

## THE ALBANIAN FINANCIAL SYSTEM AND THE ROLE OF THE INTERMEDIATION INSTITUTIONS

---

*Sherif Bundo\**  
*Edlira Luçi\*\**  
*Gentiana Cane\*\*\**

The topic of the level of development of the financial system as well as its role in the acceleration of the economic development remains always present and open to discussions among the Albanian economic circles. Currently, our economy experiences a relatively high rate of economic growth. As a new market economy, it is passing from the phase of birth into the phase of growth. In addition to the characteristics and difficulties of the present phase, our economy carries as well development potentials having not been exploited yet. The financial system is undoubtedly the catalyst or to be more exact, the laboratory where economic developments take an appropriate form and shape. The role of the economy cannot be exaggerated and identified to the role of the financial system of a country, but at the same time, the very relevant role of the financial system in the development and prosperity of the national economy can neither be neglected nor be reduced. There exists an important postulate in the theory of finance on the role of the financial system: The level of development and the role of the financial system in the economy defines the economic development stage of a country. Hence, based on the level, role and influence of the financial system on the economy, three stages can be identified with regard to the economic development. The first stage is the empirical one. Undeveloped financial institutions as well as an undeveloped financial system characterize this stage. It belongs to the natural economy and to

the low levels of economic growth and development. The low speed of the capital and rent circulation is another relevant feature of the empirical stage of the economic development. According to the recent Nobelists in the field of finance, an economy finds itself at the empirical stage of its development when the financial and banking sector is dominated by the cash economy. The second stage is the credit economy. During this stage, the role of the financial intermediation and credit institutions – mainly of banks – increases very much. The banking activity represents an important direction in terms of the transfer of resources and funds. By the intermediation of banks, the financial system becomes more active. The entities that have surplus in resources and funds transfer them to the deficit entities. As a result, the level of economic development accelerates and alongside with that, the national wealth also increases. The third stage is that of the financial markets. The financial intermediation institutions improve themselves to the extent that besides the liquidity intermediation institutions, the intermediation institutions for financial rights also develop. During the stage of the financial markets, the economy operates on the basis of the invisible money – the electronic money, whereas the titles and capitals are transferred and invested regardless of the national borders and without any quantitative or time limits. In the economy of the financial markets, the financial system shows the characteristics of infinite connections, transactions, relations and exchanges in financial flows and money, operations and national institutions, which form a chain of subsequent spiral and closed transactions. Only when conceptualized as a whole thing, these elements give a meaning to the financial system.

After this short theoretical presentation (we hope to have not been so worrisome and annoying), the fantasy of the economists and finance specialists requests an answer to these questions: Which is the level of development of our financial system at present? How much is its role felt in the acceleration of the economic development in the country? How are the relations of the various components of the financial system and to what extent do they operate in a harmonized manner in the context of the whole national economy? Further, what are the directions where suggestions are made with regard to investments aiming at improving our financial system, as well as at modernizing it? How much time will it take to pass from

one stage of economic development to another (and higher) stage? Is our financial system appropriate to the normal communication with the financial system of the other countries of Europe and the world? The fantasy of economists and finance specialists can formulate a series of such present and interesting questions. But it is again this logic and fantasy that allows us to differentiate the segment of interest and the objective of our presentation in this problematic context.

Since we will often use the term 'financial system' hereafter and since we have noted in a few cases that the term 'financial system' is confused with the term 'banking system', let us make it clear that "the financial system is the entirety of the financial markets, the entirety of the financial intermediators, the entirety of the financial services and institutions which render possible the permanent and instant communication between the household finance and the business finance, as well as public finance, without limitation of time, volume and space.

It is evident that the discussion on the financial system and its role in the economic development of our country comprises large spaces. It is also evident that statements and declarations in relation to the answer to the questions mentioned above is not just a matter in which a limited number of specialists should be involved. These topics are always open. Since any contribution is welcome, we are presenting our opinions.

We deemed it interesting to present in four main sections all the problems related to the subject about the Albanian financial system.

#### 1 AT WHICH STAGE DO THE ALBANIAN ECONOMY AND OUR FINANCIAL SYSTEM FIND THEMSELVES?

This is a question that is generally posed by everyone who knows a bit the laws of the economic development and the evolution of the financial system. The magic force of the finance and of the financial system with regard to the acceleration of the economic development and social progress consists in the mysteries related to finance and money. It is only in finance that the proverb 'the water rises higher

than its source' is really meaningful. As a market economy, the Albanian economy is a new one. It also passes through the stages of its life cycle. At the beginning of the 1990s, the market economy and market relations were established at a time when market institutions do not exist at all. As far as financial and monetary aspects are concerned, we can state with conviction that practically the relations between the economy and finance were very weak. The regulatory force of the financial mechanisms and institutions had been replaced by the cash economy. It can unhesitatingly be said that the merchandise market was the first market institution to be established in our country.

Presumably, trade and commerce represent those sectors that can operate under the conditions of absence or limited volume of financing. The role of banks and other financial institutions was visibly very weak. During the first 15 years of the Albanian market, cash reduction has been one of the primary objectives of the Bank of Albania. It means that since many years we have been experiencing the empirical stage of the economic development. An expansion in the crediting system can be observed during the recent periods. Until now, based on three possible sources of the financing of economic growth, it results that needs for the financing of the economy have been mainly supplied by the internal sources of the businesses as well as other sources outside the economy. Despite its upward trend, the intermediation role of banks and the use of long-term credit remain insignificant and below the level of this indicator in the transition economies.

Hence, during these first 15 years of the market, the bank crediting and the financial market have offered limited financing opportunities for the economic growth. The absence of an active financial market and the lack of transactions carried out through this market are facts not to be denied. Without referring to the statistics, these phenomena show that at present, the Albanian economy finds itself at the beginning of the second stage. It is entering the credit stage, a stage in which the role and activity of commercial banks is expected to increase further. The credit/deposit ratio, which ranges from 10 per cent in 2001 to 18.8 per cent in 2004, is the most significant indicator for this conclusion. At the same time, it can be concluded that the

role of the commercial credit – the credit that companies directly grant to each other – is limited. When we state that the Albanian economy is at the beginning of the second stage, this means that it tends to expand the activity and the role of banks, but not that the credit system and institutions have reached their maturity level.

Meanwhile, the role of the financial market remains limited to only some money market operations. The capital market is de facto inexistent. As a result, the rapid growth of the value of the particular assets market or of the enterprises market, during the last 10-15 years, is still an unexploited source, which is practically impossible to be included in the acceleration of the country's economic circulation. There are tens of enterprises that have been acquired, invested in or privatized, enterprises under a rapid growth process, with a multiplied market value, but because of the absence of their evaluation in the capital market, their market value remains unstated. At present, it is represented by a minimized amount registered in the accounting system of the enterprises and in the account of the owner, or at best, of a limited number of co-owners.

## 2 HOW DYNAMIC IS THE ALBANIAN FINANCIAL MARKET?

This discussion and presentation would not be comprehensive if we do not cover the progress of the Albanian financial system during these years of the market economy. Apart from the expansion, reformation and consolidation of the banking system – about which much has been and will be said in this Conference – and apart from the liberalization and the increase of the number of the operators in the property, life and health insurance market, serious and forward-looking steps have been undertaken in relation to the installation and functioning of the savings-credit institutions, stable mechanisms and sound policies in the field of taxes and customs duties in the public finance system are in place, without forgetting the diversification and variety in the organization, functioning and management of the enterprise finance. Being aware that structures are installed and that the foundations on which we expect to establish the needed infrastructure to modernize the financial system are laid down

in our country, further in this presentation we will talk about the intensification of the Albanian financial market.

Firstly, our financial system offers few alternatives for investments, the use of savings and monetary accumulations of various microeconomic entities. One of the primary objectives of the financial system is to render possible through its mechanisms the transfer of the financial power of savings from the pole of households toward the pole of enterprises, which needs funds as long as it experiences the growth stages. In order to achieve this, finance has always created and generated various products. Basically, the numerous financial products of the modern world have only one objective: to offer the households, citizens and family budgets a large number of alternatives for investment. Our economy and financial system are still far away from this objective. They are considered to be poor in their attempts to achieve this. Based on a study dealing with the investment alternatives of households, conducted in our country few months ago, it results that almost 93 per cent of interviewees do not see any alternatives other than the acquisition or construction of a house (when they do not possess one) or the acquisition of a second one when they already have a primary residence. Neither emigrants, nor Diaspora or workers and other categories do see other better alternatives apart from the acquisition or construction of a house. What do shops or small businesses that have been established on a family basis do or what should they do with their savings? What about the very small and small-size enterprises? These facts show the low level of development of the Albanian financial system. They also show the limited opportunities for other entities outside the Albanian economy. This also happened in Europe in the first years after the World War II.

Nowadays, there is a considerable category of workers in Europe who prefer to invest in the Eastern European companies because of high rates of return and limited risk. It is certain that this is rendered possible by the advanced financial systems of the respective countries. We could say the same thing about the inability of our citizens to invest in the economies of other countries. We would conclude that one of the handicaps of our financial system has to do with the fact that personal finance still are not yet integrated into the financial

system. The situation observed in the other pole – that of enterprises – is as worrisome too. The financial system transfers the funds and capitals engaged in one side in order to promote the increase in the technical capitals and the economic assets of enterprises. Its mission is to promote, support and supply with funds new projects and businesses.

Secondly, there is an important principle regarding the organization and management of enterprises, which sees the enterprise as a composition of properties from the point of view of wealth, and as a composition of assets and managerial skills from the point of view of function. In other words, our financial system offers limited opportunities for the establishment, functioning and real progress of the anonymous enterprises. Anonymous enterprises are considered to be real generators of economic development as well as of the fractioning of the property and capital. In order to stimulate this type of enterprises, it is obligatory to create the required conditions for trading capital. We deem that there would be a great number of potential shareholders willing to co-invest in the establishment and financing of large and new enterprises with acceptable return, when led by an anonymous enterprise. Neither citizens, nor small and medium-size enterprises or public entities do possess practically the opportunities to benefit from the merging of funds or from the fractioning of capital. This absence weakens the dynamism of our financial market.

Thirdly, some segments of our financial system are characterized by a substantial lack of credibility. The insurance market in particular still shows the characteristics of an unconsolidated segment of our financial system. We have to do with a financial intermediation on the basis of the risk trading. Insurance companies have based the guarantee of their returns on the large difference of the premium/damage ratio. What risk do they take in those cases where the size of the paid damages does not exceed the degree of 30 per cent of the collected premiums? Does this happen because there are not damages? Does this happen because damages that occur in Albania do not have a high market value? Does this happen because insurance companies that operate in our country have a high level of administrative spending and a high operative scale? We think that

none of the factors mentioned above gives an explanation. What happens in our insurance market is related to the lack of flexibility and ability in the market regulation. Until now, we have to do more with the transfer of funds in the insurance market, but not with the transfer of risks. In fact, their mission implies the transfer of risks. Being insured has not yet become a part of the lifestyle and an obligation for business organization. There is room for the insurance companies and the insurance market to focus on the voluntary insurance rather than the obligatory one.

Regardless of the progress that has been made and the overthrow of the old practices and mentalities, deviations and voluntarism occur in the field of financial relations of business with the state. In some sections of public finance, administrative methods dominate instead of the economic logic and market concepts. This concern becomes even more visible when the fact that a good part of the fiscal administration makes headway at a slower pace than the private sector is taken into consideration. For example, it is not enough to only have a very good law on the income tax or to reduce again and again the income tax rate. From the judicial and economic policy point of view, this marks a progress in an element of the financial system, in the segment of public finance. This progress is transformed into a serious obstacle and handicap when the amount of the earnings and of the income tax is not calculated in a right way, and furthermore, when their evaluation is carried out by weak administrative capacities. This is another element linked to the credibility of the financial market.

Fourthly, one of the most important functions of the financial system is to provide within the necessary time frame and with full transparency the necessary information on the price and costs of capital in an economy. Except for banks, which offer the necessary public information (guaranteed and open for all) on the credit, deposit and T-bills interest rates or on the exchange rate in the other segments of economy, the financial system is not always ready to help the decision-makers in decentralized decision-making and in various sectors of economy. How much have the sale price of houses changed in the last three years! The general public is not informed very much about this. When we say so, we do not intend the necessity of the functioning of state information units and agencies.

We talk about the information that the market provides or should provide itself through the financial system. Despite the changes in mentality, models and accounting practices and despite the changes and progress in the evaluation and legislation systems on accounting, we still think that the accounting information on wealth, activity, rentability, obligations to the state budget and on the other financial transactions within the enterprises is far away from the requirements of the modern world. This level of the service of the accounting information makes the activity and role of the whole financial system inefficient. The more complex the economy appears, the more important the role of the financial system in the economy is. There is a huge number of finance, banking and accounting specialists, which cannot be ignored without being integrated into the requirements for an increase in the role of the whole system.

### 3 THE ECONOMIC GROWTH AND THE SOURCES OF ITS FINANCING IN OUR ECONOMY

Growth is one of the essential parameters as it expresses the content of the economic developments of a national economy and their harmonization with the other elements of social developments. For a few consecutive years, our economy has been experiencing relatively high growth rates. According to INSTAT and Bank of Albania, during the last 9 years, this rate has ranged from 4.7 per cent in the worst case, which refers to 2002, to 12.7 per cent which refers to the year representing the best scenario, year 1998. Growth rates that are approximately at the same levels have been also recorded 2-3 years before the 9-year period covered in this presentation. Year 1997 represents the only exception, since the Gross Domestic Product contracted by 10.3 per cent throughout this year. The economic growth is the result of the increase in the productive capacities, productivity, technology, of the involvement of new capacities or resources in the economic activity, of the improvement of economic communication with the other economies of the region and beyond, of some of these factors or all of them taken together.

The economic growth constitutes a series of measurable instruments. In the balance of national economy it represents an

imagined increase in the assets, which in economic and financial terms have also their own sources of financing. Other researchers have been involved in the analysis of growth and its rate as well as in the analysis of growth in the various sectors of economy and in dynamics over different years. Furthermore, the institutions of statistical service have always focused on growth and its prospects. The Bank of Albania always takes into consideration the relations between the economic growth and the annual inflation rates as well as the other macroeconomic and monetary parameters.

Further, we would like to express our opinion on a new perspective of the economic growth: on the fact that how the economic growth is financed. What are the financial sources that finance the economic growth in our country? Are there the internal financial sources or the external financing sources that promote and accelerate the economic growth in our country? Or do they just accompany the economic developments that take place in microeconomic entities?

First, we may analyze the structure of the national Gross Domestic Product during the last three years (2001-2003), the dynamics of its change and we can systematize some opinions and considerations that are closely linked to the financial sources that support this change and this economic growth.

**Structure of the Gross Domestic Product in the Albanian economy, in percentage**

Nr	Sectors of economy	2001	2002	2003
1	Agriculture	26.0	25.4	24.7
2	Industry	10.8	10.5	10.2
3	Construction	8.3	8.6	9.1
4	Services	45.7	45.9	46.1
5	Transport	9.1	9.6	10.0
	Total	100	100	100

Source: Bank of Albania, Annual Report, 2003 and Ministry of Finance

Based on the data of this table, we would like to highlight some important moments that will assist us in the following analysis.

Firstly, the services sector, where commerce, hotels, restaurants and other services are included, according to the Bank of Albania, has given the biggest specific weight, which means that it makes

the biggest contribution to the Gross Domestic Product. The sales index for this sector increased by 11.5 per cent during the last year (2003), meaning that this sector not only takes the biggest specific weight in GDP, but also gives the biggest contribution in the annual growth of the national economy. The growth of this important sector has been financed from the sources of the private entities that operate in the services sector as well as from bank credit. Based on a detailed analysis of the use of the bank credit over different years and according to the sectors of economy, it results that credits extended by the banking system to the services sector suggest a low trend. The credit balance represents the credit amount that has been used as a long-term source of crediting for the services sector. The growth in the credit balance implies the financing of the economic growth of these sectors. The credit balance in the sectors that constitute the 'services' subsection in the last three years is presented below:

Credit balance at the end of the year, as a percentage of the total credit to the economy

No	Branches of economy Classified in 'services' subgroup	Year 2001	Year 2002	Year 2003	Year 2004
1	Trade, vehicle repairing, domestic equipment	41.3	40.4	34	23.3
2	Hotels and restaurants	4.3	6	6	8.3
3	Transport and telecommunications	4.6	2.4	1	2

Source: Bank of Albania, Annual Report, 2003 and Ministry of Finance

The comparison of the data mentioned above clearly shows the trend that the economic growth in services sector is not based on the growth of credit financing, but on other financial sources. Since in our country financial markets either do not exist or do not operate properly (even though a Stock Exchange formally exists), the financial market does not really participate in the financing of the economic growth in services sector. Thus, it can be admitted that the economic growth in services sector has been generated by the internal sources of the sector, i.e. the self-financing capabilities of the sector. In other words, we can say that in one of the most important sectors of the economy, the growth is not promoted or supported by external financial sources. The same is true also for transport, which gives over 50 per cent of the Gross Domestic Product together with the services sector. These sectors, with this financial position and support, will continue to develop at relatively low pace or at best, will continue to stay at the same level.

Secondly, agriculture, processing industry and construction represent the other sectors with a relevant specific weight in the Gross Domestic Product of our national economy. The growth rate of agriculture, even though it is considered as acceptable, is lower than the overall growth rate, which has in turn resulted in the reduction of the specific weight of this sector to the GDP. The same happens with industry, mainly with the processing and food industry, which is considered as separate from agriculture in the referring statistics, whereas construction experiences an opposite trend, characterized by the growth of its specific weight to the GDP of the national economy.

The financing of growth in these three important sectors, which have been grouped together only for the purposes of this study, also results to have not been financed by the crediting system. In this framework, we should follow the table with the respective data:

Credit balance at the end of the year in some sectors, as a percentage of the total credit to the economy

No	Branches of economy Classified in 'services' subgroup	Year 2001	Year 2002	Year 2003
1	Agriculture, hunting, silviculture	1.0	0.8	1.0
2	Processing industry	19.5	17.0	16.0
3	Construction	12.5	8.6	10.0

Source: Bank of Albania, Annual Report, 2003 and Ministry of Finance

We should accept that either the crediting rates of these sectors of economy have not changed, or that these rates have decreased, or that crediting is much lower compared to the economic growth of the sectors. As the above-mentioned data show, the financing of growth in these sectors has been performed by external factors, by financial sources outside our financial system. It is accepted that the financing sourced from the uncontrolled circulation of funds because of the informal economy, money laundering and immigrants' remittances has been more prevalent. Even though we will speak about it in the following section, it seems that the impact of the two above-mentioned sources has been very significant, particularly in the construction sector.

Thirdly, despite the conclusions stated above, in fact, the use of the commercial credits for the financing of the economy has been

increasing both in absolute terms and in relative parameters. This is expressed also by the increase in the fledgling credit/deposit ratio over years. Here we face a contradictory situation. This has happened because the banking sector has increased its crediting to economy in some sectors and activities that have not a straightforward effect on the economic growth or in some areas that accelerate the economic circulation of the output created in the previous years. The credit granted by the monetary system for the real estate has almost grown thrice over the last 6 years. Such high rates have been also registered in the credit for the so-called collective services as well as for the social or personal services. Growth in the crediting to economy has also been observed in other subgroups, which in fact are not directly identified.

The relations between the use of credit and the economic growth are more comprehensive. We only analyzed the economic growth in the main sectors of national economy as well as the increased use of credit as one of the principal sources of growth financing.

#### 4 ARE THE DIRECTION AND THE PRIORITIES OF THE FINANCIAL SYSTEM HARMONIZED WITH THE DIRECTION AND DEVELOPMENT STRATEGIES OF THE ALBANIAN ECONOMY?

It can certainly be said that the priority sectors of the economy have been clearly defined in the economic development strategies of our country, be them sectoral or of a general character, as for instance the strategy on the economic development and poverty reduction. As a result, besides the support of the state for education, health care and social protection, sectors such as agriculture, food industry, tourism and construction are visibly considered as the priority sectors of our economy. This priority is based on many essential factors such as natural resources and geographic position, the cultural patrimony and tradition, human resources and strategic position. A major part of these strategies have been approved in scientific forums, including the Albanian government. It means that our economy and our state have defined the path of development

priorities. It also means that these sectors, defined as priority ones, will be as a focus of the controlled developments and orientation and promotion policies. Meanwhile, it remains relevant to discuss whether the Albanian financial system has the same priorities or not. Are the directions of the priorities of the economic sectors harmonized with the directions of the financial system? If the answer were yes, this would be evidence to a development and progress in the right direction. If not, we need to make the necessary adjustments. This is an important issue. The great discoveries in finance and the increase of its role are in conflict with the great concentration of authority on the central levels. This economic equation cannot be solved by an invisible hand or by the state control. We have the impression that both the financial system in general and the banking system in particular have maintained a certain distance from agriculture. Our financial system still is unable to find its attractive force in the agriculture and the agricultural and animal products.

Meanwhile, the misuse of the agricultural land and its occupation by various constructions is becoming a very worrying phenomenon. The protection and the proper use of limited agricultural land, as well as the indifference of the financial mechanisms in encouraging and promoting its use and exploitation, represent a visible deficiency in the harmonization of the direction of production strategies and economy branches with the direction of the financial system.

Our financial system - even though we accept is not very modern and developed - is all the same very complex. It requires harmonized investments to be carried out simultaneously in many directions. Some links of the financial system, such as the banking sector, are making faster progress. It is useful to understand that the more consolidated components our financial system possesses, the more stable the economy is.

## REFERENCES

1. *Bodie Zvi (Nobelist), Merton Robert, Finance, (2002), foreword from Paul Samuelson, Nobelist.*
2. *Goffin Robert, Principes de Finance Moderne, 3e édition, (2001).*
3. *Rules and Regulations of Bank of Albania, 1<sup>st</sup> volume.*
4. *Bundo Sberif, Savings and financial and banking system in the Albanian economy, from the book: The economic and social developments of the Albanian regions and their regional and world integration, (2000).*
5. *Bundo Sberif, Luçi Edlira, On a range of policies that encourage the domestic production, from the book: The domestic production – the energy of progress, (2002)*
6. *Luçi Erjon, “Financial intermediation in transition economies, with special reference to Albania”, A thesis for the degree of Doctor of Philosophy, Staffordshire University, 2002,*
7. *J. Schumpeter, La théorie de l'évolution économique, Paris, 1985.*
8. *Bienayme A, ...La croissance de l'entreprise, Paris 1973.*
9. *Bank of Albania, Annual Report, 2001.*
10. *Bank of Albania, Annual Report, 2002.*
11. *Bank of Albania, Annual Report, 2003.*
12. *Institute of Statistics, INSTAT, Annual Report 2001.*
13. *Institute of Statistics, INSTAT, Annual Report 2002.*
14. *Institute of Statistics, INSTAT, Annual Report 2003.*

## ENDNOTES

\* Sherif Bundo: Economic Faculty, University of Tirana.

\*\* Edlira Kraja: Economic Faculty, University of Tirana.

\*\*\* Gentiana Cane: Economic Faculty, University of Tirana.