

Gent Sejko: Albania's economy and its interaction with monetary and fiscal policies

Statement by Mr Gent Sejko, Governor of the Bank of Albania, to the hearing session of the Parliamentary Committee on Economy and Finance, about the draft-budget 2017, Tirana, 22 November 2016.

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Honourable Chairman,

Honourable Members of the Committee,

The steady and long-term development of Albania has been and is a constant priority of Bank of Albania's work. Therefore, accomplishing this objective requires not only applying prudent monetary and fiscal policies, but also their constant and efficient coordination.

The approval of the budget and the accompanying fiscal package is decisive for the country's economic development. The budget and the relevant fiscal package outline the short and medium-term priorities for public finance, contribute to the long-term profile of growth and development by supporting with funds the structural reforms, and orientate the private sector development by determining the incentives on consumption and investments.

Therefore, the Bank of Albania appreciates the opportunity to be able to present to this hearing session our opinion on the draft-budget 2017.

In compliance with our legal mandate and the scope of our expertise, the opinion of the Bank of Albania on the draft-budget 2017 will focus on the following:

- ♦ Albania's development perspectives, intertwined with the monetary and fiscal policies;
- ♦ Fiscal projections and public finance stability; and,
- ♦ Effects of projected public borrowing on the domestic financial markets.

At the end, there are some suggestions on possible measures to boost the effectiveness and stability of public finances.

1. The expected performance of the economy and its interaction with the monetary and fiscal policies

The Albanian economy has shown signs of recovery over the past two years. This performance reflects the recovery of private consumption and investments, whereas the external environment has been and remains unfavourable. The expansion of the private sector activity was supported by our accommodative monetary policy and was favoured by the consolidating fiscal policy implemented during this period. This policy mix has brought financing costs down for the private sector and has improved the liquidity situation in the economy.

The 2017 budget takes into account forecasts for the real economic growth at 3.8% and an increase in the nominal value of the gross domestic product to 6.3%. As detailed in the draft-budget and in the accompanying explanatory notes, such economic growth will be supported by the continuation of the combination of the monetary stimulus with the fiscal consolidation policy. However, the intensity of the fiscal consolidation in 2017 is foreseen to be somewhat lower than in 2016.

The Bank of Albania deems that the expected economic developments and the sustaining

policies constitute an acceptable and consistent starting point for drafting the budget for 2017.

Economic activity at home is expected to mark an improved growth over the next two years. The monetary stimulus will support boosting domestic demand, keeping financing costs down for private consumption and investments. In parallel, the fiscal policy is expected to pursue a consolidating trend, as illustrated by the improvement by 0.2 percentage point in the primary balance-to-GDP ratio and the forecast for the reduction by 2.7 percentage points in public debt-to-GDP ratio.

The Bank of Albania has supported and continues to support the fiscal consolidation policy, deeming that – in balance – it contributes positively to the country's long-term and stable growth. The continuation of the consolidating trend in the fiscal policy reduces risk premiums, mitigates the effect of the public sector on domestic financial markets, and increases the space for lending to the private sector.

2. Fiscal projections and public finance stability

Based on the macroeconomic backdrop and measures regarding the fiscal package, described above, the draft-budget 2017 envisages:

- Public revenues amounting to ALL 436 billion, or 27.3% of the GDP. This forecast implies an increase by 6.9% from the expected revenues level for 2016 and reflects mainly the broadening of the taxable base, in response to the expected economic growth. On the other hand, the effect from changes to the fiscal package is relatively small;
- Public expenditures amounting to ALL 467.2 billion, or 29.3% of the GDP. This projection implies an increase by 6.5% from the expected level of expenditures level for 2016;
- The budget deficit amounting to ALL 31.2 billion, or 2% of the GDP. This level of the deficit stands 2.4% higher than that expected for 2016. In terms of financing, the deficit is envisaged to be financed at around 60% from domestic resources and 40% from external resources;
- A reduction of the public debt, from the expected 71.8% of GDP, at the end of 2016, to 69.1% of GDP at the end of 2017. This projection is in conformity with a requirement of the Organic Budget Law (OBL). Moreover, it is consistent with the programmed budget deficit level and economic growth projections, but it does not take into account the effects of potential volatilities in the exchange rate.

In relation to these projections and their implications for the stability of public finance, the Bank of Albania identifies the following:

2.1 On fiscal projections

Excluding the potential effects of the electoral year, which often – and regrettably – are materialised in a reduced efficiency of the tax administration, the Bank of Albania deems that the projected level of public revenues is realisable. However, the Bank of Albania considers that, like in the case of macroeconomic projections, the balance of risks to this projection has shifted on the down side. Against this backdrop, it is encouraging that the budget of 2017 incorporates some buffers against the potential non-realisation of revenues, in the form of various budget contingencies envisaged up to 0.5% of the GDP. However, such contingencies may not be sufficient. Our opinion about the optimum manners for the treatment of uncertainties and risks in forecasting is detailed in the last section.

2.2 On compliance with OBL requirements

As noted in the accompanying explanatory notes, the Bank of Albania finds that the draft-budget 2017 complies with the legal requirements laid down in the OBL.

Thus, beyond the reduction of the public debt:

- The expected nominal GDP is within the International Monetary Fund projections, detailed in the last publication of the *World Economic Outlook*.
- The projected level of capital expenditure is higher than the programmed level of public borrowing;
- The draft-budget 2017 envisages a contingency of funds equal to 0.9% of total expenditures (ALL 4 billion), to offset adverse effects from the exchange rate and interest rate volatility on the level of public debt;
- The draft-budget 2017 does not envisage revenues from privatisations.

2.3. On public finance stability

The Bank of Albania deems that the programmed reduction of public debt is a positive step toward enhancing the fiscal stability and reducing the weaknesses that arise from the still-high level of public debt.

Also, the OBL sets out certain legal requirements, which:

- require the progressive reduction of the public debt during each fiscal year;
- anchor the macroeconomic framework to IMF projections; and,
- limit the concentration of the budget deficit in certain periods of electoral years,

These requirements help to discipline the fiscal policy, improve public finance stability, and enhance the interest of investors, both domestically and internationally, in Albanian debt instruments.

3. Public sector borrowing and domestic financial market

The draft-budget 2017 envisages domestic borrowing amounting to ALL 19.8 billion. The liquidity situation in the domestic financial market and the low interest rates provide the premises for accommodating the aimed borrowing level.

However, the Ministry of Finance and the Government of Albania should give due attention to the even distribution of borrowing and budget expenditures, in order to reduce domestic markets' volatility. Also, the Ministry of Finance should constantly monitor the absorption of borrowing in domestic financial markets, in order to enable the constant re-calibration of debt instruments with market requirements.

Concluding, the Bank of Albania would like to present some suggestions, which – in our opinion – would contribute to the process of drafting and implementing the Budget in the future.

4. Suggestions and recommendations

4.1 Forecasting, Uncertainty and Risk Management

The forecast on the revenue of the budget – like any other economic forecast – is surrounded by uncertainties and risks. The proper acknowledgment and understanding of this fact necessitates measures to identify and quantify them, and paves the way to effectively manage the possible consequences.

In line with our previous suggestions, Bank of Albania deems that the *drafting and implementation process of Budget would benefit from the establishment of alternative budget scenarios, which would be implemented in the event of large deviations from the forecast.*

The Bank of Albania, in the light of priority to comply with budget deficit and fiscal consolidation objectives, suggests that the implementation of the budget 2017 should regard the following:

- In the event the budget revenues are less than the planned level and the difference is higher than the contingencies foreseen in the budget, then the Government should take additional measures to comply with the budget deficit levels. This implies the reduction of budget expenditures commensurate to the level of unrealised income.

- In the event the budget revenues are above the planned level, and the difference stems from faster than projected economic growth, such revenues should be saved, by proportionally reducing the budget deficit.

- In the event the budget revenues are above the planned level and the difference stems from the improved fiscal management, such revenues may be spent, affecting neither the budget deficit nor the fiscal consolidation intensity.

4.2 Structure of financing and public debt

The way the budget deficit and public debt are financed is as important as their level. The financing structure of the Albanian debt was and remains stable. The domestic debt is shifting towards longer-term maturities, and its sensitivity against short-term volatilities on interest rates is downward. In parallel, the external debt is mostly in concessionary terms and has long-term maturity.

Nevertheless, the Albanian public debt showed an increasing trend of financing from external resources. In the last decade, the share of external debt to total debt increased by 16 percentage points.

For this reason, the Bank of Albania draws the attention on the increasing exposure of debt servicing cost and level against exchange rate volatilities. This implies the need for added attention to external borrowing, in particular to the one in commercial terms, which should be considered as the last option in the list of possible financing resources.

4.3 Further rationalisation of the selection process of public investments

The selection process of public investments has improved considerably over the last years. This is realised, amid others, through the rationalisation of non-budgeted public commitments, the disciplining of several-years-long projects, and the improvement of selection mechanisms.

Nevertheless, the Bank of Albania deems that there is still room for improvement.

The application of a formal cost-profit analysis for public investments in certain fields, such as health and education, culture, defence or various social programmes may be difficult from the economic standpoint, even problematic from the ethic one. Nevertheless, the selection process of other public investments, in particular those in infrastructure, may be further improved, through the formalisation of the process and the standardisation of assessment techniques for the economic profitability provided by alternative projects. This would be another positive step to increase the efficiency of the Albanian public finances and support the stable and long-term growth of our economy.

4.4 Budget implementation pattern throughout the year

The uneven distribution of expenditures and public borrowing has been and remains a problem in

the Albanian public finances. The Bank of Albania has been emphasising constantly that their concentration in the last quarter of the year tends to reduce the effectiveness and increase the volatility of financial markets.

In this context, we deem that further efforts should be made to improve the distribution of expenses and borrowing throughout the year. The anchoring of the budget implementation and monitoring in quarterly plans could be a valuable instrument in this regard.

Thank you for your attention!