CHAPTER 1

INTRODUCTION

1.1 Introduction

Agriculture has always been the most important sector of the Albanian economy. Until Communists came into power in 1944, around 85 % of population made their living based mostly on subsistence farming (Lorenzoni). Immediately following their rise to power, the Communists started a rapid industrialization of the country and the collectivization of agriculture. Significant economic growth was achieved during the 1960s and early 1970s as a result. However, by the late 1980s, the Albanian economy was suffering from problems associated with poorly managed collective farms and state-owned companies.

In the turbulent year following the Democratic Revolution of 1991, almost all agricultural land was distributed to collective farm members and most of the state-owned companies were shut down. During the political transition, from January 1991 to March 1992, total output fell by 30 percent in real terms and the budget deficit was 45 percent of GDP (World Bank, 1992). During that period, the economy was severely affected by input and foreign exchange shortages, social upheavals linked to the privatization of the collective farms throughout the country, and disruptions caused by the absence of alternative distribution and allocation mechanisms to replace the collapsing centrally planned system. Social and economic chaos led to rapidly falling living standards for the vast majority of the population, especially in poor rural areas.

In response to this chaotic beginning, the Government embarked on comprehensive macro-economic stabilization and structural adjustment programs in early 1993 that resulted in impressive economic growth. From 1993 to 1996, the economy grew at 9 percent per year and inflation fell to single digits due, in part, to the broad dismantling of price and trade controls, the privatization of agricultural, retail and small enterprises. By 1996, impending economic and political problems loomed. The rapid growth had been fueled partly by unsustainable financial pyramid schemes, and by loose election-driven fiscal policy. Inflation increased three-fold and structural reforms ceased.

The pyramid schemes collapsed in 1997 triggering a social and economic crisis that brought the country to the brink of civil war and economic activities to a standstill. Macroeconomic performance slumped badly, with GDP declining by 7 percent and inflation rising to 30 percent. Remittances from abroad declined, foreign aid flows practically ceased, international trade slowed, and the Albanian currency depreciated by 40 percent within a few months. With the election of a new government in mid-1997, however, the Albanian economy returned to a path of economic growth and reform. Economic stability was quickly restored with GDP growth rates of 8 percent in 1998, 7.3 percent in 1999, and about 7 percent at present. Tight fiscal policy reduced inflation to less than 1 percent in 1999 and about 2 percent in 2000. GDP per capita reached US$ 1,130 in 2001 (World Bank, 2001).

Agriculture is still the most important sector of Albanian economy. Around 50 percent of the population is employed in agriculture (Liko, 1996). Domestic agricultural production is starting to replace food imports. On the other hand, huge investments are required in industry and tourism in order to make them competitive. The probability of such investments occurring in the near future is low because of the unstable political situation in the Balkans.

Given the importance of agriculture, the Albanian government needs to design sound policies aimed at increasing agricultural production. Up to now, policies were designed mainly based on intuition and other countries` experiences rather than on reliable data. Under these conditions, it is not improbable to find policies that contradict each other or that do not contribute to the fulfillment of government goals.

1.2 Problem statement

After the economic collapse of 1991-1992, the Albanian government faced the formidable task of restoring food security and providing income for the rural population. While the privatization of collective and state farms was expected to increase the agricultural output without any fiscal drain, other interventions could be very costly for a government that had inherited huge budget and trade deficits.

Foreign trade liberalization was one the first measures taken during the transition period leading to a market economy. Albania became a member of the World Trade Organization (WTO) in 2000, has joined the Initiative for the Establishment of a Free Trade Zone (FTZ) with other countries of the region and

from February 2003 on it started negotiations for signing the Stabilization and Association Agreement with European Union. Market regime in the country is being evaluated as very liberal with a moderated level of customs tariffs and a pragmatic system of non-tariff licenses (MEA, 2003).

Agricultural production in general and wheat production in particular are affected substantially by this process. Firstly there are some direct effects on the prices of products traded among the members of FTZ. Secondly, there are also effects on the production costs of agricultural products as the prices of their inputs change due to possible import tax reductions. In the case of wheat, the input costs such as fertilizer, fuel and pesticides will change. It also means that domestic production of these products will be no longer protected. Trade liberalization may induce some changes in factor markets as well. Land and labor costs in rural area have been relatively cheap and will become more expensive in the future. The economic reform and trade liberalization will certainly bring about changes in macroeconomic policies such as exchange rate and interest rate policies etc. All of these changes will affect the comparative advantage of wheat production in Albania. The question is to what extent and which direction the comparative advantage of wheat production will be affected given the change in each or a number of the above factors. The answer to this question has significant practical implications, not only because wheat is a very important essential good in Albania but also because the position of wheat production and its comparative advantages are always a considerable focus of concern for policy-makers in Albania.

1.3 Research question and objectives of the study

The major research question of this study is:
-What would be the possible effects of trade liberalization and market reform on the comparative advantage of wheat production in Albania?

This question touches on a range of research disciplines, international economics to agricultural economics. Trade liberalization and market reform are processes that have an effect on all industries in the economy as well as society. In other words, they have an enormous impact on all economic activities over along period. It is very difficult, if not impossible, to assess and quantify all these effects in a single study. This study merely examines the possible effects of trade liberalization and market reform on the wheat sector in Albania. However, in the view of the author, this scope is still too large to cover. As a result, only the impact on the comparative advantage of wheat production is analyzed in this study.

The specific objectives of the study are:

1. To determine the current protection level and, at the same time, the level of price distortion of wheat production.

2. To determine the current comparative advantages of wheat production in Albania and its major determinants.

3. To test the effects of changes in the world economic environment, input prices, macro-prices (exchange rate, interest rates, etc.) and factor costs resulting from trade liberalization on the comparative advantages of wheat production.

4. To assess the possible status of the comparative advantage of wheat production in Albania by the year 2015.

5. To derive policy implications for the years to come in helping to reduce the negative effects of trade liberalization and promote trade integration.

1.4 Hypotheses and methodology

With the major objective of studying the effects of trade liberalization and market reform, this study focuses on the causal relationship between them and the comparative advantage of wheat production in Albania. A number of hypotheses are tested in this study, namely:

1. Under current economic conditions and with the exclusion of price distortion, Albania still has a relatively average comparative advantage in wheat production.

2. Import wheat price, exchange rate, import prices of fertilizers and domestic factor prices are key responsive factors affecting the comparative advantage of wheat production in Albania.

3. By the year 2015, the Albanian wheat sector will lose its comparative advantage taking into account much change in macroeconomic conditions and the cost structure of wheat production.

4. However, the comparative advantage of Albanian wheat may deteriorate considerably if there are substantial changes in its sensitive determinants

such as world wheat price, exchange rate, land and labor costs as a result of trade liberalization

The methodology used in this study is a partial equilibrium and, in essence, a single sector model. Both qualitative and quantitative methods of analyses are used. The study employs the Policy Analysis Matrix (PAM) as a main analytical instrument associated with an econometric model. In the framework of PAM, economic analysis of wheat profitability is conducted and the Domestic Resource Cost (DRC) approach is employed to determine the comparative advantage of wheat production. In the process of determining the protection level and comparative advantage, the research makes use of shadow pricing techniques to estimate the social prices of different inputs and output with different treatments for different factors. In order to formulate the hypothesized yield by the year 2015, the study applies a multivariate analytical regression function. It also uses a selected number of econometric tests to test the relevance of the function such as heteroskedasticity and Durbin-Watson tests.

The methodology of PAM and DRC approaches have been utilized by a number of studies carried out by the World Bank and the Food and Agriculture Organization (FAO) as well as other research institutions. Among these studies, Yao (1997) and Yao and Tinprapha (1995) investigated the comparative advantage of rice production in Thailand with a PAM for Thai agriculture during the period 1992-1993. Nelson and Panggebean (1991) also made use of the PAM approach to analyse the effects of Indonesian sugar policy on sugar production in irrigated and dry land areas of Java in 1986-1987. Adesina and Coulibaly (1998) also applied a PAM to examine the social profitability of agro-forestry based technologies for maize production in the highland savanna zone of Cameroon. Abdel-Aziz (1995) also utilized a PAM and DRC approach to find out the protection level and economic efficiency of different crops in Egypt.

Shkodra and Lushnja districts are chosen as the study area, which can be considered representative of Albania's wheat production.

1.5 Overview of the dissertation

The dissertation is structured in seven chapters. Chapter 1 identifies the background of the research problem, its objectives, hypotheses to be tested and tools of investigation. Chapter 2 gives an introduction to Albania and reviews the performance of its economy and trade environment. It provides useful information on economic development in Albania after reunification in the context of economic reform.

The chapter analyses both domestic and foreign trade policies. Chapter 3 discusses agriculture and the wheat sector in more detail in the context of agricultural development in Albania. The trade policies for wheat during the last 15 years are presented to give necessary background for the next chapters. Chapter 4 of the dissertation is designed to provide a conceptual and theoretical framework for the study. After reviewing key concepts and the theoretical basis of trade liberalization, comparative advantages and related issues, it develops the concept of study. Chapter 5 discusses the research methodology used in the study, including the data collection process, data sets, methods and tools of analysis. It then introduces more detail about the method of Policy Analysis Matrix (PAM), and Domestic Resource Cost (DRC) techniques, and specifies the economic model to be used. Chapter 6 first describes the study area and then presents an empirical analysis of the impact of trade liberalization on the comparative advantage of wheat production. It also shows and analyses the results of different estimation scenarios (sensitivity analysis) for comparative advantage, allowing for changes in responsive factors. The final chapter - Chapter 7 - summarizes the results and draws conclusions. It also presents policy implications and outlines further demands at the end of the study.

CHAPTER 2

THE ALBANIAN ECONOMY AND TRADE

2.1 General information about Albania

2.1.1 Geographical position and climate

The Republic of Albania is situated in Southeastern Europe, in the western part of Balkan Peninsula facing the Adriatic Sea (sandy shore) and the Ionian Sea (rocky shore). Its coordinates are 39° 38' (Konispol) and 42° 39' (Vermosh) north latitude, and 19° 16' (Sazan Island) and 21° 40' (Vermik village, Korca) east longitude.

Albania has a surface of 28 748 km^2 (INSTAT, 2001) of which the arable area is 699 thousand ha, accounting for 24 % (0.2 ha per capita) of the land area and a population of 3.4 million inhabitants. It is administratively divided in 12 prefectures, 36 districts, 312 communes and 2962 villages (Agolli, 2000).

The general length of the state border is 1049 km, with 657-km land border, 316-km sea border, and 48-km river border and 72 km lake border. North and northeast, borders on what was formerly Yugoslavia, while South and Southeast with Greece.

Albania is noted for a high change in the altitude above sea level (2750 m), a feature that is associated with deep changes in geology and relief, as well as with substantial vertical changes of climate, hydrographic, land and vegetation. It is mainly a mountainous country: 13.3 % of the territory is 0 up to 300 m high, 25.5 % between 300 and 600 m, and 61.2 % over 600 m of altitude above sea level.

Albania is included in the belt of subtropical Mediterranean climate, which significantly affects the elements of nature, such as the hydrographic network, vegetation and relief. The climate of Albania is very suitable for the economic-social life and activity of people. Even though Albania is a small country, the climatic changes are big, due to the very broken mountainous relief. In the regional division of the climate of Albania, the basic factors are sun radiation, geographical latitude, general atmospheric circulation and local factors.

The values of different climatic elements are a consequence of the interaction of these factors. They influence the creation of a number of zones and sub-zones with more or less homogenous climatic features.

The four main areas are Mediterranean field zone - Mediterranean hilly zone - Mediterranean pre-mountainous zone - Mediterranean mountainous zone. The sea affects more the first two zones during the whole year. The average temperature oscillates from 15°C in the field zone, to 2°C in the north of the mountainous zone. In January, the coldest month of the year, the minimum temperature in general oscillates from - 5°C in the field zone to - 30°C in the north and northeast of the mountainous zone. The average of the rainfall oscillates between 650 mm in the southern sub-zone of the pre-mountainous zone, and 4000 mm in the Alps. In the largest part of the country, summer is a dry and rainless season.

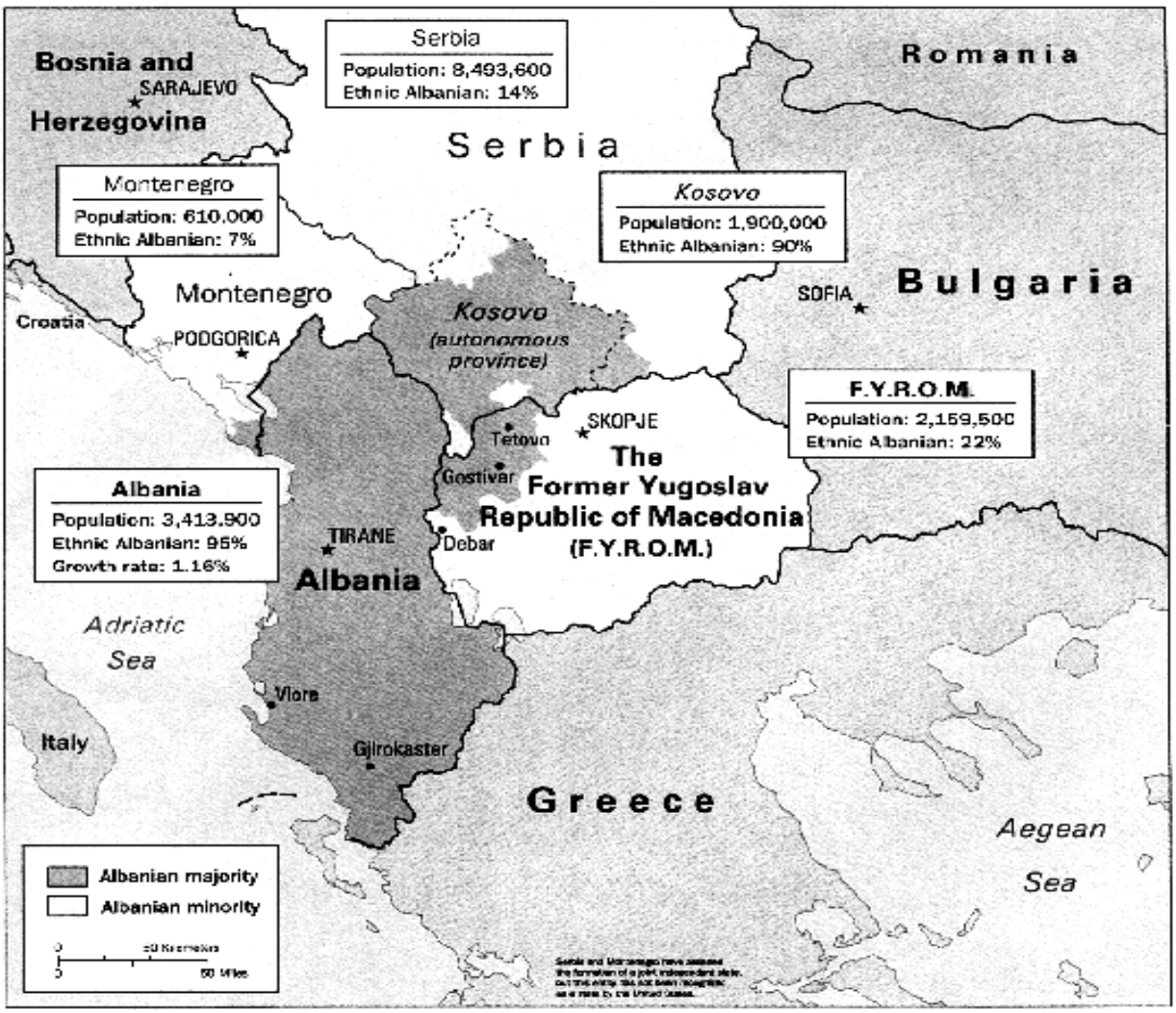

Figure 2.1: Map of Albania.

2.1.2 Population and work force

The total population of Albania in 2003 was approximately 3.16 million, of which 1.796 million were living in rural areas, accounting for 56.7 % of the total population of the country (INSTAT, 2004). Among the countries in the SEE group, Albania and Macedonia are the second-lowest countries in terms of total population and rank just behind Bosnia and Herzegovina. During 1991-1998, Albania experienced demographic changes dominated by the negative rate of population increase, migration from the villages towards the towns and from the remote areas towards the capital, the massive emigration and the decrease of births. The emigration of Albanians abroad is higher than the other countries of the Central and East Europe (3 times higher than the average emigration at present) (INSTAT, 2001). After this period the population growth showed an increasing trend and in the year 2003, reaching an estimated growth of 0.8 %, which is moderate for a developing country. The estimated total population in 2003 is more than 3.8 times (387 %) that of 1923 the eleventh year after independence proclamation.

As seen in Table 2.1, the population density is relatively high with 110 people/km^2 in 2003. Table 2.2 shows that Albania is the first most densely populated country among SEE's member nations. However, the density varies between the regions of the country. In the districts of the study area, Shkodra and Lushnja, population density was 140 and 217 people/km^2 respectively in 2001. Population is very scattered in hilly and mountainous regions and population density was low, reaching just 20 people/km^2 in the district of Kolonja (INSTAT, 2002). The average annual growth rate in the last five years is the second-largest among the countries in the SEE group and rank just behind Bosnia and Herzegovina. The agricultural population of Albania in 2003 was 46.3 % of the total population of the country and it is several times higher than other SEE member countries.