Capital Account Liberalization: The Case of Albania

Inidi Hafizi

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Prof. Dr. Elvan Yılmaz
Director (a)

I certify that this thesis satisfies the requirements as a thesis for the degree of Master of Science in Banking and Finance.

Assoc. Prof. Dr. Hatice Jenkins
Chair, Department of Banking and Finance

We certify that we have read this thesis and that in our opinion it is fully adequate in scope and quality as a thesis for the degree of Master of Science in Banking and Finance.

Assoc. Prof. Dr. Mustafa Besim
Supervisor

Examining Committee

1. Assoc. Prof. Dr. Mustafa Besim
2. Assoc. Prof. Dr. Salih Katircioğlu
3. Assoc. Prof. Dr. Cahit Adaoğlu

ABSTRACT

Free movement of capital is seen as an attempt towards economic growth, attraction of foreign investments, diversification of portfolio allocation, development of financial markets and also integrating the country with the rest of the world such as European Union (EU), World Trade Organization (WTO), etc. In the late 80's, most of developing countries started liberalizing the restrictions imposed on capital flows. This strategy brought significant prospect in these countries and at the same time became the trigger of a financial and currency crisis in most of these countries. As such, the construction of a proper policy regarding Capital Account Liberalization (CAL) is a necessity to protect liberalized countries from possible crises.

This study makes an assessment on the CAL process of Albania with regard to the possible benefits and risks that the country may face. It also aims to construct a specific policy framework for Albania in order to prevent risks associated with capital liberalization. The assessment and the development of the policy framework are done by benefiting from the other countries' experiences. The countries considered in this study are: Chile, Czech Republic, Hungary, Korea and Singapore.

This research suggests that in order to be benefiting from liberalization, in addition to the legal arrangements, countries need to consider some key policies which may be defined as prerequisites. These policies deal with: Economic Stability; Financial Sector; Accounting and Auditing, Practices and Information System; Exchange Rate Regime; Fiscal Policy; Competition Policy; Corruption and Illegal Businesses;

Informal Economy. Moreover, the study also finds that the success in CAL is very much depended on the application sequence of these determined policies.

Keywords: Capital Account Liberalization, Foreign Direct Investment, Portfolio Investment, Balance of Payments, Albania.

ÖZ

Sermayenin serbest dolaşımı, doğrudan yabancı yatırımı çekme, portföy yatırımlarının çeşitlendirilmesi, finansal piyasaların gelişimi ve bunun yanında Avrupa Birliği (AB), Dünya Ticaret Örgütü vb. dünyanın geri kalanı ile ülkeyi bütünleştirerek ekonomik büyüme yönünde bir girişim olarak görülür. Geç 80lerde, çoğu gelişmekte olan ülkelerin sermaye akımlarına empoze edilen kısıtlamaların serbestleştirmesine başladı. Bu strateji, konu ülkelerde önemli ekonomik beklentiler getirdiği gibi aynı zamanda bu ülkelerin çoğunda finansal ve para krizini tetikleyen bir sebep de oldu. Bu nedenle, ülkelerin krizlerden korunmaları için sermaye akımlarının serbestleştirilmesi sürecinde uygun bir politika uygulamaları gerekmektedir.

Bu çalışma, sermayenin serbestleşme sürecinin başlandığı Arnavutluğun geldiği aşamayı değerlendirmekte ve bu süreçte ülkenin karşılaşacağı olası fayda ve riskleri ortay koymaktadır. Aynı zamanda Arnavutluğun sermaye akımlarının liberalleşme sürecinde oluşacak risklerden korunması ve başarılı bir şekilde süreci tamamlaması için politika serisi oluşturulması hedeflenmiştir. Bu değerlendirme ve geliştirilen politika serisi diğer ülkelerin deneyimlerinden yararlanılarak yapılmıştır. Bu çalışmada, Şili, Çek Cumhuriyeti, Macaristan, Kore ve Singapur ülke örnekleri dikkate alınmış.

Çalışmada, sermayenin serbest dolaşımından yararlanmak için yasal düzenlemelerle birlikte, bazı diğer ön koşul olarak tanımlanabilecek önemli politikaların dikkate alınması gerektiğini önerilmektedir. Bu politikalar, Ekonomik İstikrar, Finans

Sektörü, Muhasebe ve Denetim, Uygulama ve Bilgi Sistemleri, Döviz Kuru Rejimleri, Maliye Politikası, Rekabet Politikası, Yolsuzluk ve Yasadışı İşletmeler, Kayıt dışı Ekonomi ile ilgilidir. Bunun yanında çalışmada, sermayenin serbest dolaşımı sürecinin başarılı olması belirlenen politikalarını doğru zamanda uygulamaya konulmasına bağlı olduğunu da ayrıca tespit etmiştir.

Anahtar kelimeler: Sermayenin Serbest Dolaşımı, Yabancı Doğrudan Yatırım, Portföy yatırımları, Ödemeler Dengesi, Arnavutluk.

To my Parents

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TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

LIST OF ABBREVIATIONS

BOA	Bank of Albania
BOP	Balance of Payments
CAL	Capital Account Liberalization
EU	European Union
FDI	Foreign Direct Investment
FEMA	Foreign Exchange Management Act
FOB	Free on Board
GATS	General Agreement on Trade and Services
GDP	Gross Domestic Product
IDRA	Institute for Development Research and Alternatives
IMF	International Monetary Fund
NTB	Non-Tariff Barriers
OECD	Organization for Economic Co-operation and Development
SAA	Stabilization Association Agreement
SDR	Special Drawing Rights
US	United States
WTO	World Trade Organization

Chapter 1

INTRODUCTION

Most of the research done on capital account liberalization try to conclude whether this process brings prosperity and growth or it brings damaging effects on the country; other ones study and compare the effects of capital account liberalization between developing and developed countries. However, this study not only considers the pros and cons of capital liberalization, also focuses on how to protect a country which is going through this process.

Liberalizing the restrictions on capital movements in a weak economy creates serious disadvantages for the country. Initially, foreign investors would not be really attracted to invest their money in unstable economies or countries with high deficits, but even if they do invest in such countries; it is mostly for speculation purposes. Another probable scenario of foreign investors investing in problematic countries can be due to misinformation about the country. This is also not helpful for the hosting country because these investments can be quickly taken out all, once investors feel to be threatened by the economic shock. This situation can be a further down push to a weak economy. As such, the government of a country liberalizing its capital account should really be careful about the structure and functionality of the economy.

Albania is a developing country which is recently showing gradual progress and stability. Just a year ago this country was using protective restrictions on its capital account. This year such restrictions are almost relaxed due to the country's determinacy of being integrated with the rest of Europe and specifically joining European Union. The government of Albania is working on adopting a proper environment for foreign investors and on mitigating the risks followed by such a strategy. Slow progress of Albanian authorities was reported in by Commission of the European Communities (2009) in this regard. As such, the purpose of this thesis is to make a general assessment of Albania's current position regarding capital account liberalization; an analysis of Albania's current economic situation and lastly, construct a policy for Albania to follow in order to avoid the risks of liberalization while benefiting from it.

In order to achieve these objectives some primary and secondary data are collected from the Central Bank of Albania, regarding the main macroeconomic indicators and balance of payments of Albania. A comprehensive analysis is used based on the experiences of five countries which have already liberalized their capital account. Learning from their mistakes helped enrich the policy construction for Albania in this study.

This research can be beneficial to the government and also the Central Bank of Albania as they are responsible for this process. The consideration of this study will also be of great help to all those countries which are heading to a free capital movement. Of course, it is impossible to use one single framework for all countries as each country's conditions and economic situation should be taken into consideration before preparing the sequencing of capital liberalization. Yet, most of them tend to have similar steps while going through liberalization. Albania's experience will be helpful.

This research will be conducted in six chapters. Chapter one deals with the introduction of the research. Chapter two is the literature review. In this chapter, the concept, understanding and impacts of capital account liberalization are underlined. The process of liberalization is also further analyzed as a process in its own. Chapter three considers each country one by one in each section of it by ending with a general summary of their experiences. Chapter four analyzes Albania's economy and its balance of payment. An insight of each of the components of the balance of payment is given separately and displayed with graphs. Chapter five brings up the policy framework of capital account liberalization. Lastly, chapter six is the conclusion of this research.

Chapter 2

LITERATURE REVIEW

The concept, understanding and impacts of capital account liberalization are the scope of this chapter which starts with the evolution of this process and ends with its real impacts in the economy of a country.

This basic chapter of this research intends to give an insight into the liberalization process, capital account and capital flows in order to follow on with a wider perspective about capital account liberalization in the next chapters.

2.1 Evolvement of Capital Account Liberalization

The greatest economic development of the late twentieth century and most probably the one likely to extend to twenty-first century is the growth of financial transactions and international capital flows. There is sufficient evidence to believe that net flows to developing countries tripled from 1989 till 1997, and continued to rise modestly till it reached the peak in 2007, as shown in Figure1.

Capital flows have occurred before late eighties as well, such as the free movement of gold. This means that capital flows are not a recent event, but the speed of the last two decades' flows has drastically improved compared to any other period of time (Eichengreen and Mussa, 1998).

Capital movement started initially in developed countries with emerging markets, where their economies were highly improved due to this international movement. As such, developing countries followed this strategy later on by allowing capital inflows in their countries. Their capital flows reached high amounts of volume as well, but whether their economies enhanced or not is still questionable. Figure1 shows the drastic increase of two main components of capital account, Foreign Direct Investment and Portfolio Investment.[1]

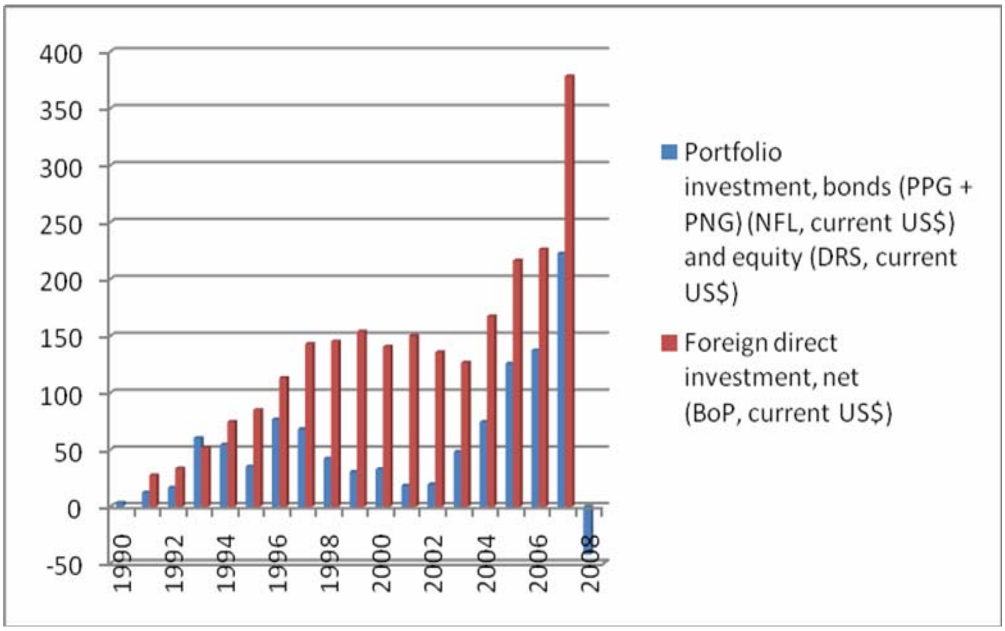

Figure 1: Capital Flows in Developing Countries (billions of US Dollars)
Source: World Development Indicators, 2008

There are many factors which have led to this massive flow. Most economists believe that main factors leading to great amounts of capital flows are as follows: the relaxation of controls and restrictions on capital account transactions like taxes, administrative restrictions and prohibitions either on transfer of funds or exchange rate, where such liberalization in many countries was due to the EU accession precondition; also, an enhancement of financial sector and overall economic stability

[1] Further explanations and definition of capital account and its components are given in section 2.2.1.

in years, such as, the creation of new risk-hedging financial instruments; the deregulation on most of the countries; privatization of many government-owned entities, which leads to new debt instruments or securities issued, and above all the improvement of technology (Eichengreen and Mussa, 1998). The latter factor has enhanced many other spheres of a society as going along with globalization, but the significant impact of technology in the financial sector has no comparison to any other sphere.

Technology enables investors to access information across borders at a high speed and very low cost. It allows financial analyst and specialists to evaluate and calculate asset prices; the continuous changes of stock prices on real-time basis; the correlation among securities' prices, standard deviation of returns and any other needed information to make the right decision and forecast.

2.2 The Concept behind Capital Account of Balance of Payment

According to the recent classification of IMF the traditional Capital Account section of balance of payments is now separated into two distinct accounts: "*Capital Account*", made up of transfers of financial assets and the acquisition and disposal of non produced/ nonfinancial assets including land, real estate or intangible assets; and "*Financial Account*", consisting of Foreign Direct Investment; Portfolio Investment; Other Asset Investment (Moffett, Stonehill and Eiteman, 2009).

Capital account helps in defining the allocation and distribution of capital assets of the domestic country and the rest of world. In cases where the capital account value of one nation is negative it implies that this country has experienced more of capital outflow than inflow and vice versa.

Capital flows are categorized into different sections under capital account traditional view, which are: foreign direct investment (FDI), portfolio investment and other investments.

As stated by OECD in the paper "OECD Benchmark Definition of Foreign Direct Investment", "Foreign direct investment reflects the objective of obtaining a lasting interest by a resident in one economy (''direct investor'') in an entity resident in an economy other than that of the investor (''direct investment enterprise''). The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise", OECD (1996).

Meanwhile, portfolio investments have no or less control of the firm where they have invested. It is usually a passive investment comprised of bonds and stocks which aims only to get a financial return. In the Balance of Payment Manual of the International Monetary Fund, the following transactions are included under portfolio investment category: "Portfolio investment covers transactions in equity securities and debt securities; the latter are sub-sectored into bonds and notes, money market instruments, and financial derivatives (such as options) when the derivatives generate financial claims and liabilities. Various new financial instruments are covered under appropriate instrument classifications."[2]

Such transactions are mostly preferred and attracted by foreign investors in countries which offer high interest rates, low tax rates and a stable exchange rate. As such, portfolio investments are usually in high volumes in developed countries.

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[2] Balance of Payment Manual, 5th Edition- International Monetary Fund (IMF)

Last category of capital account of each nation is “Other Investments”. Other investments are mainly comprised of bank lending (including here financial leases as well), trade credits and other accounts receivable and payable of the country.

2.3 The Tenets of Liberalization

Liberalization is an interrelated process with the last two decades’ merge of economies and cultures of different nations, in other words with globalization. It is the biggest player in the world’s transformation into the so-called *Globalized World* or *The Big Village*.

From the economic perspective liberalization is the process of relaxing the degree of constrains on different sectors of a country. Quite often, barriers faced in an economic activity are taxes, quotas, tariffs, administrative restrictions etc. Different strategies are used to reduce or enforce such constrains. The country who chooses to use a specific strategy in order to reduce its economic constrains with other countries is liberalizing and exposing itself to the world; it is welcoming globalization and profiting from its advantages.

Liberalization as a concept has always represented different things for different scholars. Hence it is difficult, if not out rightly impossible to provide a universally agreed-upon definition. Yet for the sake of streamlining this research, it is imperative to define liberalization. The idea which is most common among neo-liberalist scholars is that liberalization is the process of easing governmental restrictions in domestic economy, such as enabling market regulate itself. The process entails enabling for an economic atmosphere where local companies can compete in the global market and foreign companies are not deprived from competition in the domestic market of another country.

Liberalization, as a byproduct of neoliberals, calls for the liberalization and deregulation of economic transactions, not only within national boundaries but also—and more importantly across borders. It also pushes for the privatization of state owned enterprises and state-provided services. More so, it pushes for the use of market proxies in residual sector; and the treatment of public welfare spending as a cost of international production, rather than as a source of domestic demand (Jessop, 2002).

It is safe to argue that three pivotal factors are most necessary to enable for liberalization. The first is that the government reduces the barriers to free trade; which comes in the form of quota impositions and higher import taxes. Second factor is privatization of previously owned government enterprises. This is pivotal for liberalizing the economy because as private individual move to own most of the economic enterprises; the competition between the capital ventures become somehow balanced and even-handed. There cannot be liberalization if the government controls most of the economic enterprises because then, it is impossible to talk of the market regulating itself since the government enterprises would have undue advantage over their private owned counterparts. For this reason, privatization becomes an imperative factor in the process of liberalization.

Furthermore, FDIs are also a very important factor in liberalization process. Sometimes it is important to enforce the first two factors which are lifting trade barriers and privatization before enabling FDI's. Yet, a state has little possibility of attracting FDI's if the domestic economy is under strict state control or under unstable economic or political conditions. Either way, what is important to note here is that Foreign Direct Investments help the economy of the hosting country as much as the foreign investor to attain the gains of trade. The domestic economy gains from the foreign capital it receives and the employment opportunities which the FDI creates. Its citizens get to learn from working with foreign experts; hence, adapting modern rules and techniques to their business strategy. More so, the FDI experience introduces and integrates the domestic economy to the world where they could compete and enjoy the gains of trade.

2.4 Liberalizing the Capital Account

Being able to transfer excess capital savings in a given period of time among two or more countries with different investment opportunities while profiting from each others' competitive advantages, can be reached only by liberalizing each country's capital account.

"In its broadest form, capital account liberalization can be any decision by a country's government that allows capital to flow more freely in and (or) out of that country. Allowing domestic businesses to take out loans from foreign banks, allowing foreigners to purchase domestic debt instruments, and allowing foreigners to invest in the domestic stock market are three examples", Henry (2003).

It is the easing of restrictions on capital flows, which results in a forward step towards financial global integration accompanied with higher volume of capital inflows and outflows of the country (Kose and Prasad, 2004).

Capital account has been liberalized initially by industrial countries and later on followed by many developing countries. It is of significant concern and interest to further explore the fact that many developing countries chose to apply this strategy and to bear the risks that the strategy takes along.[3]

2.5 Why Moving Towards Liberalization?

The International Monetary Fund (IMF) has been encouraging capital account liberalization in many countries in the late eighties and on, as opposed to 1945 where IMF required its members to set controls on capital flows. Thereafter, it has supported those state authorities who have worked on a new control-free capital account, by carefully advising and giving technical help to them. Influenced by many international financial organizations, such as IMF, The World Bank, The US Treasury, etc, many emerging economies followed the trend of freeing and relaxing all kinds of controls.

The ideology of free movement of capital pioneered by Solow (1956) and followed by many studies such as Fischer, 2003; Obstfeld, 1998; Rogoff, 1999; Summers, 2000, was seen as a mean of new investments into the host country bringing higher productivity growth, better and more efficient allocation of sources, diversification of portfolio and risk, economic development, lower financial costs, better and more integrated standards of business and corporate governance, new technology and innovation, higher competition, etc (Henry, 2006).

In theory, the efficiency of capital allocation should result in a widespread benefit by providing higher return on people's savings in industrial countries, which have abundant capital and low rate of return on capital, and by economic improvement,

[3] Such risks are detailed in section 2.4.

higher employment rate and better standards of living in poor, middle-income level countries (Daianu and Vranceanu, 2002).

This ideology of the neoclassical world pushed emerging countries into the capital account liberalization (CAL) process, believing that the "invisible hand" will allocate sources in the best place where they can be best used, therefore creating more wealth to the economy. Attached to many advantages of liberalization, this also leads to a smoother income volatility of a country, by using foreign capital inflows in cases of economic downwards and outflows during economic upwards. Many studies have seen real evidence on these benefits coming as a result of CAL. Also, as the forces of globalization become more obvious, it is harder to keep an isolated country with capital controls. The country will end up being just futile and counterproductive.

Yet, there are open discussions and controversial arguments on whether to liberalize or not, how much to liberalize and how to do that, which never resulted at a same identical bottom line as the neoclassical viewers once believed.

2.6 The Real Impact of Capital Account Liberalization

The real world is far from the neoclassical world, far from perfect markets, perfect competition and perfect information. After the Mexican, Russian and Asian crisis during the previous decade and lastly global financial crisis in 2007, many studies started doubting whether to liberalize capital account (CA) at all. These contagious currency and financial crises after spreading their wings in some parts of the world, especially in those countries with low or middle income level, diminished the enthusiasm about CAL at high degrees.

Faced with many distortions such as: information asymmetry, monopolistic power, political influence and instability, corruption and bribes, informal economy and so on, developing countries might not succeed in getting the desired result from CAL. Depending on the strength of these distortions, institutional capacity and the ability of policymakers to avoid them, CAL might end up being an unfavorable policy mainly for such countries. According to Eichengreen, Rose and Wyplosz, 1995; Rossi, 1999, the economic integrity has now become to be seen as a factor of global financial instability (Wyplosz, 2001).

Other threats related to weak economies and capital liberalization are: A quick and massive capital inflow, which might find the hosting country unprepared and unable to absorb the inflow efficiently, causing problematic situation in the economy. An outflow liberalization combined with a fragile banking system allows the domestic savings to flow out at a massive degree leading to an economic shock of the country; as such short-term inflows will quickly adjust to this shock by causing another deepening of crisis to the hosting country (Kose and Prasad, 2004). Market concentration in best businesses/companies of the country will be a result of foreign investors' choices to profit higher. Foreign investors tend to choose best businesses and firms to place their money. This will lead to greater profits for them and also the business invested in, but unfortunately it will also lead to greater deterioration to other companies and consumers welfare. Weak economies and wrong strategies of CAL have usually destroyed the good impact that CAL is supposed to bring along.

Other controversial view related to studies done on CAL is that some studies, such as the one done by Edison et al. (2002), found positive relation between economic development and CAL in developing countries, while some other studies, such as the one done by Edwards (2001), states that CAL has brought negative effects on countries with low GDP, while highly improving developed countries (Arestis and Caner, 2009).

The pace, the timing and the speed of sequencing of CAL process has grabbed the attention of many studies related to CAL. The experiences, costly mistakes and lessons of those countries which fully liberalized their capital account can give a better clue to what should be done, when and how should be done. Coming up with the right policy is not easy as these experiences are so diverse with different implications and impacts on each country. As such, no specific universal guideline can be best fit for all countries. Each country's condition and characteristic should be carefully analyzed, in terms of macroeconomic, political factors and financial system adequacy, in order to come up with what best suits to it as a policy or strategy to follow. Different countries have been applying different policies and have chosen different lengths of time for the implementation of the process, but in a broad sense, it is noticeable that some factors or steps are mutual for all countries. Countries which liberalized their capital accounts while could skip the domino effect of financial crisis followed almost same macroeconomic policies and approach of managing the financial sector efficiently, but differed substantially regarding the timing and pace of liberalization. Meanwhile the ones that could not avoid the crisis had also some similar characteristics prior to liberalization, such as: financial system weakness, high current deficit, political instability, etc. The success undertaking of liberalization process should be seen as a contingent plan, where suppression of various barriers should be conditional upon fulfillment of various criteria (Daianu and Vranceanu 2002).

According to B. Eichengreen and M. Mussa (1998), among the problems that should be mostly feared when sequencing the CAL process, is the liberalization of capital controls before some major problems in the domestic financial system have been addressed. Such problems can be the inadequate accounting, auditing and disclosure practices and also inadequate or improper prudential supervision and regulation in the financial sector. If such threats are not eliminated on time, especially for countries with high degree of such problems, crisis will almost be inevitable.

Opening capital account received another push from OECD (Organization for Economic Co-operation and Development) especially for those countries who applied for OECD membership such as Czech Republic, Hungary, Poland and Slovak Republic. OECD helped such countries in formulating and suggesting a proper strategy to liberalize the capital account, such as Capital Movements Code, which came up to be very useful for them.

In the following chapter, five of those countries who experienced capital account liberalization in different ways under different conditions are considered. These countries are: Chile, Czech Republic, Hungary, Korea, and Singapore. Their experiences and mistakes are lessons for countries liberalizing their capital account such as Albania.

Chapter 3

EXPERIENCES AND LESSONS DRAWN FROM THE PAST

This chapter of this study will be concentrated on the previous capital account liberalizers which went through this process facing problems, difficulties, crisis and progresses as well. The way these countries with different history and economy adjusted and approached liberalization determines at a big degree the future of the economy of a country. There countries were specifically chosen to show their different experiences, nature and the way they handled it.

The following five sections consider each liberalizer individually in each sector. Countries considered in this study are: Chile, Czech Republic, Hungary, Korea and Singapore. Lastly, section six of this chapter summarizes these countries' experiences by drawing some conclusions and lessons obtained from each experience.

3.1 The Chilean Experience

If wanting to fully understand Chile's economic emancipation from a closed an inward-looking economy to one of the success stories of economic liberalization, we have to first of all have a grasp of its historic evolution.

From a historical perspective, after the Great Depression, Chile started a strategy of import substitution. This was influenced by certain reasons such as the negative price of nitrate and the economic ideas that were prevalent at the time. Developing economies or non industrialized economies (which Chile was part of) were basically using the import substitution model, instituting policies that provide backward linkages so as to diversify domestic production and make the economy self sufficient. This led the economy towards more inward oriented policies. “An active role was assigned to the government, which implemented industrial policies and created state owned enterprises. The manufacturing industry was protected with high tariffs, non-tariff barriers (NTBs), and multiple exchange rates. All these movements were implemented between 1940 and 1970; with a weak and failed attempt to reverse this trend between 1959 and 1961” (Chumacero and Fuentes, 2003, pp.2).

In the next few years, this strategy of inward policies was gaining even more power as the economy became more centralized and closed due to the new elected government. Furthermore, as a centralized economy where government plays the biggest role in the economy, government controls and barriers were present in almost every sector of the economy, including capital movement. More so, the government confiscated many private companies (Chumacero and Fuentes, 2003).

> “After the military coup of 1973, the economy moved from a highly intervened, to a market oriented economy. Among the most important changes, the economic policy focused on price liberalization, aggressive liberalization of trade and international capital flows, a reduction of the size of government, and privatization. Furthermore, Chile introduced pioneering reforms to the social security regime, financial market, and the health care system. One of the most profound reforms was the trade reform that eliminated all the NTBs and reduced tariffs to 10% across the board (except for automobiles)”, (Chumacero and Fuentes, 2003, pp.3).

In 1990, after the spread of democracy, most of the economic reforms went down, and some free trade agreements interacting and lower tariffs with neighbor countries took place during that period of time. In 2002 such agreements were extended to EU and US. However, the government maintained some restrictions such as: it increased value-added taxes, changed the corporate tax base, put reserve requirements for short-term capital flows in 1991 (Chumacero and Fuentes, 2003).

> "It is very important to point out that the opening up of trade and macroeconomic stability is not sufficient, if they do not go with solid economic institutions that reinforce the stability of incentives, the transparency of public decisions, and unless they cope with market imperfections -externalities, natural monopolies and problems of information- with market friendly criteria. In this sense, economic reforms in Chile show a successful decade of an autonomous Central Bank, a financial system highly capitalized, with a solid and prudential supervision and with regulatory agencies specialized and highly technical" (Rosales, 2003).

What can be argued to be pertinent to the liberalization success in Chile are basically the political will of the country's leadership and the professionalism of its bureaucratic machinery in putting all the liberalization schemes into force. More often it is usually believed that the reason why most developing countries fail to fully liberalize or integrate themselves properly into the global economy is due to the problem of corruption in their government. More so, the economic team in these countries lacks the required measurement of competence and transparency to push for these liberalization schemes. No foreign investor would want to invest in an environment of corruption thrives and kick-backs are the order of the day. Chile's success can be said to be influenced somehow by the fact that they properly insulated themselves from such unethical practices.

Another lesson that can be drawn from the Chilean example is the fact that heavy inflows of capital can be the start of many problems. As more inflows come into the hosting country, more of foreign currency comes in as well, by causing an appreciation in the domestic currency. This overvaluation would decrease exports as they will now be expensive for foreign investors, while imports tend to increase. With 1unit of the domestic currency, more imports can be bought than before. This can be translated into current deficit[4].

3.2 Czech Republic

Czech Republic, one of the countries who applied to be a member of both EU and EOCD, ended up being the most rapid and determined liberalizer. According to Blejer and Coricelli (1995), being a planned economy at a high degree is partly the reason of the country's authorities to hurry up the reforms. In 1993 Czechoslovakia was divided into two Republics, Czech and Slovak Republics. Pushed by the desire to join EU and OECD, Czech Republic started marching into the CAL process by firstly liberalizing existing controls on foreign credits on banks and then on firms and companies. Just like most of other countries, capital inflows were freed before outflows, as they feared the risk that massive outflows could cause financial risk to the country.

On October 1995 with the enactment of new Foreign Exchange Act, CAL process was almost over. "Almost over" because it was not a fully liberalized country as some restrictions were still there especially on the outflow side such as the issuance of debt and money market securities outside Czech Republic by residents and financial derivatives transactions. Besides, on the Foreign Exchange Act there was a clause under which the authorities could introduce deposit requirements on inflows if needed. Even though this clause was never activated it was still there.

[4]Paper Presented at the Alternatives to Neoliberalism Conference: sponsored by the New Rules for Global Finance Coalition, May 23-24, 2002. Retrieved on 13.07.2010

Without noticing the premature CAL process along with an inability of the banking system to properly intermediate capital flows, capital inflows became massive after the liberalization while monetary policy authorities were facing difficulty in keeping their fixed exchange rate regime unchanged. Short-term speculative financial credits flowed into the country aggressively where they found improper and unstructured financial market.

Sterilization and increases in reserve requirements were among the strategies that the authorities used to handle the situation and also some measures targeting short-term speculative inflows. Nothing changed the massive flow till 1996 where authorities started flexing the exchange rate regime into a broader band reaching up to ±7.5 percent and capital inflows had a sharp decrease. Furthermore, these sudden inflows caused the appreciation of the domestic currency. Foreign investors started pulling their investments out of Czech Republic. Capital inflows had their reversal in 1997. Authorities of the country faced with such a situation had to undertake serious macroeconomic policies. This followed a 10 percent decline of the currency and eventually ended up to fully shift from a pegged currency rate regime to a flexible one.

After undertaking such measures, the year of 1998 started looking much brighter for Czech Republic as it started healing and progressing fast. Though IMF initially encouraged Czech’s rapid CAL, it soon started recognizing the weak capacity of Czech Republic’s banking sector. IMF staff suggested the country’s authorities to regulate its banking sector before relaxing all controls and also to tighten fiscal policy, but IMF did not really do much about that. It simply remained an advice of IMF on air which cost a lot to Czechs.

3.3 Hungarian Case

Hungary’s CAL strategy was completely different from the one that Czech Republic followed. In contrast with it, Hungary is one of the slowest liberalizers. Considering its initial situation prior to capital liberalization, the country’s authorities chose to follow a very cautious liberalization.

During the transition period of 1990s, Hungary was faced with a situation where there were few foreign exchange reserves and high external debt, and also macroeconomic imbalances (Arvai, 2005). Three years later it applied to be a member of OECD just like Czech Republic, but it did not try to liberalize its capital account as much and fast as Czech Republic did. Till 1995, it liberalized its portfolio investment (as it had already eased FDI restrictions) and worked on its current account convertibility. By placing more importance on improving its macroeconomic factors and also the enactment of the new Foreign Exchange Act (January, 1996) helped the country to move forward with CAL process. The accession of OECD was again a major push factor toward this process. Yet, during these years of progress many restrictions were still there especially on short-term instruments to nonresidents and external lending, which became subject to speculative pressures.

Again inflows were liberalized before outflows and long-term before short-term flows. A significant move towards liberalization was the relaxing of restrictions on the issuance of medium to long-term securities to nonresidents. The authorities worked on more efficient macroeconomic system, until it managed to attract foreign investors towards Hungary by completely offsetting the consequences of outflows.

On May 1996, Hungary became part of OECD. Since then, its steps toward liberalization became the main policy of the authorities. On June 2001, Hungary was fully liberalized from all restrictions. To achieve full-liberalization it had to widen its exchange rate band up to ±15 percent. Keeping its initial band of ±2.25 percent would not help the situation of capital inflows where it requires foreign capital reserves. In order to keep the exchange rate within that narrow band, Central Bank of Hungary would have needed to buy the excess foreign exchange leading to domestic appreciation. As such, the widening of the band overcame this problem (Arvai, 2005).

"Hungary began banking reform from the late 1980s and allowed a significant presence of foreign banks from the beginning", Szakadat (1998). Such a fact diminished the effects of controls. Even though the slow removal of capital control was a proper strategy for Hungary in its condition, it came with a price. Such is Poland's case, with prolonged inefficient controls. Poland's case is very similar to Hungary's case as they had similar starting conditions and went through same steps cautiously.

3.4 Korea's Capital Account Liberalization

Korea's case about CAL reform is the case of a drastic liberalization of capital account. In the 1950s Korea was a poor country making a living on US assistance immediately after the Korean War. Few years later, faced with no US aid again, Korea had no choice but to seek a better way to develop the economy. As such, in 1960 the government chose "export-oriented" growth strategy by welcoming foreign capital, accompanied with its cheap labor. This seemed to be a wise strategy which helped Korea's situation (Wang, 2004).

Its foreign exchange regime was fixed, and its balance of payments was adopted according to current account, meaning that if current account was in deficit, then capital account had to make up for the deficit. The deficit of current account in the begging of 1980s was compensated by liberalizing capital inflows only, meanwhile restricting outflows. Domestic banks were encouraged to borrow from abroad.

Few years later, the recovery of the world's economy affected Korea as well. The increase in foreign exchange reserves was sharp and forced the authorities to undo the liberalization on capital inflows while freeing restrictions on outflows.

Following a gradual CAL, in 1990 Korea adopted a managed floating exchange rate regime. Once again, in 1990, the current account was reversed, along with an increase in inflation, drastic decrease in foreign reserves and Korean *won* appreciation. Capital inflow controls were freed, especially in 1991 by amending Foreign Exchange Management Act (FEMA) which pushed inflows harder. All needed measures were taken to incent and attract capital inflows. Direct investment ceilings were rising continuously and also portfolio investments reached their peak from the "Stock Market" opening in Korea. Korea's strong economic performance made it attractive to international investors. Further liberalization was completed by the new Foreign Exchange System Reform Plan and also by joining OECD in 1996 (Wang, 2004).

Short-term inflows, which were mainly comprised by borrowings of the banking sector, created a maturity mismatch as banks had been operating on long-term basis. This mismatch and the lack of bank supervision created problem for Korean economic situation in 1997, during the Asian crisis. Directed by IMF's program, Korea replied to this crisis by further liberalization and full floating of its currency regime. This sharp liberalization brought Korea to further advanced standards (Wang, 2004).

3.5 Singapore's Absolute Progress

"*A wonder created out of a tear drop*" Abeysinghe, (2007), this is how Abeysinghe described the progress of Singapore through years of time. Starting from scratch after it disconnected from Malaysian Federation, Singapore had to make its way up to a better standard of life. Right now, Singapore is one of the most developed countries with current account surplus, very stable currency, low inflation and low interest rate, absolutely great financial system and good institutions. Such an appealing economy is a target for foreign investors, enhancing the country's performance even further. Singapore has been ranked one of the best ten countries in the world in terms of competition, innovation and financial system.

The authorities of the country started liberalizing the country pretty much early compared to other countries by liberalizing the financial market so that it could profit from being a market oriented economy. In the early eighties when the capital account liberalization took place, a special policy was undertaken by the authorities of Singapore, "*The non-internationalization of the Singapore dollar*". On most of the financial instruments this policy was imposed, mainly because of hedging reasons from speculation and currency crisis. Non-internationalization of the currency does not mean any prevention in the international transaction, it just restricts the international use of the Singapore currency; meaning that investors must exchange the currency for abroad uses. This policy has also to do with the country's successful maintenance of its soft peg, which proved to be a great strategy likewise thought about it (Chari, 2005).

Capital controls in the economy of Singapore are almost inexistent despite two clauses. One is that: “Financial institutions are not allowed to extend Singapore dollar credit facilities in excess of S$ 5 million to nonresident financial entities, if have reason to believe that the proceeds may be used for speculation against the Singapore dollar” Chari, (2005); while the second restriction has to do with the domestic currency non-internationalization policy: “Investments, overseas loans (exceeding S$ 5 million), bond issuance by non-residents...etc, the Singapore dollar proceeds must be swapped or converted into foreign currency before used outside Singapore” (Chari, 2005).

Singapore is also developing its bond market quite well, but not with the same purpose of many other countries. Singapore is not doing so for government financing purposes. This country has already budget surpluses as mentioned above, thus other factors than that might have led to the development of bond market, which would exceed the scope of this study if going into detail. Singapore is definitely an attractive country for capital inflows, as its main economic indicators are far better than other countries’ indicators. Yet, its great financial performance and economic stability surpasses the cost of foreign investors in swapping the currency, and it still enhances these investments.

3.6 Brief Summary on Previous Liberalizers

Despite the initial condition of the country, there is only one point where all researchers and policy-makers come along, which is the right sequencing of opening capital account. Removing one of the strains or distortions to free allocation of resources from the combined network of many of them faced in the developing countries, would not necessarily bring the improved welfare; not unless other distortions are removed as well, Eichengreen (2001). As such the concept of "sequencing" has become more important to the state authorities and IMF, immediately after the experience of the Asian crisis. In July 1998, in one policy paper, the Executive Board stated: "The Asian country experiences confirm that it is necessary to approach CAL as an integral part of more comprehensive programs of economic reform, coordinated with appropriate macroeconomic and exchange rate policies, and including policies to strengthen financial markets and institutions. The question is not so much one of the capital liberalization having been too fast, since some of the countries in Asia have followed a very gradualist approach. Rather, it is more to do with the appropriate sequencing of the reforms and, more specifically, what supporting measures need to be taken" (IMF, 2005, pp.22).

Czech Republic is the case of an improper sequencing. Along with the quick removal of Czech Republics' capital inflows barriers, fiscal policy remained expansionary, currency regime was fixed and banking system was not efficient enough to properly channel all the financial transactions. According to OECD (1996 and 1998), the authorities started recognizing their weaknesses in the corporate governance sphere, banking system and the inefficiency of the privatized firms.

Also, another issue that might have affected the situation in this country is the IMF's role. IMF staff suggested the country's authorities to regulate its banking sector before relaxing all controls and also to tighten fiscal policy, but it did not really do much about that. It simply remained an advice of IMF on air. IMF also supported the pegged currency regime by underestimating the effects that this regime can have on inflows. Fearing appreciation of the currency by a floating regime ended up being a costly strategy for CAL to Czech Republic (IMF, 2005).

Some studies such as Nord (2003), argue that the slow removal of controls helped Hungary during the transition period. Authorities did not start the CAL process without working on the banking sector and supervision and some other measurements. Following some essential steps prior to capital control removal, helped the country's condition a lot considering its unsuitable starting situation with fiscal and external deficits, as it was a highly socialistic country. Being a strict socialistic country exposed the country to the 1994 crisis which was finally overcome by painful measurements by the authorities of the country.

On November, 2005, European Department published on an IMF working paper the major common CAL policy implications experienced by some transition countries that joined EU, such as Czech Republic, Hungary, Poland, Slovenia etc. Some of them are:

a. These countries tended to liberalize FDI before financial flows, as FDI were seen as stable investment, hence, less exposed to financial risks;
b. Inflows before outflows, and long-term flows before short-term flows; Short-term flows should be liberalized in a second stage after passing the two-year test period by maintaining parity with the Euro within a ±15percent fluctuation band, Busch and Hanschel, (2000). Higher volatility of short-term capital flows may expose the country to financial crisis;

c. “Slow” liberalizers, such as Hungary, Poland and Slovak Republic, received larger portfolio inflows than “Fast” liberalizers. This was mainly due to a long period of large interest differentials and more financial assets to invest in these countries.

d. Disinflation, the narrowing of the interest gap and the public debt determined the size of interest-rate-sensitive portfolio inflows;

e. The trade of government securities undertaken by non-residents significantly helped CAL;

f. Monetary and exchange rate policies were the stabilizing instruments of the massive risky inflows, while fiscal tightening was used just as a straight reply to inflows (Arvai, 2005).

European Union accession was a significant and final push factor in relaxing all controls as it is a must criterion to join EU. Most of transition countries took this step around 1995 and completed it by latest 2003. Candidate countries were not required to use a specific strategy or sequencing of CAL.

The lessons regarding Chile’s experience are these; the first is that too much capital, can also damage the economy, even if it is FDI. In East Asia (e.g., Korea), productive investment opportunities had to be wasted as there was overcapacity in such countries, and at the same time markets were not expanded. FDIs had to be diverted to shorter-term equities and treasury bills. Second, complementary policies have to be put in place for crisis prevention, such as by using selective capital controls. Another strategy of Chile to attract long term investment was to use short term reserve requirement for inflows.

“In the Chilean example, the currency still appreciated despite the control on inflow. The Chilean government had to depreciate the currency (through a crawling peg) to supplement the control on short-term capital flows. To be sure, the Chilean currency would have been much stronger if not for the control.”[5]

From Korea’s experience it is worth pointing out its successful survive from the Asian crisis but also it is likewise worthy to mention the deficiency in banking sector supervision. The Korean government should have focused more on banks supervision since its highest percentage of capital inflow was due to bank’s borrowings. A better supervision which contributes to bank’s risk management procedures would have avoided the maturity mismatch problem. Without a prudential strong supervision on domestic financial institutions, CAL can be more harmful than helpful.

Singapore’s experience implies an excellent experience which there is so much to be learnt from a well-developed banking system and equities market. The policy used by the government authorities to protect the country from financial instabilities, currency crisis or speculative attacks and at the same time leaving an amount of sufficient liquidity in the financial sector, and budget surpluses, came out to be a great strategy for this country in the world’s top ten.

[5] Paper Presented at the Alternatives to Neo-liberalism Conference: sponsored by the New Rules for Global Finance Coalition, May 23-24, 2002. Retrieved on 13.07.2010

Chapter 4

ALBANIAN ECONOMY IN THE CONTEXT OF GLOBALIZATION

Albania is progressing and is still standing strong despite the global financial crisis which has spread the negative effects all around the world. Since the start of the crisis, Albania still has had the capacity to attract investments by gaining the trust of foreign investors, as it will be shown in Figure 3. Also, according to Global Competitiveness Index, Albania has improved its situation by getting the 96th place, from 108th.

This chapter will analyze Albania's economy by firstly considering its main development indicators from year 2002 till year 2009, its progress and weaknesses in these years; and also the study will follow by focusing on the Balance of Payment of Albania during the last five years.

4.1 Albanian's Economic Path from 1990 To 2010

Just one decade ago, Albania was one of those countries where all current and capital transactions were fully controlled by the government. It was a centrally-planned economy. The collapse of dictatorship regime in 1990 had a great significance on Albania's economy.

Albania's poor condition after 1990s, with a shortage of electricity power, water supply, old technology, transportation, poor communication sector, etc, prevented the economy from growing and also did not help the financial and capital sector to expand and attract foreign investors. Moreover, Albania's political instability, informal economy, corruption and lack of laws' consideration and application kept FDI away compared to its neighbor countries. Being an agricultural based economy, this sector has also been affected by these poor indicators and most of the sector is held and managed by small families. Employment of Albania is highly relied on agriculture; almost half of the work force of Albania is employed in this sector. The income generated from agriculture is poor considering the capacity and geographical nature of Albania.[6]

In the 4th Conference of Bank of Albania "*The Albanian Economy performance and policy challenges*" (2004), it is claimed that Albania's economy has had a continuous recent improvement, though it still needs a lot more to do. Macroeconomic growth rate from 2004-2008 has been more or less at a rate of six percent, despite the decline in 2009 due to the global financial crisis it is still progressing well. Inflation varies slightly at low rates, around three percent, while the GDP in 2009 is around $ 12 billion.

Annual remittances from abroad are up to fifteen percent of GDP, which is a high rate considering Albanian's small population and shows that the economy is very dependent on remittances. They are mostly concentrated in two neighboring states of Europe, Italy and Greece. These remittances affect the Balance of Payment (BOP) of Albania as they help to neutralize the current deficit.[7]

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[6] Albania Economy 2010", *CIA* world Fact-book and Other Sources (2010)
[7] Albania Economy 2010", *CIA* world Fact-book and Other Sources (2010)

The informal economy in Albania accounts for a big part of GDP which accounts from around 30 percent to 50 percent of GDP. The income generated by such economy, also called as “gray” economy, or “black market exchange”, is usually not recorded in the measurement of GDP, and skipped from taxation as well. Informal economy has a big impact on Albania’s performance as the country’s performance measurements are misleading; suggestions, policy efforts and recommendations become not useful most of the times and also it creates a dysfunction in the banking sector. But there is also a bright point of view regarding informal economy claimed and accepted by the government, trade unions and employers, it contributes to employment and production. Despite this, it is also recognized that substantial loss occurred due to the forgone tax revenue (tax evasion), lack of employee protection and unfair competition among enterprises as corruption and bribes becomes an intermediate of the business environment. Under the informal economy impact, Albania’s capital controls lose their role and effectiveness (OECD, 2004).

Banking sector is another sector of the Albanian economy which requires a substantial concern as it is lacking behind compared to European standards and it plays a key role in CAL. It is argued by Spindler (2004, pp.9-14) that “A “culture of banking” does not currently exist, and many citizens keep savings under their mattresses rather than in banks”. This is unfortunate for Albania especially when preparing itself to be exposed to big amounts of international financial transactions that need strong financial institutions to intermediate and support such transactions. However in recent years, Albania has shown some progress and improved its position regarding banking sector (Cani and Shtylla, 2004).

The global crisis is reflected in Albania in terms of lower economic growth rates during 2009. Data on the domestic aggregate demand shows the slowdown of private consumption; along with declining investments have been the major contributor to lower GDP growth rate in 2009.

Expansionary fiscal policy introduced by the government supported the economy to generate positive growth rates although lower rates occurred than previous years. The downturn of the demand and economic activities of the country brought to slight increase in the unemployment rate. These have resulted in the negative expansion of output gap, exerting downward pressure on inflation till 2008. However, the economy of Albania is having a positive growth rate in 2009, while having a decrease in GDP per capita (US$). This fact is a result of US dollar appreciation against Albanian Lek. As such, the amount of GDP per capita in terms of US dollar will shrink.

The table below shows the main economic development indicators from 2002 to 2009.

Table 1: Macroeconomic Indicators of Albania

	2002	2003	2004	2005	2006	2007	2008	2009
Real GDP Growth (%)	4.2	5.8	5.7	5.7	5.4	6.0	7.8	4.9
GDP (current Lek, millions)	622,711.0	694,098.0	750,785.0	814,797.0	882,209.0	966,651.0	1,087,867.0	1,143,373.0
GDP (current US$, millions)	44,448.0	5,694.0	7,303.4	8,156.1	8,993.0	10,693.0	12,966.2	12,035.5
GDP per capita (current 2000 US$)	1,437.0	1,831.0	2,336.0	2,597.0	2,854.0	3,394.0	4,073.0	3,765.0
Number of empyees (thousands)	920.0	926.0	931.0	932.0	935.0	966.0	974.0	972.0
Unemployment rate	15.8	15.0	14.4	14.2	13.9	13.5	13.2	12.8
Inflation rate	1.7	3.3	2.2	2.0	2.5	3.1	2.2	3.5
Budget Deficit (as a % of GDP)	-6.1	-4.9	-5.1	-3.5	-3.3	-3.5	-5.5	-7.0
Public Debt (as a % of GDP)	62.9	58.9	56.5	57.4	56.1	53.5	54.8	59.5
External Debt (as a % of GDP)	21.0	18.4	17.2	17.3	16.5	15.2	17.9	23.1
Current Account (excluding transfers, as a % of GDP)	-10.3	-9.0	-6.8	-10.0	-7.3	-11.4	-15.8	-15.6
Exchange Rate, Lek/ US$	140.1	121.9	102.8	99.9	98.1	90.4	83.9	95.0
Exchange Rate, Lek/ Euro	132.4	137.5	127.6	124.2	123.1	123.6	122.8	132.1

Source: Annual Report 2009, Central Bank of Albania.

4.2 Balance of Payments of Albania

Balance of Payment (BOP) of Albania, which is the measurement of all international economic transactions between Albania and other countries, shows the performance of Albania's economic activity per year. A sound BOP is an incentive for foreign investors to increase their investments in Albania as they can percept this a signal to a potential promising market. Moreover, government and domestic businesses are concerned about the net result of this cash flow statement as it affects and is affected by other macroeconomic indicators of Albania such as GDP, foreign exchange rate, interest rate, inflation, etc (Moffett, Stonehill and Eiteman, 2009).

According to IMF, Balance of Payment is categorized in five sections which are as follows: Current Account; Capital Account; Financial Account; Net Errors and Omissions; Reserves and Related Items. The first three accounts comprise the Basic Balance. This balance including Net Errors and Omissions comprise the Overall Balance (Moffett, Stonehill and Eiteman, 2009). Table 2 shows the balance of payment of Albania in Euro currency with a format defined by IMF from 2005 till 2009.

Table 2: Balance of Payments of Albania (millions of Euro)

	2005	2006	2007	2008	2009
Current Account	(589.1)	(471.0)	(831.0)	(1,370.3)	(1,345.5)
Merchandise: Exports, fob	530.2	630.6	786.3	917.5	750.7
Merchandise: Imports, fob	(2,006.9)	(2,289.6)	(2,890.4)	(3,348.9)	(3,054.4)
Trade Balance	(1,476.7)	(1,658.9)	(2,104.0)	(2,431.5)	(2,303.7)
Services: Credit	967.3	1,156.6	1,415.2	1,687.8	1,718.5
Services: Debit	(1,107.7)	(1,188.1)	(1,402.3)	(1,618.3)	(1,597.5)
Income: Credit	168.2	263.2	278.6	321.4	270.0
Income: Debit	(37.0)	(54.4)	(61.3)	(266.5)	(370.6)
Private Unrequired Transfers	835.5	968.1	982.8	905.4	910.8
Official unrequired Trans., nie	61.4	42.5	60.1	31.4	27.1
Capital Account	99.2	143.4	90.1	78.2	84.9
Financial Account	351.8	415.0	758.3	1,502.7	956.6
Direct Investment	209.3	250.3	470.1	620.0	680.3
Portofolio Investment	(2.0)	27.2	18.5	(44.5)	14.2
Other Investment	135.1	131.8	264.2	932.4	269.5
Net Errors and Omissions	262.9	119.2	131.2	(18.7)	272.0
Overall balance	124.8	206.6	148.6	191.9	(32.0)
Reserve and Related Items					
Reserve Assets	(124.8)	(206.6)	(148.6)	(191.9)	32.0
Use of Fund Credit and Loans	9.4	5.8	5.5	(5.2)	(7.4)
Memorandum Items					
Total Change in Reserve Assets	(47.4)	159.2	99.0	218.4	(33.1)
of which: Revaluation	(77.4)	(47.9)	(49.5)	26.5	(1.1)

Source: Bank of Albania, 2009

4.2.1 Current Account of Albania

The standard classifications under this account are as follows:

1- Goods Trade Balance

2- Service Trade Balance

3- Net Income

4- Current Transfers

"Goods Trade Balance" is the difference of the cash outflow as a result of imports and cash inflow due to exports. Albania as a small economy with a limited capacity of production has a negative "Goods Trade Balance" by almost 2,303.7million Euro in 2009, an amount which has been increasing compared to one year ago as shown in Table 2. This is mainly due to the global crisis which has cut back the consumption and production. Figure 1 shows the relationship between imports and exports.

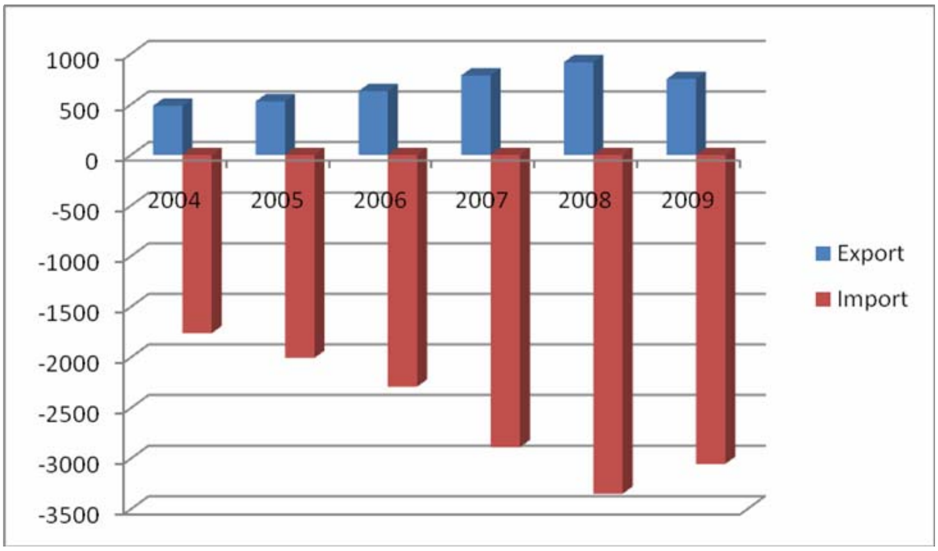

Figure 2: The Relationship between Imports and Exports of Albania (millions of Euro)
Source: Bank of Albania, 2009

"Service Trade Balance" is a net inflow for the country. Yet, the amount is absolutely small and far from offsetting the big deficit on tradable goods. Transportation services comprise the highest percentage of this sector. According to the Statistical Department of Central Bank Of Albania (BOA), 81 percent of the income generated from Service Trade Balance comes from transportation.

The imports and exports together show the level of openness of the country, as a percentage of GDP. The figure below shows the trend of openness in Albania form year 2000 to year 2009. The trend shows that the exposure of Albanian current transactions have been increasing by time, despite the last year which reflects the global crisis as imports and exports have gone down. Compared to other countries of the region, Albanian's degree of openness is relatively low.

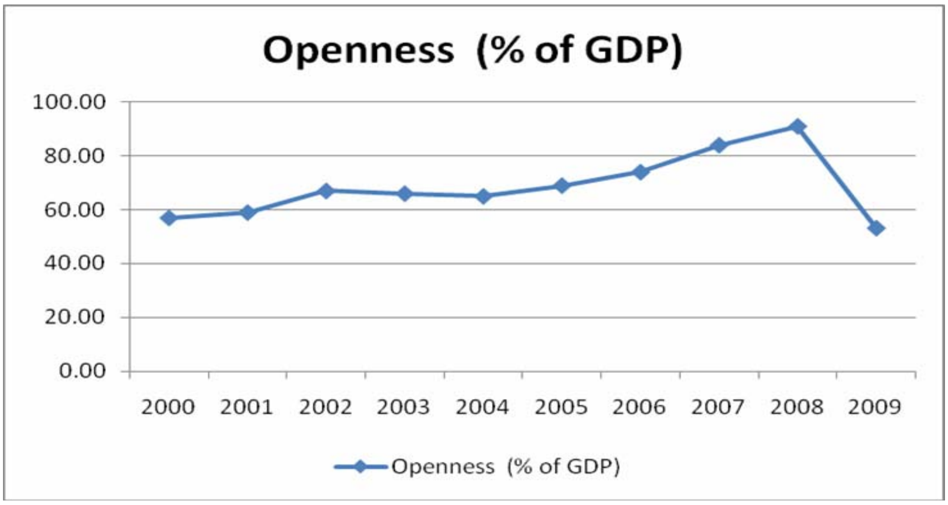

Figure 3: The Openness of Albania
Source: Bank of Albania and World Development Indicators, 2009

The third component of the current account is the proportion of the income which goes back in the form of dividend to the parent company from a previously set investment. This figure has been steadily increasing in Albania till two years ago where global crisis is somehow reflected in a slower growth rate. In 2009 this net value has become negative.

Last component of this first section of the BOP is "Net Current Transfers", which contains mostly the transfer of money in the form of remittances send to Albania. Many families in Albania, especially in the rural area, base their living only in such income, which accounted for almost 12 percent of the GDP of Albania till 2008. Last two years such remittances have decreased, they are now roughly 10 percent of the GDP. Though there is a large amount of inflow which makes up for a big part of the good deficit, it does not offset it and it leaves a negative current account. The values of all the components of the current account are shown in Figure 4.

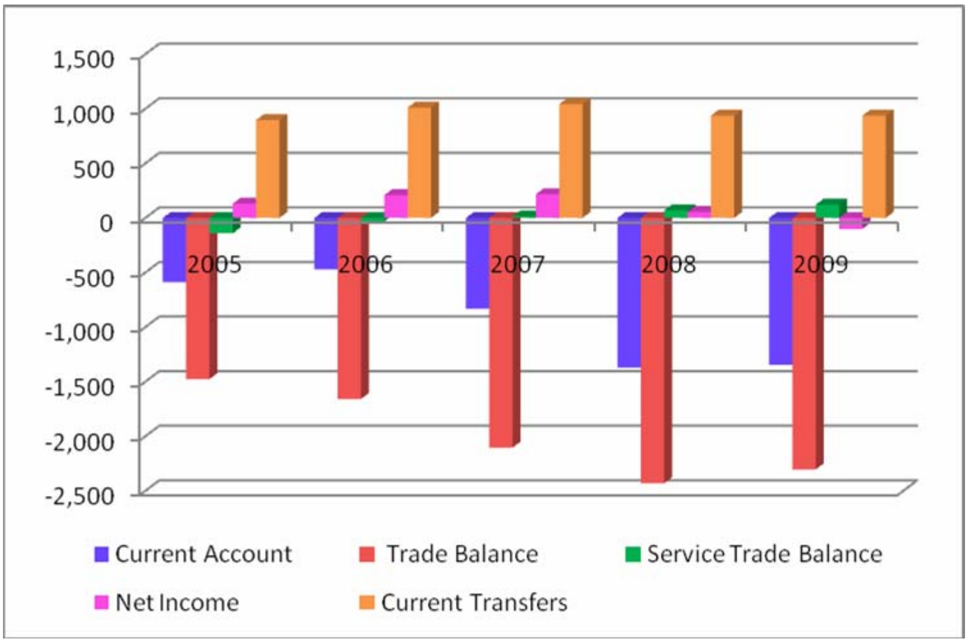

Figure 4: Current Account of Albania (millions of Euro)
Source: Bank of Albania, 2009

4.2.2 Capital and Financial Account of Albania

"Capital transactions – shall imply transactions concluded between residents and non-residents, with the purpose the transfer of capitals which are registered in the capital and financial account of the balance of payments."[8]

Capital account of Albania had registered an additional amount of 6.7million Euro in 2009 compared to the capital amount in 2008. Most of such capital transfers take the form of Capital Grants. Such gains in the form of capital account have made up 57 percent of the deficit in current account (BOA, 2009).

[8]Regulation No.70, "On Foreign Exchange Activity", (2009) Bank of Albania.

According to Regulation No.70, "On Foreign Exchange Activity", "Direct Investments" – shall comprise all types of investments in the Republic of Albania and abroad by residents and non-residents to establish and maintain permanent economic relationships.

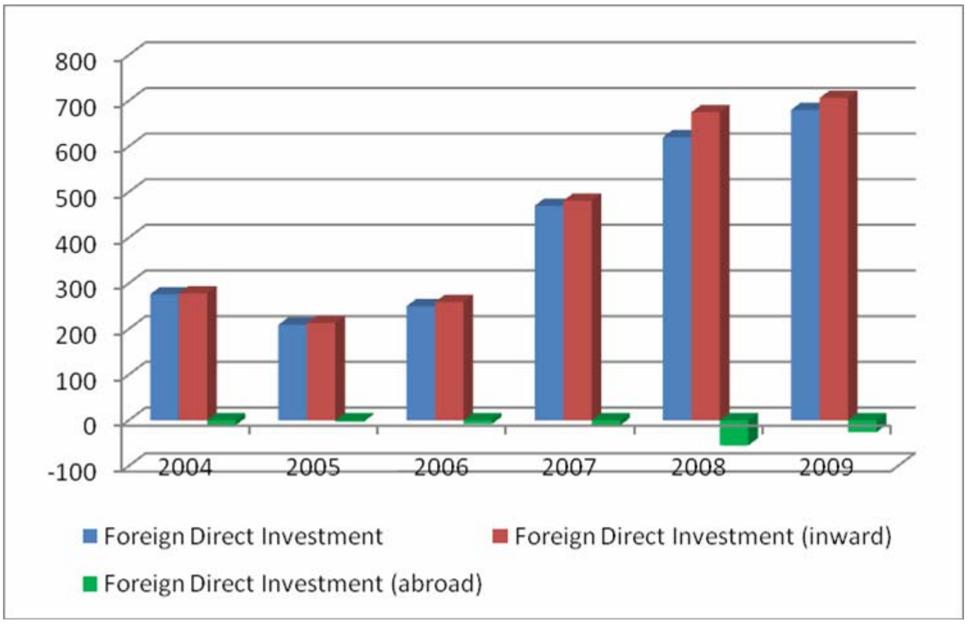

Figure 5: Foreign Direct Investment (millions of Euro)
Source: Bank of Albania, 2009

For the above mentioned weaknesses of Albania's economy and also lack of a well-developed information system and lack of technology, Albania has not experienced a large influx of foreign direct investments, meaning that it is not an attractive country to foreign investors yet enough compared to other countries close to Albania; even though these investments have been at a sharp increasing trend in the last two years as shown in the above chart of FDI. This increase is due to the changes done and reforms taken so far in liberalizing the restrictions on the welcoming of the foreign capital which will be explained further in the coming chapter.

Starting from 2005 FDI have been heading to a steady rise, though comprising only 7.8 percent of Albania's GDP, in 2009, which it is still a modest amount compared to countries in the region such as Croatia, Macedonia, Bulgaria, Romania, etc, as shown in the Figure below, for the year 2009.

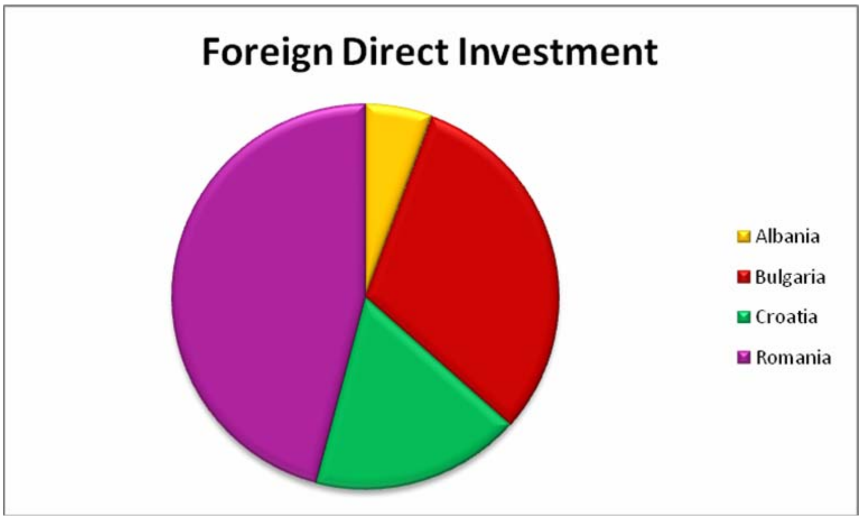

Figure 6: The Spread of FDI among Albania, Bulgaria, Croatia and Romania in 2009
Source: Bank of Albania and World Development Indicators, 2009

This low percentage is also as a result of large mistakes and omissions in record keeping of FDI in BOP of Albania. This means that FDI or any other cash inflow might be larger in number than what is shown in the BOP (Cani and Shtylla, 2004).

While inflows are free of any restriction in Albania except the purchase of Albanian land by non-residents, FDI outflows have had restrictions till late 2009 but the removal of them is yet to be implemented as will see in the following chapter. This and other factors have led that FDI outflows comprise only a very small percentage of GDP as shown in Figure 5. They are not up to 1 percent of Albania's GDP.

Portfolio Investments have been somehow not constant, as they tend to shift according to investors' sentiment. Portfolio investment is not a really developed strategy of investment for Albanians, and it is usually at very modest amounts. In 2008, due to global crisis and the increase in government expenditures, government has made some borrowings in the form of portfolio securities.

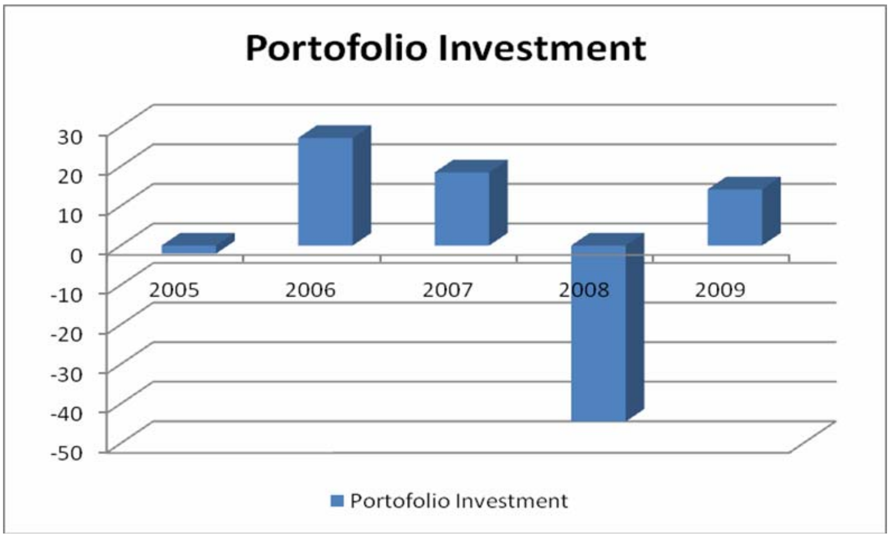

Figure 7: Portfolio Investments (millions of Euro)
Source: Bank of Albania, 2009

Figure 7 shows an outflow of such investments of 44.5 million Euro in 2008. While in 2009, this amount is partially reversed. 14.2 million Euro has entered into Albania as such investment, which shows the economic progress of the country and the trust of foreign investors in Albania. Yet, portfolio investment remains at very low values compared to other investments. The culture of such investment and also the reliance on such investments is really low in this country. Financial institutions which play the biggest role on such transactions were much undeveloped up to recent years.

Other Investment is the third and last component of Financial Account. This part is composed of Letter of Credit, payments for trade, such as accounts receivables and payables depending whether the transaction is an export or import on credit. Figure 8 gives a clear trend of these investments.

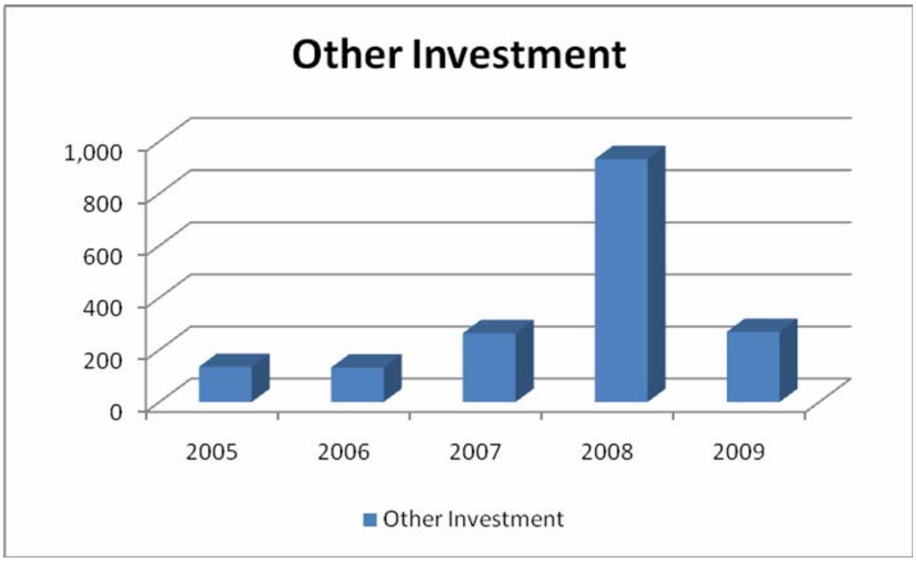

Figure 8: Other Investment (millions of Euro)
Source: Bank of Albania, 2009

Going back at Figure 3 “Current Account of Albania”, one can make an observation of the Trade Balance trend, which goes almost along with Other Investment’s trend but in different directions. This shows that in 2008, most of the investments were done based on trade credits, while other years cash has been the main medium of exchange.

Figure 9 puts together all the components of the Financial Account, to clearly see their importance on this account. FDI is the main component of this account which affects it most, while second role takes Other Investments followed by the last and smallest component of it, Portfolio Investment.

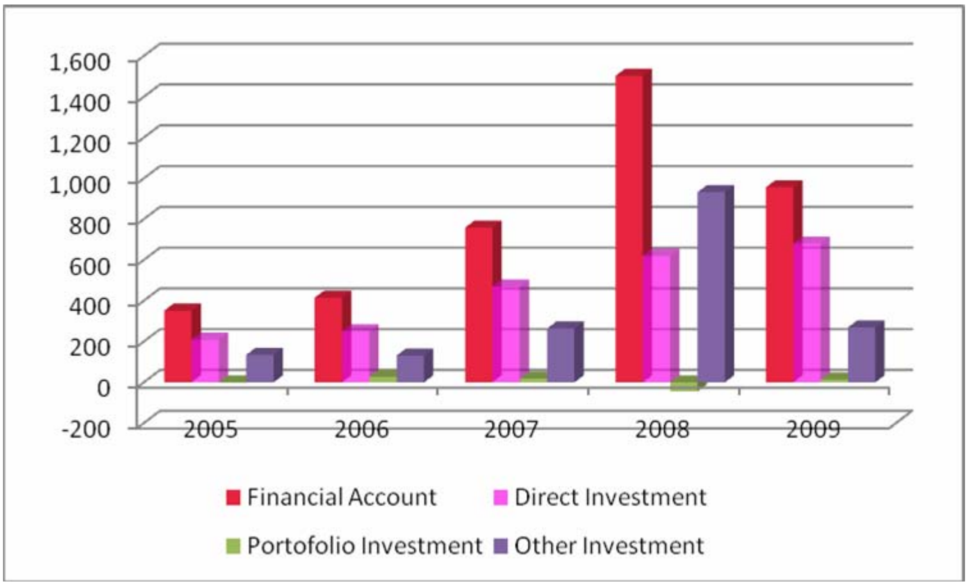

Figure 9: Financial Account in Albania and its Components (millions of Euro)
Source: Bank of Albania, 2009

The next figure shows the relationship between Capital and Financial Account at one hand with Current Account from the other hand. During these five years Capital and Financial Account has offset quite a big amount of the deficit in the Current Account. It is only in year 2007 and 2008 that current account has been offset by these two accounts, while in 2009 the difference has been by 300 million Euro deficit.

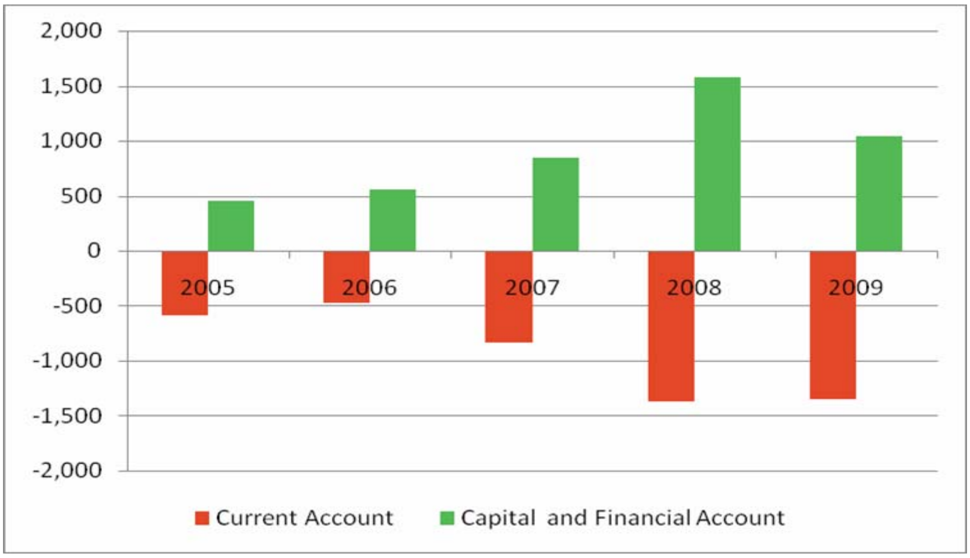

Figure 10: Capital and Financial Account versus Current Account in Albania (millions of Euro)
Source: Bank of Albania, 2009

4.2.3 Net Errors and Omissions

Current, financial and capital account entries are recorded independently of one another, not together as double-entry book keeping would prescribe. Usually, there are serious discrepancies between debits and credits due to such record keeping, (Moffett, Stonehill and Eiteman, 2009).

Thus, "Net Errors and Omissions" account for such discrepancies. According to the data of IMF statistics, these records are very high due to illegal activities in Albania which are not registered. These high values show how much cash inflow and outflow have not been registered under the appropriate accounts. As mentioned above, FDI is a sample of large unrecorded amounts of investment into the BOP. According to some studies and data, the unrecorded amount of capital inflow and especially FDI can be larger than the one shown in the BOP (Cani and Shtylla, 2004). Figure 10 shows the trend of such errors in the last five years.

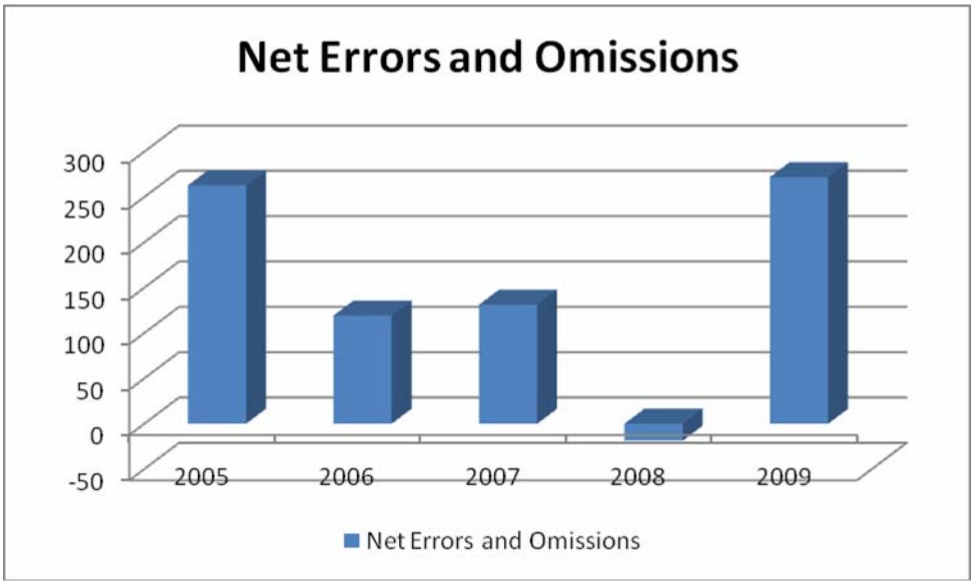

Figure 11: Net Errors and Omissions in Albania (millions of Euro)
Source: Bank of Albania, 2009

A quick comparison done between these values and those of capital account, shows that net errors and omissions are in some years higher. This indicates that such errors are due to the high degree of informality in the economy of Albania and also deficiency in the bookkeeping.

4.2.4 Reserve Assets

Reserves are the accumulated amount of international reserves coming as a result of current or capital transactions. A change in reserves is the increase or decrease of the foreign currency assets, SDRs or monetary gold of the country. Net in reserves refers to the holdings of these reserves minus reserves that have been borrowed from the IMF and other governments. Reserves make up for the amount of the overall balance in order to have a zero BOP.

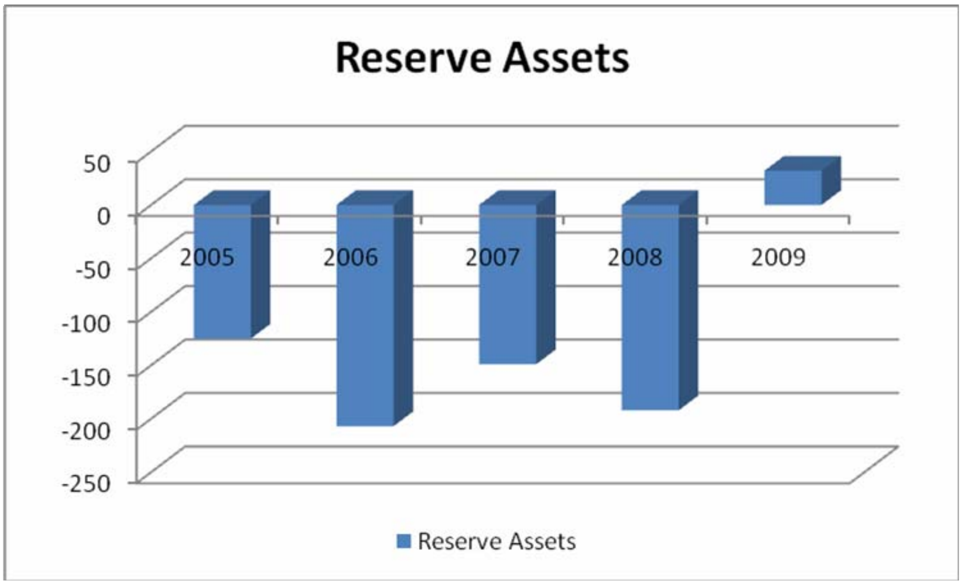

Figure 12: Reserve Assets (millions of Euro)
Source: Bank of Albania, 2009

These values are negative as the summation of Capital, Financial Account and Net Errors and omissions is higher than the deficit in Current Account for year 2005 to 2008. As such the surplus of the overall balance will be deposited in Reserves, which means it is a good situation for the country. Meanwhile, in 2009 the overall balance is negative due to many reasons such as the deepening of the current deficit due to the crisis and also the big amount of net errors and omissions. As such Reserve Assets are positive by 32 million Euros which makes up for the deficit in the overall balance.

In general, the BOP of Albania has shown that its activities with the rest of the world as not so much. This indicates that there exists a great potential for Albanian economy to explore more international activities. This can only be done if right policies are developed and put into action in the right sequence.

Chapter 5

CAPITAL ACCOUNT LIBERALIZATION: THE CASE OF ALBANIA

This chapter aims to make an assessment on the CAL of Albania. The research has found that the government of Albania has taken certain initiatives for CAL but still has a long way to go before CAL is complete. In this regard, first thesis will study the ongoing process and make an assessment regarding CAL by benefiting from the other countries' experiences. Afterwards, the study will try to draw a framework for an effective CAL process with the needed policies for Albania to follow.

5.1 Albania towards Capital Liberalization

After 1990s, serious efforts were taken to release the chains of the past regime and to integrate the country with the rest of the world; such efforts are still going on in Albania in order to join EU. This integration was what the communist regime had been preventing for 50 years. The only way to be a market oriented country is by having free interaction with other countries without any restrictions or controls imposed either on capital flows or on product flows. It is not an easy task to accomplish considering that it has been an isolated country for almost half a century.

The decision to liberalize the capital account is a result of many advantages this process offers. In the previous chapters some of those advantages are pointed out, such as, economic growth, investment diversification, reduction of the informal economy of Albania which is pretty much high and affects the capital controls effectiveness; and also another main factor affecting such decision is the fulfillment of the EU and World Trade Organization conditions (Cani and Shtylla, 2004).

As such, in 1993 under Law No.7764 "*For Foreign Investments*", Albania started initially liberalizing most of the controls and restrictions put on its capital inflows as the country suffered lack of capital investments. Meanwhile, the capital outflows were under full control by maintaining authority from the Central Bank of Albania. Capital flow issues are mainly under the responsibility of the Supervisory Council of the Central Bank of Albania, by the Law "*On Foreign Exchange Activities*" issued on November 1993. Authority was given basically to Central Bank of Albania while collaborating with other financial institutions when taking decisions regarding the amendments of regulatory "*On Foreign Exchange Activities*". One can make the argument that the reason why outflows were kept under control, quantized restrictions, full authorization of the National Bank, etc, are essentially because the country was not economically and politically strong enough to start having outflows. If done otherwise, it can be argued that at such a premature stage of the economy, a financial crisis would have been almost unavoidable.

Controls imposed on outflows which can also take the form of authorization from an institution, can protect a weak economy from crisis in many ways. This is already tested during Asian crisis, where short-term foreign currency debt was accumulated much more than other types of debt. The crisis started spreading from one country into another due to capital liberalization. In that case controls would not have allowed the pulling back of foreign investments, by not letting the reserves of the country to go down and also protecting the value of the domestic currency from depreciation. Furthermore, in an economy with inefficient financial system which is about to be exposed to the world competitors, control would be more of help than hurt at least until these problems are settled, such as the case of Czech Republic and South Korea.

Despite their protective role, controls should be removed when they become ineffective as it is the case for Albania. There is sufficient evidence to believe that cash outflows were much higher than what was recorded, and this is due to the high informal economy of Albania (Cani and Shtylla 2004). This shows that economic conditions and business climate in Albania were not good and attractive for domestic investors. Thus, even though there were many restrictions on outflows, investors found a way to move their capital out of Albania.

After making some agreements with EU Community such as "*Stabilization and Association Agreement*" which was a forward step or promise to undertake all it takes to join EU, Albania had to think and prepare itself to fully liberalize its capital account. As such, this decision is already taken by Albanian authorities and many serious initiatives are taken towards it. The government of Albania after liberalizing all restrictions on inflows, despite the purchase of land from non-residents which will be removed by the end of this year, lowered the quantized restriction on outflows gradually till it completely eliminated it in September 2009, followed by the removal of Ministry of Finance authorization.

Right now, left on concern is the actualization of this liberalization and the right ways to implement it. In consideration to this issue, probable questions to be asked are: Will steps taken so far towards liberalization help the situation of Albania or will it provoke a possible crisis? What can be done to protect Albania from a possible crisis? Is Albanian economy (based on the study done on chapter 4) ready for such openness?

In order for this liberalization to give the desired results, it is of great importance to point out the proper prior conditions to be taken and the order of them so that CAL would not be damaging for the future of Albania.

For the sake of answering such complex questions, it is important to remember that liberalization should never be seen as a one way street, because on the one hand; when it guarantees access to foreign companies to invest in the domestic economy, it may suffer from certain backlash (which may be that the foreign companies may turn out to dominate domestic companies, these domestic companies might stagnate, regress or completely drive them out of business). Moreover, liberalization once ingrained into an economic system, can be like a storm that sweeps right through all the corners of the economy. The lifting of all capital restrictions will likely guarantee a surge of foreign investments but this surge may not translate into an economic boom as experts are likely to predict. If there is capital repatriation to the host country of the foreign company, it means that the domestic economy is rather getting hurt than replenished.

However, Albania will stand to benefit in some reasonable way through liberalization. When the economy is completely open, FDI flow into the economy, creating employment boost and a possibly raising per capita income of the population. Albanian citizens who are employed in the foreign firms will gain expertise from the technical "*know how*" of the foreign firms and make the domestic economy more dynamic as well as improving the business orientation of the employees. However, to achieve such benefits from CAL there are some preconditions Albania will have to fulfill and compute as section 5.3 will detail.

Whether Albania's economy is ready for such openness or not, it is difficult to argue with certainty. This study's analysis shows that Albania should take further steps in order to enjoy the fruits of CAL. Otherwise, the impact of informal economy or government deficit, after the full openness, would be risky.

Time has shown evidence on quite a large number of countries experiencing both economic benefits and financial crisis due to such liberalization. The five country experiences analyzed in chapter three very well indicate the importance of the right ordering and timing of liberalization. In order for Albania or any other country to approach liberalization should consider some specific steps and have a healthy economy. Otherwise, expected benefits turn out a crisis.

5.2 Some Laws and Regulations on Capital Account Liberalization in Albania

Starting from 2003-2004 many laws and regulations have started shaping accordingly to a liberalized system regarding the movement of capital. Clause 61 and clause 62 in the "*Stabilization and Association Agreement*" (SAA), Council of the European Union, (2006), between Albania and other countries of EU Community, claim free movement of capital related to direct investment and the liquidation or repatriation of these investment and any profit derived from them, by encouraging and approximating Albania's policy to that of EU, must be ensured as soon as this agreement enters into force. Parties shall also ensure the free movement of capital to loans related to commercial transactions or services and financial loans and credits with maturity longer than one year (SAA, 2006). Albania's steps are similar to other countries' steps, by firstly liberalizing long term securities and later on short term ones. The article follows as such: five years from the entrance into force of the Agreement, free movement of capital for investment in securities and financial loans and loans with a maturity of less than 1year are ensured.

This Agreement entered into force on 1st of April, 2009. Further adjustments and relaxations on movement of capital were undertaken by Regulation No.70, on 30th of September, 2009, which reduces some of the active restrictions still on place on the outflow side.

According to clause 61 of Chapter IV on capital movements in SAA, citizens of European Union Member States are authorized to purchase Albanian real estate, only except for some limitations provided in the Calendar of Albania's Specific Commitments under the General Agreement on Trade and Services (GATS). Five years after the Agreement has entered into force, such restrictions shall be removed. While, in seven years later, Albania shall progressively approximate its legislation concerning the right to purchase real estate in Albania in order to provide treatment for EU parties no less favorable than the one that was provided to Albanian citizens (SAA, 2006). In this carefully designed agreement, the case of possible restrictions of no longer than 1 year is also considered only in exceptional circumstances. A similar agreement was also done for Croatia few years ago, which was taken as a sample in constructing Albanian's Agreement. Some provisions had to be modeled in accordance to Albania's situation.

According to clause 62, necessary conditions should be created for the further gradual application of Community rules on the free movement of capital, three years after SAA has entered into force, in other words in year 2011.

Six months after this agreement entered into force, a report evaluation on Albanian's progress was done. In one of the sections underlying the progress in CAL, it was stated: "There has been some partial progress on free movement of capital. The revision of the Regulation on Foreign Exchange Activity adopted by the Bank of Albania in September 2009 simplifies procedures related to the movement of capital. However, certain restrictions remain to the liberalization of capital movements required under the SAA, in particular as regards the acquisition of real estate by foreigners. Overall, preparations in the area of free movement of capital are advancing slowly" (Commission of the European Communities, 2009).

This simple review of these articles, show the gradual progress of Albania regarding the process of CAL regarding its legal procedures. Even though Albanian government has done considerably progress in this regards, the implementation of these procedures according to EU standards and its progress in the economy are somehow slow.

5.3 Policy Framework

In order for Albania to have a risk-free complete liberalized capital system, it is argued that some economic issues should be taken under serious consideration, in addition to the legal procedures. Some risks are almost always associated with the removal of restrictions in a country. This study has shown some of these risks in the previously analyzed countries. It is important to stress that such crises do not start and stop only during the Asian crisis; such financial problems are open to probabilities of occurrence at any time, such as the recent example in Greece.

Many previous studies done on CAL and the Asian crisis have emphasized the importance of sequencing regarding CAL. In order to get the full liberalization done, there should be a proper ordering of the steps followed by the authorities of the state. Some economic adjustments tend to be more significant and more affected by relaxing the capital restrictions than some other ones. That is why the policy framework should be listed in the right order.

Given the current economic statues of Albanian economy with its weaknesses and strengths combined with the reviewed literature on the country experiences and the assessment on the progress of CAL in Albania, the study suggests the following sequencing:

a) *Economic Stability*; Under an unstable economy with unpredictable GDP growth and inflation rates, public/private deficits or some other instable key economic indicators, a free flow of capital would only deepen the problems of the country by exposing it to the wild world competitors. This is the first and very important step to be considered. Singapore is an excellent example of a stable successive and productive economy with budget surpluses. Moreover, a stable economy, not necessarily at its peak period, tends to attract more investments as investors feel safe to invest in such economies with affordable external debts.

As we noticed from the previous chapter, Albania has maintained a stable GDP growth rate and inflation, which shows a clear and promising economic progress. Albania's current deficit is considerably high in 2009, though in a decreasing trend compared to one year ago. Exports are roughly 24 percent of its imports in 2009, while they were 27 percent a year ago, which has negatively affected the current deficit. Remittances make up for a large percentage of money flowing in, which would compensate for deficit in trade. Yet, remittances have declined in amount compared to previous years due to the global crisis. As such, this deficit needs to slowly run down in the coming years by using incentive strategies to attract inflows. Possible recommendations can be to increase the surpluses in the services balance by improving the tourism sector and also enhancing the business climate in Albania. According to "The Global Competitiveness Report 2009-2010" by World Economic Forum indicates that the most problematic factors for doing business are as follows (ranked according to the degree of the problem): Corruption; Inefficient government bureaucracy; Policy instability; Tax regulations; Inadequate supply of infrastructure; Access to financing; Tax rates; Poor work ethic in labor force; Inadequately educated workforce…etc. Many of the problems stated are domestic and can be solved with proper policies. Facing all the problems and trying to liberalize will not help but it will create even more instability. Moreover, these poor records will discourage potential foreign investors from investing in Albania. Such factors should be improved in order to create a better business climate for domestic and foreign investors.

b) *Strong and Sound Financial Sector*; This is one of the most important steps to be undertaken next by Albanian government in order to mitigate financial possible crises. Albania has actually done lots of progress in this sector. The government has kept the interest rate afloat for loans and deposits for the past ten years. Yet, according to the published Report on the Monetary Policy Progress by the National Bank of Albania for year 2009, fiscal policy has been quite expansionary in 2009 with greater government expenses compared to revenues. This deficit has been financed by external debts which have affected the interest rates in long term financial securities. A strong financial institution should use quite efficiently risk management techniques to keep under control big amount of money coming in or going out of the country. Such techniques can be by matching the country's foreign assets with foreign liabilities, or matching assets maturities, so that the Korean experience will not happen in Albania.

However some promising figures can be found related to this sector of this economy. Credit loans as a percentage of GDP recorded according to "World Development Indicators" in Albania are in an increasing trend from 2004 till 2008. In 2008 credit loans were up to 67 percent of Albania's GDP. This amount is quite big compared to other countries of the region (WDI, 2009). Also micro financing institutions all together have outstanding more than 150 million US dollars at the end of 2008, European Micro-finance Organization (2009). Micro finance comprised of many small businesses contributes a lot to the economy. Regarding financial products innovation, Albania has yet a way to go, but in a press release in June, 2010, BOA has promised that new market instrument will be developed; money market will be deepened further and providing modern technological solutions (BOA, 2010).

c) *Adequate Accounting, Auditing; Transparent Practices and Information System*; A great concern should be pointed to the Supervision department of each financial institution. All cash or capital flows should be transparently recorded in the accounting sheets according to EU standards. Financial institutions and all other institutions or corporations should consider this step as it gains more importance as the country goes open. Lots of transactions are not recorded at their correct amounts, in order to avoid taxes. Tax evasion is a relatively big problem in Albania which is being taken into consideration by the government. According to a study done by Gerxhani and Schram (2002) concludes that the levels of tax evasion are not due to specific tax attitudes or cultures of that country, but due to tax institutions and management and the way that individuals have learnt to deal with them. As such, more importance should be given to the means of improving the professionalism related to tax administration, to strengthen the power of required authorities, and also create a strict tax evasion denunciation and punishment system.

Also, misleading information turns out to be very risky. It is really important for a foreign investor to have sufficient information about the country he/she is about to invest. It is much easier to invest in a country where you could have free and reliable access of information. It is believed from the experience of Asian crisis that one of the causes was inadequate transparency. If investors would have been well informed, maybe they would have seen what was really going on with the banks of the host country and all the irregularities would have been noticed before lending too much, (Eichengreen and Mussa, 1998). Moreover, such ambiguities lead to asymmetric information where some investors might be cheated and misled. It is common for risky banks about to bankrupt to offer high-yield loans as they have nothing to lose even if these risky or gambling loans default. That would cause serious problems to the economy. Albania suffers from lack and misleading information, which Albania should really work on such spheres.

d) *Floating Exchange Rate Regime*; This step should be part of each CAL policy, but in Albania's case this step is already taken. Albania's exchange rate is determined by market forces. It operates under floating regime. This is a proper exchange rate regime in order to be an integrated and liberalized country. Previous crisis showed clearly the mistake of keeping the exchange under a fixed rate. Most of the authorities advocating a pegged exchange rate regime were eventually forced to widen the band of currency fluctuation due to the massive inflow and to the pressure on the domestic currency. The band was widened until the regime became completely flexible.

e) *Fiscal Policies*; Next to be considered is the reduction of power of the monetary policy instruments of the Central Bank of Albania due to the country's exposure and free interaction with other countries. As such the country cannot be monetary independent. The government can use fiscal instruments to regulate and stabilize the economy. This is a strategy which takes a longer time to show its effects on the economy. A tight fiscal policy would be more appropriate when relaxing inflow restrictions and expecting a big flux of inflows. While, an expansionary fiscal policy as the one Czech

Republic refused to use, could only be helpful under massive capital outflows. Right now Albania has kept an expansionary fiscal policy due to the crisis. What remains on concern is the importance of its role in the economy, and its stability. To be able to have sound fiscal policies, the government of Albania needs to solve the informal sector problem by enlarging the tax base and eliminating tax evasion problems.

f) *Minimize Informal Economy*; Again very important is the minimization of informal economy in the country. As it is already mentioned in this study during the evaluation of Albanian Economy, informal economy takes a big percentage of Albanian GDP and it affects the employment and production of the country. The reduction of this phenomenon is a priority for the government of Albania and a request from SAA at the same time. This unrecorded part of the economy prevents the functioning and effectiveness of regulations. As such the reduction of such activities that avoid the compliance with legal procedures and standards is a necessity for an open market oriented economy. Albania has been co-operating with OECD Investment Compact for South East Europe, and has set up 'Task Force' which helps minimizing this economy. Yet, Albania has quite a large reliance on such economy even nowadays. This shows that it is still much to be done in this area, such as properly following OECD Investment Compact policies and recommendations.

g) *Proper Competition Policy*; After the above main steps have been considered, a proper competition policy is what Albania will need in order to deal with foreign investments. It is quite understandable and reasonable that foreign investments coming into the country will tend to favor best companies with big shares and promising profits. This will deepen the gap between small and low profiting companies and the large ones. Market concentration is very probable to occur if competition policies are not strengthened. An effective anti-monopoly regulatory and a careful privatization process should be in an effective position in order not to transfer power to foreign firms which tend to invest in such powerful companies, (Daianu and Vranceanu 2002).

Competition law has existed in Albania since 1995. Poor implementation of this law has been observed due to insufficient resources given to it (Dajkovic, 2004). SAA has required amendments in almost all of the chapters of this law in order to approximate it with EU law. Such chapter relate with: anti-competitive agreements, dominance, investigation procedures, etc. Such amendments are very important to the economy of Albania, as the negligence of them might end up preventing economic growth.

h) *Fight Corruption and Illegal Businesses*; Whether a liberalized country or not, corruption is a detrimental factor of the economy. This factor takes a bigger shape when the country frees its restrictions and it should be considered as one of the CAL policies. It is unfortunate to talk about the numeric values of surveys done in this regard. Albania suffers from a high level of corruption. A survey done in Albania on May 2010, from Institute for Development Research and Alternatives (IDRA), shows that Albanian institutions are not doing good enough to fight against corruption. 91% of citizens believe that corruption is extensive in the public sector. Out of this survey, institutions are said to be 62.4 points corrupted out of 100points fully corrupted (IDRA, 2010).[9] EU standards would not allow for such high level of corruption or illegal businesses in Albania either. In order for Albania to integrate itself to European countries or other countries and to be able to interact in terms of capital transactions as well, it should seriously work on this matter. Monitoring divisions; proper actions and punishments against corrupted institutions or individuals; the increase in the role of media regarding the propaganda against corruption…etc are all possible means to reduce corruption in Albania.

This is a simple framework of what Albania should consider during these years that is implementing the process of full CAL. Right now Albania has already taken certain steps. According to this study, Albanian authorities need a lot more to push the above-mentioned policies, even though a fair amount of progress is already done.

A serious undertake of such policies in the economic and financial sector would bring Albania closer to European Union, closer to a better perspective of the future, closer to where it deserves to be.

[9]Survey (2010). Institute for Development Research and Alternatives (IDRA), "Corruption in Albania, Perception and Experience." May 5th, 2010.

Chapter 6

CONCLUSION

This study comes with an assessment of capital account liberalization as a process on its own and as a strategy used by Albania recently. In 2009 Albania has freed most of what prevents Albanian residents from investing abroad as it had already done so on the inflow part. Yet, more needs to be done to fully achieve free capital movement according to SAA, such as relaxing those restrictions on the purchase of real estate from foreign investors. After this agreement has entered into force, it will take five to seven years to accomplish the requirements of SAA in regard to CAL (SAA, 2006). As the agreement has entered into force in 2009, the prediction to achieve full liberalization will be during 2014-2016. Meanwhile, Albania needs to take time to improve some economic policies in order to succeed in its objective to join EU.

Five country experiences analyzed in this study have shown some tactics and strategies that each country authority has undertaken. Such tactics have initially considered to be best fitted for CAL. As time passed, in some of these countries, a crisis came up to be part of this process. Many other studies or experiences have shown that such liberalization comes along with economic shocks. Historically, every economic boom is followed by a recession. This has happened in most of the Asian countries after their drastic economic growth and development due to capital movement.

These experiences combined with the analysis on Albanian current economic status have helped in drawing a proper set of policies for Albania. The study concludes that Albania needs some more efforts to take in order to protect itself from CAL possible harm. These steps are sequenced according to their importance and urge of action. Albanian economy suffers from current deficit, budget deficit, and high level of informal economy, corruption and poor financial supervision and innovation.

Such weakness and more are considered while preparing the framework. As such, prior importance is given to the stability of the economy and its main indicators. An improved business climate in Albania would reduce the current deficit and incent capital inflows. Financial Institutions will not be less important when dealing with capital flows. Their efficiency is essential for the economy and the future of Albania. Prudential regulation of this sector with adequate auditing and transparent practices will help in gaining investors' trust. Tax evasion is another disruptive issue which can be cured by improving the professionalism related to tax administration, to strengthen the power of required authorities, and also create a strict tax evasion denunciation and punishment system. Floating exchange rate is proved by Asian experiences to have been the best exchange rate regime in a liberalized country. Albania already has a floating regime which helps the development of CAL. Also fiscal policy needs a further concern than previously as the country frees its restrictions and welcomes foreign capital.

Proper competition policy comprises the fifth step on this framework. Competition law is already considering some amendments suggested by SAA regarding anti-competitive agreements, dominance, and investigation procedures. Albanian authorities are making progress in this regard, but in an open economy with a weak competition law the threat of foreign investors glows more than ever. While last two steps, fighting corruption and informal economy are also a necessity for the development of the country and the approval of it by EU. The figures on these areas are big. Certain actions should be taken against them. Monitoring divisions; proper actions and punishments against corrupted institutions or individuals; the increase in the role of media regarding the propaganda against corruption will quite certainly have positive effects on corruption reduction. While regarding informal economy Albania is co-operating with OECD Investment Compact for South East Europe, and has set up ‘Task Force’ which will hopefully help the minimization of it.

An effective implementation of these eight steps will assure to a certain degree the safety of CAL effects on the economy of Albania. This process should not be seen as a one-time issue, rather as an ongoing process with multiple steps and continuous supervision.

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