
LIBERALISING CAPITAL MOVEMENTS AND THE INTEGRATION PROCESS

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So far we have not been able to read in newspapers of Albanians investing in shares or stocks or in bonds in the Frankfurt Stock Exchange or buying real estate properties in Vienna or Graz. Many of them would make these investments today, but there are some restrictions when regarding capital outflows.

Albania is committed to liberalising its capital account and it has agreed to do so within a certain time limit. In the Report of the Working Party on the Accession of Albania to the World Trade Organization, removal of capital controls is one of the horizontal commitments. The report states that: 'the Bank of Albania reserves the right to maintain capital controls which will apply on national treatment basis. The regime currently in place will be removed NO LATER THAN 2010

Albania is preparing to sign the Stability and Association Agreement, which is a first step towards integration in the European Union. This agreement will impose on Albania certain conditions regarding the sequencing of Capital Account Liberalisation and it will set, similarly to the commitments signed with WTO, a time limit AFTER WHICH THE CAPITAL ACCOUNT OF ALBANIA WILL BE FULLY LIBERALISED. This limit will depend on the time when the SAA (Stability and Association Agreement) will be signed.

The unrestricted movement of capital¹ is clearly asserted in 'Principle', Part One of the Treaty of Rome, as one of the axioms underlying the activities of the Union, alongside the freedom of movement for goods, persons, and services, and the right of establishment (Article 3). All these rights stand on an equal footing. Yet the subsequent provisions in the Treaty governing the movement of capital were drafted more cautiously than those relating to other matters.

The principle of unrestricted movement of capital is set out in Article 67 (1), which is the fundamental provision on the subject in the Treaty. This Article provides for the gradual abolition, during the transitional period, of restrictions on the movement of capital belonging to persons resident in member states, and of any discrimination based on the nationality or

residence of the parties or on the place where the capital is invested. Restrictions were to be abolished gradually 'to the extent necessary to ensure the proper functioning of the common market'.

1. Some words on capital account liberalisation

Capital account liberalisation means complete removal of controls and restrictions on movements of capital from and to a country. That means not only legal prohibition but also when quantitative restrictions are imposed, and even in the cases when, for a given transaction, approval from an authority such as the central bank is required. As the controls and the restrictions on the capital movements are both of quantitative and qualitative nature it is difficult to determine whether a country has a liberalised capital account or not.

The analysis for the level of interest rates in different countries and the development of a financial infrastructure indicates that countries with a more developed financial infrastructure benefit more than countries with a less developed financial infrastructure and suffer less in cases of crises (Sebastian Edwards)

International movement of capital allows countries with limited savings to attract financing for investment projects in the country, enables investors to diversify their portfolios, spreads investment risk and promotes future contractual trade—the trading of goods today for goods in the future

There are also opponents to capital account liberalisation, who say that capital movements do not always help total factor productivity growth.

Analysts conclude that liberalisation of capital account is a measure to reduce the distortions in economic development except in cases when domestic capital goes abroad. That is the reason why many debates actually concentrate upon the disciplining of the effects of capital account liberalisation.

There are authors (On the Benefits of Capital Account Liberalisation for Emerging Economies- Pierre-Olivier Gourinchas Princeton University, NBER and CEPROlivier Jeanne, IMF and CEPR. Draft, May 2002) who point out that politicians may open the capital account as a way of "locking-in" domestic reform, even when they cannot commit to either decision. Traditional trade arguments (e.g. Stolper-Samuelson) would argue that domestic capitalists would oppose financial integration as it reduces the return to capital, while workers

would typically favour it. The political economy of financial integration does not seem to reflect these predictions.

1.1. Arguments for capital account liberalisation

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

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

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

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

¹ Acquis Communautaire; Chapter 4: Free Movement of Capital; Source: <http://www.europe.eu.int>

1.2. Arguments against capital account liberalisation

Several economists around the world bring different arguments against full capital account liberalisation:

- countries with a more developed financial infrastructure benefit more than countries with a less developed financial infrastructure and suffer less in cases of crisis (Sebastian Edwards)
- it is hard to measure the net benefits that a country has from CAL, while, under normal conditions, it is impossible to predict the losses that the country might incur in the face of a capital crisis.
- other economists say that the process of liberalisation should be carried out gradually, because going back to a controlled state of economy from a liberalised one is known to be very costly

2. Capital account liberalisation in Albania

The last twenty years have been characterized by a continuous easing of controls on capital movements and many countries have completely liberalised their capital accounts.

A lot of Albanians in the near future will invest their funds in European Capital Markets (as well as World Capital markets) and in immovable properties around the World. Foreign and domestic firms are treated equally under the law in Albania and are guaranteed safety from expropriation or nationalization.. There is only one case in which foreign investors are not treated in the same way as residents of Albania. Foreign investors who invest in Albanian Treasury Bills must pay a 15 per cent tax on their profits as opposed to a 10 per cent tax imposed on Albanian residents.

The movement of capital to and from Albania is regulated

For the moment we have no restrictions for capital inflows but a lot of restrictions on capital outflows. Every Albanian citizen can transfer abroad for personal reasons amounts up to 3,500,000 ALL (nearly 30,000 EUR)

But capital account liberalisation would help further economic growth and would increase diversification opportunities

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Other authors consider two classes of benefits of capital account opening:

- the benefits in terms of international allocative efficiency (Eichengreen 2001)
- incentives are given to good policies or reforms that are generated by an open capital account, including the different ways in which capital account openness may improve domestic policies, practices and institutions. This means the market discipline on domestic macroeconomic policies is induced by the threat of capital flights.

Capital account liberalisation requires: stable macroeconomic parameters, a stronger institutional and regulatory regime, especially in the financial sector, appropriateness of the exchange rate regime and a sound balance of payments position. In general, a combination of structural and macroeconomic reforms.

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The movement of capital to and from Albania is regulated by the Regulation on Foreign Exchange Activities (FEA) amended on 30/7/2003.

Foreign investments coming to Albania and analysis of hesitations (informal economy and lack of regulations, level of financial infrastructure development, regional and political risk).

Advantages form possible capital account liberalisation: empirical evidences support the idea that capital account liberalisation promotes economic growth in developing countries, meeting the requirements of WTO and other international organisations, with perspectives of integration in international financial markets.

Controls in general and controls on outflows in particular are far from being effective in restricting the movement of capital between countries. It has been found that controls have to a large extent failed to inhibit portfolio capital flows, especially when devaluation was anticipated.

Theory suggests that a country that has liberalised outflows is more attractive to foreign investors. The scheme is simple. Less or no controls on outflows encourage inflows and more inflows help the country to efficiently allocate resources, to provide opportunities for risk diversification, to develop its financial system and to attract better technology and know-how from the investors. Many studies and surveys have concluded that developing countries that have liberalised their capital accounts have experienced economic growth at higher rates than under closed capital account.

Albania is committed to liberalising its capital account and it has agreed to do so within a certain time limit. In the Report of the Working Party on the Accession of Albania to the World Trade Organization, removal of capital controls is one of the horizontal commitments. The report states that: 'the Bank of Albania reserves the right to maintain capital controls which will apply on national treatment basis. The regime currently in place will be removed no later than 2010 (Report of the Working Party on the Accession of Albania to the World Trade Organization; Schedule GATS—Albania, WT/ACC/ALB/51/Add.2, 13 July 2000).

The process of capital account liberalisation in Albania goes parallel with the developments in the financial system, and especially in the banking system.

Liberalising the capital account does not mean forgetting the fight against money laundering. All commercial banks report all suspicious cases on a 72-hour basis to the Anti-Money Laundering Authority.

Most capital comes to Albania in the form of FDI and capital transfers (credit) to the government. There are no portfolio investments from abroad, whereas in the past three years domestic banks have purchased, in very limited amounts, foreign debt securities. Although we are aware of the benefits stemming from the diversification of incoming capital, we would like to investigate some of the reasons that have held back foreign direct investment (FDI) in the past few years. Inward direct investment is particularly beneficial for the host country. In a widely-held view, foreign direct investors are believed to increase domestic capital formation, to augment host country stocks of technology and managerial know-how, and to improve access to export markets and to a comparatively stable source of external financing.

On the other hand, FDI is typically regarded as less responsive to adverse macroeconomic developments. It is associated with fixed investment, which can only be liquidated at a substantial loss. (Lehmann 2002). Albania seems to have been less of an attraction for foreign investors than other south-eastern European countries, even compared to the ones of similar size such as FYR Macedonia or Croatia.

Why do foreign investors hesitate to invest in Albania?

- Financial system and banking system development. SME are credited at low levels from the commercial banks.
- Technological factors: only in recent years has Albania attracted new technology.
- Institutional reasons: risk of confiscatory taxation, the presence of informal economy, unclear property rights and uneven application of laws and contracts.
- Information asymmetry and insufficient marketing, which have also impeded foreign capital in entering the country.
- Increasing concerns about repayment which are related to the current account balance situation.

In most OECD countries² foreign investment in equity is considered extremely important to sustaining the liberalisation process. One reason is simply that foreign corporate investors are not usually willing to make long-term commitments unless they have an opportunity to exert influence on the enterprises they invest in. Equity investment provides a way of doing this. Foreign equity investment also has the potential to enhance local corporate governance practices and the investor can help develop the financial infrastructure and institutions needed to cope with free capital flows. Furthermore, equity investment, unlike debt-creating instruments, imposes no obligation on the debtor to make pre-established interest payments and to reimburse the principal at a set date. Equity investment is also generally denominated in the currency of the recipient country so that the exchange-rate risk is shared by the foreign investor.

Concluding remarks

As we proceed towards a more open capital account, we will also enhance the chances that the Albanian capital and financial market become more integrated with the international market.

The more markets are integrated, the better aligned the interest rates are and the easier it is to make educated choices about investments at home or abroad.

Albania's integration with international financial markets will be a gradual process and maybe it will need some time.

Opening the capital account exposes the domestic financial system to foreign competition

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² Liberalising Capital Flows: Lessons from Asia; By Pierre Poret