

Examination of Major Factors Affecting Exchange Rate in Albania and its Influence on Inflation and Real Economy (Period 2004 - 2014)

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Abstract

The aim of this research is to provide statistical evidence of major determinants of Euro/Albanian Lek exchange rate levels and its consequences on inflation and real economy. The method used for this purposes is empirical research, Granger Causality Test has been applied in order to provide answers to the objectives of the research. Statistical examination provided major evidence of Granger Causality of inflation, foreign direct investments, industrial production, and foreign debt on Euro/ALL exchange rate levels. In addition the research provides statistical evidence that Euro/ALL exchange rate fluctuations in long run cause Savings in Domestic Currency and in short run Savings in Foreign Currency. Moreover, there is also found the existence of Granger Causality between export and interest rates with a minimum four months delay and Granger Causality of interest rates on inflation with two months delay. Whereas, based on examined variables there could not be found any significant finding of long run influence of Euro/ALL exchange rate levels on inflation and real economy.

Keywords: Euro/Albanian Lek Exchange Rate, Inflation, Real Economy, Granger Causality, Vector Error Correlation Model.

Introduction

Understanding macro aggregates and their implications within one economy is extremely decisive in addressing economic issues as whole, including micro setting. Although, macro and micro operate at different level of abstraction, are basically interrelated, with macro aggregates depend on micro behaviour and micro behaviour is affected by macro outcomes (Schiller, 2008). In this direction, maintaining sustainable macroeconomic environment is one of the pre-determinants of economic growth, which along with the aim of increasing living quality standards within a country are and must be fundamental targets for sensible governments around the world. Many academic researchers point out that countries that are more eager in maintaining constant macro variables, tend to display higher long-term growth rates. Therefore, essential precondition for countries to maintain relatively stable macroeconomic environment is to preserve on considered necessary levels macro variables such as: inflation, interest rates, exchange rates, unemployment, the balance of payments, and some other specific macro aggregates that are reliant on economy structure of a particular country.

On the other hand, the process of globalization and high intensity of international trade, has cultivated a dynamic and complex environment, enhancing challenges for policy makers. In this sense, especially in such environment, understanding relations

and level of interdependences of macro variables is compulsory to determine the right government measures and policy designs. Moreover, economic literature has put a great deal of attention on macroeconomic conditions of transition countries as critical factors of economic growth. On this subject of transition economies, Albania is one of the last South East Europe countries that experienced back in 1991, the downfall of the communist system and had begun the transition phase from centrally planned economy to the free-market economy, relatively later compared to other neighbour countries. Consequently it has been isolated, which was the reason for economic and social underdevelopment. Nevertheless, economic opening is a very important factor for Albania economic restructuring and efficiency improvement. However, the transition process of breaking a long lasting isolation of several decades and of economic opening towards regional and global markets is a demanding task (Mañcellari and Xhepa, 2003).

Besides going through economic transition phase, additional burden for Albanian is managing sustainability of domestic macroeconomic equilibrium in the conditions of economic opening, a challenging task on its own even for developed economies. In the case of Albania, the early phase of transition has reflected to high levels of current account deficit, trade deficits, significantly high unemployment, excessive levels of dollarization/euroization of domestic market and huge depreciation of domestic currency followed with high inflation levels, particularly during the crisis of 1997-1998, when Albania suffered a political and financial crisis with the collapse of pyramid schemes. After the turbulent post-communist era of 90s', during first decade of new century, Albania experienced steady economic growth, fostered through tax reforms and market openness in conjunction with developing macroeconomic and sound monetary policies. However, Albania still faces high level of trade deficit, unemployment, increasing external debt, and high level of euroization of the economy. In addition, opting for an exchange rate regime, government decision should be steered by the economy volatility, since all applicable exchange regimes have their advantages and disadvantages. Fixed exchange rate system, which are either held constant or allowed to fluctuate within narrow boundaries, foster advantages for engagement on international trade and foreign investments without concern about exchange rate movements, whilst the disadvantage is still the possibility that the government will alter the value of a specific currency (Frankel, 2002; Madura, 2011). In this respect, Gylfason, (2000) notes that the advantage of fixed exchange rates is currency stability which promotes foreign trade and investments in particular by reduction of transaction costs and exchange rate uncertainties along with low interest rates and limited inflation. Whereas as a disadvantage is noted inflexibility of economic policy in times of crisis, strong currency seriously may affect labour market, while considering from the global point of view, a fixed exchange rate system may make countries and it's multinational corporations more vulnerable to economic conditions of other countries (Madura, 2011), and it is global market forces (Chen and Lai 2008).

To wrap up, the described pros' and cons' of both exchange rate regimes confirm the impact and sufficient interrelation between several macro variables and exchange rate. Within academic literature there could be found sufficient information to support

and designate as study context of this work the exploration of the determinants of exchange rate fluctuation, its influence, and spill over effect in macroeconomic environment of Albania that has opt for floating currency regime for more than two decades.

2. Literature Review

2.1 Overview of Exchange Rate Determinants - Focusing in Albania

Exchange rate can be defined as a price of one country's currency in terms of another currency, and it is views as a principal component of economic management in maintaining growth and stability within a country (OIC, 2012). Recent rapid expansion of global capital market and financial services, amplified exchange rate dynamics impact on the overall macroeconomic situation within countries. According to Ali Khan (2014) the volatility of the exchange rates can have an adverse effect on the economy, suggesting that variables affecting the exchange rates need to be studied with the aim of understanding and predicting that behaviour.

Several research papers about Albania noted that there are numerous key macroeconomic variables that affect the exchange rate, especially on flexible exchange rate regimes, where the value of the currency is determined by the market. Most recently Cakrani Mail (2013) noted that the Real Exchange Rate (RER) of Albania in long term is affected by the relative productivity between sectors of the economy, remittances and trade openness, while in the short term, RER is also influenced by debt service. She also empirically examined that the Balassa-Samuelson (B-S) effect occurs in Albania, witnessing relatively rapid growth of prices compare to developed countries (Cakrani Mail, 2013). Also, Shijaku (2013) named other variables in his log-linear model that included foreign direct investment, remittances, real GDP per capita, openness and government spending to assess the impact on real exchange rate in Albania. The results indicate that even government spending is associated with overvaluation of real exchange rate in Albania.

More importantly, considering relatively small transition economy of Albania with the combination of floating exchange rate regime within an inflation targeting framework indicates a composition of factors that significantly influence exchange rate dynamics. Moreover, many researchers have found a positive relationship between exchange rates and economic growth, implying that especially this relationship is more prevalent in developing countries (Bunescu, 2014). In fact, recently a significant number of researches have focused on the relationship between exchange rates and different causal factors such as inflation, exports, imports and real economic activity. Hence, there are several researches for developing countries regarding the role and influence of exchange rate volatility on trade, economic growth, FDI, GDP, inflation rate, money supply, interest rate, balance of payments, and foreign debt (Schiller, 2008).

Overall, economic literature in general, and even domestic literature presents numerous influencing macro variables on exchange rate and their implications on macroeconomic equilibrium, promoting empirical examination in order to create predicting and controlling models for adjusting macro policies towards economic

growth.

2.2 Inflation

In the field of inflation there have been many theoretical and empirical analyses that went deep into causes of inflation changes, its effects on exchange rate dynamics, and in this sense the equation of inter-correlation between the exchange rate and inflation has been develop. Trade volume, country size, investor's decisions, openness of the economy, interest rate, inflation, growth and wealth are such factors that can affect the exchange rate. However, inflation has been widely accepted as one of the most influential factors affecting the exchange rate, for that reason effort must be made by the government to control inflation (Ali Khan, 2014).

Current dynamic and volatile economic condition urges to analyze those features and shape them with the aim of controlling the exchange rate, which can contribute in implementation of the policies like monetary, fiscal and trade policy (Ali Khan, 2014). Countries that control inflation have witnessed decline in exchange rates, although with such monetary policy the exchange rate variability has increased (Edwards, 2006). Additionally, monetary policy and other tools like fiscal policy are used to keep a check on inflation and its impacts on the other macroeconomic variables like exchange rate, especially valid in economies that are emerging (Ho and McCauley, 2003). Thus, there is an inner circle between inflation, exchange rates and policymaking that affect each other. The aim is to find the right balance and counter measures if necessary to ensure growth and stability within one economy.

Regarding emerging economy of Albania authors Kolasi et al. (2001) in their empirical research support evidences that the change of Lek/USD exchange rate levels, affects the inflation rate with one lag. Moreover, they noted that the relationship between exchange rate and inflation is strong, based on unique features of Albania foreign trade, when the imported goods volume exceeds about three times the exported goods volume, and the fact CPI basket is consisted of many imported goods (Kolasi et al. 2001). Because of this relationship when deciding on monetary policy both inflation and exchange rates should be considered as interconnected variables that impact each other, and the economy as whole.

2.3 Foreign Direct Investment

Mehic et.al (2013) found statistical significant relation of FDI and economic growth using statistical model based on OLS, using FDI stock instead of flow, because it was considered as better proxy to analyze the impact of FDI in economic growth. Hence, aiming for economic growth, Albania as most of SEE countries has adopted favourable policies toward FDI and support toward the private sector development - funds are allowed to be transferred in convertible currencies using exchange rates on transfer day. Nevertheless, Albania still remains a country in which financial sector is still in early phases of development, while other country political and judicial factors may influence FDI inflows, which in a floating exchange regime may discourage FDI since it is more exposed to exchange rate volatilities.

Although, the majority of academic papers on FDI is related to economic growth, there

are several studies that directly or indirectly examine other perspectives of FDI. Ivkovic (2011) noted that high level of FDI's might have significant impact on appreciation of domestic currency, Dewneter (1995) argued that there are no statistical evidence of significant relationship between those two variables, while Froot and Stain (1991) in contrast stated that currency depreciation can lead to increase levels of FDI's. In domestic literature could be found one statistical research regarding FDI, exchange rate and economic growth. In this respect, Cakrani et al. (2013) investigated through unit root and co-integration test of several variables in Albania found evidence that 1% increase in FDI leads to real appreciation by 0.76% exchange rate, 1% increase in government spending leads to real appreciation by 0.24% and similarly, a 1% increase in remittances leads to an estimation by 0.25% of the real exchange rate.

Observing relatively stable exchange rate fluctuations showing low volatility in recent years, makes Albania a fertile ground for MNC and FDI inflows, as exchange rate volatility can either encourage or discourage FDI. At the same time, literature stresses FDI as a very important macro variable for economic growth, and also several studies identified FDI to have a relationship with exchange rate. Hence, more statistical examinations are required to further strengthen the evidence, in other words, making statistical evidence of this relationship academically significant for the research.

2.4 Euroization of the Albanian Economy

Levels of exchange rates of a country are determined by supply and demand of specific currency, which originates from level of international trade (Schiller, 2008). The level of international trade has different effects on a country, depending on which exchange rate system is used. In case of free float rates this is reflected in countries' Balance of Payment accounts, while in case of fixed rate system the level of exchange rate reserves are affected (Madura, 2011). Albania since 1992 is running a loosely floating currency regime, meaning that the international trade deficit will affect country's trade balance deficits. However, exchange rate stability even though to an ever increasing current account deficit has been largely maintained due to inflow of remittances throughout that period (Uruci and Gedeshi, 2003).

Nonetheless, in a relatively open economy like Albania, not only trade balance and remittances played a key role in keeping the stability, but also informal channels (Xhepa, 2002) and economy activities such as smuggling and contraband, whereby strong currencies such as dollar and euro circulate freely and are used as "reference currencies" for completing transactions leading to dollarization and later on euroization phenomenon (Muco et al., 2003). "Dollarization/euroization" of an economy is considered when one of those three situation occurs; unofficially usage of a foreign country's currency (USD/Euro) as legal tender for conducting transactions, private sector savings are denominated in foreign currency, or when key prices such as wages and goods are indexed to a foreign currency (IMF, 2005).

Thus, for transition economy such as Albania, additional influence on fluctuations of exchange rate can be considered the level euroization of domestic market. Also, according to Manjani (2015) high level of euroization has been shown to have potential adverse effects on macroeconomic policies and financial stability, issues

of vital importance for governments. For the purpose of measuring the level of euroization of Albanian economy Kola and Liko (2008) used two indicators, foreign deposits to M1 that measure the currency substitution and foreign deposits to M2 that measure the asset substitution to find moderate level of foreign currency in domestic market. However, Kola and Liko (2008) argued that the degree of informal euroization of Albania economy must be higher, because of enormous amount of informal remittances inflows in economy.

Acknowledging these facts, level of savings (time deposits) in both Lek and foreign currency can be considered to be reliable measurement scale of euroization. Thus, those variables were empirically examined, whether they are determinants of exchange rate movements.

2.5 Industrial Production and Exports

According to Todaro and Smith (2009), relationship between exports and exchange rate exists indirectly, hinting that exchange rate does not affect the exports directly. Spiegel (2007) by looking at the direct impact of exchange rate fluctuations on prices explains causality, for instance devaluation will lead to higher prices of imported and exported goods, making imports more expensive in local currency terms, as do exported goods, since firms generally receive a higher price in foreign markets in local currency terms. He assumed that the magnitude of the inflationary impact whether is 'once for all' effect or inflammatory spiral is likely to depend on the proportion of imported goods in the economy, especially intermediate and capital goods, because when imported goods are large, the devaluation can lead to increased costs of production in many industries. Additionally, it depends in large part on expectations, the structure of the economy, and on how the government and other economic actors respond to exchange rate movements (Spiegel, 2007).

Although it is true that economic literature ponders the significant negative effects of exchange rate to country exports, still there are several researches dispute this hypothesis. Rahman and Serletis (2009) in the research conducted on US macro data have not found differences in reaction of exports on either currency appreciation or depreciation. Petkova (2011) found non-sensitivity of exports to depreciation, while Assery and Peel (1991) argued that such statistical proof of this hypothesis could not be established due to problem of non-stationary of data included in analysis. Despite the fact of contradictory findings for several economies, it is important for Albanian macro policies to understand and measure the influence of exchange rate and inflation on real economy, which can be statistically examined by investigating the impact on export and industrial production.

2.6 Monetary Policy and Interest Rates

Openness to the market, globally free flow of goods and services are prerequisite for participation in the international markets. These circumstances has ascertained exchange rate as an essential instrument for macroeconomic policy orientation. Through literature review there can be found specifically several channels that

monetary policy can affect the real economy.

In the view of fact that for decades Albanian government artificially maintained the exchange rate of country's currency, without regard to production, prices, the external market, or other factors (Zickel and Iwaskiw, 2015), the changes of political situation in Albania in the early 90's, pushed country into the transition period which actually found government and other institutions unprepared. The market economy and market relations were established at a time when market institutions did not exist at all (Bundo, Luci and Cane 2004). After the crises the trends of transition period of financial sector in Albania were positive, moving from underdeveloped socialist economy to an emerging capital market economy, e.g. the last state-owned bank was privatized in 2003. So, after this period the market started to gradually normalize reflecting on more stable exchange rate levels. The graph below portrays historical exchange rate fluctuations from 2004-2014 between Albania's national currency and Euro, showing slight currency depreciation in 2008 and 2009 as a result of the global financial crisis, whereas in upcoming years especially after 2012 the exchange rate stabilized at around 140 Lek per 1 Euro with minor fluctuations during this period until now.

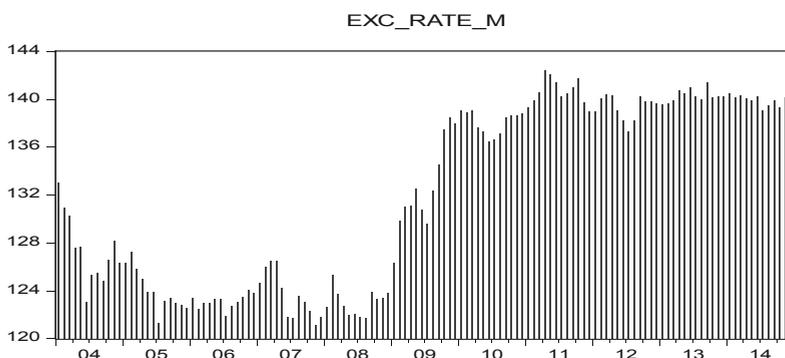


Figure 1: Euro/ALL exchange rate fluctuations 01/01/2004 - 31/12/2014
(Source: Bankofalbania.org, 2015)

Moreover, in a recent study conducted by Fejzaj (2014) has been stated that the fluctuations in exchange rates can often incite the economy and financial analysts or policy makers, to review monetary policy, fiscal and macroeconomic risks. Tafa (2015) through regression analysis for period 2002-2014 defined the impact of interest rates in exchange rate of Euro/ALL and USD/All, to find out that an increase in domestic interest rates causes appreciation of All against Euro and depreciation against USD. Additionally it was noted that the findings are not significant suggesting that exchange rate are also affected from other factors such as inflation rate, income level, government control, speculations on future exchange rates and many other external factors. Nevertheless, she found evidence of relationship between interest rates and exchange rate. Hence, policymakers must use the monetary policy as a tool to control of exchange rate as variations that have an adverse effect on the economy. Therefore, the monetary policies should be designed in a way to reduce unpredictability in exchange rate by influencing the macroeconomic factors like inflation and interest

rate (Hayakawa and Kimura, 2008).

To summarize, regardless of the vague findings, the major conclusion drawn through critically reviewed literature is that Albania through the years with application of forward-looking policy with sole aim of inflation targeting, economic expansion, and the introduction of indirect instruments of monetary policy, has fostered an economic environment that appear to have contributed to increase exchange rate effectiveness as a monetary policy transmission mechanism into the real economy. As shown, literature stresses the impact on economy of the relationship between exchange and interest rate movements' making it an objective of this research.

Conclusions

The research was set out to explore the major determinants of Euro/ALL exchange rate movements in Albania. The research also sought to know and empirically examine whether exchange rate levels influence inflation and real economy in Albania. The general theoretical and empirical literature on this subject, specifically in the context of Albanian is inconclusive and does not provide sufficient statistical examination and explanations for casualties and influence on several macro variables that are vital to research questions of this work. Also, for specific causalities among chosen macro variables there is an academic research gap in domestic literature, due to this fact this work gains additional importance.

Hence, the research sought to answer three crucial questions that have been driven from comprehensive literature review:

Determine whether economic growth (*represented by foreign direct investment, industrial production, and export*), euroization of the economy (*represented by savings currency, and external debt*), inflation and interest rate, are major factors influencing Euro/ALL exchange rate fluctuations?

Do Euro/ALL exchange rate fluctuations have an effect on inflation?

Do Euro/ALL exchange rate fluctuations influence country real economy?

In order to answer those research questions, Granger Causality test has been applied to investigate mutual causalities between several macro variables. Based on statistical analysis; several important conclusions had been reached. First is the finding of non-existence long-term causality of exchange rate on inflation, which is in line with the previous conducted researches on the topic. This finding supports the conclusion based on country-specific that factors such as existence of substantial inflows of emigrant's remittances, and other financial transfers in Albania are more important than fluctuations in the international exchange market, meaning that inflation depends mainly on the evolution of money supply and the evolution of budget deficits.

In spite of what is often reported in theoretical and policy debate about the exchange rate determinants, and its influence on inflation and real economy, on this subject this empirical examination provides evidence about Albania that inflation, foreign direct investments, industrial production, foreign debt, export and interest rates are determinants of Euro/ALL exchange rate levels. However, this does not exclude the possibility of existence of other influencing factors, which are not included within the scope of this work. On the other hand, regarding analysis of the spillover effect of Euro/

ALL exchange rate on inflation, any significant results demonstrating the influence of Euro/ALL exchange rate levels on inflation on a long run could not be found. Also, through statistical examination of selected variables any statistical evidence of impact of Euro/ALL exchange rate levels on real economy could not be confirmed.

Overall, the results confirm the benefits of inflation targeted policy adopted by Albania throughout years, which may be considered still an acceptable economic development pattern for an emerging economy. However, the government could consider and is recommended to harmonize monetary and fiscal policies with other investment or trade policies, with objective of increasing FDI and industrial production that are found to be major determinants of Euro/ALL exchange rate levels, and put additional effort to increase exports levels, in order to efficiently cope with inflation and boost economic growth simultaneously.

Recommendations

This research through empirical examination of four variables sought to provide an extensive view of major influencing factors on Euro/ALL exchange rate and its influence on inflation and real economy. Nevertheless, there are other potential influencing variables that have been excluded from examination framework of this research, mainly due to the fact that have been previously covered by other researchers. Thus, there is room for future researches in this area by including more variables in a single framework that would probably improve the explanatory power of the model and provide better overall cover of major determinants of Euro/ALL exchange rate and their influence in real economy.

Finally, considering that in the near future due to the complexity and dynamic surroundings monetary transmission in Albania are expected to develop rapidly, demanding fast monetary policy responses, which consequently would need more detailed and better statistical evidence of macro variables. In this view, although this research has contributed in this direction, there is still an urgent need to fill empirically this statistical gap, through examination of relationships and causalities among diverse macro variables in Albania.

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