Albania: Selected Issues

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ALBANIA

Selected Issues

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Approved by European Department

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Contents   Page

I. INTRODUCTION AND OVERVIEW[1]

A central theme of the Article IV Consultation was how Albania could sustain its impressive growth performance and raise income levels towards those of middle-income economies. The following selected issues papers cover key areas that would help achieve this: an examination of the determinants of growth and the microeconomic underpinnings for growth focusing on the problem of uncertain property rights; the role of remittances in the economy; and the policy response to rapid credit growth.

1.   **Sustaining high growth following transition becomes increasingly difficult as the easiest efficiency gains are exhausted.** In addition, in many economies uncertainty over property rights can hinder development and financial deepening. Part I on Growth and Institutions looks at what Albania can do to maintain strong growth and strengthen property rights.

2.   **Albania's growth performance has exceeded that of many of its Central European neighbors, but the differential with the Baltic economies has been widening**. GDP has increased significantly in Albania over the transition period, led by impressive advances in total factor productivity (TFP). Since 2000, however, the contribution to growth from TFP has declined considerably. Since Albania still has a long way to go to reach the income levels of its central European and Baltic neighbors, the slowdown in TFP growth is a serious concern. It suggests that structural reforms have been misdirected or that there are other impediments to growth. Weaker TFP performance is likely to reflect, in part, the low level of financial intermediation in Albania—notwithstanding the credit boom—but also other factors. Risk and institutional development indicators suggest that Albania is least advanced relative to the Baltic and Central European economies in terms of enterprise restructuring, competition policy and the non-bank financial sector; while risk indicators are high for corruption, law and order, and bureaucratic quality. This suggests that better targeted structural reforms in these areas could add to TFP and help sustain growth.

3.   **Informal urban sprawl and uncertainty over property rights have hindered development and financial deepening in Albania.** Around 60–70 percent of buildings built since 1990 are extra-legal. Lack of progress on resolving property rights is likely to have held back development of a land market, agriculture and tourism, and prevented effective use of collateral for lending. The government is focusing on the legalization of informal areas but it is a complex task. Moreover, it will take time to create a legal setting that is in keeping with the underlying structures of informal areas and provides the correct cost incentives to ensure individuals operate within the law on an ongoing basis. The budget impact of legalization could be substantial—but also somewhat ambiguous as both revenues from property taxes and compensation costs could be high. While success with formalization

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[1] Prepared by Alison Stuart.

offers the prospect of significant gains, containing the costs to government will require skillful management.

4.   **Workers' remittances have contributed significantly to Albania's economic development and provide an important informal social safety net.** Part II on remittances looks at their impact on the economy and in particular on the fiscal position. Microeconomic surveys suggest that remittances are significant at around 5–8 percent of GDP, but substantially lower than in the official balance of payment estimates, and they have been directed to poor households thus helping to eliminate the poverty gap. Over the medium-term, a key question is whether remittances will continue to sustain the informal private safety net and support the current account. Based on the experience of other countries, the contribution of remittances as a percent of GDP might be expected decline over the medium-term as emigration tapers off. Given the uncertainties, it would be prudent for policy makers to develop contingencies to deal with the increased pressure on social spending that could accompany a slowdown in the flow of remittances. The bulk of remittances are currently sent through informal channels. Developing financial instruments targeted at emigrants would bring more of these flows through formal channels, boosting financial intermediation and supporting growth.

5.   **Remittances are also likely to have supported the fiscal position having a significant impact on fiscal revenues and expenditures through a variety of channels.** They are likely to boost household consumption and add to indirect tax revenues, but they could also reduce the incentive to work which would lower income tax revenues. On the expenditure side, remittances provide an alternative informal safety net that reduces the pressure for government social spending. On balance, it is likely that remittances have supported the fiscal position. As remittances as a ratio of GDP are expected to slow over the medium term, continuing the practice of including a significant contingency mechanism in the budget would be appropriate.

6.   **The financial sector has developed rapidly over the past two years, but an ongoing credit boom now poses risks to macroeconomic and financial stability.** Part III looks more closely at developments in the banking sector, the experience of other countries, and the policy measures that can be taken to improve the macroeconomic and financial stability of the Albanian financial sector in the face of rapid credit growth. The policy tools available to manage the risks associated with rapid credit growth fall into three categories: macroeconomic policies; prudential and supervisory policies; and other, including market development and administrative measures. In Albania, there is some scope to use all of these levers, and a particularly strong case for intensifying monitoring and strengthening the regulatory regime. Prudential and supervisory measures are being taken or planned which are aimed at protecting loan quality, improving supervisory capacity, and raising the costs of financial intermediation to help cool credit growth.

PART I. GROWTH AND INSTITUTIONS IN ALBANIA

II. THE EVOLUTION AND DETERMINANTS OF GROWTH IN THE BALTIC AND CENTRAL
EUROPEAN COUNTRIES—LESSONS FOR ALBANIA[2]

1.   **This chapter examines the growth experience of transition economies with a
view to identifying the policies needed to maintain high growth in Albania**.[3] A standard
growth accounting analysis is carried out using purchasing power parity conversion factors
from the Penn World Tables to permit cross country comparisons. This exercise yields a
decomposition of growth into capital, labor and total factor productivity (TFP); which is then
compared and analyzed to gain insight into the sources of growth. The variation in TFP over
time is examined using a panel regression; and these estimation results are then employed to
investigate the necessary conditions for maintaining the Albanian growth rate at 6 percent.
The chapter concludes with the policy recommendations that emerge from the study.

Stylized Facts and Growth Accounting

2.   **Over 1992–2004, the Albanian economy experienced significantly higher growth
than other transition economies**. Real GDP increased by 112 percent over this period,
against average (unweighted) growth in the Baltic and Central and Eastern European (CEE)
states of 50 and 48 percent respectively
(Figure 1, LHS).[4] However, Albania's
relative position is sensitive to the time
period under review. Between 1995 and
2004—which excludes the very poor initial

Cummulative Growth	1992-2004	1995-2004
Albania	112%	62%
Average Baltic states	50%	70%
Average CEE states	48%	35%
All countries except Albania	49%	45%

growth performance of the Baltic states[5]—growth in the Baltics was rapid enough to eclipse
the Albanian performance, which is now seen to fall between that of the Baltic and the CEE
countries (Figure 1, RHS). The contraction of Albanian output in 1997 following the collapse
of the pyramid schemes contributed to this outcome as did the strong growth in the Baltic
region over 2002–04. With the exception of 1997, however, Albania has consistently
outperformed the CEE countries.

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[2] Prepared by Geoffrey Oestreicher (EUR).

[3] Countries included in the study comprised Albania, Croatia, Czech Republic, Estonia, Hungary, Latvia,
Lithuania, Poland, Romania, Slovak Republic, and Slovenia.

[4] The CEE states are defined here to include all the sample with the exception of Albania, Latvia, Lithuania, and
Estonia. Weighted growth in all countries excluding Albania was 50 percent.

[5] Estonia, Lithuania and Latvia experienced negative growth up to 1993, 1994, and 1995 respectively.

Figure 1. Comparative Growth Experience

Real Growth, 1992-2004
(Index, 1992=100, unweighted averages)

Real Growth, 1995-2004
(Index, 1995=100, unweighted averages)

Real Output per Capita, 1992-2004
(Index, 1992=100, unweighted averages)

Real Output per Capita, 1995-2004
(Index, 1995=100, unweighted averages)

Real Output per Worker, 1992-2004
(Index, 1992=100, unweighted averages)


Real Output per Worker, 1995-2004
(Index, 1995=100, unweighted averages)

Source: WEO and Penn World Tables.

This result holds with respect to growth itself, and to output per capita and output per employee (average productivity of labor, APL).

3.   **Employment followed a similar pattern in these transition economies.** A large decline in the numbers of employed persons lasting at least until the end of the 1990s was a common experience, but was particularly severe in the Baltic states. The simultaneous decline in absolute levels of labor alongside rapid economic growth is clearly indicative of offsetting gains in either capital utilization, total factor productivity, or both. The relative strengths of these two factors emerge from the growth accounting exercise that follows below.

Labor Employed, 1995-2004
(Index, 1995=100)

Albania ——— Average Baltic states · · · · · Average CEE states
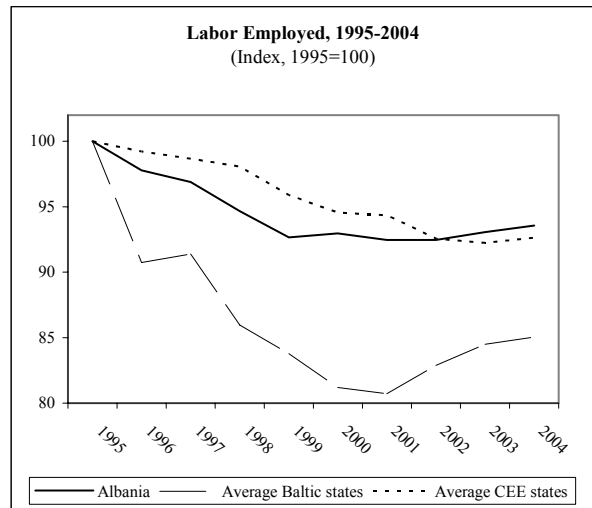
4.   **The analysis is based on a standard growth accounting exercise.**[6] Due to data limitations, and the structural break that occurred with the onset of the transition process, a number of compromises in methodology were necessary. Chief among these, the structural break representing the beginning of transition limited the sample period to 1992–2004; and labor was measured in total numbers of employed persons, rather than in hours worked. Data on capital stock and labor were derived from the WEO database and entered into a Cobb-Douglas production function under the assumption of constant returns to scale, with output elasticity with respect to capital and labor set to 0.3 and 0.7 respectively.[7] Total factor productivity, embodying all factors contributing to growth except for capital and labor, emerged as the residual.

$$Y_t = A_t K^\alpha L_t^{(1-\alpha)} \qquad (1)$$

Where Y is real PPP GDP; K is real capital stock; L is total numbers of labor employed in a given year; and A is total factor productivity.

5.   **There is significant variation among transition economies with regard to average labor productivity, TFP, and the ratio of capital to labor.** The results are summarized in

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[6] It was carried out for Albania, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia.

[7] Capital stock was derived by adding real investment to the initial capital stock and allowing for an 8 percent rate of depreciation. The initial capital/output ratio was assumed to equal 3.

Table 1, expressed as an index of the Albanian value for each variable. It is immediately apparent that differences in labor productivity are dramatic, ranging from Slovenia, with a margin over Albania of almost 250 percent in the early period, to between 30 and 60 percent for the Baltic states, and to rough parity in the case of Romania. Differentials in TFP are also large and follow broadly the same distribution by country.

Table 1. Growth Accounting Output, 1993-2004
(Albania=100)

	Total Factor Productivity			Output per employee (Y/L) (Average product of labor)			Capital-Labor ratio (K/L) Value of capital per worker			Capital-Output ratio (K/Y)		
	1993-96	1997-2000	2001-04	1993-96	1997-2000	2001-04	1993-96	1997-2000	2001-04	1993-96	1997-2000	2001-04
Average Baltics	**119**	**130**	**128**	**145**	**164**	**159**	**195**	**220**	**209**	**134**	**135**	**132**
Average CEE	**167**	**157**	**140**	**226**	**214**	**184**	**264**	**272**	**241**	**118**	**130**	**132**
Average Baltics and CEE	**153**	**149**	**136**	**202**	**199**	**176**	**244**	**256**	**231**	**123**	**132**	**132**
Romania	96	83	78	104	93	83	130	142	124	125	155	150
Albania	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Lithuania	113	116	117	141	148	146	210	227	213	150	154	146
Latvia	114	131	127	133	160	152	169	194	184	126	122	120
Croatia	144	147	132	183	189	164	224	232	206	122	124	126
Estonia	131	143	139	162	185	178	206	240	229	127	130	129
Hungary	171	158	140	233	216	183	281	282	241	121	131	132
Poland	156	156	144	194	193	176	205	205	195	106	107	111
Czech Republic	194	169	145	281	249	207	342	364	324	122	148	157
Slovak Republic	173	165	149	237	229	198	284	300	263	120	132	132
Slovenia	233	223	193	349	332	277	384	379	333	110	115	120

Source: Calculated from WEO data and Penn World Tables.

6.   **Albania's relative performance has been mixed**. Overall progress has been substantial, with the average labor productivity differential declining from 102 percent in 1993–96 to 76 percent in 2001–04. However, this improvement was all relative to the CEE countries (126 to 84 percent), while ground was lost to the Baltic states (45 percent to 59 percent) which all grew rapidly over the latter period. The evolution of TFP differentials followed a broadly similar pattern. The overall improvement of Albania's relative standing in terms of labor productivity and TFP can also be seen in the leftward shift of the kernel density plots of these variables in Figures 2 and 3.
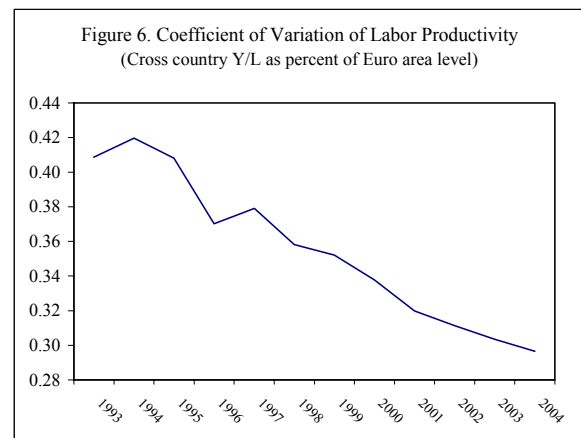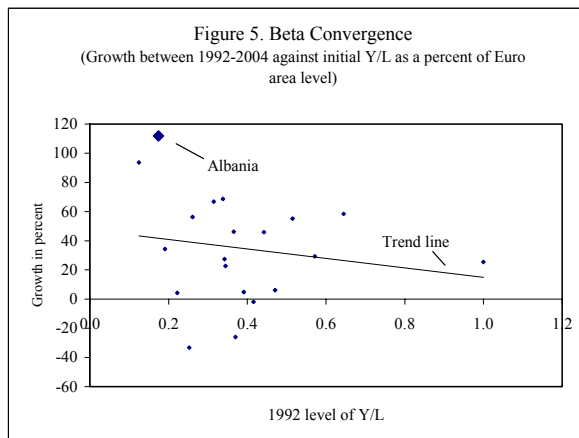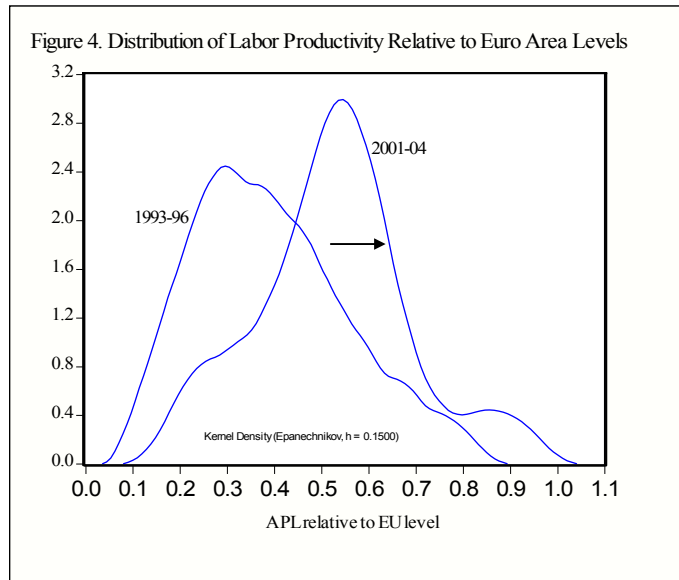

Figure 2. Distribution of Total Factor Productivity

Figure 3. Distribution of GDP per Worker
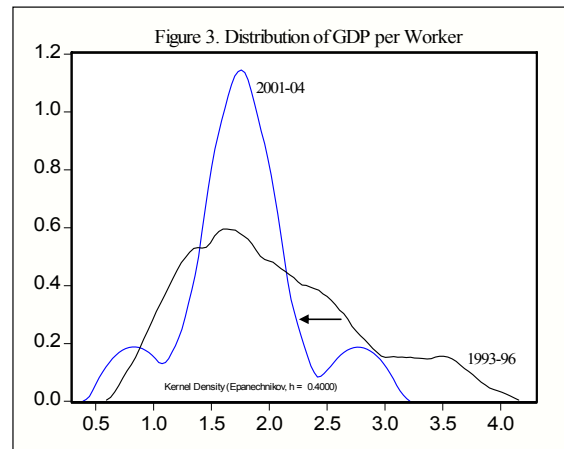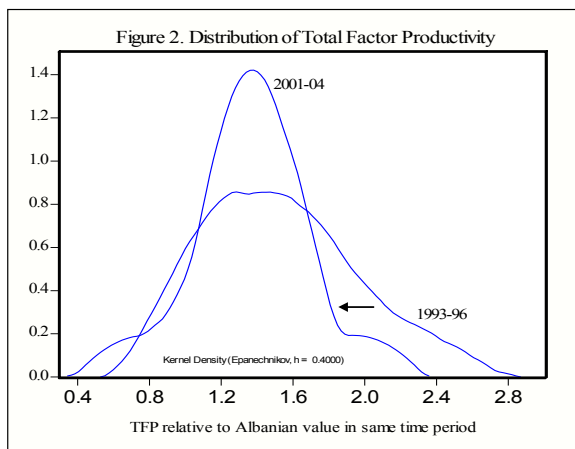
7.   **Convergence seems to be occurring between the transition economies and the Euro area, and also within the transition economies group itself**. Convergence with the Euro area is apparent from Figure 4, which is a kernel density plot of the differentials in labor productivity of the sample group relative to the Euro zone.[8] The shift is fairly obvious, with the peer group making significant progress towards the Euro area standard. Additional evidence is provided by the negative slope of the β convergence chart in Figure 5; and also from the declining value of the coefficient of variation[9] of labor productivity across countries (Figure 6). Within-group convergence can be observed in the declining variance of the distributions in Figures 2 and 3; and, in Figure 4, from the somewhat greater concentration of the 2001–04 distribution about the mean relative to the 1993–96 distribution.

Figure 4. Distribution of Labor Productivity Relative to Euro Area Levels

Figure 5. Beta Convergence
(Growth between 1992-2004 against initial Y/L as a percent of Euro area level)

Figure 6. Coefficient of Variation of Labor Productivity
(Cross country Y/L as percent of Euro area level)

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[8] For consistency, the growth accounting for the Euro area was carried out using a similar methodology to the main study, despite the availability of more detailed data on capital and labor.

[9] Standard deviation divided by the mean.

8.   **Productivity gaps among transition economies are explained mostly by differences in TFP.** Equation 1 can be rearranged to express the gap as a function of TFP growth and either the capital-labor mix or the capital output ratio.

Decomposition I: $$Y_t/L_t = A_t * (K_t/L_t)^\alpha \qquad\qquad (2)$$

Decomposition II: $$Y_t/L_t = A_t^{1/(1-\alpha)}(K_t/Y_t)^{\alpha/(1-\alpha)} \qquad\qquad (3)$$

In using Decomposition I (Decomposition II) to compare Albania's performance to the peer group, the productivity gap is described as the sum of how much of the gap with a comparator country would be closed if TFP levels between the two were equalized—holding K/L constant (K/Y constant)—and how much of the gap would be closed if capital labor ratios (capital output ratios) were equalized—holding TFP constant.[10] Table 2 illustrates that, as would be expected, the effect of TFP on productivity is greater in the case of Decomposition II than Decomposition I. However, the magnitude of the effect is sufficiently large in both cases as to render the conclusions essentially the same regardless the method of decomposition chosen.

9.   **Similarly, the improvement in Albanian TFP was responsible for most of the 25 percent relative improvement in productivity between 1993–96 and 2001–04.** As would be expected from the previous analysis, gains were posted against the countries of CEE, and losses against the Baltic states.

Decomposition I	Percentage change in Y/L gap	Percentage contribution from TFP	Percentage contribution From K/L
Change between 1993-96 and 2001-04			
Average	-25	-20	-5
Average Baltics	30	21	8
Average CEE	-33	-26	-7

Decomposition II	Percentage change in Y/L gap	Percentage contribution from TFP	Percentage contribution from K/Y
Change between 1993-96 and 2001-04			
Average	-25	-25	1
Average Baltics	30	29	1
Average CEE	-33	-34	0

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[10] Decomposition I is more usefully employed the greater the extent to which the capital-labor ratio is considered to be relatively independent of changes in TFP and output. Use of Decomposition II would be more correct under conditions where capital-output ratios are relatively constant despite increases in TFP, output, and capital-labor ratios. For Albania and the peer group, this argument would tend to favor the use of Decomposition I, as neither capital-output ratios or capital-labor ratios have been constant over the review period, but have instead followed an adjustment path that is only recently showing signs of stabilization.

Table 2. Labor Productivity Gap and Components

(In percent deviation from Albanian level)

	Total Labor productivity gap	Decomposition I Y/L = A * (K/L)$^\alpha$		Decomposition II Y/L = A$^{1/(1-\alpha)}$(K/Y)$^{\alpha/(1-\alpha)}$	
		Due to TFP gap	Due to K/L gap	Due to TFP gap	Due to K/Y gap
Average 1993-1996					
Romania	4	-4	8	3	0
Latvia	33	15	18	31	2
Lithuania	41	14	26	37	4
Estonia	62	34	28	59	3
Croatia	83	50	33	80	4
Poland	94	63	31	93	1
Hungary	133	84	49	128	5
Slovak Republic	137	87	50	132	5
Czech Republic	181	115	66	174	7
Slovenia	249	166	83	244	5
Average	**102**	**63**	**39**	**98**	**4**
Average Baltics	**45**	**21**	**24**	**43**	**3**
Average CEE	**126**	**80**	**46**	**122**	**4**
Average CEE without Romania	**146**	**94**	**52**	**142**	**5**
Average 1997-2000					
Romania	-7	-17	10	-7	0
Lithuania	48	18	30	44	4
Latvia	60	34	25	57	3
Estonia	85	49	36	81	5
Croatia	89	53	35	85	4
Poland	93	63	31	92	1
Hungary	116	69	47	109	6
Slovak Republic	129	77	52	122	7
Czech Republic	149	85	64	138	11
Slovenia	232	153	79	226	6
Average	**99**	**58**	**41**	**95**	**5**
Average Baltics	**64**	**34**	**31**	**61**	**4**
Average CEE	**114**	**69**	**45**	**109**	**5**
Average CEE without Romania	**135**	**83**	**51**	**129**	**6**
Average 2001-04					
Romania	-17	-23	6	-16	-1
Lithuania	46	19	28	43	4
Latvia	52	30	23	50	2
Croatia	64	36	28	61	3
Poland	76	49	27	74	2
Estonia	78	44	34	74	4
Hungary	83	46	36	78	5
Slovak Republic	98	57	42	93	6
Czech Republic	107	55	52	97	10
Slovenia	177	113	64	170	7
Average	**76**	**43**	**34**	**72**	**4**
Average Baltics	**59**	**31**	**28**	**55**	**3**
Average CEE	**84**	**48**	**36**	**79**	**5**
Average CEE without Romania	**101**	**59**	**41**	**95**	**5**

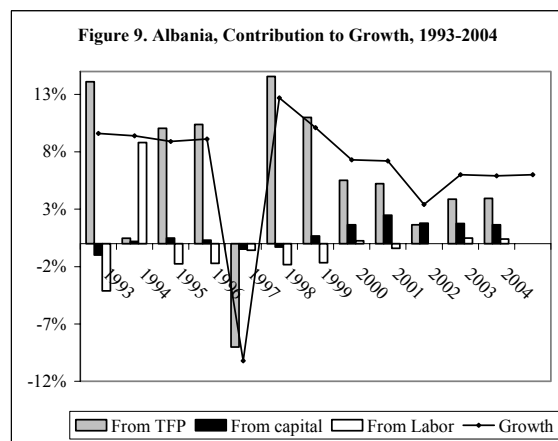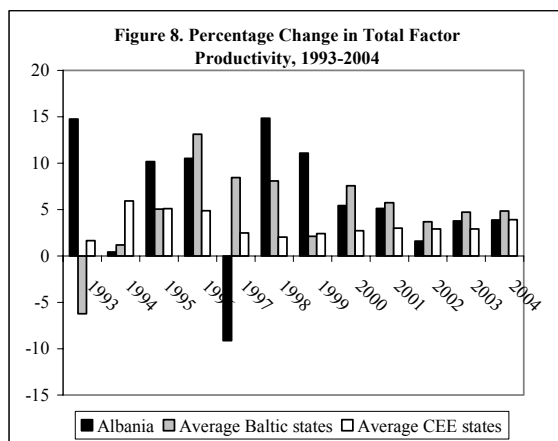Source: Calculated from WEO data and Penn World Tables.

10.   **Over this period Albania reduced only a small portion of its gap with the overall peer group in terms of capital intensity (K/L)**. The average differential between Albania and the peer group in capital intensity declined, although once again gains were posted against the CEE and losses against the Baltic states. Given that the rate of capital accumulation over the review period in the CEE countries was only marginally higher than in Albania, the slight increase in capital intensity against the CEE can be seen largely as a product of the depressed level of labor employment in Albania. Conversely, losses against the Baltic states in this area was due to both higher investment in that region, but also to its even larger decline in employed labor.

Figure 7. Distribution of K/L Relative to Albanian Values

Kernel Density (Epanechnikov, h = 0.4000)

K/L relative to Albanian value in the same time period
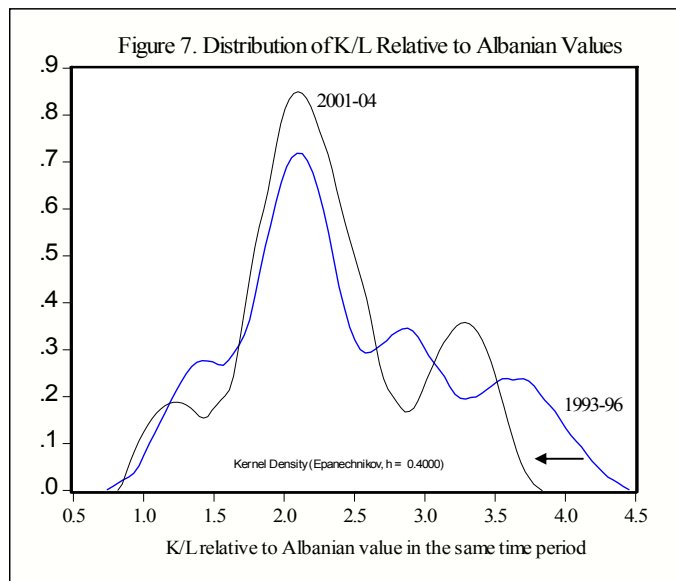
K/L Differential with Albania (Albania = 100)		
	1993-96	2001-04
Average Baltic and CEE states	244	231
Average Baltic states	195	209
Average CEE states	264	241

Real Investment (percent of GDP)		
	1993-96	2001-04
Albania	19	25
Average Baltic states	18	32
Average CEE states	22	26

11.   **The growth of total factor productivity has declined over time for all three groups of countries.** This would be expected in the transition process, as the initial economic structure would provide ample scope for large efficiency gains. Such gains would be expected to be larger the further the initial structure was from a market economy, and the further it lagged behind in terms of governance and institutional development. As the most obvious of these gains are realized, the growth of TFP would naturally slow, unless the pace

Figure 8. Percentage Change in Total Factor Productivity, 1993-2004

■ Albania ▨ Average Baltic states ▢ Average CEE states

Figure 9. Albania, Contribution to Growth, 1993-2004

▨ From TFP ■ From capital ▢ From Labor ◆ Growth

of structural reform was intensified. An examination of Figures 8 and 9 illustrates that this pattern did indeed occur. TFP growth—initially very high after the beginning of recovery from the onset of transition—declined in all three country groups. Albanian TFP gains were the most pronounced up until 1999, perhaps reflecting its lower initial state of development. Perhaps also for this reason, the slowest TFP growth occurred in the CEE. However, while growth is now at more moderate levels in all three groups than it was in the 1990s, since 2002 it has been rising in the Baltic and CEE states, but appears to be stagnating in Albania.

Estimation of Total Factor Productivity

12.   **Albania's TFP growth seems to have stabilized in recent years at a relatively low level, threatening the growth path needed for continued development and poverty reduction.** The reasons for the stagnation are not clear, but theory suggests that the slowing of TFP growth in an economy considerably less advanced in structural reform than its peers should not be occurring unless the structural reform process has either stalled, been misdirected, or if there existed structural or other impediments to the evolution of further efficiencies. The proper design of policies to boost and sustain economic growth therefore demands, as a first step, some insight into the preconditions and determinants of TFP growth.

13.   **This section addresses this demand through the development of an econometric model to explain the growth of TFP in the sample group over the period 1993–2004**. There are a number of reasons why this approach was chosen over more the traditional technique of modeling growth directly. First, as demonstrated above, the differences in TFP among countries in the region are quite significant and explain the majority of the labor productivity gap. Second, modeling TFP, rather than growth, as a function of institutional factors directly controls for capital and labor. Third, an independent estimate of TFP allows for the growth scenarios that follow in the next section—involving TFP, capital and labor—to be more easily and directly constructed.[11]

14.   **The model was specified based on the presumption that TFP is determined primarily by institutional factors**. Specifically, TFP was a priori assumed to be a function of institutional characteristics falling into two categories—the first being those that affect the *ability* of agents to efficiently combine factors of production, and the second being those that affect their *willingness* to participate in the process combining these factors. The first group includes factors such as market development, the degree to which the economy is organized along market lines, level of private ownership, and development of, and access to the financial system. The second group includes a measure of the risks involved in participation

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[11] As far as these scenarios are concerned, the issue of contemporaneous correlation between investment and the institutional variables exists in either type of model, necessitating in both either an exogenous treatment of investment, or a simultaneous determination which would be outside the scope of this paper.

in the economy, including those arising from political, financial, and market factors. Albania's relative position with respect to these variables is shown in Figure 10. In subsequent iterations, the degree of macroeconomic stability was added to this basic model;[12] as well as a catch-up component.

15.   **The model was estimated as an OLS panel regression of the 11 countries in the TFP study**. It was initially specified as follows:

$$TFP_t = \beta_0 + \beta_1 CRR_{t-1} + \beta_2 EBRD_{t-1} + \beta_3 PSCLAIMS_{t-1} + \varepsilon_t \qquad (4)$$

Where TFP is total factor productivity; CRR is a composite risk index from the International Country Risk Guide of the PRS Group, weighted half by political risk and half by financial, and economic risk (representing willingness to participate); EBRD is a composite index from the European bank for Reconstruction Development transition indicators[13] (representing the ability of agents to participate); PSCLAIMS is a measure of the degree of financial intermediation, measured as the ratio to GDP of bank and nonbank financial institution claims on the private sector (ability to participate). As these variables exhibited a high degree of serial correlation when expressed in levels, the model was estimated in log differences. The results of the estimation are presented below, where all variables are seen to be significant at the 99 percent level.

16.   **The model was subsequently expanded to include macroeconomic stability and convergence as explanatory factors.** Inflation was added as a proxy for the degree of macroeconomic stabilization;[14] and then a catch-up component was added by including the
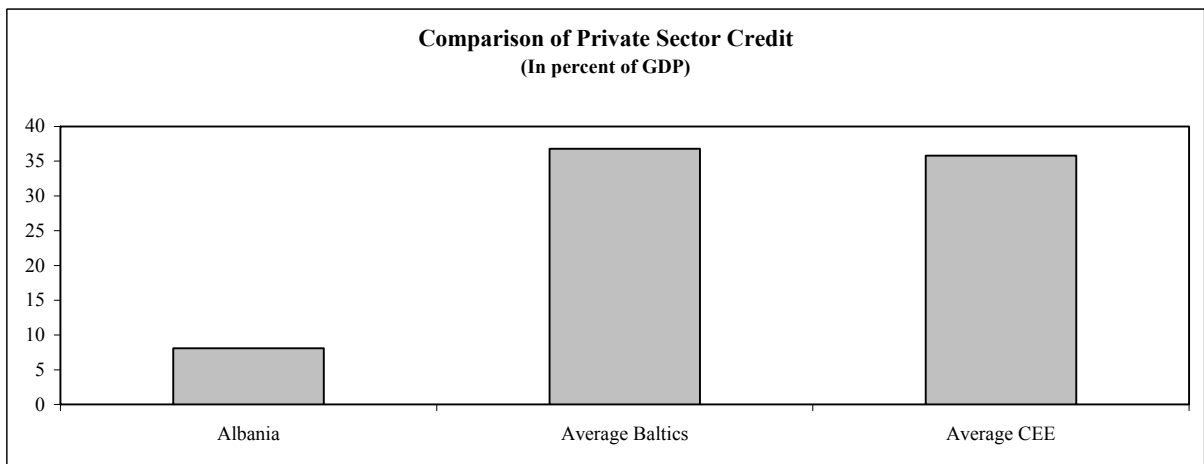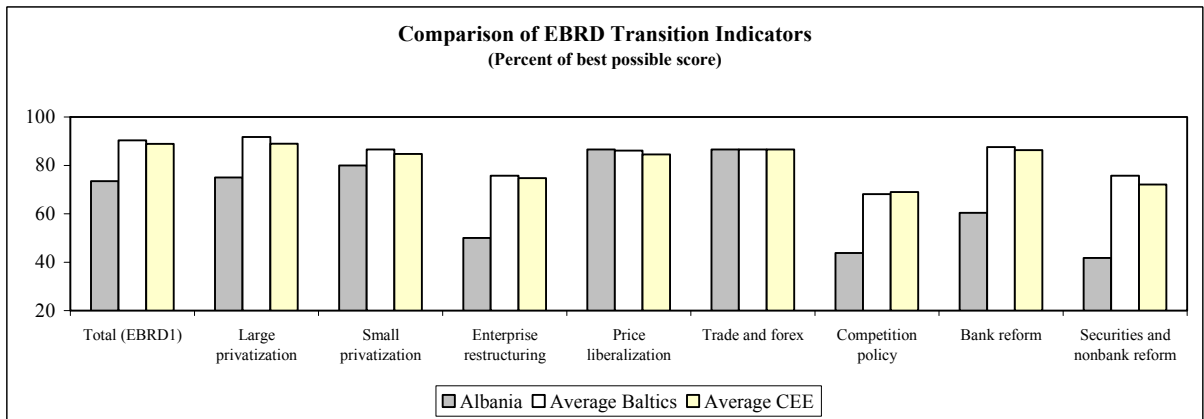
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[12] A variable that could be considered to belong to either group.

[13] Incorporating the degree of privatization and enterprise restructuring, the degree of development of the trade and foreign exchange markets, competition policy, price liberalization and financial market development.

[14] Since the data is annual, the log difference of CPI was not lagged, as the disruptive effect of a loss of stabilitywould presumably affect the period in which the loss took place.

Figure 10. Comparison of Risk Indicators, EBRD Transition Indicators, and Private Sector Credit, 2004

Comparison of Risk Indicators
(Percent of best possible score)

□ Albania □ Average Baltics □ Average CEE

Comparison of EBRD Transition Indicators
(Percent of best possible score)

□ Albania □ Average Baltics □ Average CEE

Comparison of Private Sector Credit
(In percent of GDP)
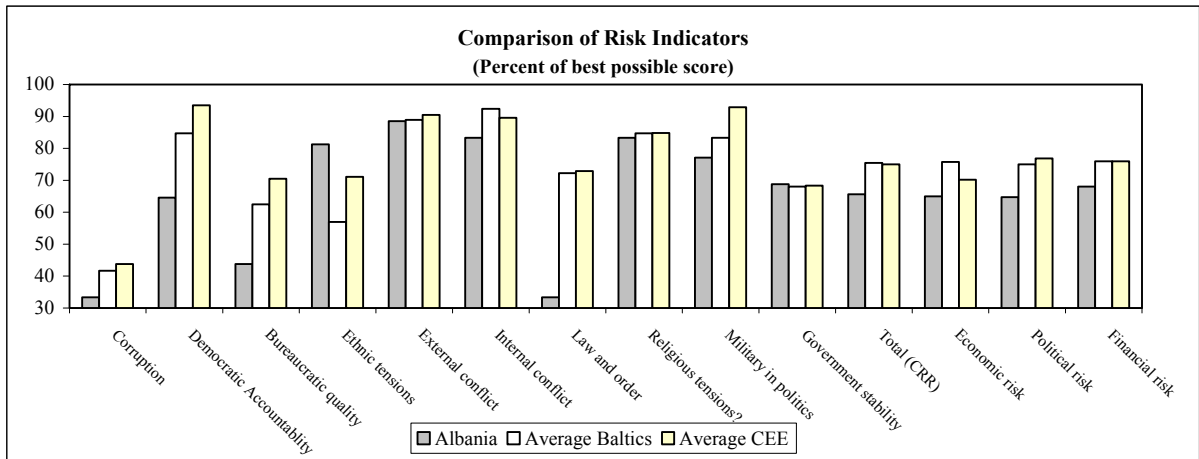
Source: EBRD, PRS Group, WEO.

lagged log difference of the endogenous variable.[15] In all, the following three equations merit mention:

$$TFP_t = \beta_0 + \beta_1 CRR_{t-1} + \beta_2 EBRD_{t-1} + \beta_3 PSCLAIMS_{t-1} + CPI_t + \varepsilon_t \qquad (5)$$

Where CPI_t is the log difference of the consumer price index.

$$TFP_t = \beta_0 + \beta_1 CRR_{t-1} + \beta_2 EBRD_{t-1} + \beta_3 PSCLAIMS_{t-1} + CPI_t + \varepsilon_t \qquad (6)$$
$$\text{(With fixed period effects)}$$

$$TFP_t = \beta_0 + \beta_1 CRR_{t-1} + \beta_2 EBRD_{t-1} + \beta_3 PSCLAIMS_{t-1} + CPI_t + TFP_{t-1} + \varepsilon_t \qquad (7)$$

17.   **The results of the estimations are presented below. All the estimated equations had relatively good fits with theoretically-correct signs.** Additionally, all variables were significant at a confidence level of between 95 and 99 percent, with the exception of the financial intermediation variable in equation 7 which was significant at the 86 percent level.

Equation 4. $TFP_t = \beta_0 + \beta_1 CRR_{t-1} + \beta_2 EBRD_{t-1} + \beta_3 PSCLAIMS_{t-1} + \varepsilon_t$

Dependent Variable: DLOG(TFP)
Method: Panel Least Squares
Date: 06/08/06   Time: 15:35
Sample (adjusted): 1993 2004
Cross-sections included: 11
Total panel (unbalanced) observations: 86
White cross-section standard errors & covariance (d.f. corrected)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
DLOG(CRR(-1))	0.173	0.063	2.760	0.007
DLOG(EBRD1(-1))	0.192	0.052	3.730	0.000
DLOG(PSCLAIMS(-1))	0.028	0.010	2.786	0.007
C	0.029	0.004	7.067	0.000

R-squared	0.253	Mean dependent var	0.036
Adjusted R-squared	0.226	S.D. dependent var	0.023
S.E. of regression	0.021	Akaike info criterion	-4.879
Sum squared resid	0.035	Schwarz criterion	-4.765
Log likelihood	213.790	F-statistic	9.251
Durbin-Watson stat	1.551	Prob(F-statistic)	0.000

Equation 5. $TFP_t = \beta_0 + \beta_1 CRR_{t-1} + \beta_2 EBRD_{t-1} + \beta_3 PSCLAIMS_{t-1} + CPI_t + \varepsilon_t$

Dependent Variable: DLOG(TFP)
Method: Panel Least Squares
Date: 06/08/06   Time: 15:36
Sample (adjusted): 1993 2004
Cross-sections included: 11
Total panel (unbalanced) observations: 86
White cross-section standard errors & covariance (d.f. corrected)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
DLOG(CRR(-1))	0.168	0.064	2.619	0.011
DLOG(EBRD1(-1))	0.259	0.063	4.122	0.000
DLOG(PSCLAIMS(-1))	0.022	0.009	2.598	0.011
DLOG(CPI)	-0.042	0.017	-2.452	0.016
C	0.032	0.004	7.971	0.000

R-squared	0.313	Mean dependent var	0.036
Adjusted R-squared	0.279	S.D. dependent var	0.023
S.E. of regression	0.020	Akaike info criterion	-4.939
Sum squared resid	0.032	Schwarz criterion	-4.796
Log likelihood	217.374	F-statistic	9.210
Durbin-Watson stat	1.636	Prob(F-statistic)	0.000

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[15] Attempts were made to include the EBRD transition indicators measuring infrastructure development. However, the model failed to demonstrate a significant role for these variables.

Equation 6. $TFP_t = \beta_0 + \beta_1 CRR_{t-1} + \beta_2 EBRD_{t-1} + \beta_3 PSCLAIMS_{t-1} + CPI_t + \varepsilon_t$

Dependent Variable: DLOG(TFP)
Method: Panel Least Squares
Date: 06/08/06   Time: 15:37
Sample (adjusted): 1993 2004
Cross-sections included: 11
Total panel (unbalanced) observations: 86
White cross-section standard errors & covariance (d.f. corrected)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
DLOG(CRR(-1))	0.226	0.064	3.515	0.001
DLOG(EBRD1(-1))	0.251	0.119	2.106	0.039
DLOG(PSCLAIMS(-1))	0.023	0.010	2.264	0.027
DLOG(CPI)	-0.033	0.016	-2.072	0.042
C	0.030	0.004	8.166	0.000

Effects Specification

Period fixed (dummy variables)

R-squared	0.465	Mean dependent var		0.036
Adjusted R-squared	0.350	S.D. dependent var		0.023
S.E. of regression	0.019	Akaike info criterion		-4.933
Sum squared resid	0.025	Schwarz criterion		-4.476
Log likelihood	228.115	F-statistic		4.049
Durbin-Watson stat	1.703	Prob(F-statistic)		0.000

Equation 7. $TFP_t = \beta_0 + \beta_1 CRR_{t-1} + \beta_2 EBRD_{t-1} + \beta_3 PSCLAIMS_{t-1} + CPI_t + TFP_{t-1} + \varepsilon_t$
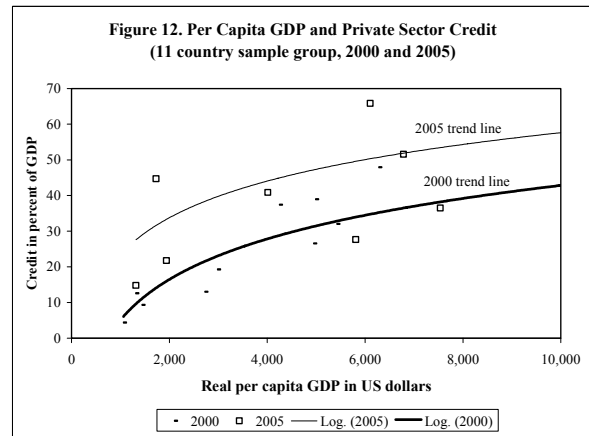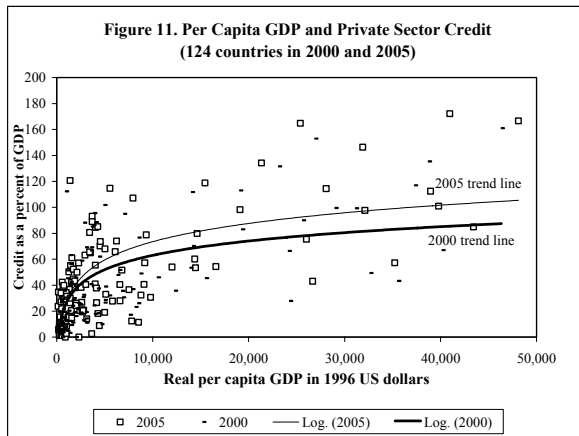
Dependent Variable: DLOG(TFP)
Method: Panel Least Squares
Date: 06/08/06   Time: 15:38
Sample (adjusted): 1993 2004
Cross-sections included: 11
Total panel (unbalanced) observations: 86
White cross-section standard errors & covariance (d.f. corrected)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
DLOG(CRR(-1))	0.135	0.070	1.927	0.058
DLOG(EBRD1(-1))	0.186	0.062	3.019	0.003
DLOG(PSCLAIMS(-1))	0.016	0.011	1.481	0.142
DLOG(CPI)	-0.079	0.020	-4.059	0.000
LOG(TFP(-1))	-0.040	0.009	-4.602	0.000
C	0.115	0.020	5.811	0.000

R-squared	0.417	Mean dependent var		0.036
Adjusted R-squared	0.380	S.D. dependent var		0.023
S.E. of regression	0.018	Akaike info criterion		-5.080
Sum squared resid	0.027	Schwarz criterion		-4.909
Log likelihood	224.439	F-statistic		11.434
Durbin-Watson stat	1.770	Prob(F-statistic)		0.000

Growth Scenarios

18.   **The growth scenarios were designed to provide a broad quantification of the contribution towards maintaining high economic growth available from a concerted program of structural reform.** They treat capital and labor as exogenous and apply the estimation results from equation 7 to determine the value of TFP. This equation is chosen because it has a relatively strong fit and high degrees of significance and theoretically-correct signs of the variables. Although the level of the financial intermediation variable is significant only at a confidence level of 86 percent in this equation, the well-documented empirical relationship between growth and financial intermediation observed worldwide and within the sample group argues for its inclusion (Figures 11 and 12). The rate of economic growth then emerges from equation 1.

Figure 11. Per Capita GDP and Private Sector Credit (124 countries in 2000 and 2005)

Figure 12. Per Capita GDP and Private Sector Credit (11 country sample group, 2000 and 2005)

19.   **The results of various scenarios are presented in Table 3**

- **Scenario 1** is a baseline case where the change in real capital stock is held at 5 percent (the estimated rate in 2005) and risk and institutional development indicators (CRR and EBRD1) are held at their 2005 levels over 2006–15. The stagnation of governance and institutional development results in a decline of TFP growth to less than 3 percent, and a decline of economic growth to 4½ percent.

- **Scenario 2** employs the same assumptions concerning the rate of increase of capital stock, but growth is maintained at 6 percent in each year through policies that reduce risk and increase institutional quality. Under this scenario, strong growth is maintained through efficiency gains, despite a fall in the capital-output ratio.[16]

- **Scenario 3** keeps the capital-output ratio unchanged and assumes that a set of governance and institution improvements sufficient to hold growth to 6 percent in all years are carried out.

- **Scenario 4** is identical to Scenario 1, but incorporates a loss of price stability.

20.   **These results suggest that structural reforms are necessary to sustain high growth into the longer term in Albania**. It is possible for Albania to maintain 6 percent real growth over the longer term provided institutional reform is pursued aggressively. As would be expected, given the higher capital stock, the necessary improvement in governance and institutions needed for scenario 3 is less than that required in scenario 2. However, it is noteworthy that in both scenarios, a significant improvement is necessary to maintain 6 percent growth, essentially requiring Albania to reach by 2015 the levels attained by the most advanced countries in the peer group. Nonetheless, as Table 4 illustrates, the levels needed for scenario 1 appear fairly common among the group and were achieved by a number of countries relatively early in the transition process. While fewer countries have yet achieved

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[16] The capital-output ratio would clearly fall whenever the real increase in economic growth exceeds the growth of capital stock, as in scenarios 1 and 2.

Table 3. Albania: Growth Scenarios, 2006-2015

	2006	2009	2012	2015
Scenario 1 (Baseline, no further improvement in governance/institutions)				
Assumptions				
Percentage change in real capital stock	4.7	5.0	5.0	5.0
Percentage change in real labor employed	0.2	0.4	0.4	0.4
Value of CRR (Risk indicator)	68.8	68.8	68.8	68.8
Value of EBRD1 (Transition indicator)	3.0	3.0	3.0	3.0
Private sector credit in percent of GDP	19.3	32.4	40.8	46.4
Inflation	3.0	3.0	3.0	3.0
Outcome				
Percentage change in real GDP	5.0	5.6	5.0	4.6
Percentage change in TFP	3.4	3.8	3.2	2.8
Memorandum items:				
Percentage change CRR	0.0	0.0	0.0	0.0
Percentage change in EBRD1	0.0	0.0	0.0	0.0
Scenario 2 (Investment insufficient to stabilize K/Y ratio and improvement in governance/institutions)				
Assumptions				
Percentage change in real capital stock	4.7	5.0	5.0	5.0
Percentage change in real labor employed	0.2	0.4	0.4	0.4
Value of CRR (Risk indicator)	68.8	69.8	74.3	82.8
Value of EBRD1 (Transition indicator)	3.0	3.1	3.3	3.8
Private sector credit in percent of GDP	19.3	32.4	40.8	46.4
Inflation	3.0	3.0	3.0	3.0
Outcome				
Percentage change in real GDP	5.0	6.0	6.0	6.0
Percentage change in TFP	3.4	4.2	4.1	4.2
Memorandum items:				
Percentage change crr	0.0	0.7	2.9	2.6
Percentage change in EBRD1	0.0	1.7	3.1	6.5
Scenario 3 (Investment sufficient to stabilize K/Y ratio and improvement in governance/institutions)				
Assumptions				
Percentage change in real capital stock	4.7	6.0	6.0	6.0
Percentage change in real labor employed	0.2	0.4	0.4	0.4
Value of CRR (Risk indicator)	68.8	68.9	70.1	75.0
Value of EBRD1 (Transition indicator)	3.0	3.0	3.2	3.6
Private sector credit in percent of GDP	19.3	32.4	40.8	46.4
Inflation	3.0	3.0	3.0	3.0
Outcome				
Percentage change in real GDP	5.0	6.0	6.0	6.0
Percentage change in TFP	3.4	3.9	3.8	3.8
Memorandum items:				
Percentage change crr	0.0	0.1	1.5	2.5
Percentage change in EBRD1	0.0	0.3	2.2	4.4
Scenario 4 (Baseline, no further improvement in governance/institutions, loss of price stability)				
Assumptions				
Percentage change in real capital stock	4.7	5.0	5.0	5.0
Percentage change in real labor employed	0.2	0.4	0.4	0.4
Value of CRR (Risk indicator)	68.8	68.8	68.8	68.8
Value of EBRD1 (Transition indicator)	3.0	3.0	3.0	3.0
psclaims--PROJECTED VALUE	19.3	32.4	40.8	46.4
Inflation	3.0	9.6	16.2	22.8
Outcome				
Percentage change in real GDP	5.0	5.1	4.1	3.3
Percentage change in TFP	3.4	3.3	2.3	1.5
Memorandum items:				
Percentage change crr	0.0	0.0	0.0	0.0
Percentage change in EBRD1	0.0	0.0	0.0	0.0

the more ambitions targets stipulated for 2015 in scenario 3, such levels are clearly possible, and were in fact attained by the Czech Republic as early as 1995.

Table 4. Countries Attaining Governance and Institutional Scores Required by Albania

Scenario 2		Scenario 3	
CRR=75.0	EBRD=3.6	CRR=82.8	EBRD=3.8
Czech Republic (1994)	Hungary (1996)	Czech Republic (1995)	Czech Republic (2005)
Poland (1994)	Czech Republic (1997)		Estonia (2005)
Slovak Republic (1995)	Poland (1998)		Hungary (1998)
Hungary (1996)	Estonia (1999)		
Slovenia (1998)	Lithuania (2002)		
Latvia (2001)	Slovak Republic (2002)		
Lithuania (2004)	Latvia (2003)		
Estonia (2004)			

Source: EBRD and PRS Group.

Policy Implications

21. **Governance and institutional reforms are essential to maintain high growth in Albania and should focus on areas where the country legs behind other transition economies.** An indication of which areas of institutional reform offer the greatest gains can be obtained by decomposing the risk and governance indicators used in the study. This is done in Figure 13, where it is apparent that, with respect to the EBRD transition indicators, reforms in enterprise restructuring, competition policy, and the nonbank financial sector are least advanced. With respect to risk indicators, corruption, law and order, and bureaucratic quality stand out as the areas in need of considerable improvement. A concentration of reform efforts in these six areas would appear therefore to offer the most efficient means of improving TFP and fostering economic growth.

Figure 13. Albania: Risk and Transition Indictors, 2005

Albania: EBRD Transition Indicators, 2005

Albania: Detailed Risk Indicators, 2005

Albania: Aggregate Risk Indicators, 2005
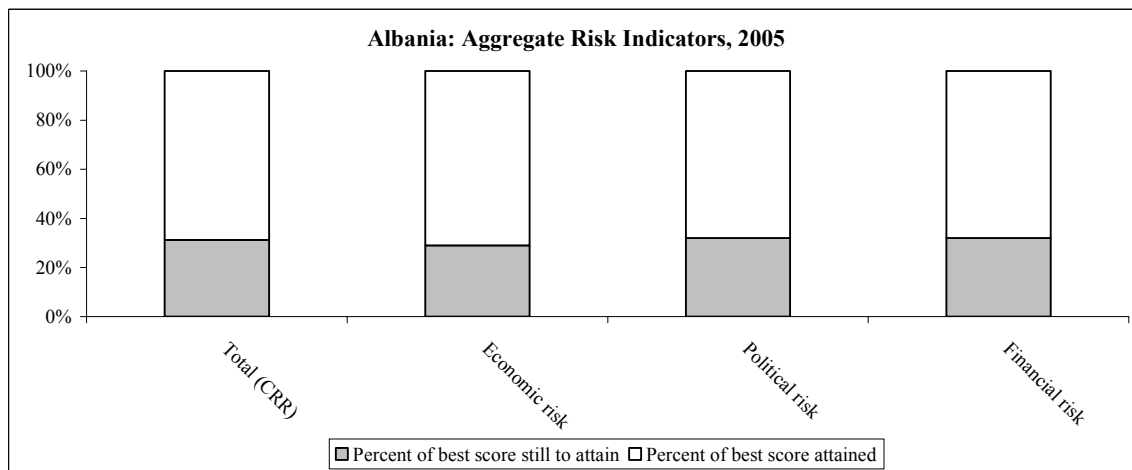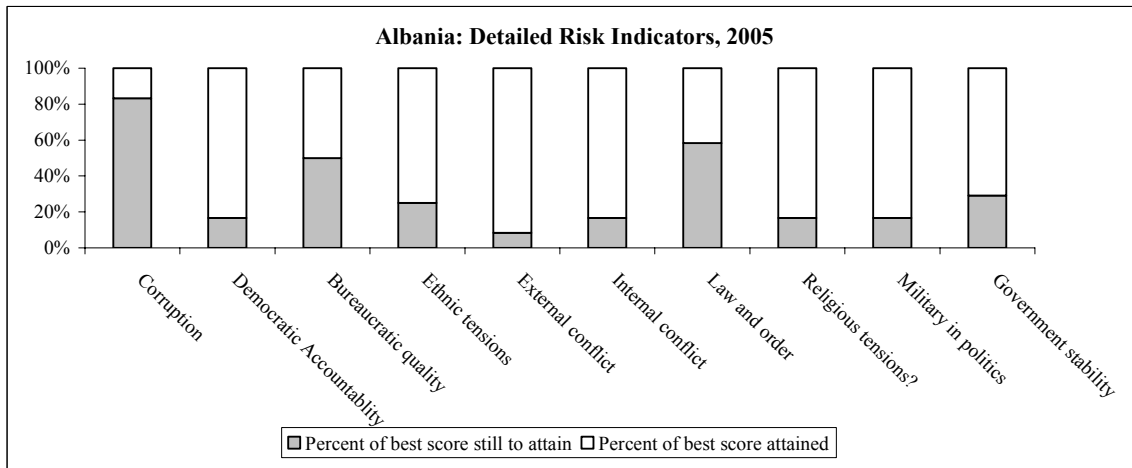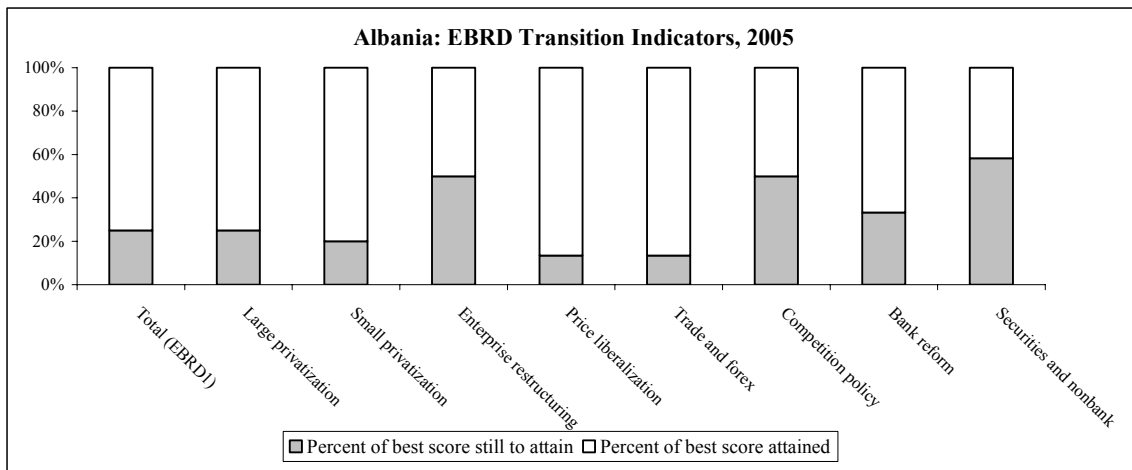
Source: EBRD and PRS Group.

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III. Legalization of Informal Immovable Property in Albania[17]

A. Introduction

1.   Since the beginning of its transition to a market economy, Albania's urban landscape has been characterized by large informal housing areas. Buildings in these areas have typically been constructed without a proper ownership of the land underneath. In other, more recent cases, buildings have been constructed on own land, but without building permits. As in other parts of the economy, high compliance costs have contributed to a large informal sector in housing. As a result, these buildings are not officially registered, and their owners do not posses legally binding ownership titles, effectively shutting them out of formal property and mortgage markets.

2.   **Uncertain ownership rights are one of the main obstacles to economic development in** Albania**.** Foreign direct investment, especially in the commercially most viable areas of the country such as Tirana and the coastal regions, is hampered by the lack of title registration, while bank financing for domestic investment is hindered by the lack of registered collaterals. These problems are increasingly recognized by the international community.[18]

3.   **This chapter looks into the benefits to the Albanian economy and financial system of legalizing informal urban areas.** The emphasis will be on legalizing informal residential areas. The theoretical underpinnings are from the framework developed by de Soto (2000), which will be applied to the current legalization process in Albania. A brief history of land reforms and privatizations in Albania is also provided to help understand how the current situation has evolved. The paper concludes with policy recommendations.

B. Property Rights and Economic Development: Theoretical Underpinnings

Background

4.   **Well-defined property rights constitute one of the basic pillars of a functioning market economy.** Not only do they enable real estate transactions to take place in a

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[17] Prepared by Ann-Margret Westin, Resident Representative in Albania.

[18] In its latest annual report on Albania, the European Commission (2005) noted that the lack of progress in resolving property issues was holding back the development of a land market and, hence, agriculture and tourism, which are potential key export sectors. The importance of clearly defined property rights was brought up by a number of Executive Directors at the last IMF Board meeting on Albania. The OECD (2006) has also noted the limited progress in the protection of land ownership.

globalized economy, but they provide for identity and records—prerequisites for participating in the market economy—as well as access to low-cost bank credit. Property rights therefore add another dimension to the underlying physical assets, enabling them to create further wealth.

5.   **However, a large part of the world's population lives outside such formal market economies.**[19] These people live and do business in informal sectors that have limited interactions with the formal ones. In particular, given the lack of well-defined property rights, assets in informal economies cannot create the same opportunities for their owners as assets that are properly registered in formal economies.

Legalization of informal property and the creation of capital[20]

6.   **Despite success with macroeconomic stabilization and structural reforms, many low-income countries still do not fully enjoy the benefits of a market economy and globalization due to inadequately defined property rights.** Most of these countries are not intrinsically "poor"—in fact, most of the poor already save and possess assets in large amounts.[21] However, their assets are held in "defective forms"—in houses built on land whose ownership rights are not adequately recorded, in unincorporated businesses with undefined liability, etc. As the property rights are not adequately recorded, the underlying assets cannot readily be turned into capital, that is, they cannot be traded outside of a narrow local circle where people know and trust each other, they cannot be used as collateral for a loan, and they cannot be used as a share against an investment.[22]

7.   **By contrast, in mature market economies, well-defined property rights enable assets to create further wealth.** In these countries, assets are properly registered. Therefore, they can provide a foundation for the creation of securities, access to financial markets, an accountable address for the collection of debts and taxes, and the basis for the creation of reliable and universal public utilities.[23]

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[19] Some two-thirds of the world's population is estimated to exist in extralegal economies (de Soto, 2005).

[20] Based on de Soto (2000).

[21] Estimated at some forty times all foreign aid received throughout the world since 1945 (de Soto, 2000, p. 5).

[22] In de Soto's words, these assets are turned into "dead" capital.

[23] The notion that the value of items can be increased by reducing the costs of knowing them and transacting with them is in line with Nobel laureate Ronald Coase's theory that transaction costs can be substantially reduced within the controlled and coordinated context of the firm; in this sense, property systems are controlled environments that reduce transaction costs (Coase, 1937).

8.   **Well-defined property rights are therefore key to enhancing financial intermediation and economic development in low-income countries.**[24] They will enable property to be sold and bought in a globalized economy and to be used as collateral for credit. They can provide a link to the owner's credit history and act as catalysts to bring in much-needed foreign direct investment.

9.   **Past attempts by governments in these countries to open up their property systems to the poor have on many occasions** failed **due to a lack of understanding of how the informal sector works.** Available evidence suggests that the primary reason why people stay outside the formal economy is not to avoid paying taxes or to pursue criminal activities, but rather to avoid the prohibitive costs of compliance with overly complex rules. Thus, properly surveying, mapping, and recording real estate assets are not sufficient to ensure that these assets will be held legally. Similarly, simply enacting laws on property without significantly reducing compliance costs will not help. Also, the existing ownership structure in the informal sector needs to be acknowledged.

10.   **Contrary to popular wisdom, operating in the informal or extralegal economy is not costless.** Participants in the extralegal sector are taxed by not being able to use properties as collateral for obtaining low-interest formal credit (or by not being able to sell shares to raise capital). Information about both informal ownership structures and creditworthiness is unavailable to the rest of the economy. This information asymmetry reduces the economic sphere of the informal areas and keeps the participants out of the formal economies. In contrast, in the formal economy, institutions like credit bureaus and tax records provide readily available information about creditworthiness. Also, given the need to hide from the authorities, businesses in the extralegal sector tend to split into small units, with little possibility to exploit economies of scale to enhance efficiency.

11.   **A full understanding of the capitalization process and the challenges facing it is critical to the success of reforms that aim to formalize informal activities.** In order to bring informal areas into the formal economy, governments in poorer countries need to face both the legal challenge of integrating the current extralegal contracts into one all-encompassing legal framework and the political challenge of opening up the formal economy to the poor (Box 1).

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[24] A recent evaluation by the World Bank of its legalization project in Peru demonstrated enormous returns (World Bank, 2006).

Box 1. Capitalization Process

The capitalization process as outlined in de Soto (2000) consists of four different steps or strategies:

The discovery strategy focuses on identifying the problem by locating and classifying the extralegal assets and quantifying their value. It aims to understand the interaction of the extralegal sector with the rest of society, identify the norms that govern extralegal property, and determine the costs of extralegality to the country.

The political and legal strategy focuses both on ensuring the support from the highest political level and establishing agencies that will permit rapid change, and on removing administrative and legal bottlenecks with a view to making it cheaper to hold assets legally than to hold them extralegally. In this context, it will be important to build consensus between the legal and extralegal sectors and create mechanisms that will reduce risks associated with private investment, including credibility of titles.

The operational strategy aims to enable the government to recognize and process individual property rights in the extralegal sector, as well as to implement communication strategies to encourage participation of the extralegal sector, support from the business community and the government sector, and acquiescence among those with vested interests in the status quo. There will be a need to reengineer the record-keeping organizations and registration processes to enable them to integrate the information about the country's extralegal assets into one data/knowledge-based computer system.

The commercial strategy, lastly, aims to implement the information and enforcement mechanisms that will enable the provision of financial services, public utilities, collection systems, databases/information services, insurance products, national identification systems, housing and infrastructure, and national security.

Source: de Soto (2000, pp. 160–61).

The Legal Challenge to Legalization of Informal Property

12.	**While nearly every low-income country has a formal property system, most citizens lack access to it.** A reliable system needs to include everyone. However, the poor cannot participate in existing systems in these countries because they are far too complicated.[25] Therefore, in order to protect their property and earn a living, the only alternative for the poor is to retreat with their assets into the extralegal sector where they can live and do business among themselves. As people continue to create property beyond the reach of the law, the law increasingly loses its legitimacy.[26] This situation has become more acute over the last forty years as billions of people have migrated to cities.

13.	**For a formal legal system to succeed, it must obtain legitimacy by recognizing the extralegal contracts that currently determine property rights.** If a government does not provide for a system of records, people will do it on their own. Hence, the extralegal assets are typically well documented or represented, although not legally acknowledged. On the basis of these extralegal representations, the underlying property rights can be determined. In mature economies, this process took place centuries ago. But by the same token, the formal property systems existing today in rich countries were also once built on these "extralegal" contracts.[27]

The Political Challenge to Legalization of Informal Property

14.	**Strong political leadership is essential to the success of reforms to make property rights accessible to a wider public.** While such reforms are likely to increase the well-being of the society as a whole, they are also likely to endanger the interests of key lobby groups. Many of the statues that prevent the majority from entering the formal economy also contain provisions that protect vital interests of powerful groups.

15.	**Reforms should offer benefits both to the poor and to vested interests.** To win the support of the poor, the gains from entering the formal sector must exceed the costs of doing

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[25] E.g., the procedure to obtain legally a home in Peru consists of five stages, the first of which alone involves 207 steps; similarly, the procedure to formalize informal urban property in the Philippines involves 68 steps, lasting between 13 and 25 years (de Soto, 2000, p. 20).

[26] This is the old Hobbesian problem: when most people obey the law, the government can enforce it effectively and relatively cheaply against those few that break it; when obedience breaks down on a large enough scale, no authority is strong enough to police everyone (Rapaczynski 1996).

[27] In the 1780s, e.g., President Washington complained about "squatters" and small illegal entrepreneurs occupying lands that they did not own.

so; hence, this transition must be easy, safe, and cheap. To win over vested interests, the strong economic benefits to them of formalizing the extralegal sector should be emphasized. As the poor become accountable under the formal law, construction businesses, mortgage companies, title agencies, and insurance firms will be able to expand. This formalization process will provide governments and businesses with information and addresses for merchandising, securing interests, and collecting debts, fees, and taxes.[28] Formalizing the informal sector will also enhance law and order.

C. Land Reform and Privatization in Albania, 1912–2005[29]

16.   **During independence (1912–44), Albania began pursuing agrarian reforms.** These reforms, which aimed to transfer land ownership to peasants, brought about little change, however, as most land remained with the original landowners.

17.   **During the communist regime (1944–90), land was expropriated and collectivized.** Within one year, in 1945, the share of land belonging to the wealthy and middle-class landowners shrank from 52 percent to 16 percent. Next, agricultural cooperatives were created, covering almost the entire country by 1967. Lastly, the size of the cooperatives was increased, thereby reducing the number of cooperatives from 1,800 in 1959 to 143 by 1983 and making Albania one of the most collectivized countries in Europe. As a final step, the 1976 Constitution eliminated all private ownership of land and immovable property.

18.   **The economic transition since the late 1980s has** reversed **these changes and created a market for immovable property.** As outlined in Appendix I, several laws have since been passed to deal with the privatization of state-owned companies and institutions, and of land that was expropriated and collectivized during the communist regime. Laws have also been passed to address the issues of restitution and compensation for former landowners.

19.   **The privatization process began in 1991 with the approval of Law No. 7501,"On Land," which recognized the right to private ownership of land and immovable property.** The law assigned rural land to those who had cultivated it during the communist regime, establishing a system of ownership rights, free of charge, for families living on the

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[28] One of the main characteristics of people in the extralegal sector in developing and former centrally planned economies, including Albania, is that they do not have a legal address.

[29] This section is largely based on information provided by the Organization of Security and Cooperation in Europe (OSCE) Presence in Albania.

ex-cooperative farms, and land-use rights, later converted into property rights, for those living on state farms.

20.   **This law, however, has not been accepted by everybody.** A controversial aspect of Law 7501 was that it did not entitle former landowners to restitution of the rural land they owned before establishment of the communist regime. It also gave rise to a system of fragmented small plots, making efficient farming difficult. As a result, implementation has not been universal, with many farmers, especially in the north, returning to the old, pre–1944, status.

21.   **The next major step was the privatization of state-owned housing and urban land.** Law No. 7652,"On the Privatization of State Housing," in 1992 allowed for ownership rights to be sold at low nominal costs to tenants with state rental contracts. As a result, only some 2 percent of units still remained in state hands by 1994. A unique feature of this privatization was the decision to treat the immovable property and the land underneath it separately.[30] Building sites were evaluated separately in the privatization process, with sites underneath multiple-unit buildings transferred in joint ownership to all the owners of the individual units.

22.   **Meanwhile, extralegal construction began in part because** the **urban planning laws were difficult to implement.**[31] Inadequate space, in combination with a weak "construction police," led to a significant amount of "extralegal" extensions, with apartments extending onto public property such as sidewalks and alleys. Extralegal construction also started to spread in public areas such as parks and riversides.[32]

Restitution and Compensation

23.   **The next legal challenge was to deal with restitution and** compensation **issues.** Several state-owned apartment buildings that were privatized in the early 1990s had been expropriated during the communist regime. To address this, Law No. 7698, "For Restituting and Compensating Former Property Owners," was passed in 1993 based on the principle to restitute to the former owners whenever possible. When restitution was not possible, the state would compensate the former owners for their loss of property through financial

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[30] "Buildings are to be considered separately from building sites, and transferred as a joint property" (Law No. 7652, Article 10.)

[31] Law No. 7693 of 1993, and Law No. 8405 of 1998, "On Urban Planning."

[32] In the case of the municipality of Tirana, a successful decision was taken in the early 2000s to dismantle all constructions from public parks and riversides.

compensation, state bonds, or equivalent land. However, in practice, all these alternatives have proved difficult to carry out.

24.   **Although required under the 1998 Constitution, all issues pertaining to restitution and compensation have not yet been settled.** In an effort to address the still outstanding issues, the 1998 Constitution required parliament to enact the necessary laws by November 2001. Just ahead of this deadline, the government approved some amendments to the main restitution and compensation laws, and a special parliamentary commission was established to review these amendments. However, progress in this area continued to be slowed by the sensitivity and complexity of the matters involved, including the lack of an inventory of state land available for compensation and the lack of clear guidelines for funding financial compensations, determining land values for the purpose of compensation, and dealing with regions that had refused to implement the existing legislation.

25.   **To address the remaining problems, a new law was passed in 2004.** Although still not allowing for restitution of rural land, Law No. 9235, "On Recognition, Restitution and Compensation of Property," established a new state committee, added an administrative appeal process, and introduced a new valuation method for compensation based on market values. The law required all requests to review existing claims to be filed by March 2005 and all new claims to be submitted by September 2005. However, as in the past, the implementation of this law has fallen behind schedule. Current estimates indicate a total of some 48,000 outstanding restitution claims and complaints.

D.   Legalization of Informal Urban Areas in Albania

26.   **As a result of the significant urban migration since the beginning of the transition, Albania's large cities are characterized by widespread informal urban sprawl.** Municipalities were unprepared for the significant migration from the rural areas to the large cities coinciding with the country's transition toward a market economy. The restitution process described in the previous section further contributed to this migration. Urban migration picked up following the civil unrest in 1997, and, more recently, sharp increases in land prices have contributed to the development of extralegal housing. The government estimates that some 60–70 percent of buildings constructed since 1990 (some 200,000–220,000 buildings) are extralegal. Most of these have been built since 1997, amounting to an estimated investment of some US$3 billion (32 percent of GDP).

27.   **The hundreds of thousands of Albanians living in informal housing have no access to formal property and mortgage markets.** This situation hinders the development of the real estate and land markets, which, in turn, impedes foreign direct investment and the growth of potential export sectors.

28.   **Extralegal owners, however, seem to recognize the benefits of legalization.** In a meeting with an association of house owners in Keneta, an informal housing area in Durres (Box 2), they agreed that moving forward with legalization, on the whole, would be

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Box 2. Keneta Informal Urban Area

Keneta is one of several informally developed settlements in Albania that are the result of the nonorderly population migration from the rural areas into the big cities since 1990—for example, in the last 15 years, the population of Durres has doubled. The initial settlers in Keneta in the early 1990s typically purchased their land from people who had claimed it previously, under the assumption that they would obtain full legal ownership.

The final Regulatory Plan for the City of Durres of 1987 called for the development of Keneta as a green area. A subsequent 1996 draft Urban Study reserved the best part of Keneta for urban and tourism development.

Co-PLAN, Institute for Habitat Development, an NGO specializing in urban development, has for the last few years been involved in the formalizing a pilot zone in Keneta. Co-PLAN works with the inhabitants of the informal areas and the municipalities in a participatory urban planning process. The pilot zone covers some 50 hectares and has a population of approximately 5,000 inhabitants. It lies within the city limits of Durres and serves as an entrance section to the rest of Keneta. The majority of the buildings (close to 80 percent) in the pilot zone are single-family homes; most of these are one-story (55 percent) and two-story (30 percent) buildings. Very few of the houses (0.2 percent) have a garage, reflecting both the scarcity of land and the low standard of living in the area. Within the zone, there is no solid waste collection. Waste is either moved to collection sites outside the area or is burnt, buried, or simply thrown into the drainage canals. Almost all (96 percent) of the children who live in the zone attend school. The majority of adults have finished secondary school and over 40 percent have finished university.

Source: Municipality of Durres and Co-PLAN, Institute for Habitat Development.

beneficial.[33] [34] While legalization would entail costs to the new owners in terms of taxation and transfer fees, the benefits of being able to fully participate in the formal economy, in particular the financial system, were thought to exceed these costs. The positive externalities to the rest of the society were also emphasized.

Property registration

29.   **Progress on the first (initial) registration process—a sine qua non for the legalization process—is much slower in urban than rural areas (Box 3).** More than 80 percent of rural land, over 2.1 million parcels, has been registered, and legal titles, or certificates of ownership, have been issued to the owners, including farmers who have returned to the pre-1994 boundaries. Nonetheless, much of the country remain unregistered, including large cities and the coastal areas. In particular, the first registration process had only been completed for 20 percent of urban cadastral zones as of March 2006. Similarly, the Vlora-Saranda coastline, a key potential tourist area, remains unregistered, mainly due to unresolved restitution and compensation issues.

30.   **Apart from unresolved legal issues pertaining to ownership rights, problems related to the registration process itself are also responsible for this slow progress**. There are capacity constraints, and the registration system is plagued with governance problems. Furthermore, because the Property Registration Office also assesses and collects the transfer tax, there is a tendency to underreport property transactions, which undermines the integrity of the property registration system. Lastly, as municipalities have begun to set boundaries for the areas to be formalized, the lack of access to the local registry offices has emerged as a new problem.

31.   **Other institutional weaknesses have also slowed progress.** Many restitution and compensation cases are being held up in the courts, as judges often do not have the necessary expertise to deal with property cases; currently, it is estimated that approximately half of all court cases involve immovable property issues. Furthermore, due to difficulties in obtaining building permits, many people resort to building illegally. High notary fees, set by the Ministry of Justice, also hinder the development of the land market.

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[33] The visit was organized by Co-Plan, Institute for Habitat Development, a nongovernmental organization focusing on participatory urban planning; a representative of the OSCE Presence in Albania also participated.

[34] See Appendix II for an overview of interviews and visits.

Box 3. First Registration Process

Currently, **9 different laws** govern the privatization of immovable property in Albania, while some **25 different institutions** have information related to immovable property (legal documents, maps, etc.) **Two different types of property registries** are in place, as remnants of the past: **the Cadastre registry**, which mainly contains the technical documentation pertaining to the property, and **the Hipoteka registry**, which contains the legal documentation regarding ownership rights, etc. The Hipoteka registry does not cover rural land.

The **first registration process,** which was established in 1994 as a result of the passage of Law No. 7843, "On the Registration of Immovable Property," aims to combine the information stored in these two registries into a single registry, similar to the **Land Book** found in western countries. The combined registration is documented in a "Kartela," a file at the Central Registry Office (CRO) that contains all the relevant, past and current, technical and legal documentation pertaining to a property. Once the first registration process has been completed, the CRO can issue a certificate of ownership and other legal documents, and the function of the Hipoteka system will be closed down.

The process is **lengthy and resource intensive,** taking up to one year to complete for an individual property. It includes the compilation and copying of all the necessary documents, the preparation and printing of maps and other technical and legal documents, a public display, a final review, and, lastly, the archiving at the CRO.

As of March 2006, the first registration process was completed for almost 79 percent of all cadastral zones, resulting in the registration of some 3.5 million properties. However, while almost 82 percent of all rural cadastral zones have been completed (corresponding to some 2.5 million properties), **only 20 percent of the urban cadastral zones have been completed** (1 million properties). For example, in Tirana, only 6 out of 28 urban cadastral zones were registered as of March 2006. Similarly, the costal area from Vlore to the Greek border remains largely unregistered. First registration in urban areas is ongoing in another 10 cadastral zones, 3 of which in Tirana.

The first registration process was initially supported by the **United States Agency for International Development,** as well as the **EU-PHARE program** and the **World Bank.** Since 2004, the **Organization of Security and Cooperation in Europe Presence in Albania** has provided support. Starting in 2007, the World Bank, in part funded by the Swedish Development Agency, will provide further support.

Source: OSCE Presence in Albania.

32.   **As registration is a prerequisite for legalization, the Central Registry Office has started to collect data on informal areas.** A registry has been set up containing technical information on informal areas in a few cities, such as Durres and Elbasan. These informal areas, built on state-owned land, cover some 12 cadastre zones.[35] The collected information will constitute the basis for the first registration and legalization process, which will include the transfer of property rights from the state to private individuals.

Legalization Framework

33.   **After the first legalization law was passed in 2004, municipalities began the process of formalizing the informal areas.** According to Law No. 9304, "On Legalization and Urban Planning of Informal Zones," citizens were obliged to declare their illegal constructions and the land area occupied by March 2005, that is, within three months of the law's coming into effect. Next, municipalities began preparing the necessary urban planning—a prerequisite for moving ahead with legalization according to this law—with a view to integrating the informal housing into the rest of the economy (Box 4). Boundaries for the areas to be formalized needed to be defined and subsequently approved by the local and national territory regulation councils, based on the self-declarations provided by the extralegal owners. Within one year of approval of the urban planning study for the informal zone, citizens were to have submitted complete technical and legal documentation.

34.   **However, with the prospects of a new legalization law, further work under the 2004 existing law stalled.** The process of defining and approving boundaries slowed significantly during the 2005 election campaign amid prospects of a new legalization law. Local municipalities were unable to move forward with their urban planning processes as the National Territory Regulation Council ceased to make further decisions on the boundaries of the areas to be formalized. Similarly, although the construction police were supposed to be charged with tearing down the extralegal buildings in informal areas that had not been reported during the self-declaration process of 2005, in reality this was rarely done.[36]

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[35] The Central Registry Office.

[36] Since the 2005 election campaign, buildings torn down have mostly been "obvious" cases, such as buildings built on school yards and hospital grounds.

Box 4. Legalization of Informal Areas in Tirana

Tirana's informal areas, characterized by unauthorized constructions, cover a surface of approximately 900 hectares, with a population of 75,000 inhabitants. Approximately 80 percent of the 25,000 buildings are two-story houses or smaller. In general, the engineering and road networks are largely missing. The existing ones are organized spontaneously and do not comply with the standards, and the roads are narrow and unpaved, with no sidewalks. There are no parks, public buildings, playgrounds, kindergartens or elementary schools in these areas.

Following the passage of Law No. 9304, "On Legalization and Urban Planning of Informal Zones" in 2004, 17,521 self-declarations of illegal buildings were presented to the municipality of Tirana. Those illegal buildings for which no self-declaration was submitted by the deadline of March 24, 2005 were to be destroyed by the construction police. Based on the self-declarations submitted, the municipality started the work of setting the boundaries of the areas to be formalized. These boundaries subsequently have to be approved first by the Tirana Territory Adjustment Council, and next by the National Territory Adjustment Council. By February 2006, the boundaries of six informal areas had been approved by the National Territory Adjustment Council. As Law No. 9304 required that the urban planning process be completed before the legalization process, the municipality began preparing urban plans for the first pilot zone based on maps already prepared by the Central Registration Office.

Source: Municipality of Tirana.

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35.   **During his 2005 visit to Albania, Professor de Soto emphasized the need for the laws to reflect the existing underlying structures and cautioned against moving too quickly with the process.**[37] He urged the authorities to find the "underlying order" in the informal areas and to use common law attributes to create record-keeping and legal systems

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[37] Professor Hernando de Soto, President of the Institute for Liberty and Democracy (ILD), was invited by Prime Minister Berisha to discuss ongoing efforts to legalize the informal housing areas. Following this visit, an agreement was reached on a two–year collaboration between the ILD and the Albanian government on assistance in legalizing informal areas following the approval of the new legalization law. The assistance of the ILD will focus on the first part of the "capitalization process," that is, on diagnosis and reform design.

that reflected this underlying structure.[38] As this is a time-consuming process, he cautioned against setting too-ambitious deadlines.

36. **In early 2006, a second legalization law, Law No. 9482, "On Legalization, Urban Planning and Integration of Illegal Buildings," was approved.** In its new program, the government made a commitment to "complete and consolidate the property rights system and create opportunities for the legalization of properties earned by work, sacrifice, and honesty, in order to include them in the economic and civil spheres."[39] A new process of self declaration of informal buildings is to start on July 15, 2006, after which no construction will be allowed that does not have the proper permits and does not comply with existing rules.

37. **This new legalization law differs from the 2004 law in several important aspects.** First, the payment required by the owners to legalize their informal dwellings has been significantly reduced from basically market value, according to the 2004 law, to amounts ranging from US$1,000 to US$4,000 for the vast majority of constructions.[40] Second, in contrast to the 2004 law, the new law allows for legalization to proceed even if the urban planning process has not been completed. Third, the new law deals not only deal with the mainly residential informal areas on the outskirts of the cities but also with new commercial and residential buildings within the city limits that have been built or amended without proper building permits.

38. **A number of concerns have been raised with the legalization laws.** Most important, both legalization laws impose a significant documentation requirement on the new legal owners, including the preparation of maps. Furthermore, there are significant concerns that the established deadlines are too ambitious, making it difficult for the extralegal owners to comply with, and for the local authorities to adequately capture the existing ownership arrangements and complete the first registration process. The latter in itself might take up to one year. Various parties, in particular international development partners, have stressed that the lack of proper consultation during the preparation of the laws might create problems during implementation—as legalization is an issue that concerns most Albanians, it should not be turned into a politically divisive issue. Furthermore, the extralegal owners and municipalities have complained about insufficient information about the process itself. Lastly, former owners, who might have had hopes that the payments from the new legal

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[38] de Soto (2005).

[39] Government of Albania (2005).

[40] Only parcels within the yellow line (city limits) larger than 300 square meters will carry a market price (note that only parcels up to 500 square meters will be subject to legalization according to the new law).

owners would subsequently be used as compensation for their expropriated land, have raised concerns about the much smaller than envisaged required payments.

Budget Impact

39.   **The budget impact of legalizing informal urban areas in Albania could be significant.** With some 220,000 buildings in informal urban areas, property taxes could yield about US$14 million, or 0.15 percent of GDP a year, while the onetime transfer fee could yield some US$459 million, or 4.9 percent of GDP.[41] This would be in addition to any payment from the new legal owners, which, under similar assumptions, could amount to some US$690 million, or 7.3 percent of GDP.[42] While the underlying assumptions may be subject to change, the fiscal implications are likely to be significant, particularly for local governments, which will be the main recipients of these revenues.[43]

E. Collateralized Lending in Albania

40.   **Banks are following a conservative approach to lending, reflecting the problems with property registration.** Interviews with commercial banks suggest that almost all lending is more than 100 percent collateralized. The lion's share of lending goes to mortgages, collateralized by the underlying property, or to commercial loans, collateralized either by real estate or by pledges. It is estimated that about 80 percent of all collaterals are in the form of real estate. Only properties with certificates of ownership are accepted as collateral. In addition, some banks also require all the information provided in the Kartela (see Box 3). If the first registration process for a property has not been completed, some banks might still accept the property as collateral if the Hipoteka information is provided. In most cases, this process takes a long time.

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[41] These estimates assume an average property size of 200 square meters. The per square meter property tax and transfer fee vary depending on where the property is located (Tirana and Durres, other big cities; or the rest of the country); when the property was built (before or after 1993); and the purpose of the building (residential, commercial, or other). For a residential building constructed after 1993 and situated in either Tirana or Durres, the property tax and transfer fee amounts to lek 30 (US$0.3) and lek 1,000 (US$10) per square meter, respectively.

[42] Assuming an informal urban area of up to 200 square meters within the "yellow line" (city limits), the payment required by the new owners ,according to Law No. 9482, will be lek 300,000 (US$3,000).

[43] Local governments receive the property tax and transfer fee, 80 percent of the payment made by the new legal owners in the legalization process (20 percent goes to the central government), and the (fixed) penalty for modern commercial buildings that lack appropriate building permits.

F. Policy Conclusions and Recommendations

41.   **Moving ahead with the legalization process will help the authorities maintain high growth and create positive externalities for the whole economy.** Defining property rights will be fundamental for attracting foreign investment and will also help develop the financial system.

42.   **The legalization process should therefore move ahead without delays.** In particular, the pilot zones that have already made significant progress with urbanization and registration, thanks to the support of international organizations and NGOs, should be allowed to proceed more quickly than other areas. This would help maintain the momentum in these areas and could provide models other areas could emulate.

43.   **First registration, which is a necessary precondition for legalization, needs to be further streamlined to make it accessible to everyone.** To this end, it should be made simple, fair, and free from political influence. Moreover, the government should provide sufficient funds to complement the financing from donors. By providing information about state-owned land, the completion of first registration will also accelerate the compensation of former land and property owners.

44.   **The cost of entering the formal sector should be made lower than that of staying in the extralegal sector.** Most people resort to the informal sectors because they cannot afford the financial and bureaucratic costs of entering the legal sector. Hence, for the legalization process to be successful, it should not impose an excessive financial burden on people. Thus, as the entire economy will benefit from legalization, there is no obvious rationale for demanding payments from informal home owners that reflect the full market value of the land they occupy. In this respect, the new law on legalization marks a clear improvement over the previous law.[44] However, the heavy documentation requirement that has been maintained will continue hindering the legalization process and make it particularly difficult to comply with the tight deadlines established by the new law. In particular, the maps necessary to complete the process should be provided directly by the central and local authorities.

45.   **Securing strong public support for the process will also be essential.** In order for any legal framework to function well, it needs to be widely accepted. This will require

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[44] This argument applies to the family homes in informal urban areas, which is the focus of this study. It is not applicable to modern buildings in city centers built or amended for commercial purposes without proper building permits. Apart from penalties, the owners of these buildings should pay market value for the land underneath the property to be legalized, in line with the new law.

maintaining an open dialogue with all key stakeholders. It will also be important to ensure that the process does not fall victim to domestic election cycles.

46. **The process of legalization should not be held up by the slow progress in resolving other major land reform issues.** In particular, the restitution and compensation of former owners are issues that are not directly linked to the process of legalization of informal urban areas, unless they are situated on land that has been reclaimed by previous owners. In such cases, the new law on legalization requires that the legalization go hand in hand with the compensation of former owners.

47. **Similarly, while it would be preferable to complete urban planning before legalization, it is not a prerequisite.** Ideally, urban planning should proceed legalization, as is the case in the pilot zones that have received assistance from NGOs and international organizations. However, the urban planning process can be time-consuming as it requires sufficient resources at the local level. There could be a transition period—up to five years—during which owners of land that needs to be expropriated for urban planning purposes would be compensated under the same terms as the ones that were applied during the legalization process. This would limit the fiscal risk that might arise from large price increases following legalization.

48. **Looking ahead, Albanians will continue to participate in the legal sector only if the financial and bureaucratic burdens of doing so are kept light.** Legalization is not a one-off event but requires continued efforts to make the system simple and user friendly. Otherwise, the extralegal sector will start growing again.

Albania: First Registration of Immovable Property -- March 2006

District	Total Cadastral Zones (CZ)	Total Registered Cadastral Zones	Total Urban Cadastral Zones	Total Registered Urban CZ	Total Rural Cadastral Zones	Total Registered Rural CZ
Berat	129	122	6	0	123	122
Durres	71	56	9	2	62	54
Elbasan	185	120	9	2	176	118
Fier	118	94	6	2	112	92
Gjirokaster	98	71	4	0	94	71
Kavaje	68	62	3	0	65	62
Korce	156	142	5	3	151	139
Kruje	43	39	3	0	40	39
Lac	28	22	3	0	25	22
Lezhe	66	62	3	0	63	62
Mat	79	76	3	0	76	76
Mirdite	83	76	3	0	80	76
Shkoder	140	101	8	1	132	100
Tirane	184	146	28	6	156	140
Tropoje	71	47	3	0	68	47
Vlore	106	72	7	2	99	70
Other districts	1433	1100	35	10	1398	1090
Total	3058	2408	138	28	2920	2380

Source: Organization of Security and Cooperation in Europe, Presence in Albania.

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APPENDIX I. Land and Immovable Property Reform, Privatization, Restitution, and Legalization 1991–2006—Legal Framework

Law No. 7501, *On Land*, dated July 19, 1991; recognizes the right to private ownership of land and immovable property, and establishes a system for land classification.

Law No. 7652, *On the Privatization of State Housing*, dated December 23, 1992; provides for rights to sell, lease, and mortgage privatized properties.

Law No. 7693, *On Urban Planning*, dated April 6, 1993; regulates legal transfer of building sites.

Law No. 7698, *For Restituting and Compensating Former Property Owners*, dated April 15, 1993; recognizes property rights of former owners of private buildings and building sites, as well as of rural land that had changed to building sites (urban land).

Law No. 7843, *On the Registration of Immovable Property*, dated July 13, 1994; lays the groundwork for establishing a uniform system of immovable property registration.

Law No. 8405, *On Urban Planning*, dated September 17, 1998; replaces Law No. 7693.

Law No. 9235, *On Recognition, Restitution and Compensation of Property*, dated July 29, 2004; replaces, inter alia, Law No. 7698 and Law No. 7699; regulates restitution/ compensation of immovable property expropriated, nationalized, or confiscated since 1944.

Law No. 9304, *On Legalization and Urban Planning of Informal Zones*, dated October 28, 2004; aims at formalizing urban informal housing zones.

Decision No. 183, *On the approval of the methodology on the valuation of immovable property that will be compensated and of the one to be used for compensation*, dated April 28, 2005.

Law No. 9482, *On Legalization, Urban Planning and Integration of Illegal Buildings*, dated April 3, 2006; replaces, inter alia, Law No. 9304.

Source: Republic of Albania

APPENDIX II. Interviews and Visits

American Bank of Albania, Ms. Ardiana Ujka, Vice President, Marketing & Corporate, March 23, 2006.

Bank of Albania, Mr. Klodion Shehu, Director, Supervision Department, March 27, 2006.

Central Registry Office, Mr. Alkend Shpendi, Acting Registrar, and Ms. Sonila Jazaj, Deputy Registrar, together with Ms. Mirvjena Laha, OSCE, February 1, 2006.

Co-PLAN, Institute for Habitat Development, Mr. Dritan Shutina, Executive Director, together with Ms. Mirvjena Laha and Ms. Eralda Methasani, OSCE, February 9, 2006.

Keneta informal housing area, together with Mr. Dritan Shutina and Ms. Anila Gjika, Co-PLAN, and Ms. Eralda Methasani, OSCE, March 17, 2006.

Municipality of Durres, Mayer's Office, Mr. Indrit Puteci, Director, together with Mr. Dritan Shutina and Ms. Anila Gjika, Co-PLAN, and Ms. Eralda Methasani, OSCE, March 17, 2006.

Municipality of Tirana, Ms. Rezarta Ismailaja, Director of Legalization and Expropriation Department, together with Ms. Mirvjena Laha and Ms. Eralda Methasani, OSCE, February 8, 2006.

National Association of Legitimate Owners, association of former owners of Vlora, December 19, 2005.

Organization for Security and Co-operation in Europe Presence in Albania, Mr. Alex Finnen, Deputy Head of Presence, January 26, 2006.

_____, Mr. John Keefe, Project Manager, International Property Law Specialist, Immovable Property Project, March 16, 2006.

Ownership with Justice, association of former owners of Tirana, November 8, 2005, and January 24, 2006.

Raiffeisen Bank, Mr. Robert Wright, Member of the Management Board—Business Segments, March 24, 2006.

PART II. THE IMPACT OF REMITTANCES ON DEVELOPMENT AND THE BUDGET

IV.   MACROECONOMIC ASPECTS OF WORKERS' REMITTANCES IN ALBANIA[45]

1.   **Albania's receipts from workers' remittances are, relative to GDP, among the highest in the world.** According to official estimates, remittances accounted for about 14½ percent of GDP in 2005 a level exceeded only by a few countries, most of which are small islands. Remittances are considerably larger than exports (1.8 times), foreign aid (7.3 times), and FDI (4.7 times). Remittances have significantly lowered the current account deficit and helped Albania build a comfortable level of external reserves. However, microeconomic surveys point to a considerably lower level of remittances than official balance of payments estimates. Therefore, a proper assessment of the size of and factors affecting remittances is essential to understand better the structure and the sustainability of Albania's external current account balance.

2.   **Remittances appear to have a significant development effect, particularly in eradicating poverty.** This depends largely on the channels through which remittances affect domestic demand: they may affect consumption or investment or both; and they can be spent on domestic production or imports. Alternatively, remittances can also be saved. They can also alleviate poverty, and recent microeconomic studies suggest that this is the case in Albania. Remittances may also complement social transfers. Hence, the prospects for larger remittances can influence the design of the public safety net.

3.   **To increase the beneficial effects of remittances, more of them should be channeled through the financial system.** Remittances are still largely transferred through informal channels. Bringing remittances more fully within the formal economy could have an important positive impact on the development of the Albanian financial system. To achieve this, financial instruments geared to the needs of emigrants should be developed.

4.   **The remainder of this paper is structured as follows.[46]** Section B compares official (balance of payments) estimates with estimates from various microeconomic survey and

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[45] Prepared by Pierre Lazar (EUR).

[46] The analysis is based on macroeconomic data on remittances and on a review of recent microeconomic studies and household surveys, including the study prepared by the Albanian government in cooperation with the International Organization for Migration (IOM) in 2005 entitled "Competing for Remittances" (CFR); the World Bank's 2004 Social Safety Net Review (SSNR) and 2003 Poverty Assessment, which both build on the 2002 Living Standard Measurement Survey (LSMS); the World Bank's "Italy-Albania Remittance Corridor ", a document for discussion (2006); and, research done by technical assistance experts from the IMF's Statistics Department.

discusses the implications for the structure of the balance of payments of the sizable differences among these estimates. Section C discusses the determinants of remittances and the prospects for their further growth. Section D investigates the development impact of remittances and their effect on the public safety nets. Section E discusses how remittances can be better integrated into the formal financial system, and Section F concludes.

A. How Large Are Workers' Remittances in Albania?

5.   **Recent household surveys suggest that remittance flows are smaller than estimated by official balance of payments statistics.** The table below shows the overall level of remittances that would correspond to the average level of remittances by family found in the 2002 LSMS, the CFR study, and a preliminary review of data of the 2005 LSMS. This is obtained by multiplying the average level of remittances by household by the number of households receiving remittances (190,000). Thus, the 2005 LSMS implies remittances of EUR 314 million, compared with euro 497 million based on the CFR study, EUR 262 million based on the 2002 LSMS, and EUR 830 million in the official balance of payment estimate. On average, the overall level of remittances derived from the three studies is only 43 percent of the official balance of payments estimate.[47] Conversely, the average level of remittances received by households corresponding to the overall estimate in the balance of payments would reach EUR 4,374, a level that appears extremely high when compared with emigrants' estimated average annual income abroad (about EUR 10,000).

Albania: Estimates of Remittances, 2004 Using Various Sources 1/
(In euros, unless otherwise indicated)

	Balance of Payments	2002 LSMS	CFR Study	2005 LSMS
Average annual value of remittances per household		1,382	2,620	1,493
Remittances as percentage of household incomes		13		
Remittances as percentage of incomes of households receiving remittances		47	43	
Number of households (in thousands)				728
Number of households receiving remittances (in thousands)				190
Income from remittances (in million of euros)	830	262	497	314
o/w through the bank reporting system	378			
Remittances in percent of GDP	13.8	4.4	8.3	5.2

1/ Data from the 2002 LSMS have been adjusted for inflation and exchange rate changes.

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[47] Admittedly, surveys tend to underestimate the level of remittances, in part because illegal activities are not reported. Nonetheless, even the highest estimate from the three studies mentioned above is equal to only 60 percent of the estimate from the official balance of payments.

Box 1. Estimating Remittances

In many countries, balance of payment statistics underestimate the level of remittances because of the lack of information on remittances transmitted through informal channels. This, however, does not appear to be the case in Albania because official statistics do not rely solely on the bank reporting system to estimate remittances. Instead, remittances are defined as remittances through the banking system and Western Union, plus the remittances other than those reported by banks and financial institutions. These are defined to be equal to the value of trade and travel not funded through the banking system. Remittances other than those reported by banks and financial institutions are estimated as a residual in the following way:

	Imports (customs data, with adjustments)
Plus	unrecorded imports (estimated)
Less	imports paid by donors
Equals	imports paid from domestic sources
Less	imports paid through banks (bank reporting on imports)
Equals	cash imports (imports paid outside banks)
Plus	cash travel debits (total debits minus the amounts paid through the banking system)
Less	cash travel credits (total credits minus the amounts paid through the banking system)
Less	cash exports (total exports minus the amounts paid through the banking system)
Plus	purchases by households of lek from banks and exchange bureaus
Less	purchases by households of foreign currency from banks and foreign exchange bureaus
Equals	Remittances.

It is assumed that 80 percent of the remittances received through banks are exchanged on the parallel market. To avoid double counting, official remittances are defined as the sum of the remittances estimated according to the residual formula plus 20 percent of the remittances received through banks and financial institutions. The underlying assumption is that all remittances are spent on imports of goods and services and that all unaccounted inflows spent on these items are remittances. Similar calculations are made for workers' compensation.

6.   **The implications of smaller remittances for the balance of payments could be significant.** Replacing the estimate of workers' remittances derived from the residual method used in the balance of payments [see Box 1] with an estimate derived from household surveys and placing the difference into errors and omissions would significantly widen the current account deficit. However, it is difficult to determine whether the unaccounted flows (the difference between the estimates) should be included in the current, capital, or financial accounts because they may reflect remittances not captured by household surveys, other current transfers, or capital flows.

7.   **Because of the magnitude involved, it is essential to research the nature of this discrepancy.** Particularly, regular surveys of remittances and improvements in the methodology would be helpful.

B. Is the Growth of Workers' Remittances Leveling Off in Albania?

8.   **While remittances have grown rapidly in nominal terms since the early 1990s, they appear to have been relatively stable relative to GDP over this period.** Based on official estimates, remittances declined rapidly in the years immediately after the beginning of the transition. They surged temporarily in 1998 in the wake of the collapse of the pyramid scheme. While in 2000-05 remittances relative to GDP grew moderately, they appear to have been relatively stable over the long run. The pattern of remittances in Albania appears comparable to a number of countries at the same stage of development (Appendix I).
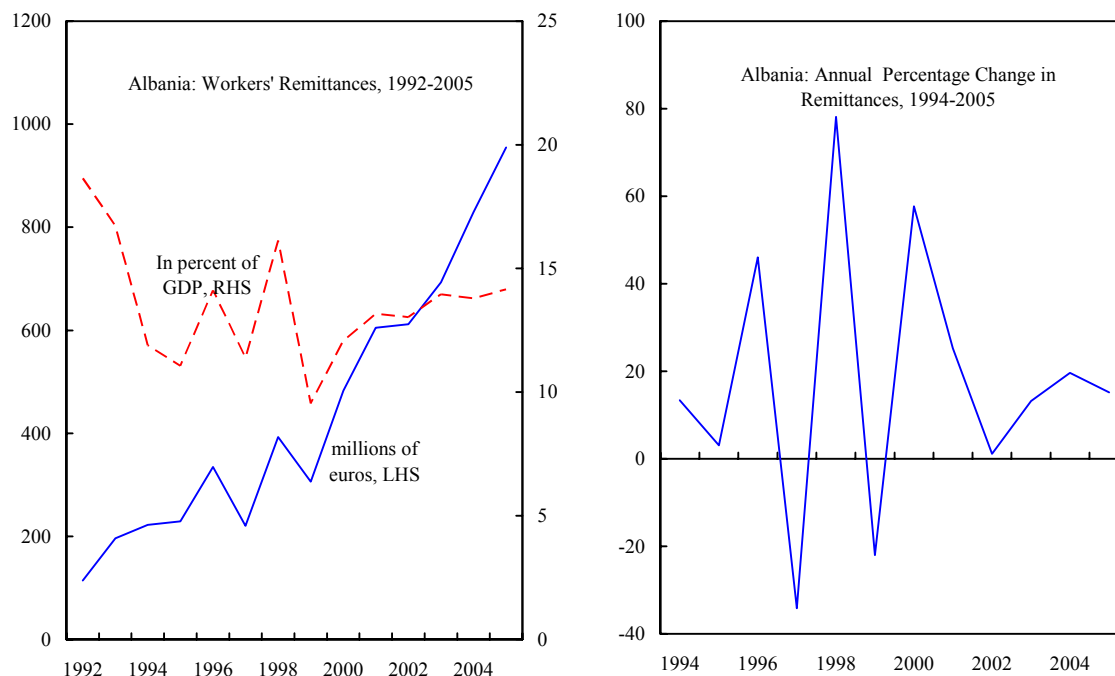
Source: IMF.

9.   **Remittances can be seen as private transfers to Albanian households from outside the country, or as earnings resulting from a migration-based family employment strategy.** Under the latter approach, families send one of their members abroad to supplement the income lacking in the home country. Developments in 1997-98 can be analyzed under this approach. Remittances declined during the pyramid crisis (1997) but picked up in 1998. In response to the crisis, families sent one or several members abroad, causing remittances to surge during the following year.

10.   **The growth of remittances in Albania broadly follows emigration trends.** Based on official balance of payments data, remittances have increased from US$150 million in 1992 to about US$1 billion in 2004. Remittances grew in the context of rapid emigration after the start of the transition in the early 1990s and of a temporary surge following the pyramid scheme crisis (see figure below). However, according to the CFR study, emigration tapered off in the early 2000s, explaining why remittances have remained relatively stable as a percentage of GDP thereafter. [48]

Albania: Emigration, 1992-2004 1/
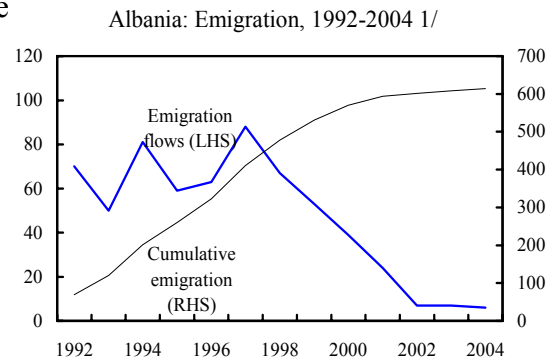
Source: IOM-Tirana.
1/ Based on a survey of 698 emigrants prepared by IOM-Tirana

11.   **The projection of remittances in Albania is plagued by a number of difficulties.** It is hard to estimate the strength and sustainability of the unaccounted remittance flows, which may or may not constitute remittances in the narrow sense. Another consideration is the pattern of emigration. The CFR study indicates an average emigration cycle of 17.6 years from the first "experience of migration" and 14.6 years from the point of obtaining legal status (in Italy, typically obtained around 2002). If one accepts the hypothesis of a 14-18 year emigration cycle, Albanian emigrants may start returning in the coming years, which, in turn, would imply a relatively rapid decline in remittance flows.

Albania: Emigration and Remittances, 1992-2004
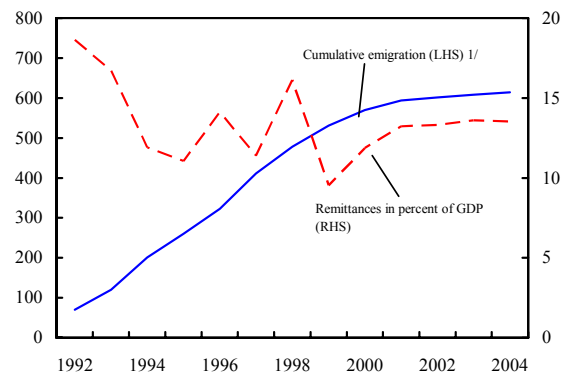
Sources: IOM-Tirana, and IMF staff estimates.
1/ Based on a survey by IOM-Tirana.

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[48] This assumption is difficult to verify as there are no official annual data on the number of emigrants. The 2001 population census revealed a net loss to emigration of 628,000 during the 1990s. The annual breakdown of emigration in the figures below is from a survey prepared by the IOM-Tirana for the CFR study.

12.   **If emigration has tapered off, workers' remittances relative to GDP could be expected to decline over time as the Albanian economy catches up with Europe.** A simple calculation, assuming that remittances will grow in line with GDP growth in Italy and Greece, shows that remittances will fall from about 14½ percent of GDP in 2005 to about 11½ percent of GDP by 2010.

C.   The Development Effect of Remittances in Albania

13.   **The literature does not suggest a strong relationship between remittances and economic growth.** A cross-country study on remittances and growth done at the IMF (Chami, Fullenkamp, and Jahjah, 2003) finds a negative relation between remittances and economic growth, suggesting that remittances are countercyclical. Using a standard cross-country regression framework, the April 2005 *World Economic Outlook* finds no statistically significant relationship between remittances and economic growth. In addition, these results apply regardless of the level of development in the recipient country. A subsequent study by Giuliano and Ruiz-Arranz (2006), using a newly constructed measure of remittances, confirms that remittances do not directly contribute to economic growth. However, remittances can contribute to growth in less financially developed countries: in this context, remittances substitute for the lack of more advanced financial intermediation. As recent cross-country studies find no evidence that remittances have a negative impact on competitiveness, there seems to be no indirect impact on growth either.

14.   **It is generally accepted that remittances can help reduce poverty.** To the extent that remittances are countercyclical, they smooth the consumption of the poor. If remittances are used mainly to finance consumption, they may have an impact on poverty even if their impact on economic growth is minimal. This has been shown in a number of countries (e.g., Guatemala, Egypt, and Mexico).[49] Cross-country studies suggest a strong link between poverty reduction and remittances, although the impact may be economically small.[50] In the case of Albania, no comprehensive study exists, but household surveys show that remittances are used primarily to meet basic consumption needs and are thus likely to contribute to poverty reduction.

15.   **The 2002 LSMS and the 2005 CFR study clearly indicate the existence of this link.** Based on the World Bank SSNR's analysis of the 2002 LSMS, remittances represent
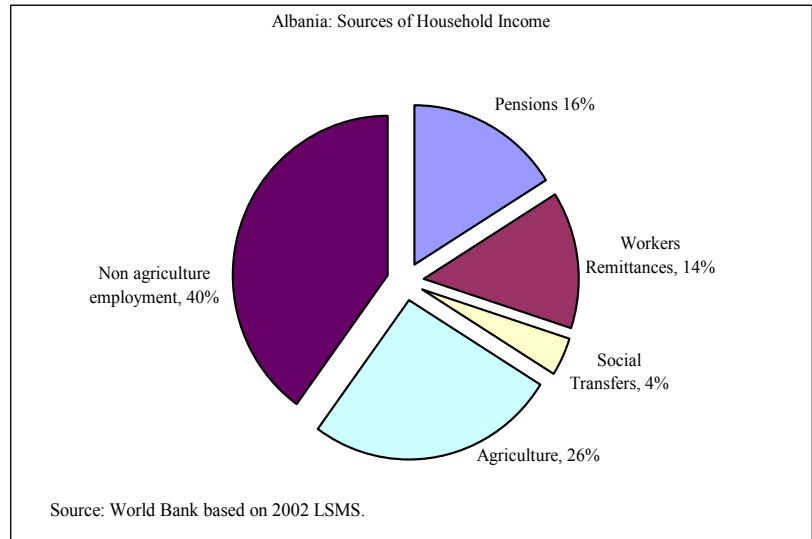
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[49] Adams, 1991 and 2004, and Stark, 2004.

[49] The April 2005 *World Economic Outlook* (IMF, 2005) found that, on average, a 2.5 percentage point increase in the remittances-to-GDP ratio was associated with less than a ½ percentage point decrease in the share of people living in poverty.

14 percent of household income, compared with 16 percent for pensions and 4 percent for social transfers (see figure below). On average, 22 percent of households receive remittances, and their average size is equivalent to 47 percent of the average monthly income. Twenty-nine percent of the poor and 44 percent of the extremely poor households receive remittances. Eighty percent of remittances go to poor households, of which 66 percent go to extremely poor households. Looking at the incidence of remittances considered as transfers, the SSNR concludes that remittances have eliminated much of the poverty gap.[51]

Albania: Sources of Household Income

Pensions 16%

Workers Remittances, 14%

Social Transfers, 4%

Agriculture, 26%

Non agriculture employment, 40%

Source: World Bank based on 2002 LSMS.

16.   **According to the 2002 LSMS, remittances reduced the poverty head count by about 6 percentage points and the extreme poverty head count by 5½ percentage points.** The table below, using the 2002 LSMS data, shows the critical role of remittances in poverty reduction. Without transfers, the poverty rate would have been 44 percent, compared with 25 percent after transfers. Without remittances, the rate would have been 32 percent, and, without public pensions (but including remittances), it would have been 37 percent. Without any transfers, the extreme poverty rate would have been 19 percent, against 4.7 percent, and without remittances, it would have been 10 percent.

17.   **Remittances appear to have a larger impact on poverty reduction than public transfers.** While public transfers have a greater impact than private transfers in reducing the poverty head count, private transfers reduce the poverty gap and the severity of poverty much more than public transfers. In other words, private transfers, including remittances, have a bigger impact on income distribution than public transfers. Based on the World Bank's calculations using 2002 LSMS data, public transfers reduce the poverty gap by 37 percent, while private transfers do so by 74 percent.

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[51] The poverty gap is the average proportion by which poor household incomes fall below the poverty line.

Impact of Transfers on Poverty and Extreme Poverty, 2002
(In percent, assuming consumption increased by 100 percent of transfer)

	Total Transfers	Public Transfers		Private Transfers	
		Total	o/w Pensions	Total	o/w Remittances
Baseline post-transfer poverty rate	25.4	25.4	25.4	25.4	25.4
Baseline pre-transfer poverty rate	43.9	37.2	35.1	32.5	31.6
Percentage point reduction	18.5	11.8	9.7	7.1	6.2
Post-transfer extreme poverty rate	4.7	4.7	4.7	4.7	4.7
Pre-transfer extreme poverty rate	19.0	11.2	10.0	10.7	10.2
Percentage point reduction	14.3	6.5	5.3	6.0	5.5

Source: Albania Poverty Assessment (World Bank, 2003).

18.   **The 2005 LSMS points to a significant decline in poverty between 2002 and 2005.** The share of population living below the poverty line fell from 25.4 percent in 2002 to 18.5 percent in 2005. At the same time, the share of households under extreme poverty declined from 4.7 percent to 3.5 percent (see the table below).

Albania: Poverty Indicators (In percent)		
	2002	2005
Absolute poverty rate	25.4	18.5
Extreme poverty rate	4.7	3.5
Two dollar- a- day poverty rate 1/	10.8	7.7
Relative poverty rate 2/	20.4	21.2
Gini coefficient	0.28	0.29

Source: LSMS . Data for 2005 are preliminary.
   1 / Percentage of population with per capita income below 2 US dollars a day.
   2/ Percentage of population with consumption below 60 percent of median.

19.   **The apparent efficiency of remittances in reducing poverty has an implication for the design of public transfer schemes.** If remittances continue to increase at the pace experienced in recent years, they can be expected to eliminate much of the poverty gap. The

design of public transfers could thus be improved by taking this impact into account and better targeting these schemes on households that do not receive remittances.

D. Sustaining Remittances Flows: the Importance of the Financial Sector

20. **Although the bulk of remittances is still sent through informal channels, the importance of the formal channel has increased significantly in recent years.** Informal channels include the senders themselves, friends or relatives carrying their remittances personally to Albania, and other informal networks, such as travel agencies and money changers. Formal channels include banks and money transfer operators (MTOs), essentially Western Union and Money Gram. The 2002 LSMS estimated that in 2001 banks and MTOs accounted for only 12.9 percent of receipts by value; in 2005, the International Accreditation and Recognition Council (IARC) estimated that in that year informal channels represented 60 percent of the transfers coming from Italy. Information collected for the CFR study indicates that, in terms of the volume of remittances, emigrants are increasingly turning to formal channels. Transfers through the formal system almost doubled between 2000 and 2003 and have grown tenfold since 1994. However, a survey done for the CFR study shows that emigrants still prefer informal channels over formal channels by a large margin (77.5 percent) and that the physical transfer of cash is the preferred means of transfer (60 percent). Based on data from the Bank of Albania and the Italian customs

Distribution of Remittances by Transfer Channel 1994-2004, (In Percent)

Source: IOM-Tirana.

police (Guardia di Finanza), the authors of the World Bank's " Italy-Albania Remittance Corridor" study reach a similar conclusion. [52]
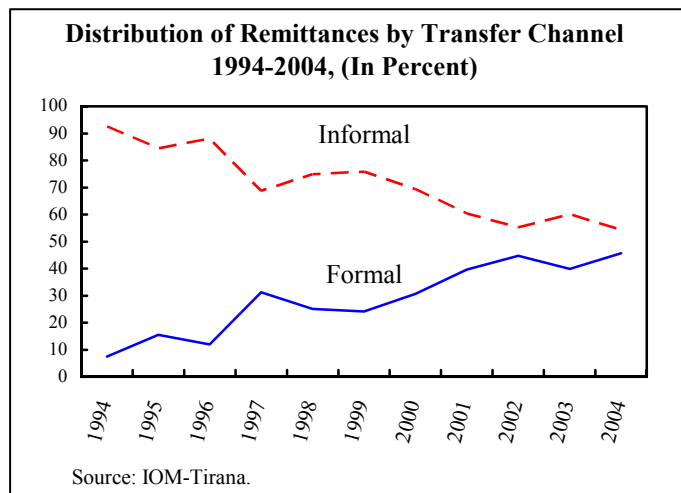
21. **These developments reflect the rise of MTOs and the continued expansion of Italian and Greek banks with branches in Albania.** Albanians residing in Italy who use the banking network tend to turn mainly to the Italian Albanian Bank. Albanians resident in Greece usually use one of the four Greek banks that operate in Albania. These banks have a network of 49 branches in 16 towns. It seems that remittances that transit through the

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[52] Hernández-Coss, R. and others, "The Italy-Albania Remittance Corridor".

banking system constitute an important source for foreign currency deposits. By comparison, 285 agents of MTOs were active in Albania in 2004. MTOs operate through a large number of financial institutions in Italy, Greece and other countries.

22.   **Increasing the share of financial institutions in remittance transfers will require a close coordination between the authorities in Albania and in the countries where Albanian emigrants reside.** In this regard, a number of useful policy recommendations have been advanced recently to boost the participation of financial institutions in the remittance corridor between Italy and Albania (see Hernández-Coss, R. and others, 2006) . These include recommendations to formalize the physical transfer of cash by promoting a registration program, to strengthen the institutional framework for remittance transfers between the two countries, and to improve data on remittances and to explore the opportunity for a bilateral pension agreement. Moreover, Italian employers should be encouraged to pay their salaries to Albanian workers though the banking system, while Italian banks involved with Albanian emigrants could develop financial products for senders and recipients. These products could include the development and transfer of dual cards, cellular phone remittances platforms, and remittance transfer through the postal service.

23.   **The government could also attempt to tap the savings of Albanian abroad.** According to the International Organization on Migration (IOM), these amounted to US$ 5 billion in 2004 (70 percent of Albanian GDP). For example, the authorities could consider issuing special bonds to Albanian emigrants. In this regard, they can learn from the experience of Israel, which started to issue nonnegotiable bonds in the early 1950s (Box 2) to nonresidents and noncitizens with special links with Israel.

Box 2: Israel's Bond Program

Bonds were issued for the state of Israel in the early 1950s, with a view to raising foreign exchange, initially from individuals and communities abroad. Subsequently, notes were also issued to medium-sized financial institutions abroad, mainly in the United States, but bonds for individuals remained the most important instrument. These bonds represented 34 percent of the government's external debt in 2003. They have been particularly useful in those years when it has been difficult for the government to raise foreign exchange. Over time, different types of nonnegotiable bonds have been offered, with each bond designed for different type of customers. The price of the bonds has become increasingly determined by the market. Today, yields on these bonds are close to those on negotiable U.S. dollar-denominated Israeli government bonds.

E.   Conclusions

24.   **Further research is needed to confirm that official statistics in Albania significantly overestimate the size of remittances.** The uncertainty about the true level of remittances hampers the analysis of the balance of payments and makes projecting remittances difficult. Improvements in the methodology to estimate remittances and regular surveys would be helpful in this regard.

25.   **Irrespective of this uncertainty, the relative size of workers' remittances can be expected to decline over time as Albania catches up with Europe.** Assuming that current migration trends remain unchanged, the analysis presented above suggests that remittances will grow slower than Albania's GDP, measured in foreign currency.

26.   **Remittances have played an important role in reducing poverty in Albania and the design of social transfers** should **take this impact into account.** The 2002 LSMS data suggest that remittances are reaching a large portion of poor and extremely poor households. The targeting of social transfers could be improved by taking this impact into account.

27.   **Further efforts are needed to encourage emigrants to send their remittances through formal channels and keep their savings in Albanian financial instruments.** This will require Albanian banks to develop products that suit the need of emigrants and a stronger coordination between the Albanian authorities and the authorities in the countries where Albanian emigrants reside. The physical transfer of cash, which remains significant in size, could be formalized by promoting a registration program. Moreover, employers in host countries should be encouraged to pay their salaries to Albanian workers though the banking system. Finally, the Albanian government could issue special bonds for emigrants.

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## Appendix I. Patterns of Development of Remittances

Figures 1 to 3 present different patterns of development of private transfers (taken as a proxy for remittances) in a stylized manner and for selected countries. The data are from the IMF's World Economic Outlook database. Figure 1 shows developments in more mature and higher- income countries, Ireland, Portugal, and Israel. In these countries, remittances have declined steadily for some time, because emigration flows have stopped and emigrants have become increasingly integrated in the host country. Figure 2 shows countries with similar income levels. These countries also display a pattern of growth of remittances similar to Albania's rapid growth during the second half of the 1990s and stabilization thereafter; in three of the four countries, Macedonia, Moldova and Morocco, remittances hover around 10 percent of GDP—a level comparable to that of Albania. Figure 3 shows cases of two countries with a somewhat higher income level than Albania's, Bulgaria and Croatia -where remittances appear to follow a pattern of growth similar to Albania but with remittances representing a lower percentage of GDP. To compare with countries where remittances represent a similar level of GDP, Figure 3 also shows Mexico, where remittances appear to continue to increase, arguably as a result of continuing emigration, and Turkey where remittances have fallen abruptly since the early 2000s.

Figure 1. Portugal, Ireland, Israel: Remittances 1980-2003
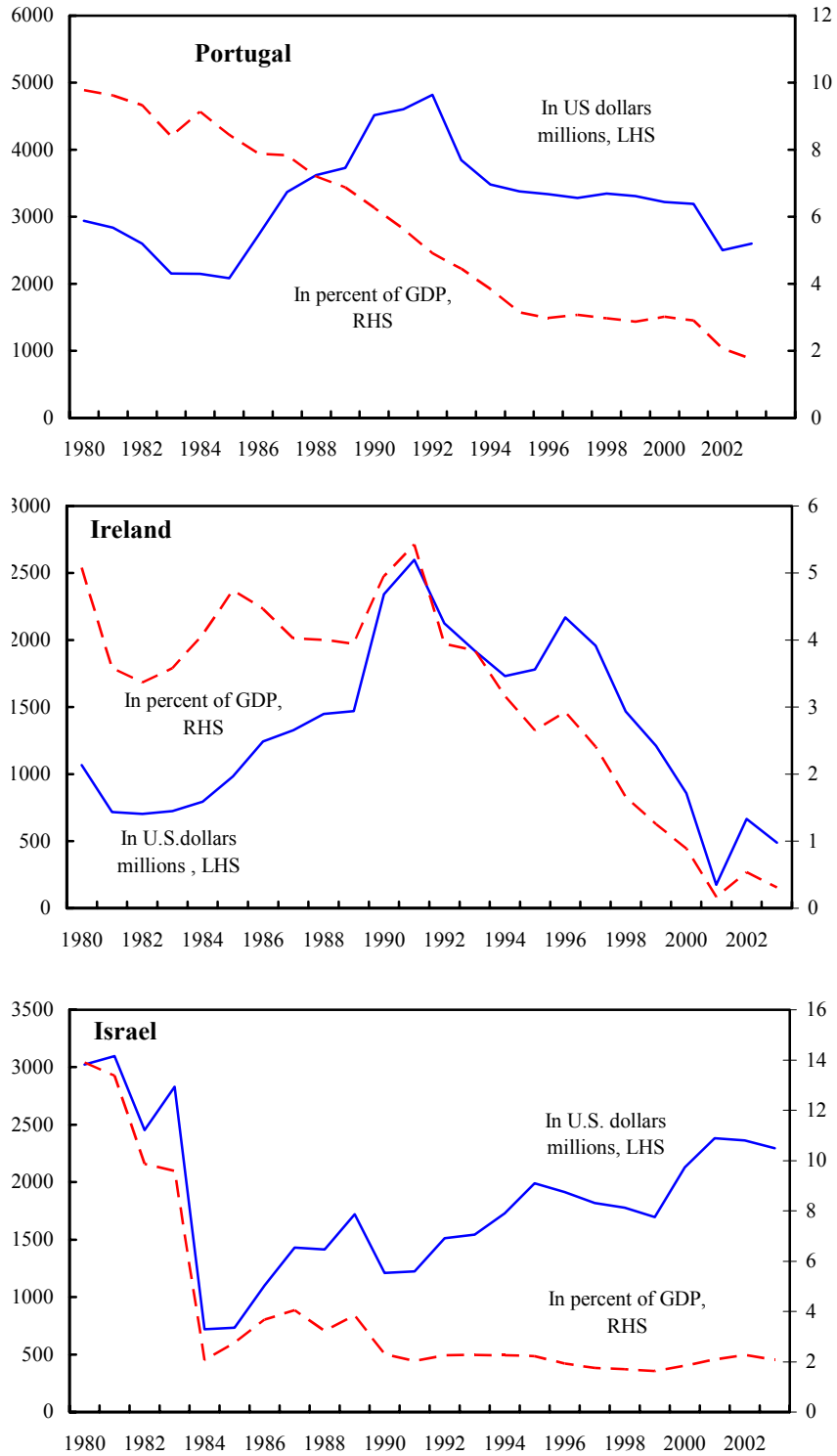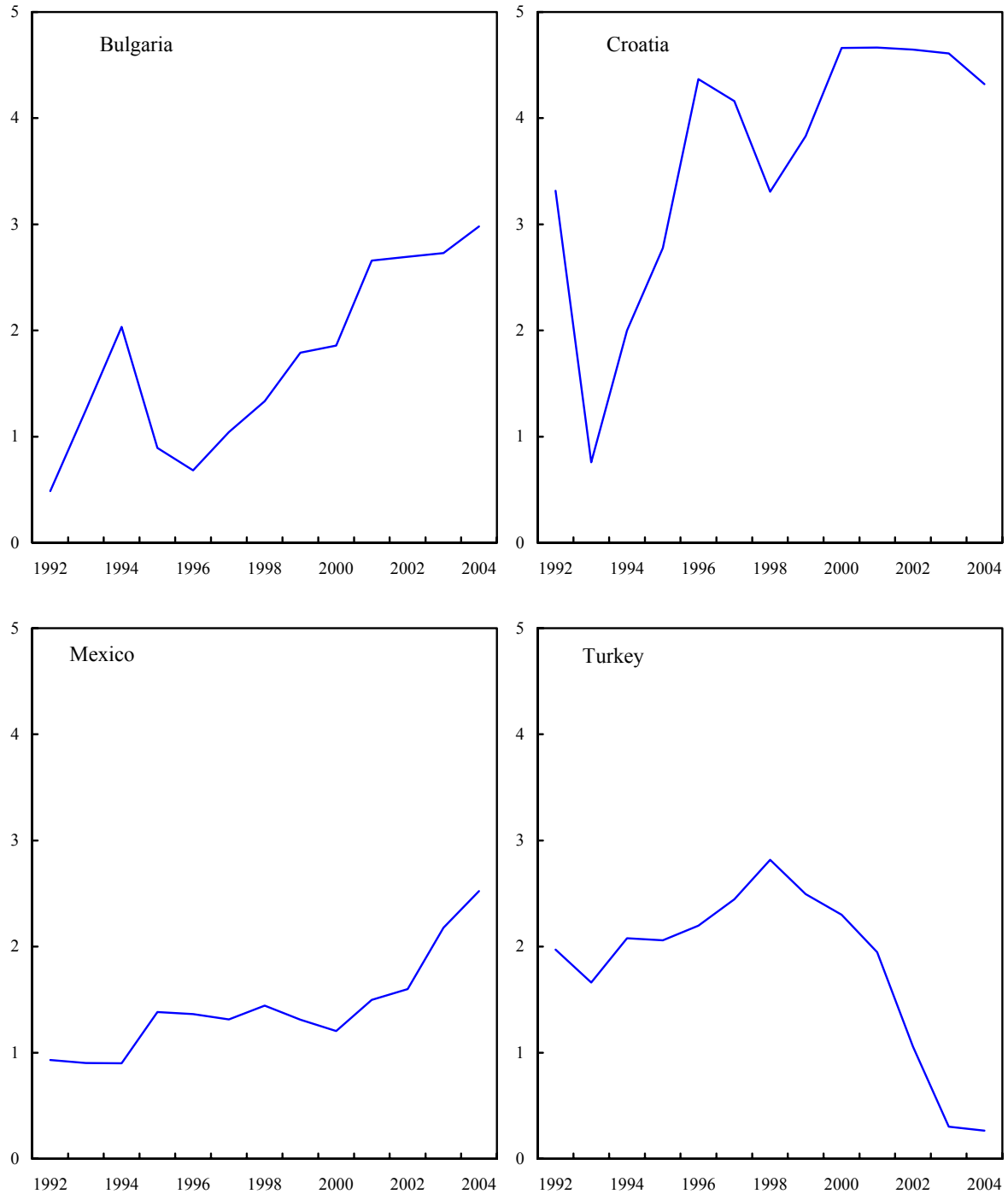

Source: IMF.

Figure 2. Remittances: Medium-Level Risers, 1992-2004
(In percent of GDP)
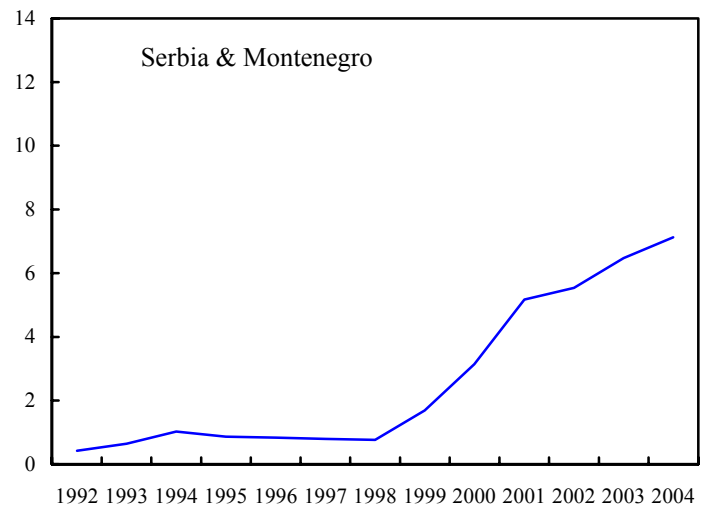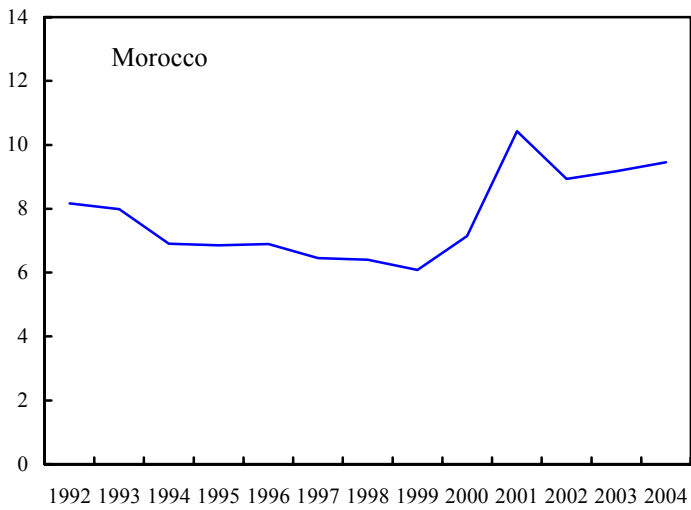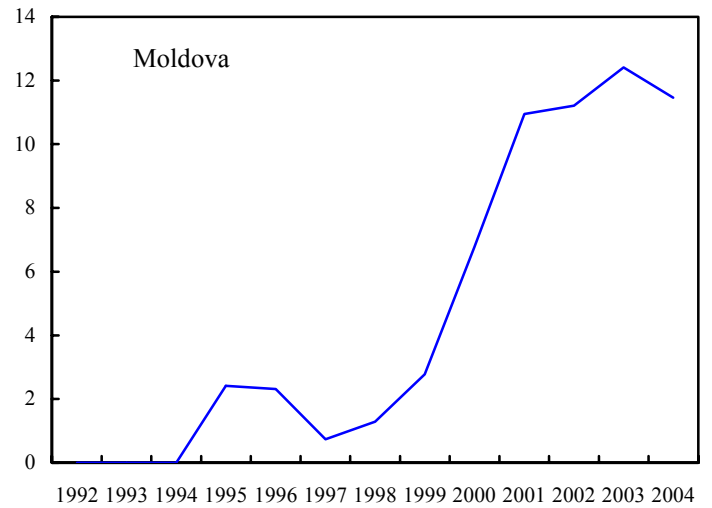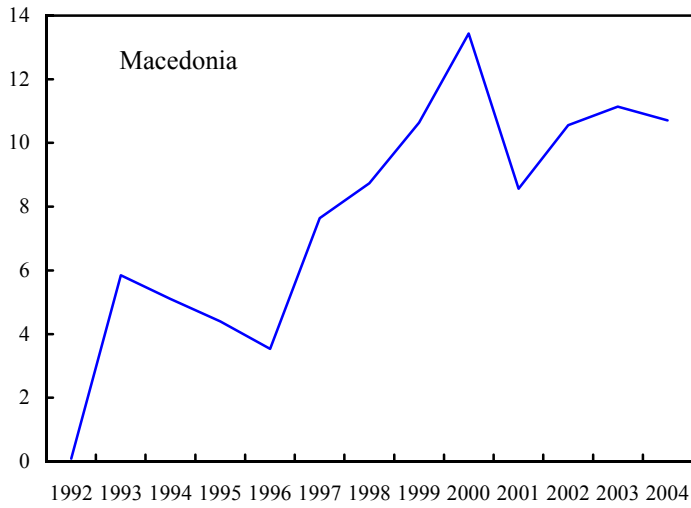
Source: IMF.

Figure 3. Remittances: Low-Level Risers, 1992-2004
(In percent of GDP)

Source:IMF.

V. FISCAL IMPACT OF REMITTANCES[53]

A. Introduction

1.   **The main goal of this chapter is to provide an initial framework for analyzing the budgetary impact of remittances in Albania and to stimulate analysis on this topic**. The chapter identifies the main channels through which remittances are likely to affect the budget in Albania and provides some estimates of the total fiscal impact. Although remittances can affect the fiscal position of a country through a number of channels, existing studies on remittances focus on the impact on growth and the financial sector.[54] This chapter—unlike most studies on remittances—examines the fiscal impact.

2.   **The chapter is laid out as** follows**.** Sections B and C describe in detail the various channels and discuss their relevance for Albania, both on the revenue and expenditure sides. Section D presents some estimates of the net fiscal impact.[55] Section E estimates the impact of a slowdown in the flow of remittances. Section F draws some policy implications on the basis of the analysis.

B. Impact on the Revenue Side

3.   **Remittances affect government revenue in Albania through two channels operating in opposite directions**. A "consumption channel" increases household consumption, boosting indirect tax revenue, while a "labor market channel" reduces income and social security tax collection by lowering the incentives to work for domestic residents.

The consumption channel

4.   **Remittances can boost indirect tax revenue through the consumption channel by increasing household consumption**. From a theoretical point of view, this intuitive relationship is confirmed by the general equilibrium model used by Chami, Cosimano, and Gapen (2006), in which remittances increase household consumption. Empirically, Quartey

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[53] Prepared by Giovanni Ganelli. (FAD)

[54] See, for example, IMF (2005); Giuliano and Ruiz-Arranz (2005); and Spatafora (2005).

[55] Due to data limitations, the task of precisely estimating the budgetary impact is a challenging one. The estimates provided are subject to several caveats, discussed in more detail below, and should therefore be interpreted carefully. In carrying out these estimates, use will be made of both balance of payments data, compiled by the Bank of Albania (BOA), and microeconomic data based on the World Bank Poverty Assessment (PA) and Social Safety Net Review (SSNR) (World Bank (2003) and (2004)), which in turn built on the 2002 Living Standard Measurement Survey (LSMS).

and Blankson (2004) confirm a positive effect of remittances on household consumption in Ghana.

5.   The recent dynamics of remittances and indirect tax collection underscore the relevance of this consumption channel in Albania. Figure 1 shows the close relationship between remittances and indirect tax revenue growth in Albania.

Figure 1. Albania: Growth of Remittances and Indirect Taxes, 1998-2004
(In percent)

Sources: BOA; Ministry of Finance; and IMF staff calculations.
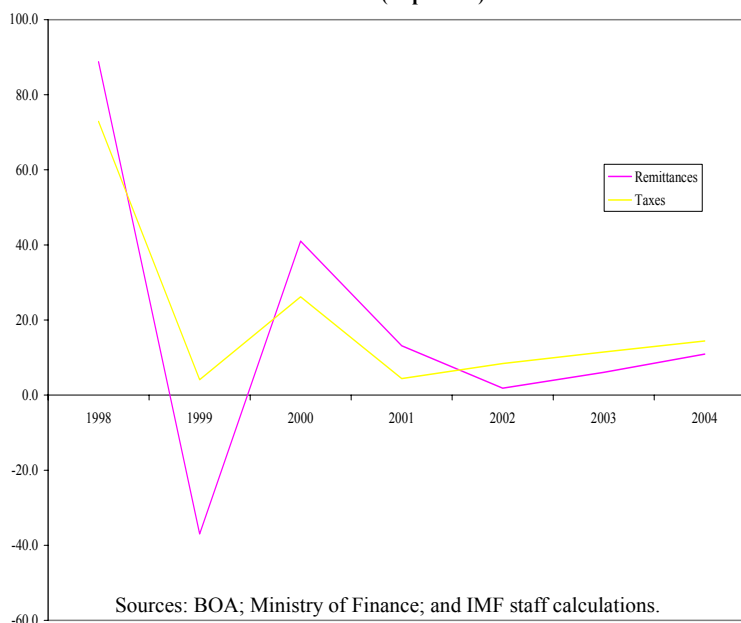
6.   **Although remittances can strengthen corporate income tax (CIT) revenue if they are used for investments that increase production, recourse to this channel is likely to be negligible.** Figure 2, based on 2002 LSMS data, shows that only 12 percent of remittances are used for investment purposes. Furthermore, this share includes activities that can be considered investment from the point of view of the individual household—such as purchases of durable goods, construction, and dwelling renovation—but have no impact on the CIT or small business tax bases. The fact that only a minimal part of remittances is used for investment is also indirectly confirmed by the observation that remittances are directed mostly to poor households, which are likely to have a very high marginal propensity to consume (see also discussion in section C).[56]

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[56] Several studies also suggest that only a minimal part of remittances are used for productive investment in other countries (see, for example, Chami, Fullenkamp, and Jahjah (2003) for a general discussion, and Sofranko and Idris (1999) for Pakistan).

Figure 2. Albania: Use of Remittances, 2002
(In percent of total estimated receipts)
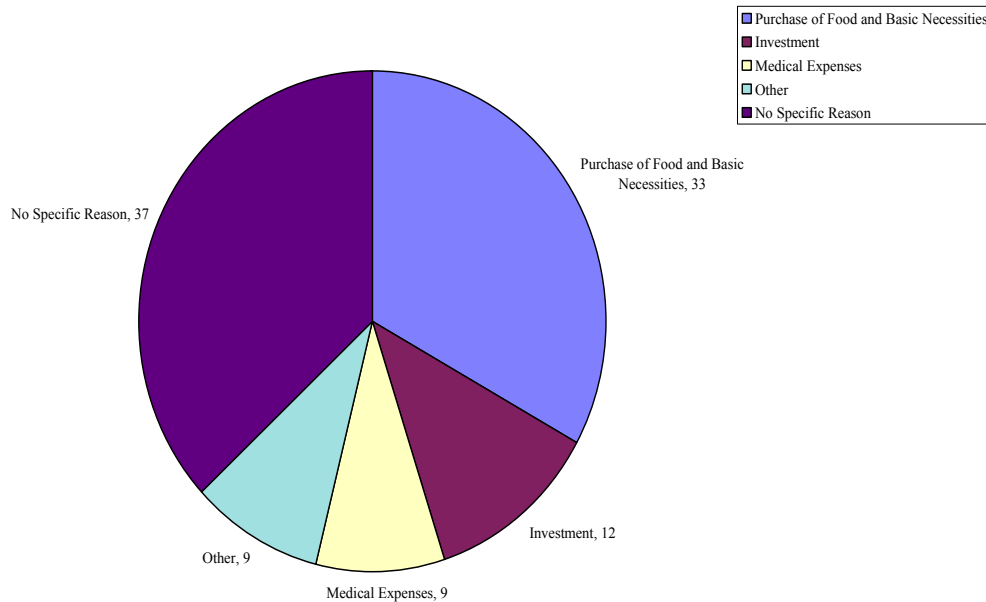
Source: World Bank.

The Labor market Channel

7.   **The labor market channel has the opposite effect of the consumption channel**. Through the former, remittances can reduce the incentives to work of domestic residents, thus lowering personal income tax (PIT) and social security tax (SST) collections. The result that remittances can reduce labor supply is illustrated theoretically by Chami, Cosimano, and Gapen (2006). They show that households spread the additional income deriving from remittance receipts across consumption and leisure according to their preferences. Empirical studies by Kozel and Alderman (1990) for Pakistan and Itzigsohn (1995) for a sample of Caribbean Basin cities also find that remittances reduce labor force participation in receiving households.

8.   **The labor market channel is likely to be active in Albania**. Figure 3 shows that, between 1999 and 2003, remittances as a share of GDP increased from below 12 percent to almost 14 percent. During this period, remittances grew cumulatively by around 70 percent. This figure shows that the increase in remittance flows was correlated with a steady reduction in labor force participation (defined as total labor force divided by working-age population), from 66 to 59 percent.

Figure 3. Albania: Remittances as a Share of GDP and Labor Force
Participation, 1999-2003
(In percent)
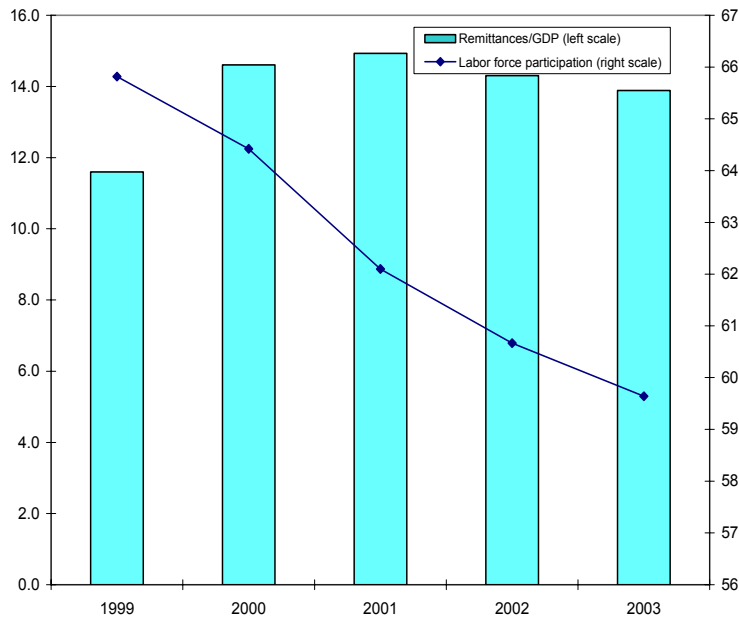
Sources: BOA; INSTAT; and IMF staff calculations.

C. Impact on the Expenditure Side

9.   **Remittances are likely to significantly reduce public spending in Albania
through a "spending substitution channel" that eases the pressure on the government to
spend for social safety nets.** As discussed in more detail in the previous chapter, remittances
play an important role in reducing poverty in Albania and appear to be better targeted to poor
and extremely poor households than public transfers. According to the World Bank (World
Bank, 2004), about 80 percent of remittances go to poor households. This large share
suggests that remittances allow the government to reduce considerably its spending on social
transfers. This conclusion is also indirectly confirmed by labor market data, which show that
only a small part of officially unemployed people are receiving benefits (Figure 4).

Figure 4. Albania: Total Unemployed and Unemployed Receiving Benefits,
1996-2003
(In thousands)
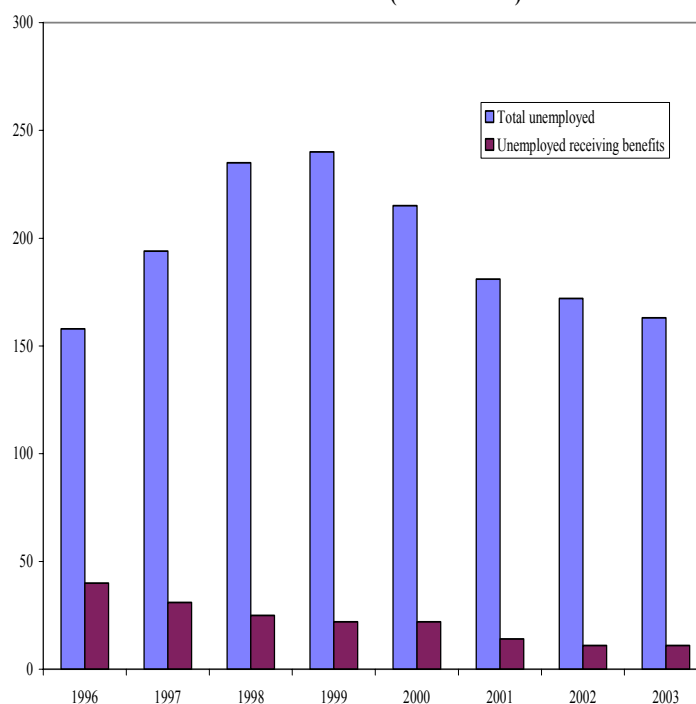
Sources: INSTAT; and IMF staff estimates.

D. Estimation of the Fiscal Impact

10. **We estimate the combined fiscal impact of remittances in Albania through the three channels, using aggregate BOA data distributed according to the LSMS data to overcome data shortcomings.** One problem is that estimates of remittances based on microeconomic sources are much smaller than BOA estimates. For example, estimates based on the 2002 LSMS, reported in the World Bank SSNR, amount to lek 27 billion (or 4 percent of GDP), while the BOA estimate of remittances for 2002 is around lek 90 billion (about 14 percent of GDP). To solve this problem, in the estimation presented below we use the aggregate BOA data on remittances, but we assume that the *distribution* of remittances (the proportion of the aggregate value that goes to poor households) follows the LSMS data.

11. **However, our estimation procedure still has limitations**. If the BOA and microeconomic data differ because some households did not correctly report their remittance receipts, then our methodology implicitly assumes that the "missing" remittances are distributed between poor and nonpoor households in the same way as the reported remittances. If the difference observed in the data is due to overestimation of the remittance flows by the BOA, our methodology overestimates the impact of the various channels, biasing the final results in the direction of the channels that have the biggest impact in absolute terms. In order to partly address the latter issue, we will also discuss at the end of

this section how our results would change if estimates based on the LSMS survey were used instead of BOA estimates.

12.   **Using the above procedure, Table 1 estimates the fiscal impact of remittances in Albania for the period 1999-2004**. These estimates are based on the following assumptions and calculations:

- The propensity of households to consume out of remittances is 100 percent.

- In the absence of remittances, the increase in income of domestic households (through the labor market channel) would be half the size of their estimated receipts of remittances.

- The amount of remittances received by poor households is estimated by multiplying the aggregate remittance estimate based on BOA data by 79.6 percent (the percentage of remittances received by poor households according to the SSNR estimates).

- In the absence of remittances, the government would compensate poor households for the lost transfers (minus the increase in net income due to the greater incentives to work).

- The increase in the value-added tax (VAT) resulting from remittances is estimated by applying the standard VAT rate to the marginal increase in consumption due to remittances.

- The increase in excise collections due to remittances is estimated by applying the effective excise rates to the estimated increase in consumption due to remittances.

- The increase in collection of import duties due to remittances is estimated by applying the effective import duty rates to the estimated increase in imports due to the higher consumption.

The first assumption is consistent with the observation that the amount of remittances channeled to investment in Albania is likely to be negligible. The second assumption is related to the working of the labor market channel: a halt in the inflows of remittances would create incentives to increase labor supply for domestic households. However, the income that they would generate is assumed to be much lower (half) than the remittance flows. This rests on two premises: (i) emigration rates are likely to be higher among high-skilled workers (see Mishra, 2006), and domestic residents are therefore likely to be less skilled than those sending remittances from

abroad; and (ii) returns to labor are likely to be lower in Albania than in the countries of origination of remittances, even at the same skill level.

Table 1. Albania: Estimated Fiscal Impact of Remittances, 1999-2004
(In billions of leks)

	1999	2000	2001	2002	2003	2004
(In billions of leks)						
Consumption channel	13.6	19.9	21.6	21.8	23.7	26.5
Labor market channel	-12.9	-18.2	-20.6	-21.0	-22.2	-24.7
Spending substitution channel	25.4	35.9	40.6	41.3	43.8	48.6
Net savings due to remittances	26.1	37.6	41.7	42.2	45.3	50.5
(In percent of GDP)						
Consumption channel	2.9	3.8	3.7	3.5	3.5	3.5
Labor market channel	-2.7	-3.4	-3.5	-3.4	-3.3	-3.2
Spending substitution channel	5.4	6.8	6.9	6.6	6.4	6.3
Net savings due to remittances	5.5	7.1	7.1	6.8	6.6	6.6
(In percent of public expenditure)						
Consumption channel	8.2	11.8	11.7	11.1	12.0	11.8
Labor market channel	-7.8	-10.7	-11.1	-10.7	-11.2	-11.0
Spending substitution channel	15.4	21.2	21.9	21.1	22.1	21.7
Net savings due to remittances	15.8	22.2	22.4	21.5	22.9	22.6

Source: IMF staff calculations.

13.   **Since the consumption and labor market channels tend to balance each other, the total fiscal impact is largely determined by the spending substitution channel.** This implies that the estimates of net savings due to remittances are biased upward if BOA data overestimates the aggregate amount of remittances. If the estimate of aggregate remittances from the 2002 LSMS were used in the calculation instead of the BOA data, net savings in 2002 would be equal to about 2 percent of GDP and 6½ percent of total public expenditures. The latter is still a sizable estimate, but considerably lower than the magnitudes presented in Table 1.

14.   **As estimated, the fiscal impact of remittances in Albania during 1999-2004 was sizable**. Table 1 shows total net budgetary savings per year due to remittances of 5-7 percent of GDP in the period considered. As a share of total public spending, savings are likely to be around 20 percent. This suggests that remittances represent a significant source of relief for public finances. Given that remittances seem to have a significant impact on the budget, it is important to assess the fiscal implications of a slowdown in their flow.

E.   Vulnerability of the Budget to a Slowdown in the Flow of Remittances

15.   **The flow of remittances could slow under two scenarios: the Albanian emigrants could find alternative** investment **opportunities, or they could return to Albania.** The first scenario is consistent with the view—often referred to as the "portfolio motive" behind remittances—that remittances behave like capital flows, that is they are driven by the remitter's desire to invest in the country of origin (see for example Buch, Kuckulenz, and Le Manchec, 2002). If the portfolio motive is the main determinant of remittances, the flow of remittances to Albania could slow as emigrants settle down in their host country, sever their link with the motherland, and become able and/or willing to diversify their investment portfolio. The second scenario—under which the flow of remittances slows because emigrants return to their home country—is consistent with the view that remittances are altruistically motivated (see, for example, Lucas and Stark (1985)). In the latter interpretation (the "altruistic scenario") emigration and remittances can be seen as part of a coping strategy adopted by families, in which one member moves to a country where employment opportunities and returns to labor are higher, while the other members of the family continue living in the home country (in this case Albania).

16.   **The estimates presented in Table 2 suggest that a slowdown in the flow of remittances would represent an implicit contingent liability for the budget under both these scenarios.** The baseline scenario in Table 2 assumes that remittances as a share of GDP remain constant at current levels in the medium term. The slowdown caused by the portfolio motive scenario, however, assumes a permanent decline in the remittances-to-GDP ratio (equal to two standard deviations of 1999-2005 levels) beginning in 2006. This scenario therefore refers to a situation in which nominal remittances keep growing, but at a rate lower

than GDP growth. Table 2 shows that the budgetary loss under this scenario, compared with the baseline, would be approximately 1 percent of GDP per year. If a slowdown is simulated under the altruistic scenario, the budgetary loss is, compared with the baseline, about ½ percent of GDP per year. The budgetary loss is smaller under the altruistic scenario because the domestically generated income earned by the returning migrants is, unlike remittances, subject to taxation. However, this does not fully compensate for the smaller indirect tax collections and lower savings on social safety nets due to the lower returns to labor in Albania.[57]

Table 2. Albania: Estimated Budgetary Impact of a Slowdown in the Flow of Remittances
(In percent of GDP)

	2005	2006	2007	2008	2009
Baseline scenario1/	6.6	6.6	6.6	6.6	6.6
Slowdown (portfolio motive scenario) 2/	6.6	5.5	5.5	5.5	5.5
Slowdown (altruistic scenario) 3/	6.6	5.9	5.9	5.9	5.9

Source: IMF staff calculations.

1/ Assumes remittances as a share of GDP are constant at 2004 levels.

2/ Assumes a permanent decline in remittances-to-GDP ratio of two standard deviations of 1999-2005 levels from 2006.

3/ Same shock as in the portfolio motive scenario, combined with reimmigration

17. **The estimates presented in Tables 1 and 2 are subject to several caveats**. As already discussed, there is still considerable uncertainty regarding the actual size of remittances. Furthermore, empirical evidence on household consumption behavior and differences in return to labor between Albania and host countries is scarce. Also, the estimates might not fully capture some longer-term factors. For example, while the labor market channel has an immediate negative impact on taxation in our exercise, the reduction in labor supply through this channel could be linked to activities—such as pursuing further education—that can stimulate growth and thus increase revenue collection in the long run. Similarly, the reduced budgetary impact under the altruistic scenario presented in Table 2 does not take into account future liabilities arising through the pension system. Finally, our estimates assume that any change in employment status would be reflected in contributions

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[57] The estimates presented in Table 2 under the altruistic motive scenario are derived on the assumption that the return to labor in Albania for returning emigrants is such that their income will be equal to 75 percent of the remittances they were sending from abroad. This, in turn, is based on the idea that employment opportunities and returns to labor are lower in Albania than in the countries of emigration, even at the same skill level.

to the tax system. However, this assumption might not be always true, given the importance of the informal sector in Albania.

18.   **These estimates also depend on the assumptions about policy reactions to a slowdown in the flow of remittances.** In particular, it should be borne in mind that, although the figures presented in Table 2 are based on unchanged policies, it is possible that the budgetary deterioration that would accompany a slowdown in the flow of remittances and/or emigration could generate incentives for fiscal consolidation. The figures in Table 2 thus provide upper bounds of the possible negative budgetary impact. It is therefore important that the estimates be interpreted carefully, rather than used in a mechanistic way, in drawing policy implications from the analysis.

F. Policy Implications

19.   **Remittances seem to have a large positive impact on the budget.** As the consumption and labor market channels tend to balance each other, the size of the fiscal impact is determined by the magnitude of the spending substitution effect. By limiting the need for social transfers, remittances have helped fiscal consolidation and freed up resources for other priority expenditure.

20.   **Nothwithstanding this beneficial impact, the strong reliance of the budget on remittances also creates fiscal risks.** A slowdown in the flow of remittances and/or emigration can be considered as a sizable implicit contingent liability for the budget. Although there would be no legal obligation for the government to compensate poor households for their losses, the political pressure to increase social spending would be strong. Furthermore, our analysis shows that this pressure for social spending would arise at the same time as a decline in revenue. In light of these additional risks associated with the future dynamics of remittances and emigration, the practice initiated in the 2006 budget of including several forms of contingency mechanisms to protect priority expenditures from exogenous shocks should be continued.

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PART III. RAPID CREDIT GROWTH IN ALBANIA

VI.   RAPID CREDIT GROWTH IN ALBANIA—WHAT ARE THE POLICY OPTIONS?[58]

1.   **This paper examines the recent acceleration of credit growth in Albania, and the policy options available to address the resulting macroeconomic and prudential concerns**. After a brief description of the Albanian banking system—including the regional and global context—the paper explores signs of macroeconomic and financial stress and presents the main considerations for assessing the impact of credit growth on macroeconomic and financial stability. Lastly, the paper discusses principal policy options, including macroeconomic measures, prudential and supervisory/monitoring, and other measures that are or may become relevant.

A.   Background

2.   **Following the privatization of Savings Bank in mid-2004, financial deepening in Albania began to take hold**. The degree of competition increased, and credit to the private sector accelerated markedly—growing by 67 percent in the year to April 2006, an increase of 6.1 percent of GDP. Growth of lending to both the corporate sector and households was high during this period, with growth of domestic currency lending—historically less important in Albania—particularly rapid at 109 percent. The stock of credit reached almost 17 percent of GDP at end-April 2006, up from 9 percent at the beginning of 2005.

Albania. Annual Percentage Increase of Private Sector Credit, January 2004-April 2005

Source: Bank of Albania.

Albania. Private Sector Credit, Jan. 2004-Apr. 2005 (As a percent of GDP)

Source: Bank of Albania.

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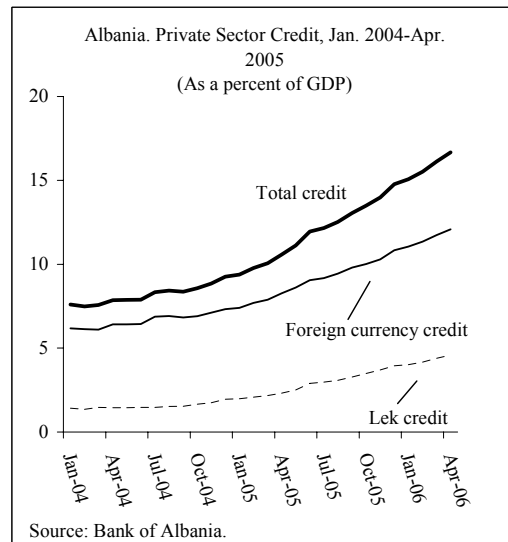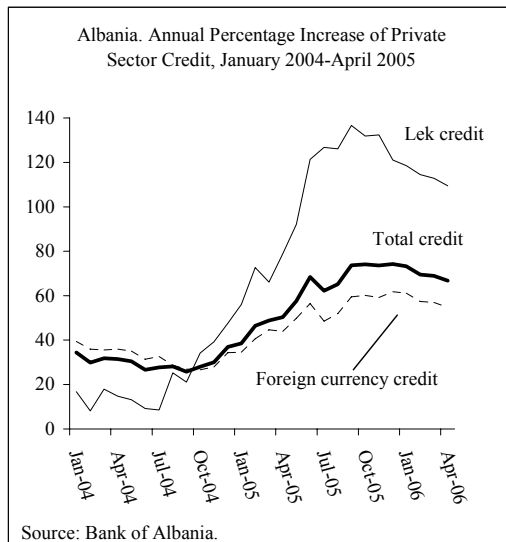
[58] Prepared by Karl Driessen (MFD) and Geoffrey Oestreicher (EUR)

- From a global perspective, the level of financial intermediation in Albania remains relatively low.

Distribution of Credit in 2002 and 2005
(Percent of GDP for 124 countries)

Source: WEO.

Distribution of Credit in 2005
(Percent of GDP for 124 countries)

Source: WEO.
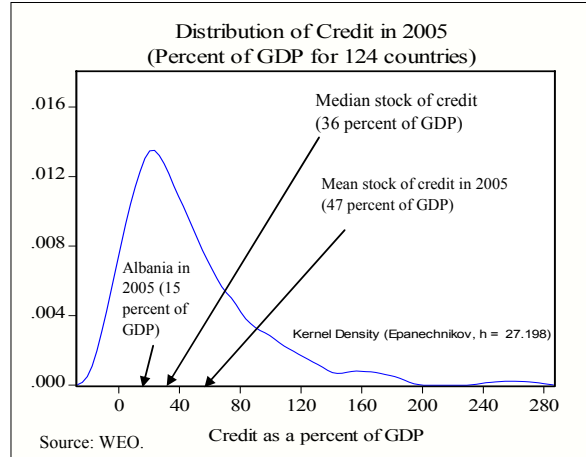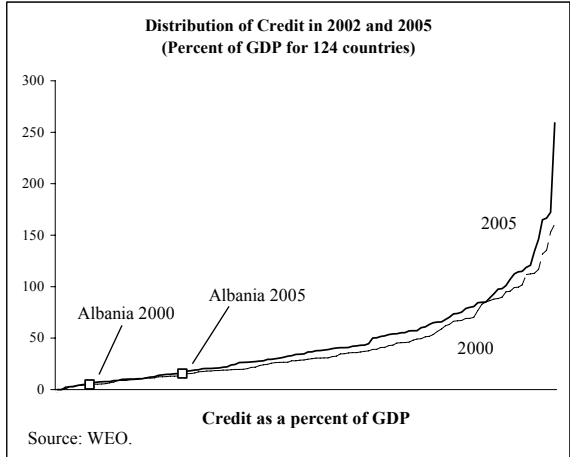
- Credit levels have been rising worldwide, but the phenomenon has been particularly intense in the transition countries.

Per Capita Financial Intermediation in the World and in Transition Countries 1/,
(Logarithmic trend lines, 2002 and 2005)

1/ Source: WEO; 124 countries in world group; 21 in transition country group.
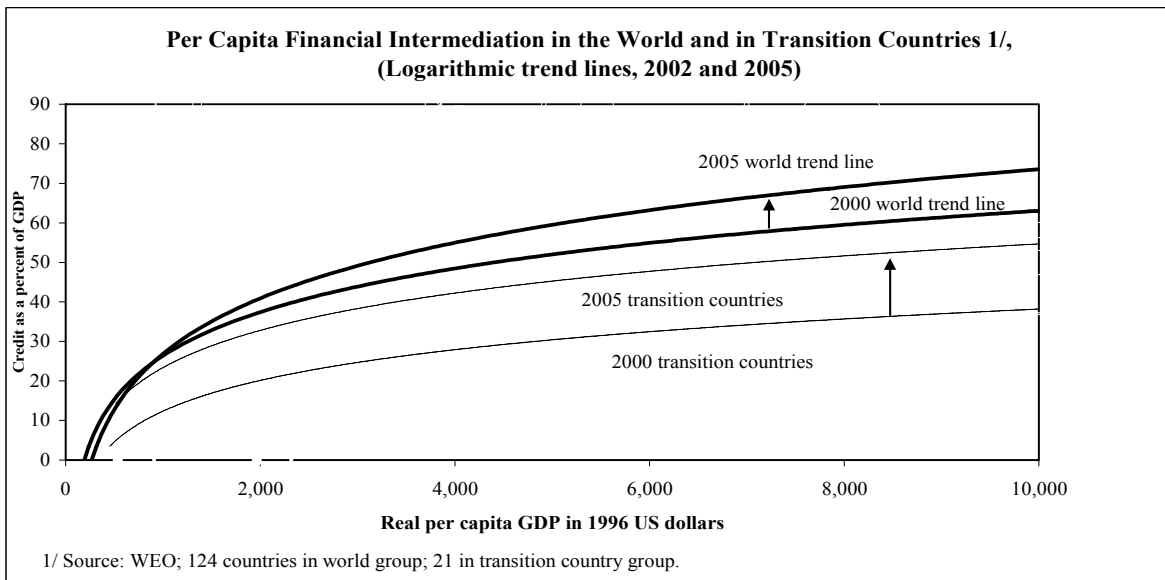
- Consequently, despite its recent rapid growth, Albania's stock of credit relative to its income level remains low by transition economy standards (Table 1).

Table 1. Transition Countries: Stock of Credit, 2000 and 2005 (In percent of GDP)			
	2000	2005	Change 2000-05
Kyrgyz Republic	4	8	4
Armenia	11	8	-2
Albania	**4**	**15**	**10**
Georgia	7	15	8
Belarus	16	21	5
Romania	9	22	12
Russia	14	27	12
Macedonia, FYR	18	27	9
Poland	27	28	1
Czech Republic	48	36	-11
Ukraine	12	37	24
Kazakhstan	11	38	27
Mongolia	9	39	30
Lithuania	13	41	28
Bulgaria	13	45	32
Hungary	32	52	20
Bosnia & Herzegovina	43	52	10
Slovenia	36	53	18
Croatia	39	66	27
Latvia	19	70	51
Estonia	37	74	37
AVERAGE	**20**	**37**	**17**
Source: WEO.			

Per Capita GDP and Private Sector Credit
(21 Transition countries, 2000 and 2005)

Source: WEO.

B. Banking Sector in Albania

3.   **The Albanian banking system consists of 17 banks, all but three foreign owned**. It is now fully under private management, following the April 2004 sale of the Savings Bank—the largest bank in the system—to Raiffeisen Bank (Austria), and the recent sale to Banco di Roma of the government's shares in Italian-Albanian Bank. The authorities are currently trying to sell their remaining minority stake in the United Bank of Albania. There are four branches/subsidiaries of Greek banks (Alpha Bank, National Bank of Greece, Tirana Bank, and Emporiki Bank). One bank (National Commercial Bank) is majority-held by the Turkish banking restructuring authority. The American Bank of Albania is owned by the Albania American Enterprise Fund, which is associated with USAID. ProCredit Bank, which operates a network in developing countries, is owned by a conso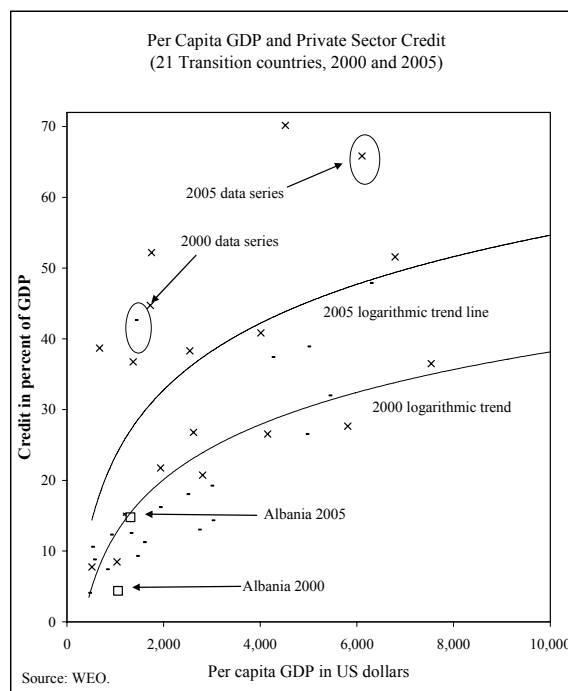rtium of international financial institutions, bilateral financial development agencies, and private parties. In July 2005, Dardania Bank, a small and inactive bank, was bought by the Italian Development Bank. Credins Bank, Popular Bank, and Union Bank are domestically owned. The remaining three banks are small and foreign owned.

4.   **Assets in the banking system are unevenly distributed**. There is one large bank with assets greater than US$200 million; nine medium-sized banks—including two of the

domestically-owned banks—with assets between US$10 and US$60 million; and seven small banks with assets below US$10 million. At end-December 2003, the then publicly-owned Savings Bank held 58 percent of commercial bank deposits and 76 percent of banks' stock of gross credit to government. Since then, the degree of concentration has declined, as Savings Bank's new owner has lowered somewhat both its share of deposits and government credit and increased its loan portfolio. At end-March 2006, assets of all commercial banks totaled 61 percent of GDP, up from 55 percent at end-2003 (Table 2).

Table 2. Albania: Structure of the Banking System, December 2003 and March 2006

	Assets of banking system		Deposits in banking system		Loans to private sector		Net credit to government	
	Dec-03	Mar-06	Dec-03	Mar-06	Dec-03	Mar-06	Dec-03	Mar-06
Percent of total								
All banks (17)	100	100	100	100	100	100	100	100
Foreign-owned (14) 1/	98	92	99	92	97	87	100	96
Domestic-owned (3)	2	8	1	8	3	13	0	4
Largest bank	52	39	58	43	1	12	76	61
Five largest banks	85	77	88	80	61	62	96	89
Percent of GDP								
All banks (17)	55	61	47	52	7	16	29	25
Foreign-owned (14) 1/	54	56	46	47	7	14	29	25
Domestic-owned (3)	1	5	1	4	0	2	0	1
Largest bank	28	24	27	22	0	2	22	15
Five largest banks	46	47	41	41	5	10	27	23

Source: Data provided by Bank of Albania; and IMF staff calculations.

1/ Classified according to ownership as at March 2006.

5.   **The structure of lending is changing.** Credit to individuals is gaining market share over credit to firms, while the share of lek-denominated lending and the average maturity of loans are both increasing.

- **Corporate lending still accounts for the bulk of private sector credit, but loans to households are grow at a faster pace**. As the corporate sector has been actively approached by commercial banks in the past, new creditworthy borrowers are expected to emerge more gradually. Many banks are therefore now marketing more aggressively toward the retail market. Households have access to salary overdrafts (equivalent to a multiple of monthly salary if the salary is deposited in the bank), consumer loans (up to around Euro 5,000), and mortgages.

Annual Loan Growth to Corporate Sector, January 2003-February 2006

Source: Bank of Albania.

Total — Foreign Currencies — Lek

Annual Loan Growth to Household Sector, January 2003-February 2006

Source: Bank of Albania

Total — Foreign currencies — Lek
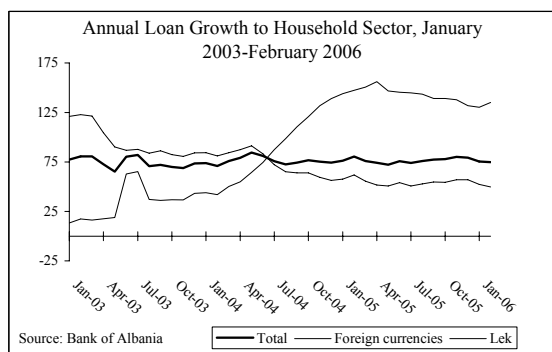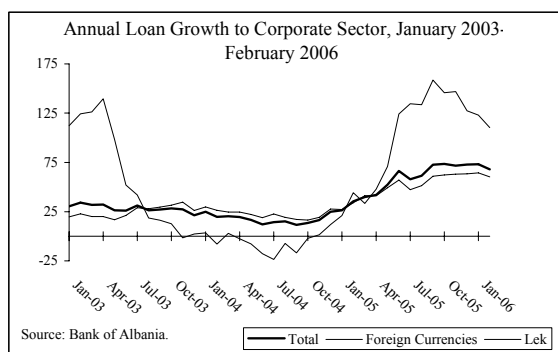
- **The traditional preference for foreign exchange denominated credit is diminishing**. The degree of dollarization/euroization of the banking system has traditionally been moderately high, but asset dollarization is now on a downward trend. Sustained macroeconomic stability over the last years, combined with low Euro and dollar interest rates, have resulted in relatively low and stable inflation, which brought down domestic interest rates as risk premiums declined. At the same time, banks are flush with lek deposits, and are eager to seek appropriate hedges for their clients, matching lek income to lek loans. As a consequence, loans that were historically predominantly in foreign currency, are now increasingly issued in lek. At end-March 2006, foreign exchange denominated loans constituted 73 percent of total loans, down from 79 percent at end-2004.

Albania: Foreign Currency Loans, December 2003-April 2006) (Percent of total loans)

Source: Bank of Albania.
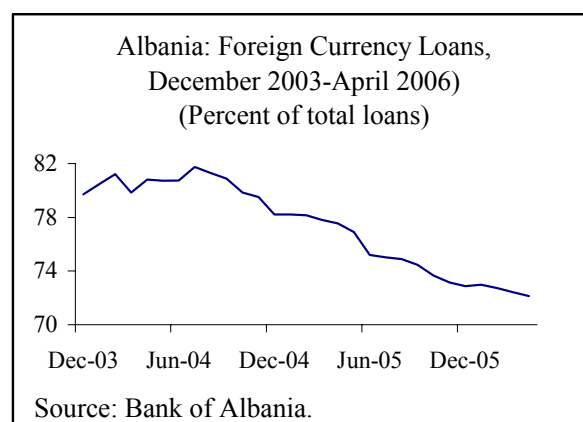
- **Maturities are lengthening**. However, as a result, borrowers are taking on more interest rate risk that could adversely impact indirect credit risk (Table 3).

Table 3. Albania: Credit stock indicators, December 2003-March 2006
(Share of total credit outstanding)

| | 2003 | 2004 | 2005 | | | | 2006 |
			Mar.	Jun.	Sep.	Dec.	Mar.
Short term credit	46	34	34	34	32	33	33
Medium term credit	33	36	35	33	31	30	30
Long term credit	21	30	31	33	37	37	37
Credit to individuals	25	31	31	31	31	32	32
Credit to business	76	69	69	69	69	68	68
Credit in lek	20	21	22	24	25	27	27
Credit in foreign currency	80	79	78	76	75	73	73

Source: Bank of Albania.

6.   **Credit is still mainly extended for productive purposes, although the share of consumer credit is rising slightly (Table 4).**

Table 4. Albania: Distribution of Credit by Sector, December 2004-March 2006 1/
(Share of total credit outstanding)

	2004	2005				2006
	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.
Agriculture, hunting and silviculture	1.5	1.3	1.5	2.4	2.7	2.2
Fishing	0.1	0.0	0.1	0.1	0.1	0.1
Extracting industry	0.3	2.4	0.6	0.5	0.5	1.4
Processing industry	17.1	15.8	15.6	13.9	13.8	14.2
Production, electricity distribution, gas, water	2.8	6.3	2.9	2.9	2.6	2.4
Construction	9.8	10.6	11.2	12.8	13.0	13.0
Trade, vehicles and house articles repairing	23.3	20.5	19.1	20.0	18.9	19.0
Hotels and restaurants	8.3	2.5	4.7	4.4	4.3	4.8
Transport and telecommunication	2.0	2.5	1.7	1.7	1.5	1.3
Financial activities	0.2	0.2	1.1	0.7	0.8	0.7
Real estate	9.8	11.4	13.5	13.9	14.2	14.6
Health and social activities	0.5	0.1	0.4	0.6	0.7	0.6
Collective, social and personal services	4.8	8.3	7.4	5.9	5.8	4.6
Consumer credit and other	19.3	18.2	20.2	20.2	21.2	21.1
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Bank of Albania.

1/ Excludes credit to nonresidents.

7.   **Looking at the system's Financial Soundness Indicators, the Albanian banking system remains solvent,** liquid**, and profitable (Table 5)**. Capital adequacy for the banking system as a whole is comfortable and the level of nonperforming loans (NPLs), though rising, has been low. Liquidity is ample, and some foreign-owned banks have access to additional funds on demand.

•   **The capital adequacy ratio—showing the relative size of the first buffer against credit risk—is still well above prudential limits, but is coming down**. From end-2004 to end-March 2006, the growth in loans to the private sector—which carry a 100 percent risk weight compared to a zero weight for treasury bills—resulted in a decline in the risk-weighted capital asset ratio (CAR) by 2.3 percentage points to 19.3 percent, notwithstanding the recapitalization of many banks, principally through retained earnings. However, this is still high compared to the regulatory minimum of 12 percent. Among the nine largest banks, one bank is at the limit of regulatory capital, and does not have prospects for rapid recapitalization. Three other banks have CARs between 12 and 14 percent, although two of these have parent companies that have the capacity to supply new capital if needed.

•   **Indicators of asset quality are satisfactory but there has been a slight deterioration recently**. At end-February 2006, NPLs as a share of total loans was

3 percent, down from 4¼ percent at end-2004. However, NPLs have been increasing slowly since mid-2005. Historically, the NPL ratio did not fall below 4 percent until the credit expansion that followed the Savings Bank privatization. Corporate NPLs, which used to hover around six percent during 2003–2004, are now at around three percent. Household NPLs have generally remained below two percent, as have nonperforming domestic currency loans.
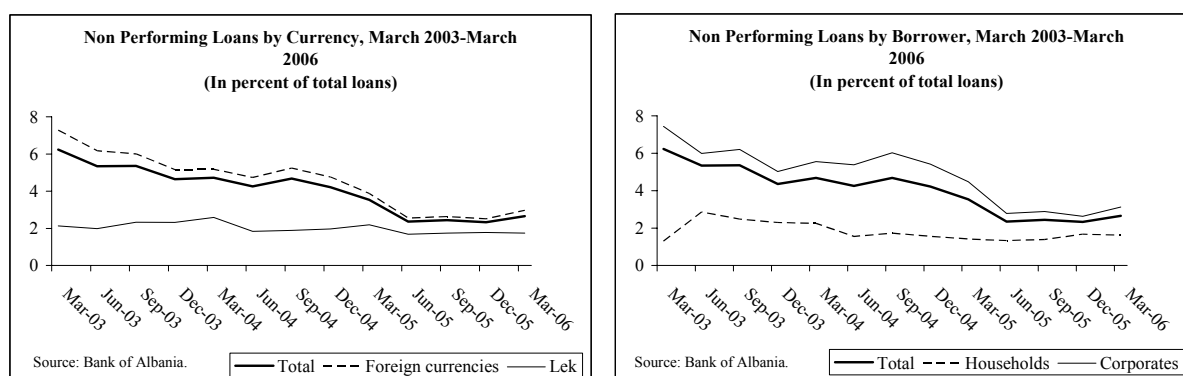

Non Performing Loans by Currency, March 2003-March 2006 (In percent of total loans). Source: Bank of Albania. Total — Foreign currencies — Lek

Non Performing Loans by Borrower, March 2003-March 2006 (In percent of total loans). Source: Bank of Albania. Total — Households — Corporates

Table 5. Albania: IMF Core Indicators of Financial Soundness, December 2003-March 2006

|		Dec-03	Dec-04	Mar-05	Jun-05	Sep-05	Dec-05	Mar-06
I	**Capital-based**							
(i)	Regulatory capital as a percent of risk-weighted assets	28.5	21.6	21.0	19.8	18.3	18.6	19.3
(ii)	Regulatory Tier 1 capital as a percent of risk-weighted assets	29.0	21.5	20.4	19.3	17.9	18.1	18.9
(iii)	Capital as a percent of total assets							
	Regulatory Tier 1 capital as a percent of total assets	4.8	4.8	5.0	5.2	5.1	5.4	5.8
	Regulatory capital as a percent of total assets	4.7	4.8	5.1	5.3	5.3	5.6	5.9
	Shareholders' equity as a percent of total assets	5.9	6.1	5.8	6.4	6.6	6.6	6.5
(iv)	Nonperforming loans net of provisions as a percent of capital							
	Nonperforming loans net of provisions as a percent of regulatory Tier 1 capital	4.8	4.8	4.5	3.0	4.1	4.4	6.2
	Nonperforming loans net of provisions as a percent of regulatory capital	4.9	4.8	4.4	2.9	4.0	4.3	6.1
	Nonperforming loans net of provisions as a percent of shareholders' equity	3.9	3.8	3.9	2.4	3.2	3.6	5.6
(v)	Return on equity (ROE) (annual basis)	19.5	21.1	22.1	24.3	24.5	22.2	21.4
(vi)	Net open position in foreign exchange as a percent of capital							
	Net open position in foreign exchange as a percent of regulatory Tier 1 capital	7.2	7.5	3.6	8.7	7.3	9.5	6.7
	Net open position in foreign exchange as a percent of regulatory capital	7.3	7.4	3.5	8.5	7.1	9.3	6.6
	Net open position in foreign exchange as a percent of shareholders' equity	5.9	5.9	3.1	7.0	5.7	7.8	6.0
II	**Asset-based**							
(vii)	Liquid assets as a percent of total assets (Liquid-asset ratio)	73.6	71.1	70.3	67.1	65.3	62.6	62.1
(viii)	Liquid assets as a percent of short-term liabilities	na	na	83.2	109.9	73.5	75.2	75.5
(ix)	Return on assets (ROA) (net income to average total assets) (annual basis)	1.2	1.3	1.3	1.5	1.5	1.4	1.4
(x)	Nonperforming loans (gross) as a percent of total loans	4.6	4.2	3.5	2.4	2.4	2.3	3.0
(x1)	Sectoral distribution of loans to total loans	na	na	na	na	na	na	na
III	**Income and expense-based**							
(xii)	Interest margin to gross income	89.6	80.3	83.2	80.5	82.0	84.0	93.4
(xiii)	Noninterest expenses to gross income	57.4	66.2	81.5	75.3	76.7	76.3	71.4
IV	**Memorandum items**							
	Other (noncore) indicators:							
	Customer deposits as a percent of total (non-interbank) loans	652.1	535.8	498.3	417.8	384.8	342.5	326.6
	Foreign currency-denominated loans to total loans	82.1	80.5	79.9	77.7	77.6	75.5	74.5
	Foreign currency-denominated liabilities as a percent of total liabilities	35.9	37.0	38.2	39.9	41.5	41.0	41.0
	Other indicators:							
	Risk weighted assets as a percent of total assets	16.7	22.2	24.4	26.8	28.7	30.0	30.8
	Total loans as a percent of total assets	13.6	16.4	17.6	20.8	22.8	25.7	26.5
	Total loans as a percent of shareholders' equity	231.2	270.3	302.6	326.5	348.7	387.0	408.7

Source: Data provided by Bank of Albania.

- **Over the last two years, margins have declined under pressure from rising competition, but greater loan volumes have maintained overall profitability**. In fact, interest income increased, as the shift out of treasury bills towards loans boosted average return on assets. As a result, return on assets (RoA) for the entire banking system increased from 1.3 percent at end-2004 to 1.4 percent at end-March 2006. Over the same period, return on equity (RoE) also increased somewhat.

- **Overall, the banking system remains quite liquid**. The liquid asset ratio (LAR) of the banking system—62 percent at end-March 2006, down from 71 percent at end-2004—is still high, but is disproportionately concentrated in one large bank. Although some banks are significantly less liquid than others—there are seven banks with LARs below 50 percent—the least liquid of these have the capacity to tap credit lines of parent institutions. Expansion of loan portfolios, however, has left some banks with liquid asset ratios of 30 percent or lower. All banks have ambitious deposit growth objectives to fund lending operations, but it is unlikely that these will be collectively met, since it would imply a significantly faster increase in money demand than presently anticipated.

C. Why is Rapid Credit Growth a Concern for Policymakers?

8.   **Rapid credit growth has the potential to compromise both macroeconomic and financial system stability**. Given the strong empirical link between the level of financial intermediation and economic growth, credit expansion would in general be expected to prove beneficial for the economy. Some evidence that financial intermediation promotes growth is provided in Chapter II. However, a too-rapid expansion of credit raises both macroeconomic and prudential concerns.
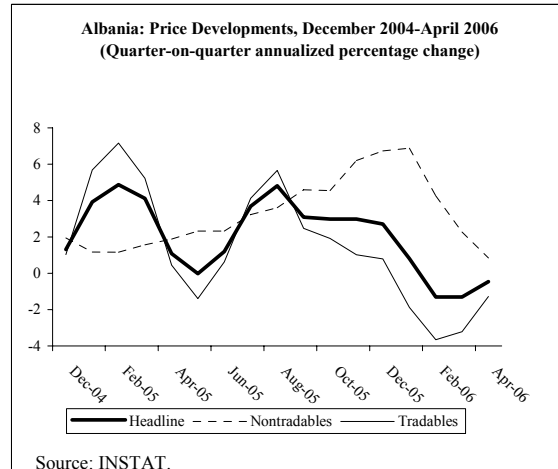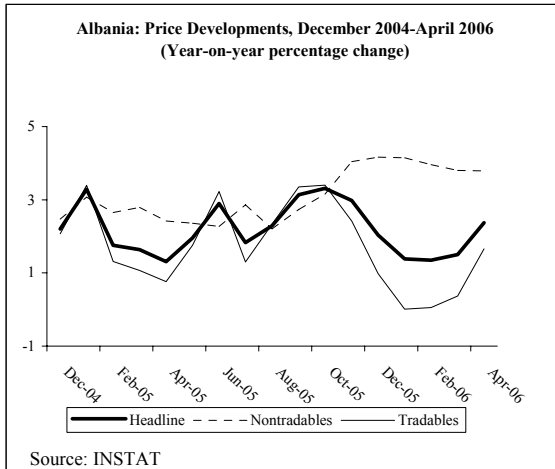

Per Capita GDP and Private Sector Credit
(124 countries in 2005)

Source: WEO
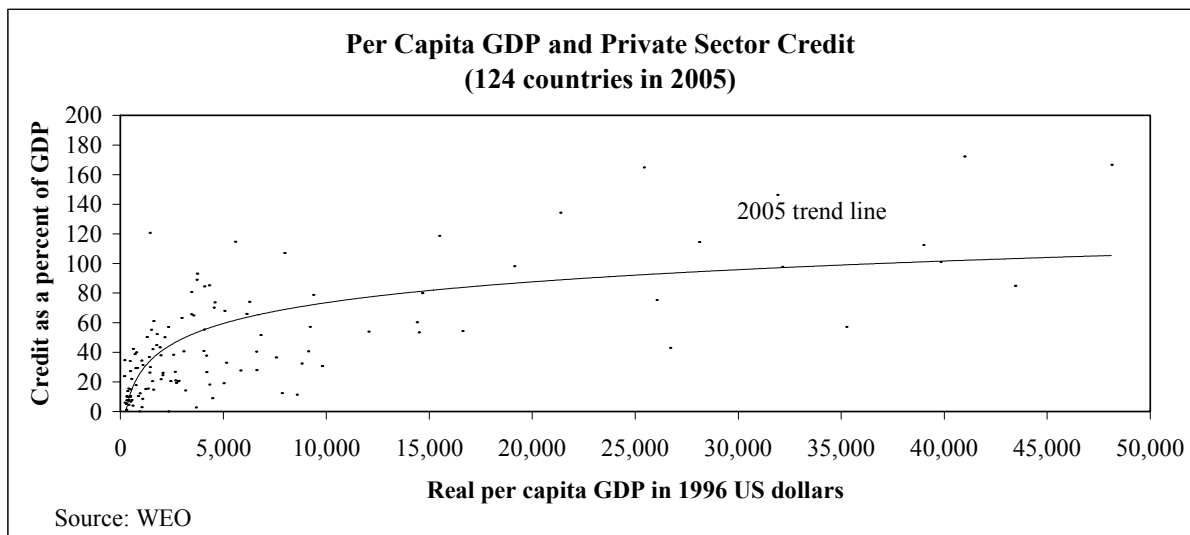
Macroeconomic Concerns Arising from Rapid Credit Growth

9.	**Credit booms have the potential to cause significant adverse macroeconomic effects.** The excess demand generated by a rapid credit expansion can lead to pressure on prices or spill over into the external current account. Moreover, credit booms have been shown—albeit in more developed emerging market economies—to exacerbate the business cycle, as an initial expansion of real GDP—significantly above trend—is generally followed by a sharp downturn after the boom peaks (World Economic Outlook 2004). This pattern has been particularly severe in the nontradables sectors of emerging market economies, which tend to be more dependent on bank financing than the export sectors. In economies with access to international capital markets, the impact of capital inflows generated to finance lending has been seen to combine with the price effect of the rapid expansion of production to raise the relative price of nontradables in terms of tradables and appreciate the real exchange rate. However, after the peak of the credit boom, the increase in the relative price of nontradables is generally quickly reversed.

10.	**Instability arising from capital flows that fund loans has been a serious issue in other countries, but is less of a concern in Albania**. Albanian banks have not historically funded loans to an appreciable extent through external borrowing, but instead have draw down their own stock of foreign assets which, at close to US$950 million (11 percent of GDP and 75 percent of foreign currency deposits) in April 2006, remains large. Consequently, external indebtedness of the banking sector does not presently pose debt sustainability problems. Similarly, the system is not significantly exposed to fluctuations of sentiments in international capital markets.

11.	**There is evidence, however, that the rapid expansion of credit in Albania has increased aggregate demand, putting pressure on prices** and exacerbating the **external current account deficit**. Although headline inflation in Albania in 2005 remained within the Bank of Albania's 3±1 percent target range, this stability masked an increase in underlying demand pressure.

- Nontradables prices rose rapidly throughout the year, but the effect on headline inflation was mitigated by declining tradables prices.

Albania: Price Developments, December 2004-April 2006
(Year-on-year percentage change)

Source: INSTAT

Albania: Price Developments, December 2004-April 2006
(Quarter-on-quarter annualized percentage change)

Source: INSTAT.

- In light of the contractionary fiscal stance, and the negative contribution to growth from the external accounts in 2005, the upward pressure on nontradables likely originated from the ongoing credit boom.[59]

Albania: Annual Growth of Credit and Nontradable Goods Prices, May 2004-May 2006
(Quarter-on-quarter, annualized)

Credit growth (LHS)

Nontradables inflation (RHS)

Source: Bank of Albania
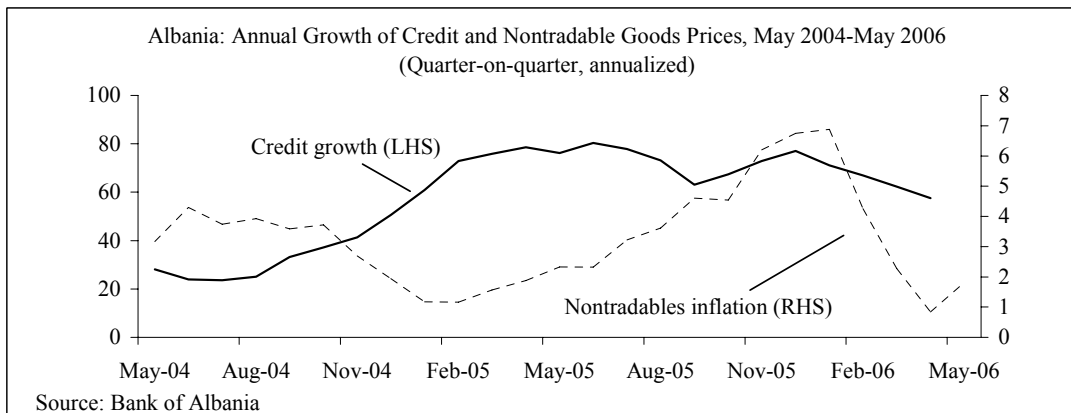
12.   **The effect of credit growth on Albania's external current account is less easily demonstrated, although it is readily observable in regional neighbors**. External data in Albania is not as reliable, timely or as detailed as price data; and the very small stock of credit prior to 2005 implies that the outturn on the Albanian current account in previous years was likely due to other factors. It can be noted, however, that the rapid credit expansion

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[59] Although nontradables inflation slowed in early 2006, this was largely due to an unanticipated fiscal tightening during this period. Pressure on nontradables prices could thus re-emerge when fiscal spending resumes its budgeted path.

in 2005 was associated with a rise in the external current account deficit relative to GDP of almost 2½ percentage points. Moreover, there is strong evidence regionally of a significant negative relationship between rapid credit growth and the current account (Figure 1).

Prudential Concerns Arising from Rapid Credit Growth

13.   **From a prudential standpoint, rapid credit growth may stress both banks' and banking supervisors' capacity to monitor and control the attendant risks**. If these risks materialize and affect banks' financial situation, confidence in the banking system may diminish, and the resulting disruption to financial intermediation could affect real activity. Consequently, despite the relatively low absolute level of lending, and a generally sound banking system, it is important to monitor credit developments closely and stand ready to address emerging weaknesses early and vigorously.

14.   **During periods of rapid credit growth, loan quality tends to fall for a variety of reasons.** Although with sharply growing loan volumes the fraction of nonperforming assets initially declines, this is mechanical and due to the fact that it takes time for new loans to develop performance problems. As the portfolio matures, NPL ratios will increase again, and are likely to rise above earlier levels.

- **Once top-tier clients have established banking relations, banks may seek to lend to less attractive borrowers**. Competition for market share, in particular from foreign banks—for which such behavior has some rationale and is sustainable for some time—may lead to aggressive lending practices where risk is underpriced. In their effort to acquire or maintain market share, banks may lower lending standards and operate under unrealistic expectations of repayment capacity. Credit risk is further increased by passing on foreign exchange and interest rate risks to bank clients.

- **Likewise, competition may shift banks into new product lines or customer classes, for which risks are less well understood**. The movement into consumer and mortgage lending in Albania may be a case in point. Even if collateral more than fully covers the loan amounts, there are no cases yet of foreclosing on houses, which may turn out to be much more costly than estimated at the outset.

- **Greater loan volumes also put risk management capacity of banks under stress**. With rapid credit growth, problems of weak bank governance are accentuated, and may, for example, further exacerbate the risks associated with insider lending. Changes in commercial banks (organizational, staffing, training), as well as in the supervisory agency (increased resources devoted to supervision) are required to keep up with greater loan demand. However, experienced and trained personnel are often in short supply.

Figure 1. Annual Change in Credit to Private Sector and Current Account Balance, 1994-2005
(In percentage points of GDP)
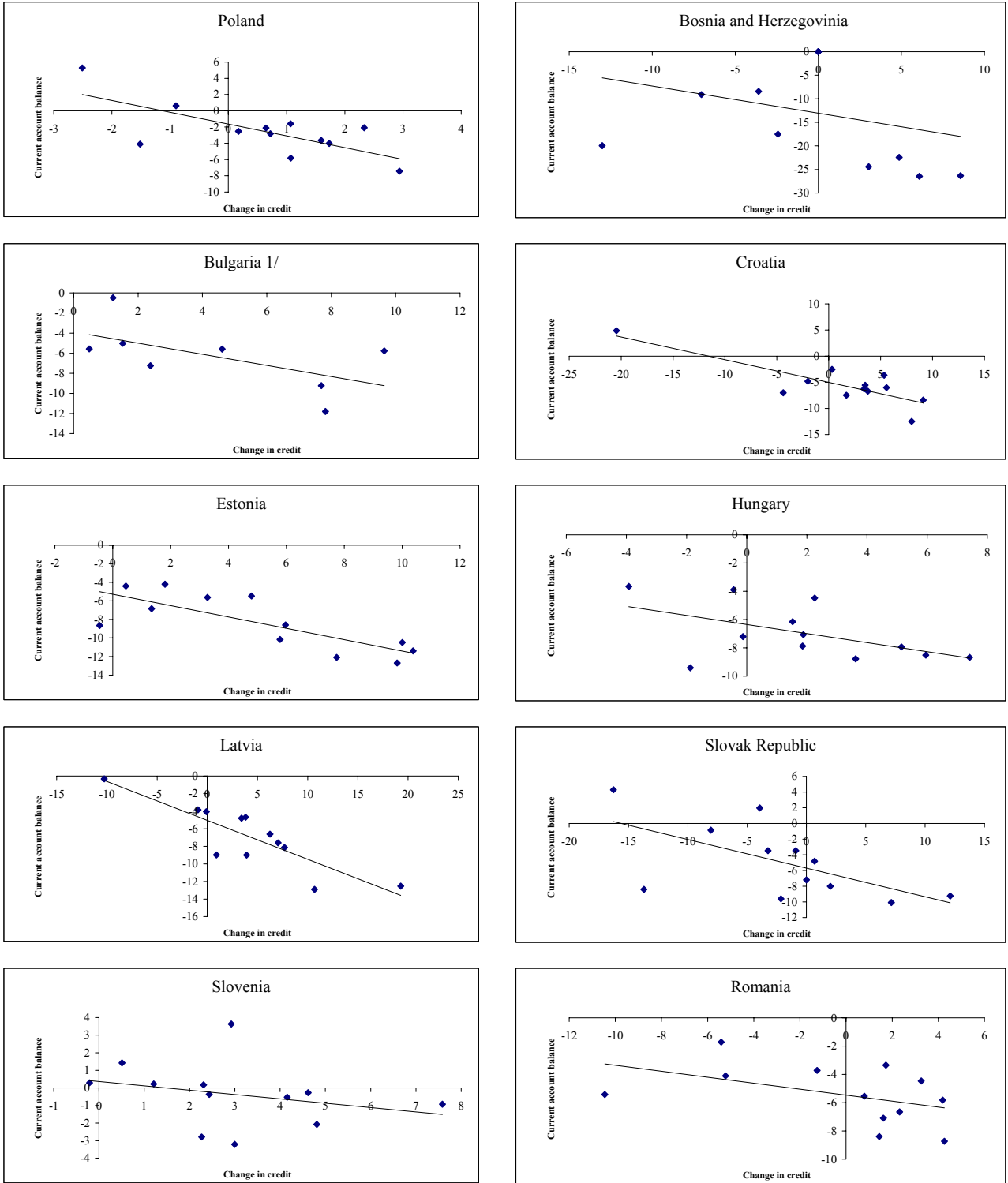
Source: WEO.
1/ Period of 1998-2005

15.   **Rapid growth of credit can also exacerbate liquidity risk, as well as problems associated with poor information concerning borrowers and weak institutional arrangements underpinning financial intermediation**. While these factors apply regardless of the growth rate of credit, they amplify the effect on financial sector soundness in case of an economic slowdown. Official financial statements may be of limited value in situations where auditing and accounting standards are weak; collateral execution is burdensome and costly, and the legal system slow and unpredictable. These factors are all present in Albania.

16.   **Risks in Albania are still moderate compared to other transition countries**. Relative to eleven other Central and Eastern European transition economies that have experienced rapid credit growth, Albania ranks fifth with respect to the capital adequacy ratio. Credit quality, as measured by NPLs, is also good, ranking four out of twelve. Albania has one of the highest shares of foreign ownership (banks with majority foreign ownership have 92 percent of banking system assets). With respect to liquidity, as measured by the loan-to-deposit ratio, Albania is ranked among the most liquid, with only about 29 percent of its deposit base lent out at end-2005. However, the share of loans to the household sector is relatively high, at 32 percent.

17.   **Nonetheless, the consequences of prudential and institutional weakness can be costly and spill over into financial and macroeconomic instability**. Moreover, relatively young financial systems often do not enjoy high levels of confidence, and even small problems can precipitate crises of confidence. The recent experience of Albania attests to this finding: it had a pyramid scheme which collapsed in 1997, and experienced a short financial crisis in 2002 when the deposit insurance scheme was introduced. Hence, it is important to maintain an adequate level of soundness in the banking system, which requires better soundness indicators than what is typical in mature market economies.

18.   **Intensive monitoring of developments underlying the credit growth and a strengthening of prudential regulation is therefore appropriate**. Information should be collected on relevant macroeconomic and financial sector data. Stress tests should be performed to insure that the financial system as a whole is sufficiently strong to withstand plausible but extreme shocks (for example, changes in foreign exchange rates or interest rates, or changes in credit quality resulting from an economic downturn). Other useful information includes disaggregate data by borrower type, sectoral allocation of credit, maturity mismatches, credit concentration, and—if market risk exposures is shifted away from banks to borrowers—the degree to which borrowers are hedged.

D. Policy Options for Dealing With Rapid Credit Growth

19. **There is a wide array of policy tools that can be used to manage the key risks associated with rapid credit growth**. Broadly, they can be classified into three categories: macroeconomic policies; prudential and supervisory policies; and other, including administrative and market development measures. These are summarized in Figure 2. The Bank of Albania as well as commercial banks have already undertaken a number of steps recently to strengthen risk management practices. The Bank of Albania is preparing to set up a credit registry; it has voiced its concern regarding rapid credit growth, and met with banks on this issue. Banks have increased staffing, strengthened loan approval procedure, and introduced risk management units.
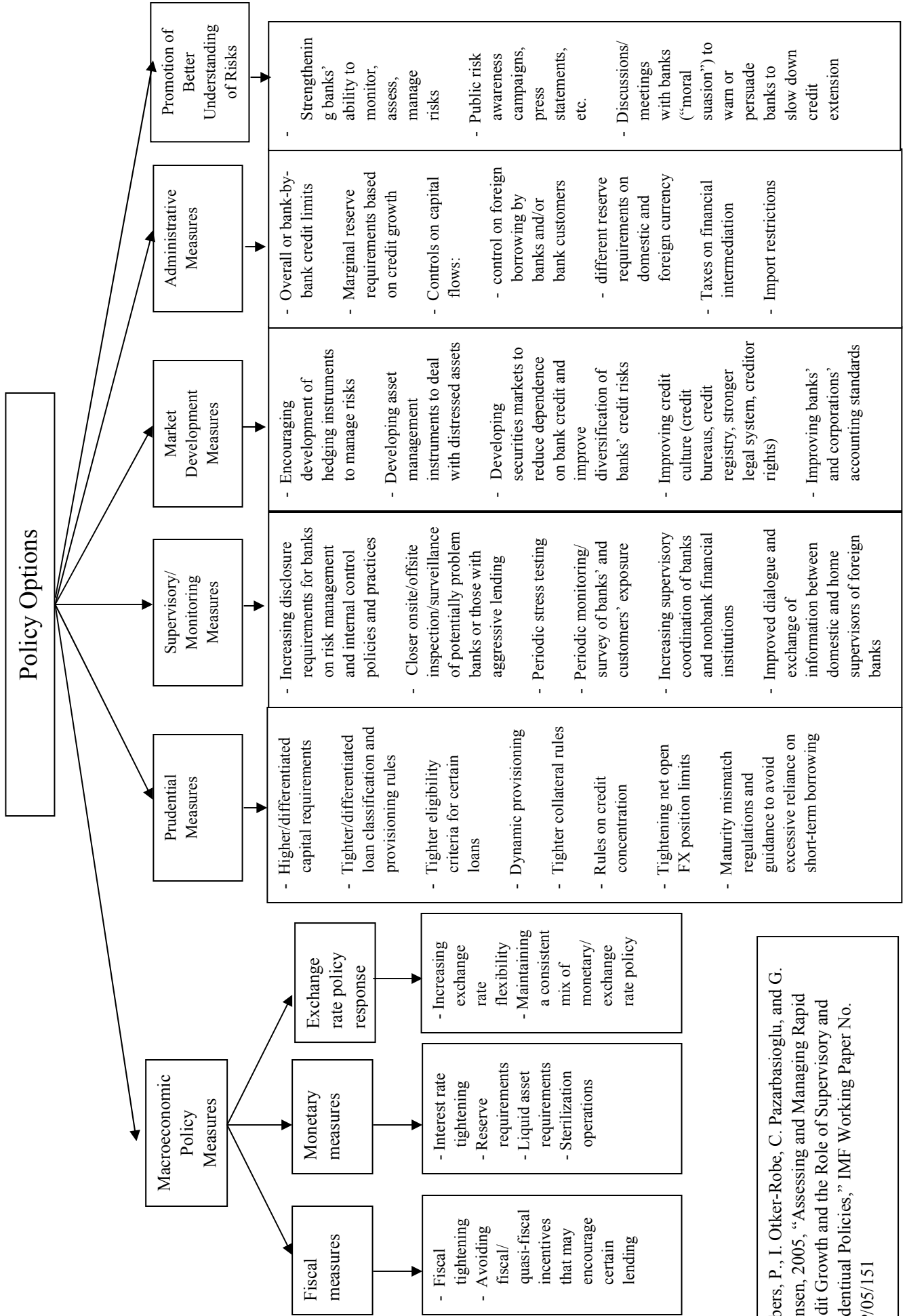
Macroeconomic Policy Response to Rapid Credit Growth

20. **Despite a flexible exchange rate regime, several factors may limit the extent to which financial policies may be usefully employed.**

- **Increases in the policy rate are unlikely to have a significant direct effect on credit volumes, although they may help control headline inflation.** The cost of borrowing for the majority—though declining—share of lending still denominated in foreign currency would be unaffected by increases in lek interest rates. Moreover, with most agents only recently gaining access to credit, the interest elasticity of lek borrowing is believed to be fairly low. However, a policy rate increase may dampen tradables inflation somewhat through its effect on the exchange rate. This could counteract to some extent a demand-driven increase in nontradables prices, but at a cost of a worsening competitive position for exporters and a further deterioration of the current account. Under these conditions, changes in the required reserve ratio, particularly on foreign currency deposits, might be a more effective monetary policy instrument.

- **The room for fiscal tightening is limited.** With a small share of public expenditure in GDP (about 30 percent) and limited taxing capacity, the size of a potential fiscal tightening relative to the demand impulse generated by credit growth would be small. Moreover, it would likely necessitate cuts in capital expenditure with ramifications for future growth potential.

Given these limitations, a monetary policy response would need to be fairly large to be effective, and, similarly to fiscal adjustment, would likely entail significant costs. This argues for greater reliance on prudential and supervisory measures.

Figure 2. Menu of Policy Options in Responding to Rapid Credit Growth

Policy Options

Macroeconomic Policy Measures

Fiscal measures
- Fiscal tightening
- Avoiding fiscal/quasi-fiscal incentives that may encourage certain lending

Monetary measures
- Interest rate tightening
- Reserve requirements
- Liquid asset requirements
- Sterilization operations

Exchange rate policy response
- Increasing exchange rate flexibility
- Maintaining a consistent mix of monetary/exchange rate policy

Prudential Measures
- Higher/differentiated capital requirements
- Tighter/differentiated loan classification and provisioning rules
- Tighter eligibility criteria for certain loans
- Dynamic provisioning
- Tighter collateral rules
- Rules on credit concentration
- Tightening net open FX position limits
- Maturity mismatch regulations and guidance to avoid excessive reliance on short-term borrowing

Supervisory/Monitoring Measures
- Increasing disclosure requirements for banks on risk management and internal control policies and practices
- Closer onsite/offsite inspection/surveillance of potentially problem banks or those with aggressive lending
- Periodic stress testing
- Periodic monitoring/survey of banks' and customers' exposure
- Increasing supervisory coordination of banks and nonbank financial institutions
- Improved dialogue and exchange of information between domestic and home supervisors of foreign banks

Market Development Measures
- Encouraging development of hedging instruments to manage risks
- Developing asset management instruments to deal with distressed assets
- Developing securities markets to reduce dependence on bank credit and improve diversification of banks' credit risks
- Improving credit culture (credit bureaus, credit registry, stronger legal system, creditor rights)
- Improving banks' and corporations' accounting standards

Administrative Measures
- Overall or bank-by-bank credit limits
- Marginal reserve requirements based on credit growth
- Controls on capital flows:
- control on foreign borrowing by banks and/or bank customers
- different reserve requirements on domestic and foreign currency
- Taxes on financial intermediation
- Import restrictions

Promotion of Better Understanding of Risks
- Strengthening banks' ability to monitor, assess, manage risks
- Public risk awareness campaigns, press statements, etc.
- Discussions/meetings with banks ("moral suasion") to warn or persuade banks to slow down credit extension

Hilbers, P., I. Otker-Robe, C. Pazarbasioglu, and G. Johnsen, 2005, "Assessing and Managing Rapid Credit Growth and the Role of Supervisory and Prudential Policies," IMF Working Paper No. WP/05/151

Prudential and Other Responses to Rapid Credit Growth

21.   **Overall, the Bank of Albania has an adequate menu of regulatory tools at its disposal that,** under **existing legislation, can be adjusted as necessary in response to increased credit risk.**

- Capital adequacy ratios higher than 12 percent could be imposed on individual banks that have relatively high risk profiles, under Article 5 of the Regulation on Capital Adequacy. In addition, as allowed under the Basel II framework, greater risk weights on particular types of relatively risky assets—even beyond 100 percent—could be imposed, raising capital requirements further.

- Additional penalties could be imposed under Article 44 of the Banking Law against *unsafe and unsound operations*, whenever banks are found to be maintaining imprudently-high credit expansion targets, insufficient risk management practices, or inadequate levels of provisioning.

- Higher provisioning on classified loans could be required if system-wide credit risk—as opposed to bank-by-bank credit risk—exceeds levels deemed prudent by the Bank of Albania.

Although these regulatory changes would be intended to serve a prudential function, to the extent that they increase the cost of financial intermediation, some reduction in the rate of credit expansion would be expected as these costs are passed on to borrowers. However, as the framework is tightened, the Bank of Albania will need to be attentive to regulatory arbitrage, which has been employed by some banks in the region to circumvent restrictions.

22.   **Both offsite and onsite supervision can be enhanced to direct supervisory resources more effectively to those institutions most at risk**. The Bank of Albania has a prudential database that can be used to closely monitor credit developments, supplemented by the results of a recent survey on credit growth. This forms the basis for an early warning system based on ratings across four categories—capital adequacy, asset quality, earnings, and liquidity—that can be used to better target supervisory activities towards credit-related risks. However, monitoring can be further improved by:

- Preparing and mandating by end-2006 enhanced reporting rules for commercial banks to allow better monitoring of banking sector developments. This could include, inter alia, collecting additional information on developments in real estate markets, and on borrowers' income, indebtedness, and sensitivity to foreign exchange risk.

- Improving coordination and communication with home country supervisors of foreign-owned banks.

- Decreasing the reporting lag on monthly bank statistics.

- Requiring banks to communicate internal audit reports to the external auditor in order to further strengthen risk management practices.

The Albanian authorities also plan to submit a new Banking Law to Parliament in early 2007 designed to grant the Bank of Albania the additional legal authority needed to improve and broaden its supervision of commercial banks; and to strengthen legal protection for banking supervisors.

23.   **Additional regulatory actions can be taken to protect loan quality**. The Bank of Albania can insist that banks adopt stricter debt service to disposable income ratios and prudent loan to value ratios; tighter internal loan classification rules; and increased risk premiums in lending spreads to take full account of indirect credit risk from foreign-exchange exposure of customers. Mandatory stress testing[60] by the commercial banks themselves would be a useful supplement to the stress testing already carried out by the Bank of Albania. The introduction of truth in lending rules—making more transparent actual annual percentage rates and the risks associated with foreign-currency borrowing—would allow borrowers to more accurately assess the risks they face in contracting bank loans. Establishment of a credit bureau with universal coverage would also be a major step forward.

24.   **Other actions and measures—some of which fall outside the mandate of the Bank of Albania—would also contribute to managing credit risk**. First and foremost are measures that reduce the degree of informality in the economy. Reportedly, many clients declare and receive through their bank accounts only part of their earnings. In fact, the number of salary payments through the banking system is still small. Changes in legislation to help execute collateral more effectively are also urgently needed.

E. Conclusions

25.   **Financial deepening is a natural, healthy development for an economy at Albania's stage of development, but one that contains inherent risks**. Credit expansion is necessary to maintain the current pace of growth and poverty reduction and, for this reason, will remain a desirable characteristic of the Albanian economy well into the medium term. However, skillful management will be required to keep it at a level consistent with macroeconomic and financial system stability.

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[60] For example, to investigate indirect credit risk arising from foreign exchange risk, indirect credit risk through interest rate risk, and liquidity risk.

26.   **Albania currently has a sound banking system and an adequate prudential framework, but continued rapid credit growth requires further improvements**. More intensive monitoring is called for, as is a graduated bank-by-bank supervisory response. If credit risk continues to increase, more stringent prudential norms should be applied. If demand pressures remain acute, a further tightening of the macroeconomic policy mix could also be considered.

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VII. ALBANIAN WEBSITES WITH ECONOMIC INFORMATION

Presidency of Albania

   http://www.president.al/

Parliament of Albania

   http://www.parlament.al/

Council of Ministers

   http://www.keshilliministrave.al/shqip/default.asp

Ministry of Finance

   http://www.minfin.gov.al/

Ministry of Economy, Market and Energy

   http://www.mete.gov.al/

Ministry of Agriculture, Food and Consumer   Protection

   http://www.mbu.gov.al/

Ministry of Public Works, Transportation and Telecommunications

   http://www.mpptt.gov.al/

Ministry of Labor and Social Affairs

   http://www.mpcs.gov.al/

Ministry of Foreign Affairs

   http://www.mfa.gov.al/shqip/default.asp

Ministry of Defense

   http://www.mod.gov.al/eng/

Bank of Albania

   http://www.bankofalbania.org/

INSTAT

   http://www.instat.gov.al

Albanian Deposits Insurance Agency

   http://www.dia.org.al/

Albanian Securities Commission

   http://www.asc.gov.al/about_us.html

Supreme State Audit of Albania

   http://www.klsh.org.al/englishh.htm

General Directorate of Customs

   http://www.dogana.gov.al

General Directorate of Taxes

   http://www.tatime.gov.al

The Centre for Official Publication[61]

   http://www.legjislacionishqiptar.gov.al

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[61] the database for all laws and government decisions