ALBANIA

Highlights

- **Growth accelerated in 2018, but has slowed in 2019.** After 4.1 per cent growth in 2018, the economy grew by just 2.4 per cent year-on-year in the first half of 2019, the slowdown being primarily due to weaker power generation.
- **Despite primary surpluses in recent years, public debt remains high.** Over the past year, the debt excluding arrears has been hovering around 68.0 per cent of GDP, even without taking into account the potentially significant costs of unsolicited public-private partnerships (PPPs).
- **The banking sector has undergone further consolidation.** At the same time, there is an ongoing shift in ownership away from eurozone banks towards domestic and foreign non-EU (European Union) owners. Non-performing loans (NPLs) have halved since 2014 but still remain at double-digit levels.

Key priorities for 2020

- **Legitimate businesses need further government efforts to tackle informality and level the playing field.** Informality remains one of the most important obstacles for doing business, and further measures are needed to tackle the problem. Measures include a simplified tax system and procedures, and strengthened capacities for inspections and the fight against corruption and bribery in public administration.
- **The government should focus on improving standards of fiscal and public governance.** Issues that need urgent attention include improving the conduct of PPPs and strengthening institutions and the rule of law. In addition, energy sources should be diversified by reducing the country's dependency on hydro generation and continuing reforms to improve governance and transparency in the power sector.
- **Financial sector resilience and intermediation should be enhanced.** The banking sector is stable but faces important challenges, including the relatively low quality and quantity of lending, high exposure to sovereign debt and high euroisation.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	2.2	3.3	3.8	4.1	2.8
Inflation (average)	1.9	1.3	2.0	2.0	1.7
Government balance/GDP	-4.1	-1.8	-2.0	-1.6	-2.5
Current account balance/GDP	-8.6	-7.6	-7.5	-6.7	-6.5
Net FDI/GDP [neg. sign = inflows]	-8.0	-8.7	-8.6	-8.0	-7.5
External debt/GDP	74.4	73.5	68.7	65.2	n.a.
Gross reserves/GDP	28.1	27.5	25.9	26.4	n.a.
Credit to private sector/GDP	37.2	36.6	35.1	33.0	n.a.

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Macroeconomic performance

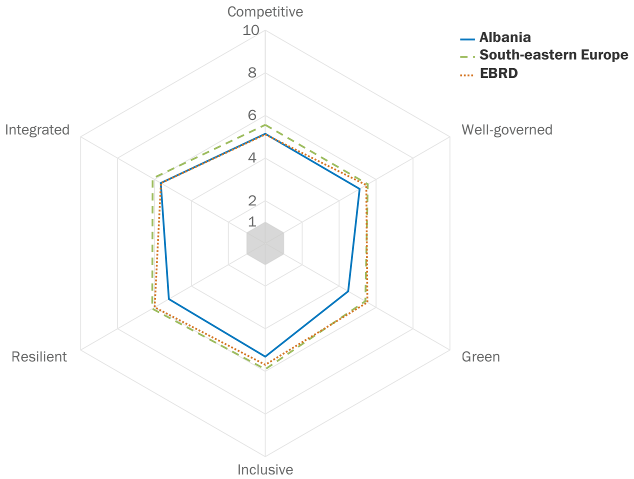
After accelerating in 2018, growth has slowed in 2019. GDP growth increased to 4.1 per cent in 2018, primarily as a result of good hydrological conditions and, consequently, high electricity production. Tourism remained an important contributor to growth too. However, the first half of 2019 saw a significant slowdown in economic growth, to 2.4 per cent year-on-year. It came mainly as a consequence of weaker power generation, combined with the high base effect from last year. Unemployment continued to decline but remains at double-digit levels (12 per cent).

Fiscal deficits are low but public debt is still high. Fiscal policy was slightly tighter in 2018, with the primary surplus increasing to 0.6 per cent of GDP (from 0.1 per cent in 2017). Overall, the budget recorded a deficit of 1.6 per cent of GDP. In the first five months of 2019, the budget (both overall and the primary one) was in surplus, but public debt remains high, at 68 per cent of GDP at the end of March 2019. Government arrears are estimated by the International Monetary Fund at 1.8 per cent of GDP, and contingent liabilities arising from recent PPP contracts, some of which have been inadequately assessed, pose risks for a further increase in public debt.

Monetary policy remains accommodative. At 2.0 per cent in 2018, inflation stayed below the central bank target of 3.0 per cent for the seventh consecutive year. In the first nine months of 2019 it decreased to 1.5 per cent on average, while core inflation, indicative of medium-term inflationary pressures, was even lower, at 0.7 per cent. As a result, the central bank's key policy rate has remained at a record low of 1.0 per cent since June 2018.

Economic catch-up is likely to slow in the short term. The economy is projected to expand at 2.8 per cent in 2019, driven mainly by private consumption, and to accelerate to 3.5 per cent in 2020, helped by the previous year's low base in power generation and under the assumption of further growth of tourism and investment in transport infrastructure. The risks to the forecast are tilted to the downside and relate to the economic slowdown of Italy and the rest of the eurozone, another delay in starting the EU membership talks, and internal risks (associated with both contingent liabilities stemming from unsolicited PPPs and the ongoing political instability).

Assessment of transition qualities (1-10)



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Major structural reform developments

The opening of EU accession negotiations has been delayed. Based on the assessment of the progress in the implementation of the comprehensive EU reform agenda, the Council of the European Union in its Conclusions on the Enlargement adopted in June 2018 set out the path towards opening the accession negotiations with Albania in June 2019. In May 2019, the European Commission issued a strong unconditional recommendation to the Council to launch EU accession negotiations with the country. However, at the European Council meetings in June and October 2019 no consensus was reached on this issue. Consequently, on 18 October 2019 the European Council decided to postpone the decision and to revert to this issue again before the EU-Western Balkans Summit in May 2020.

The business environment remains difficult. Albania was ranked 82nd overall (out of 190 countries) in the World Bank *Doing Business 2020* report, dropping 19 places from the previous year. Albania moved forward in getting electricity by increasing somewhat the reliability of power supply, but made no notable progress in other areas. Getting electricity is still one of the most problematic areas for doing business (107th), together with dealing with construction permits (166th), paying taxes (123rd) and enforcing contracts (120th). In the World Economic Forum 2019 Global Competiveness Index, the country also fell back relative to a year ago, losing five places and ranking 81st out of 141 countries. The country scores poorly in the areas of innovation capability (110th), financial sector development (105th) and infrastructure (98th).

Informality remains one of the most significant obstacles for doing business. The estimates of the size of the informal economy in Albania vary between 25 and 50 per cent of GDP. The causes are numerous and range from poverty to a heavy administrative burden, from complex procedures and frequently changing tax rules (making it altogether difficult and costly to comply), to weak rule of law and lack of trust in public institutions. Formal employment increased significantly since the launch of a campaign against informality in 2015 (with the employment rate rising from 51 per cent in 2014 to 60 per cent in 2018). However, despite contributing to creating a level playing field, a lower VAT registration threshold since April 2018 significantly increases the burden on small businesses, potentially resulting in the under-reporting of revenues.

Further controversial PPPs have been initiated. Large unsolicited PPPs continue to be awarded, particularly in the road sector (for example the Milot-Balldren and Orikum-Llogara sections), without a sufficient level of cost-benefit analysis and competition in the tender process. This increases the potential social cost and exposes the government to implementation risks, also given the general lack of track record and financial standing of the chosen bidders relative to the scale of the projects tendered.

Albania has made the first step towards establishing its first power exchange. Electricity market reforms (that is, liberalisation of the market, unbundling of distribution and supply, establishment of the Albanian Power Exchange and regional integration of the electricity market) are advancing slowly. Following the adoption of the Power Sector Law in 2015, a number of important reforms were made to liberalise the power market, but progress has been limited in the past year. The establishment of the Albanian Power Exchange (APEX), which would support price transparency, was delayed several times from the original deadline (March 2017) mentioned in the Law. Lastly, in May 2019 the government adopted the decision to set up a power exchange, with day-ahead and intraday markets. In order to establish the exchange and make it operational, the relevant implementing legislation remains to be enacted. The country continues to be largely dependent on hydropower generation and exposed to climate change risks. This can be remedied through the diversification of the energy mix, which could be supported by, among other measures, the tendering of solar capacities.

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Consolidation and change of ownership in the banking system is ongoing. Following a strategy to withdraw from the central, eastern and south-eastern European countries and the Western Balkans, several EU-owned banks have left Albania recently. The latest cases were in March 2019, with the acquisition of the Albanian subsidiary of Societe Generale Group by the Hungarian OTP Bank and the sale of Tirana Bank, the Albanian unit of Greece's Piraeus Bank. In July 2019, the acquisition of International Commercial Bank by the local Union Bank was announced. As a result, the number of banks operating in the country went down to 12 in August 2019, from 16 in September 2018.

The banking sector is stable but faces several challenges. Although the banking sector on the whole is well-capitalised, liquid and profitable, high euroisation (around 50 per cent), an NPL ratio of 11 per cent (at the end of August 2019) and high exposure to the sovereign debt (with around one-quarter of assets invested in government securities) remain among the main challenges to the sector's level of resilience. Private sector credit, at 33 per cent of GDP in 2018, is one of the lowest in Europe and acts as a drag on investment. The low level of lending is a consequence of multiple factors, both supply and demand-related: limited investment opportunities, high NPLs, weak demand by the private sector, low financial literacy of small and medium-sized enterprises, and high levels of informality in the economy, including improper accounting practices.