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ALBANIA

SELECTED ISSUES

December 2017

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ALBANIA

SELECTED ISSUES

November 14, 2017

Approved By
European Department

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EXTERNAL SECTOR ASSESSMENT[1]

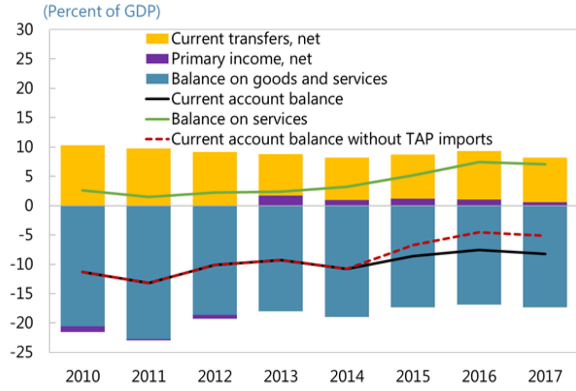
The EBA-Lite model results indicate that the external position is moderately weaker than implied by fundamentals and desirable policy settings. Adjusting for Albania's specific circumstances, the current account gap is estimated at -1.0 percent and the real effective exchange rate is overvalued by about 6 percent, reflecting Albania's low national saving and large FDI inflows. Though Albania has benefitted from the recent tourism boom in the region, the outlook for exports remains challenging. Despite its cost competitiveness, exports are narrowly concentrated in a few low-value added sectors while new investments in the non-energy tradable sector are limited. To close Albania's competitiveness gap and strengthen its external position, the authorities should complete key infrastructure projects to reduce transportation costs and address energy sector reliability; increase domestic savings; improve governance and the rule of law; and raise labor market efficiency by reducing skills shortages.

A. External Balance

1. Albania's current account (CA) deficit improved in 2016, but remains sizable. The current account deficit declined to 7.6 percent of GDP at end-2016, the lowest level over the past decade. The trade deficit also declined but remains large at 16.9 percent of GDP. The deficit is partially offset by large remittances. In recent years, the trade deficit has been driven by the imports generated from FDI in large energy projects, especially the Trans-Adriatic Pipeline (TAP), contributing around 2.5 percent of over GDP in 2016. As the FDI declines over time, the CA deficit is projected to narrow correspondingly.

Current Account Balance

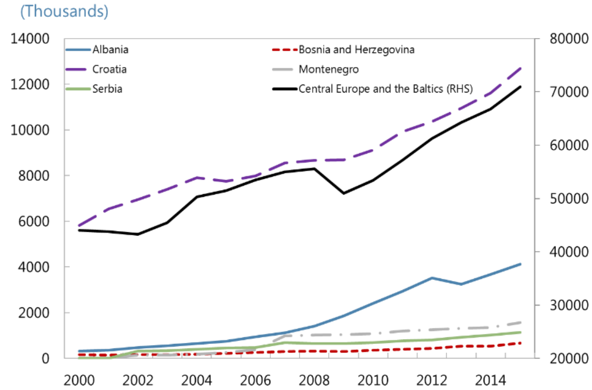
(Percent of GDP)



Sources: Bank of Albania; and IMF staff estimates.

International Tourist Arrivals

(Thousands)



Source: World Bank

2. The improvement in the trade deficit reflected increasing surpluses in the services account offsetting weaker goods exports. Propelled by a surge in travel and tourism exports,

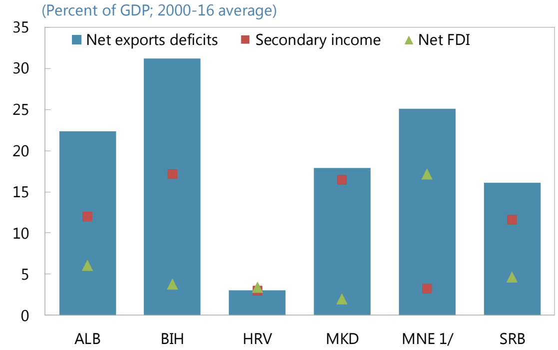
[1] Prepared by Atticus Weller (SPR)

the services balance reached a surplus of 7.4 percent of GDP in 2016, compared to 2.4 percent of GDP in 2013. This surplus has helped offset the increase in the goods trade deficit from 20.4 percent of GDP in 2013 to 24.3 percent of GDP in 2016 as goods exports declined, due in part to less favorable terms of trade.

3. As in other Western Balkan countries, substantial trade deficits are correlated with large remittance and FDI inflows. This is consistent with FDI and secondary income (used here as a proxy given the lack of comprehensive cross-country remittance data) as a source of significant import demand. Most Balkan economies have attracted sizeable FDI flows and have large diaspora populations that contribute remittances.

Net exports vs. Secondary Income and Net FDI

(Percent of GDP; 2000-16 average)



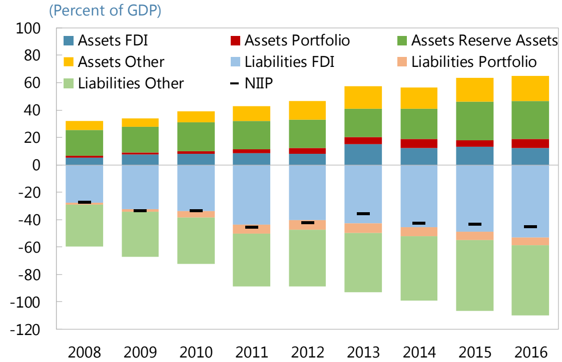
1/ 2006-16 average.

Sources: WEO database; and IMF staff calculations.

4. The net international investment position has been increasingly negative, but external sustainability risks are mitigated by the large FDI stock. The NIIP increased to -45 percent of GDP in 2016 from -36 percent of GDP in 2013, driven by FDI inflows and external borrowing. Foreign liabilities reached 110 percent of GDP, although nearly half of this stock comprised non-debt creating FDI liabilities, while other liabilities mainly comprise long term concessional public debt. The rate of growth of the NIIP deficit is expected to slow as FDI in large energy projects tapers off.

Albania: Net International Investment Position

(Percent of GDP)

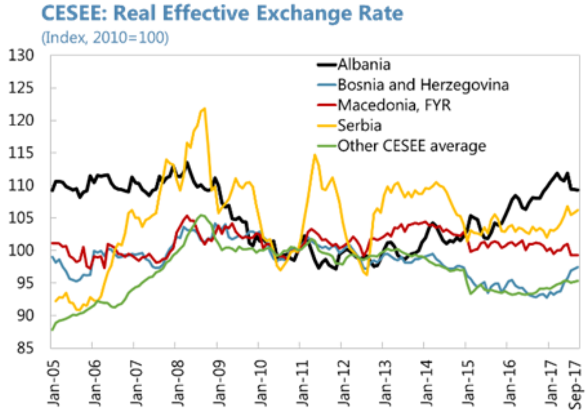


Sources: Bank of Albania; Haver Analytics; and IMF staff calculations.

5. The exchange rate has appreciated modestly since early 2016. Albania maintains a floating regime under an inflation targeting framework. The nominal exchange rate appreciated by 3 ½ percent (yoy) against the euro in nominal terms as of end-September 2017. The nominal exchange rate has generally fluctuated within a two percent band despite limited BoA's interventions, which have been small, infrequent, and typically announced months in advance. The real effective exchange rates (REER), based on CPI and PPI, have been on an appreciating trend over the past few years, reflecting an appreciation of the nominal effective exchange rate (NEER) as well as the price differential vis-à-vis trading partners. Since the beginning of 2016, the CPI- and PPI-based REERs have both appreciated by about 7 percent.[2]

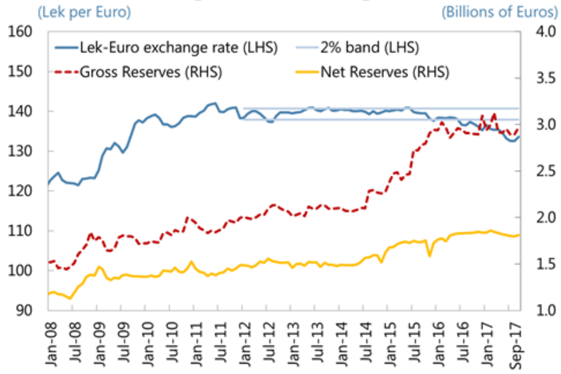
[2] CPI-based REER data is through September 2017; PPI-based REER data is through June 2017.

CESEE: Real Effective Exchange Rate



Sources: IMF, INS database and IMF staff calculations

Nominal Exchange Rate and Foreign Reserves



Sources: Bank of Albania; and IMF staff calculations.

B. Exchange Rate Assessment[3]

6. To assess Albania's exchange rate competitiveness, the Fund's standard multilaterally consistent exchange rate assessment methodology is adjusted to Albania's specific circumstances. In particular, in the EBA-Lite Current Account model, the underlying current account is adapted to include errors and omissions of around 1½ percent of GDP that are associated mainly with unrecorded remittances. The underlying current account also excludes a portion of imports financed by FDI inflows over and above the EBA-lite sample average.[4] In the external sustainability approach, the underlying current account is adjusted for errors and omissions only.

7. The EBA-Lite models suggest that the external position has improved but remains moderately weaker than implied by fundamentals.

External Sector Assessment Summary Table
(Percent of GDP)

	Current account-Norm	Adjusted actual current account	Current account gap	REER gap
EBA-Lite (Current account approach)	-4.9	-6.0	-1.0	6.1
External sustainability approach	-4.4	-6.4	-2.0	9.5
REER approach	n.a.	n.a.	n.a.	-1.0
REER elasticity	-0.17			

Source: IMF staff calculations.

[3] The EBA-Lite model is used for Albania in view of the country's large aid and remittance flows.

[4] Albania's FDI inflows have been in range of 7–10 percent of GDP, notably higher than the EBA-Lite sample average of 4 percent. In the current account approach, staff excludes approximately 60 percent of the errors and omissions and a quarter of excess FDI to achieve an adjusted underlying current account deficit of -6.0 percent.

- **The EBA-Lite's Current Account approach points to an external position that is moderately weaker than implied by fundamentals.** The CA norm, estimated at -4.9 percent, is smaller than the underlying CA balance of -6.0 percent of GDP. The gap of -1.0 percent of GDP suggests a REER that is overvalued by about 6.1 percent and thus moderately weaker than implied by fundamentals and desirable policy settings. The CA deficit norm is mainly driven by output per worker along with aid and remittances, which are partially offset by the improving fiscal balance. The norm also includes a small policy gap, estimated at 0.6 percent of GDP, which mostly reflects Albania's private credit to GDP gap, and has the effect of lowering the CA-norm.

CA Approach Results (Model vs Staff Assessment)

CA Approach results (model vs. staff assessment)

CA-Actual	-7.6
Cyclical contribution (from model)	-0.1
Additional temporary or statistical factors	-1.5
Cyclically-adjusted/underlying CA (staff-assessed)	**-6.0**
CA-Norm (including cyclical contributions, from model)	-4.8
CA-Norm (excluding cyclical contributions, from model)	-4.9
Additional adjustments to the norm	0.0
CA-Norm (staff assessed)	**-4.9**
CA-Gap (staff-assessed)	**-1.0**
o/w policy gap	0.6
Elasticity	-0.2
REER Gap (staff-assessed)	**6.1**

- **The External Sustainability approach also indicates an external position moderately weaker than fundamentals.** The CA norm needed to stabilize the NIIP at the 2016 level of -45 percent is -3.5 percent, compared to an underlying CA of -6.4 percent. Given Albania's investment needs and the expectation of continued and fairly large net FDI inflows as Albania nears EU accession, a more realistic benchmark would be to stabilize the NIIP around -55 percent of GDP, which is the average for countries in the region. Doing so by 2036 implies a CA norm of -4.4 percent of GDP, suggesting a real exchange rate overvaluation of 9 ½ percent.

External Positions and Scenarios

			CA norm (% of GDP)	Underlying CA (% of GDP)	CA gap	REER gap
Scenario 1: Stabilizing net IIP at	-45.0 % of GDP		-3.5	-6.4	-2.8	13.5
Scenario 2: Stabilizing net IIP at	-55.0 % of GDP		-4.1	-6.4	-2.2	10.6
Scenario 3: Reaching net IIP at	-55.0 % of GDP in	2036	-4.4	-6.4	-2.0	9.5

- **The REER approach points to the exchange rate being broadly in line with fundamentals.** This model, however, has weak predictive power for Albania.

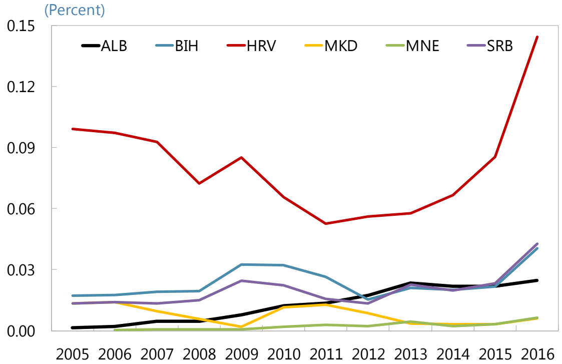
As the CA approach is the most adaptable to Albania's specific circumstances and as such has the strongest predictive value, we conclude that the external position is moderately weaker than implied by fundamentals and desirable policy settings.

C. Export Competitiveness and Growth: Key Challenges

8. Albania's export shares and competitiveness rankings show that further policy efforts are needed to create an enabling environment for investment in export sectors. To address these gaps, the authorities should complete key infrastructure projects to reduce transportation costs and address energy sector reliability; increase domestic savings; improve governance and the rule of law; and raise labor market efficiency by reducing skills shortages.

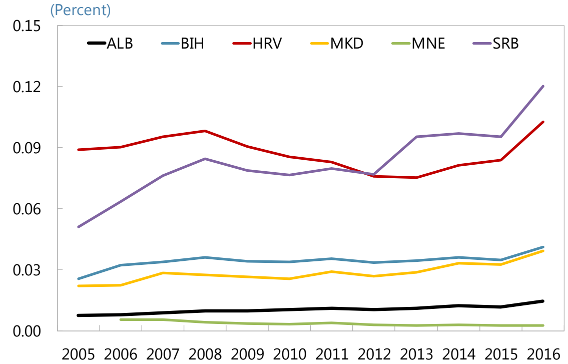
9. Albania's export market share rose in 2016, but relative to other western Balkan countries, it remains low and has grown less quickly. Albania's export market share in the oil sector, which had been growing rapidly until 2013, has since slowed. Its market share in non-oil exports has increased, especially in textiles and footwear, but at a slower pace than regional peers, including countries such as Bosnia and Herzegovina and Macedonia, which have similar income levels. Furthermore, Albania's share of world services exports has not picked up despite the recent strong growth of services exports.

Share in World Oil Export Markets
(Percent)



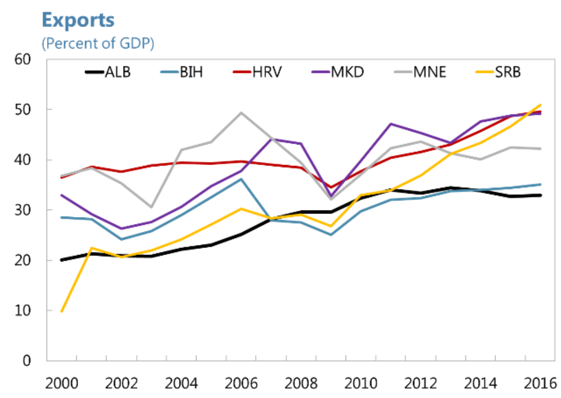
Sources: INSTAT; World Bank, WITS database; and IMF staff calculations.

Share in World Nonoil Export Markets
(Percent)

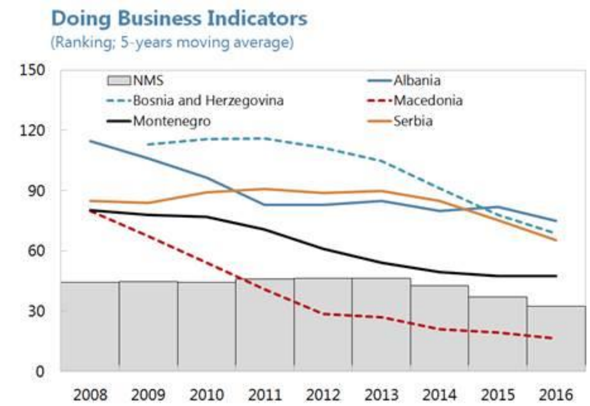


Sources: INSTAT; World Bank, WITS database; and IMF staff calculations.

10. Albania's export to GDP ratio is low relative to other Western Balkan economies and has been stagnant for the last several years. This highlights Albania's relative lack of openness and the impact of declining commodity prices in recent years. However, it may also indicate export competitiveness shortcomings compared to regional peers.



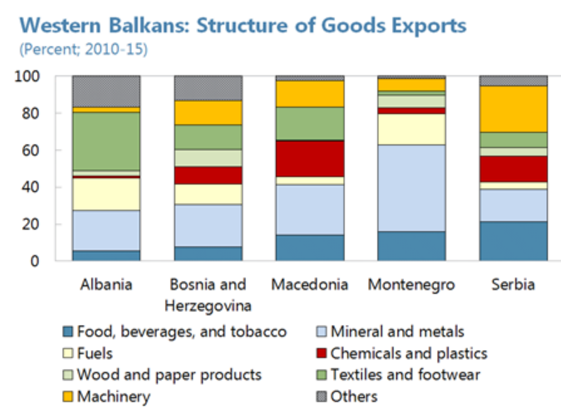
Source: WEO database.



Source: World Bank, Doing Business Reports.

11. Survey-based indicators suggest that Albania's competitiveness has improved, but its competitiveness gap with regional peers persists. Albania's ranking in Ease of Doing Business improved, but other Balkan countries such as Bosnia and Herzegovina, Macedonia and Montenegro have been converging more quickly toward EU New Member States (NMS) rankings. Albania's ranking in the World Economic Forum's Global Competitiveness Report has also stagnated, widening the already considerable gap between Albania and the NMS average.

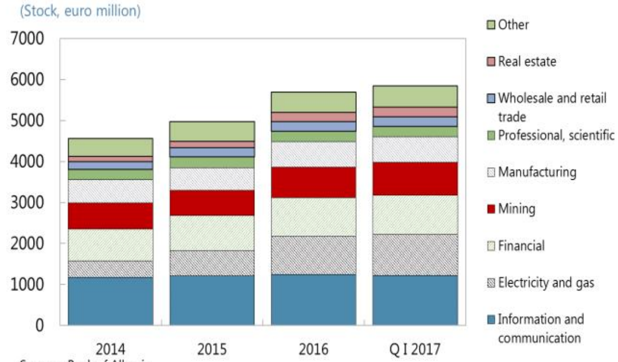
12. Albania's undiversified export markets and the concentration of its exports in low value-added sectors may be an impediment to future growth. In contrast to the higher value-added chemicals and manufacturing exports of neighboring countries such as Serbia and Macedonia, Albania's exports are mainly in the textile and footwear sectors, and oil and minerals. Growth prospects are thus constrained by the subdued medium-term outlook for oil prices, especially given Albania's high cost of oil exploitation. While regional exports are rising, more than half of exports go to Italy. While some of these products, especially textiles, are processed in Albania from imported Italian components and are subsequently re-exported to other markets, a large portion are intended for final consumption in Italy, thus making Albania dependent on a country facing low growth potential. FDI inflows have been increasing mainly in the energy (gas pipeline, hydropower) and mining sectors, but remain limited in other tradable sectors, which suggests that the recent surge of FDI may not generate significant export growth.



Sources: World Bank, WITS database; and IMF staff estimates.

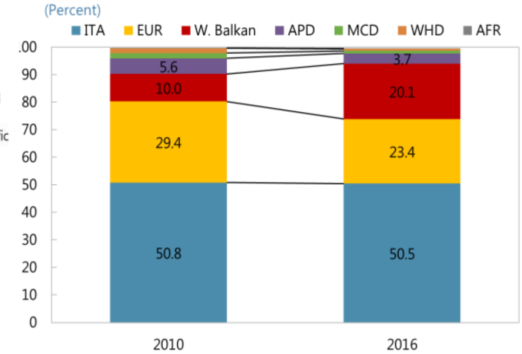
13. Could Albania build on its role as an assembly base for Italian-financed goods to become more integrated into European supply chains? The literature[5] shows that the strongest export performance globally and in Europe has been the result of successful integration with supply chains. This integration is facilitated by proximity to supply hubs, openness to trade, similarity of export structures, the business environment, and quality of infrastructure. Albania does well on the first two measures, but is relatively disadvantaged with respect to the latter three.

FDI by sector
(Stock, euro million)



Sources: Bank of Albania

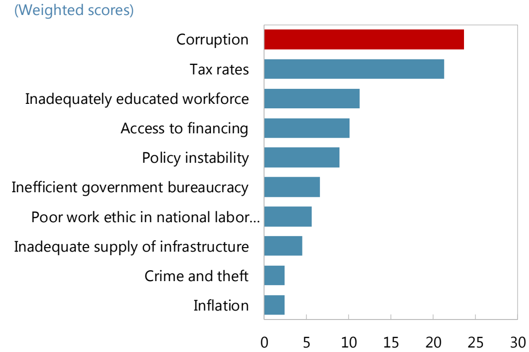
Export Markets
(Percent)



Source: Direction of Trade Statistics database.

14. Albania's greatest structural impediments to export competitiveness are weak institutions, deficiencies in infrastructure, an excessively complex tax system, access to finance, and a shortage of skilled labor.

Top Ten Problematic Factors for Business in 2016
(Weighted scores)



Source: Global Competitiveness Report, 2016-2017.

- ***Weak institutions*** constrain growth by undermining the rule of law. This is most apparent in the judiciary, where inadequate protection of property rights and enforcement of contracts hampers an enabling environment for long-term investment. The 2016 Global Competitiveness Report survey indicated that corruption was the main obstacle to doing business in Albania. The authorities are taking steps to address corruption, including passage of constitutional amendments on judiciary reform, as a precondition for EU accession, and Albania's ranking has improved in the ICRG Corruption Index, narrowing the gap relative to the average for CESEE countries.

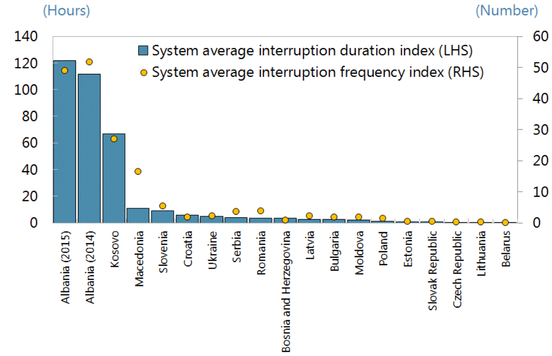
[5] Rahman, J. and Zhao T., 2013, "Export Performance in Europe: What Do We Know from Supply Links", *IMF Working Paper.*

- ***Deficiencies in infrastructure***, including roads, railways, telecommunications, ports, and airports, constrain trade and connectivity with neighboring countries. This is reflected in Albania's score of 3.6 in the WEF's infrastructure rankings, which is well below the average for NMS of 4.6.[6] Albania's power supply is notably unreliable, with the average duration of electricity blackouts far exceeding those of other CESEE countries, notwithstanding recent improvements in bill collection and a reduction in distribution losses.

- ***The complexity of the tax system*** places a substantial burden on business. The authorities have sought to simplify tax procedures and improve tax administration, but implementation challenges remain.

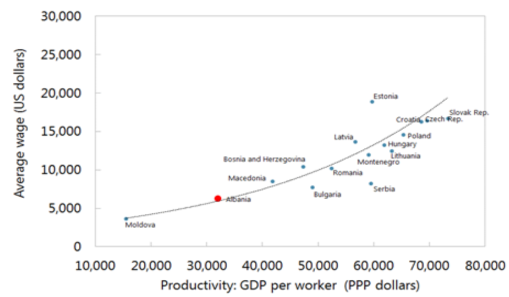
- ***Difficulties in access to finance*** constrain investment. Further institutional strengthening is needed to close the credit gap in Albania (SIP).

Electricty Blackouts, 2014



Sources: OShEE; and World Bank, Doing Business Indicators.

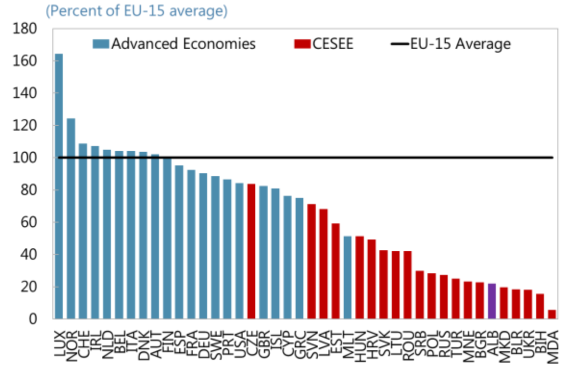
CESEE: Average Wages and Productivity, 2016



Sources: Haver Analytics; OECD; IMF, WEO database; and IMF staff estimates.

Capital Stock per Capita, 2014

(Percent of EU-15 average)



Sources: Penn World Tables, version 9.0.

15. Albania needs to improve productivity, which is relatively low compared to regional peers largely because of a capital gap and skills shortages. Output per worker is only about 61 percent of the CESEE median. Though low real wage growth has alleviated pressure on Albania's cost competitiveness—unit labor costs stood at 76 percent of NMS median in 2016—low productivity has been a constraint in the development of the manufacturing sector. This is in part a consequence of an investment deficit. While investment-to-GDP has increased in recent years, Albania's capital stock per capita is still among the lowest in Europe. Labor skill shortages also create bottlenecks to raising productivity and growth. The percentage of the labor force with only a primary school education is higher in Albania than in any other country in the CESEE. The

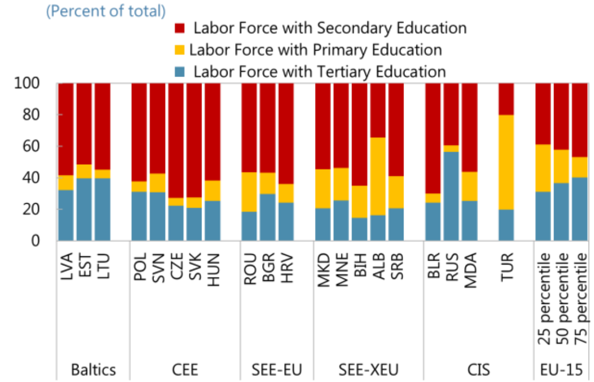
[6] World Economic Forum, Global Competitiveness Report

shortage of skilled labor has also been exacerbated by the emigration of younger and relatively more educated people.

D. Financing Risk

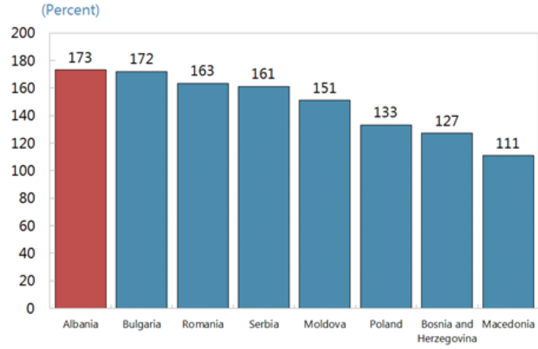
16. Despite large external financing needs, risks are limited and FX reserves coverage remains adequate. At 13.4 percent of GDP in 2016, Albania's external financing needs are substantial. However, gross FX reserves, at 27 percent of GDP at end-2016, have continued to increase, reflecting substantial inflows of foreign direct investment and donor-funded longer-term external borrowing. In 2016, net FDI stood at 8.7 percent of GDP, covering well over 100 percent of the CA deficit while FX reserves reached 173 percent of the ARA metric. While this level is above the 150 percent upper threshold for floating regimes, the higher level is appropriate given Albania's substantial euroization and large FX deposits held by domestic banks at the Bank of Albania. Reserves coverage is projected to increase relative to the metric through the medium-term in line with the increased issuance of commercial debt, and then decline as the authorities' de-euroization plans gain momentum and as FX debt is repaid. Coverage is expected to remain above the upper boundary of the ARA metric, broadly consistent with levels in other partially euroized non-Euro Area economies in the region.

Labor Force Composition by Education Level
(Percent of total)



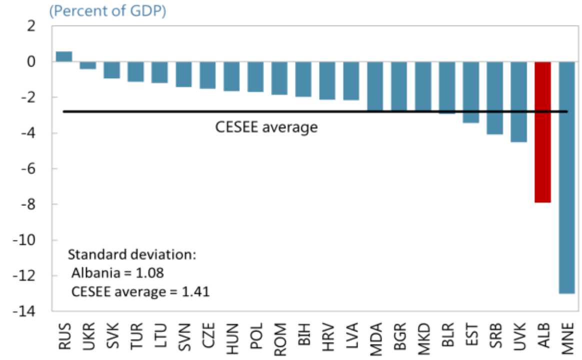
Source: World Development Indicators, World Bank.

Gross Reserves as a Percentage of ARA Metric, 2016
(Percent)



Source: IMF staff calculations.

Foreign Direct Investment, Average 2010-16
(Percent of GDP)



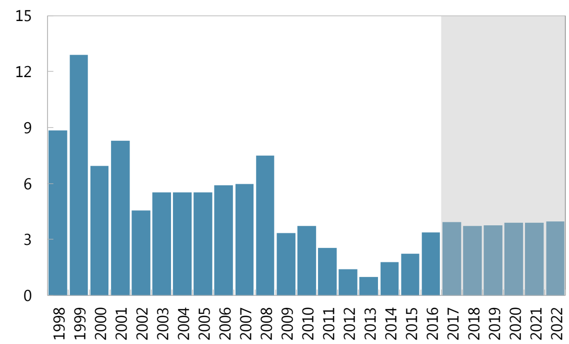
Source: WEO database.

MEDIUM TERM GROWTH IN ALBANIA[1]

Growth in Albania is recovering but has recently been driven by large FDI projects, raising concerns about the sustainability of the recovery and underlying growth potential. This study assesses the prospects and challenges for medium term growth. While Albania's external conditions are favorable, low savings and demographic trends are expected to weigh on investment and labor utilization. However, EU accession literature suggests that institutional reforms as an EU candidate country can catalyze productivity improvements and potential growth in Albania.

1. **Real GDP is expected to continue growing rapidly over the medium term, albeit below the pre-crisis pace**. Growth has accelerated over the past three years led by large FDI projects, the regional recovery after the 2012 crisis, and increasing consumer confidence. Growth is expected to pick up further in the next few years, reaching 4 percent by 2019, compared to 3.4 percent in 2016. Nevertheless, this growth rate would be lower than the pre-crisis average of 6 percent during 2000-08.

Albania: Real GDP Growth
(Percent)



Source: IMF Staff estimates.

A. Medium Term Growth[2] and Potential Growth

2. **To project medium-term growth, we estimate potential growth in Albania.** Measuring potential growth is a complex task in developing economies. Potential growth is unobservable and therefore it needs to be estimated. Each of the three standard approaches—univariate filters, production function, and multivariate filters —has advantages and disadvantages. The three techniques detailed in "Potential Output in Albania" IMF (2016) have been updated to understand what would be medium term growth.

- **First, two Hodrick-Prescott (HP) filters are considered for which the smoothing parameters are set at 100 and 6.25**. These values reflect discussions in the literature —see Ravn and Uhlig (2002).
- **Second, two specifications of the production function are used to estimate potential output.** Output growth is broken down into contributions from TFP, capital, and labor. The actual capital stock is combined with the filtered labor and TFP series to

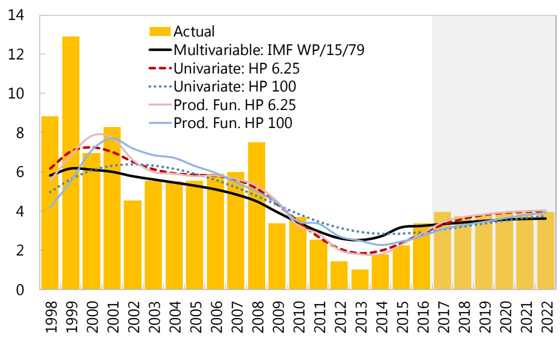
[1] Prepared by Ezequiel Cabezon (EUR).

[2] Medium term growth is defined as the real GDP growth after removing cyclical variations. In practice, it is proxied with a 5-year average or a filtered series.

obtain potential output growth. The parameters of the production function are detailed in IMF (2016), and the filtering technique is HP with smoothing parameters 6.25 and 100.

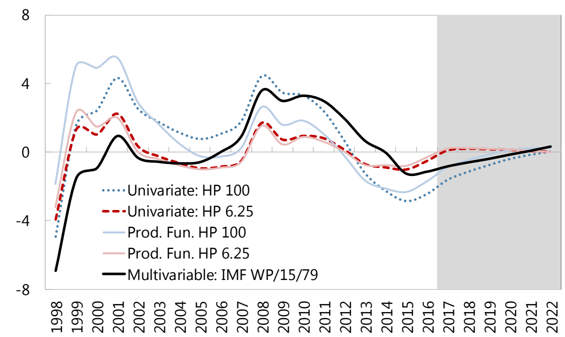
- **Third, a multivariate filter developed by Blagrave (2015) —IMF WP/15/79— is applied.** This method considers a Kalman filter augmented to considers unemployment, expectations of output growth and inflation, and relationships among variables such as the Phillips Curve and Okun's Law. Details of the filter are provided in IMF (2016).

Real GDP Potential Growth
(Percent)



Sources: IMF Staff estimates.

Output Gap
(Percent)



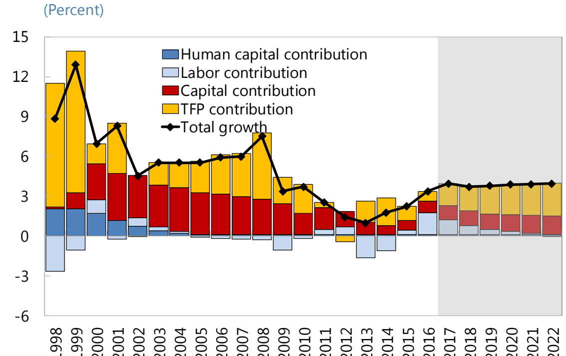
Sources: IMF Staff estimates.

3. The results point that the potential growth is accelerating. The average potential growth increased between 2013 and 2016 from 2.3 to 3.2. While caution is needed to interpret the results for the period 2018-22 —as filters can be biased by the forecast— there is no issue to interpret past trends. The past upward trend of potential growth and the negative output gaps imply that medium term growth —which measures growth after removing short-term cyclical fluctuations— can increase in the next 5 years.

B. What are the Drivers of Growth in Albania?

4. What are the main factors contributing to growth? In 2016, growth accounting showed that capital contribution is recovering while labor contribution soared. The capital contribution is attributed to spillovers of the large FDI projects and a construction revival. The high contribution of employment resulted from a pick-up in labor intensive sectors such as textiles, constructions, and tourism.

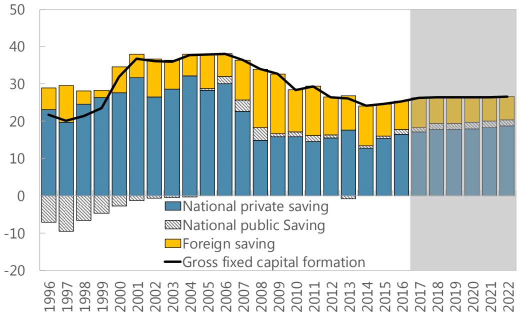
Growth Accounting
(Percent)



Source: IMF Staff estimates.

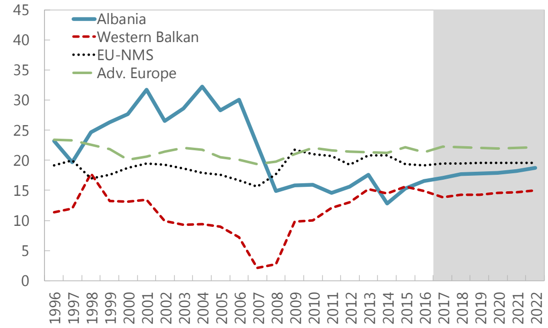
5. The contribution of capital is expected to remain low by historical standards. During the 2000s, easy credit conditions fed a construction boom, which accelerated capital accumulation. By 2009–10, a housing glut and increased risk aversion as a result of the global financial crisis halted the credit-fueled construction boom. In the last few years, the large energy projects (Box 1) and the lift of a ban on construction permits have edged up capital contributions. As the construction phase of large FDI projects is completed in 2018-20, their contribution to growth is expected to turn negative, limiting the potential for a more rapid pickup of investment.

National Saving
(Percent of GDP)



Sources: INSTAT; and IMF staff estimates.

Private Saving
(Percent of GDP)



Sources: INSTAT; and IMF staff calculations.

6. A large part of investment in Albania has been financed with foreign savings. Private savings is slightly above the Western Balkan peers, but has been on a declining trend since 2007, contributing to a decline in national savings. Declining interest rates, remittances, growth rate and lower income levels after a 2009 FX-depreciation have led to this trend. The gap between investment and national saving ratios thus raises concerns for investment sustainability. Since countries that sustain high growth show a strong link between corporate saving and investment, raising corporate saving will be key to financing higher investment.

Box 1. The Impact of Large FDI Projects in the Short Run

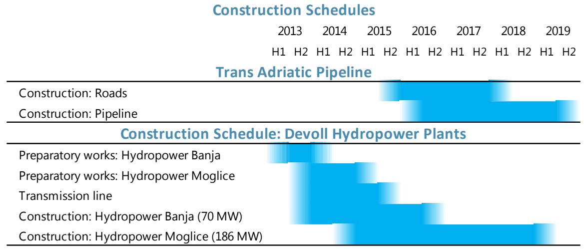
Two large FDI projects are having significant effects on economic activity. The projects include the construction of two hydropower plants and a natural gas pipeline. The aggregate cost is 14 percent of GDP. Given their capital intensity, imports account for a large share of the costs (about 60-70 percent) and the rest corresponds to wages, local contractors, and compensation for use of land. The projects have created about 3500 direct jobs (6 percent of total new jobs). The construction started in late 2013 and speeded up in 2015-17. The projects are improving road transportation as roads and bridges will be upgraded, refurnished, and built as part of their business plan.

Large FDI Projects

Project	Detail	Additional infrastructure	Period	Total cost (Euro Bn)	Total cost (Percent of GDP)	Employees - 2017 (Thousand employees)
Statkraft Devoll Hydropower plants	Two hydropower plants: 256 MW (17% of the capacity of the country)	100 km of roads rehabilitated and 14 bridges rehabilitated.	2013Q3-2018Q4	0.5	4.7	1.7
Trans Adriatic Pipeline	Natural gas pipeline: 252 Km (capacity to supply 7M households)	178 km of roads rehabilitated, 2 new bridges and 40 bridges rehabilitated.	2015Q3-2019Q4	1.0	9.3	1.8
Total				**1.5**	**14.0**	**3.5**

Source: IMF based on Statkraft and TAP reports.

Construction Schedules



Source: Devoll Hydropower Statkraft; Trans Adriatic Pipeline AG; and IMF staff estimates.

The Trans-Adriatic Pipeline (TAP), which will transport natural gas from Azerbaijan to Italy, will bring a key energy input to Albania. Lack of a pipeline implied natural gas was scarcely used. In Albania, the construction includes 252 km of pipelines with a total cost of € 1 billion (9 percent of GDP). Also, more than 175 km of access roads will be built or upgraded. The project is expected to peak in 2017. In 2016, TAP completed upgrading 58 km of roads and bridge construction works.

Devoll hydropower plants will increase the installed generation capacity by 17 percent. Two hydropower plants valued at €535M (5 percent of GDP) will be built. The smaller plant (Banja) was already completed and started production in 2016Q3. The construction of the larger plant (Moglice) —that started in 2014— is expected to be completed in 2018. The project will ensure a more reliable electricity supply and a large part of the generation will be exported.

Devoll Hydropower Plants

Power plant	Installed capacity	Annual Generation	Construction period	Start production	Total cost
Banja	70 MW	242GWh	2013Q3-2016Q2	2016Q3	...
Moglice	186 MW	475GWh	2014-2018	2019Q2	...
Total	256 MW	717GWh	2013Q3-2018Q4		535

Source: IMF based on Statkraft reports.

Box 1. The Impact of Large FDI Projects in the Short Run (concluded)

The direct impact on growth is estimated to be around 0.4 percentage point for 2015-16. The projects demand mainly construction and transportation services. These estimates are a lower bound of the impact based on FDI planned disbursements, estimated imports, and assumes all local expenditure adds to GDP. The value added (level effect on GDP) was 0.8-1.2 percent of GDP in 2015-16. The growth impact is estimated at 0.3-0.5 percentage points in 2015-16. It is relevant to consider that the value added generated by the projects once they are operating will be low.

Impact of Trans Adriatic Pipeline and Statkraft - Construction

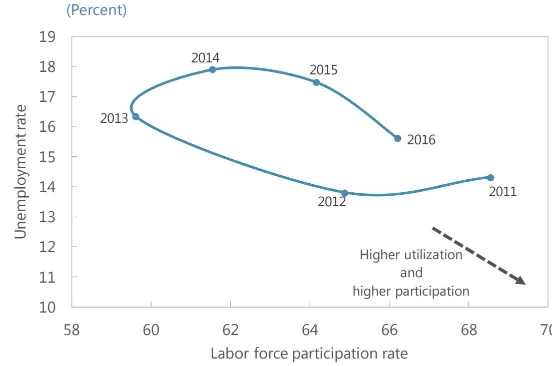
	2014	2015	2016	2017	2018	2019	2020
	Percent of GDP						
FDI related to TAP/Statkraft	0.8	2.7	3.8	3.9	2.3	0.8	0.0
of which imports	*0.5*	*1.9*	*2.7*	*2.7*	*1.6*	*0.4*	*0.0*
of which domestic expenditure	*0.3*	*0.8*	*1.2*	*1.2*	*0.8*	*0.4*	*0.0*
	Percent						
Effect on GDP growth	0.3	0.5	0.3	0.1	-0.5	-0.4	-0.4

Source: IMF staff estimates.

In the medium term, the projects can bring additional benefits for Albania. First, improved infrastructure will reduce the transportation cost in zones around the projects. Second, TAP opens the door for energy diversification helping to reduce the hydropower dependence. Repairing the Vlora Thermal-power plant and linking it to TAP is key for energy diversification. TAP will increase manufacturing productivity as firms will substitute natural gas for electricity, which will reduce costs and open prospects of developing new industries.

7. **An augmented labor utilization has recently supported growth.** In 2015-16, unemployment and labor participation improved, but long term unemployment remained high (estimated at about 12 percent) and participation low at around 66 percent. Albania's low participation is explained by high remittances and low female participation. There is also room to expand labor supply if labor skills issues are addressed.

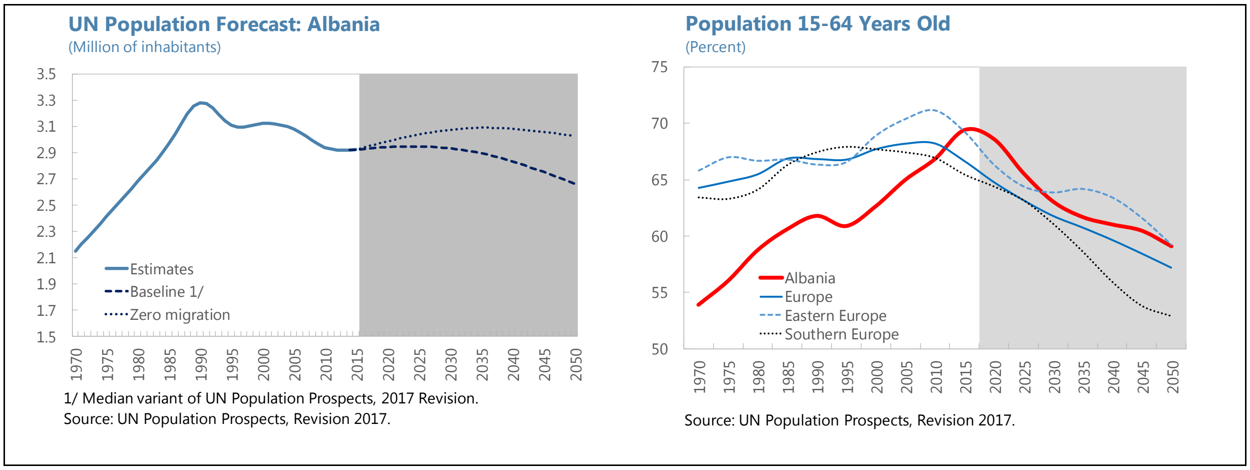
Unemployment and Labor Force Participation Rate
(Percent)



Sources: INSTAT; and IMF staff estimates.

8. **Despite the recent positive labor contributions, Albania faces demographics challenges over the medium term.** Population fell by more than 10 percent since the end of the communist regime in the early 1990s, mainly due to emigration. The pace of emigration has slowed significantly, but continued emigration together with the aging of the working population, due to declining birth rates and increased life expectancy, will contribute to a declining working age population. United Nations[3] estimates that Albania's population can grow 0.2 percentage point faster if there is no migration between 2016-20.

[3] UN Population Prospects, 2017 Revision.



9. Productivity has been low and its growth weak. Low productivity is a result of institutional obstacles that prevent diffusion and efficient use of available technologies (e.g. high risks or adverse business climate that discourage FDI). Also, structural features of Albania, such as high share of agriculture and labor intensive industries, have contributed to low productivity. During 2015-16, the slowdown in mining, and the acceleration of labor intensive sectors such as textiles, construction, and tourism resulted in downward pressures on aggregate productivity.

10. Despite structural constraints, productivity is expected to increase as Albania progresses with the EU accession process, spurring important institutional improvements. EU accession increases total factor productivity by improving institutions and as market size expands (Box 2). Also, domestic reforms such as enhanced NPL resolution framework will facilitate financial deepening and consequently allocate resources to more productive sectors. Finally, the diversification into natural gas as a source of energy will imply sizable reductions in costs (Box 3).

Box 2. What is the Impact of EU Accession on Growth?

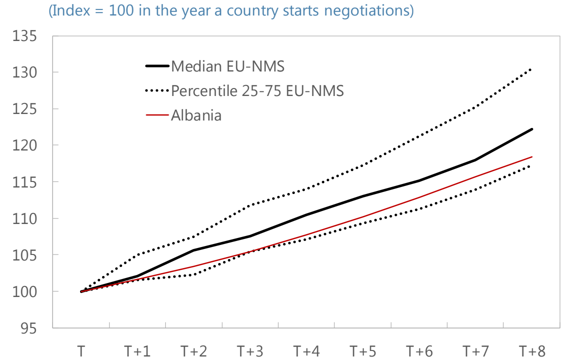
EU-accession can lead to growth acceleration. EU accession episodes (1995, 2004, and 2007) have been associated with faster growth in candidate countries. The literature on growth-institutions suggests that adopting EU institutions can strengthen growth[1]. Furthermore, access to EU markets increases the scale of the economy, boosting growth. Improved prospects for institutional enhancements and increased market size trigger FDI flows increasing capital stocks. Strong institutions also facilitate foreign trade and financial flows that enable technology transfers to close productivity gaps.

Empirical studies concluded that EU accessions stepped up growth, even after accounting for the favorable global context[2]in the 2004-07 accessions.[3] Böwer and Turrini (2009) found that EU-NMS growth was higher during the EU-accession period —after controlling for standard growth drivers and dummies variables to account for the favorable context. Campos, Coricelli, and Moretti (2014) concluded that growth in EU-candidate countries soared in anticipation of the 2004 EU-enlargement. Using counterfactuals, they estimated that annual growth per capita accelerated by 1½ percentage points compared to a case where these countries would have not joined the EU.

Albania's projected productivity path is consistent with historical productivity growth observed in previous accessions. An event study was used to assess if Albania's productivity growth —and consequently growth— is aligned with productivity growth observed in past accessions. The study looked at the total factor productivity (TFP) growth of EU-enlargements of 2004, 2007, and 2013 including 11 countries. On average those accessions took 8 years from the year T when the country starts negotiations. The results show that Albania's productivity is close to the lower quartile of the EU accessions.

TFP During EU-Accessions

(Index = 100 in the year a country starts negotiations)



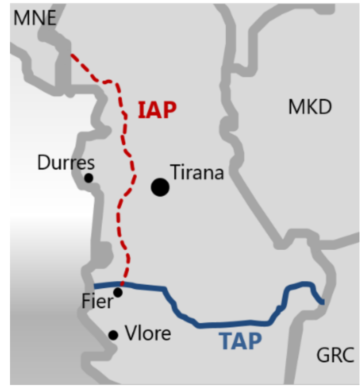
Sources: European Commission, AMECO; and IMF staff estimates.

1/ Acemoglu and Johnson (2005).

2/ Several global factors that supported growth during the 2004-07 accession episodes have slowed down. In particular, (i) the information and technology advances in the 2000s that increased productivity; (ii) privatization and FDI that reduced the productivity gaps; and (iii) the global accommodative monetary policy are reversing and challenging the idea that current EU candidate countries will be able to speed up growth.

3/ Several studies documented the positive impact of EU-accession on growth, but few considered the impact of the favorable context. Rapacki and Próchniak (2009) showed that EU enlargement contributed to economic growth of the CEE. Lenain and Rawdanowicz (2004) documented large productivity growth in the CEE4 in the pre-accession periods. Dobrinsky and Havlik, (2014) state that convergence of EU-NMS takes place but at slower speed after the crisis. Experience of Spain, Portugal, and Ireland point that productivity increases accelerated growth (Martin, Velazquez and Funck, 2001)

Box 3. How can Natural Gas from TAP increase Productivity?



Natural gas will have significant implications on Albania in the medium term. Substituting natural gas for electricity will reduce business costs and households' expenses. The cost reductions for firms and households will not be minor considering the cost of heating can be reduced to 1/3 by substituting natural gas for electricity. The challenge is that the existing pipelines and distribution networks are almost obsolete.

Construction of new pipelines and distributions networks will be needed. The government is already analyzing the cost and potential tariffs. The economically feasible infrastructure has an approximated cost of €0.5 billion for the distribution network and about €0.2-0.3 billion for the main pipelines. A key component of this new infrastructure will be Ionian Adriatic Pipeline (IAP) to bring natural gas from Trans Adriatic Pipeline (TAP) to the main urban centers (including Tirana).

The development of this infrastructure will require significant efforts to attract private sector investment. Building a sound regulatory framework is a key priority.

C. What are the Growth Prospects in Albania?

11. This study uses two approaches to understand the dynamics of medium-term growth. A first approach is based on the growth episode literature that argues countries face different growth speeds depending on external conditions and structural reforms. A second approach is the traditional growth-convergence literature that argues that low income countries grow faster. Both approaches suggest that Albania's medium term growth can accelerate.

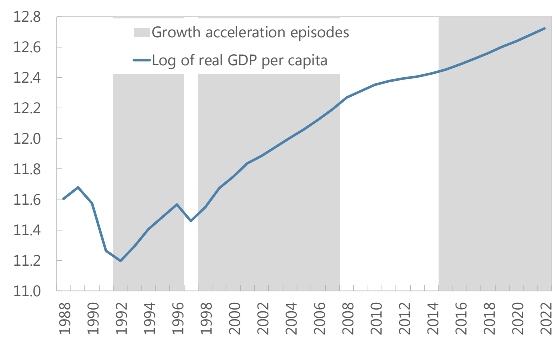
Is Albania Facing a Growth Acceleration Episode?

12. Emerging economies' growth has exhibited episodes of acceleration and reversals over time. These cycles are associated with external conditions, domestic structural features, and domestic policy settings[4]. IMF WEO (April 2017) estimates that a 1 percent shock on trading partners' domestic absorption increases growth by 0.4 percentage point in the medium term. Similarly, a 1 percentage point of GDP shock in capital inflows increases growth by 0.2 percentage points.

[4] IMF WEO (April 2017). Hausmann, Pritchett, and Rodrik (2005) documented that growth acceleration periods are correlated with openness, hikes in investment, and real exchange rate depreciation.

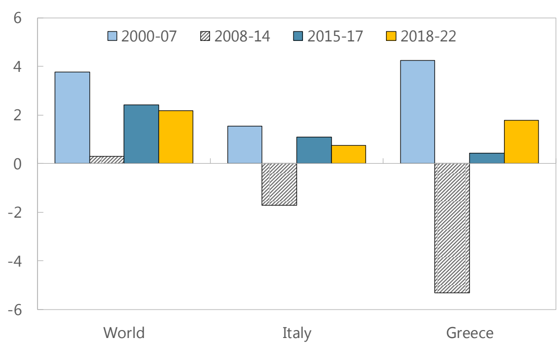
13. In Albania, growth episodes point to a growth slowdown in 2008-14. External demand conditions weakened considerably in this period. In the main trading partner and source of remittances (Italy), domestic demand growth decelerated from 1.5 to -1.7 percent between 2000-07 and 2008-14. Furthermore, terms of trade were unfavorable until 2014. On the other hand, capital flows rose over this period, driven by FDI related to mining and oil. Given its large import content, the impact on GDP growth was however more limited. Overall, external conditions were a drag on growth during 2008-14.

Real GDP per Capita
(Log lek)



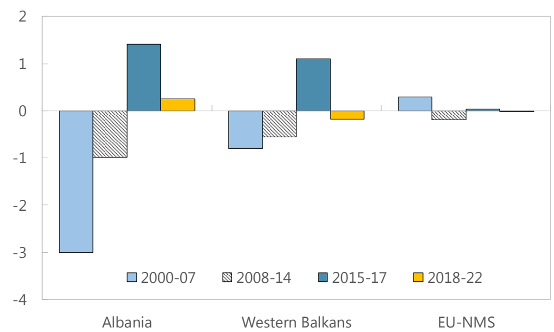
Source: IMF, staff estimates.

Albania's Trading Partners: Domestic Demand Growth
(Percent)



Source: IMF staff estimates.

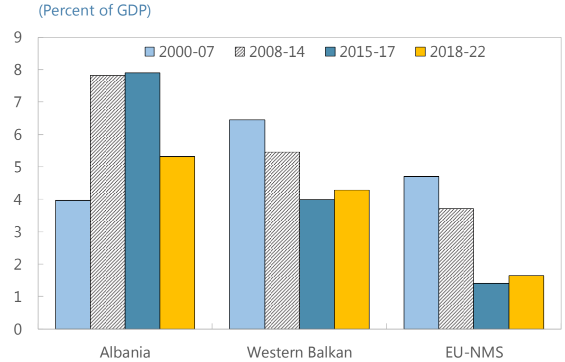
Terms of Trade
(Percent change)



Source: IMF staff estimates.

14. Since 2015, the country is entering an acceleration growth period supported by external factors. Trading partners' domestic demand are recovering and subdued oil prices are stimulating domestic consumption. Capital inflows have remained stable owing to large FDI projects. The risk from capital reversals is low given limited reliance on more volatile portfolio flows. Although FDI is expected to decline in 2018-22, it will be still higher than pre-crisis levels and higher than in regional peers. This drop will adversely affect growth, but its impact is limited given the large projects' high import content (Box 2). Furthermore, the indirect spillover effects of these projects can also mitigate the direct impact by fostering investment in non-energy sectors.

Capital Flows: FDI+Portfolio Investment
(Percent of GDP)



Source: IMF staff estimates.

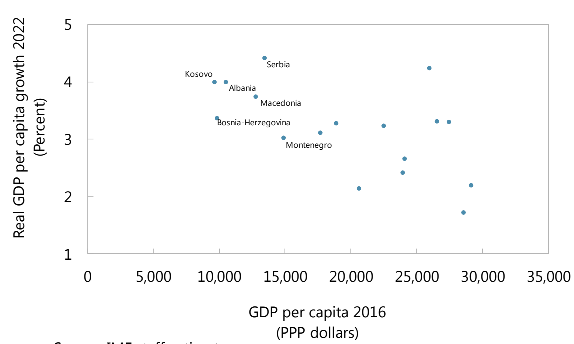
15. A key assumption behind the positive growth prospects for Albania is that the global growth continues. Global growth is critical for external drivers such as terms of trade and investment flows(WEO April 2017). Similarly, a large part of TFP fluctuations can be explained by global growth (IMF, REI May 2016). The current assessment presumes global growth continues -without a global crisis or recessions- as discussed in WEO October 2017. A global crisis or recession can delay and reduce the prospects of growth potential for Albania.

16. Completing some key reforms to improve investment climate can secure the growth acceleration. Key growth obstacles are rule of law, land property rights, and infrastructure gaps. The authorities have started to address the energy issues by rehabilitating the existing electricity infrastructure and improving corporate governance of the electricity-SOEs, and by ensuring a more diverse energy supply from the gas pipeline and hydropower projects (Box 2). These reform needs to be completed. To address the rule of law issues, the authorities are implementing judicial reform and tackling problems with property rights. Legal issues that may accompany land property ownership have been a key deterrent to investment —property ownership can be challenged in court following claims of uncompensated expropriation by the communist regime.

What does Convergence Imply for Albania's Growth?

17. The sizable income gap with EU-15 economies provides an opportunity to accelerate growth for Albania. The convergence hypothesis states that economies with lower per capita GDP should converge to higher income levels due to decreasing returns on capital —assuming similar technologies, saving, demographics features, and human capital. Saving and human capital accumulation rates are lower in Albania than in the EU-NMS and can explain part of the income gap. Albania's medium term growth is aligned with Western Balkan regional peers who are at similar income levels.

Selected CESEE: Expected Convergence



Source: IMF staff estimates.

18. Adoption of new technologies and enhanced institutions can help to close income gaps. Albanian legal, judiciary, and regulatory institutions are still catching up with EU institutions. EU accessions are associated with higher productivity due to improved institutions and higher FDI that brings the most updated production techniques (Box 3). Currently, technology gaps are sizable in key sectors such as telecommunications, digitalization, and agriculture. Addressing these issues offer Albania an important avenue to accelerate growth.

19. Estimates of convergence imply that the growth rate should be about 4 percent. Following IMF 2015 Western Balkan report, the convergence hypothesis was tested using a panel of CESEE economies for the period 1990-2014[5]. The test checks if the initial income gap — measured with GDP per capita relative to the EU15— is positively related to growth. A random effects estimate was performed, where limited heterogeneity is allowed implying absolute convergence. Projections based on these equations imply that Albania's growth should be above 4 percent.

Dependent variable: Real GDP growth per capita			
	Random effects		
	1990-2014	2000-2014	2008-2014
Income gap t-5 1/	0.004	0.006	0.006
	[0.00]**	[0.00]**	[0.00]**
WB x Income gap t-5	0.009	-0.006	0.002
	[0.00]**	[0.11]+	[0.80]
NMS x Income gap t-5	0.016	0.014	0.008
	[0.00]**	[0.01]**	[0.44]
WB (Dummy)	-0.021	0.022	-0.001
	[0.02]**	[0.19]	[0.98]
NMS (Dummy)	-0.012	-0.008	0.004
	[0.21]	[0.41]	[0.77]
Constant	0.025	0.022	0.009
	[0.00]**	[0.00]**	[0.03]**
Obs.	769	579	273
Countries	39	39	39
R^2	0.2	0.12	0.11
P-values in square brackets			
+ p<0.15; * p<0.1; ** p<0.05			
1/ Income gap = 100*[(EU15 avg./country "x") - 1].			
Projecton Albania (2015)	4.6	4.4	3.4
Average 3 specifications		4.1	

Policy Recommendations

20. To achieve higher medium term growth, it will be crucial to implement policies to address Albania's challenges. In particular, policies should:

- **consider the implication of population aging in the labor market policy design.** Increasing labor force participation among the youth and female groups will be important.

- **ensure investment sustainability by promoting national private saving and addressing land property issues.** It is key to stimulate corporate saving. To foster

[5] Real GDP growth and income gaps are based on Penn Tables 9.0.

investment and investment diversification it is necessary to address land property rights issues.

- **improve institutions, by implementing the Stabilization Association Agreement recommendations to continue the EU accession process**. Progress in judicial system procedures and regulatory frameworks will be critical.

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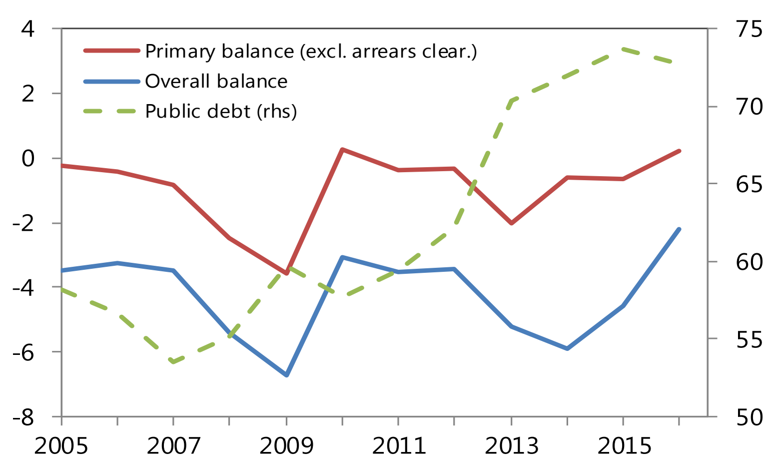
WHAT FISCAL ANCHOR AND RULE FOR ALBANIA?[1]

Albania's high levels of debt and financing needs necessitate continued fiscal effort. However, the current fiscal framework comes short of establishing a full-fledged, binding fiscal anchor. This note lays out the tradeoffs underpinning the choice of an anchor, and explores the various options in the Albanian context. It recommends anchoring fiscal policy around a primary balance target of 1½ percent of GDP over the medium term, which would be consistent with reaching a debt level below 60 percent of GDP by 2021. The chosen fiscal anchor could then be an instrument for a fiscal rule.

A. Background

1. **The fiscal framework in Albania comes short of establishing a credible and operational guidepost for fiscal policymaking**. Lowering debt is a priority in Albania—after a rapid increase in 2011–15 by nearly 15 percentage points of GDP, the debt ratio reached a peak of 73 percent of GDP in 2015 (Figure 1). The 2016 Organic Budget Law (OBL) requires each budget to target a debt level that grows slower than forecasted nominal GDP, with a long-term debt objective of 45 percent of GDP. However, it prescribes no convergence speed towards the objective, operational deficit target, nor corrective measures in case of failure to comply with the debt ratio reduction requirement.

Figure 1. Key Fiscal Indicators
(2005-2016, percent of GDP)



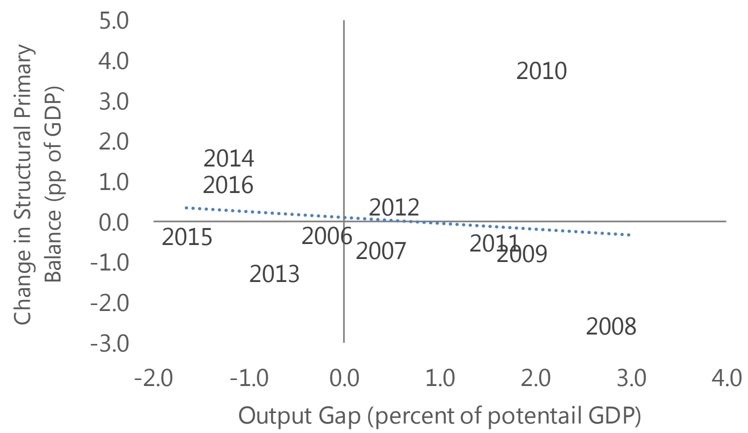
Sources: Albanian authorities, IMF staff calculations.
Note: These statistics follow the definitions used in the context of the 2013–17 EFF arrangement. Explicit guarantees are recorded both as debt (which is also the Albanian practice) and spending (which is not).

[1] Prepared by Nicolas End (FAD/F2).

2. The debt rule tends to induce procyclical fiscal policy. A debt ceiling does not require saving in good times to lower debt faster than in bad times. On the other hand, it becomes binding when fiscal policy might need to be accommodative and could prevent automatic stabilizers and discretionary spending from smoothing adverse shocks. Figure 2 shows how changes in the fiscal stance in Albania have been uncorrelated with the business cycle over the past decade. Besides, since Albania relies on a strict definition of public debt, the debt rule could incentivize the reliance on non-marketable liabilities (e.g., PPPs or arrears).

Figure 2. Cyclicality of Fiscal Policy

(2006–16, percent of GDP)



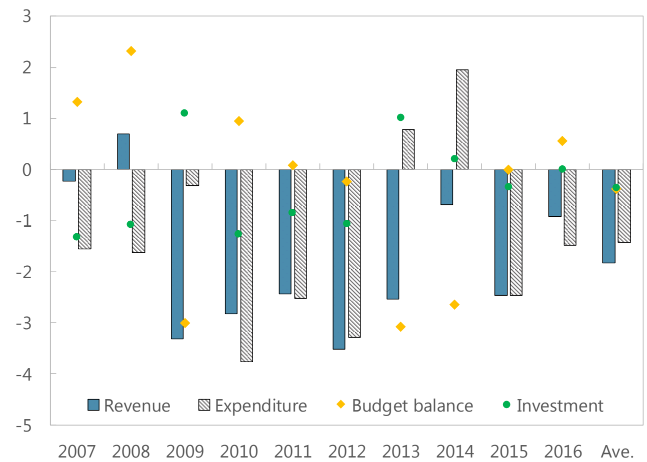
Sources: Albanian authorities, IMF staff calculations.

3. An upgraded fiscal framework would need to address challenges related to optimistic revenue forecasts and safeguard investments. Over the last decade, revenues have fallen short of targets by an annual average of 1.8 percent of GDP (Figure 3).[2] This underperformance is generally offset by under-execution of spending, almost a third of it being driven by cuts in public investment (0.4 out of 1.4 percentage point of GDP). Consequently, an anchor that avoids unnecessary cuts in foreign-financed investment in the face of forecast errors is desirable, especially given the frequency and magnitude of revisions of the main macroeconomic time series.

4. EU accession is also an important consideration to determine the right anchor. Aside from the debt ceiling of 60 percent of GDP, the Stability and Growth Pact (SGP) is based on two main operational instruments. First, it emphasizes a structural view of the fiscal stance—that is, the cyclically-adjusted balance, adjusted for one-offs—and the growth of expenditure net of discretionary tax measures. However, these approaches remain challenging for Albania given the uncertainty surrounding any output gap estimation.

[2] See also End & Thackray (2016).

Figure 3. Budget Slippages
(2007–16, percent of GDP)



Sources: Albanian authorities, IMF staff calculations.
Note: For each indicator, at time *t*, the underperformance is measured as the difference between the actual outturn and the forecast as per the budget for year *t*. A positive number means that outturn is larger than plan. Investment includes only central government capital expenditure (thereby excluding local investment as well as directed investment by SOEs). National budget definitions are used.

Table 1. Fiscal Anchor Options for Albania

Anchor	Pros for Albania	Cons for Albania
Debt Ratio	• Wide coverage (including guarantees). • Easy to monitor and communicate, since already in place. • Direct link to sustainability • Part of EU framework	• Sizable GDP revisions make the debt ratio an unstable measure • Not enough guidance for policymakers on a day-to-day basis • Large stock-flow adjustments (e.g., arrears, valuation effects) • Procyclical
Nominal Balance	• Clear operational guidance • Easy to monitor and communicate	• Some items out of the central government's control or not timely/comprehensively reported (local spending and taxes, interest payments) • Procyclical

Table 1. Fiscal Anchor Options for Albania (concluded)

Primary Balance	• Clear operational guidance • Easy to monitor and communicate • Interest neutralized (a hidden budgetary reserve)	• Procyclical • Some items out of the central government's control (local spending and taxes, one-offs)
Structural Primary Balance	• Countercyclical • Accounting for temporary shocks • Part of EU framework	• Measurement issues for the output gap and fiscal elasticities • No consensus definition of one-offs
Primary Expenditure	• Clear operational guidance • Good past performance at respecting budget ceilings • Possibly adjusted for discretionary tax measures • Part of EU framework	• Overspending is not really an issue • Risk for expenditure quality and composition (tendency to cut investment)
Tax Revenue	• Stimulus for tax policy and administration • Limit on deliberately too optimistic targets	• Procyclical • Inherent volatility, outside of the government's control • Low-quality measures
Policy Measures	• Clear operational guidance • Easy to communicate	• Reliance on a baseline that is rarely consensual and difficulty in predicting behavioral responses • Risk of low-quality adjustment • Difficult to monitor, especially *ex post*

B. Options for a Fiscal Anchor

5. **When selecting a fiscal anchor or choosing the right instrument for a fiscal rule, several trade-offs emerge (FAD, 2017b).** First, while it is desirable for the anchor to maximize coverage of fiscal accounts, it is better to use an instrument over which the government has direct control and for which it can be accountable. Thus, items such as interest payments, the cyclical component of the deficit, or even subnational expenditure are outside the discretionary powers of the central government. Second, rules that are broader and easier to communicate can clash with macroeconomic stabilization and capacity-building objectives. For example, an overall balance rule will prevent the policymaker from letting automatic stabilizers play and would not necessarily protect infrastructure spending. Third, the anchor needs to be measurable in an easy, timely, and relatively uncontroversial manner for better enforceability. Fiscal anchors should thus be easy to communicate. In practice, however, given these tradeoffs, it is generally recommended to track not one, but a set of fiscal anchors.

6. Albania should focus on the primary balance as an anchor (possibly excluding large one-offs), while monitoring the structural balance as a memorandum item. Given that Albania's main fiscal challenge is to restore sustainability and rebuild buffers, debt should be the key objective. Yet, nominal macroeconomic volatility, that has manifested as forecast errors as well as data revisions, prevents the sole reliance on the debt ratio. It also rules out the structural balance as main instrument. The fiscal anchor should be an aggregate that is not too often revised and that can be tracked both during the budget preparation and execution phases. Table 1 summarizes the pros and cons for Albania of the most popular anchor options. Overall, a reasonable choice would be to focus mainly on the primary balance excluding one-offs, with a medium-term debt objective.[3] Structural measures could also be introduced, so as to converge progressively towards the EU framework.

7. A primary balance anchor would need to be complemented by budgeting capacity building. Indeed, since the primary balance anchor does not *per se* address revenue underperformance, nor potential diversion of public money from growth-enhancing spending (investment, health, education) to more politically visible projects, improvements in public financial management and forecasting are necessary. Also, the budget debate needs to revolve more on the multiyear path, possibly structured around a fiscal rule (section IV).

C. Calibration of the Debt and Primary Balance Anchors

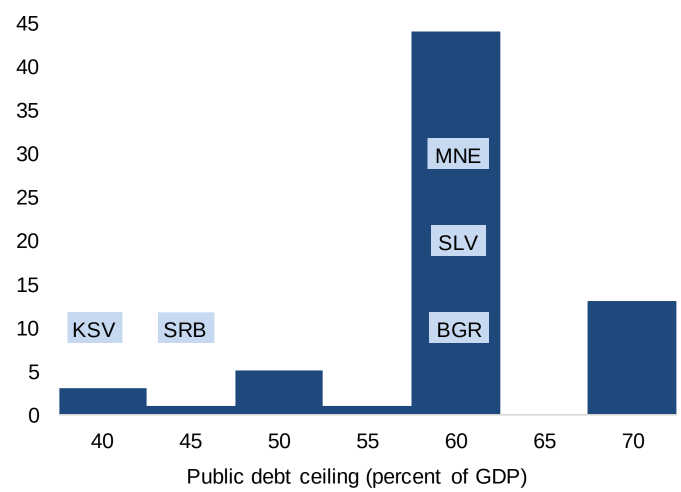
8. What quantitative objectives should guide the determination of the targets for the fiscal anchors? This section first examines the adequacy of the 45 percent long term of objective for the debt ratio, and then derives a primary balance path to reach it.

9. Contrary to many countries, Albania does not have a debt ceiling rule, but only a long-term debt objective. Most rule-based fiscal frameworks around the world incorporate a legally binding debt ceiling to help strengthen fiscal credibility. The number of countries with debt rules has increased over time. As of 2015, 76 out of the 96 countries worldwide that had a rule-based fiscal framework that enforced an explicit cap on gross public debt (Lledó and others, 2017). Specific debt ceilings can vary across countries, but typically range between 40 and 70 percent of GDP (Figure 4).[4] In the Western Balkans, fiscal rules are not yet widespread, but where they exist, debt ceilings never exceed 60 percent of GDP.

[3] The European Commission defines one-off and temporary measures as measures having a transitory budgetary effect that does not lead to a sustained change in the intertemporal budgetary position. It gives the following examples: sales of nonfinancial assets, receipts of auctions of publicly owned licenses, emergency costs emerging from natural disasters, and tax amnesties (EC, 2016).

[4] The clustering of countries around ceilings of 60–70 percent of GDP reflects the strong representation of member states of various monetary unions. Excluding supranational rules, the 60 percent threshold remains the most common among national debt rules.

Figure 4. Distribution of Public Debt Ceilings in the World
(2015, number of countries)



Sources: IMF's Fiscal Rules Database, IMF staff calculations.

10. While there is no consensus about an optimal level of public debt, several empirical arguments argue in favor of the long-term objective enshrined in the Albanian OBL. A large body of empirical and theoretical research has tried to determine public debt ratios beyond which there is a high risk of debt distress or debt has adverse macroeconomic consequences (IMF, 2016; Eberhardt and Presbitero, 2015). It is indeed well recognized that public debt has both positive and negative effects, as it finances potential-growth-enhancing public spending (e.g., education, health, and infrastructure) but crowds out private investment and potentially raises the risk premium in the economy. For countries like Albania, a reference point is the early-warning signal of 50 percent of GDP for the debt ratio that underpins the IMF's Debt Sustainability Analysis (DSA) for market-access emerging economies (IMF, 2013). Besides, using the theoretical model constructed by Checherita-Westphal and others (2014), Dabla-Norris and others (2017) find that above around 45 percent of GDP, the virtues of public debt are dominated by its negative effects in CESEE countries.[5]

11. Given the important macroeconomic volatility observed in the past, Albania should also maintain sufficient safety margins. A debt target or a safe level of debt can be defined as the debt-to-GDP ratio that ensures that debt dynamics remain under control even if bad shocks occur (IMF, 2016). As in FAD (2017a), stochastic simulations are used to determine the level of debt-to-GDP ratio that would provide enough buffers for Albania to face most macroeconomic

[5] Specifically, they estimate a growth equation, assuming decreasing returns to public capital and a golden rule under which public debt is used exclusively for public capital financing. This is, in a way, a best-case scenario, as most countries also rely on debt to finance less productive spending. The maximum debt-to-GDP ratio thus depends on the output elasticity of the public capital stock (i.e., how additional public capital translates to higher GDP levels).

(continued)

and fiscal shocks that are likely to arise and enough fiscal space to let automatic stabilizers and countercyclical policy play. Namely, real GDP growth, interest rates and the real exchange rate to the euro are fitted in a multivariate student-T distribution, using annual data covering the last two decades (1997–16). A fiscal reaction function that responds to the cycle and past debt is estimated for a panel of emerging markets.[6] In addition, stock-flow adjustments are randomly drawn to account for contingent liabilities that may stem from the energy sector and sizable PPP contracts.[7]

12. The OBL objective of 45 percent of GDP seems to be a sufficiently safe debt level, in light of the history of macro-fiscal shocks. Following the literature on debt limits and the EU limit, we select a debt ceiling of 60 percent of GDP.[8] Simulations show that given past macro-fiscal performance, debt must remain around 45 percent of GDP to ensure that it will stay below 60 percent of GDP debt limit with a likelihood of at least 90 percent over the next six years (Figure 5a). Simulations further show that under a baseline scenario with no consolidation (i.e., under a normal fiscal reaction function) and starting with the 2016 level, debt would remain above the 60 percent of GDP threshold in 80 percent of cases (Figure 5b). This argues for further consolidation to bring debt down sustainably below risky levels.

[6] The precise specification is: $p_{it} = \alpha_i + 0.47p_{it-1} + 0.20y_{it}\mathbb{I}_{y_{it}\leq 0} + \rho.D_{it-1} + \varepsilon_{it}$ with p the primary balance, D the debt ratio, y the real growth rate and $\mathbb{I}_{y_{it}\leq 0}$ a binary variable that equals 1 during recessions and 0 during normal times. Country-specific fixed-effects and variance are used for the simulations. The fiscal responsibility coefficient ρ gives the responsiveness of fiscal policy to the level of debt. It can be either estimated, or calibrated to explicitly target a long-term debt target. Figure 5b uses the "estimated" fiscal reaction function, with $\rho = 0.06$, while Figure 5a relies on a "normative" fiscal reaction function imposing that the government consistently targets 45 percent of GDP. Furthermore, since international experience points to maximum primary balances of around 2 percent of GDP for emerging economies (Escolano and others, 2014), the primary balance resulting from the fiscal reaction function is capped. In a country like Albania, this relates to the lean government size and a Laffer curve marked by pervasive informality.

[7] The 2016 PIMA finds a stock of 6 percent of GDP.

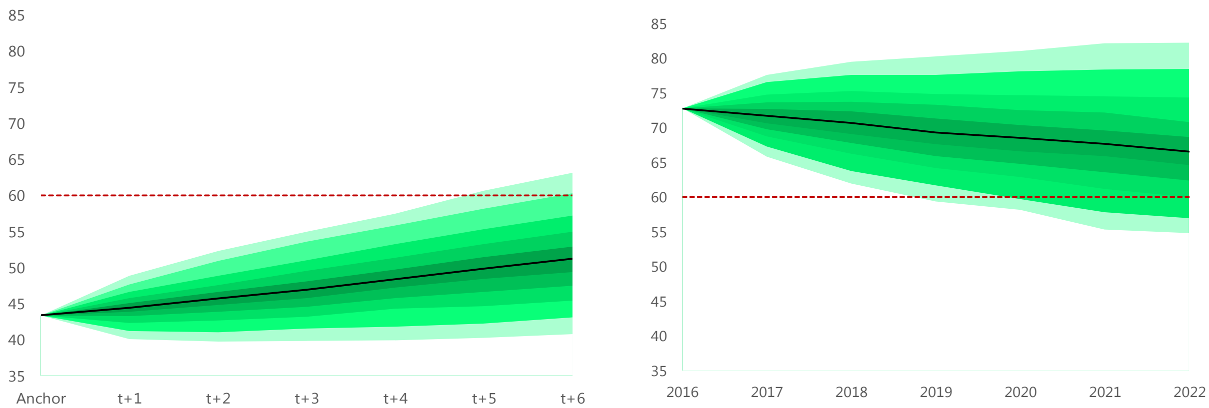
[8] The DSA debt threshold for emerging markets is slightly higher, at 70 percent. Yet, further caution is warranted in the case of Albania, which, compared with its emerging peers, is characterized by a low level of tax revenues (so that the debt-to-tax ratio was almost 300% in 2016) and a narrow access to international financial markets.

Figure 5. A Debt Anchor for Albania

(Percent of GDP)

(a) Six-year simulations starting at the anchor (normative fiscal reaction function)

(b) 2016–2022 simulations starting at the 2016 level (estimated fiscal reaction function)



Source: IMF staff calculations

Note: color bands represent 10 percent quantiles, except for the lightest green ones, which are the 5th and 95th percentiles.

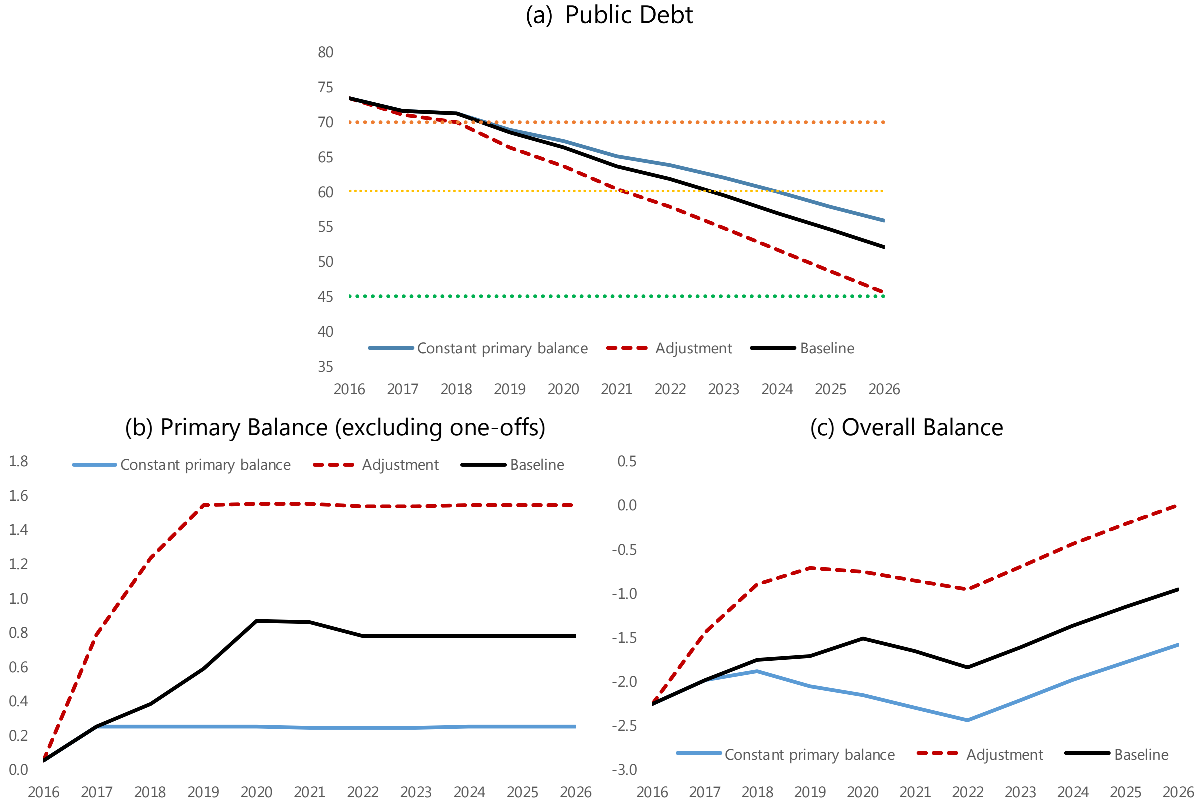
13. The recommended adjustment path targets a primary surplus (excluding one-offs) of 1.5 percent of GDP. It would bring the debt ratio to below 60 percent of GDP by 2021 and at 45 percent of GDP by 2026 (Figure 6).[9] This policy scenario assumes a frontloaded tax reform to sustain a primary balance target of 1.5 percent of GDP over the medium-term. The primary surplus target of 1.5 percent of GDP is also needed to provide fiscal policy space for accommodating adverse shocks without triggering liquidity pressures and increases in sovereign spreads.

14. This pace of adjustment seeks to balance the objective of sustainability and feasibility of high quality, permanent measures. A more ambitious adjustment risks implementation of lower-quality, temporary measures, especially given the small size of government and difficulties in tax compliance. The focus should therefore be on passing permanent, growth-friendly fiscal policy measures that are sustainable rather than ambitious primary surplus targets. For example, reforming the tax system to increase revenue elasticity to GDP would be key—elasticity is currently dragged down by a heavy reliance on specific excises and taxes levied on imports at customs.

[9] The last reviews of the 2013 EFF program were anchored on reducing the debt ratio to below 60 percent by 2019, which, after several revisions by Instat, now seems unrealistic.

Figure 6. Fiscal Path under Various Policy Scenarios

(2016–2026, Percent of GDP)



Source: IMF Staff Calculations

Notes: the baseline is a no-policy change scenario. We assume a fiscal multiplier of 0.4 on growth with no persistence, and no effect of fiscal policy on inflation nor interest rates.

D. A Fiscal Rule in Albania

15. Once anchors and targets have been chosen, a fiscal rule can help strengthen enforcement. Fiscal rules impose a long-lasting constraint on fiscal policy through numerical limits on budgetary aggregates. They typically aim at correcting distorted incentives and time-inconsistency pressures, particularly in good times. Hence, many countries and economic unions have considered them useful to ensure fiscal responsibility and debt sustainability.

16. For Albania, a simple primary balance rule would complement and strengthen the current fiscal framework. The necessary ingredients of a reliable fiscal rule include: i) a numerical objective for the anchor (target and pace of convergence), ii) an automatic correction mechanism to account for *ex post* deviations, iii) a few escape clauses to deal with exceptional circumstances (usually, recessions or natural disasters), and iv) the authority in charge of enforcement. Strengthening fiscal reporting is also essential to the credibility of the rule. In the case of Albania, fiscal reports should for instance cover the general government more comprehensively and close some accounting loopholes, such as letters of credit or off-budget funds designed to conceive the actual timing of spending.

17. An independent fiscal council is usually established to monitor and assess the implementation of the rule. Specifically, it is instrumental in ensuring realism of assumptions, as well as assessing deviations from targets and recommending corrective measures. The current OBL requirement to use WEO forecasts as budget macroeconomic assumptions goes towards achieving these objectives in the near term. Nevertheless, strengthening fiscal institutions will be increasingly important as Albania graduates from a Fund arrangement and seeks to converge towards EU standards, especially as the 2013 SGP reform requires Member States to set up national fiscal councils.

E. Conclusion

18. Albania should structure its fiscal framework around a more operational fiscal anchor than the debt ratio. While the structural balance should progressively be introduced, the budget debate should for now focus on a primary balance path that would bring debt back to a safe zone and ensure sufficient fiscal space to conduct a countercyclical policy. One way to systematize this debate would be to enshrine a fiscal rule in the OBL and charge an independent body of assessing the government's budgetary plans.

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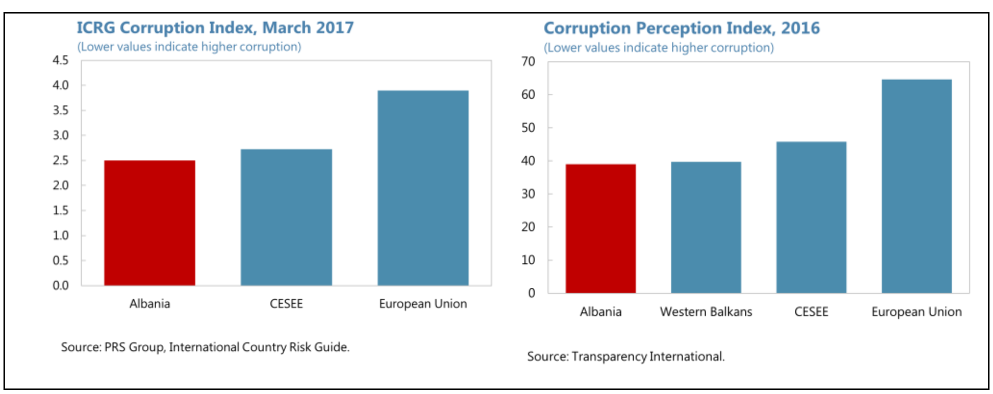
JUDICIAL REFORM AND ANTI-CORRUPTION EFFORTS IN ALBANIA[1]

Implementing judicial reform and strengthening the fight against corruption are key prerequisites for advancing Albania's EU accession process. This note takes a comparative look at Albania's recent performance, using multiple third-party indicators and reports by external observers to show that the country continues to lag behind regional peers. It shows how corruption and inefficiency within judicial institutions stunt investment, entrepreneurship, and growth in Albania. The note discusses recent efforts to reform Albania's judiciary and strengthen its anti-corruption framework, including the comprehensive judiciary reform launched by the July 2016 constitutional amendments. Finally, it discusses next steps in the reform process.

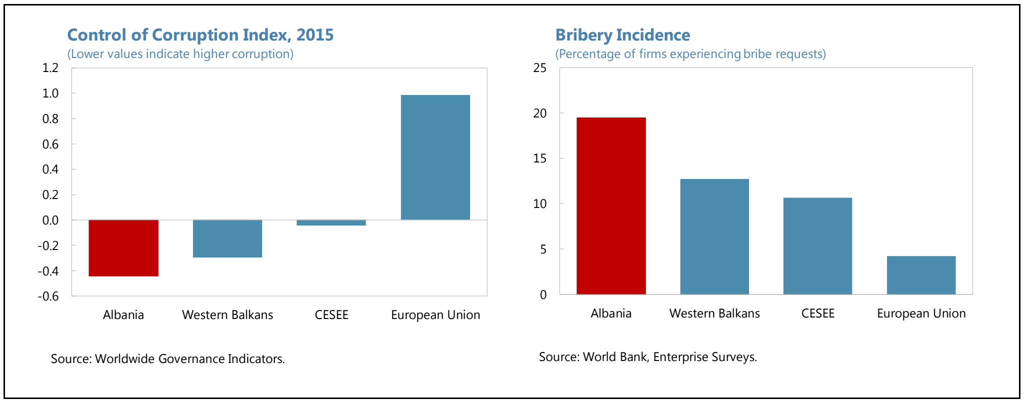
A. Corruption and the Rule of Law: Albania in International Perspective

1. This section takes a comparative look at Albania's recent performance. It uses third-party indicators and compares Albania to other countries in the Western Balkans, as well as Central, Eastern, and Southeastern Europe (CESEE) and the European Union (EU). This section also surveys assessments of the *status quo* by external experts.

2. The charts below show that Albania falls short of the averages for the EU, CESEE, and the Western Balkans in areas such as corruption perceptions, control of corruption, and bribery incidence. While each of these measures has its own shortcomings, the message is consistent across the various indicators. It is important to emphasize that most of these indices are perceptions-based. Thus, they don't measure actual corruption or its impact, and they also change very slowly over time. However, IMF (2017b) found that perceptions-based measures are highly correlated with other (institutions-based) measures of corruption, with worldwide correlation coefficients of around 0.70-0.75. Still, these indicators should be interpreted with caution, given the standardized assumptions, the limited number of respondents and geographical coverage, and the underlying uncertainty around point estimates.



[1] Prepared by Slavi Slavov. The author thanks Min Song for his outstanding research assistance.

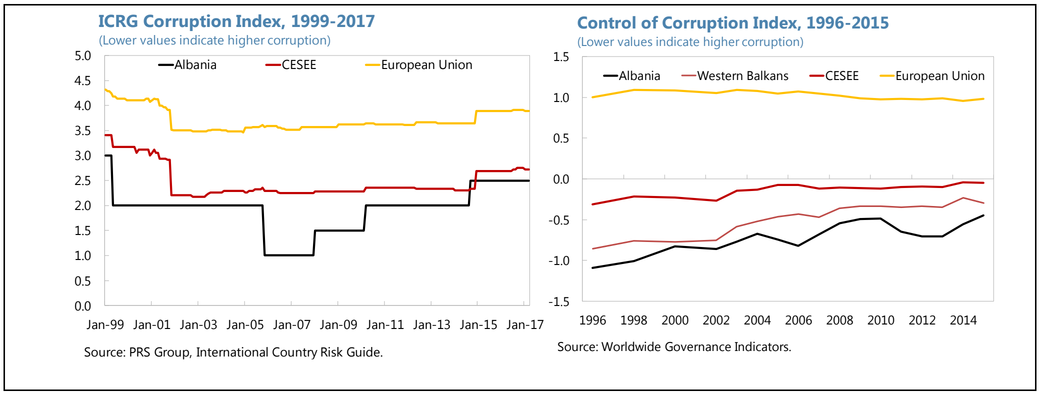


3. Reports by external experts confirm the findings from third-party indicators. The latest review of Albania's implementation of the UN Convention Against Corruption (UNCAC) found deficiencies pertaining to the criminalization of all acts of corruption. It also found weak spots in Albania's legal framework regulating international cooperation under UNCAC.

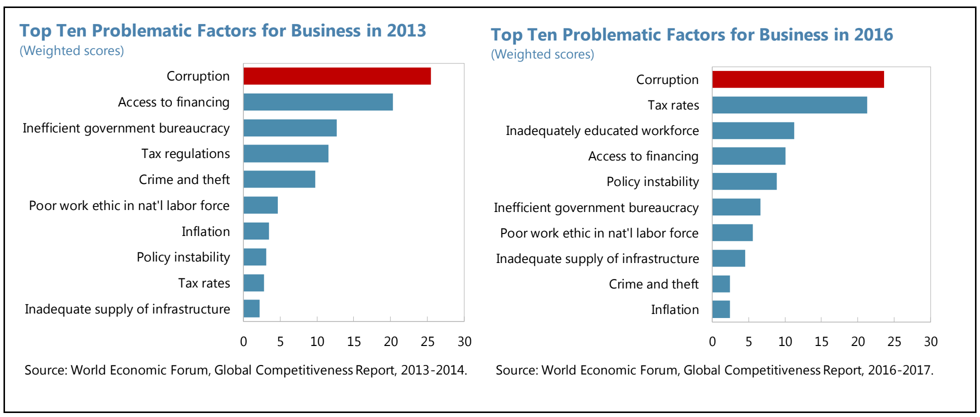
4. While there are problems with Albania's legal framework on anti-corruption, practice lags even further behind. In its latest annual report on Albania (from November 2016), the European Commission found that anti-corruption institutions have limited independence and effectiveness due to political pressures and weak capacity:

- While there has been a positive trend in **investigations, prosecutions, and convictions** of corrupt low- or mid-level officials, this has not been the case for **high-level officials**.
- **Cooperation and exchange of information** among institutions has been poor. In particular, although there has been some recent progress, the police, prosecutors, and the High Inspectorate for Declaration and Audit of Assets and Conflicts of Interest (HIDAACI) all lack access to several registers and databases, which hampers their capacity to do their jobs.
- The number of **investigations resulting in asset confiscations** remains very low and **penalties for corruption-related offences** are overly lenient.
- Very few cases of **conflicts of interest** have been formally investigated, due to legislative gaps and lack of capacity for proactive checks, even though public opinion and media reports suggest that such conflicts are a pervasive feature of Albanian public life.
- There is no **independent system to audit party financing and electoral campaign spending.** There is also no **code of ethics** for members of parliament and their **asset declarations are not published automatically.**
- Little progress has been made on setting up an **integrated electronic anti-corruption case management system.**
- However, credit should be given to the authorities for the passage and implementation of the **Decriminalization Law** in December 2015 and the **Whistleblower Protection Law** in June 2016.

5. Long time series on corruption-related indicators are scarce, but they confirm the weakness in Albania's anti-corruption framework. While there has been some improvement over the past decade, Albania is perceived as lagging behind peers.

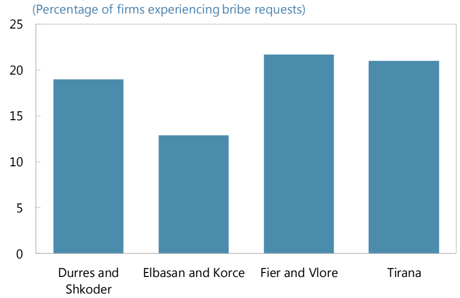


6. Despite the small improvement in corruption perceptions registered by third-party indicators, corruption remains the top concern for Albanian businesses, as illustrated by the comparison below between 2013 and 2016.



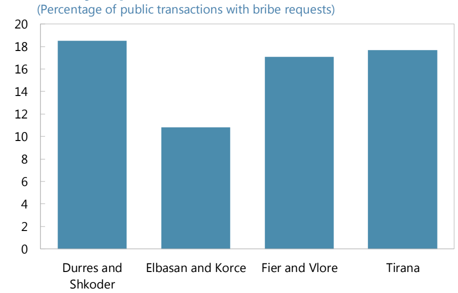
7. The charts below provide some regional granularity on the incidence of corruption in Albania. According to the World Bank's Enterprise Surveys, the incidence and depth of bribery is perceived to be lower in smaller, inland, less prosperous cities like Elbasan and Korçë than in the more populous and wealthy cities on or near the Adriatic coast like Tirana, Durrës, Vlorë, Shkodër, and Fier. These findings are consistent with those reported in UNODC (2011).

Bribery Incidence, 2013
(Percentage of firms experiencing bribe requests)



Source: World Bank, Enterprise Surveys.

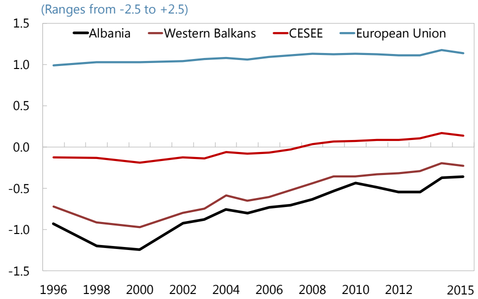
Bribery Depth, 2013
(Percentage of public transactions with bribe requests)



Source: World Bank, Enterprise Surveys.

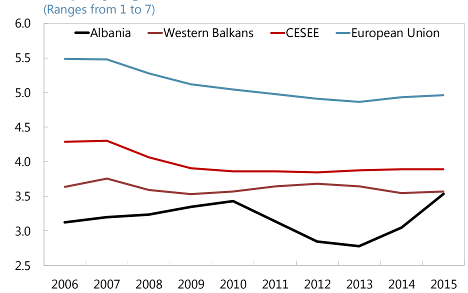
8. For many years, inefficiency and corruption in the judiciary have been a key feature of Albania's systemic corruption problem. The cross-country comparisons below show that Albania is perceived as lagging behind the average for the EU, CESEE, and the Western Balkans in areas such as the rule of law, protection of property rights, court impartiality, judicial independence, and efficiency of the legal framework in settling disputes and enforcing contracts. And while Albania has registered continuous improvements in the rule of law and protection of property rights, it has deteriorated recently on the other measures.

Rule of Law
(Ranges from -2.5 to +2.5)



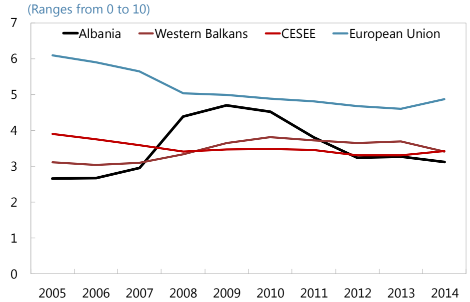
Source: Worldwide Governance Indicators.

Property Rights
(Ranges from 1 to 7)



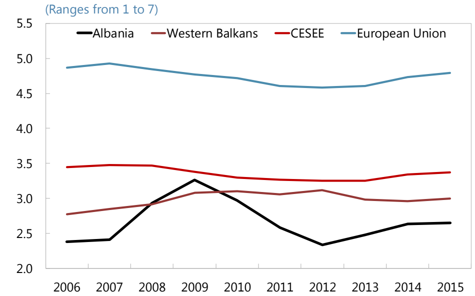
Source: World Economic Forum, Global Competitiveness Report, 2016-17.

Impartial Courts
(Ranges from 0 to 10)

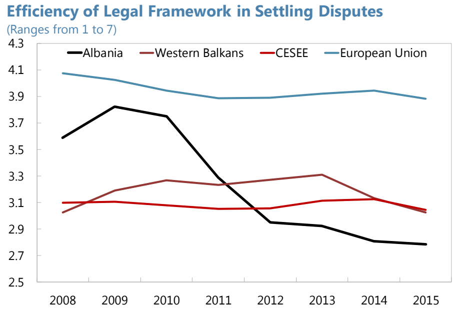


Source: World Economic Forum, Global Competitiveness Report.

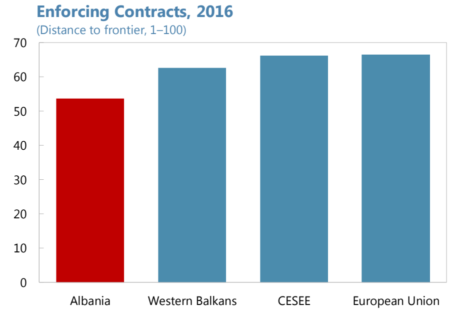
Judicial Independence
(Ranges from 1 to 7)



Source: World Economic Forum, Global Competitiveness Report, 2016-17.



Source: World Economic Forum, Global Competitiveness Report, 2016-17.



Source: World Bank, Doing Business 2017.

9. In its 2016 report on Albania, the European Commission found that:

- The **high politicization** of appointments to Albania's High Court, the Constitutional Court, and the position of General Prosecutor directly contributes to the lack of judicial independence, in addition to **direct political interference** in investigations and court cases.

- The High Council of Justice (HCJ) and the General Prosecutor enjoy **too much discretion** in managing the careers of judges and prosecutors.

- The **unified case management system** is only partly functional. As a result, cases continue to be allocated non-transparently, through drawing lots, and without ensuring balanced workloads in the system.

- **Recusals and exclusions of judges** are not registered systematically.

- The monitoring of **integrity and ethical standards** is insufficient. For example, existing evaluation criteria do not emphasize sufficiently professionalism and integrity, and compliance with the code of conduct is not part of annual evaluations.

- Disciplinary measures are rarely taken over **failures to declare assets** with HIDAACI.

- **Salaries, as well as working and security conditions** for judges and prosecutors are inadequate. Due to insufficient resources, court hearings often take place in judges' offices, undermining transparency and creating a conducive environment for corruption.

- The **overall inefficiency of the judicial system** creates incentives for judicial corruption. The **system for notifying parties and witnesses** is inadequate. As a result, about half of court hearings get canceled**. Case backlogs** are high and **clearance rates** are low, particularly in the administrative and appeals courts, as well as the High Court. **Court proceedings are long**, especially at the appeal stage, due to lack of capacity and unclear legal provisions. Improving court efficiency is hampered by the **lack of statistical data**.

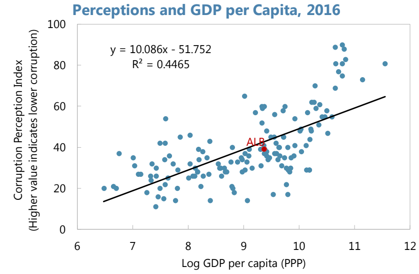
- No **effective online research tools** are available to jurists. While a **justice system archive** was established in 2016, it is not yet operational. A **case law database** exists, but the **publication of decisions** is inconsistent.

- **Enforcement of judicial decisions** is poor, including due to misaligned incentives for private bailiffs.

B. The Economic Costs of (Judicial) Corruption in Albania

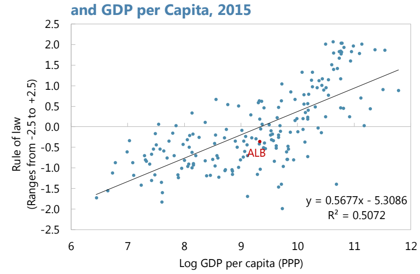
10. This section shows that corruption and inefficiency in Albania's judiciary stunt investment, entrepreneurship, and growth. According to the cross-country scatterplots below, there is a strong positive relationship between average income (as measured by the natural log of PPP-adjusted GDP per capita) and institutional quality (as measured by various third-party indicators). In the scatterplots below, Albania consistently lies below the regression line. In other words, Albania's institutions appear to lag behind those of other countries at similar levels of economic development, sometimes by fairly substantial margins.

Cross-Country Association Between Corruption Perceptions and GDP per Capita, 2016



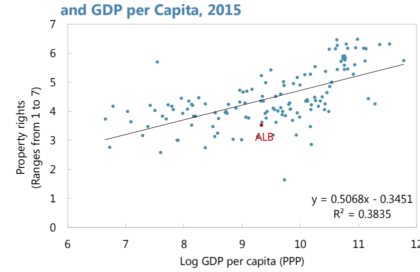
Sources: Transparency International; and WEO database.

Cross-Country Association Between Rule of Law and GDP per Capita, 2015



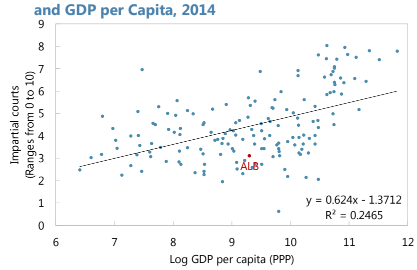
Sources: Worldwide Governance Indicators; and WEO database.

Cross-Country Association Between Property Rights and GDP per Capita, 2015



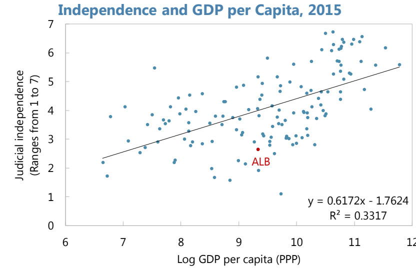
Sources: WEF, Global Competitiveness Report, 2016-17; and WEO database.

Cross-Country Association Between Impartial Courts and GDP per Capita, 2014



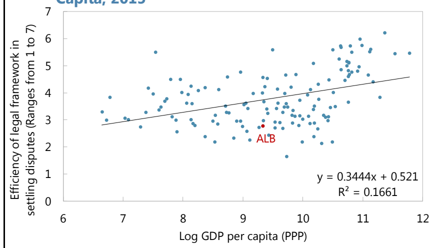
Sources: WEF, Global Competitiveness Report; and WEO database.

Cross-Country Association Between Judicial Independence and GDP per Capita, 2015



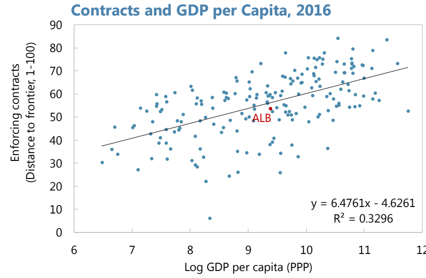
Sources: WEF, Global Competitiveness Report, 2016-17; and WEO database.

Cross-Country Association Between Efficiency of Legal Framework in Setting Disputes and GDP per Capita, 2015



Sources: WEF, Global Competitiveness Report, 2016-17; and WEO database.

Cross-Country Association Between Enforcing Contracts and GDP per Capita, 2016



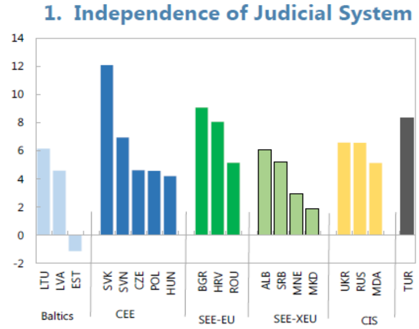
Sources: World Bank, Doing Business 2017; and WEO database.

11. Since scatterplots like these cannot provide causal identification, various studies have sought to address this issue. It is plausible that good institutions make countries rich, but also that richer countries have better institutions (Barro, 2015). However, multiple studies have identified the causal link from institutions to growth (Mauro, 1995; Hall and Jones, 1999; Acemoglu, Johnson, and Robinson, 2001; and Banerjee and Iyer, 2005). To overcome the endogeneity of institutions, these studies focus on variations in institutional quality that were driven by exogenous factors such as culture or historical events. For example, Acemoglu, Johnson, and Robinson (2001) used European mortality rates during colonization to instrument for current institutions, and estimated large effects of institutions on per capita income. Similarly, within-country variations in property rights protection due to exogenous historical events have been found to correlate with persistent income differences in Peru (Dell, 2010).

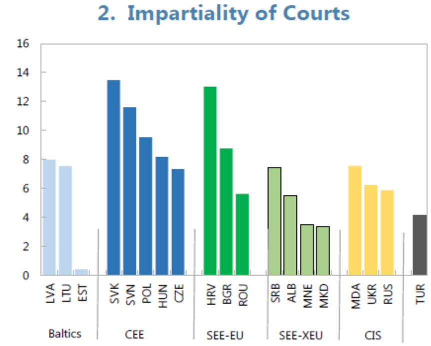
12. IMF (2016b) uses a stochastic frontier model to quantify the economic costs of inadequate judicial institutions. It estimates the impact of institutional factors on the TFP gap between 20 CESEE countries, including Albania, and the average for EU-15. The study finds that judicial independence, impartial courts, and protection of property rights are all statistically significant determinants of the TFP gap. The figure below (which comes from IMF, 2016b) illustrates the country-specific potential efficiency gains from improving judicial independence and court impartiality to the average EU-15 level. The potential gains for Albania are substantial and among the largest in the Western Balkans.

Potential Efficiency Gains from Improving Selected Structural Characteristics of CESEE Economies for the Average EU 15 Level (Percent)

1. Independence of Judicial System



2. Impartiality of Courts



Source: IMF (2016b)

13. A 2016 IMF Staff Discussion Note provides an extensive summary of the channels through which systemic corruption imposes economic costs on a country:

- Most importantly, it **hurts economic efficiency, macroeconomic and financial stability, public and private investment, human capital accumulation, and total factor productivity.** On the impact of corruption on GDP growth, see the sources cited in footnotes 7, 12, and 13 in IMF (2016a).

- Corruption also **reduces tax compliance** and **increases tax evasion**. The resulting revenue shortfalls make it more difficult to strengthen institutions, resulting in a vicious circle.

- It **undermines trust in government** and **discourages entrepreneurs from starting new businesses.**

- A 2013 study by PwC found that corruption **raised the cost of public projects** by 13% on average in eight European countries, by distorting the selection of public investment projects through bribery, rent seeking, and cronyism.

- Corruption **lowers firm productivity** by diverting scarce resources to rent-seeking and erecting barriers to entry by raising transaction costs.

- It **limits the accumulation of human capital** by promoting emigration and through the inadequate provision of healthcare and education services (as manifested through higher child mortality rates and teacher absenteeism).

- Rent-seeking and cronyism **generate the type of inequality in incomes and wealth which is both unfair and harmful to growth.**

14. In addition, there is a substantial body of literature on the economic cost of inefficient or corrupt courts.[2] That literature shows the negative impact of judicial inefficiency and corruption on firm size, labor market outcomes, incentives to invest, access to credit, and the depth of financial markets. These findings suggest that corruption and inefficiency in Albania's courts are at the root of some key characteristics of the Albanian economy, such as the disproportionate number of small companies and shallow financial markets.

C. An Agenda for Reforming the Judiciary and Strengthening Albania's Anti-Corruption Framework

15. The Albanian authorities have recently taken some bold and comprehensive steps to address the issue of corruption and inefficiency in the judiciary and the related elite impunity. After 18 months of contentious negotiations, in July 2016 Albania's parliament passed unanimously a package of constitutional amendments which fundamentally restructures the

[2] Esposito, Lanau, and Pompe (2014) offers a comprehensive survey of the literature.

country's judiciary. Seven priority laws were passed soon thereafter, and 40 more laws and bylaws are in the process of being amended or overhauled, including the Code of Criminal Procedure. The entire reform package was developed in intensive cooperation with the European Commission for Democracy through Law (informally known as "the Venice Commission"), an advisory body of the Council of Europe composed of independent experts in the field of constitutional law.

16. Perhaps the single most important component of the reform is the so-called "vetting law" passed by parliament in 2016. It provides for a re-evaluation of all judges every three years, with a focus on judges' assets, backgrounds, competence, and integrity. An International Monitoring Operation, made up of senior judges and prosecutors from the EU and the US has been established to monitor the formation and functioning of the vetting bodies for the Albanian judiciary. The three vetting bodies were established in May 2017, at the conclusion of the political crisis which opened the way for the June 2017 general elections. The Independent Qualification Commission will operate for five years, while the Ad-Hoc Chamber of Appeals will operate for nine years. The two public commissioners will represent the public in the re-evaluation process. The actual vetting of judges and prosecutors is expected to start by end-2017.

17. Another priority law (the so-called "SPAK law") established specialized institutions to fight corruption and organized crime. The law establishes a National Bureau of Investigations which is modeled after the FBI in the US, with safeguards aimed at ensuring institutional independence. It also provides for special prosecutors and judges, which will be subject to asset reviews and background checks both before and after their appointment. There should be institutional safeguards in place to ensure that the Special Prosecutions Office will be independent from the General Prosecutor. Finally, criminal cases against high state official will be transferred from the High Court to the new bodies.

18. The reform package aims to overhaul the governing bodies of Albania's judiciary. The High Council of Justice is being replaced by the High Judicial Council (HJC), a self-governing body which will be in charge of the recruitment, appointment, evaluation, promotion, transfer, dismissal, and imposition of disciplinary sanctions for all judges. The HJC will enjoy more independence both because Albania's president will no longer be a member and because five of its eleven members will come from the general public and will be elected by parliament with a 60 percent supermajority (the other six will be judges nominated by their peers). The HJC will be chaired by one of the members of the public. In addition, the minister of justice will no longer be a regular member of the HJC, but will attend some of its meetings, as needed.

19. Similarly, a new High Prosecutorial Council (HPC) will manage the careers of prosecutors. It will be independent from the Office of the General Prosecutor and will consists of six prosecutors nominated by their peers and five lay members elected by a parliamentary supermajority. The HPC will nominate the General Prosecutor and parliament will confirm the nomination by a 60 percent majority.

20. A Justice Appointments Council will vet the competence and integrity of nominees to the Constitutional Court and the position of High Justice Inspector. A High Justice Inspectorate will verify complaints against judges and prosecutors, and will replace the minister of justice in initiating disciplinary proceedings. A new territorial distribution of courts and judges should reduce backlogs. Finally, the backlog of cases at the High Court will be reduced by narrowing its scope. It will become a cassation court, with members nominated by the HJC and appointed by the president, whose job will be to provide legal interpretation and unify case law rulings.

21. Albania has taken steps to strengthen its anti-money laundering (AML) framework, which could also support anti-corruption efforts. Because the proceeds of corruption are often laundered in order to avoid detection or confiscation, an effective AML framework can contribute to both prosecuting and deterring corruption. Following its 2011 AML/CFT assessment by the IMF, Albania has taken steps to address strategic deficiencies. In line with the 2012 Recommendations by the Financial Action Task Force (FATF), work has been ongoing to strengthen banks' due diligence measures on financial transactions conducted by "politically exposed persons," to ensure the availability and adequacy of information on beneficial owners of corporate vehicles, and to improve the credibility of specialized institutions such as the financial intelligence unit.

D. Next Steps in the Reform Process

22. Implementation of the 2016 judicial reform is in its early stages and should be pursued with speed and determination, as it remains a key prerequisite for EU accession. Albania's Ministry of Justice has formulated a Cross-Sector Justice Strategy which contains a comprehensive package of measures to improve the judiciary's efficiency, including:

- supporting the introduction of an EU-funded electronic system for operational case management;
- requiring all courts to use the electronic system to allocate judges and keep registers of cases from which judges have been recused;
- strengthening online access to legislation and judicial decisions in macro-critical areas (such as insolvency and foreclosure);
- amending the Codes of Civil and Criminal Procedure to align them with the judicial reform and increase court efficiency;
- reducing case backlogs in administrative and appeal courts, as well as at the High Court; and
- reforming court fees.

23. While the implementation of judicial reform will undoubtedly require increased budget allocations, it is important to heed the findings in OECD (2013). That study found that higher judicial efficiency is driven less by the total resource envelope and more by factors such as the structure of spending and the structure and governance of courts. The study flagged factors such as computerization, active case management, the regular production of statistics, free negotiation of lawyer's fees, and granting broader managerial responsibilities to chief judges as particularly beneficial for judicial efficiency.

24. A number of measures could be prioritized to support broader anti-corruption efforts, including:

- operationalizing the National Bureau of Investigations (the new specialized national anti-corruption structure);
- strengthening the system for high-level public officials to declare their assets, with a focus on comprehensiveness, verification, and publication;
- as suggested by the latest UNCAC report, plugging legal and regulatory loopholes, and strengthening international cooperation; and
- mobilizing the AML framework to help deter, detect, and prosecute the laundering of the proceeds of acts of corruption, particularly by politically exposed persons.

25. To strengthen the protection of property rights, Albania needs to expedite work on property registration and the legal cadaster. As a first step, the 2012-2020 strategy on property rights needs to be updated to reflect the new legal provisions and provide for coordination among the restitution, compensation, and legalization processes. The authorities should appoint a national coordinator for property rights, and consider merging the various government agencies involved. The ongoing process of property registration and mapping, including the property digitalization process, should be finalized, and overlaps in land ownership phased out. The authorities should carefully coordinate and sequence work on the legal and fiscal cadasters in order to ensure that the two electronic platforms are fully compatible.

26. The Albanian authorities remain committed to this reform agenda. They confirmed that implementation of the judicial reform (including the Cross-Sector Justice Strategy) remains their top priority. They pointed out that the planned restructuring of district courts and changing the evaluation criteria for judges will also improve judicial efficiency. They are committed to reforming court fees in the near future, and to amending the Codes of Civil and Criminal Procedure by the end of the government's term in 2021. Regarding anti-corruption, the authorities are working on a comprehensive plan to strengthen the asset declaration system, as part of a twinning project with the EU. Finally, they are working on a new property rights strategy which is expected to be unveiled in 2018.

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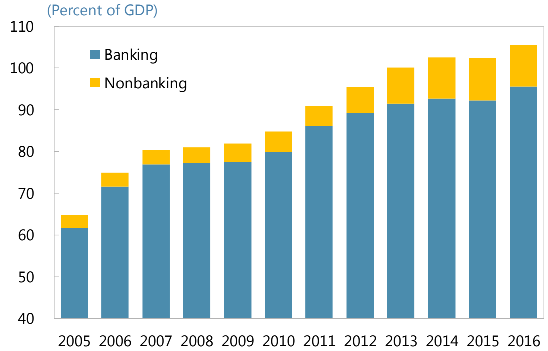
FINANCIAL DEEPENING IN ALBANIA[1]

Albania's financial depth is lower than regional peers, but is largely aligned with the institutional and macro fundamentals. An analysis of credit gaps point out that the room for credit recovery is limited if there are no institutional improvements. The development of a private capital market requires addressing weak corporate governance standards in private sector. Financial inclusion is low and needs to be considered in the financial development design. Addressing these institutional bottlenecks would help support Albania's growth potential.

Background: Financial Development and Financial Inclusion

1. **The financial system in Albania is dominated by banks.** Banks currently account for 95 percent of GDP while long-term funding institutions (insurance, pensions, investment funds), which grew rapidly from 2012, account for 10 percent of GDP. Around 85 percent of the banking system is under foreign ownership and 63 percent is held by EU-banks. Shadow banking activities are virtually non-existent.

Albania: Financial System Assets
(Percent of GDP)



Sources: Bank of Albania; and IMF staff estimates.

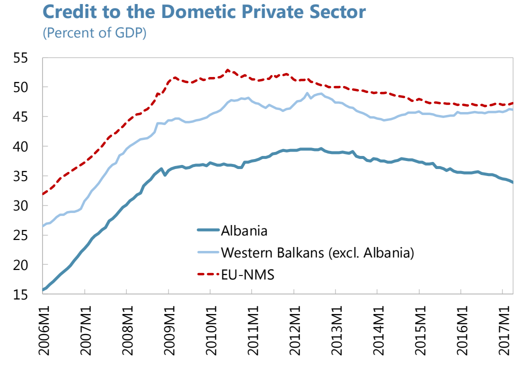
Financial System Assets: Composition
(Percent of GDP)

	2005	2015	2016
Banking sector	**61.7**	**92.3**	**95.6**
Nonbanking sector	**3.0**	**10.1**	**10.1**
NBIs, SLAs and others	1.8	3.4	3.5
Insurance companies	1.2	1.9	2.1
Pension funds	-	0.06	0.06
Investment funds	-	4.7	4.5
Total	**64.8**	**102.4**	**105.7**

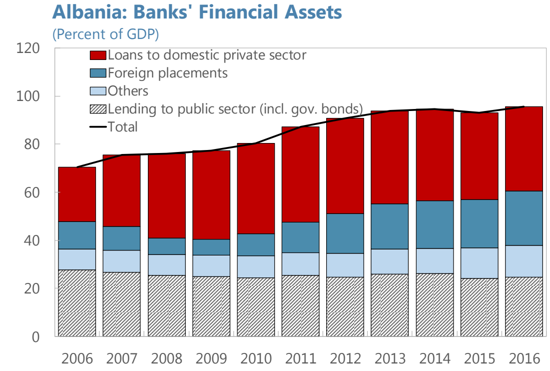
Source: Bank of Albania.

2. **Despite the large banking sector, private sector credit depth is low and credit flow has been stagnant in recent years.** In 2016, credit to the domestic private sector represented 35 percent of bank assets compared to above 50 percent in regional peers, as about ¼ of bank portfolios were allocated to the public sector. Following the global financial crisis, banks have tightened lending standards to address weak risk management practices and an inadequate NPL-resolution framework. Since 2015, credit consolidation has accelerated as banks were forced to write off impaired assets. Albania is also facing deleveraging pressures from EU-owned banks mainly due to low profitability as well as the tightening of EU regulation, and AML/CTF and corresponding banking issues. Lack of credit demand has further induced banks to place funds overseas — mainly among subsidiaries abroad.

[1] Prepared by Ezequiel Cabezon (EUR).

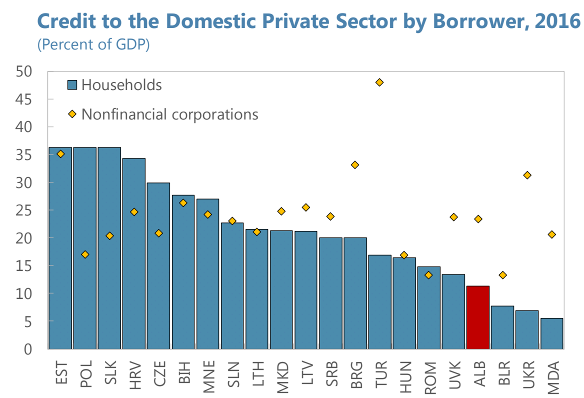


Sources: HAVER; IMF, IFS; and IMF staff estimates.



Sources: Bank of Albania; and IMF staff estiamtes.

3. Low credit to the private sector primarily reflects low credit to households. The ratio of household credit to GDP is half of the CESEE regional average. Low lending to households reflected a banking model focused on large corporate loans, issues on land property titles —that prevented their use as collateral—, and remittances that were used to finance housing construction. Nevertheless, banks are starting to expand household credit to diversify their portfolios.



Sources: IMF, IFS; and IMF staff estimates.

4. Limited access to long term funding in local currency has also contained credit growth. As short term deposits are the main funding source for banks, there is limited the scope for long term loans in local currency. Foreign banks can access parent FX-funding but they are averse to bear the FX-risk mismatching. In order to promote local currency long term funding, an institutional investor base needs to be developed.

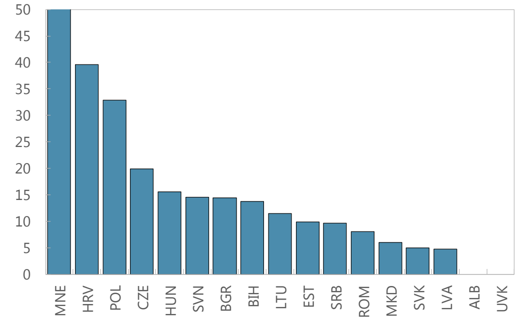
5. The nonbanking system is relatively under-developed and offers limited scope for long-term funding. The Albanian nonbanking system is aligned with Western Balkan peers, but it is smaller than in EU-new member states (Table text). The insurance sector is constrained by inadequate insurance regulation, low disposable incomes, poor record of claims performance, and public distrust in the insurance firms. Voluntary pensions have been limited due to low saving and the pay as you go pension system. The small size of the economy and weak corporate governance have also hindered private capital market development.

Financial System Assets: Regional View
(Percent of GDP)

	ALB 2016	Western Balkans[1] 2015-16	NMS: Inflation Targeters[2] 2015-16
Total	**105.1**	**91.1**	**121.9**
Banking	**95.0**	**81.7**	**90.2**
Of which lending to gov. (incl. securities)	24.1	10.6	16.3
Nonbanking	**10.1**	**9.4**	**31.7**
NBFIs, Saving Assoc., others	3.5	2.4	6.6
Insurance	2.1	4.6	7.6
Investment funds	4.4	1.9	11.6
Pensions[3]	0.1	0.4	5.8

[1]Average Bosnia Herzegovina, Macedonia, Montenegro and Serbia.
[2]Average Czech Rep., Hungary, Poland, and Romania.
[3] Excludes mandatory pension funds.
Sources: Country authorities; IMF, FSAPs; and IMF staff estimates.

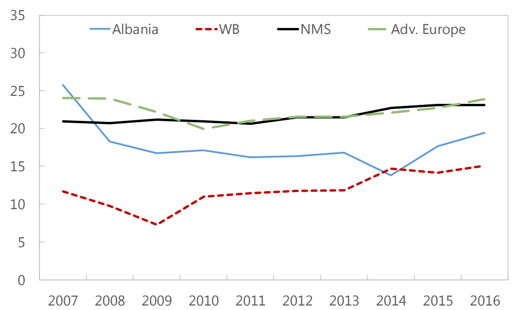
Private Capital Markets
(Percent of GDP, 2010-16)



Sources: World Bank, Global Finance Development Report; and IMF staff estimates.

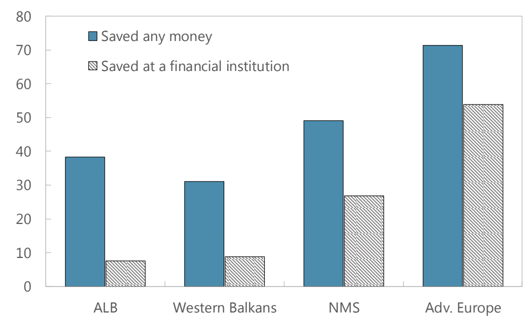
6. **Low savings rate has also contributed to limited financial development.** National saving in Albania is slightly above the Western Balkan peers and below the EU NMS, but has declined compared to 2007 and is lower than in the EU-NMS. Microdata[2] shows that while the share of individuals saving is higher than in other Western Balkans, individuals saving in financial institutions is lower.

National Saving
(Percent of GDP)



Sources: INSTAT; and IMF staff calculations.

Share of Adults Saving, 2014
(Percent)

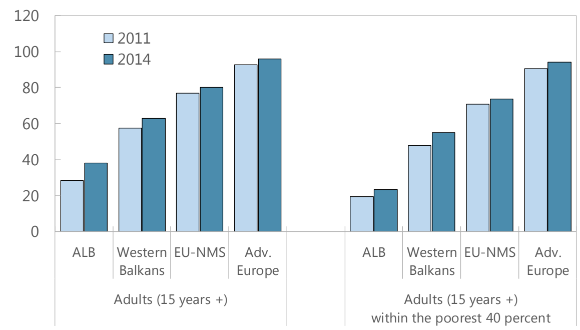


Sources: World Bank, Global Financial Inclusion database; and IMF staff estimates.

[2] Global Financial Inclusion database.

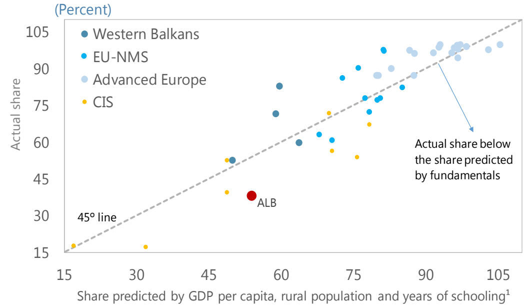
7. Financial inclusion is lagging compared to the regional peers. User-based indicators point out that the share of adults holding accounts is the lowest in the region. While low income, large rural population, and low education explain some of the gaps with peers, Albania's financial inclusion is well below the levels associated with those structural features. While financial infrastructure, measured by ATMs and branches per capita, are in the lower range in the region, they are consistent with the credit depth and institutional development level. They do not appear to be a binding constraint in financial inclusion.

Share of Adults with an Account at Financial Institutions
(Percent of adults, 15+)



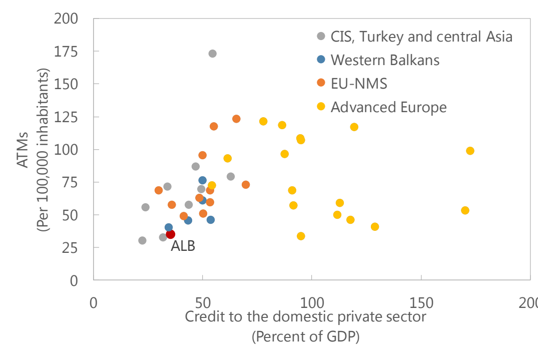
Sources: World Bank, Global Financial Inclusion database; and IMF staff estimates.

Share of Adults with Accounts in Financial Institutions, 2014
(Percent)



1/ Share predicted by a regression that includes the cited variables are regressors.
Sources: World Bank, Global Financial Inclusion Database; and IMF staff estimates.

ATMs and Credit to Domestic Private Sector, 2015



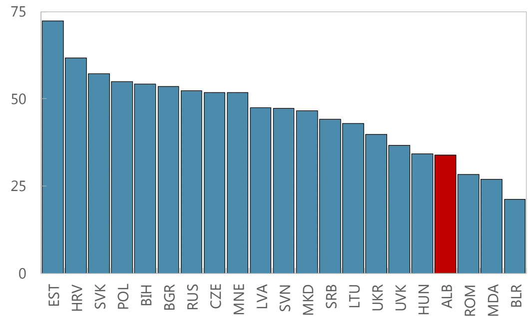
Sources: World Bank, WDI; IMF, WEO; and IMF staff estimates.

Credit Deepening in Albania

A. Assessing Credit Gap in Albania

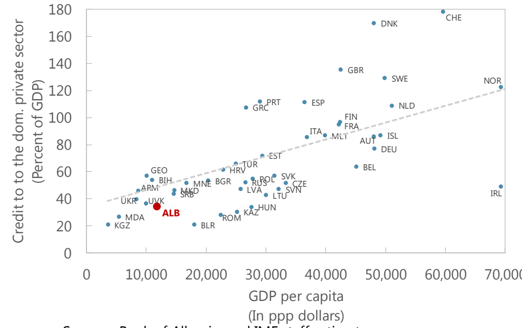
8. Albania credit to the domestic private sector is broadly aligned with institutional and income levels. Low credit-to-private sector is explained by low income, high informality, and institutional obstacles. An important institutional obstacle is related to enforcing contracts and recovering collateral. Also, lack of credit scoring in the credit registry and narrow information about borrowers contributed to weak credit penetration. Deepening credit to the private sector will thus require further institutional strengthening.

Credit to the Domestic Private Sector, 2016
(Percent of GDP)



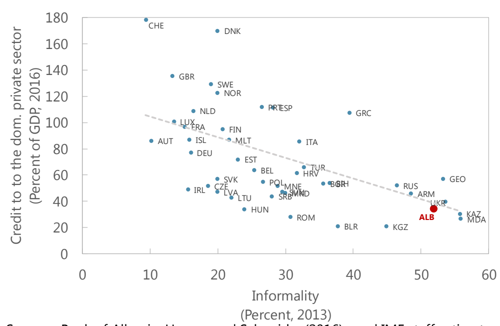
Sources: Bank of Albania; and IMF staff estimates.

Credit to the Domestic Private Sector and GDP per capita, 2016



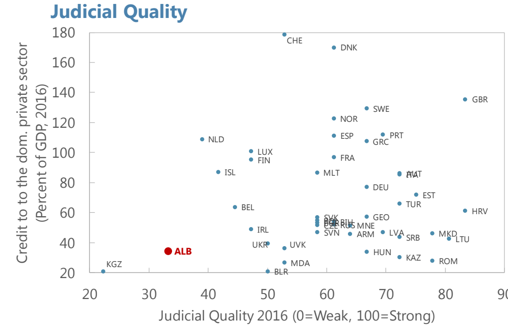
Sources: Bank of Albania; and IMF staff estimates.

Credit to the Domestic Private Sector and Informality



Sources: Bank of Albania; Hassan and Schneider (2016); and IMF staff estimates.

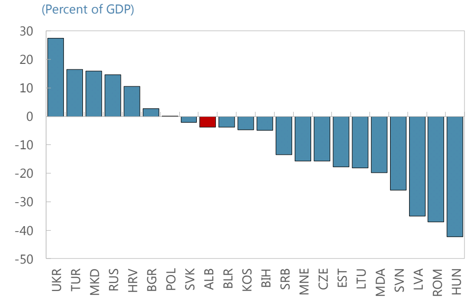
Private Credit to the Domestic Private Sector and Judicial Quality



Sources: Bank of Albania; World Bank, Doing Business Report; and IMF staff estimates.

9. Private sector credit gaps are assessed to be small in Albania. Credit gaps estimates are key to understand the extent of the credit recovery and policy measures to enhance financial deepening. These estimates — following IMF-REI May 2015— are a function of income and real interest rates. In 2016, the private credit to GDP was about 4 percent below the long-term levels. See Appendix 1 for details.

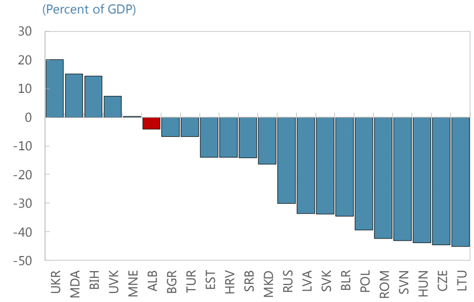
Private Credit Gaps, 2016
(Percent of GDP)



Sources: IMF staff estimates.

10. Alternative measures of credit gaps also show similar results. Estimates — following IMF WP/03/213— that include more dimensions than in the previous paragraph reach the same conclusion. The alternative measure considers the role of income, public debt crowding out, inflation, and structural features of judicial institutions. The estimates indicate that credit to the private sector is about 6 percentage points of GDP below the level implied by the structural features. See Appendix 2 for details.

Alternative Private Credit Gap, 2016
(Percent of GDP)

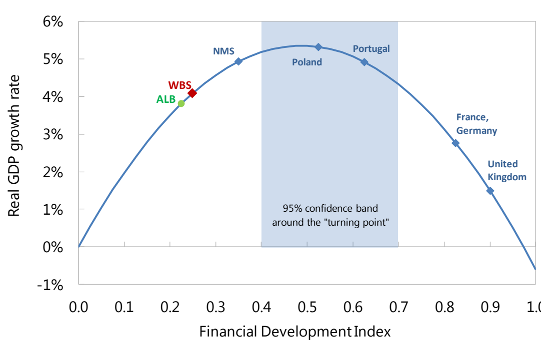


Sources: IMF, staff estimates.

B. Growth Implications of Credit Deepening

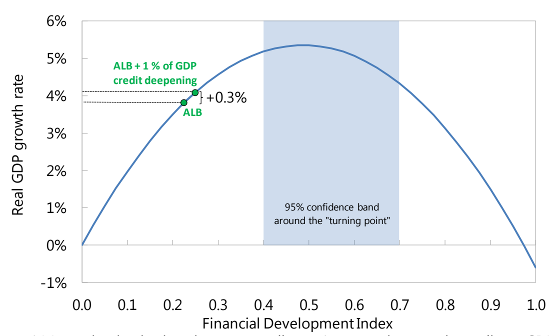
11. Credit deepening can have a positive impact on medium-term growth for Albania given the limited financial development. Studies show that initial financial development has a positive impact on economic growth but that excessive financial development can have negative implications on financial stability.[3] Financial deepening can boost economic growth by incentivizing savings, improving resource allocation, and facilitating trade. Improved financial institutions also enhance intermediation, and consequently strengthen capital accumulation and productivity. The impact on growth was assessed using a financial development index that covered financial depth, access, and efficiency dimensions. The results following IMF SDN/15/08 imply that for Albania, a 1 percentage point expansion in credit to GDP ratio is associated with an 0.3 percentage point increase in medium term growth.

Financial Development Effect on Growth



Sources: IMF SDN/15/08; and IMF staff estimates.

Impact of 1 percent of GDP Credit Deepeing on Growth[1]



1/ Assuming institutions improve to allow a 1 percent increase in credit-to-GDP.
Sources: IMF SDN/15/08; and IMF staff estimates.

12. Credit growth will also have a short-term impact on economic growth. Credit is strongly correlated to consumption and only weakly related to investment. This weak relation is explained by large FDI funding. At industry level, credit growth is strongly associated with construction and trade. VAR estimates suggest that in the short-term, the impact of an exogenous credit shock of 1 percent is 0.2 percent on GDP.

[3] See IMF (SDN/15/08) which estimated the relation of financial development and growth using a panel of 128 countries for 1980-2010, and a nonlinear relation between financial development and growth.

Correlation Between Domestic Private Sector Credit Growth and GDP Growth[1]

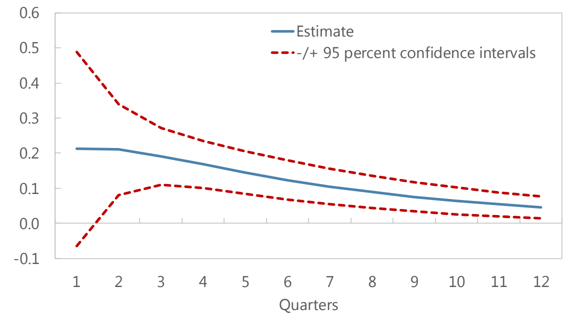
	t-1	t	t+1
GDP	0.53	0.79	0.76
Consumption	0.47	0.84	0.76
Gross Fixed capital formation	0.61	0.54	0.54
Exports	0.66	0.66	0.48
Construction	0.54	0.71	0.70
Real estate	0.60	0.69	0.74
Trade (Wholesale and retail)	0.08	0.68	0.64
Information and communication	0.56	0.67	0.65
Financial and insurance activities	0.48	0.56	0.38
Manufacturing	0.61	0.55	0.45
Other services	0.40	0.50	0.66
Transportation and storage	0.48	0.48	0.46
Mining	0.23	0.13	-0.02
Tourism	0.65	0.10	0.08
Agriculture, forestry and fishing	-0.48	-0.02	-0.11
Utilities	-0.11	-0.31	-0.29

[1]Annual data 2004-2016

Source: Bank of Albania; INSTAT; and IMF staff calculations.

Impulse Response of GDP to a Credit Shock

(Percent; Response of GDP to a 1 percent exogenous credit shock)



Note: VAR over quarterly on GDP and credit to domestic private sector, including one lag of the variables. Variables were seasonally adjusted.

Source: IMF staff estimates.

C. Private Capital Markets Development

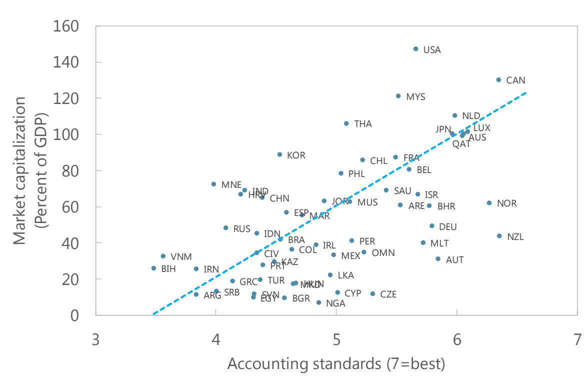
13. Development of private capital markets would also support growth potential. Capital markets in emerging economies are associated with improving capital allocation, allowing risk sharing, facilitating monetary policy, increasing efficiency by enhancing competition between corporate issuance and banks, and reducing cost of financing as foreign investors' access is eased. However, there are also negative implications as the country becomes more vulnerable to international market volatility. In addition, if listing and disclosure standards are weak, financial stability risks increase.

14. What are the prerequisites for a successful development of a private capital market? International experience suggests the following key requirements[4]:

- **Sound macroeconomic policy:** Rational monetary policy and clear debt management policies are needed to ensure predictable interest rate movements.

- **Strong legal and institutional frameworks:** An adequate legal framework to protect investors and low cost to enforce contracts are key. A solid regulatory and supervision structure for securities is another important component. Adoption of the highest standards on information quality and public disclosure are critical. In addition, credible accounting, auditing processes, and sound corporate governance are necessary to build trust.

Market Capitalization and Accounting Standards 2010-16



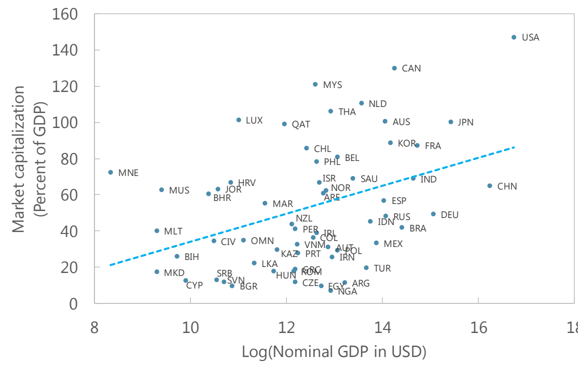
Sources: World Bank, WDI; Global Competitiveness Report; and IMF, staff estimates.

[4] Laeven (2014) and Ong and Iorgova (2008).

- **Well-functioning financial infrastructure:** Trading platforms, as well as clearing and payment systems are required. A sound government debt market that provides a benchmark to price private sector securities is essential.

- **Minimum market size:** There are economies of scale needed to develop a private capital market. For firms, there are high fixed costs to list stocks —e.g. meeting accounting and transparency standards, or getting credit ratings— and for the stock exchange operator, there are high costs to set up the trading platforms. In addition, a sound capital market needs liquidity which requires a sizable volume of investors.

Market Capitalization and Economy Size 2010-16



Sources: World Bank, WDI; and IMF, staff estimates.

- **Large saving:** Lack of domestic saving can be an important barrier. Domestic investors play a key role for development. The existence of large pension funds and investment funds are associated with successful private capital markets.

- **Banking sector complementarity:** Developed capital markets complement the financial intermediation role of banks and support the efficient allocation of financial resources.

Lessons from CESEE Experience for Albania's Capital Market Development

15. The experience of EU-new member states shows that institutional and market reforms were key factors driving the development of capital markets in the 2000s. Key reforms included privatizations that required mandatory listing of companies, pension funds reforms, and capital inflows driven by the EU accessions as countries quickly harmonized legal and regulatory frameworks.

16. Nevertheless, challenges persist in the EU new member states. Enforcement in practice was weak and lack of strong corporate governance undermined financial development and called for relaxed listing standards. Also, limited liquidity has been an important barrier for investor and market development in CESEE. Many emerging European markets still suffer from inadequate reporting standards, lack of credible corporate ratings, and weak ownership disclosure structures.

17. Stock exchanges in CESEE are facing challenges to survive. Harmonization of regulation provides incentives for large and solid borrowers to issue equity and bonds in large markets, thereby leaving the local stock exchange. At the same time, economies of scale of trading platforms and payments encourage stock exchange consolidation. The high costs associated with corporate debt issuance, such as the costs of meeting regulatory requirements and direct issuance costs, have acted as a deterrent to market development.

18. Addressing these institutional challenges will be key for the success of the newly-licensed private stock exchange in Albania. Previous attempts to develop private capital markets had limited traction due to these weaknesses. A stock exchange was established in 1996, first as part of the Bank of Albania and after 2002, as a joint stock company, but there were never trading of private equity or listing. The stock exchange never gained trust of domestic investors or local business and finally was closed in 2014. Lack of progress can be attributed to structural features such as small size of enterprises, entrepreneurs unwilling to open books to the public, large informality, and memories of past the pyramid schemes. The mistrust reflected weak institutions —legal, regulatory, and corporate governance— to protect investors.

19. Capital market development should be guided by the EU standards, but the development will take time and is a complex process. Prospects of EU membership appears to have significantly benefited the stock markets in candidate countries. As a candidate country, the best approach to develop capital markets will be to implement EU standards for the legal and regulatory framework. Joint monitoring with EU supervision authorities can help ensure sound implementation. A key feature for a successful stock exchange is to generate trust of investors and potential listing companies.

D. Conclusion and Policy Recommendations

20. It is key to improve institutions to facilitate financial deepening. Improvement of legal, judiciary, and regulatory frameworks for safeguarding property rights are crucial. Strengthening the NPL resolution framework and court procedures are essential. Enhancing credit registries and implementing rating standards will also contribute in fostering credit. Develop the stock exchange will require implementing the highest standards regarding transparency, corporate governance, and supervision. Also, the authorities' policy mix should address structural features, such as reducing informality and fostering national savings in order to support financial deepening.

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Appendix I. Credit Gaps

The credit gaps are estimated based on the private sector debt and using income and interest rates as key drivers. The work follows (IMF, REI -May 2015). The following ADL model was estimated:

$$\ln\left(\frac{D_{i,t}}{P_{i,t}}\right) = \alpha_i + \sum_{j=1}^{2} \beta_j \ln\left(\frac{D_{i,t-j}}{P_{i,t-j}}\right) + \sum_{j=0}^{1} \gamma_j \ln\left(\frac{Y_{i,t-j}}{P_{i,t-j}}\right) + \sum_{j=0}^{1} \delta_j R_{i,t-j} + \varepsilon_{i,t}$$

$\frac{D_{i,t}}{P_{i,t}}$ Per capita private sector debt stock in thousands of 2005 ppp, U.S. dollars.

$\frac{Y_{i,t}}{P_{i,t}}$ Per capita GDP in thousands of 2005 ppp, U.S. dollars.

$R_{i,t}$ Nominal interest rate on private sector debt.

i Country index

t Time index

The long-term relation can be derived if stability conditions hold ($0 < \beta_1 + \beta_2 < 1$). Defining lower case asterisk variable as log of real variables in the long run.

$$d_{i,t}^* = \frac{\alpha_i}{1-\beta_1-\beta_2} + \frac{\gamma_0+\gamma_1}{1-\beta_1-\beta_2} y_{i,t}^* + \frac{\delta_0+\delta_1}{1-\beta_1-\beta_2} R_{i,t}^*$$

The equilibrium-correction model is given by:

$$\Delta d_{i,t} = \gamma_0 \Delta y_{i,t} + \delta_0 \Delta R_{i,t} - (1-\beta_i)(d_{i,t} - d_{i,t-1}^*)$$

Appendix II. Credit Gaps: Structural Approach

This section estimates the ratio of private sector credit to GDP as a function of income and structural features of the economy.

$$PrivCred\ to\ GDP_{i,t} = \beta X_{i,t} + e_{i,t} \qquad X_{i,t} = \begin{bmatrix} Constant \\ Log\ real\ GDP\ in\ ppp \\ Inflation \\ Public\ debt\ to\ GDP * Emerging\ dummy \\ Judicial\ institutions\ index \end{bmatrix}$$

Data: The panel is estimated over a sample of 64 countries, including European countries and other regional peer included in Cottarelli and others (2003). The sample covers 1997-2016 and is estimated over annual data. To summarize the structural features of judiciary institutions we build an index based on the average of 6 indicators from doing business report (Credit information, Private Credit Registry, Quality of judicial process, Strength of insolvency frameworks, recovery rates and cost of enforcing contracts).

Dependent Variable: Private Credit to GPD – Sample 1997-2016

	Sample	Sample	EUR Sample
log Real GDP in ppp dollars	52.374	40.725	50.716
	[0.00]**	[0.00]**	[0.00]**
Inflation yoy avg: in percent	0.082	0.064	0.106
	[0.30]	[0.41]	[0.34]
Public debt-to-GDP*Dummy emerging economy	-0.016	-0.052	-0.033
	[0.67]	[0.15]+	[0.55]
Index of bank entry restriction, (0: no restr.,100: strict restr.)	0.064	0.064	0.075
	[0.29]	[0.27]	[0.33]
Judicial Institutions Index (High values more efficient system)		0.441	0.444
		[0.00]**	[0.00]**
Constant	-90.707	-82.135	-118.957
	[0.00]**	[0.00]**	[0.00]**
Adjusted R^2	0.44	0.45	0.46
Countries	62	62	40
Obs	1,117	1,117	731

* p<0.1; ** p<0.05; *** p<0.01