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Banking and finance in South-Eastern Europe: the Albanian case

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SEEMHN

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Editorial

The South-Eastern European Monetary History Network (SEEMHN) is a community of financial historians, economists and statisticians, established in April 2006 at the initiation of the Bulgarian National Bank and the Bank of Greece. Its objective is to spread knowledge on the economic history of the region in the context of European experience with a specific focus on financial, monetary and banking history. The First and the Second Annual Conferences were held in Sofia (BNB) in 2006 and in Vienna (OeNB) in 2007. Additionally, the SEEMHN Data Collection Task Force aims at establishing a historical data base with 19th and 20th century financial and monetary data for countries in the region. A set of data has already been published as an annex to the 2007 conference proceedings, released by the OeNB (2008, Workshops, no 13).

On 13-14 March 2008, the Third Annual Conference was held in Athens, hosted by the Bank of Greece. The conference was dedicated to *Banking and Finance in South-Eastern Europe: Lessons of Historical Experience*. It was attended by representatives of the Albanian, Austrian, Belgian, Bulgarian, German, Greek, Romanian, Russian, Serbian and Turkish central banks, as well as participants from a number of universities and research institutions. Professor Michael Bordo delivered the key note speech on *Growing up to Financial Stability*. The participants presented, reviewed and assessed the experience of SE Europe with financial development, banking and central banking from a comparative and historical perspective.

The 4th Annual SEEMHN Conference will be hosted by the National Serbian Bank on 27th March 2009 in Belgrade. The topic of the Conference will be *Economic and Financial Stability in SE Europe in a Historical and Comparative Perspective*.

The papers presented at the 2008 SEEMHN Conference are being made available to a wider audience in the Working Paper Series of the Bank of Greece. Here we present the eleventh of these papers, by Kliti Ceca, Kelmend Rexha and Elsida Orhan.

July, 2008

Sophia Lazaretou
SEEMHN Coordinator
Member of the Scientific and Organizing Committee

BANKING AND FINANCE IN SOUTH - EASTERN EUROPE: THE ALBANIAN CASE

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ABSTRACT

This paper aims to present the main developments of banking and finance in Albania in a historical perspective. This historical overview might help to better understand not only the great difficulties and obstacles the country faced in the past but also the successes it achieved. It is widely known that the financial system, especially the banking sector, is considered as very important as it serves as a catalyst for the economic development of the country. And this is because financial depth determines economic growth. The paper also highlights the future challenges that the Albanian financial system will face within the context of the country's European integration and the EU harmonization of the financial policies.

Keywords: Historical perspectives; Financial system; Bank-dominated system; Panics; EU integration
JEL classification: G21, G22, N24

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1. Introduction

This paper aims to present the main developments of banking and finance in Albania in a historical perspective. After the fall of the communist regime in 1989, the Albanian banking sector was still underdeveloped and centrally planned. The reform process consisted in the establishment of a two-tier banking system, the privatization of the state-owned banks, the introduction of a new regulatory regime and the entry of foreign banks. The pyramid schemes phenomenon in 1997 and the deposit crises in 2002 were the main difficulties the country had to face. During recent years, the level of financial intermediation has increased significantly due to a rise in customers' confidence in banks, adequate legal protection of lenders and the introduction of modern credit risk management techniques. The paper also highlights the future challenges the domestic financial system will face within the context of the country's European integration and the harmonization of the financial policies with the EU.

In particular, in Section 2 we analyse the essential features of the banking system in Albania and study various factors that are crucial for the development of the domestic banking sector. We present in a chronological way the main developments in the financial system, especially the banking system, as Albania is a bank-dominated market. Many sub-periods are studied: Independence Declaration in 1912; the pre-monarchist period; the monarchist period; the 1939-1944 period; the period after WWII; and the post-1990 period .In each sub-period, important monetary and financial events happened. Section 3 focuses on the key characteristics of the recent financial developments while Section 4 presents the country's financial system in a future perspective. Section 5 concludes.

2. A Historical Overview of the Albanian Banking System, 1912-1992

The development of the so-called "banking tradition" in Albania can be characterized as a slow motion process. Albania had many advantages due to its closeness to European markets and the first banking experiences in Europe, but all these advantages were undermined by unfavourable political developments. The history of the Albanian banking system passed through five main sub-periods: the pre-monarchist period; the monarchist period; the 1939-1944 period; the post-WWII period and the post-1990 period.

2.1 The pre-monarchist period

The pre-monarchist period was characterized by general economic backwardness and chaos. Till 1913, there was neither a national bank nor a national currency. Banks' genesis in Albania dates back to the Ottoman Empire of the second half of the 19^{th} century. The need for arranging a modern banking system in Albania was reflected in the efforts of the first Albanian government after the declaration of the independence in 1912. Following the Independence Declaration on 28 November 1912, Ismail Qemali, the distinguished diplomat in other tasks, was engaged to establish the National Bank of Albania together with the Italian and Austrian banking groups (on 4 October 1913). The Bank's capital was set at 10.5 million lira, denominated in gold currency. The agreement stated that the National Bank of Albania would conduct various operations, such as the selling-purchasing of titles, currencies, precious metals, trading goods etc.

The National Bank of Albania remained the sole institution vested with the right to issue banknotes. Despite all attempts made, a national system of currency and lending was not established during this period. Different (mostly foreign) banknotes circulated in the various provinces of the country. The "lek", the Albanian legal tender, started to circulate in 1922. In the same year, its conversion to gold was guaranteed and its issue was limited to no more than 3 million gold francs.

2.2 The monarchist period

This period starts with the arrangements made to the operating legal base of the National Bank of Albania established in 1925. Its sole responsibility of banknote issue was given by the government; it was also the fiscal agent to the state. From 1926, the use of foreign banknotes in state official agreements was strictly forbidden. The Albanian gold franc was approved as the official monetary unit. The Bank's modern conception emerged during this period, with a joint capital with well-diversified risk. Specifically, besides the Albanian group, 20% of the shares of the National Bank of Albania were held by Belgian, Yugoslavian and Swiss shareholders, while the shares of the Italian group were allocated among the four Italian largest banks. Albania gained for the first time the right to control 51% of the initial capital, although it was permitted to contribute only to 20% of the total capital, as the result of its inability to buy shares in the country. During the monarchist period, gold franc banknotes were issued, covered by gold and silver reserves to around 50% of their nominal value. At the same time, treasury insurance, for around 34%, was executed in the Bank of Italy, in Rome. The circulation of foreign currencies with an officially-announced exchange rate was arranged by law during 1929-1932.

The monarchist period is classified as the most successful period as regards monetary policy and the inheritance it left. The monetary policy of the monarchy helped in developing the national economy and facilitated foreign capital inflows which financed foreign investments. The lek was a stable and convertible currency, while printing banknotes lowered the risk of potential inflation, as the demand for the lek was not excessively high in the domestic market. Political conditions also served to build a favourable environment for promoting and sustaining the initiatives of the domestic economy.

2.3 The 1939-1944 period

In April 1939, Albania endorsed the Economic Agreement with Italy, which brought changes both to the revenue regime (i.e. a customs union was formed) and to the foreign currency regime. This agreement, which radically changed the stance of the country's monetary and fiscal policy, imposed some modification to the Albanian National Bank's statute in order to harmonize it with the new economic policy of the country, allowing thus an "autonomy" feature. Political and military developments significantly affected the order of the credit system, the deposits, the national currency value and financial markets in general.

2.4 Post-WWII

After the country's liberation, priority was given to the establishment of the monetary system and the completion of the monetary reform in 1946. From 1946 onwards, the State bank of Albania was vested with more responsibilities, and attention shifted to central planning and the management of the currency in circulation. The Bank functioned as a central bank as well as a second-tier bank.

During this period, a limited number of banks acted in Albania. A key feature was the centralization of the system in the hands of the state. The State Bank, as a central bank, was at the centre of currency issuance. It gathered the temporally free assets and granted short-term and long-term credit to enterprises, agricultural cooperatives and households. The Bank also conducted the unique cash account operation; it kept the income and expense accounts and saved the foreign currency reserves owned by the State.

Till 1976, the domestic banking system was centralized, consisting of a sole bank, the State Bank. However, the Bank had a very limited role because monetary policy and credit distribution were guided according to a centralized plan. In 1977, a section of the Bank which covered funds to the agriculture sector was shaped as a separate specialized bank, the Rural Bank. However, an extensive transformation of the banking system took place only post-1990.

2.5 Post-1990

After the fall of the communist regime in 1989, the Albanian banking sector remained underdeveloped and centrally planned, while money had a limited role as a medium of exchange. A reform process was desperately needed for the banking system. The main pillars of this reform were the establishment of a two-tier banking system, the privatization of the state-owned banks, the introduction of a new regulatory framework and foreign bank entry.

Till mid-1990, the banking system continued to represent an underdeveloped financial segment, absolutely dominated by the public sector and with poor infrastructure, and thus exhibiting low quality in the provision of services. Analytically, the structure of the domestic banking system was of a typical centrally planned economy, comprised by four state-owned institutions, i.e., (i) the State Bank of Albania (SBA), which acted as a central bank with commercial responsibilities; (ii) the Rural and Development Bank (BRD), which extended credits to the state-owned farms and cooperatives; (iii) the Savings Bank, the locker for all household deposits;

and (iv) the Albanian Commercial Bank (ACB) which handled the foreign trade transactions.

Albania joined the IMF in 1991 and thereafter worked to secure a standby credit agreement. The Albanian government, assisted by specialists from the IMF and the World Bank, prepared the introduction of a two-tier banking system. It was governed by laws imposed both on the central bank and commercial banks, namely the new Central Bank Law and the Commercial Banking Law approved in April 1992, replacing the previous law “On the Bank of the Albanian State”. Under the new banking law, the State Bank of Albania was renamed to Bank of Albania and retained the functions of a pure central bank. The 1992 law suspended the Bank’s dependence on the government and established that the Bank would be audited by the Parliament. Its main objective would be “to maintain the internal and foreign stability of the domestic currency”. Within the new legal framework, the Bank of Albania (BoA) started to operate as a central bank with three other state-owned banks; the National Commercial Bank (NCB), the Savings Bank (SB) and the Rural Development Bank, which later changed its name to the Rural Commercial Bank (RCB). In 1992, the domestic banking system had the structure illustrated in Table 1.

Table 1: The Albanian banking system in 1992

Banks	Ownership
Bank of Albania	State-owned
National Commercial Bank of Albania	State-owned
Savings Bank of Albania	State-owned
Rural Commercial Bank of Albania	State-owned
Italian-Albanian Bank	Joint venture (NCBA-Banca di Roma Italy)
Italian-Arabian Bank	Joint venture (NCBA-Arab Islamic Bank of Bahrain)
Dardania Bank	Foreign Private Bank

3. Financial Development: Key Features, 1992-2007

On the basis of the main features characterising the development process of the banking system, the 1992-2007 period can be distinguished into three different sub-periods: 1992-1997, 1997-2002 and 2002-2007.

3.1 First period, 1992-1997: structural changes

Albania adopted the most severe policies of state domination on the economy in relation to ownership and central planning. The transition process found the country to be the poorest among the European countries (see Table 1 in the Appendix). The real economy went deep in collapse, inflation rose fast and foreign debt further increased. Industrial production fell by more than 40% in 1991. As a consequence, the budget deficit increased to 45-50% of GDP. It was heavily financed by monetary means which led to excessively high inflation rates (10-15% on a monthly base), to the economy's dollarization and the depletion of international reserves.

The process of economic reform started in June 1992 with the support of the "Stand By" Agreement with the IMF, and contained the following main objectives:

1. macroeconomic stability: budget deficit reduction, inflation control and price liberalization;

2. re-structuring of the public sector (included the financial sector), free competition incentives;

3. privatizations;

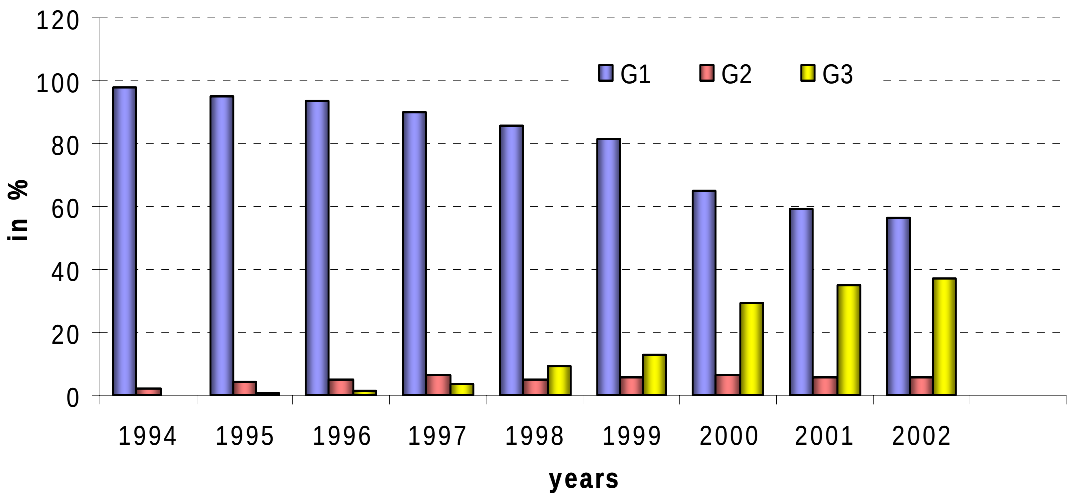
4. an opening of the economy to trade by removing the state monopolies in external trade and liberalizing import and export flows.

More specifically, financial sector reform stressed the need for the re-organization of financial and banking institutions as well as insurance and pension funds. In this context, the reforms began by first setting down the objectives for macroeconomic stability and then by carrying out the structural changes aimed at privatizing the economy and building robust financial institutions. Banking system reform, being part of economic reform more generally was initiated in 1992. The government, assisted by the IMF and the World Bank specialists prepared a two-tier banking system to be governed by laws imposed on central and commercial banking. In 1992 Dardania Bank was established and in 1996 two banks with Greek capital were licensed: Tirana Bank and a branch of the National Bank of Greece at Tirana.

In the countries in transition the banking sector used to be one of the most vulnerable and unstable parts of the domestic economy. Thanks to the reforms, it gradually turned out to be one of the most advanced sectors, going ahead of other productive sectors that continue to cause certain problems.

In 1993, banking assets to GDP were high accounting for 61.4%; however, total bank loans amounted to only 5.6% of GDP while individual deposits were 11.3% of GDP and qualified loans were 12.5% of total loans. As seen in Chart 1, throughout this period banking sector developments were characterized by the dominance of the state-owned banks (G1), even though a slight increase was observed in the share of joint-ventures (G2) and private banks (G3).

Chart 1: Banks' share according to market classification, '94-'02 (in %)



Source: Bank of Albania

In 1994, 6 banks were operating in the country with total assets of ALL 146.2 billion, which amounted to 79% of GDP. In 1996 the Tirana Stock Exchange was officially established as an independent institution and a part of the Albanian financial system, based on the framework of the Law 8080 "On security", but in fact it has not functioned. From an organizational point of view, the Tirana Stock Exchange was located at the Bank of Albania's facilities and was operating under its jurisdiction. Nevertheless, up to now, there is not any company listed, neither those derived from massive privatizations nor any stock transactions are made. The only transactions made refer to the exchange of treasury bills of one year maturity, five-year government bonds and privatization vouchers.

3.2 Pyramid schemes phenomenon

Conceptually, the domestic capital market is marked by significant drawbacks and deficiencies. For example, the rise and fall of the pyramid schemes was a major financial event in Albania during this decade.

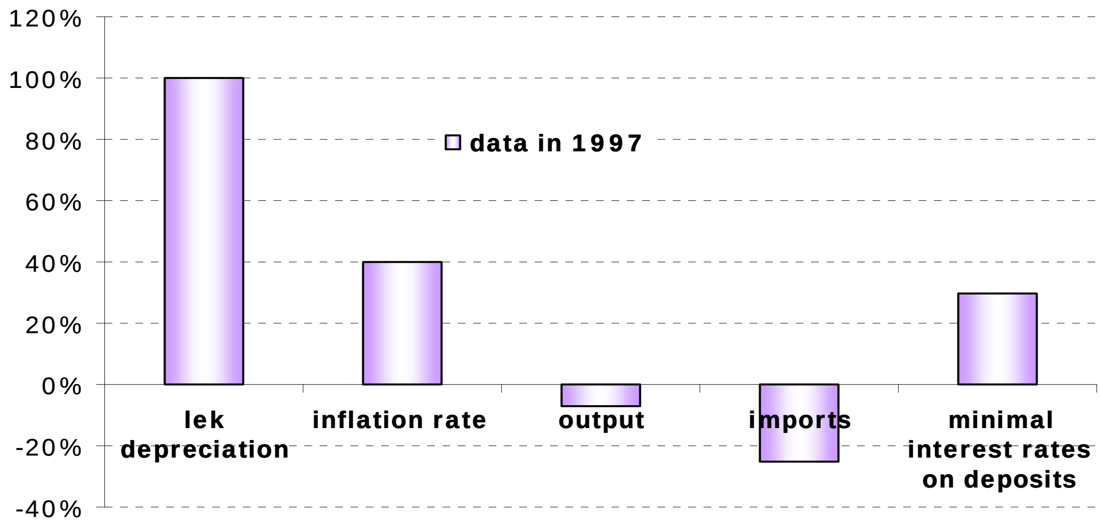
Pre-1997, the banking sector was unable to effectively function in terms of financial intermediation. Private banks, which consisted of six small foreign or joint ventures banks, were mainly focused on foreign exchange transactions and trade financing. State-owned banks were engaged in domestic lending but they operated as state agencies with soft budget constraints and failed to implement prudent lending practices. Most financial activities took place outside the licensed financial institutions, in the informal financial market or that of pyramid schemes. The appearance of Albania's pyramid schemes can be attributed to several factors, including the limited level of financial intermediation; Albanians' unfamiliarity with financial markets; and the deficiencies of the country's formal financial system, which encouraged the development of an informal market. The state-owned banks that dominated the deposits market by about 90%, performed restricted banking operations. Another important factor for the widespread appeal of pyramid schemes was the low level of the payments system. There were also governance problems, both in the financial sector and more generally in the market. The regulatory framework was inadequate, and it was not clear who had responsibility for supervising the informal market.

This informal loan market was composed either by the non-licensed exchange dealers of the exchange market or by the companies that collected deposits (mainly savings and remittances from emigrants) and made loans with them which were illegal because they were not licensed for collecting deposits. The interest rates supplied by these companies for the deposits increased to 6-8% per month, but stood below the loan rates.

The high interest rates led to large deposit inflows in the counters of these firms while their investment in production and securities was minimal, as compared to the amount collected. Other firms that had borrowed at high interest rates started to make mutual investment without lending to others. In this way, they turned into pyramid firms. The absence of a proper legal operating framework was one of the main causes of pyramid schemes' development and the 1997 financial crisis. Soon, the informal market reached a vast magnitude and the IMF and the World Bank expressed their concerns about the expanded activities of such firms. The collapse of the first pyramid firm in January 1997 shook public confidence in companies and new deposits dried up. The Bank of Albania began to limit daily withdrawals from bank accounts in an attempt to prevent other schemes from emptying their accounts. In February, the Parliament passed a law banning pyramid schemes. By March 1997, Albania was in financial, political and social turmoil.

The closest analogy to such schemes is asset bubbles, whose impact is due to changes in perceived wealth. As a bubble expands, people believe themselves to be better off than they actually are, and their demand for goods and money increases, leading to deterioration in the country's external current account and acceleration in inflation (see Chart 2).

Chart 2: Economic indicators performance in 1997



Source: Jarvis (2000).

Large parts of the country were no longer within the government's control. Government revenues collapsed as customs posts and tax offices were burned. The collapse of the schemes seems to have had a major short-term economic impact, but the most damaging effects came from the civil disorder it precipitated. Output fell by about 7% in 1997, with most of the decline being due to interruptions in production during the civil disorder. The increase in the inflation rate to more than 40% in 1997 was attributed almost entirely to the depreciation of the lek and the sharp rise in the fiscal deficit caused by the loss of government revenues during the period of civil disorder. Recorded imports fell by more than 25%, reflecting not only the loss of savings but also the disruptions to trade.

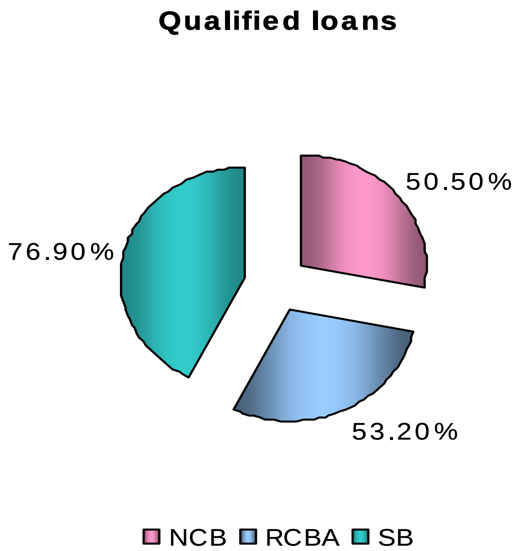
The collapse of these schemes had a measurable effect on the structure of the banking sector. In 1996, one year prior to their collapse, the three state-owned banks still maintained virtual control of the banking system, even though five foreign banks were operating in Albania. These three held 93.84% of banking assets, with the National Commercial Bank (NCB) accounting for 53.6%, and made 91.3% of all loans, with each of three having around 30% of this market. Deposit collection was even slightly more concentrated than lending with the top three holding 96.8% of both total and household deposits. With respect to total deposits, the NCB held 58% (up slightly from 1993) and the Savings Bank (SB) held 32.5% for a combined share of 90.5%. With respect to household deposits, the SB held 64.5%. Although lending was more equally divided among the three and the SB had lost some of its monopoly over individual deposits to the NCB, the Albanian banking sector was still severely segmented in 1996.

Bank assets as a share of GDP had climbed back to 45.3% but government securities had taken an even more important place on the balance sheets of the Albanian banks accounting for 38.9% of all bank assets. Just prior to the collapse of the pyramid schemes, bank loans were still a very small percent of GDP (4.9%), somewhat less than the 1993 figure while individual deposits were 14.1% of GDP. Of the total bank loans extended, one-third was classified as qualified in 1996. The effect of the financial fallout from the pyramid schemes and the crisis at the Rural Commercial Bank was apparent in the aggregate data for 1997. The SB was the major benefactor of this flight to security as individual deposits grew in real terms by 114.5% in 1997 after having fallen by 21.6% in 1996.

Even more dramatically, the SB's share of all Albanian banking assets more than doubled to 66.2% from 32.2% in 1996 due to the increase in its deposit base. By 1997, the SB was holding 51.8% of its assets and 80.5% of its individual deposits in government securities. After the pyramid collapse, the SB took over the dominant role in banking from the NCB and was operating basically as a narrow savings bank providing a safe haven for individual depositors.

On the other side of the balance sheet, qualified loans increased by 57.4% in 1997 to become 60.2% of total bank loans or about 2.8% of GDP. By 1997, the percentage of loans qualified in the portfolios of the three major state-owned banks stood at 53.2% for the RCBA, 50.5% for the NCB and 76.9% for the SB (see Chart 3). Already in serious financial trouble, the RCBA was downsized with its assets cut by almost one-half and its loans decreased by over three-quarters in 1997. The RCBA was closed at the end of 1998 leaving only the SB and the NCB to be the two remaining state-owned banks in Albania at the beginning of 1999.

Chart 3: Percentage of loans qualified in the portfolios of the three state-owned banks



Source: ERBD Transition Report (2000).
Abbreviations: (NCB)-National Commercial Bank; (RCBA)-Rural Commercial Bank of Albania; (SB) - Savings Bank.

One of the most important factors that reduced the negative consequences of the crisis was the decision taken by the government not to compensate the creditors from the state budget. Since mid-1997, the new government began to dismantle the pyramid schemes, with assistance from the donor community, and together with the Bank of Albania, indicated their full commitment to implement a comprehensive reform programme for the banking sector. In this context, the central bank suspended the extension of loans for those with bad loans over 20% and increased the minimal annual interest rates on deposits to about 30%. These measures improved the banks' portfolio and deposits began to increase again. This favourable development reflected the restoration of public confidence in banks and ensured that banks had sufficient liquidity for purchasing treasury bills and increasing private sector credit.

One of the important measures for solving the crisis was the deepening of structural reform in the banking system. The Rural Commercial Bank of Albania (RCBA) was liquidated chiefly as the result of the increase in bad loans which reached the abnormal level of 90%. Part of the RCB's assets were transferred to the Savings Bank, while the highly uncertain assets were transferred to the National Commercial Bank (NCB) and the Agency of Treating the Loans (the latter was established for treating the bad loans granted by the state-owned banks). The Trade Commercial Bank was privatized, while the Savings Bank entered into the privatization preparation process.

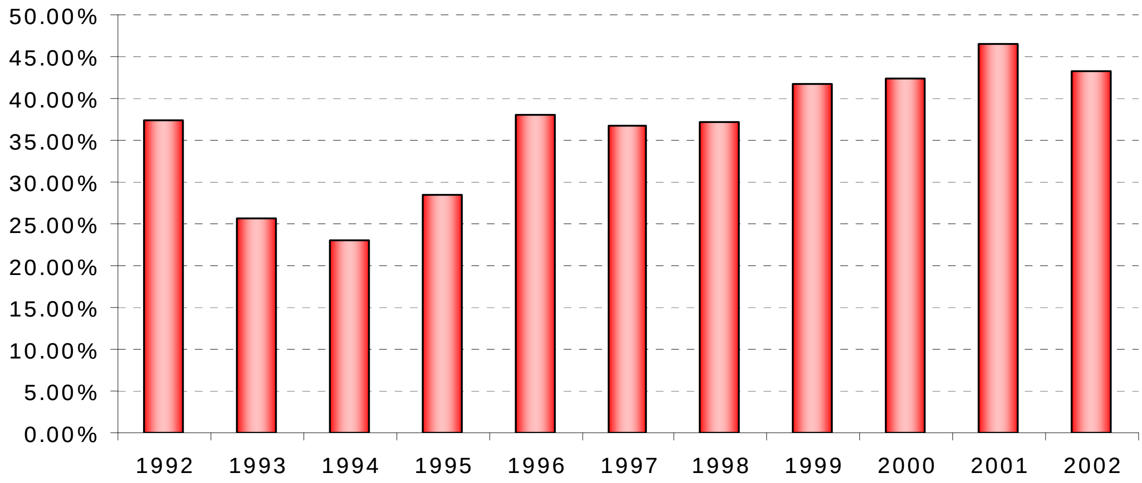
3.3. Second period, 1997-2002: unsustainable development

During this period macroeconomic stability was quickly restored and the structural reforms made progress regarding the deepening and finalizing of private and public enterprises. Initially, the stabilisation policies pursued after 1998 increased the interest rates and the consequent public response led to a significant decline in inflation to 8.7% at the end of the year. Monetary and fiscal policies performed well and the deepening of reforms led to an average annual increase of GDP by 7.4%. Inflation dropped to 3.5% in 2001.

The structural reforms in the financial sector were closely related to the privatization of the state-owned banks and the entry of new private banks, which helped to deepen financial intermediation and increased the quality of the banking services. The first characteristic of these developments was the rise in the number of newly operated private banks, which reached 14. In 1997 another bank was licensed with totally foreign capital, namely the International Commercial Bank, while in 1998 the American Bank of Albania and the Tirana Branch of the Alpha Bank were licensed. In 1999, three other banks started operations, namely the First Investment Bank, the Inter-Commercial Bank and the Fefad Bank, while in 2002 the Albanian Credit Bank, a foreign private bank, was licensed. The dominance of foreign private banks (only the Savings Bank remained with state-owned capital) was the main feature of the Albanian banking system during this period. In 1999, the share of the state-owned banks was 37.3% while that of foreign private banks stood at around 62.7%.

Financial intermediation was further deepened reflecting the positive trend of banking sector development. As seen in Chart 4, the ratio of total deposits to GDP, which shows the depth of the country’s financial intermediation, was increasing during the whole transition period, especially following 1998, reaching 47.9% in 2001. The same positive trend is shown by the ratio of time deposits to GDP; it increased from 12.8% in 1994 to 29.3% in 1998 and 38% in 2001.

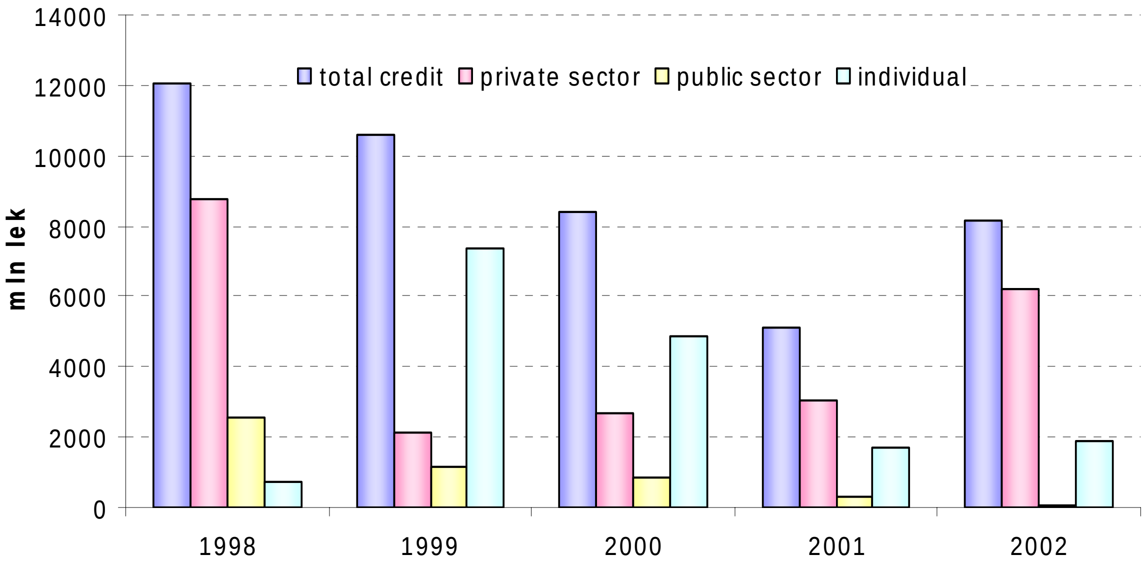
Chart 4: Bank deposits as % to GDP



Source: Bank of Albania.

Another characteristic of these favourable developments is the improvement in the credit market. Key features were the continuous increase of the private sector credit (see Chart 5) and the reduction of the bad loans to total credit (NPL) which reached the low level of 7.4% in June 2002, compared with 35.5% in 1998. By the end of 2002, the improvement in the banking system was apparent, as evaluated by performance indicators such as the quality of the bank assets, capital adequacy, liquidity indicators and bank gains (see Table 3 in the appendix).

Chart 5: Bank lending to the domestic economy, 1998-2002



Source: Bank of Albania.

In March 2002, the country's economy was confronted with a deposit panic (see Table 5 in the Appendix). It was a tizzy event for the Albanian financial sector and, more importantly, for the banking system. The panic started and expanded mainly in the Savings Bank, the country's largest bank, which was on the eve of its privatization and to a lesser extent in the National Commercial Bank, the country's second largest bank. Deposit outflows from these two banks reached 12 billion lek in March and 9.4 billion lek in April, at a time when the Savings Bank held 96.3% of these deposits, thus reducing the bank's weight in the banking system from 59.2% at the end of 2001 to 56.6% in April 2002. Asymmetric information had a significant impact on the formation of inaccurate public expectations.

The 1997 experience made people quite sensitive to the risk of losing their deposits. However, they addressed the banks, especially the state-owned ones, to deposit their savings. In this context, the interweaving of two events, that of offering the Savings Bank for privatization and the approval of the deposit insurance law, interlaced further with political factors, shocked public confidence in banks and led to a massive deposit withdrawal. In other words, the preparation of the Savings Bank for privatization, the lack of political stability internally and the approval of the deposit insurance law encouraged public uncertainty leading to a bank panic.

The deposits crisis adversely affected the real economy since money withdrawals were associated with an increase in the currency of banks, a strengthening of the inflationary pressures and the creation of liquidity problems for the second tier banks. Under these conditions, the Bank of Albania intervened. Acting as a lender of last resort, repo and fortnight deposits were given up, using largely the reverse repo instrument, Lombard loan and the overnight loans to inject liquidity in the market. Another measure taken by the central bank was to increase the repo interest rate to 1.5% which induced the banks to increase deposit rates. Other measures like interventions in the foreign currency market or the public educational campaign helped in overcoming the crisis. The deposit level was eventually replaced.

3.4 Third period, 2002-2007: Financial development and stability

Starting from 2000 the Bank of Albania has been engaged in implementing a new regime of monetary policy, namely, the inflation targeting regime. It has been preparing all the procedures and preconditions for a full implementation of this regime in the near future. Financial stability was an important precondition. Both macroeconomic and financial stability help in satisfying the main objective that a central bank has, that of price stability.

During 2003, the banking sector was developed further. The entry of two new banks (i.e., the Albanian Credit Bank and the Credins Bank) as well as the preparations for the privatization of the Savings Bank promised an increase in productivity and competition in the banking system. Its good performance was evaluated by the EBRD in 1998 and 2003 on the basis of the Index of Banking System Reform. The Index for Albania was classified in the interval [2.0;2.3] which means that "*there has been progress in establishment of bank solvency and of a framework for prudential supervision and regulation*".

In 2004, banks' assets increased at around 14.1%. A new domestically-owned bank was licensed, i.e. the Popullore Bank. Credit and the portfolio of securities experienced considerable growth; in the meanwhile, private deposits increased the banking system funds by ALL 44 billion.

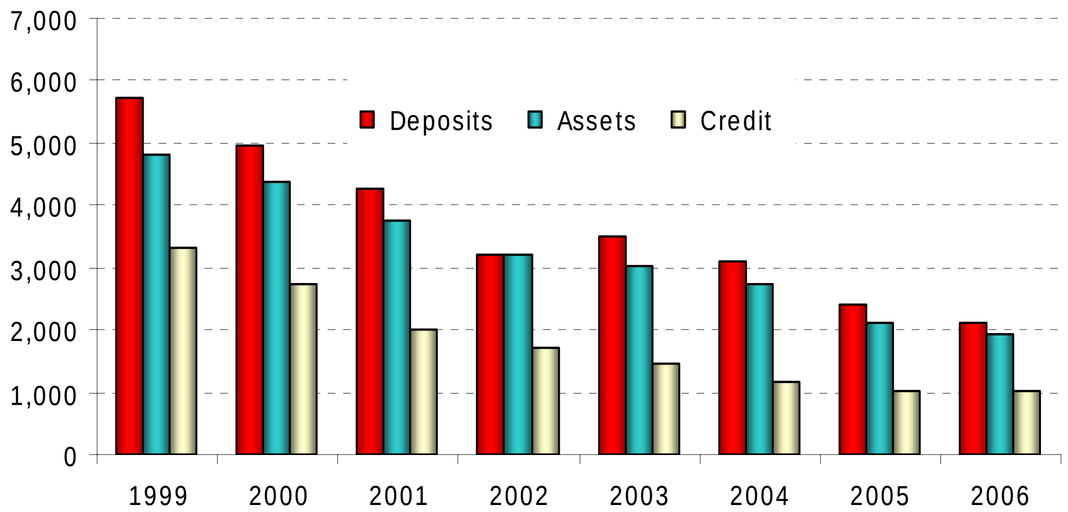
At the same time, the privatization process of the Savings Bank was finalized and in August 2004 all capital shares were transferred to the Raiffeisen International

Bank AG. As a result, the ownership structure changed: "the domestic state capital" weight was sharply reduced to 6% from 32.1% by the end of 2003 and "the domestic capital" weight was counted at 12.7% compared with 35.1% in the previous year. Whereas, the foreign capital weight increased considerably to 87.3%, compared with 64.9% in the previous year, as the result of the high capital share of the Raiffeisen Bank. The effect of the Popullore Bank was reflected in the weight of the domestic paid capital which increased to 15.3% relative to 15.1%. The privatization of the Savings Bank changed banks' classification criterion (the G1 group included state-owned banks, G2 joint ventures and G3 privately-owned banks). They are currently classified based on the size of the banks' assets. Therefore, the first group (G1) includes banks with weights under 2% of the total assets, the second group (G2) includes banks with weights between 2 and 7% and the third group (G3) includes banks with weights of over 7%.

During the last three years the Albanian banking system has been characterized by important structural developments: an increase in the number of operating banks, the establishment of domestically-owned banks, and, more recently, the entry of powerful foreign banks through acquisitions of the existing ones. Consequently, the Albanian banks are now operating in a dynamic environment and are making efforts to be better positioned in the market. Foreign banks have thus stimulated foreign direct investments in the country. The SanPaolo IMI Group (Italian capital), the Société Générale Group (French capital) and Piraeus Bank Group (Greek capital) are the most powerful. Actually, Greek foreign banks assets take around 23% of the total bank assets. Table 6 in the Appendix shows detailed information for the banks that currently operate in Albania.

To sum up, the Albanian market is considered to be highly concentrated in terms of assets and deposits, while it is moderately concentrated, close to perfect competition, in terms of lending. Chart 6 presents the Herfindahl-Hirschman (HHI) concentration index, estimated for assets, credit and deposits.

Chart 6: Herfindahl-Hirschman (HHI) concentration index



Source: Bank of Albania.

The merging process between the Italian Albanian Bank and the American Bank of Albania is worth mentioning since it is the first example of a merger that the country experiences. Both banks have been operating in Albania since 1998. From January 2008 they operate under a common name, that of the American Bank of Albania, thus reducing the number of the operating banks and consolidating the system further. It is also worth mentioning that very recently (on 3 January 2008) the Bank of Albania established the Credit Registry, a useful measure for ensuring the quality of credit portfolio and banks' effectiveness, by abstracting detailed information regarding the commercial banks' customers.

Currently, the Bank of Albania, as the supervisory authority, monitors the business performance of 16 commercial banks, 7 non-bank financial institutions specialized in lending and money transfer services, 2 unions of savings and credit associations and 58 foreign exchange bureaux. The supervision of the remaining financial institutions, i.e., insurance companies, pension funds and securities companies, is conducted by the Albanian Financial Supervisory Authority (AFSA). This institution was established in 2006 to consolidate the regulatory and supervisory functions of financial non-banking activities, which were previously carried out by the

Insurance Supervisory Authority, the Albanian Securities Commission and the Inspectorate of Supplementary Pensions Private Institutes. The protection of consumers' interests, the promotion of sustainability, the transparency and the reliability of non-banking financial institutions as well as ensuring law enforcement are the key objectives of the Authority. The insurance market is the largest and the most developed one in the non-banking domestic financial sector, whereas securities and private pensions markets are in their infancy. It has recently experienced a positive development trend and presents a large potential in terms of quality and quantity expansion.

These favourable domestic macroeconomic developments accompanied by a fast growing banking sector have facilitated solid growth of non-banking financial markets in a relatively short time interval. The non-banking financial market is comprised of 11 insurance companies, 3 private pension funds and 6 brokers (banks) operating in the secondary government debt securities market. The pensions' system is, however, underdeveloped compared to the other countries in the region. It is based on a state funded pillar, which is otherwise recognized as a Social Insurance Scheme (PAYG or, Pay-As-You-Go System). The existence of pension's third pillar is still at an early stage. Regardless of the adoption of the Law on Supplementary Pensions and Private Pensions Institutes during 1995, the activity of the initial companies in the area of private pension began only in 2006. At the same time, the securities market offers trading in the primary and secondary markets of the government debt instruments only, while the stock market remains underdeveloped and is limited mainly in the informal exchange market registered in the Albanian Share Register. The stock market also remains the most underdeveloped sector of the securities market in Albania.

Nowadays, bank assets make up to 90% of the financial market assets and around 60% of the Albanian GDP. These figures clearly demonstrate that the domestic financial system is strongly bank-dominated.

4. Future Perspectives

We conclude that the financial sector has converged towards a bank-based system, which is largely foreign-owned with a strong presence from EU financial institutions. By contrast, the non-banking sector, the security and stock markets are limited. The presence of foreign banks is associated with a more stable lending environment and risk management, which has been supported by the process of convergence of domestic banking supervisory standards to the EU regulatory framework. An important challenge for the future is the country's financial integration as it might be a potential candidate in the EU accession process. Therefore, Albania has to be strongly prepared for its EU membership in every sector of its economy.

On June 12, 2006 the Republic of Albania signed the Stabilization and Association Agreement (SAA) with the European Union. We recall that the functional existence of a market economy, as set out in the Copenhagen Criteria, requires a well developed financial sector which sufficiently channels savings towards productive investments. The establishment of an internal market in the area of financial services aims at the removal of any discriminatory treatment with regard to the establishment and provision of financial services within the territory of the EU. The removal of barriers between member countries aims at increasing competition among national markets in financial services and reducing the price of these services. Based on the relevant SAA provisions, banking and financial institutions can pursue their business in the territory of Albania or that of the EU, through the right of establishment and the freedom to provide services. The Agreement also focused on priority areas related to the *acquis communautaire* in the fields of banking and financial services. The parties will cooperate with the aim of establishing and developing a suitable framework for the encouragement of the above-mentioned sectors in Albania. This cooperation will focus on the operational aspects of improving the financial sector, as well as the supervisory framework, and will include the offering of technical assistance and training.

Challenges for the future relate to the full adoption of international standards of good governance. Risk assessment capacities need to be strengthened, in face of risks arising from market openness and increasing competition. Moreover, the process of harmonization and approximation with the EU legislation is an enormous task. Last but not least, consistent communication with the financial market can create better incentives to cope with the future challenges successfully.

5. Conclusion

The financial system and especially the banking sector are viewed as very important as they serve as a catalyst for a country's economic development. The Albanian financial system has experienced considerable changes during the last decade with respect to legal improvements, regulating framework and service quality reflecting the situation of the economy and responding to its needs.

Banking system reform is part of the economic reform initiated in 1992. Albania's government, assisted by specialists from the IMF and the World Bank, prepared a two-tier banking system to be governed by laws imposed on central and commercial banking. The Albanian financial system had the experience of abnormal episodes during the transition decade, the 1997 pyramid crises and the 2002 deposit withdrawals. Both events were the result of the backward system inherited from the socialist system, reform sluggishness, insufficient public education on the banking system and unfavourable political developments.

The deposit crises harmed the real economy since money withdrawals were associated with an increase in the currency of banks, inflationary pressures and the creation of liquidity problems for second tier banks. Important action for coping with the crises was the intensification of the structural reforms in the banking system, closely related with the privatization of the state-owned banks and the entry of new private banks.

The decade from 1992 to 2002 mainly focused on the preservation of macroeconomic stability. Starting from 2000 the Bank of Albania has been engaged in implementing a new monetary policy regime, i.e. an inflation targeting regime, and it has been preparing all the procedures and preconditions for a full implementation in the near future. One important precondition is financial stability. Both macroeconomic and financial stability preserve the ultimate objective of a central bank, which is price stability.

During the last three years, the Albanian banking system has been characterized by important structural developments, such as the increased number of operating banks, the establishment of domestically-owned banks, and more recently, the entry of powerful foreign banks through acquisitions of the existing ones. Banks are now trying very hard to be better positioned in the market.

Currently, the Bank of Albania, as the supervisory authority, monitors the business performance of 16 commercial banks, 7 non-bank financial institutions specialized in lending and money transfer services, 2 unions of savings and credit associations and 58 foreign exchange bureaux. The insurance market is the largest and most developed market in non-banking financial sector, whereas the securities and private pensions markets are in their initial development stage.

The EU accession and the possibility for adopting the euro in the future, the implementation of the new Basel II treaty, the strengthening of the regulatory framework and improved financial performance are some of the future challenges that the Albanian banks have to face. More importantly, the consistent communication with the financial market industry will create better incentives to cope with the future challenges successfully.

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Appendix

Table 1: Selected Albanian Economic Indicators, 1992-1997

Indicators	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Nominal GDP	50,697	125,334	184,393	229,793	280,998	341,716
Real GDP	11,235	12,309	13,331	15,106	16,478	15,324
GDP per capita in USD	211	381.5	610.8	737.8	808.9	684.0
Real GDP increase in %	-7.2	9.6	8.3	13.3	9.1	-7
CPI annual change in %	236.6	30.9	15.8	6	17.4	42.1
Money supply (M3) mln ALL	28,771	50,355	70,774.9	107,449.1	154,552.5	198,547.0
Money supply growth %	-	109.7	40.6	51.8	43.8	28.5
Remittances mln USD	-	325.8	377.9	384.6	499.6	266.9
Credit to the domestic economy (mln ALL)	-	-	9686.0	11440.0	15835.0	16315.0
Credit to the private sector (mln ALL)	-	-	7201	8347	10890	12995
Total deposits (mln ALL)	-	-	44,455.70	65440.9	103935.2	122891.5
Money market interest rate (TB 6M) in %	-	-	12.1	14.9	22.3	34.5
Exchange rate (ALL/USD)	75.03	102.06	94.68	92.79	104.5	148.93
Internal reserves + gold (mln USD)	37.1	152	208.6	265.3	322.6	341.7

Source: Bank of Albania.

Table 2: Macroeconomic Indicators from 1999-2006

Indicators	***1999***	***2000***	***2001***	***2002***	***2003***	***2004***	***2005***	***2006***
Real GDP growth (in %)	13.2	6.5	7.1	4.3	5.7	6.2	5.6	5
GDP (current prices, mln USD)	3,548	3,694	4,102	4,459	5,600	7,453	8,383	9,137
GDP per capita (USD)	1,143	1,212	1,339	1,456	1,884	2,341	2,620	2,911
Unemployment rate (%)	18.2	16.8	16.4	15.8	15.2	14.4	14.2	13.8
Inflation rate (%)	-1	4.2	3.5	1.7	3.3	2.2	2	2.5
Budget deficit (% of GDP)	-12.1	-8.2	-7.9	-6.6	-4.5	-5.1	-3.6	-3.1
Public debt (% of GDP)	69.7	71.3	66.8	65.3	61.7	56.6	56.7	55.9
External debt (% of GDP)	32.3	29.4	25.8	23.5	20.6	18	17.5	17.2
Current account (% of GDP)	-8.5	-7	-6.1	-10	-7.9	-4.8	-7.3	-7.6
Average exchange rate (lek/usd)	137.7	143.7	143.5	140.1	121.9	102.8	99.9	98.1
Average exchange rate (lek/euro)	147	132.6	128.5	132.4	137.5	127.7	124.2	123.1

Source: Bank of Albania.

Table 3: Banking System Performance Indicators

Indicators	*Dec.04*	*Dec.05*	*Dec.06*	*Dec.07*
Capital adequacy %	21.6	18.57	18.1	17.08
NPL (Gross)/Total loans %	4.2	2.33	3.05	3.36
ROE	21.1	22.24	20.2	20.74
ROA	1.3	1.40	1.36	1.57
Customer deposit/Total loans %	535.8	342.48	265.5	215.45
Foreign currency loans/Total loans	80.5	75.54	71.9	72.53

Source: Bank of Albania.

Table 4: Selected Indicators of Growth and Profitability, 1997-2006

Year	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*
No of banks	9	10	13	13	13	14	15	16	17	17
State-owned banks	3	2	2	1	1	1	1	0	0	0
Foreign-owned banks	6	8	11	12	12	13	13	14	14	14
Domestic banks	0	0	0	0	0	0	1	2	3	3
Assets/GDP (%)			49.2	50.2	53.5	51.6	50.2	51.9	59.3	69.4
Assets growth rate (%)				8.6	17.9	6.3	10.1	14.1	16.4	25.7
Assets/GDP growth rate (%)				2	6.6	-3.6	-2.7	3.4	14.3	17
Loans/GDP (%)			8.1	5.2	4.7	5.9	6.8	8.5	15.3	21.9
Loans/Assets (%)			16.4	10.4	8.9	11.5	13.6	16.4	25.7	31.5
Loans growth rate (%)				-31	0.2	37.7	30.5	38	82.1	54.1
Deposits/GDP (%)			42.3	43.2	46.5	44	44.5	45.7	52.3	58.4
Deposits/Assets (%)			85.9	86.1	86.9	85.2	88.7	88.1	88.1	84.2
Deposit growth rate (%)				8.7	19.1	4.1	14.7	13.4	16.4	20.1
Return on Assets (ROA) (%)		-1.8	0.5	2.1	1.8	1.2	1.2	1.3	1.4	1.4
Return on Equity (ROE) (%)		-82.3	15.7	20.6	23.4	19.2	19.5	21.1	22.2	20.2

Source: Bank of Albania.

Table 5: Deposits' Performance during the Great Panic

Deposit balance (mln lek)	Dec.'01	Jan.'02	Feb.'02	Mar.'02	Apr.'02	May.'02	June.'02	Jul.'02	Aug.'02	Sep.'02
Savings Bank	176,980	180,590	180,407	167,425	157,925	156,700	157,525	158,097	159,886	162,301.1
Alpha Bank	9,287.31	9,558.95	9,744.32	9,648.56	9,586.27	10,098	10,188	10,275	11,760	12,144
American Bank of Albania	17,938.1	19,369.5	19,418.4	20,089.4	21,005.0	21,671.1	21,878.9	22,285.3	23,411.2	23,717.0
Arab-Albanian Islamic Bank	802.1	855.5	843.8	866.9	844.7	961.0	1,079.32	1,402.05	1,210.33	1,198.34
Dardania Bank	218.4	169.9	183.5	269.9	187.6	185.8	321.4	154.5	334.3	153.3
FEFAD Bank	6,802.0	7,018.2	7,204.9	7,284.9	7,587.6	7,531.6	7,580.5	7,614.4	7,930.0	8,398.2
First Investment Bank	169.6	952.2	938.7	658.7	211.8	209.0	222.9	210.2	652.8	790.7
Albanian-Italian Bank	12,484.9	12,597.2	12,437.7	12,449.5	12,180.9	12,810.6	12,439.3	12,510.0	12,831.5	12,813.4
National Bank of Greece	6,870.0	6,946.7	6,943.9	6,934.0	6,915.0	6,982.6	6,976.0	6,965.8	7,077.9	7,382.8
International Commercial Bank	28,500.0	28,139.0	28,517.0	26,124.5	25,985.1	25,856.3	26,077.5	26,561.4	27,320.7	28,056.6
Commercial Bank of Greece	1,007.6	1,045.2	951.9	1,055.3	1,031.0	995.5	989.1	1,057.0	1,089.1	1,112.1
Tirana Bank	15,013.3	15,735.5	16,134.1	16,152.1	16,707.8	17,661.4	17,966.9	19,426.8	20,125.0	19,730.5
Banking system	277,817.93	284,582	285,545	270,700	261,873	263,311	285,082	268,309	275,361	279,626
Banking system without SB and NCB	72,337.86	75833.462	76620.09	77151.15	77963.46	80754.51	81479.68	83650.72	88153.69	89268.03

Source: Bank of Albania.

Table 6: Banks in Albania

No.	Name	Year of entry	Country of origin	Mode of Entry
1	Italian Albanian Bank (IAB)[1]	1993	Italy	Greenfield
2	Italian Development Bank (IDB)	1994	Italy	Greenfield
3	United Bank of Albania (UBA)	1994	Arab	Greenfield
4	National Bank of Greece (Tirana Branch, NBG)	1996	Greece	Branch
5	Tirana Bank (TB)	1996	Greece	Greenfield
6	International Commercial Bank (ICB)	1997	Malaysia	Greenfield
7	Alpha Bank-Albania	1998	Greece	Branch
8	American Bank of Albania (ABA)	1998	USA	Greenfield
9	Emporiki Bank (Albania) (EB)	1999	Greece	Subsidiary
10	First Investment Bank (FIB)	1999	Bulgaria	Subsidiary
11	Procredit Bank (PCB)	1999	Germany	Subsidiary
12	National Commercial Bank (NCB)	2000	Turkey	Subsidiary
13	Credit Bank of Albania (CBA)	2002	Kuwait	Greenfield
14	Credins Bank	2003	Albania	Greenfield
15	Raiffeisen Bank (RZB)	2004	Austria	Subsidiary
16	Popullore Bank[2]	2004	Albania	Greenfield
17	Union Bank	2006	Albania	Greenfield

Source: Bank of Albania.

Box 1. General characteristics of the Albanian Financial System: a brief presentation

Financial intermediation remained low during the first decade of transition, mainly due to the low amount of household deposits caused by financial turbulence in Albania during the 1990s. During recent years the level of financial intermediation increased significantly due to an increase in customer's confidence in banks, the adequate legal protection of lenders and the introduction of modern credit risk management techniques (e.g. stress testing techniques etc). As the level of financial intermediation is closely related to general economic growth and credit expansion is expected to grow rapidly in the following years, economic growth is expected to be also at high levels.

Banks ownership structure: The main feature of the Albanian banking system has been the tendency for the asset share of state-owned banks to diminish and the market share of private foreign banks to rise through the privatization process. In this context, competition becomes increasingly a feature of the banking market. The entry of foreign banks is very important, since they introduce diversified products and services and a high level of technology.

The deposit market: Deposits have grown continuously and at a satisfactory rate. Their growth rate fell only during the time of pyramid schemes. Till 1996, a main feature of the deposit market was its segmentation, as three state-owned banks effectively dominated the total market. During recent years, market structure has changed with the increasing participation of private banks.

The credit market: Despite the dominance of informal cash-based transactions, the banking system is growing and credit growth is booming. The credit expansion has been funded by broader deposit-taking as more remittance income has been intermediated. The main risk of this market has been the low quality of loan portfolio. During the last years different measures have been taken to improve the banking system asset quality.

Bank capitalization: The **c**apital adequacy ratio has improved. The banks operating in Albania are on average well capitalized, with the solvency ratio above the regulatory minimum of 12%.

Bank profitability: It has improved significantly due to the reforms made (i.e., privatization of banks, the application of modern techniques in banking and credit expansion).

Bank liquidity: The Albanian banking system is highly liquid, with liquid assets at a high 75% of total assets.

Other sectors of the Albanian financial sector: Banks dominate the financial sector with around 96% of all financial intermediaries' assets. The non-bank sector remains relatively small as a consequence of its early stage of development and the lack of understanding of financial products and services. The insurance industry is small compared to those in other South Eastern European countries. Total premium income presents only 0.5% of GDP and total assets around 1% of GDP.

[1] From January, 1st 2008, the Italian Albanian Bank operates under the name of the American Bank of Albania due to the merging process (San Paolo IMI Group). There are 16 banks which forms a more consolidated system.

[2] Popullore Bank is classified as a French capital bank after the sell of its shares to Société Generali Group.

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