

Solutions for financing public deficit of Albania

Evis Gjebrea,* Patris Poshnjari,** Ermela Kripa***

Economic Faculty-European University of Tirana

**PhD Candidate, Phone: + 068 60 31 557; @: evis.gjebrea@uet.edu.al*

***PhD Candidate, Phone: + 068 90 19 434; @: patris.poshnjari@uet.edu.al*

****PhD Candidate, Phone: + 068 60 31 463; @: ermela.kripa@uet.edu.al*

Abstract

International Organizations such as World Bank and IMF, have continuously signalized developing countries for risks posed by huge amount of public debt, including Albania. Based on official statistics Albania records a public debt near the so called Upper Limit, which is 60 % of GDP.

After the fall of communism in the 1990s, the CEE countries followed a long and difficult road of reforms and adjustments. Likewise, the Albanian economy experienced many structural and economic policies to support democratic development and market economy. The need for social, political and economic development is one of the reasons that explain high amounts of public debt over the years. This debt has been used primarily to finance public deficit and development projects, which generate low rate of returns.

The literature on Public Finance suggests different ways of financing public debt, but in this article our focus is on method of financing public deficit through public debt. Aim of this article is to find out whether there is any optimal structure of

public debt composition (domestic and foreign) to finance deficit. Our methodology includes an evaluation of risk derived from domestic and foreign debt and relies on the experience of other countries that have been successful in managing public debt with the final aim of adopting best model to the Albanian case.

Keywords: Public Deficit, Public Debt Structure, Risk Evaluation

1 Literature review on public debt

The development of public debt and budget deficit has become a crucial policy problem in most industrialized and developing countries. In this regard it is of foremost importance to set a legal target restriction for state borrowing, which should be in compliance with macroeconomic parameters. This necessity is related also to the impact of state borrowing on the economy as a whole. The aim of the following section is to present from the theoretical point of view the effects of public debt compared to financing budget deficit through taxes. In economic literature there are different views to the positive and negative effects of public debt on the economy.

Based on the Ricardian equivalence theory, which was first developed by Ricardo and later reviewed by Barro (1974), the main concept mentioned was debt neutrality. According to this concept there is no real effect on aggregate demand whether financing budget deficit by debt or taxes, because consumption is reduced either way. Buchanan criticized Barro for ignoring the effect of negative capital formation that comes with that. Buchanan (1958) also believes that there must be some shifting of the primary real burden to future generations. Buchanan and Wagner (1977) developed the idea of fiscal illusion through which public in wide does not acknowledges the burden caused by public debt as compared to tax financing¹. Meanwhile the Ricardian equivalence theory does not take into consideration fiscal illusion.

The neoclassical theory pinpoints the link between high public debt and the crowding out of the private sector, which impacts the interest rate increase due to high demand for debt by the Government. The crowding out and interest rate increase have a negative impact on the future GDP. Therefore, the intergenerational distribution is unequal because future generations faced with lower GDP and higher interest rate bear higher costs as a result. Despite the high burden through public debt the distribution theory justifies it through the fact that future generations accumulates technical knowledge as well as inherit productivity effects of public investments. In this point of view there still exists intergenerational equity, which can be provided by the so called "golden rule". It means that the upper level of public debt should be inasmuch as its net public investments.

The empirical studies that confirm the positive correlation between public debt and interest rate are made by Elmendorf 1993, Dai and Philippon 2006, Cebula 2000, Gale and Orszag 2003, Bernoth et al 2003, Codogno et al 2003, Afonso and Strauch 2003.

1 Tempelman. J (2007), p. 435-449

Another view is the allocation theory which justifies public debt in two ways: (i) tax smoothing and (ii) addressed economic problems.

The political-economic theory advocates the strategic deficit theory, which aims to attract voters for securing next electoral victory, or can be used by governments to constraint spending decisions of possible successors².

Even though some of the mentioned theories are in support of public debt there is a need for setting a public debt limit in order to protect taxpayers and voters and avoid public probable risks.

In the next chapters we will focus on public debt problems and possibility of finding a fiscal rule in the case of Albania.

2 Description of public debt and its trend in Albania and the region

After the fall of iron curtain almost all CEE countries were characterized by high public debt due to the need to restructure their economies. The main sources of financing the recovery of economies were mainly through privatizations of state own enterprises and public debt. The foreign debt was provided through international organizations such as World Bank, EBRD, EIB, KfW, IDB, IMF etc, which offered credits under concessional terms. Domestic public debt is not a new phenomenon for developing countries. Usually these countries have higher levels of domestic debt over external debt due to inability to access international capital markets. Therefore, in a need to find financing sources to cover budget deficit, they issue Treasury bills, bonds and the like.

This section focuses on Albanian public debt trend and its influencing factors. In the following graph is shown a tendency of net public debt of Albania and CEE countries for the period 1995-2012.

As the graph shows Albania after Hungary has the highest level of public debt, which has been a continuous subject of criticism by IMF calling for prudent public finance consolidation. Exception is made for Kosovo which has low level of public debt due to the formation of Kosovo as a new country in 2008 meaning that Serbia is responsible for past public debt burden.

The highest public debt for Albania was registered in 1997 due to collapse of pyramid schemes. After this year the public debt though high started to decrease and was maintained according to the recommendations of IMF, but it never fell below the Emerging Market Countries level. Between 2003 and 2007 the public debt in combination with strong GDP growth declined from 60.7 % to 53.8% of GDP. This trend reversed starting with 2008 when the public debt was 55.01% of GDP due to the increase of public investments. That

2 Sachverstaendigenrat (2007), p. 35-41

is the reason that in 2008 and 2009 the fiscal deficit increased from 5.6% to 7% of GDP due to the need to alleviate the consequences of global crisis.

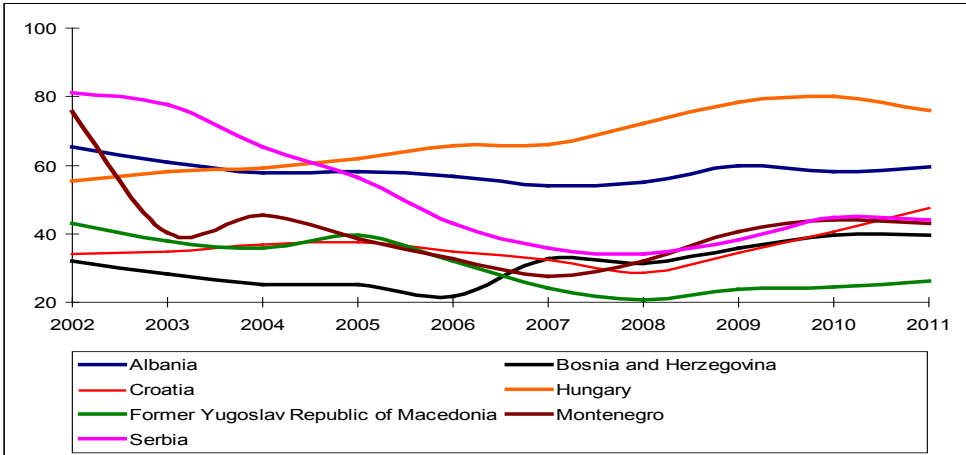


FIGURE 9.1 — Net Public debt in % of GDP for Albania and the region. Source: Ministry of Finance, own graph.

The current public debt amounts to 59.4 % of GDP, which is slightly lower than the Maastricht target of 60% of GDP. Also the higher deficit reflects government spending for key infrastructure, education and health.

A study of IMF (2003) finds out that by the increase of public debt the primary balance weakens and stops when the debt reaches the level of 50% of GDP. This points to the conclusion that on average the fiscal policy in the EMC countries ceases to be consistent with debt sustainability once the debt to GDP ratio reaches 50% of GDP³. Therefore, this can explain the target of the Albanian Government to lower debt ratio to nearly 50% of GDP until 2015. In the following sections we present a more thoroughly analysis of public debt structure as well as ways of reducing.

3 Importance of an optimal public debt composition (trade offs)

In order to measure the country's exposure to sovereign risk it is important to take into consideration the size of public debt as well its structure. A high public debt associated with higher interest rate narrows the budget space to act in favor of other expenditure items. Therefore, the focus of this section is to analyze the public debt structure of Albania in order to identify problems and to find a fiscal rule in that it minimizes risks and improves public debt structure.

We will begin our analysis by decomposing public debt structure according to its

main components and more concretely: (i) countries dependence from external debt (ii) average maturity duration (iii) type of interest rate- variable or fix (iv) indexed public debt to inflation. All these components form the indicator of public debt structure.

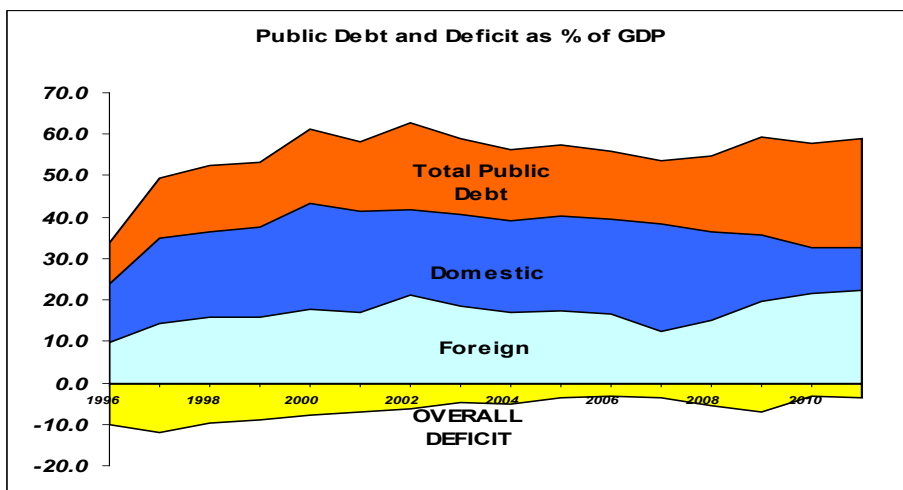


FIGURE 9.2 — *The public debt structure of Albania. Source: Ministry of Finance, own graph.*

As seen from the Figure 2 the external debt had the following trend: it increased until 2002 reaching 21% of GDP, started to decrease until 2007 reaching 12.4% of GDP and from 2007 to 2011 it increased to 22.5 % of GDP. Speaking in terms of Albania's dependence from external debt it can be concluded that ratio domestic debt over foreign debt is 60:40. The target set by the Ministry of Finance is to bring this ratio to 55:45.

Albania has been shifted from low income country to middle income country and as a result has been given country rating giving a positive signal to investors and financial markets about the economic prospects of the country. This will facilitate foreign borrowing of Albania.

Although domestic debt might seem more attractive to the Government the choice between domestic and foreign borrowing is based on four important factors:

- Crowding out effect meaning that in the short term domestic borrowing leads to higher domestic interest rates. In the short term foreign borrowing tends to avoid this crowding out effect
- Political choices
- Debt service costs
- Balance sheet effect

Government debt consists of central government debt and local government debt. The last are allowed to borrow after approval from the MoF. Central government guarantees are issued to State Owned Enterprises. Part of the debt being guaranteed is

serviced by the central government. However, overall the guarantees are not a major part of central government obligations. Compared with Albania, Former Republic of Macedonia has higher guarantee level, especially for public enterprises meaning that greater negative consequences over the budget. Therefore the future policy of Macedonia aims to reach a sustainable level of 10% of GDP.⁴

Domestic debt is mainly short term, consisting of T Bills covering 60% of the total domestic debt and 40% are long term. As we can see the composition of domestic debt is short because of slow development of capital market for trading Government long term instruments. The bonds being issued mostly consist of 2 year bonds. Starting from 2007 part of the debt portfolio are the 7 year bonds the Government issues, but in 2009 they have not been issued due to lack of liquidity and market problems. Although this trend, by the end of 2009 there is an increase of the long term domestic debt especially for 5 year bonds.

TABLE 9.1 — *Duration and average maturity in selected countries. Source: OECD Central Government Debt Statistical Yearbook 1999-2008 and Ministry of Finance Albania.*

Country	Debt	Duration (year)	Average maturity (year)
Albania	domestic debt	0,8	0,8
	external debt	6,8	11,4
	total debt	3,0	4,6
Countries in the region and new EU countries			
Czech Republic		4.1	6.6
Greece	domestic debt	5,3	
	total debt		8,4
Hungary		3.0	4.8
Italy		4.5	6.8
Poland		3.6	5.3
Slovakia		3.1	4.7
Turkey	domestic debt	0,7	2,0
	external debt		7,9

As seen from table 1 the duration of domestic debt is 0.8 year, while the external debt has a longer average maturity approximately of 11.4 years. This is due to the high external debt registered until 2005 from international organizations through concessional loans with long term maturity. Since Albania has shifted from borrowing under concessional terms to commercial terms the average maturity of external debt decreased from 11.4 to 6.8 years.

The interest rate structure of public debt is characterized by fixed and variables interest rates. What is evident is that in the first decade fixed interest rates dominate over variables ones due to the concessional loans. Whereas after 2000 due to borrowing

4 Ministry of Finance of the Republic of Macedonia, 2010, p.11.

under commercial terms there is an increase of the variable interest rates, therefore part of external debt contracted under variable interest rates has been increasing. The 5 year bonds consists of both fixed and floating rate bonds, the latter having the interest rate linked to the one year T Bill rate.

Since most of the public debt is short term, domestic debt being exposed to interest rate changes and external debt to exchange rate, debt risks are increasing which might lead to significant fluctuations of debt service. The following charts show respectively an external debt service trend expressed as percentage of exports of goods, service and income and as percentage of GNI.

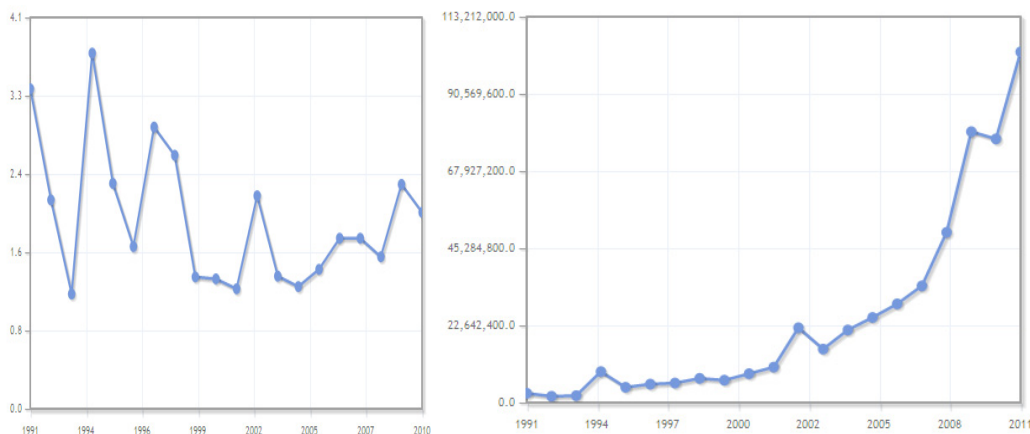


FIGURE 9.3 — Left: Interest payment on external debt. Right: Interest payment on external debt (% of exports of goods and services and income)(% of GNI). Source: World Bank, Global Development Finance

Besides the average maturity and interest rate another important factor to be taken into consideration is government instruments indexed to inflation. This option is usually offered in developed countries, for example in England about 20% of its public debt is indexed to inflation. In developing countries there is less effort to index public debt. In Albania public debt is not indexed to inflation, but inflation rate is kept under control and is within the objectives set by the Bank of Albania (2%-4%).

In summary, by looking at the public debt structure we conclude that there is a need to improve its structure in order to alleviate possible risks. In deciding the optimal structure of public debt it is important to consider the trade offs between refinancing risk and exchange rate risk. Based on the Debt Management Strategy for 2011-2014 this structure will be improved through three main objectives:

- The ratio domestic/external debt reduced to 55% / 45%.
- New borrowing in domestic market should be made only through long term instruments and external borrowing if possible be made in Euro denominated currency.
- Duration of the domestic debt should be increased to 1.29 year.

Macedonia stresses the importance of an optimum currency structure In order to reduce exchange rate risk and interest rate risk. Accordingly one of the mid term objectives for debt management is that the share of Euro denominated debt in total public debt should not be lower than 70%⁵. This option could be also valid for Albania.

4 Solutions for public debt reduction

Aim of this section is to introduce ways for reducing public debt and analyzing factors for reaching sustainable level of public debt. Public debt level is considered sustainable if it enables timely servicing and refinancing on the long run. On a broader view it depends on economic growth rate, inflation rate and development of domestic financial markets.

There are many factors that impact the sustainable level of public debt in EMC countries (IMF, 2003; Rogoff et al., 2003):

- Revenue ratio, which makes possible to service public debt
- Lower revenue volatility, which reflects the macroeconomic volatility. For Albania the coefficient of variation which measures the volatility of revenue to GDP ratio was 6.7 for 1996-2008 while after 2008 this coefficient decreased to less than 1 showing an improved macroeconomic situation.
- Low interest costs which in EMC countries account for 17% of total expenditures and 5% of GDP. In Albania these costs are lower at about 10% of total expenditures and 3% of GDP due to the concessional loans provided by international organizations.
- Sensitivity of public debt to GDP to changes in the exchange rate. For countries that have high foreign currency denominated debt, depreciation of local currency could lead to high level of expenditures. In Albania the share of foreign currency denominated debt in total public debt has decreased from 50% of total debt to 30 % of total debt.

The solutions for reducing public debt made up to now include those taken at international and national level. At international level for example these solutions are stipulated in the Maastricht Agreement and Stability and Growth Pact according to which total public debt should be not higher than 60% of a country's GDP.

At the national level we can mention the experience of Germany and Switzerland. In Germany the public debt regulation is based on Article 115 of the Constitution. According to this regulation the net borrowing by Federation shouldn't exceed investment expenditures (Diekmann Berend, 1998)⁶.

5 Ministry of Finance of the Republic of Macedonia, 2010, p.15f.

6 Diekmann, B. (1998), p 667-675.

In Switzerland the public debt regulation called “Swiss debt brake” (see the following graphic) model was implemented for the first time in 2003. This model is distinguished for 4 main characteristics which are the following⁷:

- Simple expenditure rule with binding clauses
- Consideration of exceptional circumstances
- Introduction of stabilization account
- Stipulations for the use of extraordinary revenue.

The mechanism of this fiscal rule is based on financing expenditures through current revenues instead of new debt.

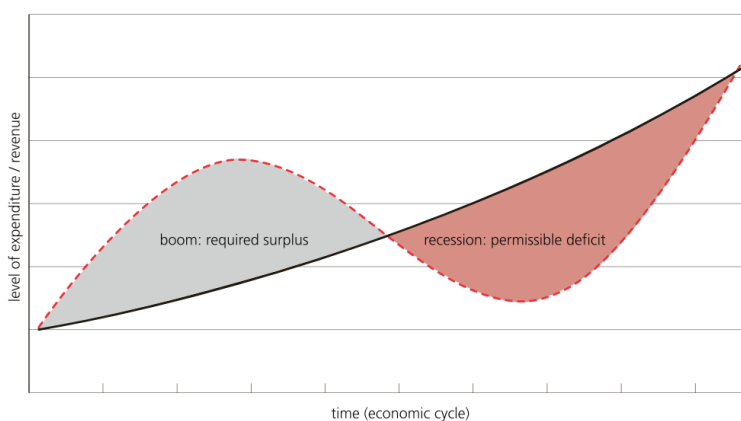


FIGURE 9.4 — Debt brake rule. Source: Geier, A (2011), p. 14

In the case of Albania, it is difficult to come to conclusion of applying these solutions because positive effects in these countries are yet unknown since their implementation started in the last decade.

On the other hand IMF (2010) introduces 2 options for fiscal rule. The first one, called debt rule mentions that the nominal public debt ratio can increase less than the nominal GDP ratio increase. This rule is more flexible in deciding how to achieve the primary balance consistent with debt target. This could be done through decreasing expenditures or increasing revenues. The second option called expenditure rule mentions that expenditure ratio can increase equal to GDP growth rate increase. This option is more constraint because it does not take into account the revenue collection.

The expenditure rule seems to be not a good option for Albania considering its need to increase public investments. Therefore, the most feasible option seem to be the debt rule because there is room to strengthen revenue collection using its potential the country has for economic growth, improvement of tax administration and reduction of informal economy.

In order to guarantee a sustainable economic growth there is a need to identify

7 Geier, A. (2011), p 7-31, see also Brandner, P at al (2005), p.1-21.

new sources of growth. So far many sources with an impact to economic growth seem to have been fully exploited such as privatizations, self-employment in agriculture, foreign aid from international organizations, discharge of labor market due to massive immigration, high level of remittances etc.

Therefore, there is a need for a new economic model regarding new potential sources of economic growth such as: knowledge economy, introduction of new technology in all sectors of economy, policies oriented towards manufacturing, industrial, agriculture, energy and tourism. Once again this new economic model stresses the idea presented above about the debt rule solution because this model contributes to revenue increase.

It is recommended that Albania focuses its efforts to processing and diversifying of its products due to increasing demands and global market expansions, as well as modernize services that have positive effects in domestic employment.

5 Conclusions

Albania in comparison with the countries in the region has high level of public debt due to the need of public investments. Considering the risks associated with public debt such as exchange rate, interest rate a high public debt could mean higher exposure to its ability of repayment. Although Albania has made progress towards public debt management there is still a need to find a fiscal rule that would reduce public debt and contribute to its sustainability.

The most feasible option seem to be the debt rule because there is room to strengthen revenue collection using the potentials the country has for economic growth, improvement of tax administration and reduction of informal economy. Therefore, there is a need for a new economic model regarding new potential sources such as: knowledge economy, introduction of new technology in all sectors of economy, policies oriented towards manufacturing, industrial, agriculture, energy and tourism.

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