

**An Examination of the Relationship between Budget
Deficit and Total Investments in Transition:
Case of Albania**

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MASTER OF SCIENCE IN BANKING AND FINANCE

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Thesis Submitted to the Faculty of Economics and Administrative Sciences, Epoka University, in
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Abstract of thesis presented to the Faculty of Economics and Administrative Sciences of Epoka University in fulfillment of the requirement for the degree of Master of Science in Banking and Finance.

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By

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January 2014

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As in other transition economies, in the past and today; budget policy is widespread instrument of fiscal policy and still increases the rate of economic growth of the country. Moreover it has been acknowledged nowadays that the public debt growth is larger than the growth rate of the economy for most of the industrial countries. The budget deficit policy and the excessive public expenditure upon collected public revenues are initiated because of economic growth impact. This master thesis analyzed empirically the co-integrating relationship between budget deficit and investment in the Albanian economy in the period 1993-2012. Since the variables in this thesis are nonstationary and present a unit root, Johansen's co-integration technique has been applied. This methodology has allowed for obtaining a co-integrating relationship among these variables. The co-integration results provide evidence of a unique co-integrating vector. In more precise terms, a long-run stable relationship between budget deficit and investment exist and this indicates that budget deficit and investment move together.

Key Words: budget deficit, investment, non stationary time series, ADF unit root test, Johansen co-integration test.

Abstrakti I tezës së paraqitur Fakultetit të Shkencave Ekonomike dhe Administrative të
Univertitetit Epoka në përmbushjen e kërkesave për Master Shkencor në Bankë dhe Financë

**Një Ekzaminim i Raportit Midis Defiçitit Buxhetor dhe Investimeve të përgjithshme në
Tranzicion: Rasti per Shqipërine**

Nga

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Ashtu si në ekonomitë e tjera në tranzicion, në të kaluarën dhe sot, politika e buxhetit është instrument i famshëm i politikës fiskale të përdorura për të rritur normën e rritjes ekonomike të vendit. Mbi të gjitha është bërë e ditur se në ditët e sotme rritja e borxhit publik është më e madhe se norma e rritjes së ekonomisë për shumicën e vendeve industriale. Politika e Defiçitit Buxhetor dhe shpenzimet e tepruara publike krahasuar me të hyrat e mbledhura publike, kanë nisur për shkak të ndikimit të rritjes ekonomike. Në këtë tezë masteri është analizuar në mënyre empirike marrëdhënia e integritit të bashkuar ndërmjet deficietit buxhetor dhe investimeve në ekonominë e Shqipërisë në periudhën 1993-2012. Meqënëse variablat në këtë tezë janë të paqëndrueshme dhe përfaqësojnë rrënjë njësie, teknikat e integritit të bashkuar të Johansen janë aplikuar. Kjo metodologji ka lejuar të sigurojë marrëdhënien e integritit të bashkuar ndërmjet këtyre variablave. Rezultatet japin të dhëna për një vektor unik të integritit të bashkuar. Në terma të tjera, ekziston një marrëdhënie e qëndrueshme afatgjatë ndërmjet deficietit buxhetor dhe investimeve dhe kjo tregon që të dyja variablat lëvizin bashkë në drejtim.

Fjalët kyçe: Deficiti buxhetor, investimet, seritë kohore të paqëndrueshme, njësite e testit të ADF, testi i integritit të bashkuar të Johansen.

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APPROVAL SHEET

I certify that an Examination Committee has met on _____ to conduct the final examination of Beltina NDONI on her Master of Science in Banking and Finance Program thesis entitled “**An Examination of the Relationship between Budget Deficit and Total Investments in Transition: Case of Albania**” in accordance with *Epoka University (Higher Degree) Regulation “On third cycle study programs”*. The Committee recommends that the candidate be awarded the relevant degree.

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Date: January 2014

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LIST OF ABBREVIATIONS

ALL	Albanian Currency
AMC	Albanian Mobile Communication
BoA	Bank of Albania
EU	European Union
EUROSTAT	Statistical Office of the European Communities
FDI	Foreign Direct Investments
FMN	Fondi Monetar Ndërkombëtar,
GDP	Gross Domestic Product
IMF	International Monetary Fund
INSIG	Insurance Institute of Albania
INSTAT	Albanian Institute of Statistics
MoF	Ministry of Finance
ODA	Official development assistance
TFP	Total Factor Productivity
WB	World Bank
WTO	World Bank Organization

Introduction

Governments pursue a budgetary process to make fundamental decisions about raising and allocating money for their activities where they also presents a budget that measures its annual cash flow in the form of expenditure and in form of receipts in tax and non-tax revenue once a year. Referring to the literature in this field, the effect of fiscal policy response in different ways of systemic banking crisis in advanced and in addition it finds that timely countercyclical fiscal measure contribute to fiscal expansions. This rely mostly on measures to support government consumption that are more effective in shortening the crisis duration than those based on public investment or income tax cuts. However, fiscal consolidation has been reversed recently and the high level of public debt remains a source of macro-financial market. Referring to other empirical sources, export base and public investment have led to a significant current account imbalance. The government expenditure has dropped significantly with the development of transition process and changing the role of the state in economy. The budget is a systematic financial statement of revenues and expenditures of walks for a certain period, i.e. for a budget year.

The long isolation during the communist period until 1991 hindered the access of foreign capital in the Albanian economy. Changes during 1991 and 1992 brought the need of passing from centralized planning methods to free market system. The years of centralized governing caused many deficiencies in the economic development of the country, establishing thus a non-productive industry and low levels of productivity. This way, Albania faced the lack of competition in the world markets (Nene *et al.*, 2008).

Therefore, in order to establish a competitive advantage in the world markets and to fulfill EU membership aspiration, there was a financing need from FDI. As result of these changes, it

was an immediate need for political and economic reforms. As the Albanian economy was on the way to free market, the foreign investments flow began.

According to Becht on the study of Corporate Governance and Control analyses that one theory takes the position that deficits have adverse influence on inflation, interest rates and private investment. As yearly borrowings to finance budget deficits accumulate into the stock of national debt, interest payments on such debt increase the burden of taxation and have distributional consequences. The second theory suggests that deficits can be employed to support economic activity and employments. Finally, there is a third theory, which considers that the deficit and public debt has little overall impact on the economy.

While outlays are large fixed, revenues are uncertain and depend on a number of factors including the performance of the economy. As a result, policy makers determine a planned excess of revenues over expenditure or vice versa and economic conditions settle the actual outcome as the fiscal year progresses. The budget is balanced when government spending equals government receipts. When in deficit period, governments can use multiple modes to finance their activities: levy taxes, print money, sell public assets or borrow. (Becht *et al.*, 2002). If borrowing is used to finance such deficit, it creates 'public' debt. Public debt is distinct from 'private' debt since the latter refers to the borrowing of consumers and businesses operating in the non-governmental (private) sector. The gross public debt of a country is the accumulation of the amounts borrowed by national governments to finance annual budget deficits.

The public debt may be owed to nationals (internal debt) or foreigners (external debt). In the case of internal debt, no claim against the productive resources of a nation, or the income and output that these resources generate arises from outside the political jurisdiction of a country. The sovereign has borrowed from government agencies, financial institutions, businesses, and

individuals within the nation. In contrast, external debt gives foreigners a claim on the wealth and productive resources of a nation. These distinctions assume importance while examining the economic impact of financing budget deficits through various modes, a topic to which we turn below (O'Brien, 1975, p.259; Buchanan, 1958, p.17).

In this thesis I have analyzed mostly the effect of foreign direct investment in Albania regarding budget deficit. The aim of this analytical study is to understand the negative impact that budget deficit have for one country, said on other words an undeveloped country. A high level of public debt is an important source of macro-financial market. I have covered briefly short literature review understanding that the most useful ways to finance the deficit by government is through taxes, borrowing and monetization. The scope of this research is to show how privatization processed financing through FDI have been developed in different sectors and have brought various advantages to our country. Another important key factor is the fiscal rule of keeping the debt below 60%; however from last development in our country this debt jumped more than 65%. In this thesis it is demonstrated and proved empirically the co-integrating relationship between budget deficit and investment in the Albanian economy for period between years 1993-2012. Since the variables in this thesis are non stationary and present a unit root, Johansen's co-integration technique has been applied by using E Views statistical program.

1 Literature review

The aim of this master thesis is to conduct an analysis of economic policies applied in post-socialist Albania. The deficit budget policy is a typical instrument of fiscal policy that used to increase the rate of economic growth of the country in the past as well as today. According to Stevan Gaber, that way of financing was established after the two world wars, oil crises and current financial and economic crises. There are three ways to finance the deficit – taxes, borrowing and monetization (inflation tax) (Gaber, 2010). The most popular model of deficit finance is borrowing, which is usually done by issue of government bonds. When the government is over indebted it tends through the National Bank to buy government bonds which increases the money flow and reduces the interest rate pressure.

However, it also diminishes the real value of money and makes the future unpredictable for the economic actors. It is known that nowadays the current public debt growth is larger than the growth rate of the economy for most of the industrial countries. It is expected that the growing public debt will cause problems in perspective related to its service. In the Western tradition, mercantilist and classical economic thought is considered as the reference point for examining debates on the economic impact of budget deficits and public debt from a study of Iqbal *et.al.*, (2002) demonstrated that budget deficits (caused by a reduction in taxes today in exchange for future tax increases of equal present value) are expected to cause no changes in private consumption. Barro's arguments are based on the theory of Ricardian Equivalence, that the effect of government spending is independent of how it is financed. Keynesian proposition supports that fiscal policy can affect the national output and that an increase in the budget deficit

leads to an increase in the real domestic product and in private consumption (Apergis, *et al.*, 2004).

According to Pavlinek, (2004), Western economists and multinational institutions advocate that “successful transition from centrally planned economy to a market-based system could only be achieved with large inflows of foreign direct investment”. Of course, a country’s economic and political factors are the main determinants of foreign investments’ inflows. The developing countries are seeking to more foreign investments. From this aspect, Foreign Direct Investments (FDI) is considered an extremely important resource in Albanian economic growth. Pavlinek, suggests that FDI typically results in rapid and profound restructuring, technology transfer, worker training, transfer of Western management structures and practices and new production strategies and organization (Pavlínek, 2004).

The ways for public debt effect on the economy are the following according to De LaRoisere (Gaber, 2010):

- 1) Direct effect on the interest rates accompanied with the necessity to sell larger supply of bonds. Respectively as the supply of bonds intended for sale increases, their prices tend to fall, and the market interest rates go up; except if credit offer is timelessly elastic and the private borrowing is reduced. The interest rate increase can be temporary limited from the capital inflows;
- 2) Interest rate component of the public expenditure will tend to rise, and consequently raise future fiscal deficits;
- 3) Correlated with the previous two effects, the effect on the investment and expenditure and thus on the perspective economic performance; this risk tends to rise when the total need for government borrowing caught substantial part of the total financial transactions. In that case the elements will have immense impact on the financial market and also on the financial stability. One interest perspective of the deficit finance effects can be seen

through the work of Lehman Brother and OECD Economics Department Working Paper. According to Friedman (1977), government bonds are close substitutes for private assets, and subsequently reduce the demand for those assets. Opposite of that, short or medium term security mainly has money characteristics, which point out that potential portfolio adjustments can have beneficial impact for private investments. It should be noted that the budget is very important as a financial instrument through which redistribution becomes a large part of the national incomes (Gaber, 2010).

2 Albania in Transformation

2.1 Policies and Performance

Drastic economic reform was seen inevitable as Albania found itself in the risk of recession, with a rapidly contracting economy, waves of poverty-induced emigration, a third of consumption coming from humanitarian aid, nearly a third of the labour force unemployed, a budget deficit of half the GDP, and inflation peaking to 45 per cent monthly in August 1992 (Bezemer, 2012).

The impact of the budget gives an important role consisting mainly on two theories:

a) Classical theory based on the concept that the private sector and citizens must share tools for budgetary expenditures to fulfill the general and common consumer. Hence, this theory is based on the function of the budget neutral.

b) Based on contemporary theory of the country today that takes the classic functions except some economic functions through which the financing of the budget set. The budget has an important role in all aspects of reproduction as in production, consumption, saving, redistribution, etc. In mid-1992, the government introduced IMF-advised wide-ranging reforms. These included the liberalization of price controls and of trade, tight fiscal and monetary policies and, starting July 1992, a floating exchange rate. By the end of 1992, macroeconomic circumstances stabilized. Microeconomic restructuring began to show results. The number of private businesses in the capital had increased from just 398 in March 1991 to 8,321 in December 1992. Tax revenues, which had fallen from 42 per cent of GDP in 1990 to 28 per cent in 1991, signaling both an increase in private sector activity and the start of functioning of the tax administration, upon which the government now depended for revenues. With World Bank support, the government started the preparations for privatizing 30 week and large state enterprises.

How does Albania stand in comparison to the average inflation performance in transition countries? The answer is if we consider the period up to 1997, Albania's record is somewhat less than impeccable. Between 1989 and 1997 inflation averaged almost 40 percent, less than in most of the CIS countries, but higher than in the Baltic and the other EU accession countries. Since 1998, however, inflation has been rapidly declining. Thanks to the implementation of firm monetary policies, inflation fell to 0.4 percent in 1999 and virtually zero in 2000.

In other words, FDI flows provide the resources necessary to improve the productivity and efficiency of the home country's primary, secondary and tertiary industries. After 1991 and 1992 as the country opened to the market economy, began the inflow of foreign direct investments. Until 1996 there was a tendency of increasing the number of enterprises with foreign capital. From 1992 to 1999 period, it is 1996 the year when FDI have the highest estimation in 90 million US\$. In 1997 the non-stability of political environment after the disorder caused from the pyramidal companies, the foreign investments drastically decreased, reaching the level of 48 million dollars (www.bankofalbania.org, accessed: 15/04/2013).

The flow of Foreign Direct Investments (FDI) in Albania has increased significantly during the last years, reflecting an increased preference of foreign investors in Albania. During the past five years FDI-s have increased sharply from 250 million € in 2006 to 827 million € in 2010, while FDI-s have grown with 17% compared to a year ago. FDI-s during 2010 has been green-field investments, in total absence of privatizations. These investments went mostly in the energy sector, exploration and drilling oil / gas and energy sector concessions. Also the service sector is one of the main sectors, attracting foreign investments and particularly in the telecommunications sector and banking. As well as other sectors such as manufacturing, construction, trading has attracted FDI inflows during 2010. Much of the FDI-s in Albania is in

the form of capital, which constitutes 70% of the total FDI-s. Re-investment of profits constitutes a smaller but growing part of FDI-s. During the period 2004-2008, 24% of total FDI-s has come as a result of privatizations, in 2009, 26% of FDI-s came from privatizations. 44.5% of FDI-s belong to the economic sectors such as mining, industry and construction, 55.5% of FDI-s belong to services, transportation, telecommunications, financial services, commerce and business services. (Dragusha, *et al.*, 2011).

As just noted, budgetary imbalances can play a substantial role in fuelling inflation. Albania is no exception to this rule. In 1992, the budget deficit stood at an astonishing 20.2 percent of GDP. It then steadily declined, except for a rebound in 1997, but was still in the two digit territory in 1999. Only in 2000 did the budget deficit fall below 10 percent. What matters most in determining inflation is the domestically financed portion of the budget deficit. Here too, Albania registers a steady improvement. The share of domestic financing in the deficit fell from 11.0 percent in 1997 to 4.9 percent in 2000. If there is a need to apply anti-inflationary policy that must be guided by the policy of budget surplus, so to reduce costs, and vice versa, the situation of depression and unemployment policy led budget deficit, then growth of state expenditures. The function of the classical theory is based on budget neutral budget position. Budget in modern economics has become very important instrument. Redistribution through the budget and expenses made of a very large share of national income. For this reason there may be budget neutral role, but conversely, has a great impact even more crucial to economic development.

Furthermore, during 2000s the level of current account deficits has always been above the threshold of 5% of GDP. Along this period, current account deficit ranged between 6 and 10 per cent of GDP, reaching the maximum level in 2002. Current account deficit may be less

sustainable, if it is derived from a large trade deficit than from a large negative net factor income (Roubini and Wachtel 1998).

Trade balance in Albania represents a growing deficit since the beginning of transition. The reason behind this deficit is the slow export performance, on average 7 percent of GDP, and the escalating import growth, estimated by an average of 30 per cent of GDP. Based on IMF estimations, savings picked up to 23 per cent of GDP during 2000-2001 and scaled back at around 18 per cent throughout 2006. While this accumulation of savings is achieved by the behavior of the private sector, public savings increased as well, from -22 per cent of GDP in 1992, they turned positive in 2004, (estimated at 0.1 per cent of GDP) and increased to 2.6 per cent of GDP in 2006. Public investments increased as well, but remained low, around 5 percent (ranging from 4.5 per cent of GDP in 1996 to 5.2 per cent in 2006) (Tanku *et al.*, 2007).

2.1.1 A Macroeconomic Outlook

During the years (1998-2001), after the macroeconomic and structural reform in Albania, a period of sustained economic growth and improving macroeconomic performance initiated. Real GDP growth in this period was 7-8% per year, inflation decreased arriving at 3%, and the part of the budget deficit, which was domestically financed, has been reduced from 10.5% to 4.6% of GDP. The highest growth rates in the Albanian economy have been in construction, transport and service sectors (Bogdani Dh.I (2002)). The Albanian government's macroeconomic policy main aim for the period 2002-2004 was to maintain the strong performance achieved in the last two years. Real GDP is foreseen to grow approximately at a rate of 7% annually, and inflation to remain at around 3% per year, (<http://www.minfin.gov.al/>, accessed: 11/07/2013).

The Albanian experience in attracting the FDI has been related mainly with the privatization process in the strategic sectors. Almost 60% of foreign investments in Albania case is result of privatization process. In 2001, foreign investments reached 207 million dollars. This was the result of the successful sale of Albanian Mobile Communication (AMC) in Cosmote, the Greek mobile operator, and later the investment done from Vodafone in the mobile telephony. In 2003, the Savings Bank was sold for 126 million \$, to the Austrian Bank, Raiffeisen (<http://www.mete.gov.al/> , accessed: 12/07/2013).

The privatization process was mainly realized in such sectors like: energy, insurances, oil and gas, telecommunications. During 2008, some privatization processes were intended in sectors like power supply system (System Operator Distribution), public enterprise (Cooperation Electroenergy Albanian), 76% of the shares possessed from the Government in the oil company ARMO, 61% of the market share in the company INSIG and 15% of the shares possessed from the government in AMC mobile company. Privatization was realized even to ARMO Company.

These privatization processes were completed during 2009. Foreign investments in Albania have been more focused on oil and gas production, mines, telecommunication, metallurgic, bank, production, insurances, cement production sectors, etc. The privatization strategy required to attract foreign qualified forms as strategic investors in these sectors. Referring to INSTAT data, the number of foreign enterprises and joint-ventures until the end of 2010 increased nearly 21% compared to 2009, representing 2.9% of the total number of active enterprises in the country. FDI in Albania has stimulated economic growth, especially through projects in services and infrastructure. As a result, the overall investment rate of Albania relative to GDP (33 per cent) was much higher than the region's average (20 per cent) in both 2010 and 2011, (<http://www.mete.gov.al>, accessed: 30/06/2013).

2.1.2 The Impact of Government Size and Fiscal Deficit in Growth

There is a lot of economic research focused on relationship between government size and economic growth. Keynesian school supports usage of government expenditure as a policy instrument in order to enhance economic growth. Many studies supports that the relationship between government size and growth is not a linear relationship. (Haderi *et al.*, accessed: 07/06.2013).

The budget has been wrong-footed by slowing growth, resulting in stop-and-go fiscal policy. Expansionary budgets for both 2010 and 2011 were predicated on over-optimistic revenue assumptions. In the event, the 2010 budget deficit was held at 3.7 percent of GDP only after significant mid-year budget cuts, about half of which were achieved through reductions in budgeted capital spending, which dropped from 8.8 percent of GDP in 2009 to 5.8 percent of

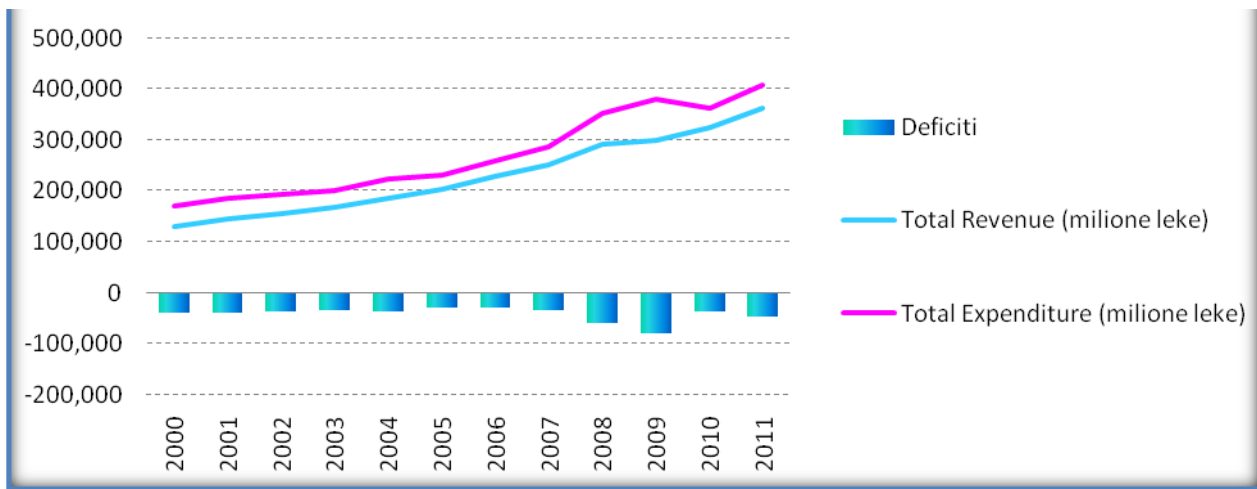
GDP. Reflecting the discretionary nature of the cuts and their implementation mid-year, payment arrears of some 0.7 percent arose. (IMF Country Report No. 11/313, October 2011 www.imf.org , accessed: 07/06.2013).

Another point is the credible Post-Boom Fiscal Consolidation where the fiscal policy discussions were overshadowed by a renewed large budget slippage. At the time of the discussions in June, a considerable underperformance of the 2011 budget had become evident, as revenue was again falling significantly short of original budget projections. Staff and authorities of BoA, agreed that the deficit should be held close to the original 3.5 percent of GDP target not in the least to avoid breaching the legal limit on public debt of 60 percent of GDP. The authorities subsequently adopted the required cuts in a mid-year budget review in July. The difference between incomes and expenses made the so called surplus – when incomes are larger than expenses or deficit – when expenses are larger than budget incomes. The difference between incomes and expenses for Albanian Government for these last 10 years is based on deficits. Incomes are not realize for the reason that not all tax payers are correct with the law but they avoid their obligations; for cause of difficulties for collecting taxes; cause of social politics the state is running. In other hand, expenses are larger for cause of high burden of public investments etc. (<http://www.bankofalbania.org/> ,accessed: 08/06/2013).

In the graph below are given three most important financial indicators of one country. The one that is more visible to see is the lower trend of fiscal deficit for period 2001-2003, so as result of an increase of incomes higher than the rate of increase in expenses. For years 2003-2004 deficit is increased by 12 % and as consequence in year 2005 is realized shrink of deficit in 28 milliard All or 3.4% of GDP. From year 2006 there is continuously increase of deficit which come at maximum level in 2008, with 5.5 % of GDP and in 2009, 6.5 % of GDP. This is one of the

highest norms of deficit overlies anytime from Albanian finance as consequent from finance of road Rreshen-Kalimash. Termination of finance for this road is followed with a decrease of deficit in year 2010 with 49 %.

Graph 1: Financial Indicators: Incomes – Expenses – Deficit

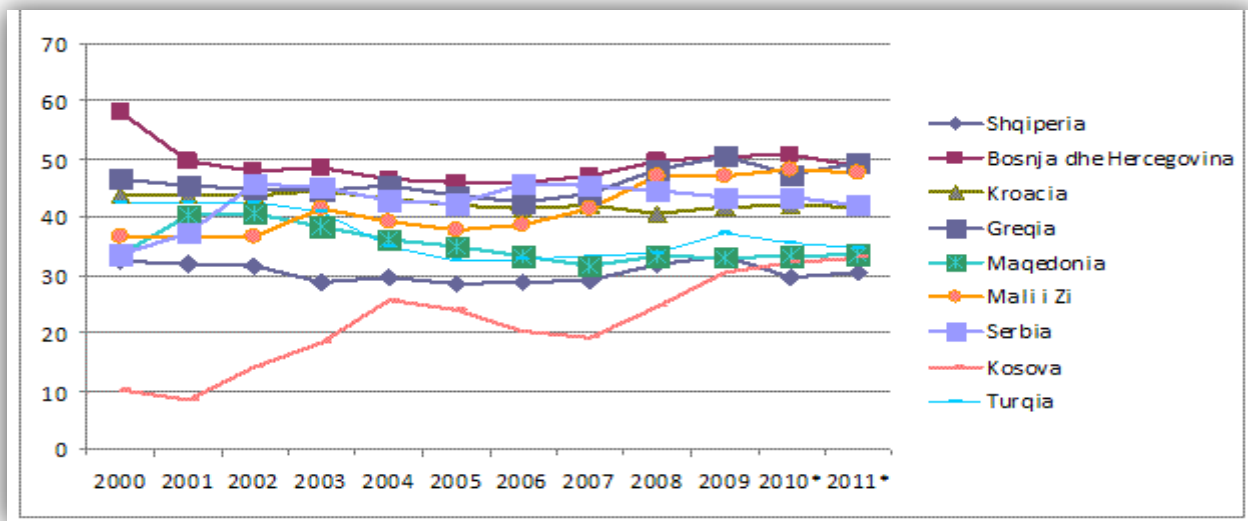


Source: Bank of Albania, <http://www.bankofalbania.org/> accessed on: 15/04/2012.

2.2 Budget Expenses of Albania Compared With Other Regional Countries

Budget expenses stand for investments and other expenses done from other public institutions by using secure funds from budget incomes. Difference between budget expenses and incomes gives budget deficit. For Albanian case, budget deficit for 2009 were about 379 milliard All or 33 % of GDP. Compared with other countries, Albania is shown in graph below:

Graph 2. Budget Deficit according to GDP (%)



Source: FMN Comments and analyze: ODA, <http://www.imf.org>, accessed on: 15/04/2012

By looking at the graph, Albania has budget expenses regarding GDP, lower than others. Meanwhile in the first place is: Greece (50.4%), followed by Bosnia & Herzegovina (50%), Montenegro (47%), Serbia (44%), Croatia (42%), Turkey (37%), Macedonia (33%) and Kosovo (31%). By making a period analysis, we assume that countries with lower budget expenses for this ten years period is Bosnia & Herzegovina, but country with highest budget expenses is Kosovo. Budget expenses for one country are financed mostly from budget incomes, also from debt or privatization of public objects. Generally budget incomes and expenses must change in proportional way so that they can prevent taking debt in not optimal levels.

3. Debt Levels and Developments

Law no.9665, dated 18.12.2006 on state borrowing, state debt and loan state guarantees in Republic of Albania regulates the emission and management of the state borrowing, state debt and loan state guarantees. State debt is the total amount of the state debt, emitted in the domestic currency and/or in an official currency other than the national currency, which does not include the financial obligations of municipalities/communes or any other authority of the local government. The state debt includes also the debts of the Republic of Albania, incurred prior to the entry of this law into effect. To the effect of calculating the state debt, in case an unpaid obligation has been emitted in a currency different from the national currency, it shall be evaluated in the national currency, in accordance with the official exchange rate, announced by the Bank of Albania at the moment of evaluation. The restrictions to the state debt amount and to the state guarantees amount for the loans shall be determined in the annual budget law. The restrictions pertaining to the debt refer, initially, to the debt amount and to the guarantees undertaken recently, and secondly, total amount of state budget and guarantees paid at the end of the year. The restriction is imposed to cover the losses of the central bank due to the re-evaluation of currencies. (<http://www.minfin.gov.al>, accessed on: 20/08/2013).

Violated the law, debt jumps to 60%. When the discussions on 2013 budget just began, the government was preparing to change this year's budget, increasing debt again. Crisis and the failure to have derived income 2012 budget indicators outside the legal parameters adopted by the Assembly. According to data from the Ministry of Finance for last 10 months shows revenues were 19.4 billion lower than forecast in the law. Faced with this situation, the Government is preparing a normative act to correct the declining numbers. From Top Channel resources is learned that the draft provides both spending cuts and revenues, but not to the same

extent. Under the plan, the income will be reduced 7 billion more than the costs and the government will finance the gap by increasing debt. Consequently, the budget deficit, the gap between spending and revenue expanded by 41 billion was provided for in the law to about 48 billion. (Todri, 2012).

Larger questions are relating to the future. In June of 2008-s, the Parliament adopted a fiscal rule, which constrained keeping national debt below the 60 per cent. Although there was a strong rule, with punitive measures in cases of violations in recent years, he has served as a psychological barrier to limit the Government to increase the debt. But the law resisted only 4 years. The border was officially violated this year and once this happened, the Government submitted to Parliament a draft that teaches violation and leaves Albania without a new debt ceiling. The government now legally no longer any obstacle to increase borrowing at will, in addition to budget constraints. But, as we have shown and last year's budget remains unstable law, which also changed to three times per year. In an election year the stakes are even higher. Next year's budget is tight though still dangerous. As never before, the Government has provided only 800 million contingencies to maintain macro-economic stability, 3 to four times less than the average of recent years. At this point, removal of the debt ceiling is a dangerous precedent for the public finances, which are debt spiral into the unsustainable path threatening financial stability. And that the government will come after elections next year threatens more that there is a nearly impossible mission to maintain control of the Albanian public finances.

Even though it can be strange, the government is forced to take the same debt for incomes and also for expenses. This is for the reason that it is continuously is forced to pay previous debt, so this means even that for the moment does not need to take debt; it continuous to pay for expenses taken before. Public Debt of the Central Government as of end of 2010 amounted to ALL

721,812 million or 59.1% of GDP. This represents a decrease of 60 basis point of the ratio of debt to GDP from 2009 level. Domestic debt continued representing the down path 2,94% standing at 33.36% of GDP while external debt standing at 25.71% of GDP, turns out with an increase of 2.33 percentage points compared to GDP. (Economic and fiscal program 2011-2013; <http://www.bankofalbania.org/>, accessed on: 10/06/2013).

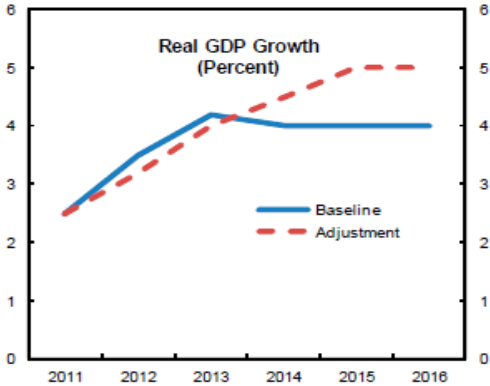
Furthermore the increase of the external debt stock is related with transaction in international bond market where the Republic of Albania successfully priced its inaugural 300 million EUR bond due 2015. 5 year benchmark was priced with a very attractive coupon of 7.50%, opening a new source of funding and creating an important benchmark for the country. The increasing tendency about the proportion of the external debt stock to GDP was noticed since later 2007, as a consequence of pursuing a financing policy from the external markets, thus giving the possibility to the Albanian economy to benefit from the loans in domestic market. The new loans for financing different projects have been borrowed with commercial interests. (Economic and fiscal program 2011-2013; <http://www.bankofalbania.org/>, accessed on: 10/06/2013).

The public debt until later 2009 is composed only by the central government debt. For the first time, during 2010 in the public debt stock is included also the debt held by local governments, which in the end of 2010 is estimated to be at the limits approved by the Ministry of Finance respectively 147 million ALL or 0.01% of GDP. The strategy of public debt for the period 2011-2014 aims to give an orientation with regard to the policy of the Ministry of Finance for the public debt management (<http://www.minfin.gov.al/>, accessed: 09/09/2013).

Public debt has drifted up, heightening near-term rollover risk and constraining budgetary flexibility. Debt is approaching the 60 percent of GDP statutory limit, a relatively high level compared with emerging markets (average of 47 percent) and regional peers. With an average

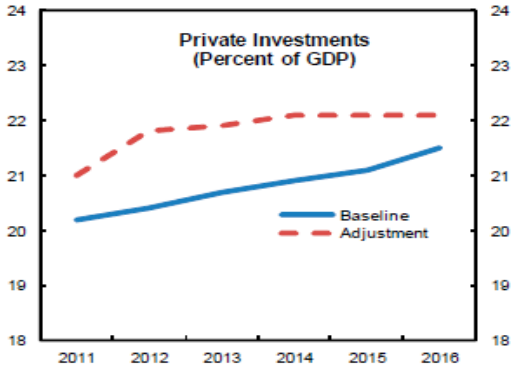
interest of some 6 percent, and notwithstanding a still large share of concessional external debt, debt servicing cost exceeds 3 percent of GDP or 15 percent of tax revenue. Moreover, debt is set to increase further under the baseline and debt sustainability further put at risk by standard shocks. Including personnel expenditure and social insurance outlays, pre-committed spending amounts to three quarters of revenue, severely constraining budget flexibility (IMF Country Report No. 11/313, October 2011, www.imf.org, accessed: 07/06.2013).

Figure1. Real GDP Growth (Percent)



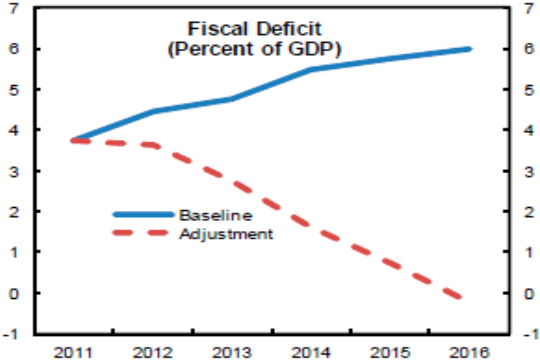
Sources: IMF staff calculations, accessed: 09/09/2013.

Figure2. Private Investments (% of GDP)



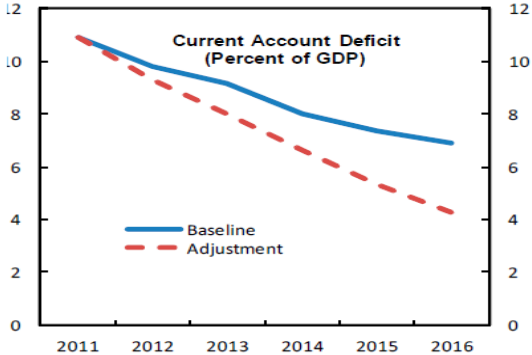
Sources: IMF staff calculations, accessed: 09/09/2013

Figure3: Fiscal Deficit (% of GDP)



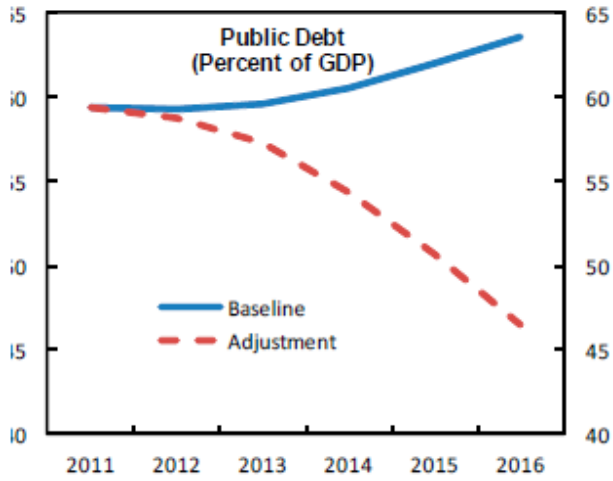
Sources: IMF staff calculations, accessed: 09/09/2013.

Figure4: Current Account Deficit



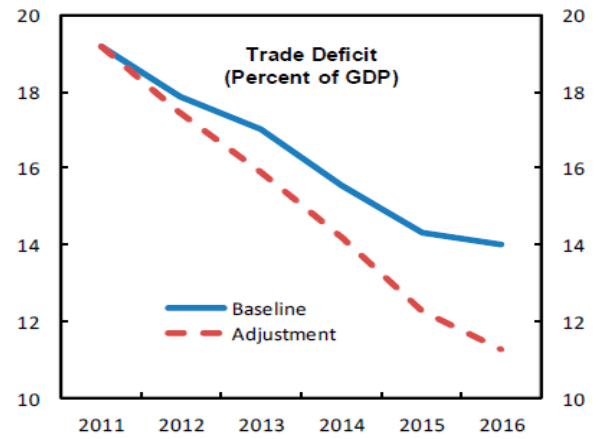
Sources: IMF staff calculations, accessed: 09/09/2013.

Figure5: Public Debt (% of GDP)



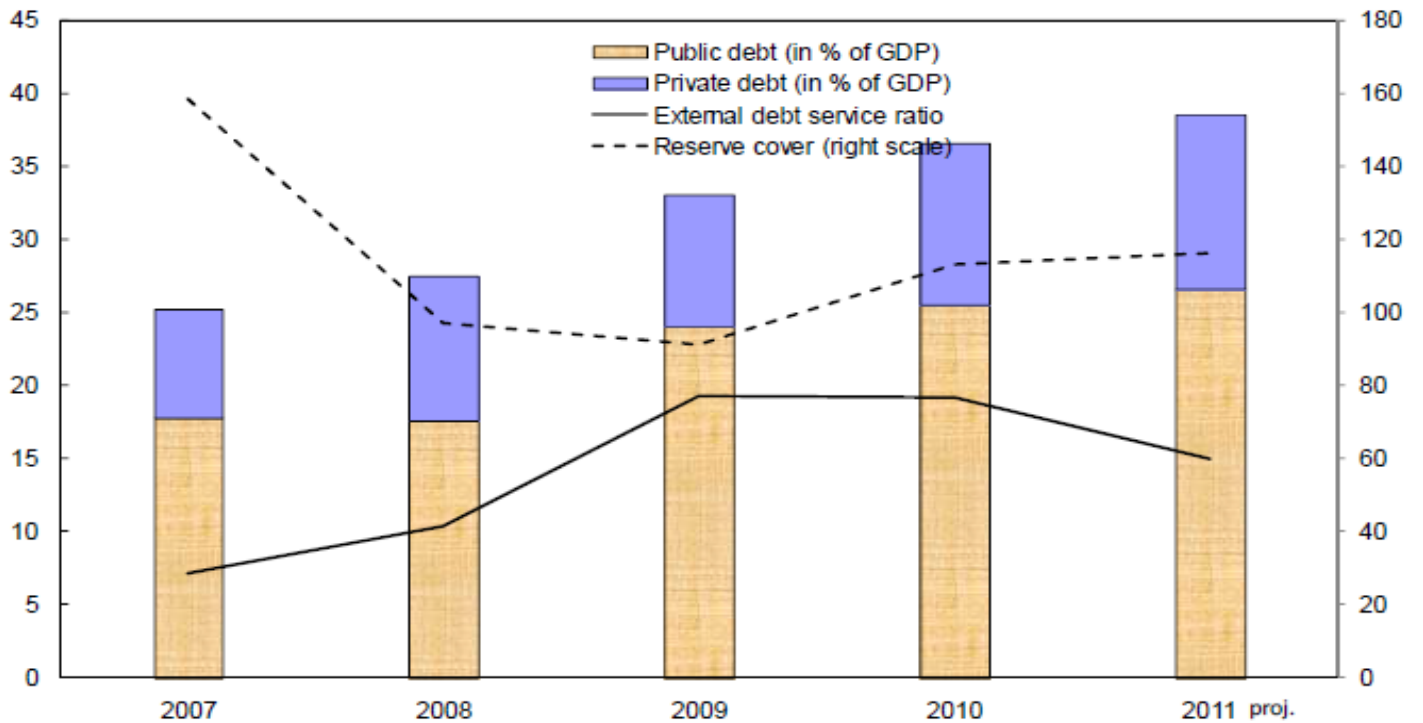
Sources: IMF staff calculations, accessed: 09/09/2013.

Figure6: Trade Deficit (% of GDP)



Sources: IMF staff calculations, accessed: 09/09/2013.

Figure7: External Debt and Liquidity Indicators



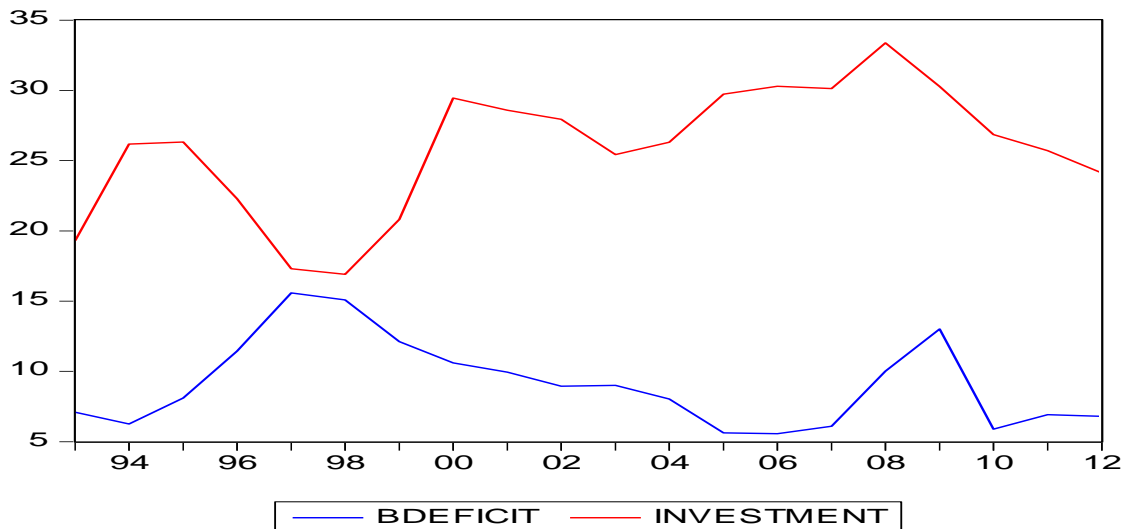
Sources: IMF staff calculations, accessed: 09/09/2012.

4. An Examination of the Relationship between Budget Deficit and Total Investments: Non Stationary Time-Series and Johansen Co-integration Test

Time series data display a variety of behavior. The main reason why it is important to know whether a time series is stationary or non stationary before one embarks on a regression analysis is that there is a danger of obtaining apparently significant regression results from unrelated data when non stationary series are used in regression analysis. Such regressions are said to be spurious (Hill et al., 2008).

The data consist of yearly budget deficits are obtained from the INSTAT (www.instat.gov.al, accessed: 24/01/2014). Yearly GDP with constant prices (real GDP) data are obtained from IMF, World Economic Outlook Database, and October 2013 (www.imf.org, accessed: 18/01/2014). Budget deficits percent of GDP with constant prices is calculated by the author using above data. Yearly total investments (percent of GDP expressed as a ratio of total investment in current local currency and GDP in current local currency. Investment or gross capital formation is measured by the total value of the gross fixed capital formation and changes in inventories and acquisitions less disposals of valuables for a unit or sector) are obtained from IMF, World Economic Outlook Database, October 2013 (www.imf.org, accessed: 18/01/2014) for Albania. The sample period is from 1993 to December 2013. All tests are performed by using E Views statistical program.

Graph 3: Budget deficit and total investment series in Albania, 1993-2012



Graph 4: Budget deficit and total investment series in Albania, 1993-2012, scatter diagram

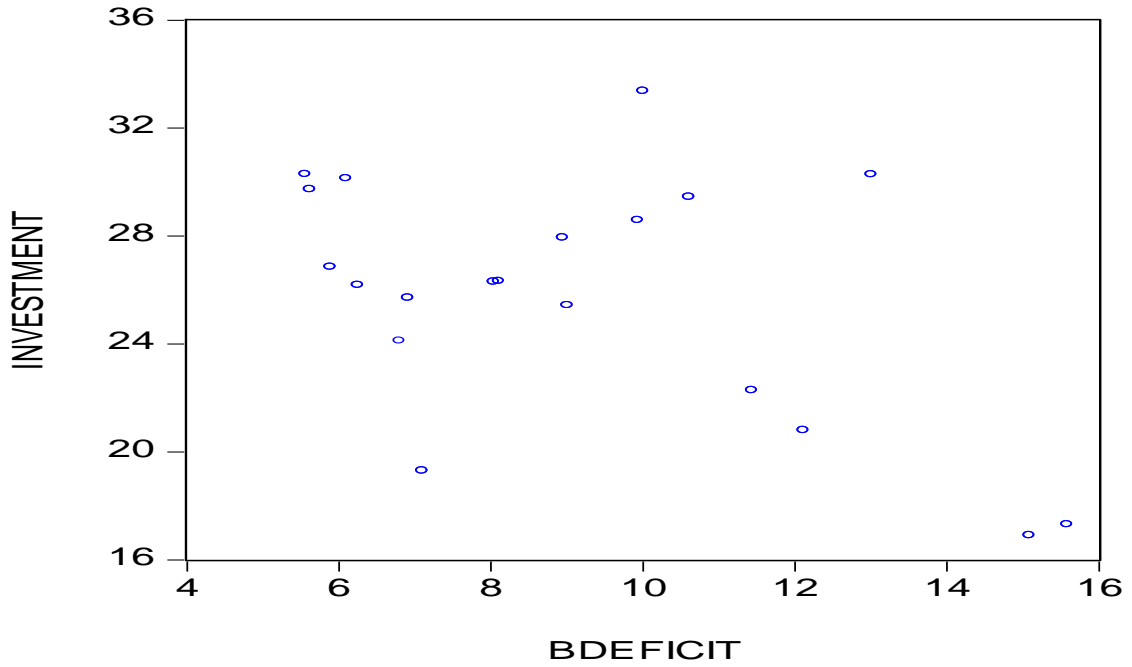


Table 1: Histogram and statistics of budget deficit series

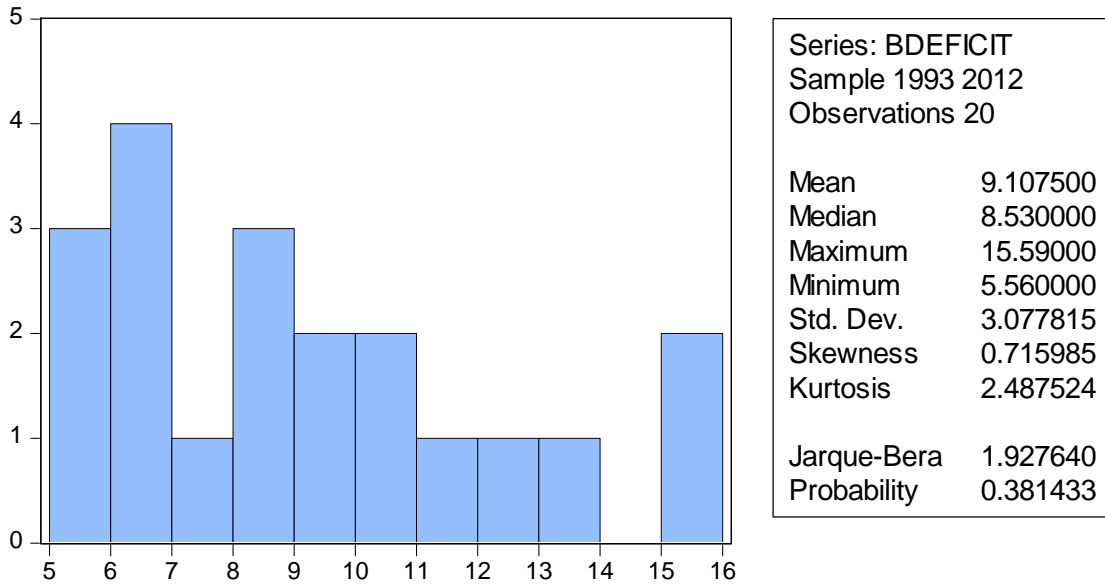


Table 2: Histogram and statistics of total investment series

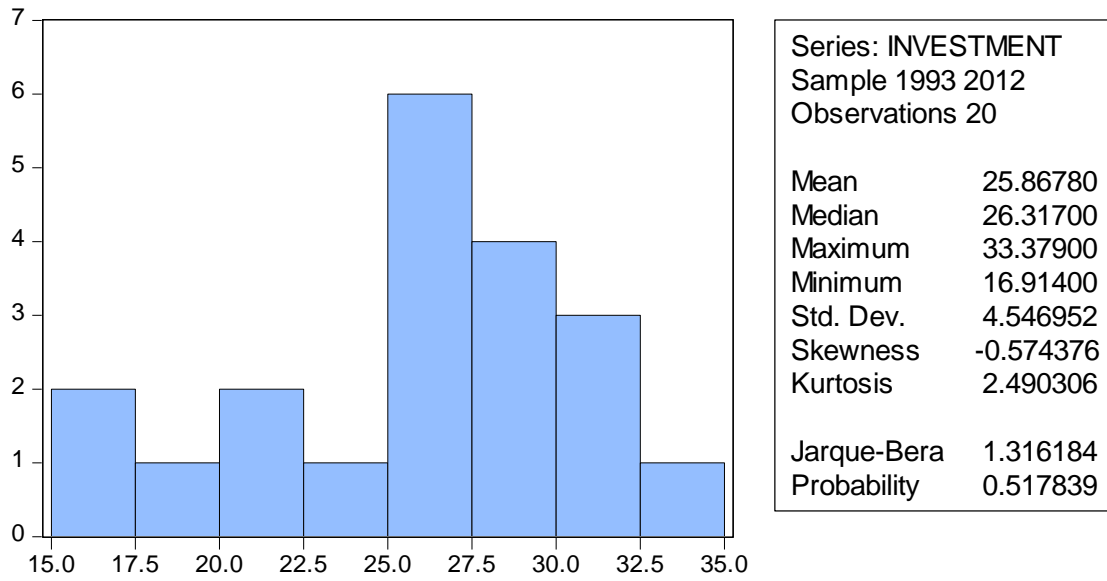


Table 3: Descriptive statistics of budget deficit and total investment series

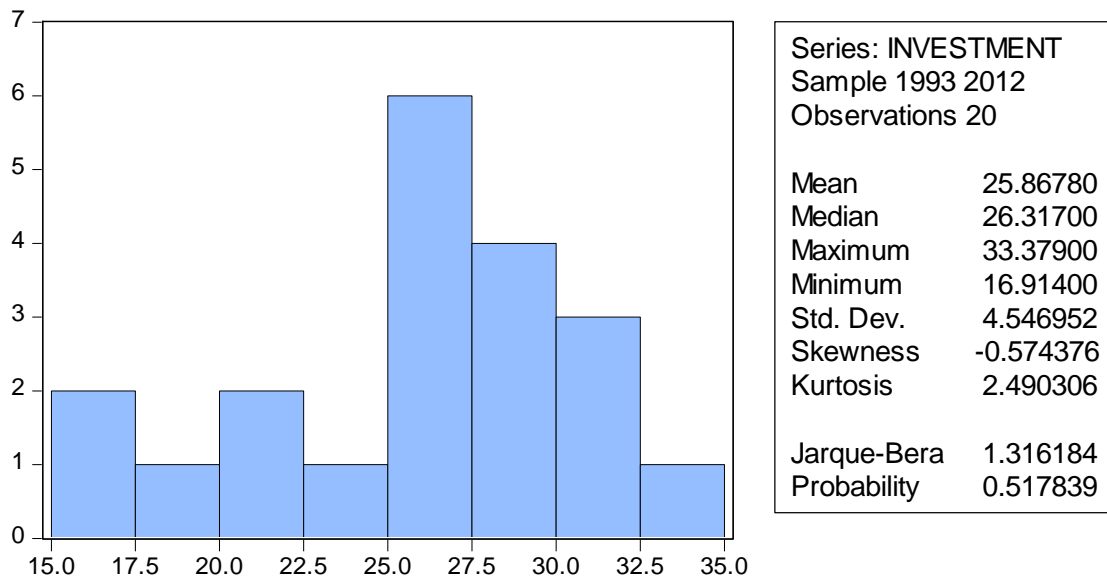


Table 4: Estimation equation output of regression

Dependent Variable: BDEFICIT

Method: Least Squares

Date: 01/27/14 Time: 17:47

Sample: 1993 2012

Included observations: 20

Variable	Coefficient	Std. Error	t-Statistic	Prob.
INVESTMENT	0.332550	0.034717	9.578831	0.0000
R-squared	-0.752741	Mean dependent var		9.107500
Adjusted R-squared	-0.752741	S.D. dependent var		3.077815
S.E. of regression	4.074754	Akaike info criterion		5.696204
Sum squared resid	315.4687	Schwarz criterion		5.745991
Log likelihood	-55.96204	Hannan-Quinn criter.		5.705923
Durbin-Watson stat	0.585100			

Before analyzing the co-integrating relationship between budget deficit and total investment, it is important to carry out a univariate analysis. The economic series tend to possess unit roots (Hill et al., 2008). The presence of unit roots in the underlying series points towards the non stationarity of the underlying series. If both the independent and the dependent variables show the presence of unit roots, the regression results do not hold much meaning. This is referred to as spurious regression, whereby the results obtained suggest that there are statistically significant relationships between the variables in the regression model, when in fact all that is obtained is the evidence of contemporaneous correlation rather than a meaningful causal relation. The problem of spurious regression is compounded by the fact that the conventional t- and F-statistics do not have standard distributions generated by stationary series; with nonstationarity, there is a tendency to reject the null in both cases and this tendency increases with sample size (Gül and Acıkalın, 2008).

The stationarity of each series was investigated by employing the unit root tests developed by Dickey and Fuller. The test consists on the regression where it shows each series on its lagged

value and lagged difference terms. The number of lagged differences to be included can be determined by the Akaike information criterion (Hill et al., 2008).

Table 5: Augmented Dickey-Fuller unit root test statistic on budget deficit

Null Hypothesis: BDEFICIT has a unit root
 Exogenous: Constant
 Lag Length: 1 (Fixed)

	t-Statistic	Prob.*
Augmented Dickey-Fuller test statistic	-2.485817	0.1349
Test critical values:		
1% level	-3.857386	
5% level	-3.040391	
10% level	-2.660551	

*MacKinnon (1996) one-sided p-values.

Warning: Probabilities and critical values calculated for 20 observations and may not be accurate for a sample size of 18

Augmented Dickey-Fuller Test Equation
 Dependent Variable: D(BDEFICIT)
 Method: Least Squares
 Date: 01/27/14 Time: 17:54
 Sample (adjusted): 1995 2012
 Included observations: 18 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
BDEFICIT(-1)	-0.519232	0.208878	-2.485817	0.0252
D(BDEFICIT(-1))	0.350657	0.240068	1.460655	0.1647
C	4.887635	2.036790	2.399675	0.0298
R-squared	0.297433	Mean dependent var		0.030556
Adjusted R-squared	0.203757	S.D. dependent var		2.740387
S.E. of regression	2.445315	Akaike info criterion		4.777236
Sum squared resid	89.69346	Schwarz criterion		4.925632
Log likelihood	-39.99513	Hannan-Quinn criter.		4.797698
F-statistic	3.175134	Durbin-Watson stat		2.008207
Prob(F-statistic)	0.070821			

Table 5 reports the Augmented Dickey–Fuller test statistics under the null hypothesis of a unit root. This table also presents the number of lagged difference terms included in the regression. The hypothesis of unit root against the stationary alternative is not rejected at 5% levels for budget deficit and investment with or without deterministic trend. However, the first differences of these variables are stationary under the test. Hence, it has been concluded that these variables are integrated of order 1. The results of these tests are shown at table above.

Table 5 reports the ADF statistics under the null hypothesis of a unit root. The hypothesis of unit root against the stationary alternative is not rejected at 5% levels (critical value) for inflation with or without deterministic trend. Since the calculated ADF t-Statistic (-2.48) is greater than the 5% critical value of (-3.04) do not reject the null of non stationary. Therefore, budget deficit series has a unit root.

Table 6: Augmented Dickey-Fuller unit root test statistic on investment

Null Hypothesis: INVESTMENT has a unit root
 Exogenous: Constant
 Lag Length: 1 (Fixed)

	t-Statistic	Prob.*
Augmented Dickey-Fuller test statistic	-2.226502	0.2043
Test critical values:		
1% level	-3.857386	
5% level	-3.040391	
10% level	-2.660551	

*MacKinnon (1996) one-sided p-values.

Warning: Probabilities and critical values calculated for 20 observations and may not be accurate for a sample size of 18

Augmented Dickey-Fuller Test Equation
 Dependent Variable: D(INVESTMENT)
 Method: Least Squares
 Date: 01/27/14 Time: 18:29
 Sample (adjusted): 1995 2012
 Included observations: 18 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
INVESTMENT(-1)	-0.373510	0.167757	-2.226502	0.0417
D(INVESTMENT(-1))	0.403341	0.204987	1.967647	0.0679
C	9.576112	4.447916	2.152944	0.0480
R-squared	0.308204	Mean dependent var		-0.114722
Adjusted R-squared	0.215964	S.D. dependent var		3.316368
S.E. of regression	2.936504	Akaike info criterion		5.143329
Sum squared resid	129.3459	Schwarz criterion		5.291724
Log likelihood	-43.28996	Hannan-Quinn criter.		5.163790
F-statistic	3.341340	Durbin-Watson stat		1.580355
Prob(F-statistic)	0.063072			

Table 6 reports since the calculated ADF t-Statistic (-2.22) is greater than the 5% critical value of (-3.04) do not reject the null of non stationary. Therefore, investment series have unit root. Both budget deficit and investment series have unit root, needed taking differences of both variables.

Table 7: Augmented Dickey-Fuller unit root test on D (BDEFICIT)

Null Hypothesis: D(BDEFICIT) has a unit root

Exogenous: None

Lag Length: 0 (Fixed)

	t-Statistic	Prob.*
Augmented Dickey-Fuller test statistic	-3.780949	0.0008
Test critical values:		
1% level	-2.699769	
5% level	-1.961409	
10% level	-1.606610	

*MacKinnon (1996) one-sided p-values.

Warning: Probabilities and critical values calculated for 20 observations and may not be accurate for a sample size of 18

Augmented Dickey-Fuller Test Equation

Dependent Variable: D(BDEFICIT,2)

Method: Least Squares

Date: 01/27/14 Time: 18:33

Sample (adjusted): 1995 2012

Included observations: 18 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(BDEFICIT(-1))	-0.910809	0.240894	-3.780949	0.0015
R-squared	0.456721	Mean dependent var		0.041111
Adjusted R-squared	0.456721	S.D. dependent var		3.703269
S.E. of regression	2.729585	Akaike info criterion		4.900129
Sum squared resid	126.6607	Schwarz criterion		4.949594
Log likelihood	-43.10116	Hannan-Quinn criter.		4.906949
Durbin-Watson stat	1.903303			

Table 7 reports, after taking second differences (lags) of variable of budget deficit, since the calculated ADF unit root test statistic (-3.78) is less than the 5% critical value of (-1.96) do not reject the null hypothesis of non stationary. Therefore, budget deficit series has not a unit root, or it is stationary.

Table 8: Augmented Dickey-Fuller unit root test on D (INVESTMENT)

Null Hypothesis: D(INVESTMENT) has a unit root
 Exogenous: None
 Lag Length: 0 (Fixed)

	t-Statistic	Prob.*
Augmented Dickey-Fuller test statistic	-3.587271	0.0012
Test critical values:		
1% level	-2.699769	
5% level	-1.961409	
10% level	-1.606610	

*MacKinnon (1996) one-sided p-values.

Warning: Probabilities and critical values calculated for 20 observations and may not be accurate for a sample size of 18

Augmented Dickey-Fuller Test Equation
 Dependent Variable: D(INVESTMENT,2)
 Method: Least Squares
 Date: 01/27/14 Time: 18:42
 Sample (adjusted): 1995 2012
 Included observations: 18 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(INVESTMENT(-1))	-0.751129	0.209387	-3.587271	0.0023
R-squared	0.423264	Mean dependent var		-0.470722
Adjusted R-squared	0.423264	S.D. dependent var		4.198701
S.E. of regression	3.188625	Akaike info criterion		5.211009
Sum squared resid	172.8446	Schwarz criterion		5.260474
Log likelihood	-45.89908	Hannan-Quinn criter.		5.217830
Durbin-Watson stat	1.622515			

Table 8 reports, after taking second differences (lags) of variable of investment series, since the calculated ADF unit root test statistic (-3.58) is less than the 5% critical value of (-1.96) do not reject the null hypothesis of non stationary. Therefore, investment series have not a unit root, or it is stationary.

On the basis of the above-mentioned unit root tests, performed the Johansen's co-integration test to see whether any combinations of the variables are co-integrated. This approach uses a maximum likelihood procedure that tests for the number of co-integration relationships and estimates the parameters of those co-integrating relationships (Hill et al., 2008).

Table 9: Johansen Co-integration Test

Date: 01/27/14 Time: 18:46
 Sample (adjusted): 1995 2012
 Included observations: 18 after adjustments
 Trend assumption: Linear deterministic trend
 Series: BDEFICIT
 Lags interval (in first differences): 1 to 1

Unrestricted Cointegration Rank Test (Trace)

Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	0.05 Critical Value	Prob.**
None *	0.291761	6.209521	3.841466	0.0127

Trace test indicates 1 cointegrating eqn(s) at the 0.05 level

* denotes rejection of the hypothesis at the 0.05 level

**MacKinnon-Haug-Michelis (1999) p-values

Unrestricted Cointegration Rank Test (Maximum Eigenvalue)

Hypothesized No. of CE(s)	Eigenvalue	Max-Eigen Statistic	0.05 Critical Value	Prob.**
None *	0.291761	6.209521	3.841466	0.0127

Max-eigenvalue test indicates 1 cointegrating eqn(s) at the 0.05 level

* denotes rejection of the hypothesis at the 0.05 level

**MacKinnon-Haug-Michelis (1999) p-values

Unrestricted Cointegrating Coefficients (normalized by b'S11*b=I):

BDEFICIT	0.362405
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Unrestricted Adjustment Coefficients (alpha):

D(BDEFICIT)	-1.432741
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LR test statistics and critical values are shown in Table 9. The results suggest that there is a co-integrating relationship between budget deficit and investment at the 5% significance level. In other words, a long-run stable relationship between budget deficit and investment exists. This indicates that budget deficit and investments move together in the long run.

Conclusion

The study concluded that the political stability in Albania is considered one of the most important factors in attracting FDI. According to estimates, this increased Albanian's public debt deficit runs at the end of this year to 61 % of the national production, compromising that from now it limit increased from 62.6 percent projected next year. Without debt ceiling next year 62.6% in 2008, the Albanian government has pledged publicly in front of the International Monetary Fund that within 5 years would reduce public debt to 50 percent of national production. The promise was not kept. In these 5 years, the debt not only did not go down, but the government increased it an average of 1.7 percentage points each year. As a result the national debt next year might go by government itself in 62.6 percent of production. IMF and the World Bank say that this burden is 1.5 times heavier than what can keep the Albanian economy, but this is not the only risk. A statistical test is a procedure of analyses and calculations, which aims to provide tools to determine objectively whether a given result is reflective of reality or unexpected attribute of "surprises" resulting during the implementation of choice. In this study, a statistical test was used to verify the existence of a relationship between two variables. High public debt and a high current account deficit combined with ambitions spending plans, lower level of investments and remain serious challenge in the near term. This master thesis analyzed empirically the co-integrating relationship between budget deficits and investments in the Albanian economy. Since the variables in this article are non stationary and present a unit root, Johansen's co-integration technique has been applied. This methodology has enabled to obtain a co-integrating relationship among these variables. The co-integration results provide evidence of a unique co-integrating vector and a long-run stable relationship between budget deficit and investment resulted.

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Annex:

Years	GDP real (ALL)	Bdeficit (ALL)	Investment as of % GDP	Bdeficit as of %GDP
1993	242.255	17,202	19.306	7.1
1994	265.027	16,590	26.18	6.25
1995	288.614	23,418	26.326	8.11
1996	314.878	36,024	22.285	11.44
1997	282.76	44,085	17.31	15.59
1998	318.671	48,110	16.914	15.09
1999	350.857	42,531	20.809	12.12
2000	376.469	39,979	29.455	10.61
2001	406.362	40,410	28.587	9.94
2002	423.557	37,922	27.939	8.95
2003	448.011	40,410	25.434	9.01
2004	473.59	38,083	26.308	8.04
2005	500.865	28,176	29.737	5.62
2006	528.067	29,372	30.289	5.56
2007	559.223	34,119	30.135	6.1
2008	601.368	60,254	33.379	10.01
2009	621.305	80,883	30.281	13.01
2010	644.914	38,031	26.853	5.89
2011	662.972	45,877	25.714	6.91
2012	673.579	45,856	24.115	6.8

BIODATA

Beltina Ndoni was born in Tirana, Albania in 1989. She graduated the Turkish College Turgut Özal, where she has started studying from elementary school till high school. She completed the Bachelor degree in Faculty of Economics and Administrative Sciences, Department of Banking and Finance at Epoka University and graduated in June 2011.

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Another publication entitled “Budget Deficit and the Impact of FDI: the case of Albania” she presented on International Turgut Ozal Congress on Business, Economics and Political Science Turgut Ozal University, Ankara, Turkey on 1-3 November 2013