

## WHAT GDP FIGURES DON'T TELL YOU. MICROECONOMIC EVIDENCE ON THE IMPACT OF THE WORLD FINANCIAL CRISIS ON THE ALBANIAN ECONOMY

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### ABSTRACT

*GDP figures would suggest that the Albanian economy was still growing during the peak of the world financial crisis, in contrast to all the other economies in the region. However, analyzing GDP growth composition and microeconomic evidence from the inward processing industry in Albania it becomes clear that the country's industries were hit by the crisis just as much as the other economies in the region. This study suggests that by referring only to macroeconomic evidence the Albanian government was in denial of the crisis and therefore not addressing the entrepreneurs pressing needs in the country. Through evidence obtained through questionnaires conducted in three cities during 2010-2011 this study analyses the impact of the world financial crisis on sales revenue, profit and trade of this very important industry and how the entrepreneurs reacted to the falling demand from the two biggest trade partners: Italy and Greece.*

**KEYWORDS:** *Exports, Free Trade, International Trade, Trade, Welfare.economic crisis, government intervention, new market,*

**JEL CLASSIFICATION:** *F16*

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### 1. INTRODUCTION

Although emerging market economies were not at the epicenter of the recent global financial crisis, the experience of the past five years may nevertheless hold important lessons for them. Given the uncertainty and the prolonged experience of this crisis, an obvious question is whether the governments of these countries responded quickly and efficiently and were aware to the needs of the industries operating in their countries during the economic crisis. In fact data from EBRD (Life in Transition Survey, 2010) shows a clear gap between the government and public preferences on public investment during the crisis. Macroeconomic evidence also would suggest no need for government support for Albanian industries as the data showed an increase in Foreign Direct Investment and positive economic growth during the 2008-2012 period.

However, this paper explores the real impact that the global financial crisis had on the inward processing industry in textiles and footwear in Albania, the biggest employer in the country with more than 140 thousand workers. This industry was a continuation of the inward processing industry operating before the fall of communism, and thus operating with very old technology. Despite this fact, Albania remained very competitive due to low cost of labor and its geographical vicinity to Greece and Italy. But despite operating in this industry for more than 18 years, before the world financial crisis hit the Albanian economy, very few entrepreneurs invested in qualifying the workforce, in finding alternative markets to Greece and Italy, and in marketing and designing Made in Albania brands. The guaranteed demand for their low cost advantage, made Albanian entrepreneurs operating in this industry complaisant and thus not ready when the crisis hit their industry.

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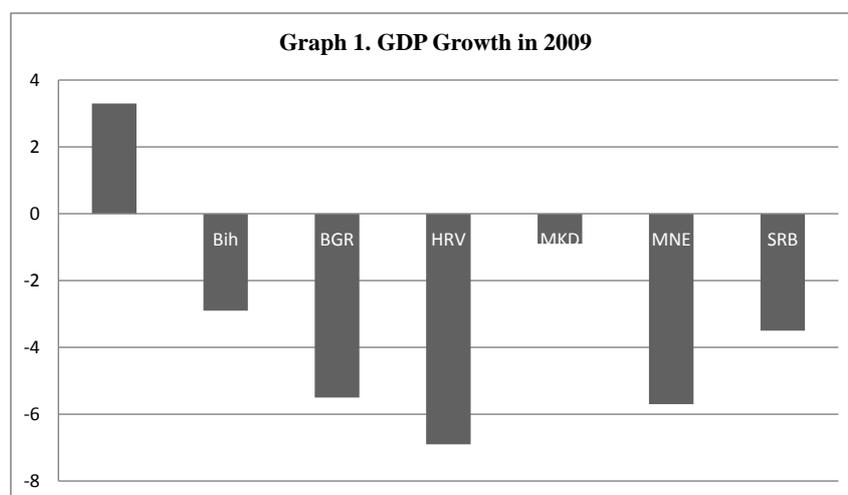
This paper draws attention to data obtained through surveys that the businesses in the country were affected negatively by the crisis, in contrast to GDP figures. The results show drop in demand, falling profits, loss of market share and contractual breaches from their international partners. The latter is usually neglected and little reported in the country.

This paper thus aims to explore the situation of the Albanian inward processing industry in relation to the global recession, clarify the negative effects transmission mechanisms, identify the social range of problems caused by this impact, and interpret suggestions on policies intended to help the industry. Due to its general characteristics, the inward processing industry is seen as a good proxy for the overall Albanian economy; hence the study offers an analytical basis to assist the policymakers, so that the public debate can be focused on finding alternatives and specific interventions with the aim of alleviating the direct economic consequences of the global economic crisis.

## 2. Macroeconomic Evidence

The impact of the global economic crisis has varied significantly across the world. The developments in the financial sector in 2008 and 2009 did not affect directly many developing countries as their exposure to toxic assets was minimal. However, by early 2009 there were clear signs that the financial crisis had indirectly affected many transition economies of Eastern Europe. By the end of 2009 the effects became much more severe with countries such as Lithuania, Estonia, Serbia and Ukraine recording negative real GDP growth of -18.4%, -13.2%, -4% and -14% respectively.

The recent events have shown that, in contrast to when small open economies were exporting financial crisis, due to the mismanagement of their economies, there seems to be a paradigm shift. The financial crisis that started in USA and spread to the periphery, had a profound impact on the Balkan economies. According to the Economist Intelligence Unit: The Balkan transition economies (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro, Romania and Serbia) were among those emerging markets that suffered the most from the global recession in 2008-09 as the real GDP in the Balkans contracted by 5.2% in 2009. The channels through which the crisis might have impacted these economies are through the fall of foreign investment, fall in demand for their exports or fall in credit to their economies.



*Source: World Bank*

Despite this, the GDP figures would suggest that Albania was the only economy that was not hit in the first two years of the economic crisis of 2008-2012. The table shows how the economy grew by 3.1% in 2009 when all the other economies of the region contracted by 5.2%. This positive result in GDP figures might have given the Albanian government a positive confidence that it should not alter its role in the economy despite the effect of the crisis on trading partners.

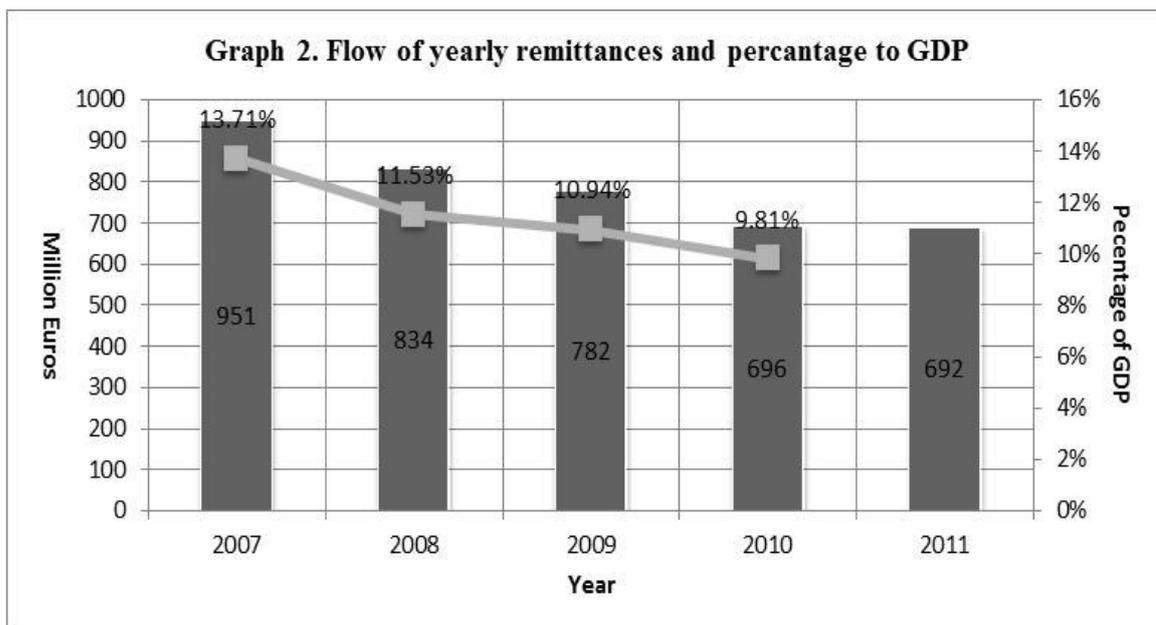
Increasing the government's confidence was the positive official data concerning Foreign Direct Investment in the country. According to data available from the Central Bank of Albania FDI in 2008 were 609.8 million Euros and in 2009 they increased to 668.2 million Euros, or 9.6% higher. While in 2010 FDI increased even further to 822.6 million Euros. Data obtained from UNCAT 2011 FDI inflows increased from one quarter to one third of the value of gross domestic capital formation from 2009 (€717 million) to 2010 (€793 million). It fell back again to one quarter in 2011 (€742 million). Despite this drop in FDI levels Albania has performed well in attracting FDI given that during 2010-2011 there have been no major privatization in the country. However the concern is that FDI goes in major industrial projects like electricity and not in sectors of the economy that might increase employment like the agriculture sector. According to UNCAT FDI stock in agriculture represented only 0.3 per cent of the total FDI stock in Albania in 2010, and 2.1 per cent in food, beverages and tobacco manufacturing.

Table 1 Foreign Direct Investment as percentage of GDP

<b>FDI/GDP</b>	<b>Albania</b>	<b>Serbia</b>	<b>Rumania</b>	<b>Bulgaria</b>	<b>EU</b>
2006-09	6.41%	10.70%	7.40%	25.51%	5.19%
2009-12	10.21%	3.60%	1.84%	5.00%	2.27%

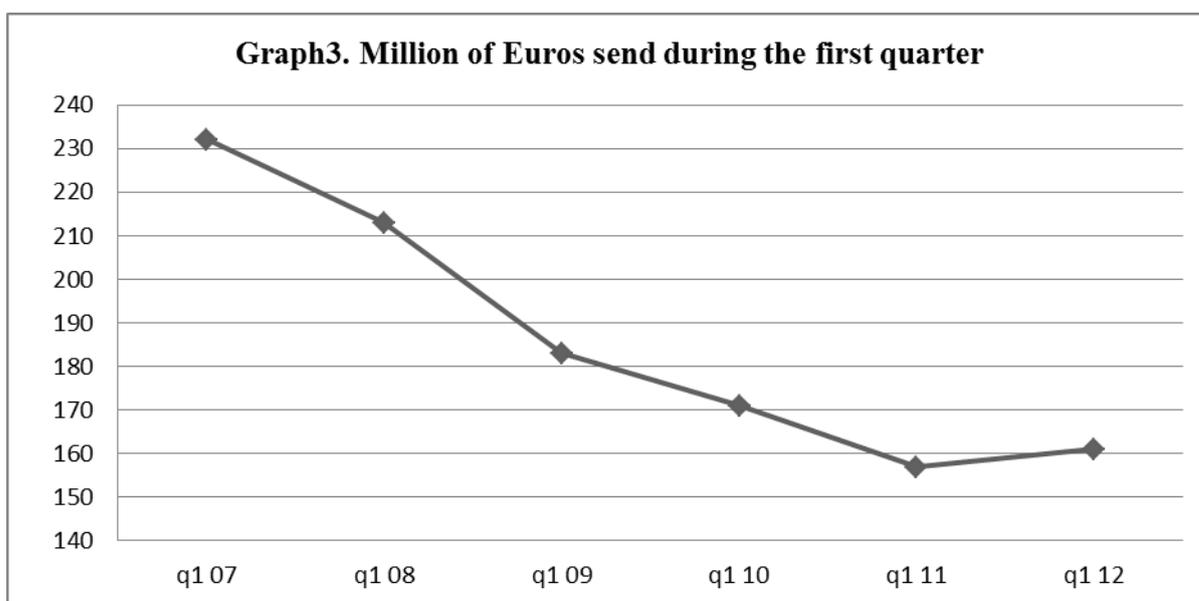
*Source: World Bank*

Secondly the Albanian economy is highly depended on remittances send from Albanian expats living mainly in Greece and Italy. There have been several studies in recent years to identify the impact that the economic crisis in Europe might have had on the families receiving remittances in Albania. While the banking sector is usually thought as being immune from the crisis it is widely believed that the major channel that the crisis has affected Albania is through the decrease in the level of remittances send to the country. A survey from the Bank of Albania( Bank of Albania, 2009) in 2009 suggested that almost 64% of annual remittances are send to rural areas in Albania and were remittances to stop the World Bank predicts that almost 35% of Albanians would be living in poverty (Monitor, 2010).



Source: World Bank Data

According to the data obtained from the World Bank the importance of remittances as percentage of GDP has fallen consistently in the past five years. The latest data for year 2010 shows that remittances accounted for only 9.8% of GDP or 5% lower than in 2006 (world Bank 2010). The data also shows a fall in absolute value of remittances. The value of remittances send to Albania had the highest value in 2007 at the wake of the global crisis but it has fallen consistently thereafter. The data shows that in 2011 the value of remittance send to Albania was around 692 million euros or 27% lower than in 2007.



Source: Central Bank of Albania

## Government Spending and Public Preferences

From the beginning it was obvious that the Albanian economy would not escape the effect of the global crisis and its impact on the economy. The European Commission warned the government when it declared that “With increasing evidence that no country will remain immune from this crisis, domestic authorities (in Balkan countries) are gradually realizing that the drastic change in their growth trajectory will challenge current planning assumptions and policies, and require a new policy mix.” (European Commission, p.23. 2010).

Despite this the Albanian government continued to pursue the same public spending pattern that it had done before the financial crisis by investing a large share of the budget on building new public road infrastructure despite the fact that industrial sector in general and the inward processing industries in particular, commerce and services, mining and refinement of minerals, started to show dropping performance indicators and augmented the pressure on the authorities for protective and supportive measures.

**Table 2. In your opinion, which of these fields should be the first and second priorities for extra government spending?**

	2006	2010
Education	18%	36%
Healthcare	37%	33%
Housing	8%	5%
Pensions	13%	9%
Assisting the poor	2%	6%
Environment	6%	2%
Infrastructure (public transport, roads, )	14%	6%
I don't know	2%	2%

*Source:* Life in Transition Survey, EBRD (2006, 2010)

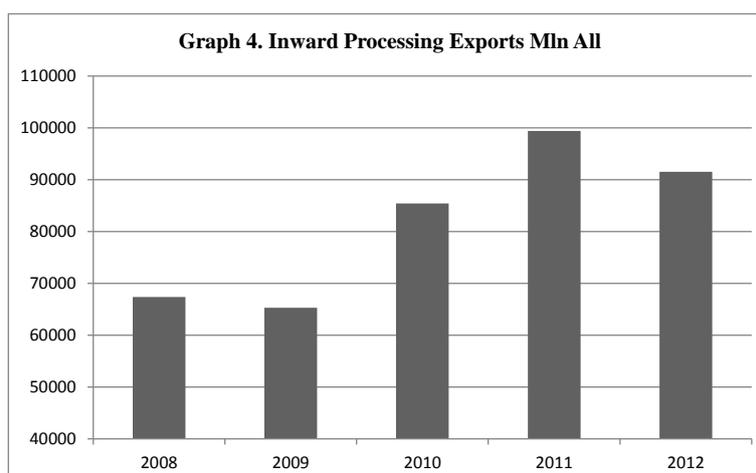
Referring to the EBRD Life in Transition data for Albania for the years 2006-2010 it is clear that the public had a completely different set of preferences for government spending. It is true that the symptoms of the crisis initially showed up on the macro-fiscal indicators, yet today even simple, not in depth analysis indicates that the crisis is present in each person's life. The survey conducted by EBRD shows that two years after the start of the global crisis the first preferences for social protection had increased as compared to 2006. Also when asked about their second best preference for government extra spending the public had a lower preference for extra spending in public roads than in 2006. Nonetheless these preferences were not addressed by the government be it at the study level, or the actual interventions that are needed.

<b>Table 3. In your opinion, which of these fields should be of second priority for extra government spending</b>		
	<b>2006</b>	<b>2010</b>
Education	23%	12%
Healthcare	22%	26%
Housing	8%	12%
Pensions	19%	13%
Assisting the poor	5%	13%
Environment	5%	5%
Infrastructure (public transport, roads,	17%	12%
<b>I don't know</b>	2%	2%

Source: Life in Transition Survey, EBRD (2006, 2010)

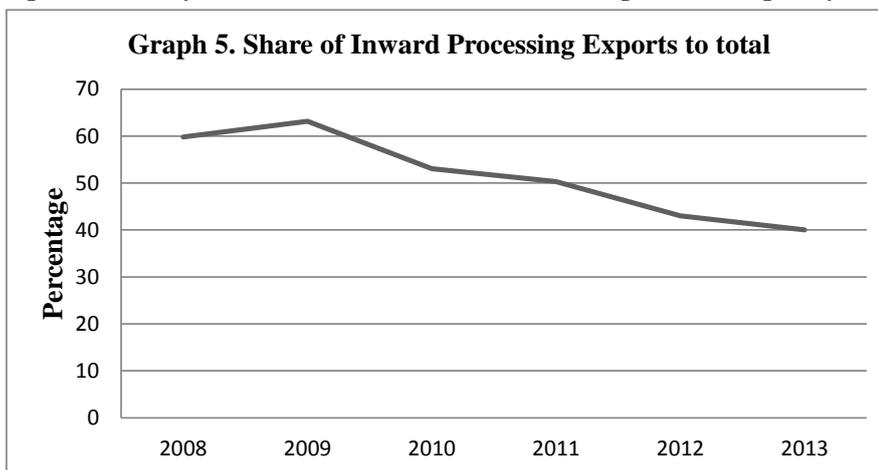
### Microeconomic Evidence: Inward Processing Industry

The inward processing regime employs more than 140 thousand workers in Albania. Data from the national statistical office shows that the value of inward processing industry has increased steadily from 2008 with a slight drop in 2009 and 2012. However, as a percentage to overall exports this industry in 2013 accounts for 26% less than it did in 2009. The decrease of exports to Italy, main destination of Albanian exports (79.3% of total exports to EU-27), by 6.9%, impacted the most the overall export decrease (ACIT, 2009, p.24). Greece, the second largest export partners, showed similar export's dynamics as compared to 2008. Exports have decreased by 23.7 percent and their share to total has fallen to 9.2% from 11.1%. Textile and footwear account still for the major part of exports to these countries with a total share of 58.4% and a slight increase by 2.5 percentage points. This was represented mainly by inward processing items that are re-exported to their country of origin, mostly Italy and Greece.



Source: INSTAT 2013

A questionnaire was designed and carried out in three major cities in Albania, Tirana, Korca and Shkodra. The questionnaire aimed at measuring the economic impact on Albanian enterprises of the inward processing industry with a sample of 77 businesses, where almost 88% of the companies of the sample specialize in the textile and shoes industry. Almost ¾ of the companies employed a considerable number of workers, with the majority employing 20-79 persons. When asked about their experience concerning their operating capacities during 2009, almost half of the companies report that they have faced a reduction in their operation capacity.



Source: INSAT 2013

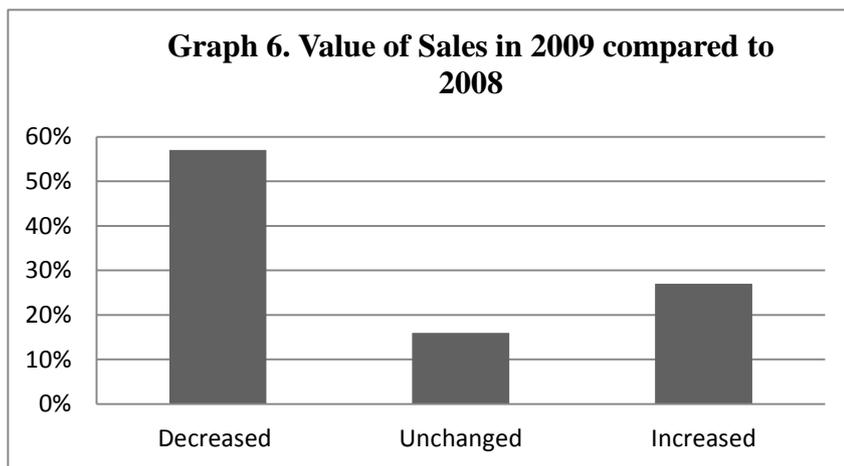
The data shows a high degree of vulnerability and exposure to foreign demand of the inward processing industry as 54 out of 77 companies confirmed that they produced 80-100% of their goods for export only. Other important information obtained from this data is the fact that most of the companies decreased their operating capacity by 15% during this period. This is in line with other findings from the Central Bank of Albania which found that in 2009 most of the companies in Albania operated at 67% of their capacity, or 10% lower than the previous year.

Albania	138
Bosnia-Herzegovina	159
Croatia	381
Serbia	159

Source: Friedrich Ebert Stiftung, 2009.

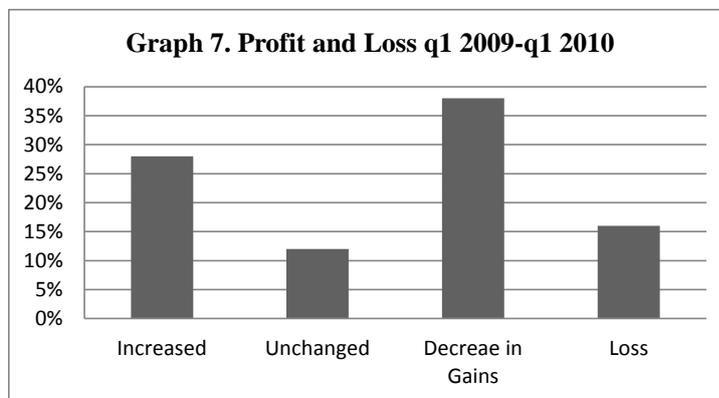
This sector is heavily dependent on a cheap and low-skilled labour force. As we mentioned earlier this industry employees more than 140 thousands workers with an average wage of 18.000 ALL(138 euros). According to the data the increase of the minimum wage by the government has greatly affected their cost of production and thus making them less competitive. It is obvious that the fall in capacity can be attributed to increasing costs of production and the fall in foreign demand. Another characteristics obtained from the microeconomic data is that the inward

processing industry has shown certain level of continuity, with almost 45% of the companies reporting that they have been in business for seven or more years. 29 out of 77 companies report that rising cost of production and operational costs are important in explaining the worsening financial results. This is more significant for Shkodra where 12 out of 22 are negatively affected from these costs. The raise of some costs has also been an important factor for the operation decrease, for example, the rising costs of electricity and fuel, social contribution and minimum wage. These are seen as the two contributors to rising costs of production. As shown by the data 57% of the companies interviewed experienced a fall in their value of sales during 2009.



Source: ACIT Survey Data 2010

The gap between the companies that experienced decrease in sales and those that had increased sales is substantial with 25 out of 35 companies reporting a decrease in sales, 6 reporting no change and only 4 companies reporting an increase in sales. In contrast to official figures, which describe a resurgent foreign demand<sup>19</sup>, the survey shows that sales of inward processing products have dropped. The figures show that 65% of the companies report that their volume- as well as their value- of sales decreased in the first quarter of 2010. Just in the first quarter of 2010 the number of companies reporting decreased sales increased by 8%, vs. the number of companies reporting the same experience for 2009. Also the data shows that more than half of the companies (56%) report decreasing profits and only 30% of them recorded profit during the first quarters of 2010.



Source: ACIT Survey Data 2010

In order to understand the measures that the government needs to take in economic hardship we looked into the reasons the companies believe have contributed to the fall in sales. As already shown almost three quarters of the companies that answered these questionnaires exported 80-100% of their goods. It is therefore hardly a surprise that the companies point out that the drop in foreign demand has been the most important factor in depressing their sales during 2009. According to our survey the most important factor that has contributed to their fall in sales has been the drop in foreign demand. The survey shows that 55 out of 77 companies, or 71%, believe this to be the main contributor to the fall in the sales.

It is obvious that any government would find it difficult to help in the short run any industry that is solely depended on foreign demand. However, what went unreported and not addressed by the Albanian government was the breach of the contracts by the ordering companies. A major issue for companies operating in emerging markets is the lack of legal institutional support for international trade. According to the survey data, more than 34% of the companies surveyed report contractual breaches from the ordering company as of major problem. Usually the companies point out that the ordering companies in Greece and Italy would cancel their order without compensating them, thus increasing their costs and making them suspicious of future agreements. In fact some companies even reported that several companies in Korca district had shut down their operations due to these contractual breaches.

What is also important is the fact that this industry did not experience any fall in demand or loss of market share due to increased regional competition. For two decades this industry had maintained competitive advantage due to low labour costs and thus had little incentive to invest in new technology. However in the short run the best alternative was the search for new markets. According to the survey data more than 50% of the companies had searched for new international markets due to the fall in demand from Italy and Greece. In fact more than 40 companies expressed that this measure had been efficient. The data below in fact confirms the geographical spread of the inward processing firms to other destinations apart from Italy and Greece. In fact the data confirms that other destinations increased from 2.2% in 2009 to more an 9% in 2012. However, due to better economic performance in Italy and Greece the share of these markets increased once again in 2013. Despite this this positive trend shows a clear objective of these companies for market diversification. Also as we have seen above during the crisis the inward industry experienced contractual difficulties and after 2010 it sought new partners, especially in Germany and USA.

	2009	2010	2011	2012	2013
Italy	82%	74%	74%	79%	83% %
Greece	7.60%	5%	5%	-	5%
Germany	4.10%	4%	4%	3%	4%
Kosovo	1.40%	5%	5%	3%	1%
Other	2.20%	2%	5%	9%	5%

*Source: ACIT 2013*

What is interesting to note is that these companies, despite the pressure from falling sales did not reduce workers' wages nor did they fire workers. This is mainly due to the fact that their wages are already very low and to the fact that they thought that the crisis was temporary. In fact the survey data shows that 20 companies that had reduced the number of workers said that this had not been helpful to their business operations.

### **Post crisis government intervention**

The *fason* industry (inward processing industry) is one of the best organized industries in the country. However, despite the big number of workers that the industry employs they still maintain that the government is not always their partner and does not recognize their requests. Their proposals after the financial crisis include: removal of profit tax of this industry, subsidies for buying new machinery, government payments up to 2000 euros for every new worker that they employ, organization of industrial parks in the country etc.

The impact of the crisis was also felt in figures relating to the import of the inward processing of machinery which decreased by 7.6% during 2009. Most important items within this category remain assembly parts used for machinery of headings, as well as other machinery parts. The drop in demand for machineries continued even in 2012 as the demand for machinery parts decreased by 14.8%. This drop in demand clearly showed the lack of investment and therefore a hindrance in enhancing the position of this industry. However, due to increased pressure the government removed the VAT cost from imports of machinery which resulted immediately in an increase in machinery investment. In January 2013 the government removed VAT costs for all the industries importing machineries in the country. According to the Albanian prime minister the cost to the state budget by removing this tax was estimated at 140 million euros; a considerable amount considering the high levels of public debt.

Another important request from the *fason* industry is the support of the government especially concerning international marketing, where 49 out of 77 companies believed that this step would increase their sales.. Companies are now aware of the necessity of expanding their markets and searching for new partners. The medium and long term dependence from markets that proved to be at risk (such as Greece and Italy), encouraged them to seek for other collaborations as seen from the data. Lately the government is also responding to their request for training new staff, even though the survey showed that only 19 out 77 companies said they would need government assistance for finding and training new workers. New professional schools have been opened in the country since the crisis that have helped in the consolidation of their labour market and thus permit the long term investments.

### **Conclusions**

The Albanian economy never went into recession during the height of the global financial crisis. However, as this paper shows the impact of the crisis was felt in the inward processing industry from the beginning of 2010. Despite the calls to the government from entrepreneurs in this industry to come to their aid the government reacted only after the crisis to their needs. Since 2009 the GDP growth rates even though positive have consistently diminished, halting close to 0 in 2013. In fact data from the national statistics office shows an increase in poverty rates in the country during 2008 to 2012 period. This could be linked to several reasons that are specific to the Albanian economy, like the fall of remittances, lack of extra government expenditure in social welfare and increased unemployment. In fact this paper shows that the government's preferences for extra public investment were contrary to the public's expectations and the entrepreneurs needs. Future studies should focus on the impact of the crisis on Albanian's companies and how the increased minimum wage will affect its competitiveness to other countries in the region.

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