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"Capital Account Liberalization - What should Albania do?"

Mr. Shkëlqim Cani, Governor of the Bank of Albania
Ms. Diana Shtylla, R.Department, Bank of Albania

Liberalizing Capital Account in Albania: Why, When and How?

1. What is capital account liberalization: the pros, cons and a brief history of capital controls.
2. How liberalized is Albania's capital account: theoretical approach and empirical evidence.
3. Why do we advocate capital account liberalization?
4. Conditions for capital account liberalization and the current situation in Albania.
5. Suggested steps of liberalization in Albania.

Abstract

Capital account liberalization is one of the processes Albania will have to undertake in the near future. Restrictions on movements of capital are no novelty. They have been prevalent in many countries around the world especially during times of turbulence such as wars or economic depressions. The last two decades have been characterized by a continuous easing of controls on capital movement, and many countries have completely opened up their capital accounts.

However there is a number of countries, Albania included, that are not yet liberalized. While Albania imposes no restrictions or controls on capital inflows, it maintains controls on most capital outflows. The reasons behind the need for capital account opening are linked to the benefits stemming from this process such as higher economic growth, increased diversification opportunities, financial development, fulfillment of the requirements set by the Albanian authorities in collaboration with the WTO and the European Union, reduction of the informal economy, stable and low inflation etc..

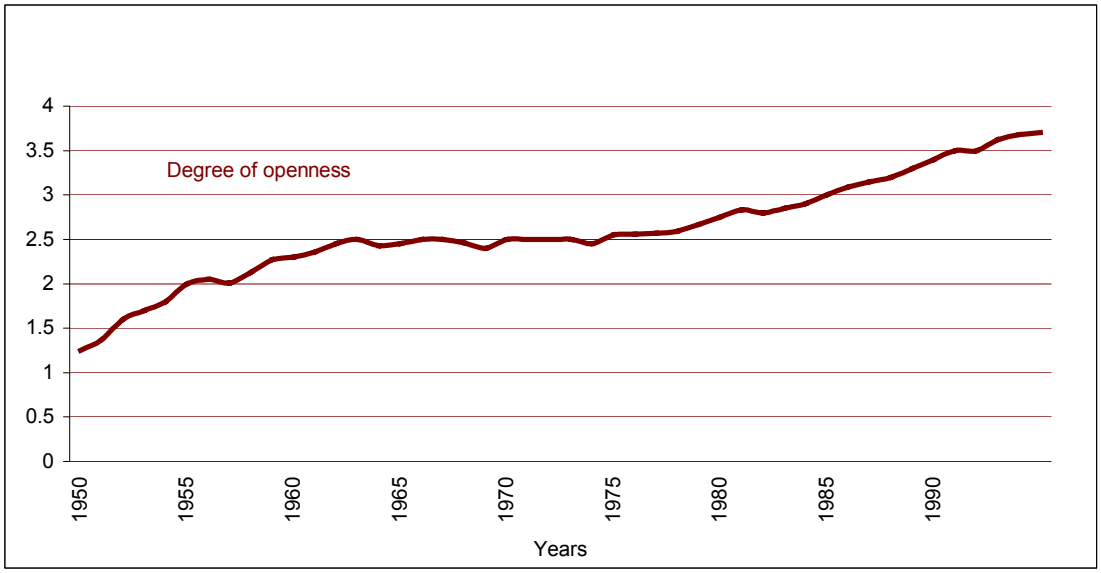
Capital account liberalization requires the fulfillment of certain conditions such as: a sound macroeconomic framework; strong institutional and regulatory regime especially in the financial sector and appropriateness of the exchange rate regime. Therefore we stress the importance of preserving and improving current macroeconomic indicators such as GDP growth and inflation, the importance of the continuation of structural reforms, the importance of carefully monitoring the levels of total and especially foreign debt, and the immediate necessity to develop a foreign exchange-generating strategy that will enable Albania to maintain a sound balance of payments position.

As far as the liberalization steps are concerned, in line with theory and recorded evidence so far, we suggest that a careful approach be taken as Albania opens its capital account. The sequencing of the liberalization steps is very important. Sequencing stands for an ordering and a combination of structural and macroeconomic reforms with steps towards the opening of the capital account.

1. What is Capital Account Liberalization: the pros, cons and a brief history.

Capital account liberalization means complete removal of controls and restrictions on movements of capital from and to a country. The word 'restriction' is used not only for outright legal prohibition, i.e. in cases when the law completely prohibits a certain transaction, but also when quantitative restrictions are imposed, and even in the cases when, for a given transaction, approval from an authority such as the central bank is required. At this point it is necessary to underline the distinction between the obligation to receive an approval (authorization, permission) and the declaration required at the point of entry or exit of the capital. Some countries apply the system of the declaration of the quantities of capital that leave the country for mere statistical reasons or tax-related concerns. These declarations do not constitute restrictions or controls on the movement of capital because they do not impede or decelerate this movement. Because controls and restrictions on the movement of capital are both of quantitative and qualitative nature it is difficult to determine whether a country has a liberalized capital account or not. Quinn and Inclán (1997) measured capital account openness in a number of countries by coding measures limiting international capital mobility according to their degree of restrictiveness.

Graph 1: Degree of openness[1]



It is clear that in the second half of the last century the degree of capital account liberalization has been increasing especially in the last decade.

[1] Based on Quinn and Inclán (1997)

Brief overview of controls on the movement of capital.

Capital has been moving from one country to another long before sophisticated financial and capital markets were in place. However, the movement of capital has, to various extents been subject to controls, the size and scope of which differed from one economic and political era to another. It is wrong to assume that controls on the movement of capital have been gradually lifted over the decades. There have been periods when capital has moved from one country to another with a greater freedom than it does today. Such was the gold standard period during which capital was transferred and invested in huge quantities, while interested rates of different countries were closer than they had ever been before. The fixed exchange rate regime, the gold standard, was regarded by many countries as a reliable and stable one. Short-term capital helped finance many new economic activities in many countries. The gold period was followed by the war period which included the two world wars and the interwar period – the Great Depression (1914-1945). This period was characterized by an increasing nationalistic feeling and anti-cooperational policies. Trust in the gold standard eroded after the breakup of WWI and monetary policy focused on the solution of domestic problems and mostly on the financing of war-related deficits. Capital controls were imposed in countries all around the world as means that could protect them from currency depreciation and help keep the gold in their possession. The world economy shifted from a developed stage of globalization to almost full autarchy within a few decades. Capital movement was almost inexistent, international investment was viewed with suspicion and international prices and interest rates stopped moving in tandem. Global capital and international investment was even considered as the main cause of the depression in the 30s.

The third period - the Bretton Woods period (1945-1971) - was an attempt to reconstruct the world economy. Trade transactions flourished and economic growth was more prominent than ever. Despite the remarkable growth fears related to the movement of capital had not been appeased. IMF initially sanctioned controls on the movement of capital as a means to prevent currency crises. These controls granted the governments some independency to pursue active monetary policies. The philosophy advocating capital controls, was not abandoned until the end of the 60s when it became visible that global capital could not be contained. Capital markets were regenerated during the controls era, while fixed exchange rate regime was the common feature of many developed economies.

In the fourth and final period-the post Bretton Woods or the flexible exchange rate period- the trend was different. Although some countries were hesitant to replace the fixed exchange rate with the flexible one, between 1970-1990 capital movement has been quite remarkable. The governments of developed countries did not regard capital controls as necessary, as fixed exchange rates were not their priority any more. Since a flexible exchange rate could accommodate developments in the capital market, controls could be lifted without causing problems. The removal of controls encouraged the movement of capital in and

out of many countries. In the peripheral countries economic reforms reduced transaction costs and direct investment risks. As a result, capital flew into these countries at least until the end of the 90s, when foreign investors became aware of the problems that could arise from the fixed exchange rate regimes that were still widespread among developing countries.

Arguments for the capital account liberalization

The classical theory[2] suggests that international movement of capital allows countries with limited savings to attract financing for investment projects in the country, enables investors to diversify their portfolios, spreads investment risk and promotes intertemporal trade-the trading of goods today for goods in the future.

If capital is free to move from one country to another, then individuals, firms and countries can consume as much as they want to by borrowing from abroad when their income is not sufficient. Borrowing from abroad, helps smooth business cycles and allows domestic firms and individuals to keep consuming and investing even when domestic production and income are at low levels.

Capital account opening has been found to raise credibility in the monetary authorities. According to William McGruben and Darryl McLeod who compared inflation performance of countries that liberalized their capital account during the 90s with that of countries that did not do this, the continuous lifting of controls can bring down the yearly rate of inflation by up to 3 per cent. A similar conclusion has been reached by Eichengreen, Rose and Wyplosz (1996b). They studied the record of macroeconomic variables in countries that underwent crises, while some of the countries selected had liberalized their capital account and others had not. The authors found that inflation, money growth and trade imbalances are higher in crises occurring in the presence of controls. In another study done by Alesina, Grilli and Millesi-Ferreti (1994), it is made clear that countries imposing controls tend to have higher inflation and greater seigniorage revenue but lower real interest rates.

Johnston and others (1998) find that the intensity of capital controls is negatively correlated with economic development and positively correlated with the level of tariff barriers, the black market premium and the volatility of the exchange rate.

Arguments against capital account liberalization

A number of economists around the world bring forth several arguments against full liberalization or the manner in which it was conducted in certain countries. Some of these arguments follow:

In the first place it is hard to measure the net benefits that a country would reap from CAL, because, under normal conditions it is impossible to predict the losses that the country might incur in the face of a capital crisis. In a proper analysis a country must estimate the probability of a crisis as well as the potential losses that the crisis could bring about.

[2] "Liberalizing Capital Movements", Economic Issues 17, IMF.

One opponent of the CAL, Sebastian Edwards, has found that capital movements do not always help total factor productivity growth. He separated countries into distinct groups according to their level of development, and found that financially sophisticated countries have much more to gain than financially underdeveloped countries. In other words, Edwards concluded that, a country can benefit from CAL only after having reached a certain level of economic development. In the same line of thought, it has been argued that developing countries suffer much more than developed countries in periods of crises.
In the private sector, CAL raises the question of access to credit especially for individuals and medium-sized companies. Small borrowers benefit less from foreign capital, and are more severely hit by swift capital flights because of their limited ability to transfer their assets abroad and limited access to financial services.
A number of economists while not being fully against liberalization, suggest that this process should be carried out cautiously and gradually. They argue that going back from a liberalized state to a controlled one, in case of crises, might be very costly and detrimental to the economy.

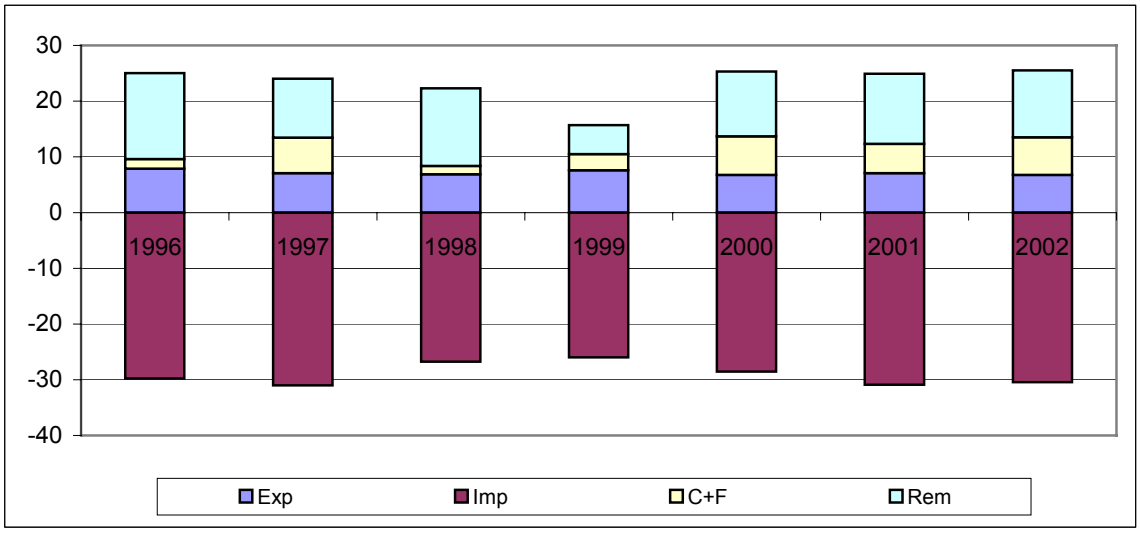
2. The degree of liberalization of Albania's capital account and reasons behind the modest inflows.

Albania is regarded as a country with low barriers to foreign capital and direct investment. An index of Economic Freedom constructed by Wall Street Journal ranks Albania higher than countries such as Japan, Canada, France, Slovenia, Bulgaria, Malta, Cyprus and all the ex-USSR countries. The reason behind this is because according to Albania's Regulation on Foreign Exchange Activities[3], there is no approval process, and no sectors are closed to foreign investment. In the same way, repatriation of initially-invested foreign capital as well as the earnings stemming from these investments, face no obstacles in leaving the country. According to this evaluation 'Foreign and domestic firms are treated equally under the law in Albania and are guaranteed safety from expropriation or nationalization.' There is only one (accidental) case in which foreign investors are not treated in the same way as residents of Albania. Foreign investors who invest in Albanian Treasury Bills must pay a 15 per cent tax on their profits as opposed to a 10 per cent tax imposed on Albanian residents.

The movement of capital to and from Albania is regulated by the Regulation on Foreign Exchange Activities (FEA) amended in 30.7.2003. As mentioned above foreign capital entering the country is not subject to any restrictions or controls. Despite the lack of controls, inflows of capital in Albania are very modest and we feel the need to analyze some factors that might have limited the incoming capital to Albania.

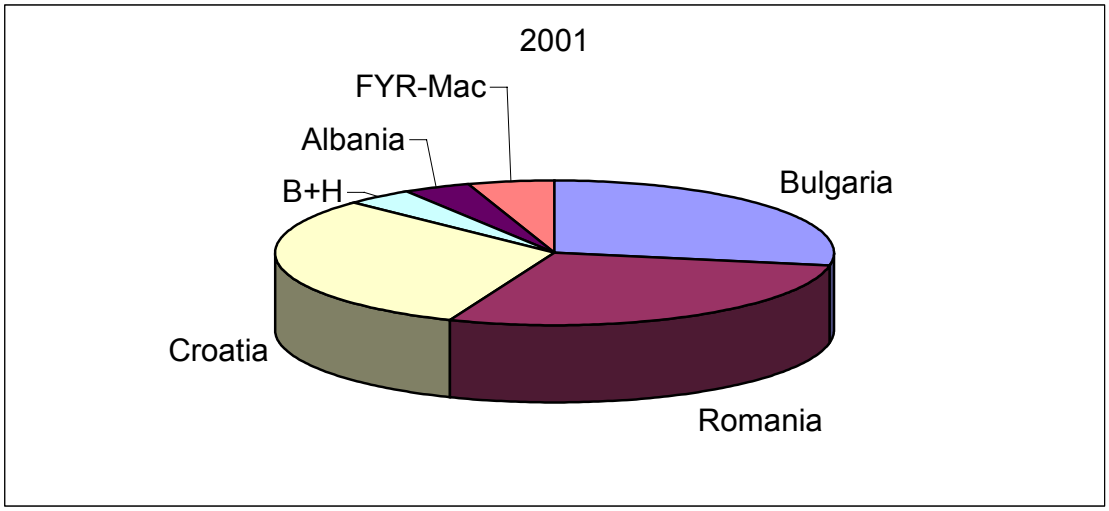
[3] The Regulation of FEA, approved by Supervisory Council Decision no. 64, dated 30.07.2003, is published in the Official Bulletin of the Bank of Albania, no. 12, July 2003.

Graph 1: Imports, exports, capital + financial flows and remittances (% of GDP)



Most of the capital comes to Albania in the form of FDI and capital transfers (credit) to the government. There are no portfolio investments from abroad whereas in the past three years domestic banks have purchased, in very limited amounts, foreign debt securities. Although we are aware of the benefits stemming from the diversification of incoming capital, we would like to investigate some of the reasons that have held back foreign direct investment (FDI) in the past few years. Inward direct investment is particularly beneficial for the host country. In a widely-held view, foreign direct investors are believed to increase domestic capital formation, to augment host country stocks of technology and managerial know-how, and to improve access to export markets and to a comparatively stable source of external financing. On the other hand FDI is typically regarded as less responsive to adverse macroeconomic developments. It is associated with fixed investment which can only be liquidated at a substantial loss. (Lehmann 2002). Albania seems to have been less of an attraction for foreign investors than other southeastern European countries, even compared to the ones of similar size such as FYR Macedonia or Croatia.

Graph 2: Distribution of FDI among southeastern European countries for 2001 (total 100 %).

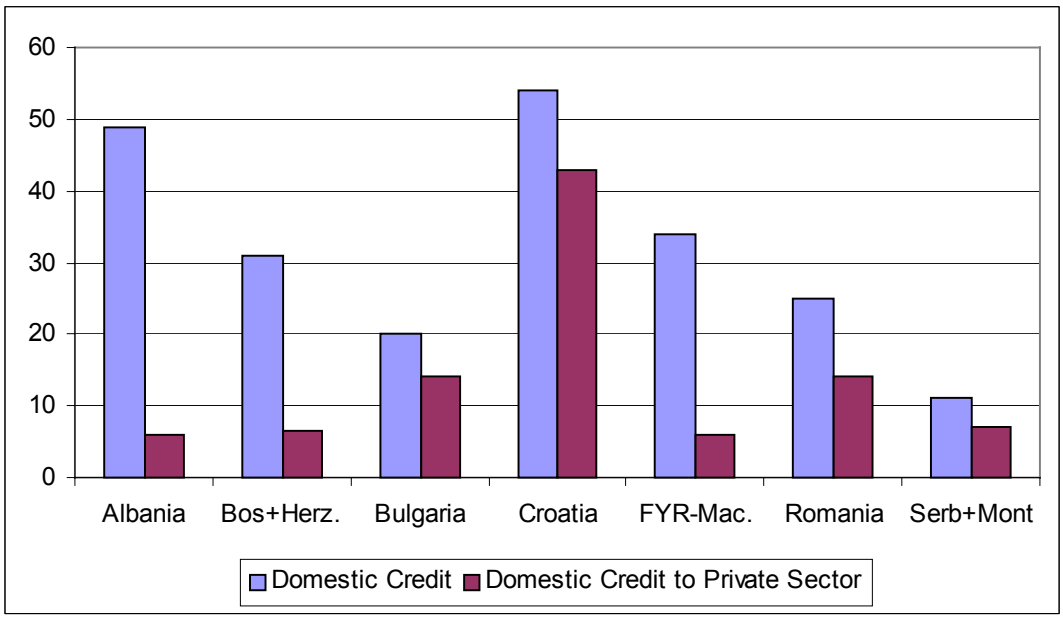


Reasons behind investors' reluctance to invest in Albania can be related to:

1. Technological factors which may result in differences in production between the investing and the host country. Although Albania lags behind other developing countries, it is making progress in terms of attracting new technology. In the last two years imports of machinery and equipment, mostly related to investment in telecommunications made up 16-18 per cent of total imports.
2. Institutional factors that determine the perceived risk of confiscatory taxation, the presence of informal economy, unclear property rights and uneven application of laws and contracts. All these phenomena are observed and are still present in the Albanian business environment. Despite recent improvements, cases of arbitrary decisions, evasion and preferential treatment of specific subjects have been observed. Unclear property rights, which often result in dual ownership of an asset, corruption, delays, gaps and irregularities in the enforcement of law make it difficult for foreign investors to purchase or construct buildings, to acquire technology and to normally engage in a business activity in Albania. In addition to the overall improvement of investment conditions in the future, we believe that, the liberalization of the buying and selling of land may also aid foreign investors to conduct their business in Albania.
3. Financial system flaws and credit market constraints which have confined the development of the private sector. Albania is one of the SEE countries with the lowest level of domestic credit to private sector[4]. SME-s, for a number of reasons, are still having difficulties in attracting financing from domestic banks.

[4] Reference to Falcetti, Sanfey and Taçi 2002.

Graph: Bank intermediation in SEE in 2001 (in percent of GDP)



Under these conditions it is obvious that well-developed financial system is required as an intermediary between foreign capital and SME-s in the country.

4. Lack of information and insufficient marketing which have also impeded foreign capital from entering the country.

5. Increasing concerns about repayment which are related to the current account balance situation. It is said that current account deficits are regarded as warning indicators of a crisis and higher account deficits tend to be associated with higher required risk premia. (Lipschitz, Lane and Mourmouras, 2002). As the current account deficit of Albania (as percent of GDP) has been growing continuously during the last 4 years, until it stopped at 8.3 % of GDP in 2002, concerns about the ability of the country to repay its external debt must have grown accordingly.

After scrutinizing the reasons behind shallow FDI-s in the last decade in Albania, we must mention the undeniable fact that FDI-s, like the majority of statistics in Albania, are subject to some erroneous registrations, estimations, misspecifications etc.. The Albanian balance of payments has been constantly registering positive large errors and omissions and this is a sign of underestimated inflows. Based on these observations and other information, we might conclude that incoming capital and especially FDI-s might be higher than those registered and presented in the balance of payments.

Outflows of capital, on the other hand, are still subject to restrictions. No approval is required for outgoing cash transfers from the territory of the Republic of Albania, when the amount transferred for investment purposes in Albania from a foreign bank has not been used; and for outgoing transfers from the territory of the Republic of Albania, for an amount up to the total of paid-in capital and earnings resulted from such capital investment, if this is supported by the appropriate documentation (Law no. 7764 dated 02.11.1993, "On Foreign Investments"). Commercial credits given abroad also need no approval, as long as their maturity is shorter than one year. Immigrants who are not residents of Albania can also transfer foreign exchange obtained through their occupation abroad, or the selling or investments of their wealth. In order to be able to transfer capital abroad, physical and judicial persons as well as individuals, residents of Albania, need to receive the approval of licensed subjects (commercial banks). The ceiling on the amount that could be transferred abroad by a single individual was raised from 20,000 usd to 3.5 million leks (currently 28,000 usd) or the equivalent in foreign exchange. Although the FEA Regulation does not allow residents to carry out direct investment abroad, investment in foreign securities, lending to non-residents etc., we believe that Albanian residents have transferred and continue to transfer capital out of the country both through legal and illegal channels. In sum we conclude that the capital account of Albania is completely liberalized on the side of inflows and more liberalized than suggested by legislation on the side of outflows.

3. Why do we advocate CAL?

We are of the opinion that Albania should not ask whether to liberalize or not, but rather, when and how to conduct the liberalization process. For various reasons that will be presented in the paper, it seems that liberalization is unavoidable, and what we must take care of is the ordering of the steps and the preparation of a smooth liberalization process that will yield the desired benefits and diminish the drawbacks. Below are presented some points that support the liberalization thesis in Albania.

(a) Fictitious controls; large informal economy; evidence that controls on outflows are being circumvented; theoretical support that controls on outflows are less efficient than controls on inflows of capital;
(b) Empirical evidence that capital account liberalization promotes economic growth in developed and especially developing countries;
(c) Long term prospect to become more integrated with the international financial system;
(d) Short –to- medium term commitment to meet the requirements of EU, WTO and other international organizations;

a) There is good reason to believe that the size of the informal sector in SEE, as a percentage of the formal sector, is large compared both to advanced industrial economies and to transition economies in central eastern Europe and the Baltic states. Informal activities thrive in weak states where enforcement of the rule of law is patchy and barriers to entry are large. (Falcetti, Sanfey, Taci, 2003). Although Albania is not ranked among the countries with the highest share of informal sector/GNP (only 33.4 vs. 45.1 in Moldova and FYR-Macedonia) there is evidence that the share of informal sector is underestimated due to the method of estimation being used. Muent, Pissarides and Sanfey (2001) report evidence from a survey of legal enterprises in Albania that competition from the informal sector is the biggest obstacle they face in doing business, outweighing even access to finance or taxes. It is clear that in an economy where illegal and unregistered activities play an important role, unrecorded flows of capital both in and out of the country are present. Illegal activities are generally financed from sources outside of the banking system, such as revenue from other illegal activities carried out in the country or abroad. Most of the transactions in this fraction of the economy are conducted in cash, which is easy to transfer either through customs or through other channels. To illustrate this fact, we can refer to the low percentage of imports and exports that are paid for via banks. The figures for 2002 were 40 and 44 per cent whereas for the first six months of 2003 they were 34 for imports and 32 per cent for exports.

If we consider legal ways of transferring the money abroad, we conclude that a standard 5-member family can transfer abroad through commercial banks around 130-140 thousand usd a year. If one manages to trick the interbank information system, which should not be very difficult in the current conditions, then one can transfer more than the alloted amount under the same name or using different identifications. There are sufficient reasons for us, as central bankers, to believe that Albanian residents can and do get around restrictions on capital movement. They tend to do this when political and economic conditions in the country deteriorate, when they suspect that their savings in foreign currency are not safe in the domestic banks (as was the case in March-April 2002), or for reasons related to illegal activities.

Referring to theory, in addition to the points made above, we must mention quite a number of studies which have found that controls in general and controls on outflows in particular are far from being effective in restricting the movement of capital between countries. It has been found that controls have to large extent failed to inhibit portfolio capital flows, especially when a devaluation was anticipated. Evidence from a number of countries and a number of studies shows that only the most comprehensive and repressive controls on outflows have had at best limited effects.[5]

[5] "Capital Account Liberalization- Theoretical and Practical Aspects" , Occasional Paper 172, IMF.

In conclusion, keeping in mind the size of the informal sector in Albania, the significance of cash in the economy, the continuous tendency of residents to circumvent controls, and the evidence that controls on outflows, even in the best cases, have resulted less efficient than controls on inflows, we might say that controls on the movement of capital in Albania are to a large extent ineffective and at the same time impossible to maintain.

b) Albanian economy has a strong need for foreign financing as it develops. Foreign capital is needed both for the privatization of existing entities, as well as for greenfield projects which are crucial to the overall economic development of the country. Theory suggests that a country that has liberalized outflows is more attractive to foreign investors, as the fear of being stuck with their capital in the country at a moment of crises is much smaller than otherwise. The scheme is simple. Less or no controls on outflows encourage inflows and more inflows help the country to efficiently allocate resources, to provide opportunities for risk diversification, to develop its financial system and to attract better technology and know-how from the investors. Many studies and surveys have concluded that developing countries that have liberalized their capital accounts have experienced economic growth at higher rates than under closed capital account. Quinn's empirical estimates (1997) suggest that the change in capital account liberalization has a strongly significant effect on the growth in real GDP per capita in his cross section of 58 countries over the period 1960-1989. Bekaert, Harvey and Lundblad (2001) find that financial liberalization leads to a 1 percent increase in annual per capita GDP growth over a five year period and that this effect is statistically significant. Along with these studies, there is a number of other studies which have found no correlation between liberalization and growth or which have found that this correlation is inexistent for developing countries (Arteta, Eichengreen and Wyplosz, 2001, and Klein and Olivei, 2000). Because we are faced with a choice here, we prefer to regard capital account liberalization as beneficial to the economy.

c) As we proceed towards a more open capital account, we will also enhance the chances that the Albanian capital and financial market become more integrated with the international market. The more markets are integrated, the better aligned the interest rates are and the easier it is to make educated choices about investments at home or abroad. Albania's integration with international financial markets will be a gradual process and maybe it will some time, before we actually witness the outcomes.

d) Albania is committed to liberalize its capital account and it has agreed to do so within a certain timelimit. In the Report of the Working Party on the Accession of Albania to the World Trade Organization[6], removal of capital controls is one of the horizontal commitments. The report states that: 'the Bank of Albania reserves the right to maintain capital controls which will apply on national treatment basis. The regime currently in place will be removed no latter than

[6] Albania is a member of WTO since October 2000.

2010'[7]. At the same time Albania is preparing to sign the Stability and Association Agreement, which is a first step towards integration in the EU. This agreement will impose on Albania certain conditions regarding the sequencing of CAL and it will set, similarly to the commitments signed with WTO, a time limit after which the capital account of Albania will be fully liberalized. This limit will depend on the time when the SAA will be signed. However, based on the SAA already signed with Macedonia and Croatia, we believe that this limit will not fall beyond year 2010. As shown above, Albania does not have only the good will, but also the official commitment to open its capital account within a relatively short period of time.

4. Conditions for CAL and the situation in Albania

In this section of the paper will be presented several generally-acknowledged conditions that countries should meet before they decide to open their capital accounts. Transition economies that open themselves up to free capital flows are vulnerable. Global capital markets are huge relative to the size of these economies, so small portfolio shifts can exert an overwhelming influence on capital flows and domestic financial conditions. Policies should be set so as consciously to reduce vulnerabilities (Lipschitz, Lane, Mourmouras, 2002). As each condition is presented, the current situation of Albania is described along with some proposals for the immediate future.

a) Sound macroeconomic framework and continued restructuring of the economy;
b) Strong institutional and regulatory regime in the financial sector;
c) Ability to use fiscal policy to offset the effects of large capital inflows or outflows;
d) Access to information; policy transparency and data dissemination;
e) Appropriateness of the exchange rate regime;

a) Not all countries have opened their capital account while they were at the peak of their economic performance. However, according to the conventional view, macroeconomic stability is a key precondition for the liberalization of the capital account. Economic instability may deepen the weaknesses of the financial sector and the liberalization of capital account under these conditions may make matters worse. Sound macroeconomic policies are essential to the neutralization of this mutual relationship. In Albania's case we must once again stress the importance of preserving macroeconomic stability; current rates of GDP growth; inflation at low levels; maintaining external debt at sustainable levels; and, as we speak of capital account liberalization, the importance of designing foreign-exchange generating strategies.

[7] Source: Report of the Working Party on the Accession of Albania to the World Trade Organization; Schedule GATS – Albania, WT/ACC/ALB/51/Add.2, 13 July 2000.

Albania has a low export/imports ratio, while remittances from immigrants working abroad are almost twice the amount of exports. We could say that the real export of Albania is not that of goods but that of labor. Capital inflows are much lower than both exports and remittances. Since some of the sources of foreign exchange in Albania (remittances, foreign aid and revenues from illegal activities) are expected to pour less foreign exchange in the medium-term, we have to think of other long-term sources through which Albania can finance its current account. Good tourism, export -promoting or import-substitution strategies can help reduce the current account deficit, while strategies designed to attract foreign direct investment can help increase financial inflows.

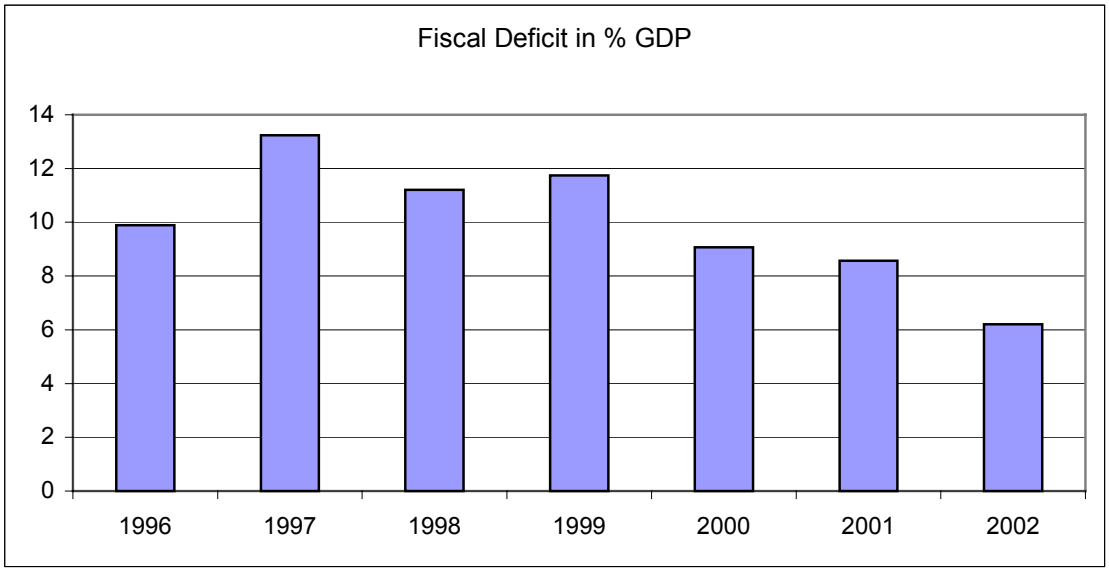
b) Opening the capital account exposes the domestic financial system to foreign competition. Hence, most developing countries have attempted to implement financial sector reforms before fully liberalizing capital account. These reforms typically include freeing interest rates on loans and deposits, developing indirect monetary instruments etc.. Viewed from this perspective, the financial sector in Albania has done good progress in terms of preparing for liberalization. Interest rates on loans and deposits were liberalized in 2000 whereas credit ceilings had been abolished already. Bank of Albania is now relying on indirect instruments to conduct its monetary policy. From above we might conclude that the financial system in Albania is not unfit for CAL. Despite this fact, the financial system in Albania is still narrow and relatively underdeveloped. The banking system comprises the biggest fraction of the financial system. Banking supervision has done quite a progress towards international standards, whereas supervision of other financial institutions such as those of insurance requires essential reform.

Apart from the need to improve and strengthen prudential supervision, we must emphasize the necessity to improve the enforcement of law, especially regarding money laundering. The issue of money laundering is of crucial importance in the case of Albania for reasons related to the large informal sector and especially to the illegal and/or criminal activities that take place in this fraction of the economy. The fight against money laundering in Albania is a result of the combined efforts of the Ministry of Finance, Ministry of Public Order, Bank of Albania, General Prosecution Office and the National Informative Service. These institutions have signed a memorandum of understanding in 2002, with the purpose of designing a general action plan and of creating a representative group that would engage in the 'Interinstitutional Cooperation in the Fight against Money Laundering". The law 'For the prevention of money laundering' has been approved in 2000 and recently (2003) amended by the Albanian Parliament. Bank of Albania has also contributed to the anti-laundering campaign with a regulation dating 1997. Supervision inspectors from the Bank of Albania pay special attention to the forms filled for cash transactions, for quantities above 2 million lek or the foreign exchange equivalent. The authority in charge –the agency at the MoF- receives a special report filled by commercial banks and inspected by BOA inspectors, for each transaction above 70 million leks or its equivalent. The fight against money laundering is becoming more important with every report published by

international organizations in which organized crime, smuggling, illegal activities etc.. are cited among the major problems of Albania.

c) Openness to global capital markets reduces the possible range of action for monetary policy. The fiscal stance becomes, therefore, *the* preeminent tool of stabilization policy. But there are practical limitations to the ability of fiscal policy either to offset the expansionary impact of a large capital inflow or to provide support for economic activity in the event that these flows are reversed (Lipschitz, Lane and Mourmouras 2002). It follows that a country must be able to adapt its fiscal policy to the changes in the quantities and the direction of capital flows. It is suggested that a country uses contractionary fiscal policy if faced with large capital inflows and that it does the opposite when capital flies out of the country. If a country decides to use its fiscal policy as a flexible tool to stabilize capital flows, it must enjoy a strong fiscal position. Albania's fiscal position is a relatively stable one despite the high fiscal deficit. However, we should be aware of the fact that the use of fiscal policy is limited by multi-year governmental obligations and programs and is subject to parliamentary debate and approval. The message here is that Albania should be very careful about how it manages its fiscal policy if it decides to open up its capital account.

Graph: Fiscal Deficit of Albania in % of GDP.



d) Access to information, policy transparency and data dissemination are important when liberalizing. When information on a country is restricted, the large throng of relatively uninformed investors follows the few who are deemed to have special access to information. This makes for runs and panics. Easy access to information allows investors to assess risk independently and is likely to militate against herd behavior. Therefore policy transparency and data dissemination should be seen as essential elements of economic management. Two of the biggest weaknesses in Albania are insufficient and erroneous information and

poor dissemination and there is a lot to be done to improve the information system, to enlarge the body of users of this information, to raise the quality and usability of information and so on. The responsibility falls on all the institutions that produce, collect, use and publish information such as INSTAT, all ministries, Bank of Albania etc.. Policy transparency is at a somewhat higher level but, in this direction also, there is room for improvement.

e) The impossible trinity theory says that a country can not have an open capital account while it pursues an independent monetary policy and maintains a fixed exchange rate. Although both types of exchange rate regimes have their drawbacks in the face of capital flows, there is evidence that the floating exchange rate regime is less vulnerable than the pegged regime. Domestic borrowers in a country with a long –lived pegged regime may feel safe and may decide to assume more risk than necessary while borrowing. Albania's regime of floating exchange rate, and its commitment to this type of regime smooth the progress of CAL.

5) Suggested steps of liberalization in Albania

No matter how much or how little they support CAL, most economists tend to agree on one thing: the importance of the sequencing of CAL. Sequencing stands for an ordering and a combination of structural and macroeconomic reforms with steps towards the opening of the capital account. On one side, as already explained above, a country must undertake reforms that will improve the overall situation and will facilitate the process of liberalization. Controls on capital movement can not replace sound macroeconomic, financial and structural policies. Therefore, before we begin to lift controls, we must identify the flaws of other policies, that these controls are intended to correct. The pacing, the timing and the sequencing of liberalization must take account of the political and regional situation. The commitment of authorities to engage in the liberalization process and their interest in reforms should be considered. It may be the case that, political considerations hold back the enforcement of an optimal reform program in the financial sector. For such reasons it is imperative that the authorities be cooperative, cautious and transparent as reforms are designed and implemented.

The improvement and strengthening of banking supervision is very important as liberalization is discussed. Complete restructuring of banks may require a long time. However it is recommended to follow through with liberalization after the necessary prudential measures are in place. Accounting practices are very important in this respect. Some of the practices that require special attention are related to the assessment of assets, the classification, provisioning and the amortization of loans etc..

Drawing from other countries' experience, economic theory and 'the recipe' for capital account liberalization outlined in the Stability and Association Agreement

signed by Croatia (assuming that the one that will be signed by Albania will be similar in content) we have come up with a general framework for liberalization and some suggestions regarding other processes that might facilitate CAL.
We have to clarify that, from here on, every time we mention a control or the liberalization of a certain item of the capital account, we refer to an outward movement of capital or a control on outflows, since, as explained before, Albania imposes no controls on capital inflows.

- We first propose that the 15 per cent tax on the yield of Treasury Bills to which non-residents are subjected, be lowered to the level of 10 per cent. If this change is made, there will be no discrimination versus non-residents and non-discriminatory practices are very important when liberalization is concerned.

- As a rule, a country begins to liberalize outflows by lifting controls on direct investments abroad. As was pointed above, residents of Albania, are able to get capital out of the country for saving, consumption or investment reasons. This being the case we suggest that Albania remove controls on outward direct investments gradually. Given the present condition of business and economy in Albania, we believe that the risk of capital flight, if outward investments are liberalized, is low. As the Albanian economy becomes more competitive, domestic investors will be more willing and encouraged to explore investment opportunities in the country rather than export capital abroad. At this point it is appropriate to emphasize the importance of improving the overall investment climate in Albania. The controls on outward investments can be abolished by raising the ceiling of the amount that can be transferred abroad (for investment) and by finally eliminating the ceiling altogether. This process may take a few years but not more than 3 or 4. One way to monitor outward direct investment can be through the Ministry of Finance. The MoF can initially issue authorization for outward investments after the resident entity presents proof that it is has paid its fiscal obligations and has generated profit for a certain period of time. This would provide for 'clean' and controlled capital. After a certain period of time, requirement for authorization from the MoF can be lifted and residents may be allowed to invest freely, while still reporting the capital they export, for statistical purposes.

There are certain processes that could facilitate direct investments from Albanian residents abroad. One regards the visa procedures. It is a well-known fact that visas to and out of Albania are a hindrance to investors. There have been cases when non-residents have encountered difficulties in acquiring an Albanian visa, not to speak of the long and painful application process that Albanian residents have to go through in order to obtain visa for almost every foreign country they visit. We believe that, if the movement of people in and out of the country is made easier, foreign and resident investors will be able to better assess investment opportunities in the country or abroad. We encourage foreign and domestic authorities to give this matter special attention in the immediate future.

- In the first stages of the liberalization process, we may start considering the possibility of allowing the issuance of commercial credits of a maturity longer than one year to non-residents along with financial loans of the same maturity. The maturities of these types of credits are normally considered as a protection against crises. The liberalization of both outward direct investment and long-term commercial and financial loans should be accompanied by:

  - review of the financial legal framework;
  - improvement of statistics and standard accounting procedures;
  - strengthening of general agreements on liquidity and accompanying monetary operations as well as those regarding the exchange rate.

- In the last stage of liberalization, we propose the liberalization of portfolio investments as well as that of financial credits and loans with maturities shorter than one year. The lifting of controls on these capital transactions is recommended after the following requirements are met:

  - Strengthening of the legislation; of supervision and risk administration;
  - Financial sector and corporate reforms;
  - Development of capital markets including pension funds.

All the above recommendations are based on the ordering of the liberalization steps that have generally been agreed upon. We must say that , when capital account liberalization is discussed, as is the case with macroeconomic, fiscal and monetary policies that countries choose, there is no single recipe that would yield the desired results at any time and in any place. For this reason, the need for a thorough analysis of the economy arises. This analysis would identify the specific conditions of the country, the relationship among various sectors of the economy, the sensitivity of each sector to external developments etc.. This analysis should be conducted not only at the beginning of liberalization, but at each liberalization phase since, domestic and external conditions are subject to constant and, often unpredictable, change.

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