THE STATE OF NOMINAL AND REAL CONVERGENCE OF ALBANIA IN THE CONTEXT OF ITS EU ACCESSION

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Abstract

The paper aims to explore the state of nominal and real convergence of Albania, as well as some factors that are determinants of the catching-up process and might explain the results so far. The topic is of particular interest as in July 2022 the EU accession negotiations with Albania were launched. Therefore, it is relevant to research to what extent the country fulfills the Maastricht criteria and what is the state of real convergence, as they have a significant impact on the smooth integration of the economy in the internal market and eventually in the euro adoption process. The focus is on Albania and where appropriate, comparisons will be made with the other Western Balkan countries which have an EU candidate status.

Key words: nominal convergence, real convergence, Albania, EU accession

JEL: E3, E6, F36

Introduction

Albania is a small open economy in the Western Balkans (WB), aspiring to become a member of the European Union (EU). The country applied for EU membership in 2009 and in 2014 it acquired the status of EU candidate country. In July 2022 was held the first intergovernmental conference on which the negotiation process for Albania officially started.

The paper aims to explore the state of nominal and real convergence of Albania, as well as its level of trade and financial integration with the EU. As they have a significant impact on the smooth integration of the economy in the internal market and eventually in the euro adoption process, it is relevant to research to what extent

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the country fulfills the Maastricht criteria and what is the state of real convergence. The focus is on Albania and where appropriate, comparisons will be made with the other Western Balkan countries which have an EU candidate status, those being Bosnia and Herzegovina, Montenegro, North Macedonia, and Serbia. We observe the period 2013-2022 which is the last ten-year period and 2022 is the last year with available data, although not for all economic variables. It should be noted that it was hard to find data for all the parameters from one and the same source, therefore we used different databases. And what is more, where data is available the definition of the country may differ from that of Eurostat for example.

The paper is structured in five parts as follows: introduction, literature review, nominal convergence, real convergence – evolution and determinants and conclusion.

Literature Review

The nominal convergence concept relates to the EU and Economic and Monetary Union (EMU) enlargement theory and proposes that countries willing to join the common currency should aim to achieve similarity of certain macroeconomic variables, namely inflation rate, budget deficit and public debt, interest rates and exchange rates. Even though those criteria are controversial and spark debates, they are still valid, and the theory suggests that by fulfilling them the countries gain macroeconomic stability and similarity to EU, which contributes to real convergence. The real convergence, as the growth theory proposes, appears when countries with lower GDP per capita display higher growth rates than countries with higher GDP per capita and thus their income levels become more similar. There is not a single measure to judge on the real convergence but GDP per capita is the most extensively used parameter. Productivity level, synchronization of business cycles, structure of the economy similarity are also possible measures of real convergence.

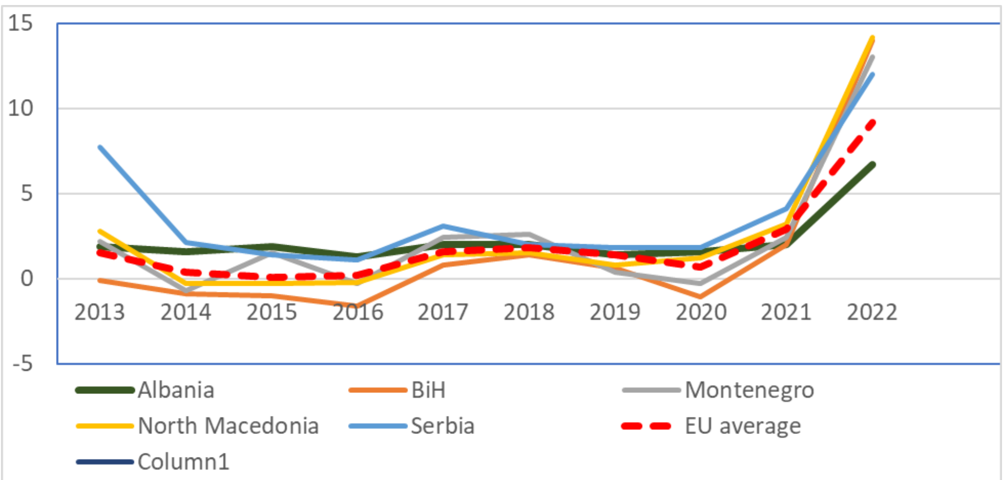
The problem of the nominal and real convergence of Albania specifically is not extensively treated by the literature, but it starts to receive greater attention. Studies devoted exceptionally to Albania are those of Boka and Torluccio (2015) and Prol (2014). The first one assesses the level of nominal convergence of Albania as of 2014 and looks at the level of fulfillment of the Maastricht criteria, concluding that Albania does not fulfill them and that there are methodological misalignments in computing the data. The second one also point out to the lack of nominal and real convergence but assesses that during the decade, leading to 2014 Albania has performed well and the differences with the EU had diminished. While literature on Albania is scarce, it is more common to find papers that treat the WB candidate countries as a group and there are more studies, looking at this group and to Albania as one of the economies, belonging to it. In research by Bobeva (2021), the author explores the level of nominal, real, structural, and institutional convergence of four WB candidate countries in the period 2007-2018. The findings are that while those economies have achieved some results in terms of nominal convergence, the progress in real convergence is still small. The author finds that Montenegro is the best performing in terms of real and structural convergence but at the same time worst in terms of nominal convergence. This gives grounds to conclude that nominal convergence is not a precondition for real convergence. On the other hand, the study shows that Albania is the worst performing in terms of real, structural, and institutional convergence.

Nominal and real convergence

Nominal Convergence

As mentioned above we study the level of nominal convergence by checking as to what extent Albani and where applicable other WB countries fulfill the nominal convergence criteria in the period 2013-2022. We start with inflation rates, and we omit long-term interest rates because there is no available data we can use.

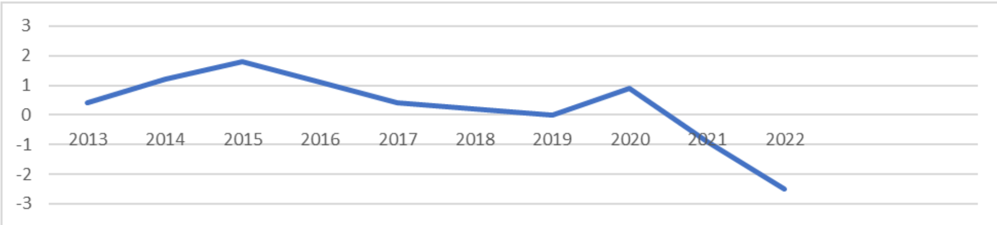
Figure 1below depicts the evolution of annual inflation rates in the five WB countries and the EU average inflation. During the observed period Albania has the second lowest average inflation rate of 2,24%, preceded only by BiH with 1,41% and given that the EU average inflation for the period was 1,98%. The inflation as well as inflation differential between WB countries have been subdued between 2014-2019. The pandemic, geopolitical stress and supply chain stress have brought an increase in inflation and in differential as well.



Source: World bank and Eurostat

Figure 1: Inflation rates in WB countries and in EU27 in 2013-2022

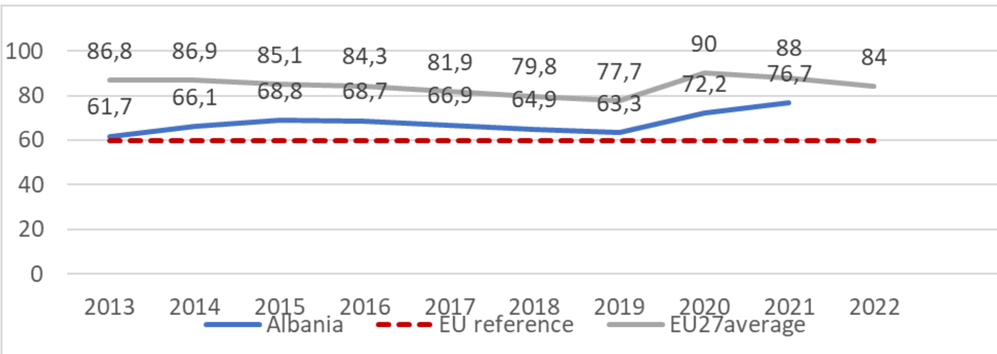
Figure 2 points to decreasing inflation differential between Albanian and EU inflation rates in the years, showing a sign of convergence in inflation. Looking at the five convergence reports in the observed period (2014,2016, 2018,2020 and 2022), the annual inflation rate of Albania is above the reference value of inflation in 3 instances (years) and below it in two.



Source: Own calculations

Figure 2: Inflation differential between Albania and EU average 2013-2022

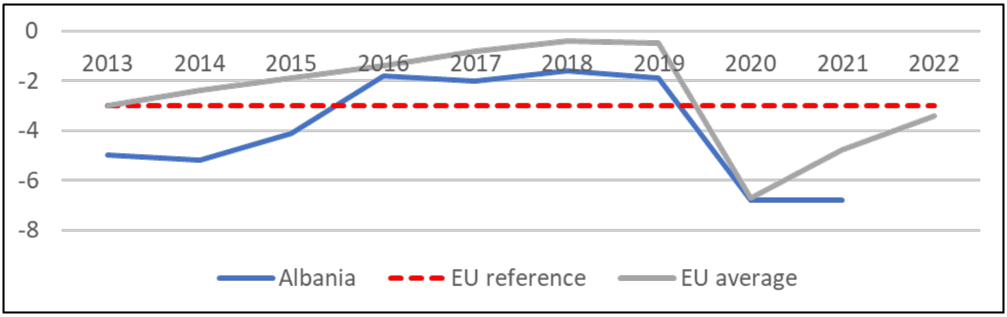
The evolution of the fiscal parameters is demonstrated in the two figures below. Figure 3 depicts the evolution of Albania's public debt to GDP ratio compared to the EU reference (Stability and Growth Pact reference of 60%) and the EU average. The picture shows a trend of decreasing the differential to the EU reference in the period 2015-2019, followed by increasing the differential after 2020, which is a result of the Covid-19 pandemic. At the same time the Albania's government debt is below the average public debt of EU 27.



Source: Eurostat

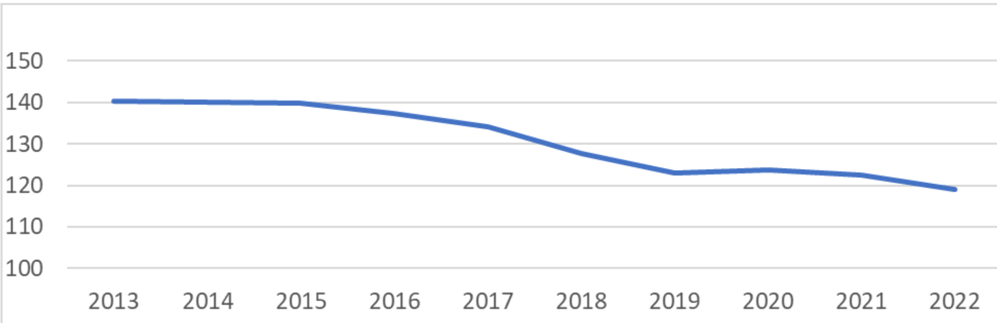
Figure 3: Albania's gross government debt as % of GDP compared to EU reference and EU average.

These findings are in line with the observations of the Albania's budget balance, which is above the threshold of -3% in the period 2016-2019 but afterwards the budget deficit increases in response to the increase of the public expenditure needed to finance the anti-Covid 19 measures. In 2020 and 2021 the budget deficit amounts to 6,8%.



Source: Eurostat

Figure 4: Albania's budget balance as a % of GDP, compared to EU reference and EU27 average



Source: Eurostat

Figure 5: EUR/ALL exchange rate, annual average

Albania does not strictly fulfill the exchange rate criterion as its currency does not participate in the EURII mechanism. The country applies a floating exchange rate regime under an inflation targeting framework. The figure above shows that the Albanian lek has appreciated against the euro by 15% during the observed period. The most significant appreciation has been between 2015-2019 and then 2020. The strong inflow of FDI as well as the high value of currency inflow from tourism and remittances encourages the lek appreciation.

Based on the data above and the reference values of the nominal convergence criteria found in the convergence reports we can see the level of fulfillment of the criteria by Albania, as depicted in Table 1. The instances in which the country does not fulfill are marked in red.

Table 1. Fulfillment of nominal convergence criteria by Albania

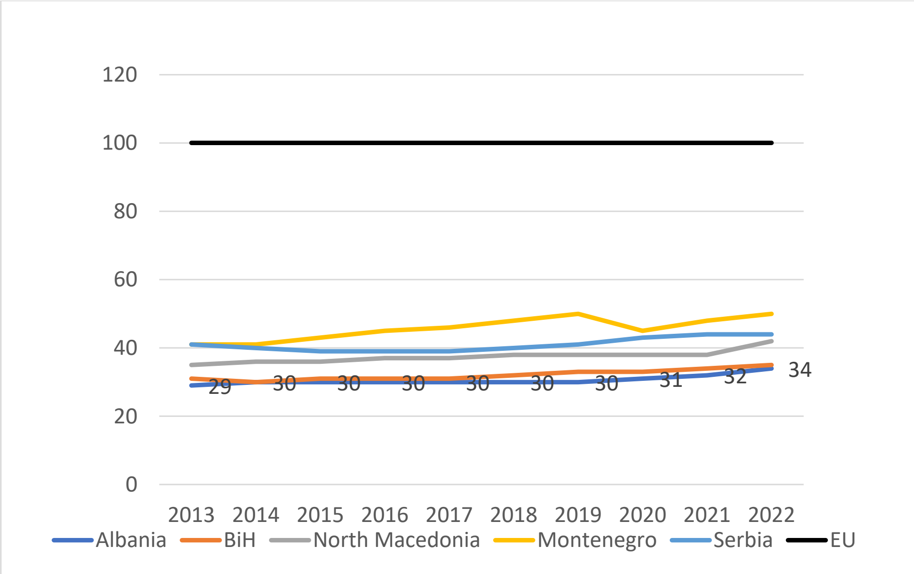
	HIPC inflation rate	Budget Deficit/ Surplus	Public Debt	Long-term interest rate
2014	1,6 (1,7)	-5,2	66,1	n.a.
2016	1,3 (0,7)	-1,8	68,7	n.a.
2018	2 (1,9)	-1,6	64,9	n.a.
2020	1,6 (1,8)	-6,8	72,7	n.a.
2022	6,7 (4,9)	n.a.	n.a.	

Source: the above data and Convergence Reports of ECB

Despite that the picture discloses a sporadic and unsustainable nominal convergence, Albania has achieved a progress in reducing the differences with EU averages, especially in 2015-2019. Starting from 2020 the pandemic and the other related challenges have contributed to increase in differences. Overall, the economy of Albania is characterized by a macroeconomic stability.

Real convergence

Looking at the evolution of GDP per capita shows that in the period under consideration Albania, in terms of GDP per capita has moved from 29% to 34% of EU average and is still far from achieving real convergence as the gap remains large. Its performance resembles that of BiH. The best performer is Montenegro, whose GDP per capita is now 50% of the EU average. Excluding Montenegro, the remaining WB economies are still far from achieving the level of convergence required typically at the time of accession (50-60% of EU average).



Source: Eurostat

Figure 6. Real convergence of WB countries in 2013-2022, GDP per capita in PPS, EU27=100

The data above corresponds to the ranking of the WB countries by their Human Development Index, which is a more complex measure of economic development. Judged by this index for 2021, Montenegro and Serbia, which have highest income levels display also highest HDI, 0,832 and 0,802 respectively, falling within the category of very high HDI. At the same time the remaining WB countries fall within the category of high HDI with Albania, having 0,796, BiH 0,780 and North Macedonia 0,770.

Based on Eurostat data, the average growth rate for the observed ten-year period for all the countries in consideration has been below 3%. Albania's average growth rate is 2,85%, close to the highest growth rate, displayed by Montenegro (2,92%). The lowest average growth rate is registered for North Macedonia (2,24%). At the same time the EU27 average growth rate has been 1,6% which is below that of the WB economies. This evidences that a process of real convergence between WB economies and EU27 has taken place, but it has been insufficient. In a study by ECB[3] the calculations show that Albania's GDP per capita must grow by around 4% annually to reach 50% of EU average by 2035 or by around 5% if it wants to achieve this target by 2030.

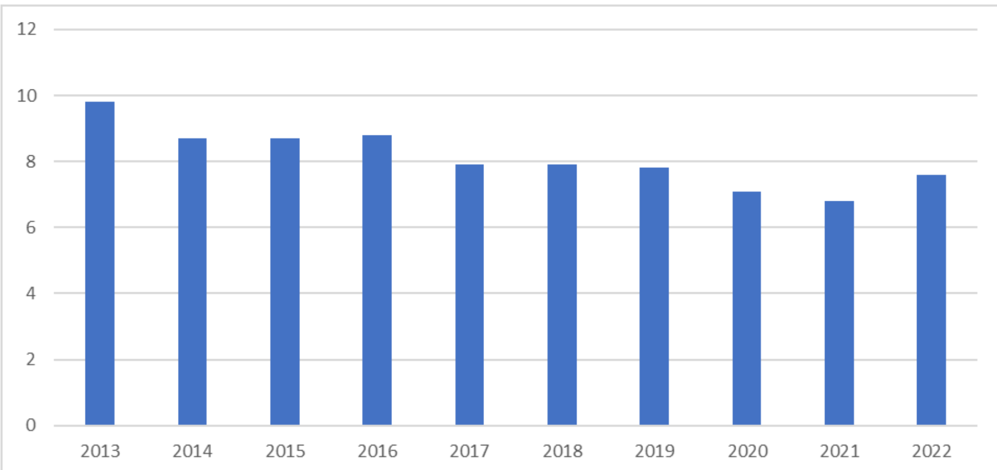
[3] Zuk, P. and L. Savelin, 2018, Real Convergence in Central, Eastern and South-Eastern Countries, ECB Occasional Paper Series No. 2012, July 2018.

Determinants of real convergence

The growth theory explains growth to be determined by capital and labor stock and accumulation as well as by total factor productivity (TFP). TFP is a measure of the efficiency with which labor and capital are utilized in the production process. In the cited above study ECB shows that in WB in the period 2000-2008 the growth was driven predominantly by TFP, while after the crisis, in 2010-2014 the main contributing factor was capital accumulation, while the role of TFP diminished. In the paper below we try to look at certain aspects and factors that may explain the total factor productivity in Albania.

Albania and the other WB countries are characterized by low capital stock and low savings rate, compared to the EU average and therefore the investment inflows are very important for capital accumulation. The FDI not only helps the capital accumulation but also supports labor productivity and TFP through the transfer of know-how.

FDI flows into Albania have steadily increased since the early 2000s, averaging more than USD 1 billion annually between 2008 and 2020. According to UNCTAD's 2022 World Investment Report, FDI inflows totaled USD 1.2 billion in 2021, an increase of 11.3% yearly and a return to pre-pandemic levels. The stock of FDI reached USD 10 billion in the same year, accounting for approximately 55% of GDP. Foreign investments are primarily concentrated in energy, banking and insurance, information and communication technology, and real estate. According to Central Bank data (2022), FDI flows totaled EUR 984 million in the first three quarters of 2022, with the Netherlands (EUR 147 million), Italy (EUR 98 million), and Germany (EUR 75 million) being the central investing countries. Switzerland holds the most stocks, followed by the Netherlands, Canada, and Italy.



Source: World Bank Indicators

Figure 7. FDI inflows as % of GDP in Albania

According to Lubeniqi (2023), changes in political and economic circumstances and the prospect of EU integration have resulted in Western Balkan countries attracting fewer foreign direct investments than other countries in transition. Albania has implemented reforms to increase FDI. The state has implemented a tax reform that benefits foreign investors and aims to reduce corruption and administrative difficulties that can discourage investors. The country stated that it will seek foreign investment in the following areas: energy and mining, transportation, telecommunications, infrastructure and urban waste, tourism, agriculture, and fisheries[4]. In Albania, FDI is hampered by a lack of transparency in public procurement and poor contract enforcement. Albania currently lacks a mechanism for reviewing inbound FDI investments.

As far as the *quality of human capital* is concerned, the share of population with at least bachelor's degree in Albania is 13%, given the EU average of 23% for 2016.

Among the factors that exert influence on the TFP is *the structure of the economy*, which may determine the productivity level. This factor is quite relevant for Albania. Looking at the structure of the economy of Albania, it deviates significantly from that of the EU economy, as the share of the value added by agriculture, forestry, and fishing in 2022 is high at 18,6% (1,5% for EU), while the share of services is 47,3%, given the average for EU of 60%. Despite that, the trend in the last two decades is for reducing the share of agriculture and increasing that of services, which gives scope for labor reallocation from agriculture to services and industry. Yet, the existing differences from EU economic structure are evident and they determine the low total factor productivity.

Trade openness and competitiveness are other factors that can impact on TFP. Increased openness of the economy contributes to specialization and efficient reallocation of production factors thus impacting positively growth.

Looking at *the overall competitiveness* of the Albanian economy we have used the Global competitiveness index of the World Economic Forum as a measure of the different aspects of competitiveness. It captures 12 indicators that cover the economic environment, human capital quality, markets efficiency and innovation ecosystem, relying on survey based and hard data. The analysis points to an improvement of the overall performance of Albania in the period as its rank in 2013 was 95 and in 2019 was 81 among 141 economies. The ranking and the score of Albania is like that of North Macedonia and BiH and a bit worse than that of Serbia and Montenegro. The figure below compares the index of Albania with that of Bulgaria, as representing EU member-states outside euroarea and Germany, as representing euroarea member-states. Albania and Bulgaria score similarly in skills, markets efficiency and business dynamism. The areas, where progress needs to be made is evident as particular efforts are needed in improving institutions, infrastructure, human capital skills and innovation capacity. Quality of institutions

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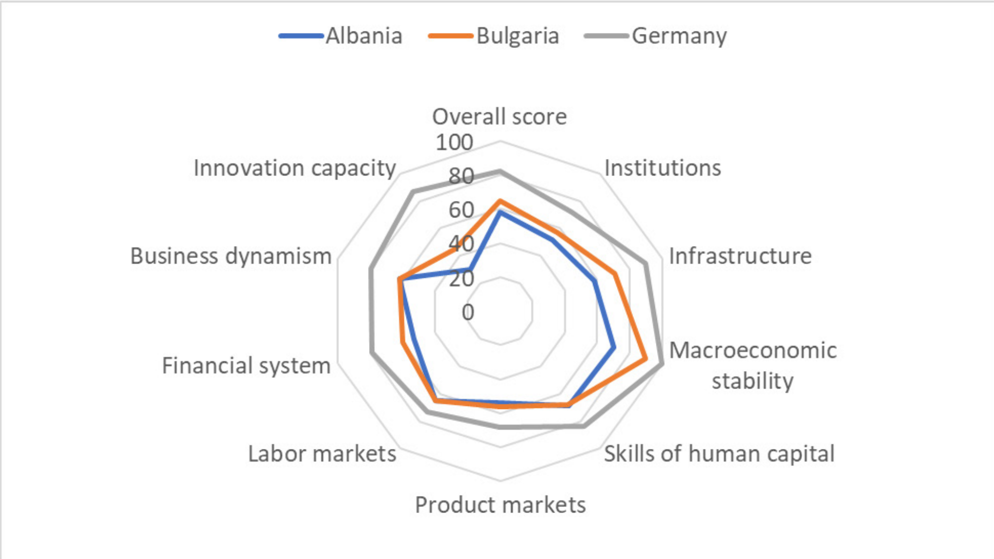
4 https://international.groupecreditagricole.com/en/international-support/albania/investing

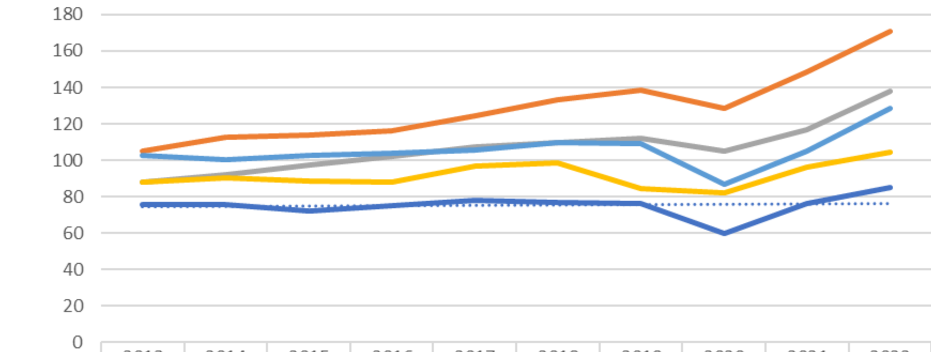
is a key factor explaining the differences in growth. In research, Kaufmann, and Kraay (2002) found a positive causal link between improving institutional quality and income growth. The EU accession process represents a momentum to improve rule of low, regulatory environment and fight with corruption, as the experience of the last EU entrants showed that the biggest improvements in institutional quality were made in the years preceding their EU accession.



Source: World Economic Forum, Global Competitiveness Report 2019

Figure 8. Global Competitiveness Index of Albania, Bulgaria, and Germany in 2019

Trade openness has a positive impact on economic growth and therefore in achieving convergence. During the last ten years in Albania, this indicator has had an average value of about 75, ranked with the lowest value among the WB countries (the figure below). North Macedonia has the highest value of trade openness, with an average of 129 for the study period, followed by Serbia, with a level of openness of 105. Serbia and Bosnia Herzegovina had an average trade openness during the last ten years of 105 and 91, respectively. According to the ranking by The Global Economy for the year 2022, Albania ranks 18th with a trade openness index of 85.31. According to this ranking, the first place is occupied by North Macedonia with an index of 170.82, followed by Serbia with a value of 137, ranked third, and Montenegro with 128.65, ranked in sixth place. Bosnia and Herzegovina, for the year 2022, is ranked tenth with a value of trade openness of 107.14.



	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
ALB	75,87	75,41	71,8	74,81	78,19	76,81	76,28	59,83	76,02	85,31
MKD	104,86	112,54	113,7	116,19	124,14	133,22	138,58	128,24	148,47	170,82
SRB	87,92	92,23	97,4	101,86	107,53	109,49	111,95	104,72	116,76	137,64
BIH	87,93	90,55	88,29	88,24	96,65	98,43	84,52	82,11	96,07	104,17
MNE	102,77	100,13	102,69	103,67	105,55	109,61	108,84	87,01	105,03	128,65

Source: World Bank Indicators, 2022

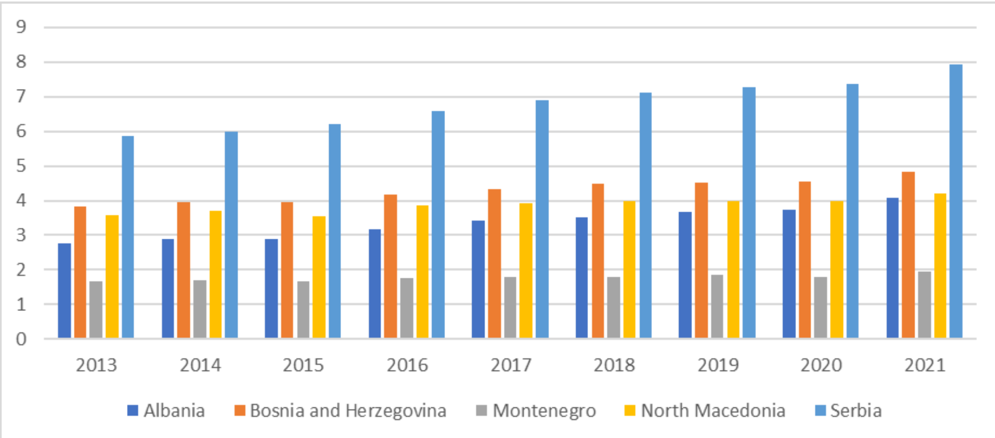
Figure 9: Trade Openness as a percentage of GDP for WB countries in the period 2013-2022

Despite Albania's gradual diversification of trade partners, the EU remained the country's primary trading and investment partner. External trade averaged 77.3% of GDP from 2015 to 2019, falling to 61% in 2020 before rebounding to 76.4% in 2021. Services continued to dominate exports, and the EU remained the primary destination for goods and services exports. Due to faster growth in trade with non-EU countries, the EU's share of Albania's foreign trade has decreased slightly, with exports to the EU accounting for 72.2% of the total in 2021 (down from an average of 76.4% in 2015-2019), while imports from the EU fell to 54.4% in 2021 (down from 60% in 2015-2019). Conversely, the volume of goods traded with CEFTA countries increased gradually from 5.7% of GDP in 2019 to 7.6% in 2021. Kosovo remained Albania's main export destination in CEFTA, while Serbia accounted for most of its imports. FDI flows to Albania from the EU increased by 26.5% in 2021, far exceeding those from the rest of the world (7.8%), accounting for 59.7% of total FDI inflows. The index of the Albanian lek's real effective exchange rate increased by 1.8% in 2020 (3.5% in 2019), though at a slower rate than its 2015-2019 average of 3.7%.

Export marketpenetration[5] shows how Albanian goods reach and penetrate export markets worldwide. The index of export market penetration for Albania has

[5] https://wits.worldbank.org/CountryProfile/en/Country/ALB/StartYear/2013/EndYear/2021/Indicator/HH-MKT-CNCNTRTN-NDX

increased yearly during the study period. In 2013, this index was around 2.6; in 2021, its value almost doubled to reach 4.1. Albania's trade balance has remained in deficit during the last ten years, but exports have increased compared to imports. Compared to other WB countries (see Figure 10), Albania ranks in the penultimate place. Montenegro has the lowest value of this index, with an average from 2013-2021 of around 1.8. Meanwhile, Serbia has the highest Index of Export Market Penetration value throughout the study period, with an average of 6.8, about 3.3 points higher than Albania for the same period. The high value of this indicator for Serbia is related to the high levels of exports that this country has compared to other WB countries.

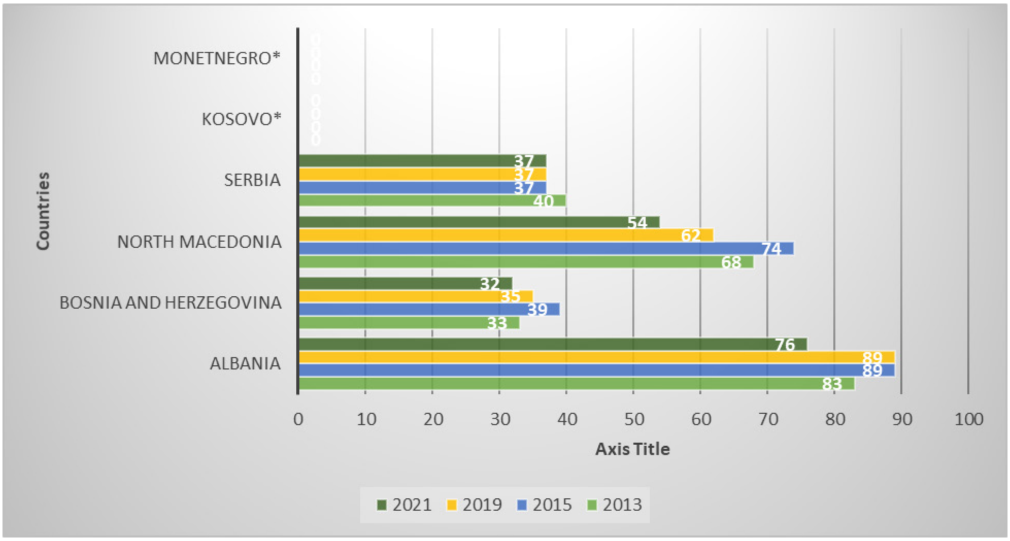


Source: World Bank Indicators

Figure 10. Index Of Export Market Penetration for Western Balkan Countries

Another indicator that impacts countries' growth is the *Economic Complexity Index (ECI)*. This index is a comprehensive measure of significant economic systems, typically cities, regions, or countries. The ECI, in particular, seeks to explain the knowledge accumulated in a population as it manifests itself in the economic activities present in a region. The Economic Complexity Index indicates Albania is the 76th most complex country. Albania's economy has become more complex in the last decade, improving one position in the ECI ranking. The diversification of its exports has driven Albania's increasing complexity. Moving forward, Albania is well-positioned to capitalize on limited opportunities to diversify its production while retaining its existing know-how.

For its income level, Albania is slightly less complex than expected. As a result, its economy is expected to expand moderately. The Growth Lab's 2031 Growth Projections predict 3.2% annual growth in Albania over the next decade, placing it in the top half of countries globally. In 2021, Albania was ranked 76th in the economic complexity index. According to Harvard Growth Lab (2021), during five years (2016-2021), Albania has improved at least 12 positions, ranking 76 compared to 133 countries in the study. Despite that improvement, Albania has the lowest complexity index compared to other Western Balkans countries, as seen in the figure below. According to the value, compared to Serbia, Bosnia Herzegovina, and North Macedonia, Albania has a lower advantage in the diversification of exports, which will also affect sustainable economic growth. The country with the greatest Economic Complexity Index in the region is Bosnia and Herzegovina, which in 2021 ranked 32 out of 133 countries.



Source: Country Complexity Rankings, Harvard Growth Lab

**There* is no data available for Kosovo and Montenegro

Figure 11. Western Balkan country's complexity index

Conclusion

Our research about Albania's nominal and real convergence in 2013-2022 brought us to some critical conclusions. As far as nominal convergence is concerned, Albania does not fulfill Maastricht criteria consistently. At the same time, during the observed period, convergence to the average EU levels of the nominal variables has been achieved, specifically in the years till the outburst of COVID-19. The country's macroeconomic framework is stable and thus conducive to economic growth. As far as real convergence is concerned, advances have been made, but still, they are not enough as Albania's GDP per capita is just 34% of the EU average. The income and the productivity gap remain large.

Looking at the factors that determine the real convergence we can highlight those that might be dragging the catching-up process. Yet the structure of the

Albanian economy remains fundamentally different from that of the EU and even from that of the other WB countries, dominated by agriculture and with low share of services. A further increase of the share of services and reallocating labor resources could lead to an increase in labor productivity. Improving infrastructure and institutions is also vital for the business environment and market efficiency.

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