it was used) and US dollars are broadly used from the population for savings and transactions. So the exchange rate lek/US dollar and lek/DEM have an important effect on economy.
- ❖ AD is affected from emigrants' remittances. So the overvaluations and undervaluations of LEK affect consumer expenditures.

A previous study (T.Kola, H.Mytkolli, and A.Mançellari) has concluded that:

⇒ Between inflation and exchange rates exists a very strong trade off.

A model that represents this trade off is:

$$INF=A_1e^{(A_2+A_3DNER)NER(-1)}$$

And the empirical estimation is:

$$INF=2.76e^{(1.15+1.08DNER)NER(-1)} \quad \text{where:}$$

DNER is a dummy variable; NER is the exchange rate lek/US dollar.

DNER is 1 when the exchange rate increases and 0 when the exchange rate decreases. In this manner it makes clear the effects of unexpected economic shocks on inflation. So, when the exchange rate increases the reaction rate of the inflation is: $1.15+1.08=2.23$ and when the exchange rate decreases the reaction rate is: $1.15+1.08*0=1.15$

⇒ Changes in the general level of prices are predicted from changes in exchange rate.

⇒ The relationship between the variables is unilateral.

This study is made to show that in Albania exist a strong relationship between inflation and exchange rate. So, the exchange rate is one of the main factors that can be taken in consideration when we need to predict inflation.

Hadëri et al made another very interesting study in this field. They made an econometric analysis through which examined the interrelationships among remittances, money supply growth, the exchange rate (lek/US dollar) and inflation. Inflation is the depended variable and the other variables are explanatory variables. They tried to include even dummy variables but it turned out that these variables were irrelevant in explaining the ongoing of inflation in Albania. One of the conclusions of this study is that exchange rate is one of the main determinants of inflation and this is due to the features of Albanian economy, which include emigrants' remittances and high imports.

On my opinion this study is a good one because it include the main factors that influence the ongoing of inflation in Albania (for further details contact the authors).

To examine inflation is considered lek/US dollar exchange rate and this is due to the huge dollarisation of economy. Even in this paper will be taken under consideration the exchange rate lek/US dollar.

Two channels through which the exchange rate affects short and long run inflation are **real exchange rate channel** and **import prices channel**.

2.1 Real exchange rate channel.

This channel shows how production (GDP) is affected from a change in exchange rate. In Albania, for the major part of the transition period, production activity was quite completely stopped. From 1997 and on as a result of the general stabilisation of Albania, we have had some big investments from different firms like AM Group, VODAFONE. Also the privatisation of the public sector is on a good way. This is shown from the successful privatisation of: AMC (Albanian Mobile Communications), National Commercial Bank etc. Exactly here we see the effect of the real exchange rate. Theory says that:

$$R = e \frac{P_{US}}{P_{ALB}} \quad \text{where:}$$

P_{US} are US prices, P_{ALB} are Albanian prices; R – is real exchange rate, e - is nominal exchange rate

Generally in Albania we have had an undervaluation of Lek. Table 2 shows this:

Table 2: The tendency of exchange rate (lek/dollar)

| Year | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---------------|-------|--------|-------|-------|-------|--------|--------|--------|--------|--------|
| Exchange rate | 75.02 | 102.06 | 94.68 | 92.79 | 104.5 | 148.03 | 150.64 | 137.69 | 143.71 | 143.48 |

Source: Bank of Albania

Exchange rate is very sensible to the economy shocks. So before the '90-s it was 7lek/dollar and during 1992 when Albania was moving to market economy it became 75.03lek/dollar. After the crisis of 1997, lek was undervalued immediately and the exchange rate was 148.03 lek. During Kosovo crisis lek was overvalued and the exchange rate was 137.69 lek/US dollar. This happened because there was a surplus of US dollar supply that resulted from the big amount of foreign currency that came in Albania from Kosovars and different humanity international organisations, which helped our country to pass through this crisis successfully.

In Albania the major part of the transactions is made in US dollars and this fact shows us that transactions are sensible on changes in exchange rates. In theory Central Bank affects the exchange rate by changing the domestic interest rate. In Albania knowing

that the financial system isn't developed well, this kind of operation isn't effective. When is needed to affect the exchange rate BoA has to interfere directly to the foreign currency market.

So if domestic interest rate (for the deposits) increases, deposits in lek will get more preferred. The demand for lek will increase and lek will overvalue. Investment costs will increase and the investors will postpone their investments for the future. This will lead in a decrease of AD, production (GDP) and an increase of unemployment.

The increase of exchange rates and inflation are accompanied with the growth of interest rates and as a result with the slowing down of the investments, especially long-run investments and those related with the production activity.

2.2 Import prices channel

Albanian economy is depended from imports because 60% of the consumption goods are imported goods. As we see from the table imports are much bigger than exports.

Table 3: Exports and imports in Albania (million dollars)

| Year | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---------|-------|-------|-------|-------|-------|------|------|------|
| Imports | 601.6 | 601 | 679.8 | 922 | 693.5 | 812 | 938 | 1022 |
| Exports | 111.7 | 141.3 | 204.8 | 243.7 | 158.6 | 208 | 275 | 330 |

Source: Ministry of Finance

This means that Albanian economy becomes very sensitive on changes of imported goods prices. So the increase of the import prices affects our economy through the increase in the general price level. This is called the imported inflation and a very important factor that causes it is the change in exchange rates.

In Albania we have flexible exchange rates. When lek is undervalued so exchange rate (lek/dollar) increases, Albanian goods became cheaper and exports increase. But at the other side imports became dearer. So the imported inflation increases. But when the exchange rate is overvalued then we have a decrease of the imported inflation. Is proved from previous studies (Bank of Albania) that between exchange rates and imports exists a very strong trade-off.

Another factor that affects inflation are the speculations made by shopkeepers because even a small and unimportant shock of the economy causes the increase of prices of good that have nothing to do with import. The exchange rate is not strongly affected by the interest rate but it's affected by some other factors such as the geo-political situation in the region, power crisis, and the unexpected shocks of the economy.

When the exchange rate changes from these factors it by its turn affects inflation. For example the oil shock on December 2000 led in an increase of oil prices and an increase of inflation.

As a conclusion it can be said that import prices channel, knowing the features of the Albanian economy, is an important channel of the Albanian monetary transmission mechanism.

Conclusions

Monetary policy actions can be transmitted at the economy through the different channels of the monetary transmission mechanism.

From the two channels studied in this paper the most important is the exchange rate channel. Its importance derives from the features of the Albanian economy. Albania is a country that depends on imports. Also 20% of its population are emigrants and their annually remittances are brought in the country in foreign currencies.

Also banking sector prefers to credit the economy only in foreign currencies because in this way it avoids the exchange rate risk.

This paper has just described how the theoretical monetary transmission channels work in Albania and I think that it is only the beginning because this field is a large one and a lot of other studies can be done. These studies may be done to test the effectiveness of the monetary policy instruments and to try finding a trade off between inflation and other variables that may influence inflation through a clear monetary transmission channel.

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The Countries of the Region and the Challenge of Economic Integration

Introduction

The advantages of economic integration are widely emphasized by economic theory. As one of the country of Balkan Peninsula, Albania accepts optimistically any opportunity of economic integration and, in particular of region cooperation. In the region, political “variables” are often inextricably entwined with economic ones, data are often contradictory and the economic policies of the countries involved are not homogenous. These difficulties are due to a series of social, historical and political factors that are linked with the past and the present of the region, one of the most complex in Europe. “Yesterday the ‘powder keg ‘of Europe, today a jigsaw puzzle of small states which -except for Greece- as they emerge from half a century of being part of the “socialist camp”, seem to rediscover the need to assert their national identities through interethnic quarrels and archaic border claims”. [Castellan G., Histoire des Balkans, Paris, Fayard, 1991]¹

This political and social view of the region makes one accept the idea that the element that can smooth the above obstacles is increase in economic cooperation. This cooperation should initially lead to more intense trade exchanges among the countries in the region.

The purpose of this paper is to argue some options for possible future cooperation in region as a first step to the European integration process.

1. Regional integration

The regional integration is considered as the first phase of the overall integration process.[Minxhozi, Muco: “Issue and opportunities for future economic cooperation in Balkans”]² Albania is committed to contribute by all means to the political, economic and institutional regional cooperation. In this respect, we are convinced that this process will soon create a new climate for economic relations among our countries for the development of trade and investment, factors crucial to economic restructuring and modernization.

The future of Albania relies on our membership to international political and economic organization. The accession to the World Trade Organization reconfirms that Albania is a serious country seeking integration in all pan-European and Euro-Atlantic structures. It has agreed to assume its WTO obligations upon accession. We believe that, by encouraging the trade links between countries, this membership can help foster greater peace, stability and development in southeast Europe community.

Increasing trade relations with neighboring countries and the fulfillment of our further trade liberalization and facilitation within the region will be realized through steps

¹ Castellan G., Histoire des Balkans, Paris, Fayard, 1991.

² See Minxhozi, Muco: “Issue and opportunities for future economic co-operation in the Balkans”.

within the Stabilization and Association Agreement process, which is the immediate target of the Government.

It has prompted the launching by the international community of a major new initiative the “Stability Pact for South-Eastern Europe”. This aims to support countries in south-eastern Europe in their efforts to foster peace, democracy respect for human rights and economic prosperity in order to achieve stability in the whole region.[Progress Report of the Stability Pact 2001]³

The economic integration of the region, within itself and into the European and world economies, is a central objective under the Pact. The EU appointed a Special Coordinator for the Stability Pact. The Pact’s main organizational structure is the South-East European Regional Table, which meets periodically, bringing together representatives of the participant countries. The Regional Table reviews progress in implementing the Pact’s projects and initiatives and provides guidance for advancing its objectives. The Regional Table ensures coordination among three working tables on democracy, economic reconstruction and security.

In the context of the Pact, the EU has launched a Stability and Association Process. This focuses on progressive integration into EU structures as a way of promoting regional cooperation, security and development. Its main instrument will be “Stability and Association Agreements”. The process offers the eventual prospect of EU membership, and may therefore improve the confidence of foreign investors in the stability of the policy and administrative environment.

Details of the agreements remain sketchy partly because they are to be tailored to each country’s initial conditions. Albania Croatia, FRY and FYR Macedonia are in principle eligible. Condition for opening negotiations relate to democracy, rule of law, human rights, economic reform, good neighbourly relations and compliance with the Dayton Accord (for Croatia and FRY). It is likely that negotiations will begin first with FRY Macedonia and Albania.

The first country to sign a SAA was FYR Macedonia in April 2001. Over the past two years it has been one of the fastest reforming countries with significant progress being made on privatisation, banking reform and institutional reform, including competition laws.

Croatia and Albania are following closely in the SSA process. Croatia was already relatively advanced in reform and therefore was able to move quickly in January 2000. It signed the agreement in October 2001 and is well positioned compared with other countries. Albania has made substantial gains in institutional strengthening since 1999 as shown by two peaceful nation-wide elections (local and parliamentary) in past two years. It is now negotiating an SAA.

2. A comparative analysis of regional countries

In this analysis I have taken into consideration the following six countries that are part of Balkan Peninsula. I consider important to analyse; Albania, Bulgaria, Croatia, FYR Macedonia, Romania and Slovenia.

³ Progress Report of the Stability Pact 2001.

The aim of this factor analysis [Dumani “Natalite et development socio-economique en Albani”,1995]⁴ consist in the possibility to find a relationship between variables, to better understand the dimensions that variables take and finally the relation with the development of the region.

For this reason, I have taken into consideration ten different economic variables from different sector of economy like: agriculture, industry, trade, external sector, governmental sector, employment and some important macroeconomic indicators.

The selection of these economic variables is done for some purposes

- to study the level of development of these countries
- to see if this development is concentrate only in one economic variable, in two variables or more.
- to asses the degree of similarity and the future possibility for co-operation with each other.

Table 1 Figures for the year 2001 for each country

| Country | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|----------------|------|------|------|-------|------|------|------|-------|------|-----|
| Albania | 1094 | 11.5 | 51 | 35.3 | 16.8 | 141 | 27.5 | 146.7 | 31.4 | 0.1 |
| Bulgaria | 1476 | 25.1 | 13.4 | 90.1 | 17.9 | 1000 | 86.4 | 148.3 | 44.5 | 9.9 |
| Croatia | 4179 | 22.3 | 8.1 | 60.8 | 16.1 | 827 | 57.2 | 125.7 | 47.3 | 6.2 |
| FYR Macedon | 1686 | 21 | 9.5 | 98.9 | 32.1 | 169 | 46 | 99 | 37.8 | 9.2 |
| Romania | 1644 | 27.6 | 11.4 | 61 | 10.5 | 1009 | 27 | 81.7 | 35.1 | 46 |
| Slovenia | 9073 | 27.7 | 2.9 | 103.5 | 7.2 | 110 | 34.3 | 58.1 | 44.1 | 8.9 |

Source:EBRD Transition Report 2001

1-GDP per capita (US \$); 2-Share of industry in GDP (in percent)
 3-Share of agriculture in GDP (in percent); 4-Share of trade in GDP (in percent)
 5-Unemployment (annual average); 6-Foreign direct investment, net
 7-External debt/GDP (in percent);
 8-External debt/exports of goods and services (in percent)
 9-General government expenditure; 10-Inflation (annual average)

In Table 1 are presented the data for each country. There are analysed six countries and 10 variables. It is important to stress that analysing the table [IMF, “Albania”, in IMF Economic Reviews, May-August 1999, EBRD, Transition Reports 2001, Human Development Report 2000.]⁵ or different variables shown different classification of the countries. For example the first variable, GDP per capita, Slovenia is in the first place because has a high level of GDP per capita and Albania is the last because has a low level.

From another variable for example inflation is Romania in the last place because has a high value of inflation rate.

⁴ For a detailed explanation of the model see: Dumani ”Natalite et development socio-economique en Albani”,1995.

⁵ Data are drawn from: IMF, “Albania”, in IMF Economic Reviews, May-August 1999, EBRD, Transition Reports 2001, Human Development Report 2000.

And if I should continue with each variable, I could find different classification. But the problems come if all variables are including in one, which is the classification of the countries of region? This question finds answer in the next analysis.

First of all taking the results from analysis (table 2) is important to stress that component one is more important than the others because it explain 41,3% of variance. Component two explain 24% of variance. Component three 20% of variance and component four 11.9% of variance. The four components together explain 97,5% of cumulative variance.

Table 2. Total variance explained

| Component | Initial Eigenvalues | | | Extraction Sums of Squared Loadings | | |
|-----------|---------------------|---------------|--------------|-------------------------------------|---------------|--------------|
| | Total | % of Variance | Cumulative % | Total | % of Variance | Cumulative % |
| 1 | 4,13022 | 41,3022 | 41,3022 | 4,13022 | 41,3022 | 41,3022 |
| 2 | 2,406112 | 24,06112 | 65,36332 | 2,406112 | 24,06112 | 65,36332 |
| 3 | 2,023696 | 20,23696 | 85,60028 | 2,023696 | 20,23696 | 85,60028 |
| 4 | 1,195516 | 11,95516 | 97,55544 | 1,195516 | 11,95516 | 97,55544 |
| 5 | 0,244456 | 2,444562 | 100 | | | |
| 6 | 2,54E-16 | 2,54E-15 | 100 | | | |
| 7 | 6,36E-17 | 6,36E-16 | 100 | | | |
| 8 | -1,5E-17 | -1,5E-16 | 100 | | | |
| 9 | -1E-16 | -1E-15 | 100 | | | |
| 10 | -2,9E-16 | -2,9E-15 | 100 | | | |

Extraction Method: Principal Component Analysis

This fact shows that 10 variables are dimensioned in four important components or I can say that these countries have development in four components in which the first one is more important because explain a great part of variance. In table 3 is shown the component matrix and in the first component are included: Share of agriculture in GDP (in percent), external debt/exports of goods and services (in percent), GDP per capita, general government expenditure, share of industry in GDP (in per cent) and share of trade in GDP (in percent). In the second component is included only external debt/GDP (in percent). In the third component are included: foreign direct investment, net and inflation and in the fourth component is included only unemployment.

Table 3. Component Matrix

| | Component | | | |
|----------|-----------|----------|----------|----------|
| | 1 | 2 | 3 | 4 |
| AGRIC | -0,94381 | -0,15036 | -0,00852 | -0,21553 |
| EX_D.EXP | -0,68634 | 0,677576 | 0,09883 | -0,23813 |
| EXT_DEB | 0,217968 | 0,958496 | 0,003584 | -0,0659 |
| T | | | | |
| FDI | 0,253862 | 0,459569 | 0,833926 | -0,1559 |
| GDP_C | 0,680646 | -0,3481 | -0,50513 | -0,39862 |
| GOV_EXP | 0,706666 | 0,541495 | -0,21823 | -0,34507 |
| IND | 0,947704 | -0,00522 | 0,291522 | 0,077631 |
| INFL | 0,334352 | -0,36494 | 0,822777 | 0,278993 |
| TRADE | 0,743164 | 0,194569 | -0,41589 | 0,405417 |
| UNEMPL | -0,36268 | 0,457189 | -0,2841 | 0,733151 |

Extraction Method: Principal Component Analysis.

This data are taken from table 3 based on the correlation coefficients between variables and components.

From this short analyses, it show clearly that the economic variables are dispersed in different components (exactly four) and show another time that the economic development of these countries doesn't consist in the same dimension or these countries are in different directions. They are development in one sector, and less in the other one. And this means that they have much to do to co-operate with each other and they have much to do in the difficult way of European Union.

It is interesting to know the grouping of six countries that shown similar development. (table 4). If they will be arranged in groups I distinguish four important one. In the first group is Albania and FYR Macedonia. In the second group is Bulgaria and Romania. In the third is Croatia and in the fourth group is Slovenia, which is more developed than the other countries.

Table 4. Average Linkage (Between Groups)

| Cluster Membership | 4 Clusters | 3 Clusters | 2 Clusters |
|--------------------|------------|------------|------------|
| Case | | | |
| 1:Albania | 1 | 1 | 1 |
| 2:Bulgaria | 2 | 1 | 1 |
| 3:Croatia | 3 | 2 | 1 |
| 4:Fyrmaced | 1 | 1 | 1 |
| 5:Romania | 2 | 1 | 1 |
| 6:Slovenia | 4 | 3 | 2 |

First of all it is important to stress that Albania have the possibility to co-operate with FYR Macedonia because they are in the same group and have the same development.

And after that Albania has to think about another cooperation with other countries that are more development than US.

I think this result is interesting and important because in reality Albania have concluded a **free trade agreement with Macedonia**. [According the discussion with specialists in Ministry of Economy]⁶ and is working to conclude a free trade agreement with Croatia.

This step consists in a serious effort to open the market through a very constructive way, considering it as one of the main elements of cooperation in the region and integration with EU.

The last round of negotiations with Macedonian side, followed several steps and signing three protocols between both sides, focused on the approval of the agreement on all other issues except reduction on tariffs and rules of origin, which will be under negotiations in the very near future. Related to the tariff systems of our countries, there are some differences.

Albania, because of the WTO membership is represented with a very liberalized system, while Macedonia is applying for the membership, and is undertaking steps to reduce and liberalize its tariff system. We are trying to have approximately the same base, in order to start further staging in time and tariffs rates.

Within this frame, preparing the next round of the negotiations, Ministry of Economic Cooperation and Trade in collaboration with the Ministry of Finance and other line Ministries, are currently studying to estimate the budget implications as a result of the

⁶ According the discussions with specialists in Ministry of Economy.

Free Trade Agreement (FTA), and also, to find out the ways of the compensation related to the expected revenue lost due to such agreement, through

- ✓ shifting from customs revenue to internal taxation revenue, as the main source of the budget account,
- ✓ strengthening and reform in the tax administration,
- ✓ custom control,
- ✓ intensification of the struggle against smuggling, increasing the capacity of custom administrators etc.

Considering that civil society and private sector in particular, are important pillars to implement successfully the strategies, we are intensifying the efforts in having constructive relations between private and public sector. During the last year, with the initiative of the Ministry of Economic Cooperation and Trade, it was established the Consultative Council of Business headed by the Ministry of Economy, which is composed by several representatives of the Business Community.

This structure set up a new area of the cooperation and is reviewing all legal and sub-legal acts that are affecting the trade. The negotiation team on FTA is composed by the representative of this community. In this respect, it is organized a national seminar on understanding of the FTA and discussing the policies that have to be undertaking during this phase, within national frame.

This agreement is actually approved by the Government and the Commissions of the Parliament, and is ready to be ratified by the Parliament.

Within the process of further trade liberalization and facilitation and the custom administrative assistance with neighboring countries, PRO Committee in Albania aims to stimulate the cooperation of the Business Community, to be involved in such a process, with countries of the region and with the border country.

Concluding Remarks

Economic integration in Europe is not an easy process. Moreover cooperation within regions such as the Balkans is hindered by various restriction, due to the economic, political and institutional differences between individual countries. Traditions and historical events have also had an impact on the process. With the long-term aim participation in the E.U, regional integration efforts try to smooth differences and create the conditions for further economic growth in the region. Yet, this is strongly linked with the implementation of economic reforms in individual countries. A cross-comparison of economic data indicates that there is some potential for integration in the Balkan region, despite the obvious difficulties. Albania is strongly interested in becoming integrated into EU as soon as possible, despite the awareness that the process will take time. However, progress in the process of economic transition remains a priority in the short-term and a necessary pre-condition for any integrative effort.

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Progress Report of the Stability Pact 2001

A Review of the Controversies and Evaluation Approaches on the International Monetary Fund's Supported Programs.

1. Introduction

Albania started the reform, abandoning rigid adherence to central planning and economic self-sufficiency, in 1991. It did so, however, in the throes of an economic crisis, which is deeper than that facing virtually any other reforming socialist country. It is clear that IMF recommendations and models have affected stabilisation and growth policies in Albania. This is because, since 1992, the Albanian government has embarked on some macroeconomic stabilisation and structural reform programmes supported by the IMF.

Its presence is notable for other transition economies, also. (See, Table. No.1).

“There has been considerable controversy about the appropriateness of IMF adjustment policies and facilities to the circumstances of the low-income countries and there is evidence that its stand-by programmes in these countries were subject to high failure rates. (Tony Killick, 1995, p. 603) ” On the other hand, the Fund continuously has defended its position. The Fund's Annual Report of 1993 concluded that,

“[the ESAF Enhanced Structural Adjustment Facility (ESAF)] has proved an effective mechanism for Fund involvement in low-income countries...”.

There is a vast literature on the theoretical aspects of the economic modelling underpinning the Fund's supported programs as well as evaluations of their effects in countries which have applied them. This has resulted in a range of critiques of the IMF's philosophy and approach, which offers, also, the criteria for the evaluation of the programs.

One strand of this critique is found in the literature evaluating these programmes in developing countries. “Although there are substantial differences between the countries of Eastern Europe and many of the less developed countries undertaking structural adjustment, there are also lessons that the former can learn from the later. (Killick, 1991)”

Firstly, I present the controversies on the International Monetary Fund. Secondly, some approaches to the evaluation of the programs are introduced. Finally, I present the methodology that I am thinking to use in order to assess the appropriateness of the IMF's supported programmes in Albania and some evidence about the effects of these programs in some transition economies.

2. Controversies on the International Monetary Fund.

For better understanding the criticism on the Fund's supported programmes, it is useful a short description of the most important economic and political factors, which led to the Fund's establishment, as well as, to the deviation of the Fund's role from that it was originally set up for.

As World War II raged across Europe and Asia, the leaders of England and the United States realised that, they would need multilateral institutions in order to improve the international chaos of the 1930s, experienced with high unemployment, hyperinflation, recession and fluctuating exchange rates, and to ensure a liberal, capitalist world economy after the war. The two men, who drafted the foundations for these

international institutions, are Harry Dexter White (member of the US Treasury until 1946, the time he took up the post of the US Executive Director of the Fund) and John Manyard Keynes (Honorary Advisor to the British Treasury in the period 1940 until his death on April, 1946).

The formal negotiations, in Bretton Woods, New Hampshire, USA, July 1944, resulted in what became known as the Bretton Woods Institutions, or the International Financial Institutions, with the International Monetary Fund (IMF) among them.

In general, “the International Monetary Fund was established in order to encourage international co-operation to cope with recession and protectionism on a world scale and to discourage individual countries from pursuing policies that would beggar their neighbours and eventually themselves” (Bird 1985). It provided short-term assistance to countries whose currencies were pegged to gold or the US dollar in case they found themselves running short of foreign exchange. In turn, the borrowing country would undertake to pursue policies that were expected to restore its reserves and confidence.

Article 1 of the Articles of Agreement (Articles of Agreement of the IMF) states the Fund’s purposes and policy conditions to its loans.

1. To promote international monetary co-operation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems

2. To facilitate the expansion and balanced growth of the international trade, and to contribute thereby to the promotion and the maintenance of high level of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

3. To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

4. To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

5. To give confidence to members by making the general resources of the Fund temporary available to them under adequate safeguards, thus providing them with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or their international prosperity.

6. In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balance of payments of members.

The Fund shall be guided in all its policies and decisions by the purpose set forth in this article.

“Throughout the 1950s and 1960s there were no many questions asked about the legitimacy of what the Fund was doing. At least superficially, the Fund appeared to be successful in achieving the objectives it has been set. (Bird 1995)”.

The circumstances in 1970s affected the Fund activities in two ways. On one hand, in September 1971, all the world’s currencies were floated and the Bretton Wood system broken down. Many doubted the rationale for the IMF, finding it with little or no

systemic role, as the Fund's charge was the monitoring of this system. On the other hand, the Third World countries experienced a deep indebtedness, caused mostly by the two oil shocks associated with recession among industrial countries and unfavourable national policies associated with corruption and mismanagement. This shifted the focus of the Fund's conditions to its financing sharply towards adjustment in the borrowing country. "In an attempt to deal with the deepening crisis of the budget deficits, falling revenues, chronic balance-of-payments problems, gradual decay of infrastructures as well as social welfare facilities, many of these countries experimented IMF and World Bank structural adjustment programmes. (Mohan et al. 2000)" During the 1970s the IMF had continued to make a few relatively large loans to a limited number of industrial countries (Italy and United Kingdom), but beyond the mid-1970s industrial countries ceased to draw any resources from it.

The last decade, a new group of countries were added to the borrowers list of the Fund - East European and former Soviet Union countries - in their transition to market economies.

Recently, some of the more advanced developing countries like Indonesia, South Korea and Thailand, in 1997/98, Brazil in 1998, experienced deep financial crises while attempting to liberalise their economies toward globalisation. "These crises have resulted in demands on the IMF and World Bank for financial assistance for purposes other than those for which their assistance was originally designed. (Mikesell, 2000)"

Critiques on the Fund.

Economic, political, and social changes in the world have brought, also, changes in the environment the IMF operates. They have, also, contributed in the controversies surrounding the IMF's policies. Below, I will present some of the most discussed controversies, focusing especially on the critiques to the role of IMF in developing countries.

As Nowzad (1981) notes, in the period 1970-1980, the main charges which stemmed from developed countries were directed to the Fund's tendency to behave like a development finance agency, and that consequently failing to fulfil its proper role as the centre of the world monetary system. In this context, the loss of its systemic role, after the Bretton Woods system broke down, was seen as sufficient reason to close it down.

Another contested feature was the Fund intrusiveness on the borrower country sovereignty, by overextending its policy conditions or by lending to countries that could perfectly well borrow from the commercial banks instead (Mohan et al, 2000).

Schwartz (1998), agrees with the Fund that balance of payments problems of underdeveloped or developing countries have structural roots, but suggests that the Fund should refrain from dealing with them, reducing the scope of intervention. The Meltzer Report and the U.S. Treasury Report sustain this also, both sharing the idea that the expansion of the IMF intervention with long-term structural reform programs have not worked as expected. The principal source of this inefficiency, is seen the supposed 'moral hazard' associated with the Fund's lending. To put it simply, the borrower country wont be determined to pursue thoroughly the right measures to their balance of payments problem, as they are attracted by the possibility of having finance from the Fund at subsidised and concessionaire rates.

From the other side, analysts of the programs in developing countries have argued that the Fund was behaving as an inappropriate development agency and that its supported policies did more harms than good, particularly to the poorest of them.

As Williamson (1983) notes, the traditional criticisms where that the Fund adopts a doctrinaire monetarist approach which is insensitive to the individual situations of

borrowing countries; imposes onerous conditions; is ideologically biased in favour of free markets and against socialism and that it overrides national sovereignty and perpetuates dependency.

These points are briefly elaborated below.

The Fund employs a 'monetarist' framework for economic analysis. This general 'philosophy' has been the subject of much disapproval. As Nowzad (1981) points out, the approach of the institution to its members, its analytic approach to economic problems, its assumptions regarding causative factors, and its modus operandi are subject of debate too, as they are directly affected by the Fund's philosophy.

The critics argue that the monetary framework yields uniform and rigid conclusions regarding the content and timing of programs and therefore a "standard package" incorporating elements that it applies to all countries in all circumstances.

This inflexibility is illustrated with the Fund's balance-of-payments policies. The Fund often fails to distinguish between exogenously and endogenously caused balance-of-payments problems. "By applying, in a dogmatic way, the monetary approach to balance-of-payments problem, the Fund treats it as mainly caused by "expansionary financial policies mainly associated with large budgetary deficits and /or from a complex of cost-push factors and expectations. (Dale, 1983)". This in turn leads to a wrong medicine prescription for the problem and to a fierce conditionality for its financing, as the Fund will require the borrowing government to undertake measures even if the causes are actually external and beyond its means.

At this point it is useful to refer to "structuralist" critique on the Fund response to the balance-of-payments problem. Taking into account certain structural characteristics of the developing countries, they assess, that balance-of payments problems in the Third World often arise from the characteristics of the development process itself. They call it a "development deficit", which is not primarily the result of countries "misbehaving", but it is aggravated mainly by external factors. "If this is the case, 'developing countries should not be "punished" for deficits with monetary contraction and other measures embodied in Fund programs (Pastor, 1987)", rather "an enlarged flow of international assistance is the more appropriate policy response, i.e. finance rather than adjustment (Killick et al, 1992)".

Fund programmes, thus, are seen as neglecting the supply side causes of payments difficulties and economic growth prospects.

Stiglitz, 2001, gives an example of the Fund's 'a one-size-fits-all approach' and intellectual incoherence displayed throughout the management of the Asian financial crisis. He argues that, although the Fund recognised the key factor of the crisis to be financial institutions, its staff continued to use outdated macromodels that did an inadequate job of incorporating the financial sector. He further stress the fact that the Fund did not consider the widespread discussion in the USA of how the failure of much more sophisticated models used by the US Federal Reserve had led to inadequate policy responses.

De Carvalho et al, 2001, assessing the strategy of the Fund in the recent Asian crisis, comes out with the same argument as Stiglitz. He notes that, 'the Fund did recognise the structural specifics of Asian economies, nevertheless, the short term adjustment policies the fund recommended were, somewhat surprisingly, identical to those proposed to conventional cases of excess demand imbalances'.

The above argument supports another critique stating that the conditionality attached to the programs undermines program ownership. The IMF is criticised for not considering

that the authorities of the borrowing country are much more informed about social and political priorities of their country. The conditionality often imposed, so wide ranging and with micro-managed structural policy recommendations, is perceived costly by the developing countries, therefore many of them try to avoid borrowing from the Fund during crisis. They are reluctant, partly because they fear that the acceptance of such conditions will undermine the political base of the government and drive it from office. Therefore, current methods of conditionality, urging greater selectivity in support of locally initiated or "owned" programs are suggested.

The Fund policy conditions are seen as "harsh", detailed, lacking a clear economic rationale, and frequently self-defeating. These could be some of the reasons for the evaluation of the IMF's programs as unwidely, highly conflictive, time consuming to negotiate, and often ineffectual.

The Fund's approach is characterised as market fundamentalism, which implies firstly, a weakened labour power and secondly, removal of the state from the key sectors of the economy.

Anderson, 2001, argues that the so-called "labour market flexibility", promoted by both IMF and WB, makes it easier to fire workers or to undermine the ability of unions to represent their members. Analysing the financial crisis in the mid-1997, it is pointed out that although reckless international investors and domestic banks caused the crises, the costs were borne by the workers.

The state is seen as inefficient in resource allocation. But, as Stiglitz, 2001, points out, 'the arguments concerning governmental inefficiency and incompetence hold equal or stronger force at the international level than they do at the national level...the IMF's economists would expect an international governmental body such as itself to be a market failure.' Polanyi, 1960, underlines the ironic side of Fund's approach to posit the 'freedom' of markets and the limited use of state power by massive amounts of political interference (structural adjustment programmes. Mohan, 2000"

The Fund is sometime seen as an institution that serves to impose the vision of the world held by its more influential members on its other members, and/or as a device by which the rich countries increase their power over the poor. The key elements that help in this are its rigid approach together with its doctrinaire philosophical underpinnings. Often the Fund appears to be a bill collector for lending nations. It ensures that the borrowing countries will be in able to repay the loans by keeping a overvalued exchange rate, in order to achieve a massive trade surplus as quickly as possible and regardless of the costs.

As can be noticed, a great emphasise is put on the effects of Fund-supported programs in the economic development of the borrower country. Many of the arguments offer a growth-oriented critique. The growth oriented critique; contends that Fund-supported stabilisation programs have short-run recessionary impacts, damaging the prospects for long-run growth and poverty reduction because the policies adopted in a short-term stabilisation program, aim primarily the restoration of the balance of payments viability and stabilisation and therefore are too much deflationary.

The evidence brought in support to this critique is the fact that most of the growth rates, of the countries that have been under IMF supported programmes, were negative. The Fund counter argument, as showed by Guitan, 1980, is that its programs build the bases for sound and sustained economic growth rates, by improving the BoP and bringing the inflationary pressures under control.

Pastor, 1987, argues against growth-oriented critique and recast the criticism of the Fund in terms of class and income distribution. Mikesell, 2000 makes this point also when analysing the Asian crises. He recognises that the Fund loan conditions do not proposed 'priority actions' aiming the protection of the poor during financial crises.

Another sort of critique has to do with the existence of two institutions, IMF and World Bank (WB), making the same kinds of loans to the same countries i.e., the long-term facility for poverty reduction and growth (PRGF). This overlap of their activities has led to the suggestion that the WB functions should be taken over by the IMF.

The arguments showed above and others have lead to a wide debate for reforms on the international financial architecture, including the IMF.

3. Alternative approaches to estimate the effects of Fund-supported programs.

The approaches to measure the effects of the Fund-supported programs suggested in the literature and elaborated by Haque et al (1998) and Killick et al (1992) are presented below.

1. *The before-after approach.* It compares the macroeconomic performance under the program (or after it has been initiated) and performance prior to the program. Although it is easy to calculate, the approach carries important problems, too. The estimation of program effects will typically be biased and unsystematic over time. They will be biased because this approach incorrectly attributes all of the change in outcomes between the pre-program and program periods to program factors. They will also vary over time, because the estimated program effects for a given year will be dominated by specific non-program influences of that year.

This approach is a poor estimator of the ideal counterfactual, since it assumes a counterfactual in which policies and the external environment would have remained constant at their pre-program values.

2. *The with-without approach.* It is designed to overcome the inability of the before-after approach to distinguish between program and non-program determinants of macroeconomic outcomes. Firstly a control-group is determined, with non-program countries that are subject to the same non-program determinants as the program countries. Then, before-after changes in macroeconomic outcomes are compared. The effects of external factors will cancel out leaving the difference between the groups performance to reflect only the effects of Fund-supported programs.

The problem with this approach is that program countries do differ systematically from non-program countries prior to the start of the program. This because, program countries are not randomly selected - the country seeking for the Fund financial support has a balance of payments need. Therefore, the estimates from this approach will be biased.

3. *The generalised evaluation estimator.* This approach is a with-without approach modified in two ways. Firstly, it accepts the non-random selection of program countries, identifies the specific differences between program and non-program countries in the pre-program period, and then controls for this differences while comparing economic performances. Secondly, it attempts to capture the effects of policy and other variables

on the macroeconomic outcomes, taking into account how policies would have evolved in the absence of a program.

For the best estimates with this approach, the initial conditions and a range of empirical relationships have to be determined and a substantial amount of data to be provided.

Its estimates are likely to be less biased than those of the first two approaches.

4. *The comparison of simulations approach.* It does not determine program effects from actual macroeconomic outcomes in program countries. It relies in simulations of econometric models to infer the hypothetical performance of policies included in a Fund-supported program and an alternative policy package. The problem with this approach is its need for an econometric model that incorporates the relations between various policies and certain important macroeconomic variables, which remains yet unresolved.

These approaches are used in many empirical studies examining the programmes' effects on a range of economic indicators. Pastor, 1987, applying the before after approach, in a sample of 18 countries, finds a positive effect of the program in the balance of payments, but no effect on current account. He also argues against the growth-oriented critique and recasts the criticism in terms of class and income distribution. Killick, 1995, uses the before after approach for a sample of 16 countries. He essentially comes out with the findings of IMF staff (such as the paper by Schadler et al, 1995) regarding improvements in the external situation of the borrowing country but is sceptical that IMF programs have much effect on policies, except with respect to exchange rate. Generally, the empirical evidence shows that the programs do not significantly influence indicators like growth and inflation.

Goldstein et al (1986) find negative effect of the programs in the balance of payments and current account, while Khan (1990) using the same method of generalised evaluation shows a positive relationship even though significant only at 5%.

From the discussion above it is clear that the evidence and the conclusions are mixed living room for further studies on this matter.

4. My Approach to Program Evaluation.

In order to play the role of policy adviser for the borrowing country, along with its financing role, the Fund must have a robust understanding of issues concerning the balance of payments problems. These issues comprise the identification of the formal relationships between the balance of payments, money, prices and growth. Therefore the use of macroeconomic and econometric model becomes an integrated point of the design of the Fund-supported programs, as they define the appropriate policy instruments consistent with the achievement of specific objectives of the program.

The Fund financial programming, known also as the IMF's approach to economic stabilisation, is based to a large extent on the models developed in the Fund, at the end of the 1950s, particularly, the studies by J. J. Polak and E. Walter. Robichek.

As Polak, 1997, puts it, the model appears "to be still very much alive 30 or 40 years later", as many studies from the IMF staff are devoted to this model and its policy implications¹

¹ The documents referred by Polak (1997) are the IMF Occasional Paper No. 50, attributed to eight senior staff members of the research Department and entitled *Theoretical Aspects of the Design of Fund-Supported Programs*, 1987, and a workbook prepared as a training manual in the Fund's Institute: *Financial Programming and Policy: The Case of Sri Lanka*, 1996.

Killick, 1995, points out a critique often made on this monetary model. It is suggested that the assumptions about the effectiveness of monetary policy implicit in the Fund financial programming model are questionable in the conditions of low-income countries.

Below we will introduce the monetary model and distinguish the hypothesis to be tested. The test of this hypothesis, referring to Albania and possibly panel data from some transition economies, will be the focus of the forthcoming work.

The model was designed to study the effects on both income formation and the balance of payments of the two most important variables: autonomous changes in exports and the creation of bank credit, which then could be used for policy purposes.

The model contains two behavioural and three definitional equations:

1. $\Delta MO = k \Delta Y$
2. $M = m Y$
3. $\Delta MO \equiv \Delta Md$
4. $\Delta MO \equiv \Delta R + \Delta D$, which is transformed as follows:
 $\Delta R \equiv \Delta MO - \Delta D \equiv \Delta Md - \Delta D \equiv f(\Delta y, \Delta P, \dots) - \Delta D$

by explicitly including other elements of the absorption approach and the monetary approach to the balance of payments, such as income and expenditure relationships and the role of private capital movements, it can be further transformed as: $Y - A + \Delta K = \Delta M - \Delta D$.

It tells that absorption will exceed the sum of the supply of domestic income and foreign savings when the change in domestic credit exceeds the change in the money stock.

5. $\Delta R \equiv X - M + K$

where,

MO = money supply

Md = money demand

Y = nominal GDP

M = imports

R = reserves

D = domestic credit

X = exports

K = net capital inflow of the nonbanking system

k = the inverse of the velocity of circulation of money

m = the marginal propensity to import

Δy = change in real income

ΔP = change in domestic price level

The endogenous variables are ΔR and Y. MO also enters the model endogenously as implied from the monetary approach to the balance of payments when exchange rate is fixed.

The exogenous variables are X, K and ΔD .

Explicit Assumptions on the Model:

1. constant income velocity of money²
2. fixed exchange rate³
3. M_d is a function of a few variables, such as the real income, prices, interest rates and so forth.
4. The variables entering the function of the demand for money are independent of the changes in domestic credit.

The Financial Programming Framework has undergone some modifications, adapting to the changing circumstances in the world economy, which we will briefly introduce below.

The first extension is made in order to take account of the balance of payments so as to specify from what direction the improvement in the balance of payments is coming - via current or capital account, and within current account, via reductions in imports or increase in exports. This is done by adding the behavioural relationship (already showed in the model) of the demand for imports.

The second extension is to link the monetary expansion with the fiscal position of the government. This is done by; (*) discriminating between the expansion of credit to the private sector and that to the public sector and by (*) taking into account the connections between the government budgetary position and official borrowing on the one hand and the growth of domestic credit on the other hand.

In response to the critiques that the programs have adverse effects in the growth the borrowing country, the Fund is increasingly including growth as well as stabilisation as objectives of its programs. But, as Wood, 1997, notes, "the growth objective still remains a secondary objective and program design is not constraint by minimum growth rates". The most recent and ambitious effort to include medium term growth as an objective of the adjustment program, is the work from Khan and Montiel, 1989. The two building blocks of the model are the monetary approach to the balance of payments and a variant of the open-economy neo-classical growth model (Harrod and Domar growth models of 1940s), that is still used in the World Bank. The integrated model was expected to be a tool in analysing adjustment with growth in developing countries (linking growth, inflation and balance of payments with government policies and availability of foreign financing), but this desired characteristic of the model is rejected on theoretical aspects as well as on evidence bases. Polak, (1997), assesses that attempts to marry the monetary model of IMF to medium-term growth models have foundered on fundamental incompatibility with these two types of models.

² It has been found useful to concentrate on the balance sheet of the central bank and its credit activities rather than on consolidation of the balance sheets of the monetary system as a whole. Therefore the definition: $\Delta H = \Delta R + \Delta DCB$ and the behavioural equation $\Delta MO = q\Delta H$ are introduced.

H is reserve money (currency plus reserves of commercial banks), DCB is domestic credit of the central bank and q is the money multiplier.

³ The model allows for flexible exchange rate by introducing the exchange rate variable in the behavioural equation of the demand for imports.

How the Model is Applied for Financial Programming and What About the Assumptions - do they hold?

The relationship which is used for policy purposes in the financial programming is showed in equation (4), which tell that a ceiling on the change of domestic credit determines the change in the net foreign assets.

Firstly, a target for changes in foreign net assets is set. Then, an estimate of the probable course of the demand for money over the same period is made. This involves projecting, or setting targets for, the principal determinants of money demand, such as income and prices⁴, or an assumption on income and velocity of money behaviour, if the simple velocity function is utilised. The last step, given a forecast of the demand for money and a target for the balance of payments, is the derivation of the figure for the needed change in net domestic credit from the balance sheet of the banking system.

Equation (4) remains the analytic core of the Fund programmes and it is the relation. This is most evidently in the modest change of the content of stand-by programmes, and essentially the same calculations, the same resulting domestic credit performance criteria, or 'benchmarks'⁵, remaining at the core of even the less short-term and more supply side Extended Fund Facility and Enhanced Structural Adjustment Facility programmes.

Following equation (4), in order for the policy instrument (change in domestic credit) to have a predictable effect on the target (balance of payments), the money demand must be a predictable relationship to a limit set of variables. The demand for money, therefore becomes a critical relationship in the analysis. Is its stability one of the assumptions that I will test in order to assess the appropriateness of the Fund-supported programs in Albania.

Another crucial and in the same time contested assumption of the model, that we also test referring to Albanian economy, is that the variables entering the demand for money function are not related to the changes in domestic credit. With other words, it is assumed that changes in domestic credit result only in changes in reserves, therefore, an expansionary open market operation by the monetary authorities must have no effect on the domestic interest rates, spending decisions, prices, or exchange rate.

As noted in different studies, within the Fund and out of it, such an assumption will clearly not apply to a large country with a floating exchange rate, nor to a developing country with restricted capital inflows and undeveloped capital markets. As Killick, 1995, notes, that there is considerable doubt whether many developing countries governments are in a position to exercise the degree of policy control over the change in domestic credit that the financial programming model requires.

The scope of our further work will be to test the questionable assumptions about the effectiveness of monetary policy implicit in the Fund financial programming model in the conditions of low-income countries, with special reference to transition economies and Albania.

⁴ One of the allowances that has to be made in the model, according to Polak, is that the domestic interest rate, which does not even appear in the simple model, may be strongly affected by the size of the government deficit and the way it is financed (from the banking system or in a nascent domestic capital market).

⁵ Structural benchmarks are indicators which aim to delineate the expected path of reform for individual structural policy measures. They are usually expressed qualitatively, as structural policies can not be expressed in quantitative form.

The Impact of the IMF-Supported Programs in Transition Economies.

As mentioned, one of the critiques on the IMF was that its programs often hamper growth and do not achieve their own objectives such as external viability and low inflation. We have already mentioned some of the evidence for the impact that programs have on growth and seen that there are not clear cut conclusions. The same applies to the tests regarding the effects of the programs in borrowing countries' inflation. Pastor (1987) finds no effect. Killick, 1984, and Killick et al, 1995, find a reduced inflation but the effect seems not much significant. Goldstein and Montiel, 1986, find an increasing inflation while Khan and Knight, 1985, find a significant reduction in the indicator.

Below I try to give some more evidence on this matter. In the light of studies by Havrylshyn et al, 1999, and Mercer-Blackman et al, 2000, we test for the effect of the IMF supported programs in the price level using a key conditionality aspect of Fund arrangements with transition countries – the performance criteria⁶. The hypothesis is that countries with more successful implementation of the conditionality of the Fund programs also tend to undertake policies, which result in a better performance of macroeconomic indicators such as inflation.

For testing purpose we use the Program Implementation Index⁷ (PII) which measures the extent of compliance with performance criteria. The cross-country analysis considers 17 transition countries that have undergone Fund programs in the period 1994 to 2000. (See Table No. 1 for further information on the programmes)

The first regression (showed in Table 2) tests the association between the Fund program implementation and inflation. Other variables such as economic growth, domestic credit, aggregate transition index, measured by IMF and/or EBRD, are included in the regression. The parameters have the expected sign, with the regressors explaining 82 % of changes of the dependent variable. The compliance with the Fund criteria lowers inflation but the coefficient on this variable is statistically significant only at 10 % level. The parameter for the aggregate transition index is also statistically insignificant in explaining inflation. In the second regression (Table No.3) we exclude the aggregate transition index and include the initial conditions index. Statistically is not straightforward to include this index. The reasons are two. Firstly, it is difficult to measure it in such way that it will appropriately rank the countries by their level of development, trade with CMEA, macroeconomic disequilibria, distance to EU, state capacity, etc. Secondly, its effects becomes increasingly less important, being offset by better policies. But as noted in Havrylshyn et al, 1999, it is worthy to include it. In fact, the goodness of fit increases in 86 %. The parameter on initial conditions has a positive sign, which could be explained by the effects of price and trade liberalisation reforms, which are usually undertaken at the beginning of the programs. The program implementation index becomes much more insignificant. The variable deletion test suggests its exclusion from the regression and the adjusted R squared increases after we exclude it (Table No. 4). The change in domestic credit keeps its significance through all the tested equations. An explanation for this could be also that this variable present an important policy instrument included in most of the IMF supported programs.

⁶ Performance criteria consist of a set of numerical floors and ceilings placed on various macroeconomic policy instruments or outcomes. While structural benchmarks vary depending on the country's specific needs for structural adjustment, PC tend to be generic across programs.

⁷ The way it is measured is presented in both papers by Havrylshyn et al and Mercer-Blackman et al. The index is also included in the IMF database (MONA).

The insignificant coefficient, of the program implementation index variable, may assess that the impact of the programmes on inflation is less than that the critics or the defenders of the Fund generally pronounce it. Anyway, these results should be taken in consideration with caution. They do not mean that successful implementation by itself could result in better performance of the indicator, because as noted in Killick et al, 1993, there is no more than a moderate connection between programme execution and the achievement of desired results. Rather, as noted by Mercer-Blackman et al, 2000, better compliance with program conditionality could be related to other factors, that also affect positively macroeconomic indicators, such as the greater willingness of the country authorities to follow the reforms, or the higher speed of reforms like liberalisation and stabilisation undertaken within the program.

**TABLE 1: The IMF Supported Programmes in Place During the Period
1990 – 2002 in Transition Economies.**

| COUNTRY | TYPE OF FACILITY | APPROVAL DATE | EXPIRATION DATE |
|-------------------------|-------------------|---------------------|---|
| 1. Albania | SBA | 24- Aug - 1992 | 23 - Aug - 1993 |
| | ESAF | 14 - Jul - 1993 | 13 - Jul - 1996 |
| | Emergence Program | May - 1997 | April - 1998 |
| | ESAF - PRGF | 13 - May - 1998 | 12 - May - 2001 |
| 2. Armenia | SBA | 28 - Jun - 1995 | 27 - June - 1996 |
| | ESAF - PRGF | 14 - Feb - 1996 | 13 - Feb - 1999 |
| 3. Azerbaijan | SBA | 17 - Nov - 1995 | 16 - Nov - 1996 |
| | ESAF | 20 - Dec - 1996 | - Dec - 1999 |
| | EFF | 20 - Dec - 1996 | - March- 2000 |
| 4. Bosnia & Herzegovina | SBA | 29 - May - 1998 | 31 - March - 2001 |
| 5. Bulgaria | SBA | 15 - March - 1991 | 14 - March - 1992 |
| | SBA | 17- Apr- 1992 | 16 - Apr - 1993 |
| | SBA | 11 - Apr - 1994 | 31 - March - 1995 |
| | SBA | CAPut! - Jul - 1996 | 18 - March - 1998 |
| | SBA | 11 - Apr - 1997 | (off - track) |
| | EFF | 25- Sept - 1998 | 10 - Jun - 1998 24 - Sept - 2001 |
| 6. Croatia | SBA | 14- Oct - 1994 | 13 - Apr- 1996 |
| | EFF | 12 - Mar - 1997 | 11 - Mar - 2000 |
| 7. Estonia | SBA | 16 - Sep - 1992 | 15 - Sep - 1993 |
| | SBA | 27 - Oct - 1993 | 27 - Mar - 1995 |
| | SBA | 11 - Apr- 1995 | 10 - Jul - 1996 |
| | SBA | 29 - Jul - 1996 | 28 - Aug - 1997 |
| | SBA | 17 - Dec - 1997 | 16 - Mar - 1999 |
| | SBA | 1 - Mar - 2000 | 31 - Aug - 2001 |
| 8. Georgia | SBA | 25- Jun - 1995 | 27 - Jun - 1996 (canceled in Feb/28) |
| | ESAF - PRGF | 28 - Feb - 1996 | 13 - Aug - 1999 |
| 9. Hungary | SBA | 14 - Mar - 1990 | 13- Mar - 1991 |
| | EFF | 20 - Feb - 1991 | Feb - 1994 (canceled in Sep/1993) |
| | SBA | 15 - Sep - 1993 | 14 - Dec - 1994 (disagreement with IMF) |
| | SBA | 15- Mar - 1996 | 14 - Feb - 1998 |
| 10. Kazakhstan | SBA | 26 - Jan - 1994 | 25 - Jan - 1995 |
| | SBA | 05 -Jun - 1995 | 05 - Jun - 1996 |
| | EFF | 17 - Jul - 1996 | 16 - Jul - 1999 |
| | EFF | 13 - Dec - 1999 | 12 - Dec - 2002 |
| 11. Kyrgyz Republic | SBA | 12 - May - 1993 | 11 - Apr - 1994 (off track) |

| | | | |
|-----------------------------|------|------------------|-----------------------------|
| | ESAF | 20 - Jul - 1994 | 26 - Mar - 1998 |
| | PRGF | 26 - Jun - 1998 | 25 - Jun - 2001 |
| 12. Latvia | SBA | 14 - Sep - 1992 | 13 - Sep - 1993 |
| | SBA | 15 - Dec - 1993 | 14 - Mar - 1995 |
| | SBA | 21 - Apr - 1995 | 20 - May - 1996 |
| | SBA | 24 - May - 1996 | 23 - Aug - 1997 |
| | SBA | 10 - Oct - 1997 | 09 - Apr - 1999 |
| 13. Lithuania | SBA | 21 - Oct - 1992 | 20 - Sep - 1993 |
| | SBA | 22 - Oct - 1993 | 21 - Mar - 1995 |
| | EFF | 24 - Oct - 1994 | (cancelled) |
| | SBA | 8 - Marc - 2000 | 23 - Oct - 1997 |
| | | | 7 - Jun - 2001 |
| 14. Macedonia, F.Y.R | SBA | 05 - May - 1995 | 05 - Jun - 1996 |
| | ESAF | 11 - Apr - 1997 | 10 - Apr - 2000 |
| 15. Moldova | SBA | 17 - Dec - 1993 | 16 - Mar - 1995 |
| | SBA | 22 - Mar - 1995 | 21 - Mar - 1996 |
| | EFF | 20 - May - 1996 | May - 2000 |
| 16. Romania | SBA | 11 - Apr - 1991 | 10 - Apr - 1992 |
| | SBA | 29 - May - 1992 | 28 - Mar - 1993 |
| | SBA | 11 - May - 1994 | 24 - Apr - 1997 (off-track) |
| | SBA | 22 - Apr - 1997 | |
| | SBA | 05 - Aug - 1999 | 21 - May - 1998 |
| | | | 31 - May - 2000 |
| 17. Russian Federa- tion | SBA | 05 - Aug - 1992 | 04 - Jan - 1993 |
| | SBA | 11 - Apr - 1995 | 10 - Apr - 1996 |
| | EFF | 26 - Mar - 1996 | 25 - Mar - 1999 |
| | SBA | 28 - Jul - 1999 | 27 - Dec - 2000 |
| 18. Tajikistan | SBA | 08 - May - 1996 | 07 - Dec - 1996 |
| | PRGF | 24 - Jun - 1998 | 23 - Jun - 2001 |
| CAPut!?. Ukraine | SBA | 07 - Apr - 1995 | 06 - Apr - 1996 |
| | SBA | 10 - May - 1996 | 09 - Feb - 1997 |
| | SBA | 25 - Aug - 1997 | 24 - Aug - 1998 |
| | EFF | 04 - Sept - 1998 | 03 - Sept - 2001 |

Sources: IMF, Annual Report of year 2000 and IMF Occasional Paper No. 184.

TABLES No. 2-3-4: Econometric Testing Results

TABLE No. 2

Dependent variable is **INFLATION**

| Regressor | Coefficient | T-Ratio | [Prob] |
|---|--------------------|-----------------------|---------------|
| Constant | 20.5170 | .9119 | [.380] |
| DG Economic growth rate | -1.9496 | -2.8648 | [.014] |
| PII Programme Implementation Index | -.22313 | -1.1851 | [.259] |
| DDC Domestic Credit Change) | .55759 | 6.1973 | [.000] |
| ATI Aggregate Transition Index | 3.0822 | .52796 | [.607] |
| ***** | | | |
| R-Squared= .86927 | | R-Bar-Squared= .82570 | |
| Overall F-statistics. F(4, 12) = .9486[.000] | | | |
| ***** | | | |
| Diagnostic Tests | | | |
| ***** | | | |
| * A:Serial Correlation | | | |
| CHSQ(1)= | 1.0369[.309] | F(1, 11)= | .71450[.416] |
| * | * | * | * |
| * B:Functional Form | | | |
| CHSQ(1)= | 6.6387[.010] | F(1, 11)= | 7.0480[.022] |
| * | * | * | * |
| * C:Normality | | | |
| CHSQ(2)= | 1.8990[.387] | Not applicable | |
| * | * | * | * |
| * D:Heteroscedasticity | | | |
| CHSQ(1)= | .60402[.437] | F(1, 15)= | .55259[.469] |
| ***** | | | |

TABLE No. 3

Dependent variable is **INFLATION**

| Regressor | Coefficient | T-Ratio | [Prob] |
|---------------------------------|--------------------|----------------|---------------|
| CT | 18.1310 | 1.1119 | [.288] |
| DG | -2.4343 | -3.5746 | [.004] |
| PII | -.090537 | -.49560 | [.629] |
| DDC | .57489 | 7.0327 | [.000] |
| INITCOND | 1.9034 | 1.7504 | [.106] |
| ***** | | | |
| R-Squared | | .89344 | |
| R-Bar-Squared | | .85793 | |
| F-stat. F(4, 12) 25.1542[.000] | | | |
| ***** | | | |
| Diagnostic Tests | | | |
| ***** | | | |
| * A:Serial Correlation | | | |
| CHSQ(1)= | .49074[.484] | F(1, 11)= | .32698[.579] |
| * | * | * | * |
| * B:Functional Form | | | |
| CHSQ(1)= | 3.7028[.036] | F(1, 11)= | 2.8446[.076] |

```

*           *           *           *
* C:Normality      CHSQ( 2)= .62745[.731]      Not applicable
*           *           *           *
* D:Heteroscedasticity
CHSQ( 1)= .029312[.864]      F( 1, 15)= .025908[.874]
*****
    
```

TABLE No. 4

Dependent variable is **INFLATION**

```

*****
Regressor      Coefficient      T-Ratio      [Prob]
CT           10.2487         2.9355       [.012]
DG           -2.5838        -4.3599      [.001]
DDC          .58610         7.6877      [.000]
INITCOND     2.1084         2.1602      [.050]
*****
R-Squared = .89126      R-Bar-Squared = .86617

F-stat.  F( 3, 13) = 35.5182 [.000]
*****
    
```

Diagnostic Tests

```

*****
* A:Serial Correlation
CHSQ( 1)= .37927[.538]      F( 1, 12)= .27383[.610]
*           *           *           *
* B:Functional Form
CHSQ( 1)= 3.4830[.052]      F( 1, 12)= 2.4347[.089]
*           *           *           *
* C:Normality      CHSQ( 2)= .29613[.862]      Not applicable
*           *           *           *
* D:Heteroscedasticity
CHSQ( 1)= .0040954[.949]      F( 1, 15)= .0036144[.953]
*****
    
```

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Emigration and its Economic Consequences; the Transition Phase of Albania

Introduction

Emigration phenomenon characterizes the transition period for the Central and Eastern European countries, but from the size and its role in the restructuring of the country, emigration for Albania is of profound importance. It has accompanied Albanian transition for more than one decade being at the same time the result of it. The first flows of people towards foreign embassies in 1990 on the other hand, sign the very beginning of the transition phase.

The paper takes a brief view on the size and structure of emigration to continue with its macroeconomic effects on the economy, that particularly are:

- On the Labor market (the effects implicating the level of unemployment, creation of the human capital etc.);
- Related to remittances that affect investments, consumption and import financing, alleviating the negative pressures of deficit on the balance of trade;
- The relative steadfastness of the exchange rate between “Lek” and other foreign values, contributing to maintaining slow level of inflation, since imported goods have a significant share in the consumer commodities which are measured for inflation.

Given the informal nature of the phenomenon, researchers and policy – makers face the problem of the absence of detailed information about migration in particular, the inadequacy of official information sources, very difficult to obtain especially in transition economies. Studies conducted in this field are mainly based on theoretical approaching and models, and different surveys on groups of people.

Consequences of immigration on host countries are another topic of this paper, showing at the same time the policy implications for both, native and host countries.

1. The structure of emigration

The eruption of migration was the first step of the Albanian economic transformation towards an open economy. The number of the Albanians who have emigrated during the last 12 years is steadily increased and yet accounts for about 700000 people (at about 20% of the population ². According to surveys, emigration has touched young ages in both genders, affecting in such a way the labour market in Albania. 67.7 % of emigrants are males, while 32.3 % are females. As about the average age of emigrants, it is 30.6 years old for males and 32 years old for females. Males group of 20-24 ages make up the bulk of the males leaving the country whereas most of the women are around 30-34 years old (Living Condition Survey 1998, INSTAT 2001). Migration towards foreign countries is more notable in the south areas, implying low levels of unemployment for these regions. The rates of unemployment are around 13,4% in the south where mass emigration exists, and about 19,1% in the northeastern areas where the level of emigration is lower (Albanian Human Report).

² Estimated by the Greek Ministry of Foreign Affairs

Table 1: Main indicators of population compound (in thousand)

| Year | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|----------------------|------|--------|------|--------|--------|------|------|------|
| Population | 3202 | 3248,8 | 3283 | 3324,3 | 3354,3 | 3354 | 3373 | 3401 |
| Labor Force | 1347 | 1423 | 1309 | 1247 | 1301 | 1320 | 1305 | 1283 |
| Employment | 1046 | 1161 | 1138 | 1116 | 1107 | 1085 | 1065 | 1068 |
| Rate of unemployment | 22,3 | 18,4 | 13,1 | 12,4 | 14,9 | 17,8 | 18,2 | 16,8 |
| Emigrants* | 381 | 353 | 413 | 476 | 571 | 690 | NA | NA |
| Rate of emigration** | 11,9 | 10,86 | 12,6 | 14,3 | 17 | 20,6 | NA | NA |

Source: INSTAT and Bank of Albania

* The figures for the emigrants are from the Greek Ministry of Foreign Affairs

** Own calculations (calculated as a ratio of the number of emigrants over the number of the total population).

Albanian emigration is often driven by seasonal and temporary employment. The destination of emigrants flows is notably affined from the geographical neighbourhood to the host countries (the case of Greece and Italy), the easy access and the possibility of having several entrances for the seasonal emigrants who reach their familiars at home and the lower costs of movement compared to that from the other countries³, as well as from the economic, historical and cultural affinity.

Table 2: Emigration by states (in percentage)

| Greece | Italy | USA | Germany | Switzerland | France | Other |
|--------|-------|-----|---------|-------------|--------|-------|
| 54,7 | 30,8 | 4,1 | 3,9 | 1,1 | 0,9 | 4,5 |

Source: INSTAT, July 2001 Results of Households living condition survey (October 1998)

2. Implications in the domestic labour market

Emigration flows enhance job creation both directly (through remittances) and indirectly, by reducing the burden of unemployment on the government.

Thus, being that the average age of the emigrants is 28.8 years old (BoA 1999), the decreasing levels of the rate of unemployment during the years show emigration's important impact in the reduction of unemployment rate, especially for the first 1990s, when the big masses of people were directed abroad.

It is impossible to estimate precisely what percentage of the labor force is working abroad, and thus to estimate the release of unemployment, because emigration takes place across the whole population and not just among those of working age.

It should be emphasized that due to the short-term nature of most of the emigration, and the fact that much of it is clandestine, many of these emigrants might be included also in the labour force figures, both employed and unemployed.

Referring to surveys however, the analysis based on the economic status of the emigrants (Household Condition Survey 1998, INSTAT 2001) reveals that 76 percent of them have jobs, 7 percent follow studies and about 15 percent are unemployed⁴. But these analyses don't say anything about the nature of employment for those who have jobs.

If we consider the figures for the 1998 (Table 1), with simple mathematics we can estimate the hypothetical rate of unemployment if there was no emigration hence the potential rate of unemployment:

First multiply the number of emigrants with the percentage of those employed and unemployed abroad:

$(75,5\% + 15,3\%) * 690$ (emigrants) = 626,52 (in thousand)

³ For those who had emigrated, the majority had left more than once. See Kule et al, 2000

⁴ Results of Household Living Condition Survey, October 1998, INSTAT, Tirane, July 2001

We figure out that from 690000 emigrants, about 626,52 of them are a labor force. If we add this number to the actual labor force in the country and to the total unemployment, we find out the potential rate of unemployment:

$$\text{Potential rate of unemployment} = (626,52 + 1320) / (626,52 + 235) = 44,25\%$$

This hypothetical rate of unemployment seems to be much higher than the real one with the participation of emigration phenomenon.

The impact of emigration on the labor market is visible not only by the direct reduction of the rate of unemployment. Remittances and the experience acquired abroad are good incentives for job opportunities at home. Money flows from emigrants create the possibility for private investments and hence self-employment. Besides, with the job skills acquired abroad, those who return seem to have more chances for finding a job than the “non-emigrants”⁴.

The effects of emigration on the transition Albanian economy are explored in Papapanagos and Sanfey 1997, in a theoretical model. Based on the assumption that job creation in the private sector is a linear function of profits per employee (Aghion and Blanchard 1994), the model analyzes the determinants of the optimal speed of transition by using a dynamic framework. The main conclusion is that emigration, by improving the rate of job creation in the private sector and by reducing the burden of unemployment on the government, may lead to an earlier switch to rapid adjustment of labor, and hence to a faster transition towards a market economy.

The impact of emigration in the Albanian economy has also the other part of the coin. The diminishing of the labor force is spread in all the levels of human capital. The very concerning problem has to do with the “brain drain”. Various surveys show that during 1990-1999, approximately 40% of the professors and research scientists of the universities and science institutions in the country have emigrated. This exodus is growing and a 1998 survey shows that even more of the highly educated people want to emigrate (Albanian Human Report 2000).

3. Emigrants remittances

Emigrants’ remittances represent approximately one fifth of GDP⁵, almost twice as much as foreign exchange revenues from exports, almost four times the value of direct investments and approximately 60% more than the revenue generated by industrial production⁵.

Table 3: Remittances and other components of Balance of Payment (in thousand)

| Year | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|--------------------|-------|-------|-------|-------|-------|-------|-------|--------|
| Imports | 620.5 | 601.0 | 679.8 | 922.0 | 693.5 | 811.7 | 937.9 | 1076.4 |
| Exports | 111.6 | 141.4 | 204.8 | 243.7 | 158.6 | 208.0 | 275.1 | 255.4 |
| Direct investments | 68.0 | 53.0 | 70.0 | 90.1 | 47.5 | 45.0 | 41.2 | 143.0 |
| Private transfers* | 324.1 | 374.1 | 348.9 | 476.0 | 235.7 | 421.3 | 188.4 | 438.6 |

Source: Bank of Albania (Statistical report, February 2001)

* Remittances are shown in their net value.

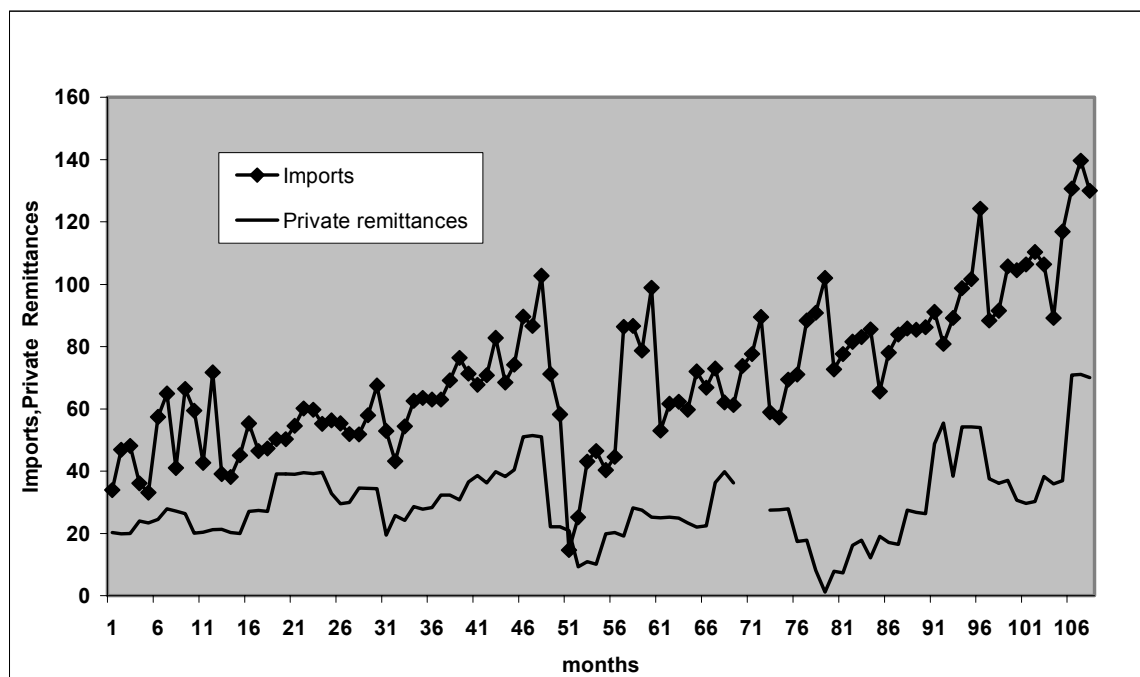
⁴See Kule Dh. , Mançellari, A. , Papapanagos, H. , Qirici, S. & Stanfy, P., “The causes and consequences of Albanian emigration during transition. (2000)

⁵Albanian Human Report 2000

A relative comparison of remittance data for all the Mediterranean countries has shown that Albanian emigrants' *remittances* are significantly higher. As a percentage of GDP, they are approximately 2.5 times higher than in Yugoslavia, 5.1 times higher than in Turkey, 7.7 times higher than in Greece and 40 times higher than in Italy⁵. This trend is partially explained by the low level of GDP in Albania.

The income effects of remittances on consumption, production, imports, employment are shown through a sectorial analysis by Nicholas Glytsos, 1993, in the case of Greece, and the author develops also empirical results. As far as dates are available, what we can show here is the relationship between remittances and imports. Because of the low level of GDP per capita, a good share of revenues goes for consumption. In the Albanian case, consumption is very closed related to imports, since they compound the biggest share for the deficit of the trade balance. In the graph below one can see broadly similar patterns in the two trends, although the match between them is far from perfect.

Figure 1: Imports versus Remittances



Imports and Private Remittances figures are in million \$. The period measured is January 1993-December 2001. The data are from Bank of Albania, the Balance of Payment.

This convergence is maintained almost for all the months, besides the period of 1997-1998. The explanation for that is the political instability and social unrest in the second part of 1996 and in 1997 Albania was faced with. The inability of the financial and banking sector to respond promptly to the financial needs of growing private sector led to a flourishing informal financial market, and to the expansion of the pyramid schemes. The unprecedented high interest rates offered by these schemes especially at the end of 1996 swallowed much of the domestic savings and remittances from abroad. In consequence, because of the lost of trust in the financial sector, remittances show decreasing levels after the year 1997.

The unstable situations in the Balkan region and the Kosovo crisis, in 1999, are another reasons for diminishing remittances in this year. Foreign aids during this period were a substitute of remittances, providing the balance of payment with the foreign currency needed.

3.1 The impact of Remittances in the Albanian macroeconomic stabilization process

The flow of remittances into Albania was maintained even after the narrowing of the official interest rate differential between Albania and Greece continuing to finance both consumption and investment in the expanding private sector. The decrease of interest rates from government with the purpose of achieving the macroeconomic stability hasn't stopped the Emigrant remittances from growing continuously.

The stability of the nominal exchange rate can be attributed in large part to private remittances from emigrants abroad. Remittances provide Albania with a much-needed source of foreign exchange reserves, and help to finance an ongoing deficit in the trade balance. Hadëri et al 1999 by using vector autoregression analysis, concludes that remittances have a direct effect on the exchange rate and hence on the rate of inflation. The analyses include the affect of M3, inflation and remittances in the exchange rate. The result is that after a 12-month horizon, innovation to remittances, contribute nearly 30% to the explanation of the forecast error variance of the exchange rate, while innovations in the in the inflation rate and money growth explain very little. Meanwhile taking lessons for other transition countries from the Albanian experience, the absence of significant flows of remittances for many of these countries means that maintaining a stable exchange rate and low inflation becomes even more of a challenge.

As mentioned before, the macroeconomic shocks in Albanian transition economy on the other side have affected the flows of remittances from abroad. This shows that emigrants with their remittances are sensible to the different developments of the macroeconomic shocks, affecting in the same way the exchange rates and the inflation rate.

4. Emigration and investments

Remittances have been an important source of finance for domestic investment. The majority of remittances have gone towards business development, housing and personal savings in banks.

Albanian Human Report 2000, shows that from studies conducted on the start-up capital for small and medium size private business, that 39% of the funding comes from family members in Albania or abroad, of which 17,5% are remittances. Whereas finance from government programs and bank credits account for only 9%.

World trends⁶ have shown that in most cases, remittances are spent on consumer and individual goods and assets (household appliances, cars, land purchase, and shops) rather than investment in production. This trend is to a certain extent present in Albania (as mentioned before), where more than halves of the numbers of private enterprises are trade enterprises. Among all firms (including those where the owner had never emigrated) remittances contribute about 17% to the establishment of businesses (Kule et al 2000).

Remittances have also served in alleviating the housing problem. Recent surveys show that 60% of new apartments have been constructed with remittances. They have also aided the recovery of the banking sector through increased savings.

Different surveys show that Albanian emigrants want to invest two thirds of their savings in Albania and a third in the country where they have emigrated. The top investment priority is the purchase of land and construction of a house in their hometown. Bank savings in the country where they have emigrated, is also a high priority.

⁶ See Nicholas Glytsos, "Measuring the income effects of migrant remittances: A methodological approach applied to Greece"

There do not exist dates about consumption and private investments to show the extent to which remittances are used for investment rather than consumption purposes. The results and figures come from surveys made through questionnaires.

5. Consequences of migration for the host countries and policy implications

Different studies show that immigration is generally considered to be beneficial for the host economies (see, for example Borjas 1994; 1995, Friedberg, M. and Hunt, J. 1995; Williamson, J. G. and Hatton, T.J., 1992). Borjas (1990) concludes that the impact of immigration on the wages of natives is negligible. This is particularly true in cases where native and immigrant workers are complements.

Friedberg, M. and Hunt, J. 1995, in their study, suggest that 1 percent point rise in the net migration rate rises long-term growth by 0.01 percent for the United States and by 0.04 percent for Japan.

On the other side, the contribution of the Albanian emigrants to the GDP of the country is about 2 %. (Mançellari et al 1999).

All of the above show there do exist benefits from emigration for the origin and destination countries, and policies towards this phenomenon should be directed in the right way in order to receive the right ones. Agreements between the country of origin and the host country especially for the temporary emigration would ease the costs of emigration for individuals, release the burden of unemployment and make it measurable. The informal character of this issue has to do with the uncontrolled and illegal movements of people who intend to emigrate. Controlling and planning emigration with the right politics, directing remittances through the right channel of the formal banking system, and create the appropriate environment for the private investments with the remittances would be the duties for the government, in order to release the burden of transition and speed the way to the stability.

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Exchange Rate Variability and Policy Implication

Abstract

This article analyses the development of exchange rate and tries to explain the volatility of exchange rate during the transition period in Albania. Exchange rate is an important macroeconomic variable for a small open economy like my country. The formal exchange rate market and the informal one, exist both in Albania. Both markets perform a large transaction volume and have an important market share. In this work, I have used only the data generated by the formal market, because the data of the informal market are not very accurate and often contradictory.

- ▶ Volatility of exchange rate has a strong impact on domestic price of imported goods. In Albania the total volume of Import is three times larger than export.
- ▶ Volatility of exchange rate effects directly the consumer's decision since they have an essential part of there saving on foreign currencies.
- ▶ The variability of exchange rate may also have serious complication for performance of our monetary policy. Foreign private banks dominate our second level banking system. The volatility of exchange rate, forces the banks to give more credit to the foreign currencies to fulfill the need of the market. In 1998 these banks gave 51.3% of total volume of credit to private sector on foreign currencies and on 2000 these amount increase to 80.5%.

Before 1990 in Albania was applied fixed – exchange rate of lek (our national currency) with foreign currencies. After starting the democratic reform, it was impossible for BoA, that was losing the state reserves of transaction to secure the fix exchange rate, so in July 1992 in Albania was implemented the flexible exchange rate.

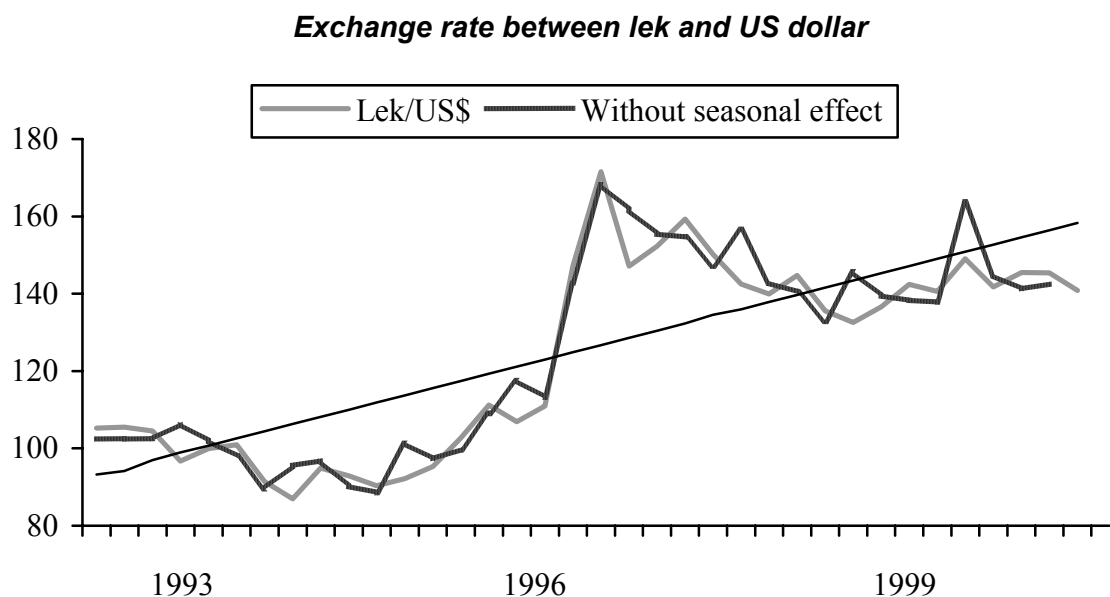
The demand and supply for foreign currencies determine the exchange rate course. This article aims to analyze the factors that determine the exchange rate and tries to find the best model that generates exchange rate forecasting. Having into consideration that our national currency is not traded out of the country borders, and that it has to face the foreign currency that comes in our country mostly by trade channels, the role of exchange rate market is very limited.

1 Empirical analyze of exchange rate Development

For creating an overall view of behavior of exchange rate during the transition period first I repressed a graphical link with monthly base of exchange rate between Lek and USA \$. The reason for choosing this exchange rate is the fact that many transactions in Albania are performed in US dollar. Time series between Lek and euro is relatively young and could not by used for generating accurate future forecasting.

The exchange rate used is $1\$ \rightarrow x$ lek. As it is shown on the chart the tendency of exchange rate is growing. There are two main breaking points on the exchange rate

Course. The first happened in 1992 and the second in 1997. In 1992 there was a big devaluation of lek, as a result of price liberalization. The high inflation expectation of economic agents, influenced negatively on exchange rate course. The official exchange rate from 50 lek/us\$ grew to 100 lek/us\$.



Decreasing of the total of the export volume on that time and the reaction of individuals and firms that began to stockpile their saving on real good - that reserve their value better than money in an inflation environment such as it was created in the country - had a negative effect in exchange rate stability.

The second breaking point happened in 1997, and it corresponds with the ruin of pyramidal schemes. The public lost the faith in our banking system and the value of lek fell about 40% against main foreign currency. The consumer price index was increased by 62%.

The policy implemented by Bank of Albania by that time was efficient and managed to stabilize the exchange rate course. The increasing on official interest rate for deposits in lek for state owned banks, about 37% compared to the previous period, returned the public faith on banking system. The public, began to increase the deposit in lek, and so exchange rate course began to evaluate in the mid of 1998.

This empirical study aims to evaluate the trend of exchange rate course and to find the best model that generates future expectation for exchange rate. In these study I use both multiplicative model and ARIMA model. The reason for using multiplicative model in this stage of analyze is the strong linkage that exists between these elements in practice.

$$ERT_t = T_t * C_t * S_t * I_t$$

The elimination of the seasonal effect it is used first the moving average with four terms and then a centered moving average. After eliminating the seasonal and irregular component, the trend of time series is determined and future expectation for exchange rate is constructed.

The dependent variable exchange rate:

```
*****
Regression      Coefficient      Standard Error      T-Ratio
INTCP           91.76700        2.987000           30.72000
TIME           0.58800         0.046000           12.70800
*****
```

$R^2=0.597$; $R\kappa^2=0.593$
 $F=161.490$

The linear trend is statistically significant. It will also be used for constructing future expectation for 2000 since the data it contains, cover the period from 1993 to 2001.

Based on these trend the forecast for January 2002 it is 1\$ → 157.621 Lek

The real value of exchange rate between lek and US dollar was 1\$ → 142.24 Lek. The estimation error on absolute term it is 15.38 lek per US dollar.

The future expectation generated by this linear regression overvalues the real exchange rate. I think the reason for this distortion of future expectation, is as a result of using one single linear trend, to explain all the date involved in the sample period. Considering the fact that in 1997 the exchange rate time series have an important breaking point I use a dummy variable for this year.

The dependent variable exchange rate

```
*****
Regression      Coefficient      Standard Error      T-Ratio
INTCP           93.95504        2.372575           39.5583
TREND           0.140901        0.665829           2.140414
DM97            35.91074        4.393331           8.17392
Dependent variable ER
*****
```

$R\kappa=0.746432$
 $F=162.9044$

The determination coefficient is increased significantly. This meant that the second model explains a big part of the variation of dependent variable compared with first one. All the coefficients of this regression are statistically significant.

Based on this regression the forecast for 2002 it is 1\$ → 132.38 lek. The real value was 1\$ → 142.24 lek. The estimation error in absolute term is 9.86 lek per US dollar. The forecast generated by this model is more accurate than the first one (the forecast error in absolute value, is lower). This results show, that a single linear trend does not justify the date observed. One reason for these distortion, may be the fact that, time series of exchange rate may not be trend stationary process but difference stationary process.

The Autoregressive Integrated Moving Average model (ARIMA) is used for the purpose of testing these and generating more accurate expectation. For the identification process is used only the graphical technique.

Figure 1: Represent the autocorrelations function of exchange rate between lek and US dollar.

Autocorrelations: KURSI

| Lag | Auto-Corr. | Stand. Err. | -1 | -.75 | -.5 | -.25 | 0 | .25 | .5 | .75 | 1 | Box-Ljung Prob. |
|---|------------|-------------|----|------|-------|------|---|-----|----|-----|----------|-----------------|
| +-----+-----+-----+-----+-----+-----+-----+-----+-----+-----+-----+ | | | | | | | | | | | | |
| 1 | .978 | .094 | . | *** | ***** | | | | | | 109.068 | .000 |
| 2 | .940 | .093 | . | *** | ***** | | | | | | 210.703 | .000 |
| 3 | .898 | .093 | . | *** | ***** | | | | | | 304.334 | .000 |
| 4 | .856 | .092 | . | *** | ***** | | | | | | 390.311 | .000 |
| 5 | .816 | .092 | . | *** | ***** | | | | | | 469.186 | .000 |
| 6 | .785 | .091 | . | *** | ***** | | | | | | 542.845 | .000 |
| 7 | .765 | .091 | . | *** | ***** | | | | | | 613.415 | .000 |
| 8 | .750 | .091 | . | *** | ***** | | | | | | 681.991 | .000 |
| 9 | .733 | .090 | . | *** | ***** | | | | | | 748.110 | .000 |
| 10 | .710 | .090 | . | *** | ***** | | | | | | 810.676 | .000 |
| 11 | .678 | .089 | . | *** | ***** | | | | | | 868.392 | .000 |
| 12 | .641 | .089 | . | *** | ***** | | | | | | 920.486 | .000 |
| 13 | .599 | .088 | . | *** | ***** | | | | | | 966.391 | .000 |
| 14 | .551 | .088 | . | *** | ***** | | | | | | 1005.686 | .000 |
| 15 | .504 | .087 | . | ** | ***** | | | | | | 1038.843 | .000 |
| 16 | .459 | .087 | . | ** | ***** | | | | | | 1066.643 | .000 |

The sample autocorrelation function of exchange rate is persistently nonzero and does not tail off until lag 16. The sample partial autocorrelation function is close to 1. The exchange rate time series between lek and US dollar is not stationary therefore it exhibits a stochastic trend.

Figure 2: Represent the autocorrelations and partial autocorrelations function of the first difference, of exchange rate course between lek and US dollar

Autocorrelations: KURSID

| Lag | Auto-Corr. | Stand. Err. | -1 | -.75 | -.5 | -.25 | 0 | .25 | .5 | .75 | 1 | Box-Ljung Prob. |
|---|------------|-------------|----|---------|-------|------|---|-----|----|-----|--------|-----------------|
| +-----+-----+-----+-----+-----+-----+-----+-----+-----+-----+-----+ | | | | | | | | | | | | |
| 1 | .493 | .094 | . | *** | ***** | | | | | | 27.477 | .000 |
| 2 | .113 | .094 | . | ** | | | | | | | 28.936 | .000 |
| 3 | .000 | .093 | . | * | | | | | | | 28.936 | .000 |
| 4 | -.091 | .093 | . | ** | | | | | | | 29.903 | .000 |
| 5 | -.270 | .092 | . | *.*** | | | | | | | 38.441 | .000 |
| 6 | -.340 | .092 | . | ***.*** | | | | | | | 52.124 | .000 |
| 7 | -.222 | .091 | . | **** | | | | | | | 58.044 | .000 |
| 8 | .012 | .091 | . | * | | | | | | | 58.060 | .000 |
| 9 | .168 | .091 | . | *** | | | | | | | 61.501 | .000 |
| 10 | .243 | .090 | . | *** * | | | | | | | 68.782 | .000 |
| 11 | .182 | .090 | . | **** | | | | | | | 72.912 | .000 |
| 12 | .175 | .089 | . | *** | | | | | | | 76.754 | .000 |
| 13 | .172 | .089 | . | *** | | | | | | | 80.504 | .000 |
| 14 | .000 | .088 | . | * | | | | | | | 80.504 | .000 |
| 15 | -.121 | .088 | . | ** | | | | | | | 82.398 | .000 |
| 16 | -.174 | .087 | . | *** | | | | | | | 86.355 | .000 |

Plot Symbols: Autocorrelations * Two Standard Error Limits .

Total cases: 114 Computable first lags: 109

Partial Autocorrelations: KURSID

Pr-Aut- Stand.

| Lag | Corr. | Err. | -1 | -.75 | -.5 | -.25 | 0 | .25 | .5 | .75 | 1 |
|-----|-------|------|----|------|-----|------|---|-----|----|-----|---|
| 1 | .493 | .095 | | | | | | | | | |
| 2 | -.172 | .095 | | | | | | | | | |
| 3 | .026 | .095 | | | | | | | | | |
| 4 | -.112 | .095 | | | | | | | | | |
| 5 | -.236 | .095 | | | | | | | | | |
| 6 | -.135 | .095 | | | | | | | | | |
| 7 | -.005 | .095 | | | | | | | | | |
| 8 | .144 | .095 | | | | | | | | | |
| 9 | .110 | .095 | | | | | | | | | |
| 10 | .099 | .095 | | | | | | | | | |
| 11 | -.079 | .095 | | | | | | | | | |
| 12 | .062 | .095 | | | | | | | | | |
| 13 | .089 | .095 | | | | | | | | | |
| 14 | -.065 | .095 | | | | | | | | | |
| 15 | .048 | .095 | | | | | | | | | |
| 16 | -.069 | .095 | | | | | | | | | |

The sample autocorrelation function of the first difference of exchange rate time series named kursid, tail off exponentially. The partial autocorrelation function has two nonzero spikes at lag 1 and 5. So the first time series of exchange rate is stationary and the original time series is integrated of order 1. Based on the corelogram of ACF and PACF ARIMA (5.1.0) is the more suitable model for exchange rate. For estimation of the model parameters is used the ESSP program.

ARIMA (5; 1; 0)

| | β | SEB | T-Ratio | Approx.prob |
|----------|------------|-----------|------------|-------------|
| AR1 | 0.5534513 | 0.0949461 | 5.8287772 | 0.0000000 |
| AR2 | -0.1827756 | 0.1095660 | -1.6681775 | 0.0980000 |
| AR3 | 0.0411091 | 0.1116743 | 0.3681165 | 0.7130000 |
| AR3 | 0.0266306 | 0.1109117 | 0.2401067 | 0.8110000 |
| AR5 | -0.2299538 | 0.0958844 | -2.3982388 | 0.0180000 |
| Constant | 0.3476463 | 0.4637574 | 0.7496647 | 0.4550000 |

The regression to estimate has a form:

$$ER^* = \alpha_0 + \alpha_1 ER^*_{t-1} + \alpha_2 ER^*_{t-5}$$

ER^* is the first difference of time series of exchange rate.

$$ER^* = 0.35 + 0.55 ER^*_{t-1} - 0.23 ER^*_{t-5}$$

| | | | |
|---|--------|---------|----------|
| t | (0.35) | (5.828) | (-2.398) |
|---|--------|---------|----------|

Analyze of ACF and PACF of residuals for ARIMA (5.1.0) process does not show any significant value of Autocorrelation or Partial autocorrelation at any lag. Therefore this model is a good model and can be used for generating future expectation.

The forecast for 2002:

$$\hat{ER}_{Jan_02} - \hat{ER}_{dec_02} = \alpha_0 + \alpha_1 [ER_{Dec-01} - ER_{Nov-01}] + \alpha_2 [ER_{Aug-01} - ER_{Jul-01}]$$

$$\hat{ER}_{Jan_02} = 136.725$$

The real value of exchange rate was 1\$ → 140.18 lek

The forecast error on absolute term 4.43 lek

Comparing with previous model, ARIMA generates more accurate forecast.

Although the value of estimation error, is better than the previous model, it still is not good enough. The main reason for this distortion may be the fact that ARIMA model includes only the present and the past values of exchange rate time series, between lek and US dollar. In the next section, the empirical analyze is extended further, by including some more other important macroeconomic variable on analyze.

2 - Factorial model

► The first variable included in the model, it is the interest rate. Before 1992 in Albania the interest rate has not played an active role in economy. Although the interest rate was increased during that period, the inflation growth was higher, because of the price liberalization process. This is the reason that this time period is excluded from the analyze.

► Since our national currency is not traded abroad, the foreign currencies that came from trade channel have important role in the determination of exchange rate course. So, the value of the imported and exported goods is the second exogenous variable included in the factorial model.

For creating an overall idea of the role of trade channel on exchange rate development, first it is represented a trade balance and exchange rate between lek and US dollar for the sample period.

| Year | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---------------|--------|--------|-------|--------|--------|--------|--------|--------|--------|
| Export | 111.7 | 141.3 | 204.8 | 243.7 | 158.6 | 208.0 | 257.1 | 255.8 | 260.2 |
| Import | 601.6 | 601.0 | 679.8 | 922.0 | 693.5 | 811.7 | 937.9 | 1070.1 | 1073.6 |
| Trade balance | -489.9 | -499.7 | -475 | -678.3 | -534.9 | -603.9 | -662.8 | -814.3 | -713.4 |
| Lek/us\$ | 102.06 | 94.68 | 92.79 | 104.5 | 148.93 | 150.64 | 137.69 | 143.71 | 142.43 |

Source Bank of Albania

Albania is a country based mainly on imports. Devaluation of our currency has not brought to improvements of trade balance. The demand for imported goods is quite perfectly price inelastic, because many of imported goods are necessary goods.

For example, the devaluation of our currency in 1993 increased the trade deficit from \$453 million to \$489.9 million. The devaluation on 1996 increased the trade deficit from \$475.0 million in 1995 to \$677.3 million.

► Other variables included on the factorial model are: the money supply (M3) and the consumer price index (CPI). In many studies about Albania economy, it is proved that the exchange rate is one of the most important factors on determining inflation in Albania. The rivers link between this macroeconomic variable may result also important. For this reason, the CPI it is included in the model as exogenous variable.

Changes on the macroeconomic variables of the foreign countries are not taken into consideration, because their effect on Albania exchange rate it is expected to be very small compared to the impact of national variable.

Based on the features of our economy, the impact of imported goods and exported goods it is analyzed separately.

The exchange rate between lek and US dollar is not a stationary time series. In the previous section, it is shown that this time series is integrated of order one. So, before constructing the factorial model, it is important to examine if others variable involved in the model are stationary or not. If the other variables are integrated of the same order, then the link between them is important and the problem of spurious regression is avoid. For checking the stationary of these time series, a graphical examination it is used just as before

Figure 3: Autocorrel ation funcion of CPI

| Lag | Corr. | Err. | -1 | -.75 | -.5 | -.25 | 0 | .25 | .5 | .75 | 1 | Box-Ljung | Prob. |
|---|-------|------|----|------|-----|------|-----|-------|----|-----|---|-----------|-------|
| +-----+-----+-----+-----+-----+-----+-----+-----+-----+ | | | | | | | | | | | | | |
| 1 | .973 | .099 | | | | | *** | ***** | | | | 96.690 | .000 |
| 2 | .945 | .098 | | | | | *** | ***** | | | | 188.747 | .000 |
| 3 | .916 | .098 | | | | | *** | ***** | | | | 276.098 | .000 |
| 4 | .889 | .097 | | | | | *** | ***** | | | | 359.356 | .000 |
| 5 | .866 | .097 | | | | | *** | ***** | | | | 439.197 | .000 |
| 6 | .845 | .096 | | | | | *** | ***** | | | | 515.967 | .000 |
| 7 | .822 | .096 | | | | | *** | ***** | | | | 589.363 | .000 |
| 8 | .797 | .095 | | | | | *** | ***** | | | | 659.133 | .000 |
| 9 | .770 | .095 | | | | | *** | ***** | | | | 724.966 | .000 |
| 10 | .742 | .094 | | | | | *** | ***** | | | | 786.738 | .000 |
| 11 | .712 | .094 | | | | | *** | ***** | | | | 844.282 | .000 |
| 12 | .681 | .093 | | | | | *** | ***** | | | | 897.512 | .000 |
| 13 | .648 | .093 | | | | | *** | ***** | | | | 946.367 | .000 |
| 14 | .615 | .092 | | | | | *** | ***** | | | | 990.916 | .000 |
| 15 | .581 | .092 | | | | | *** | ***** | | | | 1031.107 | .000 |
| 16 | .546 | .091 | | | | | *** | ***** | | | | 1067.061 | .000 |

Plot Symbols: Autocorrelations * Two Standard Error Limits .

Chart4.Autocorrelatio of: IM

| Lag | Corr. | Err. | -1 | -.75 | -.5 | -.25 | 0 | .25 | .5 | .75 | 1 | Box-Ljung | Prob. |
|---|-------|------|----|------|-----|------|-----|-------|----|-----|---|-----------|-------|
| +-----+-----+-----+-----+-----+-----+-----+-----+-----+ | | | | | | | | | | | | | |
| 1 | .838 | .095 | | | | | *** | ***** | | | | 77.936 | .000 |
| 2 | .702 | .094 | | | | | *** | ***** | | | | 133.137 | .000 |
| 3 | .595 | .094 | | | | | *** | ***** | | | | 173.173 | .000 |
| 4 | .503 | .094 | | | | | *** | ***** | | | | 202.079 | .000 |
| 5 | .487 | .093 | | | | | *** | ***** | | | | 229.398 | .000 |
| 6 | .435 | .093 | | | | | *** | ***** | | | | 251.437 | .000 |
| 7 | .415 | .092 | | | | | *** | ***** | | | | 271.732 | .000 |
| 8 | .371 | .092 | | | | | *** | *** | | | | 288.069 | .000 |
| 9 | .391 | .091 | | | | | *** | *** | | | | 306.392 | .000 |
| 10 | .401 | .091 | | | | | *** | *** | | | | 325.845 | .000 |
| 11 | .405 | .090 | | | | | *** | *** | | | | 345.904 | .000 |
| 12 | .423 | .090 | | | | | *** | *** | | | | 368.070 | .000 |
| 13 | .325 | .089 | | | | | *** | ** | | | | 381.269 | .000 |

| | | | | | | |
|----|------|------|---|--------|---------|------|
| 14 | .282 | .089 | . | *** ** | 391.322 | .000 |
| 15 | .233 | .088 | . | *** * | 398.272 | .000 |
| 16 | .206 | .088 | . | **** | 403.745 | .000 |

Plot Symbols: Autocorrelations * Two Standard Error Limits .

Figure 5: Represent the autocorrelation function of interest rate
Autocorrelations: INTERES

| Auto- Stand. | | | | | | | | | | | | | |
|-----------------------------------|-------|------|----|-----------|---------|------|---|-----|----|-----|---|-----------|-------|
| Lag | Corr. | Err. | -1 | -.75 | -.5 | -.25 | 0 | .25 | .5 | .75 | 1 | Box-Ljung | Prob. |
| +---+---+---+---+---+---+---+---+ | | | | | | | | | | | | | |
| 1 | .981 | .110 | . | *** ***** | 79.015 | .000 | | | | | | | |
| 2 | .948 | .110 | . | *** ***** | 153.725 | .000 | | | | | | | |
| 3 | .903 | .109 | . | *** ***** | 222.310 | .000 | | | | | | | |
| 4 | .849 | .108 | . | *** ***** | 283.868 | .000 | | | | | | | |
| 5 | .792 | .108 | . | *** ***** | 338.128 | .000 | | | | | | | |
| 6 | .733 | .107 | . | *** ***** | 385.267 | .000 | | | | | | | |
| 7 | .675 | .106 | . | *** ***** | 425.735 | .000 | | | | | | | |
| 8 | .617 | .105 | . | *** ***** | 460.039 | .000 | | | | | | | |
| 9 | .560 | .105 | . | *** ***** | 488.756 | .000 | | | | | | | |
| 10 | .505 | .104 | . | *** ***** | 512.361 | .000 | | | | | | | |
| 11 | .445 | .103 | . | *** ***** | 530.986 | .000 | | | | | | | |
| 12 | .382 | .102 | . | *** ***** | 544.942 | .000 | | | | | | | |
| 13 | .315 | .102 | . | *** ** | 554.575 | .000 | | | | | | | |
| 14 | .247 | .101 | . | *** * | 560.592 | .000 | | | | | | | |
| 15 | .180 | .100 | . | **** | 563.827 | .000 | | | | | | | |
| 16 | .114 | .099 | . | ** | 565.148 | .000 | | | | | | | |

Plot Symbols: Autocorrelations * Two Standard Error Limits .

Figure 6: Represent
Autocorrelation function of M3

| Auto- Stand. | | | | | | | | | | | | | |
|-----------------------------------|-------|------|----|-----------|----------|------|---|-----|----|-----|---|-----------|-------|
| Lag | Corr. | Err. | -1 | -.75 | -.5 | -.25 | 0 | .25 | .5 | .75 | 1 | Box-Ljung | Prob. |
| +---+---+---+---+---+---+---+---+ | | | | | | | | | | | | | |
| 1 | .970 | .095 | . | *** ***** | 104.461 | .000 | | | | | | | |
| 2 | .940 | .094 | . | *** ***** | 203.448 | .000 | | | | | | | |
| 3 | .910 | .094 | . | *** ***** | 297.133 | .000 | | | | | | | |
| 4 | .884 | .094 | . | *** ***** | 386.356 | .000 | | | | | | | |
| 5 | .858 | .093 | . | *** ***** | 471.221 | .000 | | | | | | | |
| 6 | .832 | .093 | . | *** ***** | 551.752 | .000 | | | | | | | |
| 7 | .805 | .092 | . | *** ***** | 627.995 | .000 | | | | | | | |
| 8 | .779 | .092 | . | *** ***** | 700.068 | .000 | | | | | | | |
| 9 | .753 | .091 | . | *** ***** | 768.056 | .000 | | | | | | | |
| 10 | .726 | .091 | . | *** ***** | 832.039 | .000 | | | | | | | |
| 11 | .700 | .090 | . | *** ***** | 892.124 | .000 | | | | | | | |
| 12 | .674 | .090 | . | *** ***** | 948.388 | .000 | | | | | | | |
| 13 | .647 | .089 | . | *** ***** | 1000.788 | .000 | | | | | | | |
| 14 | .620 | .089 | . | *** ***** | 1049.375 | .000 | | | | | | | |
| 15 | .593 | .088 | . | *** ***** | 1094.318 | .000 | | | | | | | |
| 16 | .568 | .088 | . | *** ***** | 1136.013 | .000 | | | | | | | |

Dependent variable Exchange rate

```
*****
```

| Regressor | Coefficient | Standard Error | T-Ratio |
|-----------|-------------|----------------|-----------|
| INTC | 48.36918 | 5.239565 | 9.231645 |
| CPI | 0.389840 | 0.133819 | 2.913188 |
| IM | -0.234010 | 0.042980 | -5.444605 |
| M3 | 0.208761 | 0.033021 | 6.321959 |
| I | 1.543818 | 0.137830 | 11.20081 |

```
*****
```

$R_k=0.912455$

The above regression expresses the relationship between the exchange rate monetary supply (M3), the interest rate, the imports and the consumer price index. From theoretical point of view, the interest rate would have a negative effect on exchange rate course. The reason for this distortion is the multicollinearity that exists between explanatory variable.

Dependent variable Exchange rate

```
*****
```

| Regressor | Coefficient | Standard Error | T-Ratio |
|-----------|-------------|----------------|-----------|
| INTCP | 34.99383 | 5.676813 | 6.164344 |
| M3 | 0.122378 | 0.033799 | 3.620738 |
| I | 1.465182 | 0.170215 | 8.607806 |
| EXP | -0.215094 | 0.165734 | -1.297830 |
| CPI | 0.648076 | 0.148451 | 4.365564 |

```
*****
```

$R_k=0.87$

The second regression expresses the relationship between the exchange rate, the exports the money supply, the interest rate and the consumer price index. In this regression export and interest rate have not the right signs. The model suffers of multicollinearity.

The generation of future expectation, based on factorial models, as represented above in a certain sense is limited since both models suffer of multicollinearity. A more detailed model should be constructed, to determine the impact of specific factors of current account, such as the emigrant's transfers and the services on exchange rate development.

Conclusion:

The exchange rate is a variable especially important for Albania. All economic agents, consumers, business firms, are too sensible in front of changes of the exchange rate. The importance of this variable on price development in Albania has been proved in many studies about exchange rate during the transition period. Domestic price of imported goods is strongly affected by changing of the exchange rate. This article aimed to find the best model that explain the exchange rate development in our economy and generate more accurate future forecast. The method used in this article to select between the different models, was the comparison of the real value of exchange rate and the evaluated value for the next time period. I think that this method used is sufficient for selecting between the different modes, taking into consideration that during the last years the exchange rate has been quite stable and in Albania.

The use of a single linear trend to explain the exchange rate course between lek and US dollar brought to a big distortion of future forecast of these time series for year 2002. The main problem with this model with monthly base was that a single linear trend was not appropriate for explaining all the data observed. The time series between lek and US dollar was proved, as

on later analysis to be, not a trend stationary process, but a difference stationary process. The future forecast generated by ARIMA model was more accurate and the forecasting error in absolute term was smaller than in other model.

Since ARIMA model takes into consideration only the present and the past value of exchange rate time series and the error term, so living apart the influence of important macroeconomic +variable, in the second step of the analyze, are included - as explanatory variables - same macroeconomic indicators. Such as the interest rate, the monetary supply, the consumer price index, the value of exported and imported goods.

The impact of exported and imported goods was study separately based on the feature of our economy - the imported good volume excess about three times the exported good volume and the fact that many of imported goods are necessary goods. The factorial model suffered of multicollinearity. The interest rate and exported goods have the wrong signs. The model in present stage was not use for generating future forecast, because the presence of high multicollinearity could bring to serious distortion. The model needs to be improved more in the future and allow the possibility of including other important variable such as emigrant remittances and others specific factors for Albania economy.

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The Increase of Competition: an Important Factor for a Successful Transition

Introduction

Efficiency allocate is a situation in which are realized all of the possible exchange profits. The efficiency is a characteristic of the pure competitive markets where a lot of independent competitors compete each other in order to absorb the costumers.

Democratic nation, whether they have governments of the right or the left, usually have well articulated policies towards intervention in private industry. Such policies are designed to promote the efficient allocation of resources through the encouragement of competition, which is seen as the active progenitor of economic efficiency and welfare. They are, likewise, employed to limit the losses in efficiency that can arise from the presence of elements of monopoly.

1. The competition: a challenge for the transition country.

Competition is the engine that makes market economies work. The core of competition is the existence of sufficiently many sellers independently offering choices, or standing ready to offer, choices to buyers.

Success thus depends upon efficient production of goods and services that consumers or business buyer's want, along with aggressive pricing at levels consistent with efficient costs. Great success goes to those who risk their efforts and capital to invest in creating new desirable choices for tomorrow.

But not always competitive maintain the efficiency. There are only a few big companies created from the competition and rivalry. As a result it is observed a deformation of the market and inefficiency allocate. The competition often creates between these companies' different agreements, (about high prices, separation of the market etc.) which bring to them many profits.

Thus dominance can be seen to arise where a firm has the power to behave independently of its competitors and customers, and this may result from a combination of a number of factors, none of which separately would necessarily imply dominance.

The predictions of economic theory are not sufficiently clear-cut to permit us to proscribe monopoly outright. Theory does point to a clear suspicion that a lack of competition can, most certainly, lead to inefficiencies, but it also identifies possible benefits from the attainment of lower-cost production. An unambiguous policy recommendation would require evaluation of all these costs and benefits.

A code of competition conduct is especially vital in a nation new to the free market from of economy and especially in Albania. Under central planning, or in an encompassing state owned sector, normal acceptable business culture entails discussion, agreement, and lobbying with respect to collective pricing; rigid and exclusionary patterns of distribution; and agreements on market allocation. Rivalry is viewed as wasteful, or at best, peripheral to the workings of the system. The desired norm is efficiency through agreements that assign roles without needles or divisive overlap such as agreements that eliminate independent action and choices.

This is the reason why Sherman, the first antitrust law was invented in U.S.A two centuries ago.

This law emphasizes the prohibition of deformations of the competition for the big companies and enables small companies to develop their competition. Even other countries execute this law, which is modified according to the objectives and their competition policies. Involvement in the trade economy made this law necessary for the Eastern and Central Europe countries.

The countries of Eastern Europe share many features of the process of transition to market economies and also of the evolution of competition, its nature and role. The interest of economic theory was until now primarily concerned with competition in well-established market economies. Competition was very limited in the “pre-transition” period in ex-socialist countries. The evaluation of competition in these countries is directly related to their overall progress in the transition towards market economies.

2. The progress of competition in Albania.

The Albanian competitive law is approved in 1995 and 2 years later was established an independent institution as Economy Competitive Directory.

The competition law intends permission protection, and stimulation of competition, so in this way it helps and stimulates the business and economy development, and to support the public interest.

This law regulates the activity of independent participants in market through the determination of the right and their obligations. From analyze of its continent we see that competitive law is a law with more value. This law is based on the world experience mainly on that of developed countries, especially on German and EU experience etc.

What is done in those years for promotion of competitive in Albania?

Is the fact that economic potential for the efficiency increase is not used enough. There are many objective and subjective reason:

1. One of the key problems, in transition country, unsolved yet is the privatization of big enterprises in the strategic sector. These enterprises are in monopoly's position (some of them as natural monopolies Alb telecom, Albanian energetic corporation) as long as they are state-owned.

If we consider the case of saving's Bank, we see that it has a predominant position in the most part of the general activity of the bank system.

As the result of these administrative actions in the 1996 and 1997, which brought about its joining with a part at the network activities of the National Trade Bank and Agrarian Trade Bank, it gained a predominant position in the bank's field.

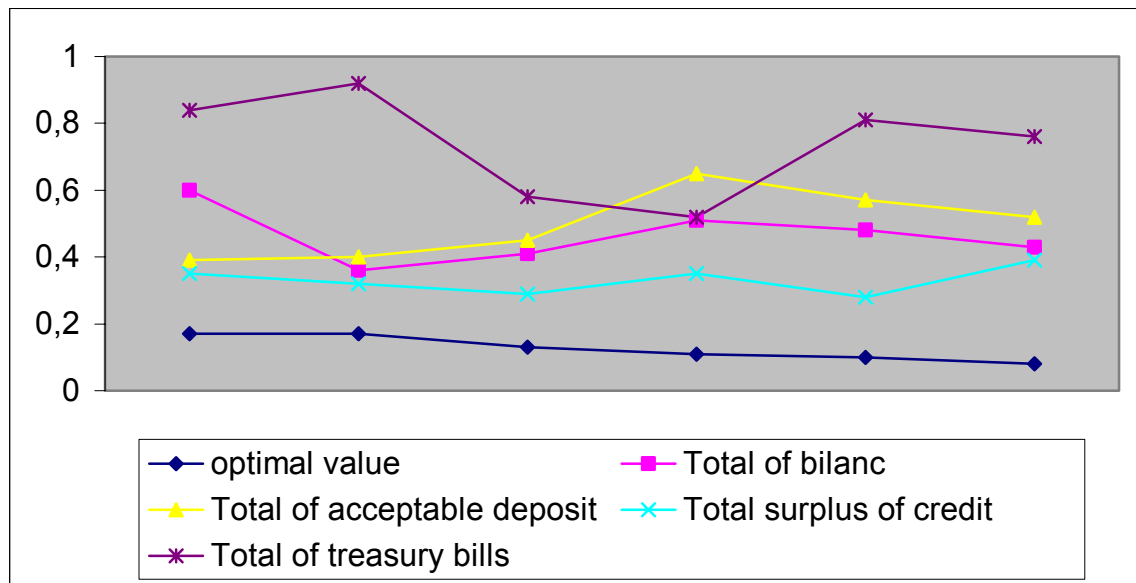
Basing on geographical extension and bank network's view, the market is deformed and monopolized by the Saving Bank. This cause the increase of bank's services, the lack of new product in the state bank trade etc. and other negative consequences such of the execution of the policy of the Albanian Bank's instrument.

Table.1 The course of Herfindal index in the years

| INDEX H | 1994 | 1996 | 1997 | 1998 | 1999 | 2000 |
|-----------------------------|------|------|------|------|------|------|
| Optimal value | 0.17 | 0.17 | 0.13 | 0.1 | 0.08 | 0.08 |
| Total of bilanc | 0.60 | 0.36 | 0.41 | 0.51 | 0.48 | 0.43 |
| Total of acceptable deposit | 0.39 | 0.40 | 0.45 | 0.65 | 0.57 | 0.52 |
| Total surplus of credit | 0.35 | 0.32 | 0.29 | 0.35 | 0.28 | 0.39 |
| Total of treasury bills | 0.84 | 0.92 | 0.58 | 0.52 | 0.81 | 0.76 |

Source: The Bank of Albania

Figure 1: The course of Herfindal index in the years



Source: The Bank of Albania

As we see in the figure below the present value of Herfindal index are over the optimal level. It is argued that Albanian bank market is presented as deformed, and has a big concentration. But in other side we see a reduction of concentration tendency, comparing with 2 last years.

This opposes the competition's law. In this case this law is not executed because of powerlessness of the competition sector, long preparation of the Bank in order to be privatized, and also because of expectation situation that always characterizes the periods before privatization.

There are the joint efforts of the competition sector, Albanian Bank, the political good will, privatization necessity etc. that realize the decline of Saving's Bank power at 40% which is within the limits permitted by the law.

It is widely known that the privatization is an economic necessity but it is not absolutely sure that privatization provides the efficiency of the enterprise.

There are private monopolies, which are inefficient, have high management costs and lacks flexibility.

Monopoly rather than brings benefits for the economy as a result of technological developments, can cause inefficiencies in the economy as there is no place for free competition which organizes the material and financial sources that increase the level of production, quality and employment.

Their privatization maintaining the monopoly's position brings about the market's domination and damages the competition.

But, there is no other way because this the only possibility to take advantages of scale economies or to have foreign investors who will invest and guarantee the successful future of the strategic sector.

In this case the consumers should be protected and the regulatory role of the state should be strengthened, while ECD should found any small secondary role companies to increase competition.

2. Until now, ignorance of de facto of ECD, preservation of confidentiality has not permitted the study of market, in order to observe the power of market companies and to execute the law. This has been the biggest shortage because one of the main purposes of the law is the competition's protection from the increase of power of only few big companies in the market.

3. After the ECD creation, despite of the difficulties of the first applications of the new things there are seen extensions and reductions of this directory in a sector, which cannot provide even the necessary data in order to execute the law because of the other state institutions. This sector was not anymore an independent institution as it was predicted in the law, but in fact it was an audition of the Ministry whom it belongs to.

The 2001' s is the year of turning in the competition's policies field. It is seen an all-sided assistance from the world organization, and also a general mobilization of the Parliament, regulator agencies etc. for considering ECD which is now treated as a directory by executing this important law.

It can be obviously seen the work that is done from the market companies about the unfair competition. New experience of price liberalization and privatization made necessary the legislation's execution against unfair trade practices.

3. Suggestions about possible methods for the improvement of the legislation's execution in the future.

Even though it is done an important change in competition policies it is necessary to draw attention to some main direction in order to improve the labor in the future.

1. Albanian competition law is a good one, but it still needs a regulation. In this direction we can mention:

a. One of the law shortcomings is that one which does not forbid the predominant position with more than 40 % of the predominance of one company or a group of companies without being interesting in the fact that this companies are valuable or not in the whole economy. So, one company which has less than 40 % of the market can apply abusive practices against the competition which is not mentioned in the law, while a bigger company that has 60 % of the market that does not abuse is efficient and its existence is worth for the economy, (for example benefits from the advanced technology, reduction of the expenditures of transaction's costs etc.)

On the contrary if the competition is not damaged, our new economy needs increasing productive companies. So, the law must reflect in a better way the development's needs of the economy.

b. The law must predict stronger and wider sanctions for its breakers.

c. Law must punish opened and expressed agreement of price fixation, which an obvious and easily punished, but even those are hidden and silent among the big and predominant companies of the market. It is necessary a rigorous study of competitive

rules of the companies and an invention of the fact if there are silent agreements that represent damage of competitive.

d. Law must give among the exceptions from its competition like natural monopolies, different argues about those exceptions for example: if they “improve the production or the allocation of the goods”, “technical or economic progress”.

2. State should appreciate ECD in order that it can have regular and continues information about market structures, or enough information in order to calculate with its specialists the market power.

3. Transformation as soon as possible of ECD in an independent institution from respective agency, which it belongs to, as in the other countries including even those of Eastern Europe in order not to be conditioned from the agency but from the Cabinet. From the last years experience it is necessary to maintain this independent position of directory.

4. In order to help the competition and the economy, it becomes necessary to supervise natural monopolies even after their privatization when they abuse with prices, damages the efficiency via the difference price-cost etc. by putting them obligations for prices.

5. Competition’s law should be executed rigorously, at the moment that the respective institution is having its right place and is being completed with the right personnel.

4. Factorial analyze of variables that influence in market competition, in Southeast Europe.

The main purpose of this factorial analyze is to find a model of the relations between the variables in order to understand better their dimensions of the competition’s development in those countries. For our purpose we will consider 9 variables for 10 countries of Southeast Europe. Firstly we are analyze those variables for 1993, so in the beginning of transition (see appendix, table 1). Seeing the results of this analyze (Table 2), we say that 10 variables are dimensioned in 4 factors that explain 84.85 % of variance.

Table 2: Total variance explained

| Component | Initial Eigenvalues | | | Extraction Sums of Squared Loadings | | |
|-----------|---------------------|---------------|--------------|-------------------------------------|---------------|--------------|
| | Total | % of Variance | Cumulative % | Total | % of Variance | Cumulative % |
| 1 | 3.662522 | 40.69469 | 40.69469 | 3.662522 | 40.69469 | 40.695 |
| 2 | 1.681883 | 18.68758 | 59.38228 | 1.681883 | 18.68758 | 59.382 |
| 3 | 1.172203 | 13.02448 | 72.40676 | 1.172203 | 13.02448 | 72.407 |
| 4 | 1.120342 | 12.44824 | 84.855 | 1.120342 | 12.44824 | 84.855 |
| 5 | 0.672996 | 7.477731 | 92.33273 | | | |
| 6 | 0.443325 | 4.925831 | 97.25856 | | | |
| 7 | 0.219252 | 2.436134 | 99.6947 | | | |
| 8 | 0.027373 | 0.304139 | 99.99883 | | | |
| 9 | 0.000105 | 0.001165 | 100 | | | |

Extraction Method: Principal component Analysis

The first important factor has a value of 40,695%, which means that about 41 % of variance is explained by the first factor. The second one is 18.7%, the thirsty is 13.02%, and the fourth is 12.45%. So basing in this information, the competition is presented with 4 dimensions. From the Component Matrix(see appendix table 2) we are see, that in the first dimension are included 5 from the 9 considered variables: export, foreign investment net per capital, import, index of competition policy and private sector share in GDP because of the correlation's coefficient between the variables and the component.

While in the second component there are included: consumer prices, credit to private sector, in the third it is included: General government expenditure and in the fourth is the price liberalization.

Considering the values of correlation's coefficients and the low percentage, it is obvious that there is not a clear difference between the factors. We can see this from the 3-dimension-graphic which shows the position of the variables (see appendix figure1).

So, in the beginning of the transition the variables looks somehow scattered which means that competition does not has a single dimension, but different countries have differences in different ways.

If we would analyze the same variables (see appendix table 3) for 2000, which is a period of 7 years later, we have almost a better model in which the four dimensions are cut in three and the first factor explain the largest part of the variance that is about 41 %.

Table 3: Total variance explained

| Component | Initial Eigenvalues | | | Extraction Sums of Squared Loadings | | |
|-----------|---------------------|---------------|--------------|-------------------------------------|---------------|--------------|
| | Total | % of Variance | Cumulative % | Total | % of Variance | Cumulative % |
| 1 | 3.688542 | 40.9838 | 40.9838 | 3.688542 | 40.9838 | 40.9838 |
| 2 | 1.727514 | 19.1946 | 60.1784 | 1.727514 | 19.1946 | 60.1784 |
| 3 | 1.627831 | 18.08701 | 78.26541 | 1.627831 | 18.08701 | 78.26541 |
| 4 | 0.908922 | 10.09913 | 88.36454 | | | |
| 5 | 0.565577 | 6.284187 | 94.64873 | | | |
| 6 | 0.301344 | 3.348265 | 97.99699 | | | |
| 7 | 0.113885 | 1.265388 | 99.26238 | | | |
| 8 | 0.060365 | 0.670718 | 99.9331 | | | |
| 9 | 0.006021 | 0.066903 | 100 | | | |

Extraction Method: Principal component Analysis

This factor includes these variables: credit to private sector, export, general government expenditure, and import. In the second factor is included: foreign investment net per capital and the index of price liberalization.(see appendix table 4 and figure 2). In the 2000's analyze we see that there are changes comparing it with 1993. This difference can be seen not only graphically but also from the determination of the 3 factors.

We have to stress that still there is some place for improvement in order that variables that are related with competition can be included in only one dimension. This comes from a large inferiority that is a result of the centralized system that had concentrated everything. So in order to resolve this, it is needed time and no doubt big efforts in order for these countries to have free competition as developed countries.

An appropriate competition policy is designed under the impact of different factors, such as the existing economic conditions, the effect of various forms of the market

structure as a consequence of the character and degree of competition, and the overall objectives of economic policy.

Thus, the goal of this phase of development in the coming years is to apply a concept and strategy of development based on the economy and policy of transition; this implies applying the model of an open economy with the emphasis on domestic and international competition and export. The key issue in beginning the implementation relates to the complex of privatization and changing the market structure away from the concentration of supply.

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APPENDIX

Table 1: The data for 10 country in 1993

| Country | Pri_lib | Priv_sec | In_com | Cre_pri | Con_pri | Gov_exp | export | import | fdi | Fac1 | Fac2 | Fac3 | Fac4 |
|-----------------|---------|----------|--------|---------|---------|---------|--------|--------|-------|--------|--------|--------|--------|
| Albania | 3 | 40 | 1 | 3.7 | 85 | 34.9 | 112 | 602 | 14.06 | -0.025 | 0.137 | -1.715 | -1.414 |
| Bulgaria | 3 | 35 | 2 | 3.7 | 73 | 48.1 | 3727 | 4612 | 4.7 | -0.327 | -1.041 | -0.342 | 0.218 |
| Croatia | 3 | 30 | 1 | 47.3 | 1512 | 35 | 3904 | 4864 | 22.17 | -1.333 | 1.699 | 0.494 | -0.363 |
| Czech | 4 | 45 | 2.7 | 50.8 | 20.8 | 41.9 | 13 | 13.3 | 54.66 | 1.298 | 1.345 | -0.801 | 1.847 |
| Fyr macedoni | 3 | 35 | 1 | 59.3 | 338.4 | 55.3 | 1056 | 1013 | 0 | 0.072 | 0.939 | 1.199 | -0.454 |
| Hungary | 3 | 50 | 2 | 28.2 | 22.5 | 54.6 | 8.1 | 11.3 | 226 | 1.420 | -0.301 | 1.209 | -1.291 |
| Poland | 3 | 50 | 3 | 12.2 | 35.3 | 50.5 | 13.6 | 15.9 | 15.06 | 1.111 | -0.670 | -0.610 | -0.191 |
| Romania | 3 | 30 | 1 | 10 | 256 | 34.2 | 4882 | 6012 | 3.81 | -1.222 | -0.291 | -0.858 | -0.081 |
| Slovakia | 3 | 45 | 2 | 32.1 | 23.2 | 51.3 | 5447 | 6379 | 20.18 | -0.191 | -0.897 | 0.838 | 0.849 |
| Slovenia | 3 | 25 | 2 | 22.1 | 32.9 | 46.7 | 6083 | 6237 | 55.5 | -0.804 | -0.928 | 0.586 | 0.877 |

Source: EBRD

1. Price liberalization (pri_lib)
2. Private sector share in GDP (priv_sec)
3. Index of competition policy (in_com)
4. Credit to private sector (cre_pri)
5. Consumer prices (con_pri)
6. General government expenditure (gov_exp)
7. Export
8. Import
9. Foreign investment net per capital (fdi)

Table 2: Component Matrix

| | Component | | | |
|----------|-----------|----------|----------|----------|
| | 1 | 2 | 3 | 4 |
| CON_PRI | -0.54615 | 0.650489 | 0.190543 | -0.18749 |
| CRE_PRI | 0.12861 | 0.730133 | 0.572944 | 0.288854 |
| EXPORT | -0.80329 | -0.36161 | 0.249938 | 0.368201 |
| FDI | 0.532372 | -0.06596 | 0.413553 | -0.25442 |
| GOV_EXP | 0.535887 | -0.36197 | 0.675182 | 0.033406 |
| IMPORT | -0.83437 | -0.34088 | 0.188425 | 0.324481 |
| IN_COMP | 0.67738 | -0.33012 | -0.04332 | 0.511054 |
| PRI_LIB | 0.456127 | 0.475872 | -0.28144 | 0.649178 |
| PRIV_SEC | 0.876795 | -0.08882 | -0.04095 | -0.11152 |

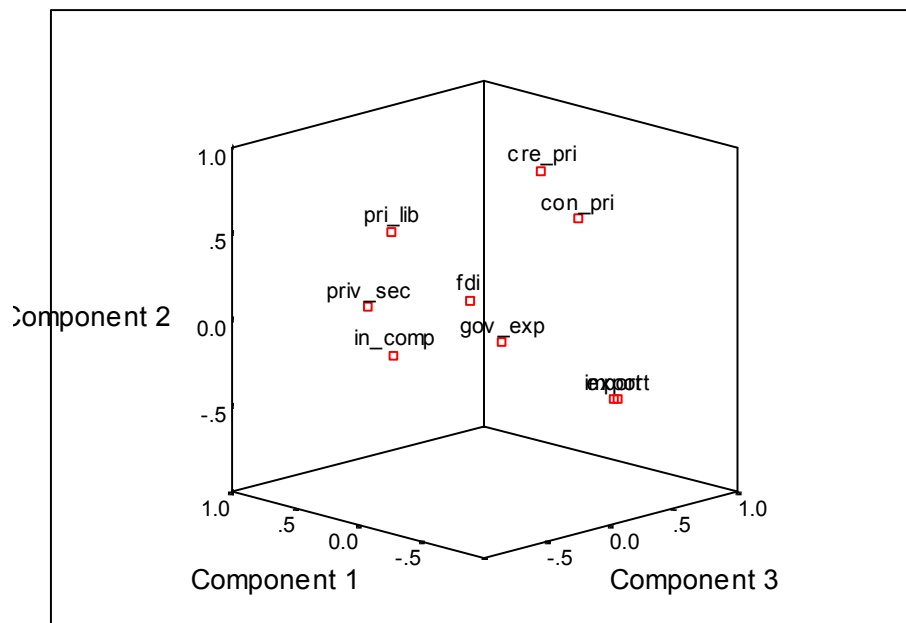
Figure 1: Component plot**Component Plot**

Table 3: The data for 10 country in 2000

| Country | Pri_lib | Priv_sec | In_com | Cre_pri | Con_pri | Gov_exp | export | import | fdi | Fac1 | Fac2 | Fac3 |
|--------------|---------|----------|--------|---------|---------|---------|--------|--------|--------|--------|--------|--------|
| Albania | 3 | 75 | 17 | 3 | 0.1 | 31.4 | 256 | 1070 | 41.47 | -1.611 | 2.265 | 0.332 |
| Bulgaria | 3 | 70 | 2.3 | 12.2 | 9.9 | 44.5 | 4812 | 5988 | 739.2 | -0.149 | -0.193 | -1.736 |
| Croatia | 3 | 60 | 2.3 | 23 | 9.7 | 47.3 | 4567 | 7771 | 179.8 | -0.269 | -0.759 | -0.681 |
| Czech | 3 | 80 | 3 | 45 | 3.9 | 44.5 | 29052 | 32183 | 434.7 | 1.343 | 0.536 | -0.617 |
| Fyr macedoni | 3 | 55 | 2 | 11.2 | 9.2 | 37.8 | 1367 | 1968 | 84.5 | -1.110 | -0.682 | -0.063 |
| Hungary | 3.3 | 80 | 3 | 23.6 | 9.8 | 45.1 | 25346 | 27466 | 116.7 | 1.002 | 0.404 | 0.967 |
| Poland | 3.3 | 70 | 3 | 18.8 | 10.1 | 42.6 | 28277 | 41422 | 220.28 | 0.997 | 0.120 | 1.305 |
| Romania | 3 | 60 | 2.3 | 12 | 45.7 | 35.1 | 10366 | 12050 | 43.24 | -0.971 | -1.473 | 1.040 |
| Slovakia | 3 | 80 | 3 | 37.6 | 12 | 45.4 | 11870 | 12786 | 381 | 0.514 | 0.149 | -1.033 |
| Slovenia | 3 | 65 | 2.7 | 37 | 8.9 | 44.1 | 8808 | 9947 | 55 | 0.254 | -0.369 | 0.486 |

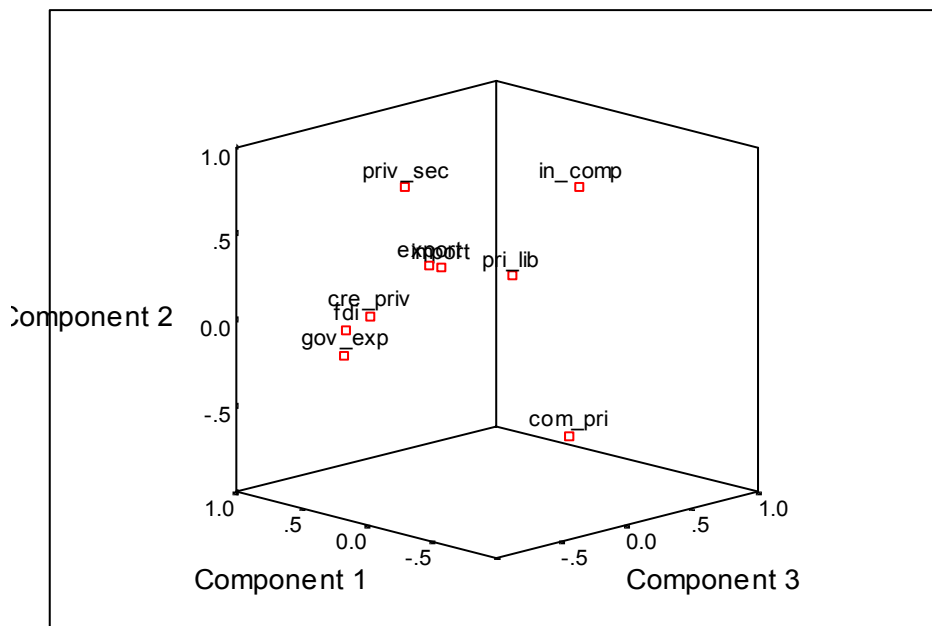
Source: EBRD

Table 4: Component Matrix

| | Component | | |
|----------|-----------|----------|----------|
| | 1 | 2 | 3 |
| COM_PRI | -0.2271 | -0.68988 | 0.317538 |
| CRE_PRIV | 0.768901 | -0.08463 | -0.20586 |
| EXPORT | 0.873694 | 0.077751 | 0.349569 |
| FDI | 0.377492 | 0.017966 | -0.77892 |
| GOV_EXP | 0.768589 | -0.27951 | -0.39795 |
| IMPORT | 0.833065 | 0.063948 | 0.401698 |
| IN_COMP | -0.50051 | 0.832889 | 0.134743 |
| PRI_LIB | 0.518371 | 0.035921 | 0.634594 |
| PRIV_SEC | 0.579634 | 0.678849 | -0.12297 |

Figure 2: Component plot

Component Plot



Part III:

Research on other Transition Economies

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A Debt Rate Paradox: Why is home financing not as effective as it was thought to be?

1. Introduction

The aim of this study is to present the short history and the latest tendencies in home financing in Hungary, and to point out the potential traps of indebtedness. It will compare the sinking savings rate with the financial effects of high debt ratios.

2. Tendencies in home-financing before the political changes in 1989

The socialist political system gave priority to the amelioration of the living circumstances. About 70% of the Hungarian citizens obtained some kind of pecuniary assistance in those times. Two-third of the aid derived directly from the budget, one third arrived through various other channels to the households. The large scale of the aids was still not effective enough. The system preferred the rented flats despite of own flats. The rents were kept very low, but the building or buying of own flats was difficult. The lack of building materials was an every-day problem. Typical preferences were only granted to low comfort flats, luxury living conditions were objected. The principle of one family-one flat was in the core of the system. The state influenced both the supply and the demand side of the home market.

The aiding system was relatively complicated and the costs of it were hard to estimate even for the state budget. Only some periods later was the government able to declare the calculated costs of the former obligations. This system was very unfair, with high costs, and caused diversity in the society. For those who were not granted any subsidies came from the poorest layers of the community. The average income of these people was about 8% lower than that of the privileged. The living circumstances were 6% worse of them compared to the preferred groups. In fact, the source for the financial assistance towards the aided was taken from the poorest through redistribution.

In the 70's and 80' home finance debts were granted at a negative real rate. These credits financed great portion of construction. However, as soon as the inflation reached two figures, the cost-effects became radical of these loans. In 1989 about 8% of the GDP was spent on various forms of home-related aids.

From 1990 the diminishing of these grants began: the rate of the old loans was radically risen, following the higher inflation rates, but the rates were still under real rate. The debtors could choice: either to pay the higher rates, or to pay back 60% of the loan immediately with the rest of the loan remitted. Approximately 100 thousand households chose to pay the higher rates. This caused costs to the budget, because these rates were still lower than the market rate. The budget of 1995 still contained 42 milliard Forints obligatory costs connected to the home aiding, which was one-third of the former home-aids.

The tenements were conferred to the local communities, and the aiding of them through the budget was also stopped. The total value of the aids sank to only 1,6% of the GDP in 1995.

2.1. A reasonable redistribution

Any governmental aiding system is based on redistribution: transferring resources from one group to another preferred group of the society. Based on the professional literature, the criteria to a fair and efficient redistribution are the following:

The first group of the motives are moral. Based on it, those households that have low income or many dependent children should be granted home aiding. The decision covers the limit of the income and the relation between the number of children and the aids. Ethically, the redistribution from every tax-payer (including lower income groups) towards those better off is unjustifiable. Finally, no ethical explanation can be found to the preference of hiring to owning flats.

The second group of the motives are economic. There are debates on the fiscal influence of the home-financing process, whether grants or tax-reduction – or even extra taxes – are allowed to intervene in the allocation. It can be reasonable though to help the sector towards better conditions: new home buildings or renovation.

The third group of the motives is the aiming of the redistribution. Examination should implicate, how direct the selection of the preferred group was.

2.2. The effects of the redistribution

This part examines the redistribution effects on the building, consumption and insufficiency of homes. For many years, the main problem of the population was the scarcity of flats. This scarcity was diminished from the supply side from the 70's and 80's. The enlargement happened from two sides: through the buildings of state-owned tenements, and the extension of supports to the private buildings as well. The shortage in the home sector became a quality, rather than a quantity-problem. The newly built flats had in most cases of objectionable quality. Few efforts were taken to renovate the old flats. In consequence of it, the home-wealth of Hungary suffered a diminution of 440 billion Forints, which was 42% of the whole value.

The redistribution – based on false diagnose – could not solve these problems. They stimulated over-consumption in the home-sector because of the irrationally low rents. The situation became paradox: the home-consumption of Hungary was higher than its expected level calculated from the development of the country. However, the subjective feeling of home-shortage was still there.

After the political changes in 1989, the state-supported home-construction has almost terminated. Only the higher layers of the society had at last the opportunity to build own, luxury homes. The bureaucratic hurdles has ceased, so the demand and the supply both increased. The structure of home-consumption reflected the real, solvent demand. The former shortage held off, not so because of the extension of supply, but rather of the diminution of the demand. The costs of building, renting, and even maintaining flats meant in many case unaffordable costs to households. Now home-ownership depends on financial circumstances, not on supply any more.

3. How do financial supports redistribute welfare?

Supports have several redistributive effects. In Hungary, the support system distinguishes between people living in tenements, and people living in own flats. Before the political changes, one quarter of the flats were tenements. The state privileged and favoured the rented flats, and so granted financial advantage to the renters. The owners of flats had one and a half times bigger flat-connected monthly costs than the renters. Not mentioning the huge initial building costs. After some time, the disfunctionalities of the system became more obvious. Pressure arrived from three sides: some part of the social base of the regime (workers) still lived in own flats, the forces of the political power wanted to have own flats as well, and thirdly, the market mechanism always reminded the of the discrepancies of the artificially low rents.

Without the support of the state, there should not be so much difference between the costs of the two types of flats. In most market economies, the states supports rather own buildings, and almost never renting, by offering for example tax reduction.

As soon as the pitfalls became obvious, reforms took place. The relative part of the tenements sector started to drop dramatically after the political changes. After the privatisation of the tenement sector the tenement rate in all households reached only about 8%. The privatisation prices of these flats were far under the market price. This difference was financed from the budget.

Who were the winners, and who paid the price? The privatisation of flats made the position of the renters even better, the present value of the privatisation gift was higher than the value of the flat (*Dániel* [1996]). The owners of the flats paid the price. Another respect shows, that the higher social classes gained more advantage from the flat-privatisation, than the lower income classes, because they lacked the necessary means to pay even the discount price of the immobile. It is morally disapprovable to make the poor finance the rich, and to help the rich into a favourable situation against the poor.

Of course, the winner and loser expressions mean only relative position. It is based on income related data, such as support pro 100 Forints of income, or support pro square meter in the various income classes.

The first group of the winners was already mentioned: the renters of the tenements, who gained not only the advantages of the irrationally low rents, but were given privatisation gifts as well.

Because of the good circumstances, the saving rate in this group was significantly higher, than in other segments. For many years, investing in immobile was one of the most attractive and sure opportunities. Many of this group built an own cottage, or home, or bought an own flat, by still living in low-rents tenements. So they had the benefit of not only the rent-supports, but also of the discount-rate building credits.

The second group of the winners are the educated layer of the society, mainly because of there higher income. Winners were the large, low-income families with at least three children, who enjoyed the social attention of the society. This institution is outmost favourable in any society.

But who had to pay the price? Those, who were not granted so much support from the state. Flat support to low income groups, to those living in small villages, to pensioner and to low educated people was under the average.

After the political changes the low rents were gradually raised. Compared to the previous years, the portion of the discount to the income fell from 24% to only 8%. The transition shock made it difficult both for the government to keep the former supports and for the people to try to make own houses from their own salary.

The market economy liberalised construction as well, which solved the problem of lack of materials, but also directed the attention to the insufficiency of financial facilities. One of the main problem areas in the housing sector was the diminution of credits. On average, credit financing reaches 60-80% of the value of the house, while in Hungary this rate was only about 10%. The causes came from many aspects. Firstly, investments in the housing sector fall dramatically: in 1991 only half as many flats were built than in 1980, in 1997 only one third. The financial structure of the housing investments has also changed. Credit financing almost disappeared, and cash financing became more relevant.

The motives have two sides. Banks gave loans at high real rates, which was hard to pay back for any debtor. Secondly, the transition changed the way of thinking of the people, but this could not happen at once. The old habits of relying on the paternal state had to disappear and a more adult society had to develop. Besides these, the financial situation of the people did not get better too quickly. There was a period of adjustment, when efficiency and market share were the most required feature. Under such circumstances people did not dare to risk bankruptcy.

The required level of the yearly home-investment should reach 1% of the total value of the immobile in a country. Analysing the investment levels in Hungary, the value of the investment always exceeded this margin, and the surface of the new construction was also slightly over the needed amount.

Table 1.

| Year | Total surface of the immobile (1000 m ²) | Newly built home surface (1000 m ²) | Rate of new buildings surface in percent of the whole immobile | Total value of the immobile (Billion Forints) | Value of the new buildings (Billion Forints) ⁹ | Rate of the new buildings value in percent of the whole immobile |
|------|--|---|--|---|---|--|
| 1991 | 208 600 | 2891 | 1,39 | 31317 | 64,8 | 1,06 |
| 1992 | 215 454 | 2336 | 1,08 | 3646 | 64,2 | 1,76 |
| 1993 | 221 029 | 1961 | 0,89 | 3914 | 61,8 | 1,58 |
| 1994 | 225 939 | 2116 | 0,94 | 4655 | 84,6 | 1,82 |
| 1995 | 225 939 | 2440 | 1,08 | 5556 | 125,4 | 2,26 |
| 1996 | 240 197 | 2720 | 1,13 | 6973 | 193,4 | 2,77 |

This study analyses the role of credit in home financing and the rate of home-related credits to the total value of homes and to the total credits. There are four usual sources in home financing: cash, income from selling the previous home, credit and support. The role of the credit among these sources has diminished: from 10 % in 1991 it reached only 1% in 2000. The reason is that the old credits from the previous regime

were paid back by pre-instalments, causing contraction of credit. Parallel to this, saved cash played an ever-increasing role. The supports started at 20% in 1991 and ended at 7% in 2000.

If we analyse the possible causes of the low home-credit ratio, several reasons derive from the background. The supply side of home finance credits suffered from difficulties the 1990's. There were not enough sources for long term credits, and more efficient areas – among them the budget - siphoned off the money. The company sector has always had priority against the citizen's sector because of the uncertain credit risks. These facts though would not influence the credit offer, if suitable demand could influence the tendencies.

The demand side, however, has also not been utmost in power. It derives from the changes of the savings habits of the population, which will be shown in the next passage. Inflation also causes diminution in credit-demand, and the high real rates are not tempting for indebtedness.

Since the competition has intensified in the banking sector, which started to reduce the too high rates, the source of the low home-credit problem must be derived from the demand side. First, I analyse the income and saving habits, than the dwelling position and home financing needs of the population.

4. Financial discrepancies

The income of the households has changed disparagingly following the economic tendencies in the 1990's: the real income set back. From the year 1997, the real income of the households started to rise. In 2000 it reached 1,5%, in 2001 6,3%, and in the first quarter of 2002 the real income increase was 11,5%. This growth enables the households on one hand to enlarge their consumption and also their savings, and on the other hand, it builds coverage to credibility. Despite these tendencies, the savings of the households shrank, and the net financial wealth has not grown at the expected rate. The cause of it is the suffered loss on stock investment prices. Another reason is the expansion of consumption. After the years of budgetary restriction in the middle of the 1990's, there is a natural need in most of the households to recover the deferred consumption. The major expenditure groups are food (28,6%), maintenance of dwellings and investment on housing (22,7%), which is more than the half of the household's income. These high ratios can also cause precaution towards high housing debts and instalments.

5. Consequences

The low home investment rates were not tolerable for too long. The government introduced a comprehensive home-subsidisation system. Recognising the need for low rate loans, the state gives rate-reduction and social benefits to new home investments. At the first decision only few households were able to get the loan. Firstly, because most of them did not fulfil the requirements, and secondly, because they still found the rates too high. After the modification of the conditions, the population moved towards the credit. Many thousands of households have already got the loan, and many more still want to use the opportunity. The question is, whether this high debt ratio can cause financial trespasses. My opinion is, that many debtors will not be able to pay back their loans, so it will require more governmental help in the future. This view can be proved

by the low and ever sinking saving rates. This means, that people prefer consumption, and that they do not see many future goals to save the money for. If the society is used to spend the income from time to time, this habit is very difficult to get changed. And lastly, even at discounted rates, the amount paid back over the credit period is twice or three times more than the value of the house.

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Monetary Policy in Bosnia and Herzegovina – Currency Board Arrangement

Introduction

The main motive for choosing the topic “Monetary policy in Bosnia and Herzegovina – currency board arrangement” is actual position of the Central bank of Bosnia and Herzegovina and the link of bosnian monetary mechanism through fixed foreign currency exchange between Convertible mark (KM) and German mark (DM) in currency board arrangement. On 1.01.1999. euro becomes common currency of EMU. Having this in mind we have got indirect link of our currency to euro from 1st. January 1999 (1KM = 1DM = 0,51129EURO). Direct link of Convertible mark and euro starts from 1.01. 2002 by introducing in circulation euro as common currency in euro-zone countries. Considering actual needs of the state Bosnia and Herzegovina within the region and having the need to be the part of EU in economic domain, as well as in monetary mechanism, would require clearly defined plan in the future.

The main hypothesis is that currency board arrangement, for our situation the best and current functioning institutional solution, represents the basis for achieving the stable currency project what would ensure additional power in fastening the process of monetary integration of the Central bank of Bosnia and Herzegovina through regional approach towards long-term goal accessing EMU and becoming the member of ECB. The open question in monetary policy sphere in Bosnia and Herzegovina is what after currency board arrangement, or continue with it?

1. The Establishment of the Central bank of Bosnia and Herzegovina in the framework of actual institutional solution

According to Dayton Law of Constitution of Bosnia and Herzegovina the Central bank of Bosnia and Herzegovina has been established as the only authorized institution for implementing monetary policy at the whole of Bosnia and Herzegovina. The Central bank of Bosnia and Herzegovina (later on CBBiH) is the bank at state level of Bosnia and Herzegovina that started its work on 11th August 1997. After the establishment of the CBBiH, National bank of Bosnia and Herzegovina and National bank of Republic Srpska have stopped operations as central banks.

The concept of monetary policy has been determined according to the principles of currency board arrangement. Therefore according to the Article III in the Law of Constitution the monetary policy is under authority of the state Bosnia and Herzegovina.¹

Authority of central bank will be determined by assembly of the state's parliament. However, in the first six years (1997-2003), the central bank would not be able to offer loans by issuing money and in that sense would function as currency board. After this period of time assembly of state's parliament may decide to give CBBiH functions of

¹ “The Law of Constitution of BiH: Annex 4 general peace agreement in BiH.

typical central bank.² Defined position of CBBiH in this manner, that functions as currency board arrangement, really narrows functions of central bank and sets it in the first six years period more like technical-operational mechanism rather than the institution that operates in creative way in monetary policy sphere, especially in area of money and credits.³

The law of CBBiH⁴ defines main goal of CBBiH, and that is maintaining the stability of domestic currency, Convertible mark, that is issued under currency board arrangement. The above stated law defines the principles of currency board as follows:

- New currency– Convertible mark (KM) is linked to euro at fixed exchange rate 1KM = 0,51129 euro. This exchange rate is determined by the Law of the CBBiH. International standard code for Convertible mark is “BAM”, or numerical code 977.
- CBBiH may issue in circulation Convertible mark only if it provides 100% reserves in convertible foreign currencies. (approximately 95% is in euros and 5% other currencies).
- CBBiH cannot give credit to any sector. It means that it cannot finance the government and it cannot be the lender of last resort.

2. Functioning of currency board arrangement in Bosnia and Herzegovina

Monetary policy in Bosnia and Herzegovina based on the principles of currency board arrangement encompasses the following:

- full coverage of monetary liability of CBBiH by its net foreign reserves,
- fixed exchange rate with euro 1euro = 1,95583 KM as reserve currency,
- unlimited convertibility of KM in euro and vice versa following the fixed exchange rate mechanism.

At the same time it is stated by the Law that CBBiH may not be involved in open market operations at money market nor capital market and may not give any credits to any sector, including banking as well as government sector.

2.1 Why currency board in Bosnia and Herzegovina and not the central bank?

Often asked question from the sphere of monetary policy is why currency board in the monetary system in Bosnia and Herzegovina, and not a typical central bank? Having said this we naturally find the question in the country why it is proposed, according to Dayton Law of Constitution, the central bank functioning through the currency board arrangement for the six years period meaning from 1997 until 2003? For this solution we may find more reasons whereby we state the following⁵:

- As the country that started the process of transition towards the market oriented economy it is very important to have macroeconomic stability and within it one of the key factors is stable currency,

² See: S. Kreso: “Novac Bosne i Hercegovine”, Jež Sarajevo, 1997, pg. 30-31

³ See: S. Kreso: “Novac Bosne i Hercegovine”, Jež Sarajevo, 1997, pg.132

⁴ The Law of Central Bank BiH, Official Gazzette 1/97.

⁵ For more details see: S. Kreso: “Novac Bosne i Hercegovine”, Jež Sarajevo,1997, pg.137

- As the country that came out of the war with deep trauma, divisions and mutual untrust we would have great difficulties in defining the goals of CBBiH, if it has to implement discretionary monetary policy. Due to that rigid and automatic rules as currency board follows was the best solution to start the process of economic and monetary integration in the whole country,
- As the country that is economically devastated we could hardly follow the reasonable framework of “discretionary” policy of central bank and “break” the boundaries due to huge needs of the money in the process of reconstruction and redevelopment of the economy as well as for public expenditure. Strong pressure in the way of financing budget’s needs by issuing more money would surely lead to high inflation what would create strong negative effects on economic social development.

Monetary policy of CBBiH based on currency board rules is being followed for four years already and results are summarized below:

- Maintaining consistently stability of the currency (Convertible mark - KM);
- Maintaining the rate of inflation at around 4% per year;
- Management of official foreign currency reserves held by CBBiH according to the instructions from Governing Council so that its investment is done in secured manner and with optimal interest earning;
- Established cooperation with institutions in Bosnia and Herzegovina;
- CBBiH has led the process of payment system’s reform in the country whereby now it is done by commercial banks and runs smoothly (giro clearing and RTGS system);

CBBiH, in currency board arrangement, is one of the key factors to have stable economy and developing self-sustainable bosnian economy. This is based mainly on stable Convertible mark that ensures further development of healthy and stable financial system in Bosnia and Herzegovina.

The stable and strong financial sector is precondition for strenghtening whole economic development (production growth, increased employment, growth of export, economic growth and national income growth), what would enable Bosnia and Herzegovina the realization of the european integration process with the long-term goal to become the member of EU and integration of CBBiH in euro system and ECB. The currency board arrangement would continue to act in maintaining stability of the bosnian currency. Therefore currency board in Bosnia and Herzegovina has justified its goal. Justification is proven by KM stability, trust by citizens in KM, and maintaining minimal rate of inflation.

Finally functioning of our central financial institution in currency board arrangement will positevely influence future development and more effective functioning of macroeconomic policy while ensuring faster accession in european monetary integrations.

3. Continue with currency board arrangement in Bosnia and Herzegovina?

Since its establishment CBBiH implents the monetary policy through currency board arrangement. Bearing in mind situtation that Bosnia and Herzegovina had been in the past decade we may say that there was not better solution in implementing monetary

policy. Currency board arrangement according to Dayton Law of Constitution will last until august 2003. The question that arises here is whether the CBBiH will continue to function under principles of currency board and certain period of time after 2003. The answer stated here is taken from the speech by Mr. Peter Nicholl, governor of CBBiH, where it follows ⁶:

- there is wide spread support to continue with currency board arrangement due to the fact that it has ensured one of the basic stability's element what citizens of Bosnia and Herzegovina earlier did not have;
- it would be risky to change it. The trust in KM would decline because citizens would be waiting to see how alternative monetary policy would function;
- currency board arrangement functions well in few countries in Europe such as Estonia, Litvania and Bulgaria; currency boards become acceptablei, even "modern";
- long-term goal of monetary policy in Bosnia and Herzegovina is to get closer bosnian economy to EU. Convertible mark is already linked to euro. Therefore it would have sense to keep this link.

Since currency board arrangement is very important monetary "weapon" for the transition country as it is Bosnia and Herzegovina different theoretical questions on future development perspectives of CBBiH remain open, but practically currency board would remain for certain period time in the future. It depends what would the Parliament of Bosnia and Herzegovina decide in august 2003.

4. Conclusion

Since its establishment CBBiH implents the monetary policy through currency board arrangement. Bearing in mind situtation that Bosnia and Herzegovina had been in the past decade we may say that there was not better solution in implementing monetary policy. Currency board arrangement according to Dayton Law of Constitution will last until august 2003. Since currency board arrangement is very important monetary "weapon" for the transition country as it is Bosnia and Herzegovina different theoretical questions on future development perspectives of CBBiH remain open, but practically currency board would remain for certain period time in the future. It depends what would the Parliament of Bosnia and Herzegovina decide in august 2003.

European Union, is as the result of economic integration, successfully implemented and monetary integration. It means implementing common monetary policy by European central bank that issued in circulation common currency euro on 1st January 2002 in all 12 countries members of economic and monetary union.

Bosnia and Herzegovina, as European country, has long-term goal, and that is to go towards European monetary integration. Bosnia and Herzegovina has become 44th member of Council of Europe on 24th April 2002 and that is the first initial step in long-term process of integrating bosnian monetary system in monetary system of EU.

Having the link of bosnian currency with Euro is the chance for our country to move further in taking all necessary steps and reforms in realizing long-term goal. It is important to say that link between KM and euro from 1st January 2002 through currency

⁶ His argumets regarding this question governor P.Nichol has presented in lecturing postgraduate class at Economics Faculty Sarajevo, June 2001.

board arrangement is not “shortcut” for entering economic and monetary union. It is needed to reach stable economic growth and self-sustainable development, create single economic market, establish institutional infrastructure for functioning of financial market, synchronize fiscal and monetary policy, create safe legal framework for attracting investments from EU countries and implement in many aspects standards required by EU.

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Specifics of the Transition Process in BiH – Framework of Development Strategy for BiH

1. Introduction

The commands economy and social ownership have not withstood the historic battle with private ownership. The historic error made will be rectified in the process of transition. This is very complex dynamic process that will enable the return of private ownership, the development of new infrastructure, a more efficient market and the democratic institutions appropriate to a multi-party parliamentary democracy.

In the paste decade, countries in transitions have seen very different trends in macro-economic performance. Transition in Bosnia and Herzegovina is an integral part of the overall process of transition. BiH, like all other transition countries (there are 27 of them in Europe) started that process in 1989. Initial liberalization has been completed, transition recession was dominant for first two-three years, and then later, macroeconomic stabilization has been reached. But, there is a historic fact, which has changed BiH transition process and put this process away from the "ordinary" scenario – it is four years war. The war left its own mark, so these reformes have seen a complete turnaround from the situation at the outset. After the war, BiH government decided to start/continue the process of transition.

Economic growth in BiH has been large in quantitative terms, while the quality of the growth is not satisfactory. The achieved results in terms of the establishment of self-sustainable economy are weak. The major source of growth remains largely dependent on the flow of international aid. The unemployment rate has been reduced, although it is still intolerable as it is around 40%. The export ability is weak, while a balance of payments deficit is continually high, from one year to another. The private sector participates in GDP with around 35%, which is too small a percentage in comparison to other countries in transition.

2. Some aspects of the transition process in BiH

There are specific characteristics of BiH's economic transformation compared to the other countries in transition, since the country restarted from ruins caused with conflicts. Thanks to foreign donors, infrastructure has been significantly reconstructed, and macroeconomic disorder has been removed to a significant extent.

"During the reconstruction period i.e. 1996-1999, around US\$ billion 3,5 provided by international donor community was spent on reconstruction of the country.

The following results were achieved with these funds:

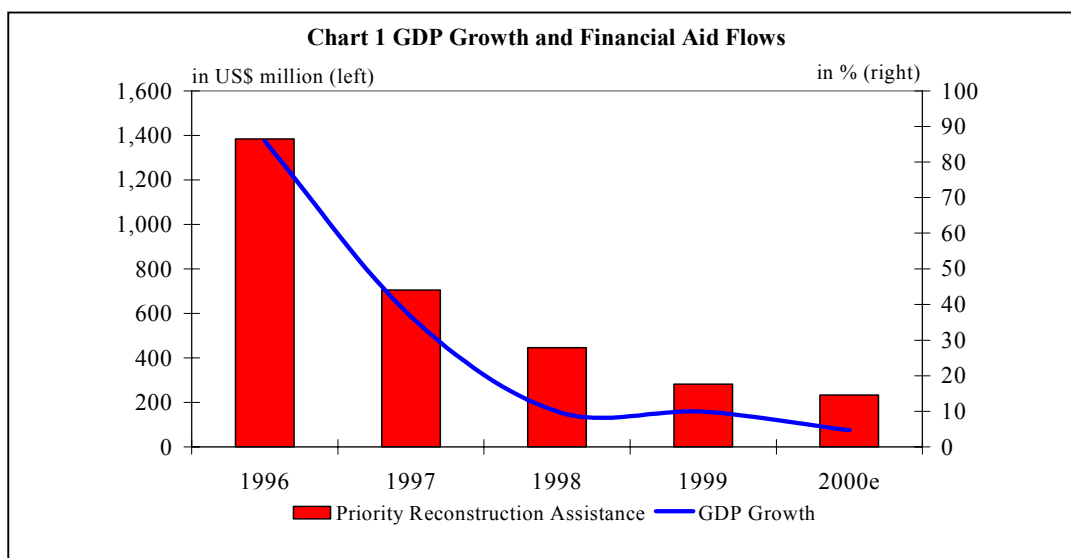
- Over 90 % of roads are in good condition
 - Electric power generation achieved 80 % of prewar level
 - Water-supply achieved 90 % prewar level
 - In FBiH over 30 % and in RS 15 % of housing was repaired
 - Relatively free flows of goods throughout BiH has been ensured, etc."
- [Council of Minister BiH, 2001, S.6]

But, as international donor community withdraws, BiH will face the problem of lack of foreign exchange funds, which is, given large trade deficit and high level of foreign indebtedness, of critical importance. Country's financial system is based exclusively on banks in which population does not have confidence, thus large portion of funds stay out of financial system. Therefore foreign direct investments are more than welcome to BiH.

Although the reconstruction stage of Bosnia and Herzegovina is mainly completed, economy is still in the phase of incomplete transition towards market economy. A low level of production, collection of revenues, exports and investment activities make this country dependent from the official international assistance. Under the conditions of engagement of the Currency Board¹ this is the only way of covering fiscal and external imbalance with which Bosnia and Herzegovina is being faced.

Macroeconomic stabilisation in the country has been achieved only partly. However, there are some indications that the revival of economy and the progress has been achieved along with the risk of making national income dependent on the flow of pecuniary assistance. High growth rates over the past years have been partly supported by foreign assistance – donations, unilateral transfers and not by private investments – the so-called aid driven GDP. The correlation of GDP growth and the flow of international assistance to BiH are shown in Figure 1.

Figure 1: GDP growth and financial aid flows to BiH



Source: A report on implementation of the world banks country assistance strategy

As we can see, there is very strong positive correlation between financial aid flows and GDP growth rate. Economic growth was maybe high over these five years, but what is more important, it was not a good quality growth, because:

- Poverty grows
- Inequality grows
- Unemployment grows

¹ Currency Board represents a manner in which the BiH Central Bank operates until 2003

Specifics of the Transition Process in BiH [...]

It is not good sign. It is not big step from traditional towards modern society. Also, if we look other aspects of transition, we will not find better results. Evolution of current course of transition shows very bad position of BiH economy.

Table 1 gives review of key economic indicators of BiH economy.

Table 1: BiH: key economic indicators, 1999

| Employment (1989 =100) | Unemployment rate (%) | Foreign-trade balance (bill. US\$) | Net foreign debt/export (%) | Total foreign debt/GDP (%) |
|---------------------------|-----------------------------|--|-----------------------------------|----------------------------------|
| 37,6 | 39,1 | - 1,44 | 203 | 68 |

Source: EBRD 2000, Transition Report

Based on table 2, it can be concluded that in BiH, there are:

- Very low employment of labor force (employment has reached only 37,6 % of prewar employment, while in South-European economies in transition in 1998 it was 77,1 %, and in Central European economies in transition 87,4 %. There is no economy in transition with lower employment than BiH.)
- Huge unemployment of labor force (there is no economy with higher unemployment rate; average unemployment rate for South-European economies in transition is 16,6 %, and for Central-European economies in transition 12,5 %);
- Huge foreign-trade deficit (there is no single other country with such relatively high deficit), which is not decreasing, on the contrary, increasing;
- Huge foreign indebtedness (ratio between total foreign debt and GDP is 68 %, while South-European average is 40 %, and Central-European average 111 %).
- Very poor creditworthiness (ratio between net foreign debt and export is 203 %, while South-European average is 111 %, and Central-European 108).

Table 2 provides review of achieved level of economic reforms in BiH.

Table 2: Achieved reform level in BiH, 2000

| | Private sector share in GDP (%) | Enterprise restructuring | Competition policy | Banking | Capital market |
|------|------------------------------------|-----------------------------|-----------------------|---------|-------------------|
| BiH | 35 | 1,67 | 1,00 | 2,33 | 1,00 |
| SETE | 59 | 2,22 | 2,00 | 2,78 | 1,78 |
| CETE | 72 | 3,07 | 2,93 | 3,40 | 3,01 |

Source: EBRD. *Transition Report 2000*.

SETE: Albania, Bulgaria, Croatia, Macedonia, Romania; CETE: Check Republic, Hungary, Poland, Slovenia, Slovakia.

Ranking index: 1 (lowest level) to 4+ (highest level).

Based on the table 3 it can be concluded that in BiH:

- Private sector development is very low
- Extremely slow enterprise reform due to slow privatization, poor restructuring and poor corporative management.
- Undeveloped competition policy
- Extremely slow privatization

- Poor developed banking sector

Also, there is no overall macroeconomic stability in BiH. More precisely, fiscal stability is a big problem, since there are significant budget deficit (in year 2000 they amounted officially around 3 % of GDP BiH). Prices are pretty stable – inflation is about 4 % a year. Central bank BiH has established as "Currency Board" – main reason for monetary stability in the country. These facts are the reality, but we have to keep in mind that BiH faces with huge problems. The most difficult problems are:

- Development of government system
- Return of refugees
- Reconstruction of country
- Transition

3. Development strategy for BiH

As we have seen in the first part of the presentation, BiH economy is facing with a lot of problems. It was the reason that BiH government has started to build development strategy for BiH, which will try to solve crucial problems of the economy. They established mid-term strategy – 2000-2004 – under the name "Entrepreneurial society – Bosnia and Herzegovina Development Strategy Global Framework 2000-2004". It was published in May 2001. Also, it is base for new document, which will provide to solve the problem of poverty in BiH – PRSP program – Poverty Reduction Strategy Paper that is now in progress. Bosnia and Herzegovina Development Strategy Global Framework 2000-2004 (hereinafter: the EDSGF) based on broad understanding of development. Development is understood as transformation of society, movement from traditional towards modern society. Illustratively said, the EDSGF is a frame of composition of development strategy.

4. Priorities of development strategy for BiH

We will present the objectives of "Entrepreneurial society" for the period 2000-2004 and priorities for their achievements.

Table 3: Development priorities of "Entrepreneurial society"

| Level of priority | Priority |
|-------------------|--|
| AAAa | ◆ Employment increase |
| AAAb | ◆ Institution building |
| AAa | ◆ Capital mobilization |
| AAa | ◆ Acceleration of economic sector transition |
| AAb | ◆ Completion of reconstruction process |
| AAb | ◆ Non-production sector development |
| A | ◆ Housing development |

Source: Council of Ministers BiH, Entrepreneurial society – BiH economic development strategy Global Framework 2000-2004

Note: ranking is digressive from AAAa, through AAAb, etc. to A.

5. Development engines - EDSFG

EDSFG gives very strong importance to five development engines for economic improvement:

1. Foreign direct investments - it would be extremely important that foreign trade and direct foreign investments cover whole BiH, rather than only certain enclaves.
2. Education – education is from long-term prospective of crucial importance for economic development. It trains people how to learn, to accept and conduct transformation of society.
3. Entrepreneurship– entrepreneur is focus of attention of EDSFG. Also, in the comparable group of countries (Greece, Portugal, Austria) small firm is a key word in services, industry, crafts-work and agriculture.
4. Export – BiH lost foreign and even domestic market. These results with deficits of current payment balance, and leads worsened situation with foreign debt, which presents significant cause of short-term instability and severe long-term development constraint. It would be of particular importance to develop strategy of entering foreign markets, with focus on markets, which can realistically be entered.
5. Regions – certain regions of BiH could become production, investment and export platforms of South-East Europe, in sense that BiH could become host to transnational corporations, which could use BiH export platforms to perform certain productions, which would cover the needs of the whole region.

6. Strategy implementation policy

As strategy implementation policies EDSFG sees:

1. Fiscal policy – reform of State and Entity institutions would be necessary first of all. Then audit and control of all budgets in the country would be necessary, as well as adjustment of public expenditures to fiscal capacity of the economy. Fiscal policy has to be based on firm compliance with stand-by arrangement rules and adjusting public expenditures with tax capacity of the economy.
2. Monetary and credit policy – the Central bank BiH would be developed in the following direction (it is Currency board arrangement now): development of monetary-credit instruments, developing banks credit capacity, developing internal payment system.
3. Foreign economic policy – harmonization of registration policy for foreign investments on BiH level and Entity level in the sense of maximal simplification of the procedures and location where it can be done; to continue concluding bilateral agreements and investment insurance; to promote local economy abroad, market analysis and support for export enterprises through reform and training.
4. Transport policy – recovery and stabilization of transport on prewar level as well as undertaking institutional and political reforms of transport sector.
5. Competition policy – enterprise restructuring in post privatization period also presents one of the steps towards strengthening competition both in local and international market. Without its strengthening and reduction of activities related to political rent-seeking activities, particularly in the area of import, it would be difficult to expect larger progress.

6. Environmental policy – development must be based on maintenance of biodiversity and natural resource for next generations. Short term oriented development base on air, water and soil pollution would not be acceptable.

Before conclusion, we will look the expectations of EDSGF for period 2000-2004.

Table 4: Expectations of EDSGF document for BiH 2000-2004

| | 2000 | 2001 | 2002 | 2003 | 2004 |
|------------------------------------|-------|-------|-------|-------|-------|
| GDP | 5.333 | 6.262 | 7.090 | 7.731 | 8.386 |
| GDP growth (%) | 14 | 14 | 10 | 6 | 5 |
| GDP per capita | 1.274 | 1.448 | 1.678 | 1.762 | 1.833 |
| GDP per capita growth (%) | 13 | 13 | 9 | 5 | 4 |
| Gross domestic investments (% GDP) | 32 | 32 | 28 | 26 | 25 |
| Savings (% GDP) with grants | 15 | 17 | 18 | 19 | 20 |
| Savings (% GDP) without grants | 14 | 16 | 18 | 19 | 20 |
| Public expenditures (% GDP) | 48 | 47 | 44 | 43 | 42 |
| Public revenues (% GDP) | 31 | 35 | 36 | 37 | 38 |
| Public deficit (% GDP) | - 17 | -13 | -11 | -7 | -5 |
| Export | 1.816 | 2.162 | 2.498 | 2.796 | 3.044 |
| Import | 2.863 | 3.124 | 3.234 | 3.358 | 3.460 |
| Current account balance | - 879 | -831 | - 640 | -504 | -424 |
| Net-foreign direct investments | 162 | 185 | 200 | 200 | 200 |
| Net-long term loans | 117 | 190 | 146 | 144 | 96 |
| Foreign debt | 3.348 | 3.629 | 3.819 | 3.954 | 4.063 |
| Debt servicing | 136 | 115 | 151 | 178 | 191 |

Source: Council of Ministers BiH, Entrepreneurial society – BiH economic development strategy global Framework 2000-2004

7. Conclusion

After all we can conclude that even in the case that BiH will have a good macroeconomic management, population will not have a standard of life measured in terms of per capita GDP in 2004 compared with 1989.

Bosnia and Herzegovina is the country in transition, but also the country in postwar reconstruction. It is very difficult to promote strategy in the environment like this one – strategy that should help to avoid all those problems and in the same time to reach self-sustainable development.

BiH is quickly moving towards better future. Almost all levels in the state have prepared strategic document for economic development and restructurings that will enable to make positive steps in the future. The State and Entity levels have adopted strategy for economic development and these days they are working on final stage of operative strategy paper document for reduction poverty in BiH – PRSP document.

As we could see through this presentation, expectations for BiH economy are not very optimistic one, but they are positive. Bosnia and Herzegovina slowly, but strongly, goes "up" and towards Europe – European Union. We hope, that one-day – but very soon, BiH will be an integral part of European integration.

8. Literature

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9. Appendix

Table 5: BiH - Key indicators, 2000

| | |
|------------------------|--|
| Population (mill) | 3.835.777 |
| Age distribution | 0-14 years: 20 % 15-64 years: 71 % 65 years and over: 9 % |
| Expected life time | 71,49 (male 68,78; female 74,38) |
| Area (square km) | 51.129 |
| Terrain | Mountain/valley |
| Extreme altitude | 0 m (Adriatic Sea) i 2.386 m (Maglić) |
| Sea cost | 20 km |
| Climate | Hot summers and cold winters; mountain regions with short cold summer and long severe winters; along sea cost moderate rainy winters |
| Land by use | Arable lend (14%), Cultivated (5%), Pastures (20%), Forests (39%); Other (22%) |
| Irrigation (square km) | 20 |
| Natural resources | Coal, iron ore, bauxite, magnesia, forests, copper, chrome, lead, zinc, hydro-power |
| Natural risks | Destructive earthquake |

Source: CIA. The World Fact book 2000

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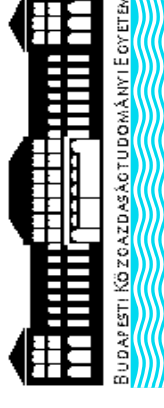
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Opening

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Welcome address

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Seminar Concept

14.15 – 18.00 **Papers with discussion**
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14.15 **Guido Heineck**

Does religion influence the labour supply of married women in Germany?

15.00 **Zsombor Ligeti**

The validity of the Kuznets "inverted-U" hypothesis in Hungary after transition

15.45 **Stefan Hopp**

Selected pieces of the economic theory of J.-B. Say, or: Economics today: Rhetoric or science?

16.30 **Arsena Gjipali:**

Emigration and its economic consequences in the transition phase of Albania

17.15 **Dorjana Dervishi**

The Balkan region economies and the challenge of integration

Wednesday, June 05, 2002

8.30 – 12.15 **Papers with discussion**
Chair: Michael Schmid

8.30

Suela Thimo

Competition strengthening, an important factor for a successful transition in Southeast Europe

9.15

Dzenan Donlagic

Monetary policy in BiH - currency board arrangement

10.00

Adnan Efendic

Specifics of transition process in BiH- framework of development strategy for BiH

10.45

Elida Liko

Exchange rate variability and policy implications - the case of Albania

11.30

Gunther Grathwohl

Structural macroeconomic characteristics of developing countries

Afternoon

Individual and / or cultural program

Thursday, June 06, 2002

9.00 – 12.00 **Papers with discussion**
Chair: Volker Treier

9.00

Michael Eichinger

International alliances - an approach of a trust-based management

9.45

Ernelinda Fejzullahu

Critical assessment of the IMF structural adjustment programs

10.30

Holger Käthelein

Fiscal competition on the local level: May commuting be the source of financial crises?

11.15

László Balogh

Growth stimulating tax systems

13.30 – 16.30

Papers with discussion
Chair: Dietmar Meyer

13.30

Anikó Dobricza

The debt rate paradoxon – Why isn't home financing as effective as it was planned to be?

14.15

Arjeta Abazi

Transmission mechanism of the monetary policy - the case of Albania in transition

15.00

László Horváth

The Keynesian and the Post-Keynesian approach to distribution – similarities and differences

15.45

Borbála Szűle

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17.00

Final discussion

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