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"Fear of Floating" in Albania and Economic Growth

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Abstract:

This study endeavours to understand the volatility of the exchange rate in Albania and to see if there are sign of "fear of floating" present. De jure Albania currently applies a flexible exchange rate regime. Traditionally the main argument in favour of this policy is that monetary policy is not constrained by the predetermined level of the exchange rate. Thus, monetary policy sets interest rates in order to achieve domestic equilibrium (ie. price stability) while the nominal exchange rate adjusts to balance the external accounts. Theoretical evidence concerning the impact of exchange rate stability on growth is mixed. The theoretical arguments in favour of flexible exchange rates are mainly of macroeconomic nature, as flexible exchange rates allow for an easier adjustment in response to asymmetric country specific real shocks. From a microeconomic perspective low exchange rate volatility can be associated with lower transaction costs for international trade and capital flows thereby contributing to higher growth.

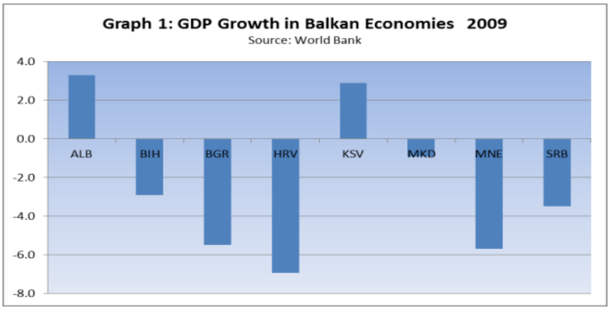
Key words: exchange rate, fear of floating, trade, economic growth.

1. Introduction: economic growth

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 exchange rate regime adopted by the small open economies in the Balkans, and especially Albania, helps explain how they fared during this crisis, particularly in terms of output losses and growth resilience.

The recent events have shown that, in contrast to previous experiences when small open economies were exporting financial crisis, due to the mismanagement of their economies, there seems to be a paradigm shift; they are importing crisis. 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. However, it is important to investigate whether the exchange rate regime and the monetary policy of these countries might have had a role as well.

Previous studies have shown that for countries in the economic catch-up process where capital markets remain underdeveloped and macroeconomic instability tends to be high, fixed exchange rates are an important anchor for macroeconomic policies and private expectations. In particular they provide an important anchor for the adjustment of asset and labor market Schnabl (2007). But this conclusion does not hold for the latest financial crisis. Albania for example let its currency independently float and did not fall into recession in contrast to Bulgaria or Macedonia.



There are no studies done on the impact that the exchange rate regime and the monetary policy have had on economic growth of Balkan economies. So far there has been only one study that tries to identify whether the regime choice impacted economic growth during and after the financial crisis. Tsangarides (2010) using a cross section analysis finds that during the crisis period, controlling for other potential factors affecting growth performance, those countries with pegged regimes fare no worse than those with floats. However, this study shows that, in contrast to the crisis period, during the recovery period 2010–2011, countries with pegged regimes appear to be faring worse than those with floats. However, a quick observation to economic growth of the Balkan countries during 2011 shows that those economies that have their currencies pegged have performed better than those that float.1 This study assesses the role of the exchange rate regime in explaining how emerging market economies fared in, and are recovering from, the recent global financial crisis. According to this study during the crisis period the countries with pegged regimes fare no worse than those with floats. They investigate these issues using a sample of 50 EMEs. However, this study shows that, in contrast to the crisis period, during the recovery period 2010–2011, countries with pegged regimes appear to be faring worse than those with floats. Understanding whether the exchange regime has had an impact on economic performance in the Balkans helps these

[1] According to World Bank Data ccountries in the Balkans that have their currencies pegged grew on average at higher rates that those that float.

countries better position themselves in the wake of similar situations in the future.

Aghion (2005) offers empirical evidence that a country's choice of exchange rate regime can have a significant impact on its medium-term rate of productivity growth. Domaç (2001) concludes that it is not possible to make any inference about a particular exchange rate regime being superior to the other in terms of growth performance, but it makes a difference for inflation performance. Bailliu et al (2003) concludes that “it is the presence of a monetary policy anchor, rather than the type of exchange rate regime per se, that is important for economic growth”. On the other hand Petreski (2009) applying dynamic system-GMM panel estimation on 169 countries over the period 1976-2006 finds that the exchange-rate regime is not statistically significant in explaining growth.

2. Exchange Rate Regime

The exchange rate is a nominal variable that could, however, influence economic growth. Previous studies and the theory show that the channels through which regime might influence growth could be distinguished at: i) level of uncertainty imposed by certain regime, which than affects trading and investment decisions; ii) regime as shock absorber; iii) its linkage to productivity growth, which usually interferes with financial development. Previous studies on the impact of regime on growth have been inconclusive (Petreski, 2009).

While the impact that the exchange rate regime has on economic growth is inconclusive there seems to be a consensus regarding the exchange rate volatility. Schnabl (2007) uses panel estimations revealing a robust negative relationship between exchange rate volatility and growth for countries in the economic catch-up process with open capital accounts. Even countries that have adopted inflation targeting regimes do not always embrace independently floating regimes –and, in some cases, are actively pursuing some sort of intervention in the foreign exchange market. Bastourre (2003) show non-neutrality of the exchange rate regime. Particularly, it is found that the more rigid the regime is the grater real volatility will be. Even when it is performed an exchange rate regime classification that allows a comparison between consistent pegging and consistent floating, the former has a higher volatility.

It is important to note that exposure to the euro area crisis is magnified because neighboring Balkan economies have significant economic links with Greece. Trade with Greece is most important for Montenegro, Macedonia, Bulgaria and Albania (10-12% of total goods exports). Albania on the other hand conducts 60% of all imports and 70% of all exports with EURO zone countries. At the same time the proportion of FX-denominated loans is also high, constituting more than 50% of total loans to the private sector in the region and over 70% of loans in Albania, Bosnia-Herzegovina, and Croatia leaving these countries vulnerable to currency depreciation. Therefore, given the importance of the stability of the domestic currency to the EURO currency we test the hypothesis that despite the official policy of floating exchange rate the Albanian Central Bank pursues a managed exchange rate regime.

The importance of low volatility of the exchange rate has been emphasizes before by Calvo (2002). This study shows that countries that say they allow their exchange rate to float mostly do not. He concludes that - there seems to be an epidemic case of "fear of floating". Therefore the low variability of the nominal exchange rate "does not owe to the absence of real or nominal shocks of these economies – indeed, relative to the United States most of these countries are subject to larger and more frequent shocks to their terms of trade, given the high primary commodity content of their exports in many cases". In debtor countries with highly euroized (dollarized) financial sectors, the incentive to avoid sharp exchange rate fluctuations is even stronger (Chmelarova and Schnabl, 2006). Maintaining the exchange rate at a constant level, in particular preventing sharp depreciations, is equivalent to maintaining growth (McKinnon and Schnabl 2004).

The literature on emerging economies shows that apart from the exchange rate regime an undervaluation of the currency (a high real exchange rate) stimulates economic growth (Rodrik, 2008; Gala, 2007, and Gluzmann at al. 2007). Rodrik shows that developing countries that systematically undervalue their currencies in real terms grow faster than their counterparts that do not. According to this study this relationship holds only for developing counties; it disappears when we restrict the sample to richer countries and gets stronger the poorer the country. The relative price of tradable to non-tradable (the real exchange rate) seems to play a more fundamental role in the process of economic convergence.

In empirical research the exchange rate regimes are classified as: fixed, floating and managed. But the literature shows that emerging economies might pursue an exchange rate regime that is different to the de jure policy maintained by the Central bank authorities. It is however difficult to conclude that even in those cases where there might be a discrepancy between the official policy and exchange rate data we cannot conclude that this is due to a systemic policy pursued by the banking authorities Levy-Yeyati and Sturzenegger (2005).

3. Albanian Currency and EURO: Presence of Fear of Floating

Balkan economies are considered developing countries, are geographically close to each other, have common foreign trade partners and have all emerged from a centralized economic system. But they differ in the exchange rate regime that they apply. Albania has adopted a free floating exchange rate regime; Croatia and Serbia have adopted a managed float regime; Bosnia and Herzegovina has operated under the currency board regime with a fixed peg of the national currency to the euro; FYR Macedonia has implemented a de facto pegged regime; and Montenegro and Kosovo have a unilateral euroization.

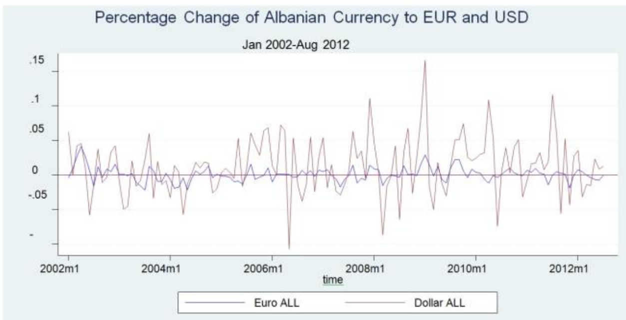
In addition the high proportion of FX-denominated loans - constituting more than 50% of total loans to the private sector in the region and over 70% of loans in Albania, Bosnia-Herzegovina, and Croatia leaves these countries vulnerable to currency depreciation. Banks in Western Balkan countries are faced with an increasing share of non-performing loans in the overall loan structure. From 2009 to the end of 2011, the average share of non- performing loans in the total loan portfolio soared from 3% to as high as 15%. Thus analysing the impact of exchange rate regime and the volatility of ER will be a significant contribution to the literature.

The graph below shows the average exchange rate of the Albanian currency (ALL) to the Euro and USD for the period January 2002 to August 2012. Both currencies are floating according the central bank, but it is easy to observe that the USD shows greater signs of volatility as compared to the Euro during the same period. Graph 2. shows the percentage change of both currencies for this period where USD shows a volatility coefficient of 0.15 while ALL/EUR shows a volatility coefficient of 0.05.

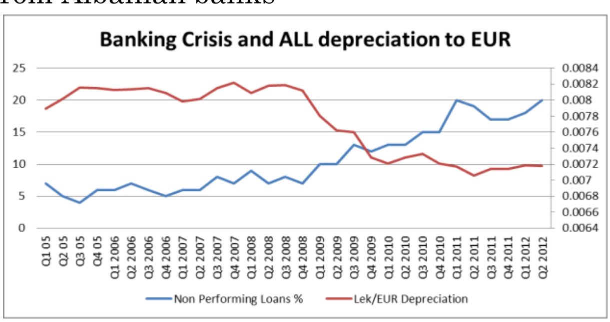
Results: Stationary Test Dickey Fuller EURO AND USD			
	EUR	USD	IMF De Jure Classification
Albania	Stationary	Non-Stationary	Floating
Serbia	Non-Stationary	Non-Stationary	Managed Floating
Romania	Stationary	Non-Stationary	Pegged
Poland	Non-Stationary	Non-Stationary	Floating
Croatia	Stationary *	Non-Stationary	Managed Floating
Macedonia	Stationary	Non-Stationary	Pegged

We conduct a Diceky Fuler test for Albanian currency in order to test the volatility of the currency compared to USD and to tests whether a unit root is present in an autoregressive mode. We find that Albanian Lek is stationary and thus shows no signs of volatility in contrast to other currencies.

Given that trade volume with Eurozone countries is around 70% of total trade than maintaining a stable exchange rate is justified in terms of macroeconomic stability and controlled imported inflation. At the same time credit in EURO is 55% of total credit in Albania and cost of credit has been around 5.44% for businesses compared to credit in Albanian currency. Therefore perceived stability in EURO currency has led most businesses and families to borrow money in Euro.



The Albanian currency has shown a great deal of stability apart from the October 2008-june 2009 period which coincided with the height of the financial crisis and the withdrawal of euro deposits from Albanian banks



4. Conclusion

Albania is a small open economy and it maintains that it adopts a floating exchange rate regime. The economic theory shows that this policy allows the local economy and its authorities to pursue an independent monetary policy and thus become more flexible in dealing with external shocks to the economy. It also allows the value of the local currency to be established by market forces and promote trade. However, given that more than 50% of all credit to business and individuals is accessed in EURO, 70% of trade is done with Eurozone countries and imported inflation might affect the economy directly we have shown that the Central Bank might be pursuing a policy in contrast to the official policy of free floating. The low volatility levels, especially when compared to USD currency, and other countries that have free floating regime, shows signs of "fear of floating" policy.

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