Is Savings a Determinant of Economic Growth in Developing Countries? (The Case of the Albanian Economy)

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Abstract

The question of whether a savings-led economic development model can produce faster and sustainable economic growth than a consumption-led economic one or vice-versa has been one of the most difficult ones to address by policy makers and countries' leaders worldwide. International examples of economic development show that even though the determinants of development models are similar among countries, their contribution varies from case to case. Savings is an important determinant of economic growth however extensive savings at the expense of consumption can create an economic model that produces fast growth but not sustainable in the long run (China and USA). On the other hand, the opposite also holds true. Extensive domestic demand, not met by aggregate supply, at the expense of savings also creates fast growth but not sustainable in the long run (Albania). However, more than levels of savings, it is the allocation of the capital accumulated that spurs economic development in a country (Japan). Albania's economic development prior to the crises was a success story of fast economic growth rates, welfare improvement and total factor productivity growth. However, the financial crises of 2008 unveiled many domestic balances that had emerged due to the consumption-led economic model the county's incapability to increase supply. This produced fast but unsustainable economic growth. The new Albanian economic model should encourage savings in order to increase the capital productivity, the driving force of economic growth in Albania since

2000s; allocate credit available to priority sectors with comparative advantage; support export-sectors as the only way to balance the balance of payments, credit account deficits and trade deficits and invest in improving the Total Factor of Production productivity.

Keywords: *Economic, Development, Growth, Savings, Consumption, Exports*

Introduction

The question of whether a savings-led economic development model can produce faster economic growth than a consumption-led economic one or vice-versa has been one of the most difficult ones to address by policy makers and countries' leaders worldwide. The existing literature and historical data show a mixed evidence of the superiority of one model over the other. Another important aspect of this question is whether faster economic growth produced by either of the models is sustainable of not in the long run. The determinants of growth are similar for developing countries but are also dependent on country specifics. In the case of China, extensive savings were the driving force of the export and investment- led growth model which proved to produce fast growth but not sustainable in the long run. The economic model of Japan also relied heavily in savings but its success was determined by the strategic allocation of credit available to the most competitive sectors. Thus, more than an issue of the level of savings vs. consumption, the credit reallocation was the key to a successful economic development model. In the case of Albania, the consumption-driven growth proved to be an absorption-led growth model and unsustainable in the long run, especially after the 2008 crises. The level of consumption more than out-weighted the supply of goods and services produced in the country and led to growing trade and current account deficits. The importance of capital accumulation and savings became evident in the period after 2000. This domestic-demand-led model produced impressive growth prior to the financial crises of 2008 but proved to be not sustainable after 2008. The new Albanian economic model should encourage savings in order to increase the capital productivity, the driving force of economic growth in Albania since 2000s; allocate credit available to priority sectors with comparative advantage; support export-sectors as the only way to balance the balance of payments, credit account deficits and trade deficits and invest in improving the Total Factor of Production productivity.

This article is organized as follows: Section two presents the case of the mass-consumption economic growth model implemented in United States of America and its future prospects. Section three presents the economic development model in China, its implications and results in the economy and the future development model; Section four presents the case of East Asian countries as among the most successful stories of economic development. It focuses on the case of Japan and the determining factors of economic success. The fifth section provides a thorough analysis of the economy of Albania and its economic development model from the fall of communism until nowadays.

USA, the mass-consumption-driven economic growth model

At the end of the WWII, Unites States was determined to enhance the economic recovery brought on by the war but to create a prosperous peacetime it had to move away from military industry to produce new things and sell them to new people. Everyone believed that mass-consumption was the center force that would bring economic prosperity. The previous military factories were re-constructed and ready to produce new things. However, this mass-consumption solution to economic prosperity was difficult to be embraced by consumers that were very cautious about spending their savings that they had accumulated. Thus, businesses, labor unions, government agencies and the mast media started conveying the message that "mass consumption was not a personal indulgence. Rather, it was a civic responsibility designed to improve the living standards of all Americans, a critical part of a prosperity producing cycle of expanded consumer demand fueling greater production…" (Cohen, 2004). Consuming became a characteristic of a good citizen and of responsible people helping USA become a more desirable place for its people. This mass-consumption-driven economy held out not only the promise of a prosperous future but also a more equitable and democratic society. They argued that the ever-growing economy fueled by increased productivity and mass-production would increase the "overall pie" without reducing the size of any portion.

The postwar, American motto was "more, newer and better" and consumption become the dominant source of economic growth in the United States during the recent decades. A striking example of the mass-consumption economy was the unprecedented growth scale of new residential construction in USA. In 1960s, 25% of the residential housing was built in 1950s and 62% of Americans would claim they owned a home as compared to 44% in 1940s. This housing boom was made possible by the government subsidies to private sector. During last 10 years prior to the recession of 2008, personal consumption expenditures (PCE) grew at a rate of 3.47%,investment(I) and government expenditure (G) grew by1.70%, while gross domestic product (GDP) grew only by 2.91%. In terms of its contribution to the average quarterly GDP growth in 2007, PCE contributed for 81.3% while the other components (I, G and NX) accounted only for 18.7%. During the past

25 years, PCE grew at 3.50% while the rest of the economy (I, G and NX) grew at 2.79%; PCE contributed 70.8 % to the average real GDP growth while all the other components contributed only 29.2%. Consumer spending has been a large and increasingly important part of the American economy.

US consumers served as the locomotive of economic growth not only for US but for many exporting countries and the global economy. Imports of good (44% of imports) and services increased by a rate of 7.5% during the decade ending in the third quarter of 2007. US incurred large trade deficits and required inflows of foreign capital to finance them. The three characteristics of US and global economic growth – large spending and low savings, large US trade deficits, and substantial inflow of foreign capital might be the main reasons of the US housing bubble and the global financial crises (Bernake, 2011). Economists were left with the question of how sustainable this growth could be and what is wrong with an economy where 70% of GDP is consumer spending.

Theoretical reasoning and empirical evidence show that a consumption-led growth is not sustainable. Economic growth theories argue that for an economy to grow sustainably it must continuously invest in new capital goods and structures in order to grow, improve productivity and improve living standards. Empirical evidence shows that if consumption "crowds out" investment spending, the economy will not grow as fast. Cross country studies show that during periods when consumer spending was high, the investment levels were low. In the period 1951-2010, consumer spending generally was higher than its average when investment was lower than its average and vice versa. Studies for the 1951-2010 show that the correlation between the share of consumption and economic growth is negative, while the correlation between the share of investment in GDP and economic growth has shown to be positive. The correlation between the consumption and economic growth has in average been – 0.31 for the period 1951-2010 and the correlation between investment and economic growth has in average been 0.50 for the same period. The diminishing influence of consumption in economic growth is best shown by the highly negative correlation of -0.81 between consumption and economic growth in the period 2001-2010 (Emmons, 2012). The bottom line is that the main reason why a consumption-led-economic-growth is not desirable is that consumption has the potential to crowd out investments which are better enhancers of economic growth.

Furthermore, consumption cannot continue to be the engine of growth especially after the 2008 financial crises. These are some of the reasons:

1. The average American's wealth has decreased as housing prices- their main principal asset in many cases - continue to weaken even after the crises is over. Moreover, negative equity situation- when market value of the house

is lower than the debt the consumer needs to pay- has affected 22-29% of households. These factors have put pressure on the consumer spending.
2. Lending has been reduced notably. Mortgage credit is available only to the strongest borrows and it is very limited. The 2008 crises led to credit standards that have limited the quantity of credit available.
3. The consumer confidence has been strongly hit by the 2008 financial crises. Even though, consumer confidence indexes have improved significantly since the financial crises period, the consumption growth rate is 1% short of the growth rate before the crises.

All of these factors combined indicate that the growth engine of the American economy can and should no longer be consumption. A rebalancing of the economy that will lead to higher investment levels needs to happen in order for the economy to grow at the pre-level rates.

China's transition to a consumption driven economy

The Chinese economy has for many years been one of the fastest growing economies in the world with 10.4% increase in GDP in the last decades. Over the last two decades, the Chinese economy growth has been led by increased exports and investments. However, this has led to a continuously declining level of consumption which has altered the balance of the economy due to the reliance on volatile exports and imports. Additionally, many economists argue "that this 'Investment and Export Oriented Growth' is not sustainable and for China to continue grow at a continuously improving rate it has to significantly increase the share of domestic consumption in its GDP."

The decreasing share of consumption in China is not a new phenomenon for countries going through an industrialization phase of economic growth. The share of consumption has been falling also in Japan (1955-87), South Korea (1961-1995) and USA during the Second World War. However, the 34.3% share of consumption in China's GDP is the lowest one observed, which indicates that it cannot (entirely) be attributed to the industrialization process. As a result, policy interventions like decreasing the savings rate, increasing disposable income and increasing the share of consumption of households should be undertaken.

A consumption-led growth is economically, socially and environmentally sustainable in the long run. Historical data indicate that growth in investment can be much more volatile than the growth in consumption. Investment is volatile and can be postponed because of business cycles and uncertainties in the market. On the other hand, consumption cannot be postponed and is continuous, representing a less volatile driver of growth. Furthermore, given the large population of China and very low consumption, there is a lot of potential for consumption-led growth.

Chinese economy has focused in developing heavy industries such as steel, cement and iron which have not only exploited the country's natural resources but also caused an environmental crisis. Today, China is the world's leading greenhouse emitter. In a consumption-led economic growth scenario, the economy would shift from the heavy industry to the services sector. This would lead to human capital development and would lessen the pressure on depleting natural resources (Lardy, 2006).

Furthermore, the economic growth in China has not benefited all the society but has had an unevenly distribution. This has led to increasing inequalities between urban-rural areas.

On the other hand, a consumption-led growth leads to a more inclusive economic development. This approach will lead to "more job-creation per unit of investment" which would benefit the average employee and help decrease the disparities in the society.

The economic development model of China points out that savings are important in the industrialization phase of the country because they provide available credit for the sectors to grow. However, very high levels of savings that harm consumption lead to a volatile source of growth and make the economic development sustainable only in the short – run. As a result a combination of both, consumption and savings, would allow for export growth, investment expansion and also for a long term sustainable economic model.

Japan's export-led development model

One of the most interesting economic development cases of the past decades has been the emergence, growth and development of East Asian countries. The impressive, constant economic growth of the "Asian Tigers"[1] since WWII has given rise to new theories in economic development. The first theory argues that the later in time developments starts, the less time it takes because the developing country can learn from other development processes of already developed countries. The second theory, which is more plausible in explaining the economic growth of East Asia, argues that these countries developed a new model of economic growth based on low levels of inequality. The "Asian development model" is used to refer to the export- led development model (Fujiwara, 2005) in which the country starts by exporting inexpensive products and educates its workforce to produce and export more lucrative goods. Another important feature of this economic development

[1] Hong Kong, Singapore, South Korea, and Taiwan

process was the "transition" effect that happened in the region. As countries were moving from the production of inexpensive goods to more lucrative goods, the cost of labor was rising. Thus, many companies moved basic manufacturing to other countries where the cost of labor was lower. This is the case of China nowadays, benefiting from the low cost of labor to keep basic manufacturing in the country.

Among the most prominent stories of economic development in East Asia was the case of Japan, the country with the fastest economic growth and the first non-western country to successfully accomplish industrialization. Japan went through an export-led economic development model that was later on implemented in other East Asian countries. The development of Japan was mapped out since the beginning of the transition period, after WWII, a track from very labor-intensive, inexpensive products to higher-value, complex products. Among other factors that enhanced growth in Japan was the fact that the process was more a re-industrialization one after the disruptive events and destructions of WWII rather than industrialization from ground 0; also Japan had a fairly educated population able to perform the basic manufacturing processes in the early years and to bring innovation in the economy later on. Further education opportunities increased the capabilities of the employees and helped Japan becomes the leading manufacturer of automobiles in 1980s (Kimura, 2009). The social- buy in– the willingness of the people to sacrifice for a better future – was another guarantee for the success of economic development process. People were willing to postpone consumption and increase savings (Mosk, 2000). The government discouraged consumption and routed national savings into low-cost industrial loans. This led to capital formation, increased capital productivity in the economy and sectors' development. The government provided credit to the most profitable companies and encouraged mergers between them to increase economies of scale. Furthermore, the government was continuously implementing favorable foreign policies for Japanese companies. In other words, the government's role in shepherding successful companies and drafting favorable policies was crucial in credit allocation and export support. Japan established a competitive advantage through low-cost labor and focused on serving export markets, not local ones. It also committed to use the most advanced technology possible at least for the first decades in order to enhance growth and shorten the transition period.

The economic model of Japan, similar to the Chinese one, relies on heavy savings that the government routes back in the economy in the most productive sectors oriented to export. This outward focus of Japan together with the centralized credit allocation, based on sectors' competitive advantage, was among the key pillars of the country's impressive economic growth. Other than the level of savings itself, it is its allocation in the most profitable sectors oriented to exports that ensures the success of the growth model.

The case of Albania

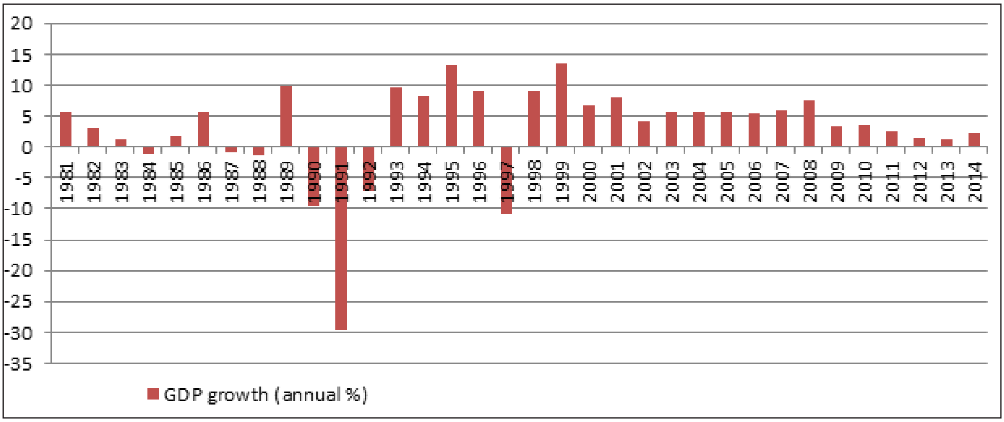
After WWII, the Albanian economy came to be one of the world's most centralized and closed systems. For more than 45 years, under the Albanian socialist, centrally-planned economic model, the leaders of the country tried unsuccessfully to meet demand and supply within the country by creating an enormous economic and social burden for the people. They undertook different economic structural reforms especially in the field of agriculture which proved to be very unproductive and harmed the production of this sector, one of the most important ones for the country. These structural changes were not made based on the competitive advantages or the growth potential of the sectors but were demand-driven. The effects of these re-structuring were not foreseen at the time of planning which brought unexpected and undesired outcomes later on. Furthermore, the economic split with China seriously disrupted the development of the country and shook the economic equilibrium. After that, Albania started consuming only what was produced within the country or previously during their "romance" era with China. The changes in the economic model led to hidden debts that brought the collapse of the economy 10 years after in 1990.

After the fall of communism, Albania was rich in natural resources and factors of production but it lacked the market, the democratic market to allocate these factors to the best potential economic sectors. It also lacked people that were able to understand and lead the economic changes in Albania. Internal migration, changes in the labor force allocation, closure of some of the factories and destruction of some others brought a lot of changes to the economy of the country. The changes in the labor force and later on capital markets brought a quick and impressive growth. However, as the World Bank described it, that was a "growth without development".

The economic development model of Albania was led by domestic consumption which caused growing trade and current account deficits because it was financed by remittances, privatization process and FDI inflow (at a very low level). Another characteristic of this model was the growing importance of the non-tradeable goods (services) sector. Even though this economic model was producing continuous growth, the financial crises of 2008 (although its impact was not as severe as in other developing countries) questioned the sustainability of this economic development model.

Immediately after the change of regimes, the economic structure, market functions and the until-then established capabilities in different sectors vanished due to the internal immigration and emigration of population.

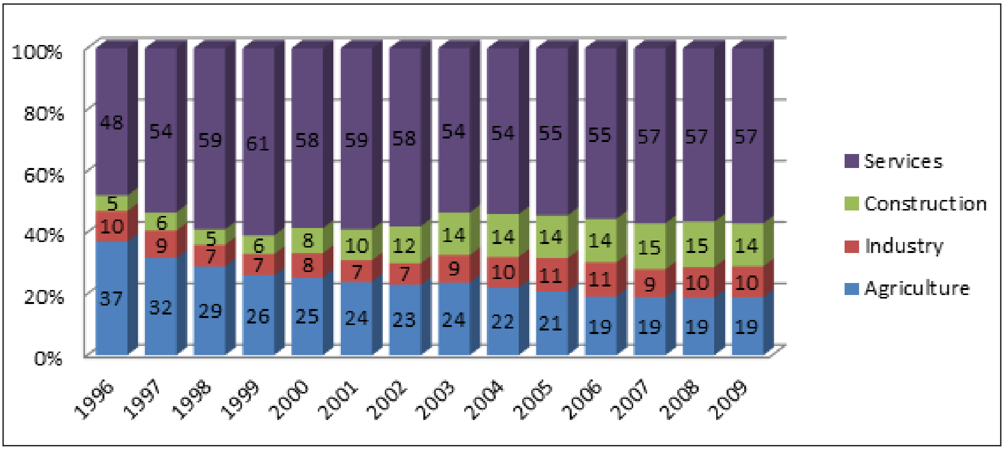
GRAPH 1: Annual GDP growth



At the beginning of the transitional phase, right after the fall of communist regime, the country's GDP decreased by a cumulative of 39% in 1990-1992. As a result of macroeconomic stabilization policies, gains in efficiency, reallocation of resources and political stability, GDP rose to an average of 9% annual growth. In 1997, the urgency for capital accumulation and financial illiteracy led to the creation of Ponzi Schemes in Albania. They promised (anddelivered for a short period of time) very high returns on investment which led to an increase in household consumption. As the fraudulent nature of these schemes unveiled and these institutions collapsed, the economy entered in a very difficult stage of development. The political instability in the country after the collapse of Ponzi-Schemes and the amount of money lost in these schemes affected the economy very badly. The annual GDP for 1997 fell by 11%. However, as shown in figure 1, this was only a short-term condition as the economy started to recover there-after. In 1998, the year right after the economic crises caused by Ponzi-Schemes, GDP rose to 8 % and the consequent year the growth reached 13 %. The economy kept growing at a constant level of around 6 % during the period 2000-2008. In 2008, the economic growth was affected by the financial crises. GDP growth fell to 3% in 2009 and 1% in 2012 and 2013.

Kota (2009) argues that despite the drastic fall of GDP in 1990 and the difficult economic conditions in 1997, Albania is among the only country (together with Hungary) that have surpassed the GDP level of 1990 in 1999. For other countries (Bosnia and Herzegovina, Croatia, Estonia, Hungary, Macedonia, Poland, Romania, Turkey) the recovery period lasted until 2003.

GRAPH 2: Percentage of GDP by Sector contribution[2]



Source: World Bank and Bank of Albania, authors own calculations

The determinants of such economic growth and the reallocation of factors of production is the starting point of the analysis of the economic model in Albania during the years of transition. Until 1990, the resource allocation was in line with the centrally- planned economic priorities rather than sector prioritization based on their efficiency or competitiveness. The reallocation of resources and the improvements in the productivity of factors of production (labor, capital and total factor productivity) shaped the economic model of Albania by favoring the development of some sectors at the expense of others.

The reallocation process fundamentally changed the structure of the economy in Albania. Previous research (Kota 2009, Fullani 2012) show that the industry sector fell from 39 % of GDP in 1990 to 10% of GDP in 2009 due to the lack of efficiency of the sector. This was one of the sectors that the centrally planned reforms tried to develop despite the low efficiency and productivity of it. On the other hand, the construction sector has had an almost linear growth trend since 1990. It expanded from 3% of GDP in 1990, to almost 8 % in 2000 and reached a peak of 15% of GDP in 2008. The expansion of this sector was driven by the internal immigration of the population in large cities like Tirana, Durres, Shkoder etc., the increasing demand, the needed improvements of infrastructure, the high demand for land utilization, the improving productivity of factors of production and the high profitability of the sector. The largest expansion happened in the services sector, while the largest contraction happened in the agriculture sector. Agriculture expanded from 23% of GDP in 1990, to 37 % in 1996 and dropped to 19% of GDP in 2009. The contribution of this sector in GDP was driven by

[2] The time horizon is limited by the availability of official data by the Bank of Albania and INSTAT. Earlier or later data on GDP composition is not available.

the internal immigration away from the rural areas to big cities, the low efficiency of the factor, imports from abroad and the destruction of the old agriculture organization schemes (decentralization) and in rural areas. On the other hand, the services sector expanded from 33% of GDP in 1990 to 63% in 2009. Some of the factors mentioned above were also the drivers of this impressive expansion.

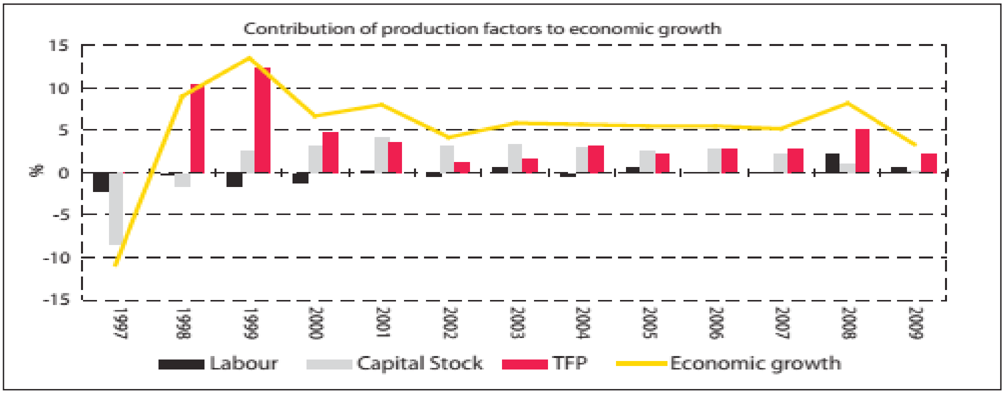
Production factors reallocation

These structural changes of the economy indicated a reallocation of factors of production according to the market demand and sectors' development. The existing literature provides two main approaches to the study of the determinants of growth:

1. The first one is the neoclassical model that decomposes the economic growth by the contribution of fundamental sources of growth such as Labor Productivity (L), capital productivity (K) and total factor of production productivity (TFP)
2. The second is a more detailed approach that studies specific variables that contribute to the above mentioned factors (L; K; TPF). These variables are: investment rate, international trade integration, macroeconomic stability indicators, quality of institutions etc.

The first approach is the most widely used to study development in developing countries and will be the basis of this session's discussion. Kota 2009 provides one of the most through studies of the contribution of the factors of production to the Albanian economic growth. The graph below illustrates the main findings of this study.

GRAPH 3: Contribution of production factors to economic growth



Source: Fullani, 2012

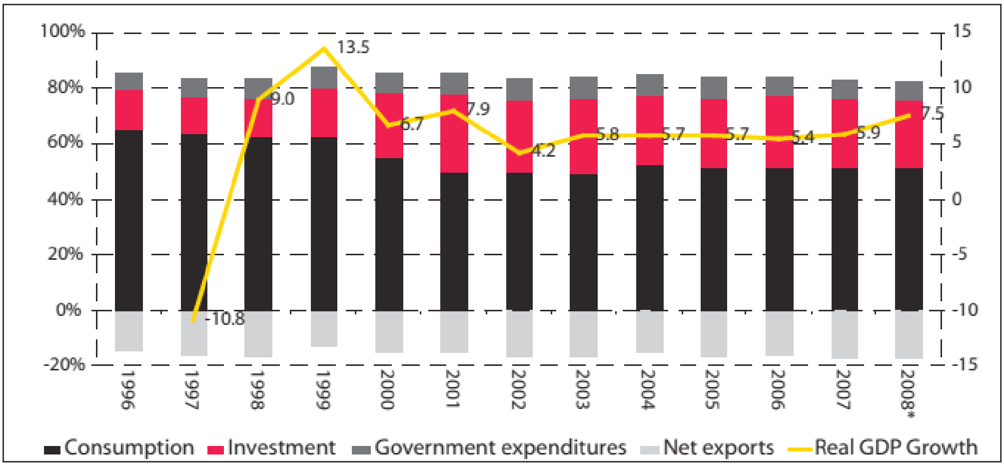
Kota (2009) and Khan (2004) find that the Total Factor Productivity fell drastically during the period 1990-1992 and recovered only after 1993. TFP has been the main driver of economic growth for the period 1993- 2000, as shown by Figure 1 above. The rising lending activity after 2000, is reflected in the increasing capital stock for the period 2000-2009.

After the economic crises of 1997, the GDP growth rate of 9.7% was followed by a TFP expansion of 9.3 % and an increase of only 1.4% in capital stock. In the period 2000-2008, the main drive of the economic growth was the capital stock which increased by an average of 3%, followed by a 2.5 % rise in TFP (the second determinant of economic growth). Labor Productivity seems to have not been an important determinant of economic growth. However, the accuracy of this later finding might be questioned because of the large informal labor market existent in Albania and not accounted for in this measure of labor productivity. Also, as stated before, labor productivity measures the employment contribution to economic growth, while improvements in the labor force (higher education of workers, training, etc.) are part of the TFP.

These findings are also enforced by other studies conducted about Albania and are in line with the development trends in factor of production in other developing countries. According to Khan (2004), one of the main sources of TFP growth in Albania has been the reallocation of production functions and the economic transformation and structural changes. He argues that in developing countries, it is expected that the TFP will play a greater role in the beginning of transition due to the reallocation of economic resources, the quick pace of improvements and rising quality and efficiency of resources. However, as the country develops, the contribution of TFP is expected to drop and the main determinants of economic growth become the capital stock and labor productivity.

One of the most surprising results is low contribution of labor in the development of economy in Albania. Kota (2009) argues that despite the very low contribution in economic growth, labor productivity has improved. During the first years of transition, labor is expected to reallocate to the most efficient sectors of the economy. This process should lead in a higher aggregate and labor productivity which in turn should contribute to economic growth. According to Kota (2009), labor productivity has increased by 6.4% in the period 1996 – 2008 driven mainly by the improvements in sector's efficiency and productivity. The services sector appears to have experienced the largest productivity gains by the reallocation of labor force despite the fact that the largest share of population (according to official data and not accounting the informal labor market) is employed in agriculture.

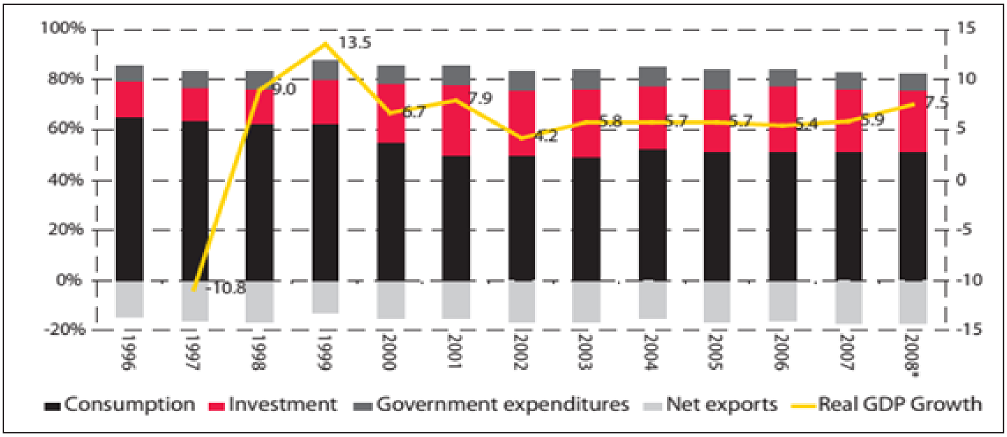
GRAPH 4: Components of domestic demand



Source: Fullani, 2012

Previous literature on economic growth in Albania argues that domestic demand, in terms of consumption and investment, is the main driver of economic growth. The increases in consumption and investment were fueled by the increasing availability of credit in the economy which was injected mainly in the services sector. The large increase in consumption and investment in the services sector led to a rapid increase in current account deficit because the production in other sectors could not meet the increasing demand for consumption and investment. The credit account deficits, which will be discussed in details below, are common among developing countries undergoing economic structural changes.

GRAPH 5: Annual gross savings, remittances inflow, FDI, Domestic credit to private sector as % of GDP



Source: World Bank and Bank of Albania, author's calculations

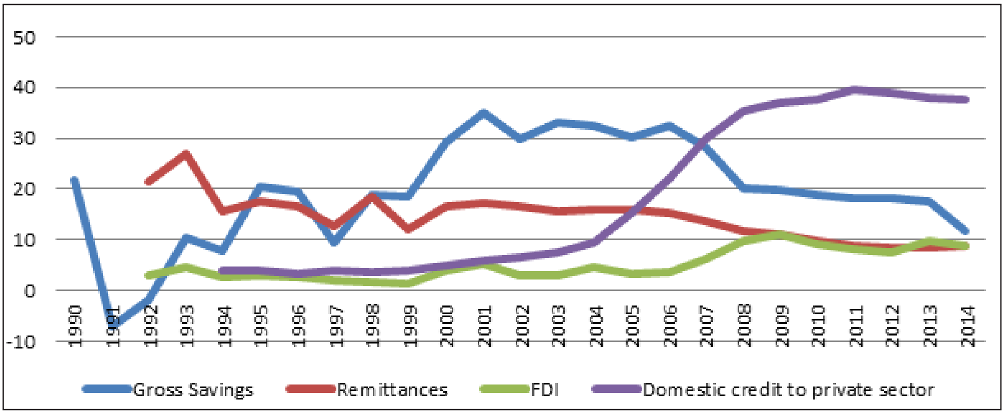
Differently from other developing economies in Central and Eastern Europe, the largest portion of credit was financed by domestic resources such as bank deposits and capital. As shown by graphic 5 above, remittances played an important role in supporting domestic demand. They accounted for 27% of GDP in 1992, their highest peak. Remittances continued to be a prominent source of financing for the transitional economic period. They were adversely affected by the financial crises of 2008 by falling to levels lower than 10% of GDP. This crisis unveiled the misbalances in the country's domestic consumption and spending by emphasizing the reliance on the economic activity in Europe. As previous study and data analysis show (comparison between graph 4 and graph 5), the bulk of credit received through remittances inflow were utilized for consumption, construction and improvements of the living standards. In other words, this credit was used to meet the demand of families and was not utilized in investment which would mean plugging money back in the economy. Furthermore, Germenji and Swinnen (2004) argue that the small portion of remittances that are invested in the economy have shown a tendency of avoiding the sector of agriculture towards the services sector. As a result, the sector of services has benefited most from remittances at the expense of the other sectors.

Furthermore, FDI inflows have been relatively low in Albania compared to other developing regional countries. The FDI inflow amounted to 3% of GDP in 1992 and through the privatization process, they increased to 6% in 2000 and more than 10 % of GDP in 2010. Even though the rise in FDI inflows is undoubtedly a positive signal, the sustainability of this trend could be questioned. The privatization process has been the main source of FDI inflows for many years but this is not a continuous source of FDI inflows. The privatization process was very intense in the beginning of the transition but has slowed down significantly. Another source of FDI is the entrance in the banking sector of large foreign banking groups, the developments in the fason industry etc. The government of Albania is now trying to attract FDI inflows through the establishment of Special Economic Zones as a profitable investment opportunity based on a new legal framework that allows for predictability of investment. By addressing the main issues identified by foreign investors, Albania is trying to attract investment and help the economy grow.

The bias towards consumption has led to very low savings rate at the beginning of the transitional period. The improvements in saving rates were visible only during the 2000- 2008 period when saving rates more than doubled and reached to 33% of GDP. However, the financial crises of 2008 affected savings adversely and the level of 2000-2008 is still not reached.

Domestic financing through credit allocation to the private sector has been an important determinant of the expansion in domestic aggregate demand after 2002. It rose from a level of 6 % of GDP in 2002 to 35% of GDP in 2011. Only 8% of the credit has fueled consumption, 1/3rd of it is used to financed capital investment, the other 1/3rd is used by businesses to meet their liquidity needs and the rest has been injected in few non-service sectors like construction. Credit reallocation and increasing investment in non-construction related activities might help spur the economic growth in Albania.

GRAPH 6: Current Account Balance as % of GDP



Source: World Bank and Bank of Albania, author's calculations

A current account deficit indicates that the country's liabilities to the foreign trading partners are increasing. The level of current account deficits has been increasing for Albania especially after 1998. It rose from 1% of GDP in 1998 to 10% of GDP in 2008. Since 2008, the credit account balance has been improving but it remains still negative. The existing literature for developing countries shows that current account deficits are common for developing countries in the phase of economic transition.

In order to maintain an external sustainability these deficits should be met by future current account surpluses. In order to obtain these surpluses savings should increase, which means that consumption should fall. Under another scenario, if consumption was to be kept constant, the country should use the current account inflow to produce more output and invest in assets that can pay high returns in the future which can be used to pay the creditors. This means that the country's capacity to produce services and goods should increase to secure the external sustainability. This external sustainability can also be affected by the valuation effects. If liabilities are denominated in the local currency, devaluation would increase the value of foreign assets by more than the value of liabilities which would change the balance of the current account. However, most of the current account deficits have been associated with increased consumption, not with increases in investment.

A current account deficit implies that foreign capital, used to finance the deficit, is entering the country. However, this capital inflow does not necessary translates into an increase in investment. On the opposite, the capital inflow (financial capital) could put pressure to decrease the savings rate which leads to increase consumption and might leave investment levels unchanged.

Klemm (2013) argues that in most of the cases current account deficits are caused by increases in consumption levels than savings. By grouping the countries in three different categories: large economies (US, UK, Japan, Germany); euro-area crises and vulnerable countries (Spain, Greece, Portugal, Ireland), the impact of country-specific developments is studied.

Within the first group, US and UK are examples of large economies characterized by current account deficits. The 1980s, 1990s and 2000s current account crises in US were associated with increases in investment levels. The later current account deficit (2000s) was also significantly associated with increases in consumption. In UK, the 1980s crisis was marked by an increase in investment and a subsequent fall. On the other hand, the deficits (small) in 1990s and in 1999s were associated with increasing levels of consumption. Furthermore, the 1999s impact of increasing levels of consumption could not be compensated despite the fall in investment. Germany and Japan are used as examples of large economies running on current account surpluses. In Germany, the surpluses of 1980s and 1990s were both associated with increasing savings and the latter one was also marked by a fall in investment. Japan offers an unusual example where the current account surpluses have been constant for many decades despite the fluctuations in saving, consumption and investment. Moreover, the consumption growth in Japan was higher than the one in USA and UK, however the current account balance was not altered because of the simultaneous reduction in domestic investment.

In the "euro-crisis and vulnerable countries", all current account deficits were associated with high levels of investments prior to the crises. In Greece, investment levels fell after 2010; in Portugal the high consumption was another reason that altered the deficit; in Ireland, high consumption and investment were followed by a dramatic fall in investment; Spain's consumption has been constant prior and after the crises period.

The "previous-crisis" countries offer mixed examples of consumption-led deficits in Brazil and Argentina (1980s) and investment-led deficits in Argentina (1990s), Thailand and Latvia.

It is important to conclude that investment-led current account deficits, which increase the production capacity for tradable goods and services, produce higher growth impact in the economy. Thus, a reorientation of credit towards investment, other than consumption could translate in higher economic growth rates for Albania.

The need for new sources of economic growth

The financial crises of 2008 unveiled some imbalances in the economic growth of Albania and noticeably affected the main pillars of growth. Prior to the crises the economy was experiencing a relatively-long period of high economic growth which was interrupted by the 2008 financial crises. The economic growth remained positive but slowed down significantly. Due to the low integration of the Albanian financial sector with the international one, the crises did not affect the country as severely as other neighbor countries.

However, the difficult financial situation in the international markets affected adversely the inflow of foreign currency in the country mainly by reducing the remittances inflow and a decline in financial intermediation due to liquidity problems of the international banks. Also, an unreasonable wave of deposit withdrawals driven by the financial illiteracy of the people affected the balance sheets of Albanian banks. The current account deficit deteriorated because the domestic financing sources of Albania were affected by the crises and the demand for consumption could not be met. Credit growth shrank by 9 % from 2007 to 2008, 19% in 2009 and 50% in 2010. As a result, the private sector activity shrank and investments contracted due to the unavailability of credit. This in turn affected the economic growth. As external financing was hit by the crises, the excessive demand and consumption in Albania could not be sustained. Due to the crises, but not only, the economy could not use its resources efficiently to meet demand.

The crises resulted in an increase of current account deficit, impaired private sector balance-sheets and limited credit availability to the private sector. The period after the crises showed that the consumption-driven, credit-led growth model could not be sustainable in the long run because it could not support domestic demand as the main driver of economic growth. This growth model has aggravated the savings – investment balance and the financial situation of households, private and banking sector. As a result, despite the positive economic growth introduced in the pre-crises period, the current growth model proved to be unsustainable and vulnerable to outside shocks.

The way towards the new economic model

Financing

Promoting savings

Despite the impressive economic growth, the core pillars of the economic model of Albania were shaken by the 2008 financial crises. The consumption –driven growth could not be sustainable in the long run. The financial institutions need to promote savings and investment. The current instruments used by banks are in the form of deposits and investments in government bonds but they are short-term and cannot guarantee economic development in the long run. These instruments do not encourage households to decide and balance between present or future consumption. Differently from the characteristics of the Albanian financial sector, in developed countries long term investments are encouraged. Some of the mechanisms used, such as pension funds, encourage households to balance their current and future consumption while increasing the supply of credit for the banks.

Empirical research has shown that the financial sector and the real one are interconnected and affect each other. A greater supply of domestic credit available in the banks can translate to potentially higher loans for the private sector. This allows for improved capital accumulation capacities and potentially increased capital productivity. It is important to mention that capital productivity was the driving force of economic growth in the period 2000-2008, despite the low but increasing levels of domestic savings. This in turns leads to increased levels of production, improvements in resource productivity and increases in employment. If the bulk of credit is invested in the trade-able sector, then exports and the competitiveness of the sector have the potential to improve.

Reorientation of credit to export-oriented sectors

Economic growth is highly dependent on the ability of the country to meet internal demand for investment and consumption. In the case of Albania, this requires reallocation of funds towards the export oriented sectors. In this regard, the reorientation of credit to private sector needs to be more favorable towards the tradable sector, goods sector at the expense of the non-tradable sector, services. Currently, the services sector has benefited from the credit available at the expense of goods sector.

Even though exports doubled in the period 1996-2010, Albania has not yet established a competitive export sector, one with comparative advantage to other countries. Export-led growth would also benefit the country's balance of payment. Export is the only component of demand that allows for a cushion for stabilizing the foreign currency exchange rate. It also enables faster growth for other components of demand such as consumption, investment and government spending which contain a component that need to be paid in foreign currency. Thus, export-led growth not only relaxes the balance of payments constrains but also enables consumption, investment and government expenditure to grow faster because it enhances growth by increasing supply.

Furthermore an export led growth model that enhances sectors with comparative advantages is one that promotes long-term growth. This model would lead to higher domestic supply, substitution of some imported goods with domestic ones (when competitive) and will diversify the bundle of products the country produces. Furthermore, it will lead to productivity enhancements and the introduction of new technologies in order to be competitive in the international markets. In other words, it relies on the ability of the Albanian economy to improve competitiveness which means enhanced TFP. This is expected to boost further economic growth.

The end goal is to channel domestic and foreign savings into productive investments especially in the export-oriented sectors. For the purpose of economic growth, it is of extreme importance that the banks allocate credit to the most profitable and sustainable investment projects. Bank credit data show that credit allocation was biased to trade, industry and construction at the expense of other sectors. The re-allocation of credit would move away from the construction sector, which suffered the most and concentrate even more on trade.

TFP improvements

Total Factor Productivity has been one of the main drivers of economic growth in Albania, like in most developing economies. However, within the first decade its contribution to economic growth declined as the reallocation of resources slows-down. After the catching up phase, the differences in TFO growth can be explained only by the countries' specific characteristics such as physical technologies, the efficiency of technology use etc. Romer (1986) and Lucas (1998) associate the TFP growth rate to innovation and human capital accumulation as the determinants of TFP growth. For a small economy like Albania, innovation should not be defined as production of new technology or knowledge but rather as the ability or the process to adopt better practices, knowledge and technologies from developed economies. Dahlman (2009) argues that developing countries with a fast economic growth have benefited from innovation in three ways:

1. Acquisition of the existing technology
2. Domestic creation of relevant new knowledge
3. Spreading and implementing the newly acquired knowledge throughout the economy.

All these three areas represent windows of opportunity and growth for Albania because not much has been done in these regards. The large contribution of TFP was fueled by resource allocation and not by innovation, knowledge acquisition or implementation. Furthermore, a sustainable economic growth requires continuous investment in human capital through education and training. Vocational trainings have become the key word of the current educational program in Albania.

Conclusions

International examples in the field of economic development show that even though the determinants of development models are similar among countries, their contribution varies from case to case. Savings is an important determinant of economic growth however extensive savings at the expense of consumption can create an economic model that produces fast growth but is not sustainable in the long run (China). On the other hand, the opposite also holds true. Extensive domestic demand, not met by aggregate supply, at the expense of savings also creates fast growth but is not sustainable in the long run (Albania). However, more than levels of savings, it is the allocation of the capital accumulated that spurs economic development in a country (Japan). Therefore, it is imperative for Albania to identify the most competitive sectors, prioritize them and fund them with available credit.

The Albanian economic development, similar to many other developing economies, was driven by the growth in TFP during the first decade of the transition and by capital productivity after 2000. The country's economic development prior to the crises was a success story of fast growth rates, welfare improvement and TFP growth. However, the financial crises of 2008 unveiled many domestic balances that had emerged because of the high domestic demand and the county's incapability to increase supply. This domestic-demand-led economic model produced fast but unsustainable economic growth. The orientation of the economy towards the services sector and non-tradable goods increased demand much faster than aggregate supply. Remittances have been very important source of financing for the economy but their orientation towards consumption rather than investment did not yield the expected effect in the economy.

The new economic model should focus both in enhancing savings as well as reallocating the available credit into the priority, export-led sectors. This would improve the balance of payments, credit account deficits and trade deficits in the country. Furthermore, it would increase capital productivity and exports. Also, the new economic model should focus in improving the total factor productivity by encouraging innovation, best practices applications and enhancing human capital through greater and better education possibilities.

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