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AN ANALYSIS ON THE EFFECT OF INFLATION AND EXCHANGE RATE FLUCTUATION IN ALBANIAN ECONOMY POST PANDEMIC

Zamira Veizi, PhD 

Eqrem Çabej” University, Gjirokastra, Albania

veizizamira@outlook.com

Rovena Bega

Eqrem Çabej” University, Gjirokastra, Albania

rovenabega5@gmail.com

Abstract

This article analyzes the impact of the exchange rate and inflation on the economy of Albania. The exchange rate and inflation are two key factors that have a direct impact on economic stability and the purchasing power of citizens. Through a detailed analysis of the current situation in Albania, this article will examine the causes and impact of changes in foreign exchange rates and inflation on the domestic economy. To better understand this interaction, economic and monetary policies and the role of the central bank in their management will be evaluated. Exchange rate changes have an impact on the level of import and export, while inflation constitutes the general increase in the prices of goods and services. To meet the challenges, the Bank of Albania monitors monetary and fiscal policies, aiming for a stable exchange rate and under-control inflation. The analysis of the impact of these two factors helps to understand the challenges and potentials that are presented to the Albanian economy, while management policies must be careful and advance with the consultation of experts to ensure sustainable economic development and well-being for citizens.

Keywords: Exchange Rate, Inflation, Economic Stability, Monetary Policy, Purchasing Power, Macroeconomic Factors



INTRODUCTION

In order to better understand the role of the exchange rate and inflation in the economy of Albania, it is important to explore their changes in the context of international developments and local economic policies. Reflecting their impact at the macro and microeconomic level, this article will provide readers with a broad overview of the challenges and opportunities that the Albanian economy faces and the necessary steps to build a sustainable economic development. The Bank of Albania has long adopted and implemented a flexible exchange rate regime. However, the Bank of Albania pays special attention to the performance of the exchange rate, given Albania's position as a small and open economy and with a relatively high level of euroization of financial markets. The presence of euroization in the financial system and more widely in the economy, has important impacts on the effectiveness of economic policies. The Bank of Albania underlines that stable positions, even in the strengthening of the lek against the euro in the foreign exchange rate, can be a driving factor in the euroization of the economy and the financial sector. According to the Central Bank, in situations where the exchange rate is stable and its volatility is low, economic agents tend to increase the volume and frequency of their financial transactions in foreign currency.

These premises make the level and dynamics of the exchange rate have an important role in the progress of prices and economic activity, as well as in the stability of the main economic, monetary and financial balances of the country. The value of the lek against foreign (*fig.1*) currencies is determined freely in the foreign exchange market. Exchange rate fluctuations reflect the free movement of goods and capital in Albania's commercial and financial exchanges with its trading partners. Without violating the regime of a free exchange rate, the Bank of Albania can carry out actions in the foreign exchange market with the objective of adjusting the exchange rate to the level determined by the basic macroeconomic factors, avoiding disturbances and increasing or decreasing the foreign exchange reserve. The exchange rate is one of the factors that has influenced to keep inflation under control (*fig.2*).

Exchange Rate Appreciation

Albania applies a free regime of exchange rates, which means that the value of the national currency Lek, compared to foreign currencies, is determined by supply and demand in the domestic foreign exchange market. The official exchange rate of the main currencies EURO and USD is determined daily by the Bank of Albania, based on the quotations of ten banks participating in the interbank market, while the exchange rate of other currencies, such as GBP, is calculated by indexing against the US dollar. as a reference currency in the international market. The exchange rate of the lek against the European currency has had an appreciating trend,

started since 2015, temporarily restrained during the pandemic period (2020-2021), and continued during 2022 and 2023. This strengthening trend reflects the improvements structural of the Albanian economy and financial markets, manifested in the strengthening of the external position of the economy and in the increase of public confidence in our national currency. The strengthening trend of the lek reflects the rapid growth of foreign exchange flows in our economy. But the unprecedented strengthening of the Lek in the exchange rate with the Euro this year is perhaps, for the first time, seriously confronting the economy with what could be the dangers of a strong currency. In July, the Euro-Leke exchange rate dropped to the level of 100.5 Lek, with a record annual drop of 13.3%. It is difficult to say with certainty how the ratios have changed to such an extent as to justify the fall of the Euro to the level of 100 Lek, just as it is difficult to share precisely to what extent the strengthening of the Lek is due to the role of the economy formal and what is the impact of foreign currency flows of money originating from criminal activities. In such a situation, stakeholders and experts have suggested interventions to curb the appreciation of the Lek. The most persistent voice has been that of the exporting companies, which are suffering significant losses from the strengthening of the Lek in the exchange rate.

Figure 1. The Rate of EUROS against the Local Currency 2021-2023



Source: Bank of Albania

Regarding the factors of Lek appreciation, it is difficult to find a general consensus and this is a public debate that has been going on for years. The Bank of Albania estimates that the strengthening of the Lek has come mainly from the improvement of the Balance of Payments, illustrated by the reduction of the current account deficit and the overcoming of this deficit from incoming financial flows, mainly in the form of Foreign Direct Investments. The Bank of Albania has described the improvement of the Balance of Payments as an indicator of the strengthening of the economy, since this means narrowing the negative contribution of net exports to the Gross Domestic Product.

In particular, the real estate market continues to show high growth rates and brought the main contribution to the country's economic growth for the first six months of this year, despite the cycle of interest rate increases. The development of the property market is also related, to a large extent, to foreign exchange inflows. According to real estate agents, there is a high demand in the property market from foreign buyers or non-resident Albanians. Another factor that should be considered is the monetary and fiscal policy cycle in Albania. The increase in interest rates and the slowdown in lending has led to a decrease in the monetary supply of Lek during this year. This tendency is further accentuated by the parallel tightening nature of fiscal policy. In the middle of this year, the budget recorded a record surplus of 46 billion ALL. The above factors have caused the monetary aggregate M2, in the first part of the year, to record low growth rates. In parallel with them, the strengthening of the exchange rate has helped the stability of the financial balances of borrowers in foreign currency, having a direct positive effect on the level of problem loans and on the financial stability of the country. Finally, the strengthening of the exchange rate has improved the stability of the foreign debt of the Albanian economy, reducing its financing costs in international markets.

Inflation and the Impact of Exchange Rate Appreciation on the Economy

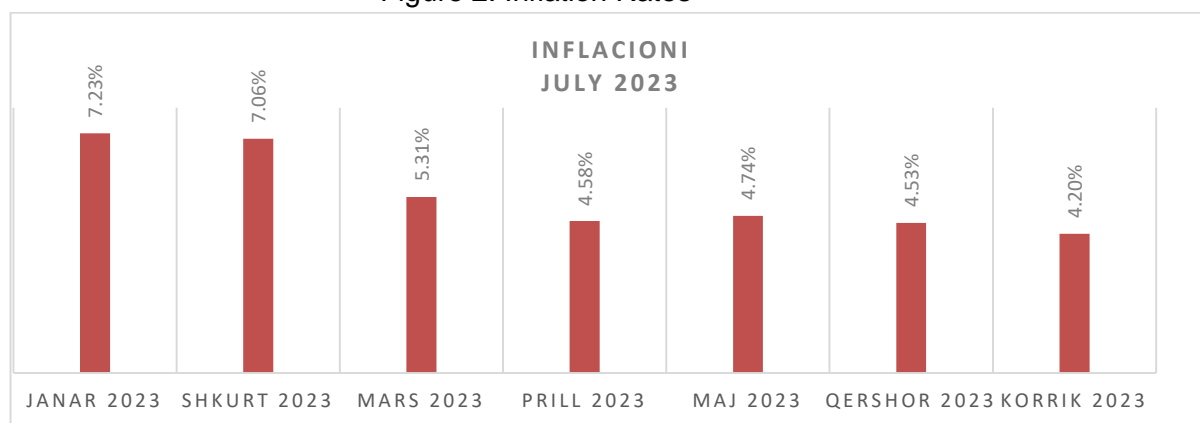
The attitude towards inflation and exchange rate stabilization has changed significantly, especially over the last decade. The performance of the exchange rate has an important role in the transmission of foreign inflationary pressures in the country, in the competitiveness of Albanian exports in foreign markets, as well as in the financial stability of the country, seen from the point of view of the solvency of currency borrowers. foreign and the stability of the foreign debt of the public and private sector. The strengthening of the exchange rate has not affected the growth of Albanian exports. On the contrary, it has helped to control inflation in the country, which has been and remains the lowest in the region, helping to maintain purchasing power. The impact on inflation is depending on the degree to which the country is dependent on fuel and energy. The Consumer Price Index in July 2023 reached 113.8 compared to December 2020. The annual change in the Consumer Price Index in July 2023 is 4.2%, a year ago this change was 7.5%. The monthly change of the consumer price index in July 2023, compared to June 2023, is -0.1%. Alongside the trend of inflation is the trend of the strengthening of the lek, functioning as the channel through which external and internal shocks were transmitted to the economy. While the euro has weakened from January 2023 by 10.2%, it seems that the impact on average inflation for the same period has decreased by 2.5%, mainly through the reduction of import prices. This reduction comes as most goods are priced in euros and other hard currencies. Inflation in the country fell significantly during the first half of the year, but it remains

above the 3% target. Annual inflation in the second quarter was 4.6%, from 6.5% recorded a quarter ago.

The decline in inflation was broad-based, but it was faster in oil and processed food prices, as a result of the latter's decline in global markets and exchange rate appreciation. On the other hand, inflation components more closely related to demand and labor market performance – such as services inflation, durable goods inflation, core inflation – remained at high levels. With the overvaluation of the lek against the euro, the prices of energy and raw materials and imported goods have recorded lower costs in purchasing from imports. Moreover, in the presence of foreign price shocks and a high level of inflation in the country, the Bank of Albania considers that the strengthening of the exchange rate has had an overall positive effect on the Albanian economy. The Bank of Albania foresees a continuous growth of the economy in the medium term horizon. This growth is expected to be spread across all branches of the economy, including the export sector, and to be supported by solid balance sheets and the improvement of confidence in the private sector, by the good financial health of the banking sector, by the positive perspective of the labor market, as well as from a still accommodative financial environment.

The trend of price increase during this year will continue to stabilize at faster rates. In the annual report, the Bank of Albania analyzes the fact that the decrease in inflation in the first months of this year is a sign that prices will continue to fall. The forecasts of the Bank of Albania show that inflation will return to the target within 2024. The fall in inflation will be supported by the stabilization of prices in global markets, such as food products, energy or fuels, but also by the effects of the normalization course of monetary policy. Inflation has continued to decrease even for the month of July. According to INSTAT, the annual change in the consumer price index in July 2023 is 4.2%, a year ago this change was 7.5%, while in June of this year inflation was 4.5.

Figure 2. Inflation Rates



Source: INSTAT

The Effects of the Strengthening of the National Currency

The strengthening of the lek has a positive effect on borrowers in foreign currency, in this case the state as borrower. The stock of gross external debt reached 9.8 billion euros at the end of 2022. The drop of over 8 percent in the value of the euro is accompanied by the reduction of obligations, expressed in Lek, for the stock of external debt, with a benefit of about 90 billion Lek. The main weight, 48% of the external debt is held by the government, the main beneficiary of the strengthening of the lek (around 44 billion lek less liabilities for the external debt), since the income is generated in the lek and the payments are made in euros. Another short-term benefit for the government is the reporting in euros of improved fiscal and macroeconomic indicators, such as indicators of income and gross domestic product per capita, or the indicator of external debt to gross domestic product. Beneficiaries are also businesses and families that have loans in foreign currency and income in Lek. Foreign currency credit in banks reached over 3 billion euros in February 2023, accounting for 48% of the total credit of 6.3 billion euros. The strengthening of the lek reduces the obligation for the monthly installment in lek, of repaying the foreign currency loan from the government, by about 27 billion lek in total. Except for cases where the parties have credit where they foresee a review of the calculation of the installment according to the Basic Rate. Given that lending interest rates have increased significantly in the last 6 months, the positive effects from the exchange rate are partially offset by the negative effects of interest rates for businesses/individuals. The strengthening of the lek has a positive effect on the imports of goods and services, which become more competitive in the domestic market, due to the drop in prices from the exchange rate. For 2022, the trade balance of payments (imports minus exports) was 4.3 billion euros. The benefit in favor of importers can be estimated at around ALL 38 billion in total, but the impact on consumers is not expected to be similar, since traders do not immediately pass on the price differences to the final consumer. In general, the improvements in the balance of payments in the first quarter of the year support an appreciating tendency of the local currency. The main sources of foreign currency inflows that have narrowed the current account deficit are exactly tourism, the improvement of the trade balance of services in general and remittances. On the other hand, foreign investments have continued to grow and their amount significantly exceeds the value of the current account deficit. The figures of the first quarter showed a slowdown in the investment of foreign citizens in real estate, but, however, according to foreign exchange market agents, the second and third quarters of the year have brought an increase in investments by foreign buyers, especially in tourist areas. It is clear that, at least for the summer season, the expectations of exchange agents remain for a further strengthening of the Lek against the Euro. Based on historical data,

the peak of the seasonal effect on the exchange rate is usually reached in the first days of August.

Intervening in the exchange rate would have implications for monetary policy and important macroeconomic parameters. In a situation where inflation is still above the target, an intervention by the Bank of Albania to withdraw the Euro by selling the Lek would increase the monetary supply of the Lek and increase inflationary pressures. At this moment, such a move would conflict with the basic legal mission of the Bank of Albania, that of maintaining price stability. In an opposite scenario, of devaluation of the currency, the intervention of the Bank of Albania would erode the foreign exchange reserve.

The problems that accompany such a strong and rapid devaluation of the Euro in the national economy are:

1. Absorption of exchange rate losses by exporters, as the main problem identified in the economy, where precisely exporters have little or no opportunity to minimize its effects within a short period of time, even a year. And these losses are not accounting losses, but real ones. Their losses are also reinforced by the fact of the complete lack of use of "forward" or "futures" financial contracts, contracts that could amortize their strong and continuous losses, but which unfortunately have not been used almost at all (in fact have almost zero use) by exporters, since in Albanian business practice these instruments or professional advice may have been considered excessive and meaningless costs. Now exporting businesses are facing high risks, which come both from the increase in labor costs, but also from the appreciation of the local currency in the exchange rate.
2. Hospitality service providers, another category that is experiencing in a somewhat more indirect, but sure way, the loss from this devaluation, who are forced to buy goods and services in the local market mainly with Lek, exchanging it that with an increasingly weak euro.
3. Expatriate families and foreign currency savers appear to be the other big losers from this sharp and rapid devaluation of the euro, who are seeing their savings (if they could be used) suffered a significant loss of value.

Beyond the identification of losers and beneficiaries from this devaluation of foreign currencies, it should be emphasized that such a situation in the domestic foreign exchange market has and will continue to have long-term consequences in the way and form of doing business in Albania, the positioning of the enterprise in the market, business models and those of cost construction. Inevitably exporters, as the biggest net losers, will have to reposition their approach to business, where some of them, if such devaluation continues, or does not stabilize, will go out of business or, will be uncompetitive in international markets and in the long run will

go out of business. This will cause them to have difficulties in new business plans for their expansion, loan applications and acquisition of new technologies, and of course in granting higher wages to employees, thus losing the skills of the current workforce and increase the costs of training and preparing the new workforce, which will be significantly less professional, but will demand and negotiate higher wages, which are not related in fair proportion to the productivity of its work.

CONCLUSIONS AND RECOMMENDATIONS

The strengthening of the lek in the last two years has reduced inflation in the country by 2.5%, causing citizens, businesses and the government to save a total of 92 billion lek. The projections of the Bank of Albania remain positive, the downward trend of inflation will continue. But emphasizing the general monetary and financial conditions, which must remain suitable for the return of inflation to the target. The strengthening of the exchange rate has made it possible to absorb part of the inflationary pressures from the foreign market. However, for the Bank of Albania, the inflationary pressures still remain severe, so the possibility that there will be another increase in the base interest rate for the lek is not excluded. According to the Central Bank, the weakening of foreign inflationary pressures has not been able to spread widely to the most stable components of the economy, due to high pressures from the labor market and wages. With the latest inflation trends, not only in Albania, but also globally, the expectation for GDP growth is set at 3.6% in 2023. Despite the strong growth shown last year, in the following periods it is expected that the economic growth will be affected by the increase in inflation. Inflation, on the one hand, will erode the purchasing power of consumers and increase the cost of imports, and on the other hand, it will increase export prices, reducing the competitiveness of Albanian products. The amplitude of these impacts may be important for the Albanian economy, but not at such levels as to undermine the positive trend of economic growth. The fall in inflation in the country will be supported by the stabilization of prices in international markets, by the good performance of the exchange rate, by the downward revision of inflation expectations, but also by the effects of the normalization rate of our monetary policy. The Albanian economy has shown a good resistance to foreign supply shocks and the tightening of monetary conditions, in the country and in the world. Driven by the dynamism of the private sector, the economic growth of 2022 was around the 4% level and there is a good sectoral distribution. Likewise, employment and wages have grown rapidly, while the unemployment rate is at historically low levels. Although the growth rate is expected to show a slight decrease, the Albanian economy will continue to generate new jobs and positive growth rates during 2023.

Recommendations on the exchange rate and inflation in Albania should be based on an analysis of the current economic situation and the possible challenges that the country may face. Here are some recommendations:

- **Continuous Monitoring:** It is important that the Bank of Albania and the economic authorities continue to carefully monitor the economic situation, including the exchange rate and inflation. Regular and transparent information can help to take appropriate measures at certain times.
- **Improving Macroeconomic Stability:** The authorities should continue to improve macroeconomic stability, including the implementation of inflation management policies and the necessary intervention in the foreign exchange market to maintain the exchange rate at acceptable levels of volatility.
- **Improving Productivity and Economic Development:** Increasing productivity and investing in strategic sectors are essential for long-term economic growth and controlling inflation. Investments in infrastructure, education, and the private sector can help in this direction.
- **Improving Fiscal Policies and the Labor Market:** The authorities should take care of fiscal policies and the labor market to improve the economic situation. The necessary changes in the fiscal system and measures to combat unemployment can help stabilize inflation.
- **International Cooperation:** Albania should continue cooperation with international organizations, including the International Monetary Fund (IMF) and the World Bank, to receive the necessary advice and support for the management of its economy.

The content of these recommendations can help Albania maintain economic stability and face potential challenges related to the exchange rate and inflation. However, it is important that these measures are implemented carefully and in accordance with the current economic conditions and situation of the country.

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