



Weekly Briefing

Albania economy briefing:
Euro depreciation in Albania: cause and consequences
Marsela Musabelliu


China-CEE Institute

Kiadó: Kína-KKE Intézet Nonprofit Kft.

Szerkesztésért felelős személy: Chen Xin

Kiadásért felelős személy: Huang Ping

 1052 Budapest Petőfi Sándor utca 11.

 +36 1 5858 690

 office@china-cee.eu

 china-cee.eu

Euro depreciation in Albania: cause and consequences

The common European currency was established by specific provisions of the Maastricht Treaty in 1992, from that year on the member states had a decade to meet the strict criteria, such as a budget deficit of less than 3% of their GDP, a debt ratio of less than 60% of GDP (both of which were ultimately widely flouted after introduction), low inflation, and interest rates close to the EU average. As of September 2019, Euro is the second-most traded currency in the foreign exchange market after the United States Dollar (US\$) and is the official currency of 19ⁱ out of 28 member states. These 19 countries, also known financially as the eurozone, count a total of 343 million citizens. With more than €1.2 trillion in circulation, Euro has one of the highest combined values of banknotes and coins circulation in the world, having surpassed so the US Dollar.ⁱⁱ The earliest date of local currency being abolished was in Germany, where the Mark officially ceased to be legal on 31 December 2001 and was replaced by the Euro.

This change in currency impacted the Albanian financial market as well, and from 2003 onwards Euro became the most traded foreign currency in the country. This “flow” of the European common currency into Albania happened due to three main channels: a) trade: considering the main trading partners of Albania were Italy and Greece; b) Foreign Direct Investments (FDI): were also in majority form the Eurozone; c) remittances: the majority of Albanians living abroad would soon transfer Euros from their residence country to Albania.

Official motifs for strengthening of the local currency (Lek)

The exchange rate with the main foreign currency is certainly an important factor in determining the dynamics of economic growth and inflation in any country. Exchange rate appreciation/depreciation impacts price stability directly, through low/high import prices, and indirectly through the effect on aggregate demand and output gap/overcapacity.

Starting from the end of 2015, Euro has been losing points towards the local currency *Lek* - this decrease in values has been unstoppable and reached an all-time low in August and September 2019. Official sources from the Bank of Albania state that the main reasons influencing this tendency are structural improvements in the Albanian economy such as exports growth, more flows of inward FDIs, more income from tourism and the decline in preference to hold assets in Euro due to low interest rates.ⁱⁱⁱ Albania has an extremely high level of foreign currency use (mostly Euro), for this reason in 2017 and 2018 the strategy of “de-euroization”^{iv} package was implemented, justifying this move as a preventive measure to potential major

risks, both macro and micro to the financial stability of the country. *The risks of massive use of foreign currency were listed as:*

- affecting the reduction of the monetary policy effectiveness;
- restricting the role of the free exchange rate as an automatic stabilizer in the case of macroeconomic shocks, in the context of the higher sensitivity of economic entities to large exchange rate fluctuations;
- undermining the effectiveness of fiscal policy through the potential increase in the cost of debt service and the unintended change in its structure;
- usually associated with costs to the central bank in the form of opportunity costs for maintaining a relatively higher level of foreign exchange reserves as well as for the loss of revenue (seniority) associated with the replacement of the domestic currency by the foreign currency.

In terms of financial stability, the high level of euroization could:

- increase the exposure of the financial system and economic operators, especially those with open currency positions in the balance sheet, to unfavorable exchange rate developments;
- increase credit risk and affects the banking sector's ability to perform financial intermediation and support economic growth;
- expose the financial system to foreign currency liquidity risks, when the central bank's instruments to support foreign currency liquidity are objectively more limited.

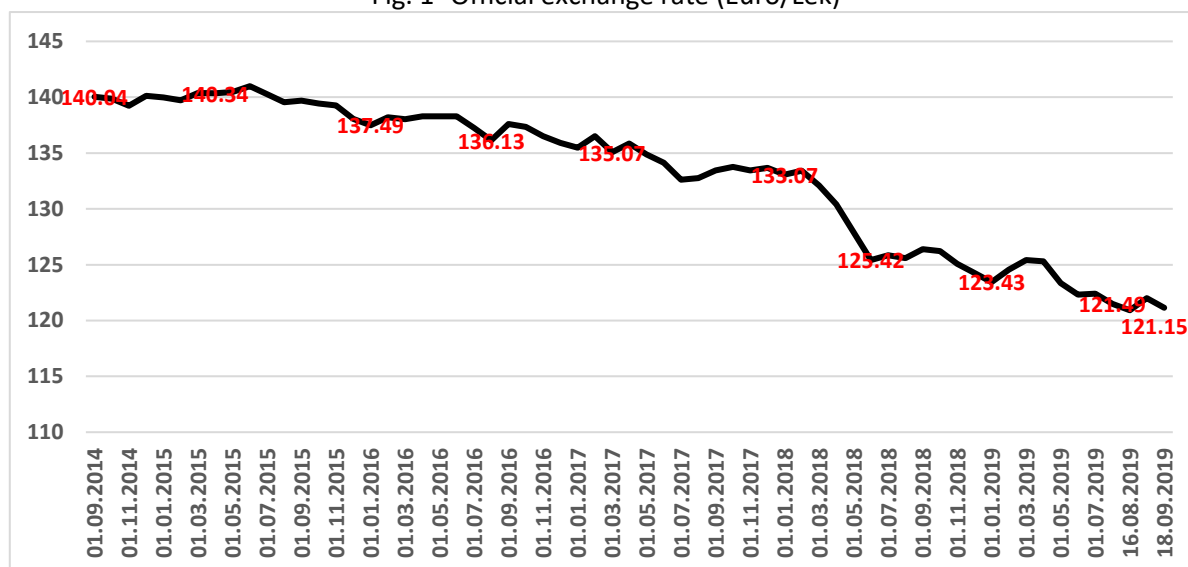
According to the Vice-Governor of the Bank of Albania the undertaking of this strategy is reasonable because of:

- the presence of economic and financial stability, which testify to the public's confidence in the national currency and facilitate easier adoption and increased effectiveness of the measures. If these sustainability factors were missing, then a lack of public trust would render these measures ineffective.
- the need to address some developments in the banking sector balance sheets, such as the decline in foreign currency lending or even the high level of foreign currency deposits. These tend to influence each other dynamically. Through these measures, Bank of Albania seeks to control the performance of foreign currency deposits, and to maintain lower levels of foreign currency lending, particularly where borrowers are unprotected from exchange rate risk. The strategy has a long-term perspective and aims to increase the resilience of the entire economy.^v

Further developments

If the aim of Bank of Albania (BoA) was to have a temporary depreciation of the Euro, however, the outcome was not as predicted because the decreasing value of the European common currency was unstoppable. By August 2019, Euro lost points of conversion on international scale against the US\$ in a widely expected move, the US Central Bank cut its interest rates by 25 basic points in order to protect the American economy from a potential crisis, including here trade tensions.^{vi} Another main cause for Euro depreciation, according to BoA Governor, is the massive conversion of the capital of two commercial banks operating in Albania – Intesa San Paolo through its merger with Veneto Bank – as well as the payment of a loan to the European Bank for Reconstruction and Development (EBRD); the total of which would amount to 300 million Euros. This high amount of currency needed to be converted at a given time, put pressure on the exchange rate and increased the expectation of the financial system at that specific moment.^{vii} However, if the trend of the Euro/Lek is analyzed closely, it appears that the above mentions reasons are not substantial enough to influence these levels of depreciation. The graph below demonstrates the monthly exchange rate for the past five years.

Fig. 1- Official exchange rate (Euro/Lek)



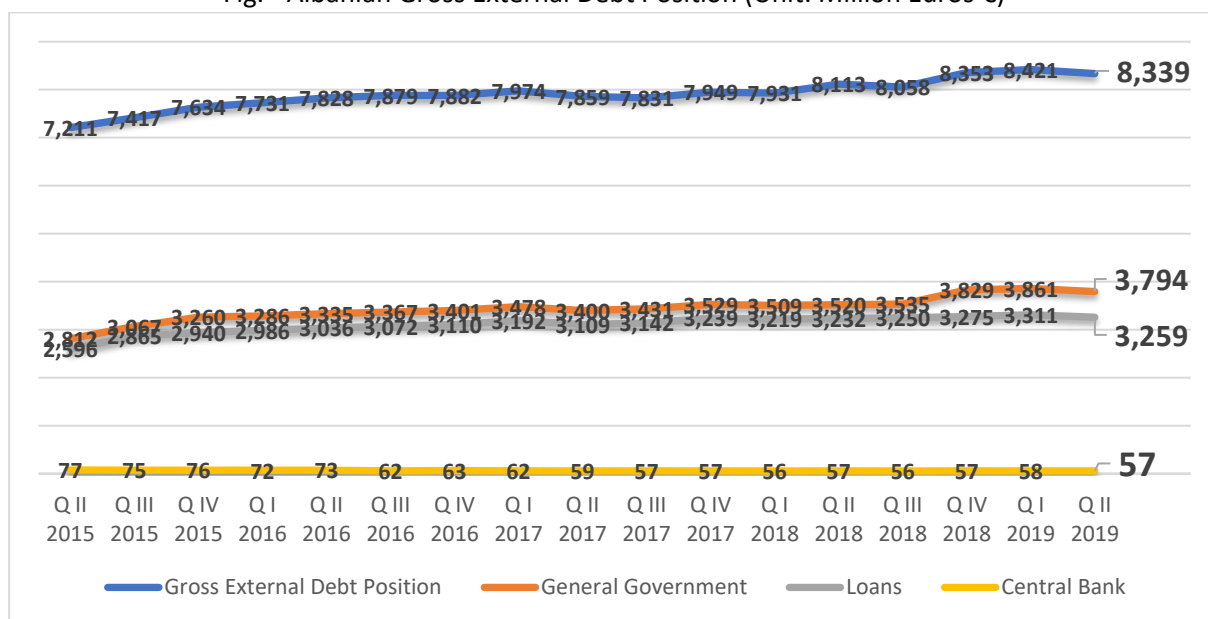
Source: Bank of Albania (own graphic elaboration)^{viii}

From the other side, there are insinuations that this devaluation is due to the alleged “black market” and informality related to organized crime and money laundering (mostly the overflow of cash from the selling of cannabis). At the moment these remain allegations, but if any of these allegations will be proved true in the near future, it would explain plenty.

Who wins and who loses from the strengthening of the local currency?

First and foremost, the Albanian government is the biggest beneficiary of this unstoppable drop on the value of Euro in the country. According to the latest estimation 70% of the Albanian external debt lays with the Eurozone currency, and also according to general estimation the external debt service payment has an average of decrease around 4.5%.^{ix} In the below graph the values of the Gross External Debt Position are displayed for the past five years. Taking into consideration that the total GDP of Albania amounts at 13 billion Euro and the latest know data of the debt account for 8.3 billion Euros, the levels of the external debt rise to 65% of the GDP.

Fig. - Albanian Gross External Debt Position (Unit: Million Euros €)



Source: Bank of Albania (Own graphic elaboration)

As seen from the data, Euro's drop in value did not affect as wished the external debt, in fact, there has been an increase of the later (See General Government trend line).

On the other hand, the sector most affected negatively is the local industry; this ongoing devaluation of the most traded foreign currency is bringing significant damages to Albanian exports and according to INSTAT, the drop of exports up to 5% is attributed to this depreciation. The groups that have negatively affected the annual decline in exports are: "Minerals, fuels, electricity", "Construction materials and metals" as well as "Textiles and footwear".^x For this reason, representatives of the *Fasson* industry - which make up the bulk of the country's exporting companies, came out to a press conference waving alarm bells over the economic difficulties facing the sector. Since most of their expenses are in Lek, their lower income as a result of the depreciation of the euro are causing serious problems in facing production costs, salaries, taxes, etc. Their claim is that if this trend continues the majority of these business will

face bankruptcy, considering that the average profit margin for them is 15% and the drop of Euro is affecting with a decline in turnover of 7%.^{xi}

Conclusions

Local currency appreciation usually means cheaper import commodities and this should translate to a benefit of lower prices, leading to lower overall inflation. However, this is not the case of Albanian economy in the past years. The strengthening of the local currency against the Euro has only checked the negative boxes of the theory (export cost increase, negative value of bank deposits in foreign currency). Furthermore, the unstoppable drop of the European common currency fuels the insinuations of illegal activities and money laundering schemes injecting cash into the country, obviously outside of the legit banking system.

ⁱ The eurozone consists of Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain. Other EU states (except for Denmark and the United Kingdom) are obliged to join once they meet the criteria to do so.

ⁱⁱ European Central Bank. Banknotes and coins circulation. Available at: https://www.ecb.europa.eu/stat/policy_and_exchange_rates/banknotes+coins/circulation/html/index.en.html

ⁱⁱⁱ Available at: <https://balkanweb.com/zyrtarja-e-larte-e-bsh-arsye-t-e-renies-se-euro-s-dhe-nuk-ka-vend-per-panik/>

^{iv} De-euroization package. Bank of Albania. Available at: https://www.bankofalbania.org/Financial_Stability/De-euroization_Package/

^v Ibid.

^{vi} Euro in dive, the lowest level in 12 years in the domestic market. *BalkanWeb*. Available at: <https://balkanweb.com/euro-ne-pikiate-ne-nivelin-me-te-ulet-ne-12-vjet-ne-tregun-vendas/>

^{vii} More info available at: <https://www.gazetaexpress.com/lajme-nga-shqiperia-analiza-pas-renies-drastike-te-euros-ne-shqiperi-fshihet-pastrimi-i-parave-te-krimet-626761/>

^{viii} All data are elaborated from official statistics of Bank of Albania; detailed exchange rate available at: https://www.bankofalbania.org/Markets/Official_exchange_rate/

^{ix} The drop of Euro and its effects on the Albanian Economy. Available at: <https://gazetamapo.al/renia-e-euros-dhe-efektet-ne-ekonomine-shqiptare/>

^x National Institute of Statistics.

^{xi} Alarm bells from the producers and exporters. Available at: <https://a2news.com/2019/09/18/fasonet-japin-alarmin-gjika-krize-nga-euro-dhe-mungesa-e-punetoreve/>