

FINANCIAL SYSTEM IN ALBANIA

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1. INTRODUCTION

Significant political changes in Albania at the beginning of '90s should be associated with the start of economic reforms in Albania that would enable the shift from central to market economy.

An important element of structural reforms for all countries that embarked into a market economy system comprised the reforms in financial and banking system. The efficiency and rapidity to reform financial system bears a significant importance, since the efficiency

and the quickness of reforms in this sector has a decisive influence in the time it takes to change other sectors of economy.

Financial system, considered as a set of institutions, markets and financial instruments, has experienced relatively positive developments during the last ten years facing various challenges during its consolidation.

The unfavourable macroeconomic and financial conditions as well as the underdevelopment of financial and banking institutions that initiated this reform were followed by many other problems that reached the climax with the pyramid schemes crisis.

This crisis spurred a whole chain of consequences that destabilised the country and led to total economic collapse of Albania. In light of these developments, the complete and fast reformation of financial system was considered and emergency for our economy.

The following years developments were characterised by the continuation of reforms in financial and banking system. The purpose of completed reforms and those in process is to increase system's efficiency through the achievement of re-structure and privatisation of financial institutions. Consequently, there are 13 banks operating in Albania today. Savings Bank is the only state-owned bank while the others are jointly (2) or privately (10) owned.

In addition, the operation of other non-bank financial institutions has improved. There are four private insurance companies operating in the Albanian market. Even the Insurance Institute (INSIG), the main institution in the market, will be privatised. Also, improvements of legal framework provide grounds for the operation of other financial intermediaries and private pension funds.

Although it is not developed, money market is functioning somehow, while capital market is still in an embryonic phase. Further development of these markets is base on the attempts to expand market operators and instruments. Also, the privatisation of state companies, which has improved these last two years, provides the bases for capital market development.

Approaching end 2001, we can say that reforms in financial system in general and those in banking system in particular, have accelerated and consequently have assisted the macroeconomic stability and economic development of the country. Considering the

inheritance and current development of financial system, it is noted that financial institutions and above all, banking ones occupy the main share in the system. The following table indicates the distribution of financial system by looking at the share of assets of financial institutions in the total assets of the system.

Table 1. Specific weight of assets of financial institutions (as of 30. 09. 2001).

Institutions	Absolute value of assets	In %
Banking System	301.0	95.0
Pension Fund	7.6	2.4
Insurance Institutes	8.0	2.6
Total	316.6	100.0

The development of two other components of financial systems remains a challenge in the medium-term economic development of Albania. Therefore, this paper will deal with problems of banking system mostly.

2. STABILIZATION POLICY AT THE BEGINNING OF TRANSITION

Albania started the process of changing from a central economy of Eastern type to a market economy of Western type following the same scheme applied by other Eastern countries. This scheme, first of all underlined the achievement of economic stability through monetary and fiscal policies in tandem with structural reforms.

Stabilization policies and structural reforms are inseparable elements of one entity. The set of measures to transform Albanian economy into market economy is drafted having in mind that during the 45 years of communist regime, Albania was the country that adopted the most extreme policies of state domination on economy in relation to ownership and central planning. Passive financial policies responded to the fulfillment of the "plan" which was regarded as the law itself. Furthermore, a complicated exchange and trade system was set in practice to isolate the economy from changes of prices in international market.

The limited reforms of '85-'90, not only aggravated the economic conditions, but also introduced Albania to indicators unknown

before. In 1990, budget deficit was created for the first time accounting for 15 per cent of GDP.

Starting from 1990, crises unfolded swiftly in association with the fall of the old regime and transition to market economy. Economy went deep into collapse, inflation rose remarkably and foreign debt increased further. The collapse hit mostly the industrial sector, whose production fell by more than 40 per cent during 1991, while many of its branches closed down. As agricultural cooperatives dissolved spontaneously and distribution system was destroyed, agricultural production fell significantly. With the fall of production, budget deficit increased further to 45-50 per cent of GDP (1991) as a result of waste of budget revenues which were mainly supplied by state enterprises. Budget deficit was financed by monetary means and this led to high inflation rates of 10-15 per cent on monthly bases, to dollarization of economy and exhaustion of international reserves.

Given these circumstances, the government elected after March 1992 elections prepared an economic program whose goal was to transform the economy into one functioning according to market economy laws.

The set of measures included in this program was related to the followings :

- a) Macroeconomic stability (decreasing budget deficit, public debt and inflation) ; The completion of reforms in financial system was considered a prerequisite to achieve this objective.
- b) Price liberalization and removal of subsidies.
- c) Liberalisation of economic activity by abandoning the central planning system; provision of conditions for free market operation through establishing new institutions (commercial banks independent from central bank, insurance institutes, and securities market).
- d) Replacement of state ownership with other forms of ownership (personal, joint, cooperatives including also the participation of foreign economic agents, elimination of state monopolies and encouragement of small and medium enterprises).
- e) Opening of the economy, removing state monopoly in foreign trade, liberalisation of imports and exports, currency exchange.

2.1 REFORMS IN FINANCIAL AND BANKING INSTITUTIONS

Transformation of financial system was mainly based on reforming its first component, i.e. existing financial institutions. The other two components were almost non-existent during the period of planned economy.

The reforms in Albania started by first setting down the objectives for macroeconomic stability and then by carrying out the structural changes whose purpose was to privatize the economy, build financial institutions in compliance with market economy rules. Thus, important elements of institutional structural reforms are the reforms of monetary and financial institutions. They provide the necessary framework to complete the process of privatization and the development of financial markets, apart from real markets of services and goods. However, before we start analyzing the period of transformations in banking system, let us briefly describe the banking system in Albania till 1990.

2.1.1. A Short History of Banking System in Albania

It should be noted that because of the underdevelopment of capitalistic relationships in production, Albania inheritance of institutions which operate in conditions of market economy was very poor. These institutions were built much later than in the other European and Balkan countries.

Banking system in Albania originates from the agreement between King Zog and a group of Italian financiers in March 25, 1925. This agreement marks the establishment of National Bank of Albania. The monetary system implemented in Albania was similar to "ardevise" system as it assumed that one third of the banknotes in circulation would be made of metal. This system was designed keeping in mind the mentality of Albanians, who used gold and silver as the only means of money payments and thus, it was hard for them to exchange these with banknotes issued by Bank. Therefore, the purpose of the system was to increase public confidence in depositing money with the bank.

After the liberation of the country, the first step in establishing our monetary system was to found the Bank of Albanian Government, which started functioning in January 22, 1945 and finished the monetary reform in 1946. All the other reforms that followed were undertaken in the context of improving the system or as a reaction to outside factors.

Monetary reform of 1946 determined other exchange rates based on demand for new notes, gold price and its relevance towards other goods. Since 1946 and on, state bank was vested with more responsibilities and gradually its attention shifted to planned organization and management of currency circulation. The Bank of the State had the functions of a central bank as well as those of second-tier banks.

Till 1970, banking system comprised Bank of State of Albania which had both the functions of a central bank and those of second-tier banks. Its main functions were to issue currency, adopt the monetary policy, perform budget expenditures and payments with foreign parties as well as accomodate the needs of state enterprises.

Apart from Bank of the Albanian State, in 1949 the Directory of Savings Desk was established. Its main function was to collect idle monetary resources from population. In 1953, these savings desks were used to perform the state insurance of property as well, and consequently, the Savings and Insurance Desk Institute was established.

This institute continued its activity till 31.07.1991 and after its dissovement, Savings Bank was established based on law no 7505 on grounds of the previous institution. Savings Bank started its activity in the last quarter of 1991.

The need to credit agricultural sector led to the foundation of Agricultural Bank in December 1969. This bank started operating in January 1970. Main functions of the bank included short-term crediting of agricultural enterprises considering that investments needs were covered by budget, and short-term and long-term crediting of agricultural cooperatives.

It should be noted that this bank was not functioning independently from the Bank of the State, but it was rather a supplement of the latter. Credit planning was strictly supervised and it was part of the state crediting plan. Likewise, money taking function was shared and it was mainly performed by Bank of the State.

This type of subordinate relationship continued till May 1990 when the law "On Bank of Albania" was approved based on law no 7378. According to the law, the activity of Agricultural Bank was divided from that of central bank. The banking system continued to encompass two banks and Savings Desk Institute till 1990 when

the political pluralism was allowed in Albania. The change of the political regime came as a result of changes that happened in Eastern Europe initiated by Perestroika reforms in Russia in 1985 as well as from internal pressures that reached their peak during the students movement in December 1990. The transformation of political regime led the way to the change from central economy to market economy.

2.1.2. The Setting of the Start of banking system Changes

Like in other countries of Eastern Europe, such as Hungary, Poland, Czech Republic, Bulgaria and Romania, the transformation of banking system in Albania started from the bases of socialist banking system. However, unlike other countries, the socialist banking system was never subject to reforms. Other countries, have attempted to reform their respective banking systems several times, but these reforms were related to partial restructuring of the system rather than essential reforms to change the system into market economy based on private ownership.

Initially, the purpose of these reforms was to increase the accuracy and efficiency of central planning (by strengthening institutional structures, assigning definite tasks and improving administrative supervision tools). However, it was soon noticed that these partial reforms could not soothe the increasing pressures on the economy. The supply for consumption goods was considerably insufficient, the quality of products was very low and the technical progress was slow.

Till 1989 no changes happened in the banking system. The system was characterized by a monobank which behaved as a central and commercial bank. As a central bank, it was responsible for issuance of currency, supervision of monetary policy and it assisted the needs of enterprises for credit and money depositing by keeping their accounts. On the other hand, the system had a savings case, which could not be called a bank since it only administered deposits from the public and did not extend credit. It also enjoyed another function, that of protecting wealth, mainly that of co-operatives.

Apart from these two financial institutions, another bank responsible for performing payments with foreign entities existed. This bank held the accounts of foreign trade enterprises and was established in 1.12.1990 based on the decree no. 7439.

2.2 THE INITIAL STEPS OF FINANCIAL SYSTEM REFORMS

The process of changing into a market economy placed a great importance on the transformation of financial system. Reforming financial system is very important for achieving macroeconomic stability. All the countries whose main objective was the transformation of the system, have tried to establish a two-tier banking system, to increase central bank independence, competition in banking system, to encourage the development of financial and monetary market, rationalization of payment system, to increase the efficiency of banking supervision, restructure the banking system and carry out the privatization process.

The first important step in reforming financial system in countries of planned economy is to change from a monobanking system to a two-tier banking one. In the second case, the state bank takes on the functions of central bank (issues currency, adopts monetary policy, intervenes in foreign trade, etc.) while the new commercial banks are responsible for transactions related to deposit taking and lending.

Table 2. shows the period when the new law on banking system came to existence in six countries, Hungary, Poland, Czechoslovakia, Bulgaria, Rumania, and Albania. The table displays that in all countries, except Rumania and Albania, this law was approved before the time the political changes took place. Also, it is noted that Hungary and Poland have been more successful with the reforms as they have approved the new law in 1987 and 1989 respectively. Another remark about these two countries is that their banking system included private banks as well, two and five respectively, before the law "On banking System" was approved.

In Albania, the law "On Bank of Albania" was approved in April 22, 1992 replacing the previous law "On the Bank of Albanian State". The new law delegated to the central bank responsibilities previously enjoyed by government such as: determining the amount of credit, issuance of currency, banking interest rates, payment system, etc. Also, now central bank would report to Parliament rather than Government.

Table 2. Banking System before reforms²⁷.

	Hungary	Poland	Czech	Bulgaria	Rumania	Albania
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²⁷Alfredo Throne: Eastern Europe experience with banking reform.

			Rep.			
Start of multi-party system	1989	Apr. '89	Nov. '89	Nov. '89	Dec. '89	Dec. '90
State-owned commercial banks	4	9	2	59	4	3
Foreign commercial banks	2	5	0	0	2	0
Specialised banks	10	1	1	8	2	0
Average banks specialised with outside transactions	1	3	2	1	1	1
Savings banks	1	1	2	1	1	1

The 1992 law "On Bank of Albania" provided the bases to establish an institution in compliance with Western standards and with a relatively high independence. Later laws approved in 1996 and 1998 further increased Bank of Albania independence. The 1992 law removed Bank of Albania dependence from the Government to the Parliament and it also determined that the main objective of the bank would be "to maintain the internal and foreign stability of domestic currency". The law includes provisions for the structural organisation of the bank, i.e. the Supervisory Council, board of directors, Governor, as well as for the main responsibilities of Bank of Albania with regard to monetary policy and banking supervision. Special room was given to the regulation of relationships between central bank and government in relation to budget deficit finance as a new phenomenon challenging our country in the following periods.

The approval of two laws on Bank of Albania and banking system marked the establishment of the new banking system in Albania. The new legal framework acclaimed Bank of Albania (BoA) as a central bank and also the existence of three state-owned banks;

National Commercial Bank (NCB), Savings Bank (SB) and Agricultural Development Bank which later changed its name in Agricultural Commercial Bank (ACB).

3. REFORMS IN BANKING SYSTEM AND PROBLEMS WITH ITS DEVELOPMENT

3.1 LEGAL FRAMEWORK

The banking legal framework has changed continuously during the last ten years not only because of the need to improve but also because of the negative influences on this sector. In April and May 1992, the main legal bases to formulate monetary policy, to establish commercial banks and to regulate their activity were approved. These legal provisions were included in the law "On Bank of Albania" which acknowledges this bank as the highest monetary authority responsible for formulation of monetary policy as well as in the law "On Banking System in Albania" which determines the organization and function of commercial banks. **Based on these two laws, a two-tier banking system was created. The system incorporates Bank of Albania as central bank and commercial banks supervised by it.** The two laws changed considerably in 1996 to reflect the developments of the respective period.

The financial crisis of 1997 caused by the collapse of pyramid schemes reveal that banking legal framework was not complete and it was its deficiencies that allowed the rise of pyramid schemes. For this reason, during end of 1997 and 1998 the two laws improved significantly in increasing Bank of Albania independence as the only monetary and supervising authority. They also progressed in strengthening banking system by regulating and reinforcing the implementation of market tools. The law "On Bank of Albania" tries to ensure the real and formal institutional independence of central bank in accord with its main objective, while the law "On Banking System" tries to build a complete directing and supervisory system for banks. This framework is improving in accordance with international standards on loan classification, reserve funds, capital adequacy, liquidity, foreign exchange position, etc.

Apart from legal improvements, during the last years Bank of Albania has substantially improved the supervising and regulating procedures for second-tier banks through strict license

requirements and by making clear the international standards related to many of banking indicators.

Albanian banks and branches of foreign banks, state-owned or private as well as any other financial institutions licensed by Bank of Albania are subject to supervision and control of Bank of Albania.

The formulation and approval of banking regulation is in agreement with Bank of Albania strategy to supervise effectively. The strategic objective of supervision is to maintain a credible and financially sound banking system. The achievement of this objective entails a whole dynamic process and requires that a number of other short and medium-term objectives be met, such as:

- further consolidation of supervising and regulating framework in agreement with international standards of Basle Committee and European Union guidelines on banking supervision;
- strict compliance with legal arrangements;
- limitations on risk-taking operations by banks that can threaten the safety of clients deposits.

These objectives are being achieved through the following means:

- a. supervision of new entries in the system (licensing);
- b. adjustment of second-tier banks activity and continuous supervision of rules;
- c. supervision of financial situation of banks (analysis of banks and banking system);
- d. supervision of the process dealing with doubtful banks (varies from regulating decisions to void of license).

3.2 DEVELOPMENTS IN BANKING SYSTEM

During this period of 2001 Albanian economy experienced further development indicated by positive performance of labor market and growth of trade activity. The latest data of 2001 affirmed the consolidation of equilibrium set during the previous periods.

Economic growth is mainly attributed to the invigoration of private sector manifested by the higher credits accorded to this sector, increase of import of machinery and equipment, budget revenues,

and by other factors, while the contribution of public sector to economy is becoming secondary.

Annual inflation rate in September was 3.53 per cent. Although for some months during this period monthly rates have been negative the annual rate of inflation was positive and within the targeted interval set by Bank of Albania.

Monetary policy of Bank of Albania, whose main objective is price stability, initially took a loose approach (following the application of low interest rates) and later changed into a neutral one (since it does not try to increase interest rates). During the first half of the year, instruments to lower banking intermediary costs included also the remuneration of required reserve, apart from repo auctions. However this decision did not bring the expected results as the price of credit is still high.

The stable macroeconomic situation in the country had its effects also on banking system performance. Banking system remains the largest and most developed segment of financial market in Albania. It consists of 13 banks, one of which is state-owned (the largest bank in the system), two are with joint capital (state and private) and ten banks are completely private (including branches of three foreign banks).

A state-owned bank, Savings Bank, dominates Albanian banking system. Main features of this phenomenon are that this bank is dominant in the overall performance of the system, network expansion, deposit market and Treasury bill market. The concentration feature of banking activity is more a consequence of its history rather than a result of Savings Bank attempt to hinder new entries and their enlargement in the system. On the other hand, the number of new banks in the system has increased and they are constantly increasing their share in the banking market.

Thus, after 1997 the main trend in the banking system was that of reducing concentration ratio, i.e. weakening the dominant position of Savings Bank in the market. This trend has been emphasized more during 1999 and thereafter and it is expected that it will be even stronger in the future. The reasons which will lead to this change of dominant position of one bank might be as following:

- Increase of the number of banks operating in Albania;
- A more active activity of private banks;

- Privatization of Savings Bank (the process of privatization will be associated with a shrinkage and freezing of its activity);
- Bank of Albania's actions in favor of competition.

3.2.1. Privatization of State-Owned Banks

Banking system reforms was underlined by the idea that banks would be the most important institutions for the future development of the economy. **The motto of the banks would be based on the trinity: support and development of Albanian economy; support and compliance with monetary policy of Bank of Albania; survival and progress of the banks.** During this period, banks managed to combine their objective of survival in a market economy with the compliance with supervision requirements of Bank of Albania. Considering the importance of state - owned banks in the market, increasing their efficiency was a priority. Certainly, privatisation is the main way to achieve this objective. Placing banking activity in the hands of private sector, who is responsible for any loss also terminates the usage of government funds to cover the insolvency of the banks. Also, privatisation leads to better management of costs because of the inflow of capital, technology and know-how.

The privatisation process started in 1995 when the law "On transforming state-owned banks into trade companies and allowing their privatisation" was approved. Other legal acts and decrees followed this law later. The inefficiency of these banks especially in relation to payables showed that the first steps of restructuring the system were inadequate. Initially, Agricultural Commercial Bank went into liquidation and part of its assets was distributed to other state-owned banks while bad debts were transferred to the Agency of Credit Restructuring. This process, not only did not raise concerns to the depositors but also helped to speed up the privatisation process of the other two banks, which had started based on the existing legal grounds.

The formula used in privatising National Commercial Bank and Savings Bank assumes that besides increasing bank efficiency, the process will attract strategic investors in order to spread the origin of capital and the inflow of foreign capital.

This is the reason that privatisation of the banks considers a priority that purchasers be institutional investors that offer to buy more than one third of the shares with voting rights or even the absolute majority of the shares of the bank. It was believed that the

best way to manage privatisation process was through tender. This assumes that price offers will be received by at least three investors thought as suitable to purchase the bank.

First, privatization involved National Commercial Bank and by this time it has been carried out. The buyers of the bank are a Turkish state investor (after KENT bank was taken over by the Turkish state) with 60 per cent of the shares and two international financial institutions, EBRD (20 per cent minus one) and International Financial Corporation (IFC) with 20 per cent minus one. The privatization of the banking system first of all requires that the state give up the direct management of banking institutions and take the position it is entitled to as a supervisory body of the banks. Other countries experiences suggest that privatization is the only way to ensure that management structure is appropriate (it allows bankers to take independent decisions with regard to credit allocation) and that market operates efficiently. This is the key to understand the role of the banks during transition. Private property of capital provides the necessary system to monitor risks and returns, which are the bases of business management in market economy.

3.2.2. Privatisation of Savings Bank

Albanian authorities approve of Savings Bank privatisation and the process has started years ago. It is expected that this process finish by the half of next year. A number of legal acts and decrees as well as the decision on the procedures that will be followed are approved in support of this privatisation. These documents define the program and strategy for privatisation, the formula, bank recapitalization and the issuance of treasury bills to cover the losses, etc. It should be noted that for the first time during these last ten years Savings Bank recorded earning in 1999 and then these earnings only increased providing sound grounds for future perspective of the bank. Also, the fact that bank recapitalization was carried out before its privatisation (unlike National Commercial Bank that was recapitalized the moment it was privatised) is considered an advantage and makes the bank more attractive to foreign investors. The purpose of privatising Savings Bank, assuming strategic investors will participate in it, is to increase the efficiency and profits of the bank, competition in banking system, to bring new technology and services, to increase the quality of service and to offer new products according to international practices of modern banking, which will increase bank reputation and its credibility.

3.3 ALBANIAN BANKING SYSTEM AND ITS FURTHER DEVELOPMENTS

This year developments tell us for the achievements in Albanian banking system as a result of reforms that were carried out and the attention from respective authorities. **The progress is evident in the sound financial situation of the banks, expansion of their credit activity, increase of deposits, geographic scope as well as in the new banking services offered.** Although at a slow rate, it has been possible that apart from settlement of Agricultural Commercial Bank and privatization of National Commercial Bank, all the necessary conditions for privatization of Savings Bank as the last state-owned bank exist. In addition, the number of foreign banks operating in our country has been considerably increased during the last two-three years. Today, there are ten private banks and it is expected that another bank starts its activity soon. The structure of banking system with regard to capital ownership can be classified in three groups:

- one state owned bank (G1)
- two banks with state and private capital (G2)
- ten banks or branches with private capital (G3)

The change of banking system structure has improved the ration in favor of the third group. Changes in banking system involve not only the increase in the number of private banks but also in their geographic scope. So, Tirana Bank operates with four branches in Durres, Fier, Gjirokaster and Korca; FEFAD Bank operates with four branches in Tirana, Durres, Fier and Elbasan; Italian-Albanian Bank operates with two banking agencies in Tirana and Durres; National Bank of Greece has opened three banking agencies in Tirana, Durres and Elbasan; National Commercial Bank operates with ten branches, while Savings Bank has 37 branches and 70 agencies spread all over the country. Obviously, it is the main cities that have attracted private banks to expand their activity in the country. The following table provides data for each bank as of end of September 2001.

Table 3. Albanian Banking System (as of 30.09.2001) .

No	Banks	No of branches	Share in deposits market (%)	Share in credit market (%)

I	State-owned banks		64.7	4.5 ²⁸
1	Savings Bank	37	64.7	4.5
II	Joint private and state owned banks		4.8	33.6
2	Italian-Albanian Bank	2	4.5	33.2
3.	Arabic-Albanian Islamic Bank	1	0.3	0.4
III	Private Banks		30.6	61.9
4	National Commercial Bank	10	10.2	0.1
5	Dardania Bank		0.2	0.7
6	Tirana Bank	4	5.2	14.6
7	National Bank of Greece (branch)	3	2.5	0.9
8	International Commercial Bank		0.4	2.3
9	Alpha Bank (branch)	3	2.9	17.2
10	American Bank of Albania	1	6.5	10.0
11	FEFAD Bank	5	2.1	9.4
12	First Investments Bank (branch)		0.1	0.1
13	Commercial Bank of Greece		0.5	6.6

Source: Bank of Albania.

Although Savings Bank still owns the majority of deposit market, it is evident that private banks are making great progress to increase their market share. These banks are attracting deposits in Lek and foreign currency at a fast rate.

They are offering new updated payment means to the clients (which has affected the increase of demand deposits) and are trying to increase time deposits placed by savers. The weakening of monopolistic position of Savings Bank is notices if we compare the performance of share of each group on banking system as a total.

Table 4. Share of each group on banking system.²⁹

Group	Total balance	In %	Total balance	In %	Total balance	In %	Total balance	In %
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²⁸ This indicator includes the transfer of doubtful loans from Savings Bank balance sheet to the Loan Collection Agency

²⁹ The data of end 2000 for the first group exclude the total of NC balance sheet, as the bank belongs to the third group now.

	Dec. '98		Dec. '99		Dec. '00		Sep. '99	
Group I	176.4	85.6	205.4	81.4	175.5	64.8	181.5	60.3
Group II	10.4	5.1	14.7	5.8	16.8	6.2	18.0	6.0
Group III	19.2	9.3	32.4	12.8	78.6	29.0	101.7	33.7
Total	206.0	100.0	252.5	100.0	270.9	100.0	301.2	100.0

Source: Bank of Albania

In 1998 total balance of Savings Bank accounted for 85.65 per cent of that of banking system, in 1999 it accounted for 81.4 per cent, in 2000 for 64.8 per cent and at the end of the last nine months of 2001 it accounts for 60.3 per cent. Since state owned banks are restrained from applying credit limitations, credit to economy is channelled through private banks, although the process has not gone quite smoothly. These private banks have developed their credit portfolio, which allows them to extend short-term loans using the same funds. At the end of 2000 Bank of Albania removed limitations on credit and monitors the crediting activity based on supervisory indicators. This decision allows commercial banks to increase the amount of lending to economy.

Being part of institutional measures, payment system remains one of the challenges that reconstruction of banking system faces. Despite the positive changes that have taken place, this element is still one of the weak points of the existing system and one of the hardest challenges for the future.

Payment system involves the transfer mechanism of funds among clients and among banks. At present, the improvement of the system occurred on two directions:

- a) the project for improving interbank transactions through implementation of RTGS (Real Time Gross Settlement System). This project is regarded as a short term objective of Bank of Albania;
- b) the improvement of clearing system.

Implementing these two systems will offer the commercial banks and their clients a fast and high quality service, flexibility and standardisation, which will provide the means to increase banking system efficiency.

4. BANKING MARKET

4.1. BANKING MARKET FEATURES

Being one of the main indicators of development, competition is becoming increasingly present in the banking market. The main feature of Albanian banking market is the tendency to diminish Savings Bank monopoly in the market (although not at a desirable rate) and to increase the market share of other private banks. This encourages market forces to determine the price of lending and deposit taking in domestic currency. This trend appeared not only as a result of private banks' expansion but also as a result of Bank of Albania's policy to make use of indirect instruments allowing market factors to decide. Private banks are increasing their market share in the banking system. Banks of the second and third group have expanded their banking activity in the deposit and money market. As an indicator of that we can mention that the specific weight of "transactions with clients" category representing transactions in deposits and accounts on the liability side has increased for private banks and those with joint capital. The data below show that private banks activity has intensified considerably and the share of these banks in the system (the category "transactions with clients") has increased from 6.2 per cent in 1999 to 30.7 per cent in September 2001.

Table 5. Share of "Transactions with clients" category in banking system (in %).

	31.12.1999	31.12.2000	30.09.2001
Group I	89.6	69.1	64.5
Group II	4.2	4.6	4.8
Group III	6.2	26.3 ³⁰	30.7 ³¹

Source: Bank of Albania

The role of private banks in the market is reinforced with the entry of National Commercial Bank, which operates in ten main cities of the country for over a year. Expanding their activity, private banks have increased the quality of their service, as a way to attract new clients. Therefore, the banks are investing in new technology

³⁰ This indicator for the third group is higher since it excludes NCB for comparative purposes with year 1999. This bank is included in the first group.

³¹ This indicator for the third group is higher since it excludes NCB for comparative purposes with year 1999. This bank is included in the first group.

implementing up-to-date programs and systems. Even Savings Bank felt threatened by competition and has started to invest in these. The increasing competition is driving the banks to design specific strategies to be more active in winning the market.

4.2. DEPOSITS MARKET

Of a particular nature, banking business is based on appropriation of monetary sources by third parties and deposits occupy the main part of total liabilities. Applied interest rates to attract savings are in agreement with Bank of Albania monetary policy to control money supply. Central bank monitors monetary aggregates to minimize inflation pressures from these indicators.

Deposits have grown continuously and at a satisfactory rate. Their growth rate fell only during the time of pyramid schemes (October-December 1996). The ration of total deposits on GDP shows the level of financial intermediation. In 2000 this indicator was 43 per cent while during the following year it was 44 per cent. Although this ratio stands below that of the Euro zone, 78 per cent, it still is comparable to those of other transition countries. Also the ratio of total time deposits on GDP is at satisfying rates, 37 per cent in 2000 and 40 per cent in 2001. This ratio is more significant as it represents the rate of savings of individuals and their trust in the banking institutions.

Till 1996, three state-owned banks managed deposits market. Main feature of the market was its segmentation. Savings Bank was dominant in the deposits market from the public, holding 85 per cent of it. National Commercial Bank held 70 per cent of deposits from enterprises and 90 per cent of the total credits granted to them, while Agricultural Commercial Bank operated mainly in the rural area through its agencies. During the last 2-3 years, deposits structure, expectations and preferences of the clients have changed as a result of increasing competition among banks of second and third group. The participation of state-owned banks in deposits market has decreased. In 1999 this group occupied 84 per cent of the market while in September 2001 this ratio fell to 64 per cent. The market structure has changed in accommodating an increasing participation from private banks. It is important to mention that private banks are more active in foreign currency deposits market however, recently they are showing some interest in Lek deposits market too. During the first nine months of the current year, total deposits have increased by 28 billion Lek or by 12 per cent. Foreign currency deposits enjoy

higher growth rates also because of the low interest rates for Lek deposits.

Table 6. Deposits in banking system (in billions of Lek).

	31.12.2000	30.09.2001
Group I	158.8	165.6
Group II	10.5	12.3
Group III	60.5	78.6
Banking System	229.8	256.5

Source: Bank of Albania

4.3. CREDIT MARKET

During the last ten years, credit to economy is conditioned by political and economic factors as well as by other phenomena characteristic for transition period in Albania. However, it is important the fact that credit to private sector has increased steadily. Today, private sector occupies 94.5 per cent of the total credit to economy compared to 63 per cent that was in 1993. On the other and, lending rate to economy has been low during the last year. In Albania, credit to economy accounts for 5.3 per cent of GDP while in other countries of Eastern Europe this figure is between 35-40 per cent. In Western European countries, given that the economy is significantly credited by banking system (apart from USA where most of it is financed by financial markets) the ratio of credit to GDP varies from 70 per cent to 100 per cent. Although during 1993-1999 Bank of Albania had established limitations on lending from banking system, the banks never needed to meet these limits and thus, this instrument has not prevented them from crediting the economy.

Table 7. Credit limitations and actual credit figures (in billions of Lek).

	1993	1994	1995	1996	1997	1998	1999
Upper limit	7.4	5.4	2.9	3.1	2.3	8	8
Actual figure	2.9	3.5	1.75	2.9	1.7	2	2.2
In %	39	64	60	95	75	25	27.5

The low level of crediting compared to its limits is not explained by the low demand of businesses for credits but by other factors. Till end of 1996, credit market was dominated by three state-owned banks, which apart from their funds were responsible also for administration of most of the funds from financial projects. In view

of various factors, these banks did not select efficiently their clients and thus their credit portfolio suffered. In 1993 bad loans occupied 14 per cent of the total credit while in 1994 this figure was doubled and in 1997 it reached to 60 per cent. The collapse of pyramid schemes and the aggravation of financial situation led to further increase of this ratio risking the normal activity of banking system. For this reason, Bank of Albania suspended lending activity of banks whose bad loan ratio was above international standards of 20 per cent. Consequently, all three state-owned banks suspended their credits and succumbed to a deep reforming process.

On the other hand, considering that high inflation rates of end 1997 (42 per cent) fell, Bank of Albania tried to lower the price of credits in Lek for those private banks which started operating during this period. Although during 1998-1999 interest rates fell considerably, credit interest rates did not follow the same trend. Their margin remained still high. The credit extended by private banks was mainly in foreign currency but it was not sufficient to meet the demands of economy. The main reason for this is the minimization of exchange rate risks. On the other hand, the high margin between deposit interest rates and credit interest rates in Lek, has increased the price of credits in Lek.

Some of the main reasons that have led to low crediting of the economy are:

- High risks (country risk and political risk) which prevent banks from expanding their lending activity;
- Banks and businesses do not establish partnership relations. Businesses do not work with the banks and the latter not knowing them, consider these businesses as risky clients;
- Inefficient judicial and execution system;
- Banks that extend credit do not cover all the country's territory.

Also, **apart from reluctance to lend, banks have special policies for credit market.** So, FEFAD bank has developed a strategy focused on small and medium enterprises, while other banks target large enterprises leaving FEFAD without competition. Economic and financial stability achieved during 2000 and during the current year, entry of new serious and credible businesses are the main factors that have encouraged banks to be more active in credit market. During the first nine months of 2001, credit by banking system increased to 5.3 billion Lek while in 1999 it was 2.2

billion Lek. New credit accorded by banks during these nine months was 19.5 billion Lek. However, **banks still prefer to lend in foreign currency**. The following table shows credit market performance during this year:

Table 8. Performance of credit to economy (in millions of Lek).

	December 1999	December 2000	September 2001
Credit level	19,890	28,213	31,244
Credit in Lek	10,612	13,129	11,200
Credit in foreign currency	9,277	15,084	20,044
Share of credit in foreign currency in %	47.0	53.5	64.5

The data show that only the second and third groups offer credit service, while Savings Bank is not allowed to extend credit till its privatization. Initially, only short-term credit was offered while during the current year **the weight of medium and long-term credit has increased**. Medium-term credit is extended to processing industry while other sectors that receive credit are trade, construction, fishery, etc.

Credit to economy in fact is higher if we consider the lending activity of various projects financed by donated funds (Besa Foundation, Rural Finance Fund, Albanian-American Fund for Development of Enterprises, etc.).

5. DEVELOPMENT OF OTHER FINANCIAL INTERMEDIARIES

5.1. NON-BANKING FINANCIAL INSTITUTIONS

Insurance Institutes. The origin of this industry dates back ten years ago when the Insurance Institute was founded. The activity of these institutions is based on law no. 8081, "On insurance and re-insurance activity" dated 07.03.1996. At present there are four insurance institutions operating in Albania, INSIG, SIGAL, SIGMA and ATLANTIK Ltd. out of which the last three ones are private institutions. When INSIG will be privatized, insurance market will be managed by private institutions only and state participation in the market will end.

Pension Funds. In Albania there is only one institution that deals with social insurance, "Social Insurance Institute" founded based on the law no. 7703 dated 11.05.1993 "On social insurance in the Republic of Albania". The activity of other private pension institutions or pension fund schemes is based on the law no. 7943 dated 01.06.1995. These private institutions are still not present in the market. The reason for their nonexistence is related to their business specifics, as they function based on the investment in diversified securities portfolios. Also, the lack of a supervisory authority for these institutions, the incapability to invest large amounts in these schemes and the high risks are other factors, which sustains the absence of private pension funds. Like investment funds, operation of pension funds depends on the availability of a variety of tradable financial instruments in Tirana securities market. Last, the existing legislation does not provide the proper status to institutional investors of these institutions.

5.2. MICRO-CREDIT FINANCIAL INSTITUTIONS

A positive development noticed recently is the development of micro-credit institutions represented by mutual funds which are credit cooperatives that employ the savings of their members and extend credit to these members only. The activity of these institutions is based on the law "On Institutions for Mutual Cooperation" and "On Savings-Credit Funds". The need to start the operation of micro-credit institutions rose from the banks' indifference to credit small business in the city as well as farming activity. Various donators are playing an important role in supporting the establishment and consolidation of Saving-Credit Funds through some well-known projects.

Today, there are 81 funds operating in Albania. The amounts invested by the members are small, however from the psychological point of view, the process is considered positive. The following table provides some data on the activity of these funds.

No.	Name	No. of institutions	Credit Portfolio (US dollars)
1.	Rural Financial Fund	51	1.011.736
2.	Movement for development of savings-credit institutions	30	123.323
	Total	81	1.135.059

These institutions cover those territories where banking system has not reached yet, increasing the number of actors in the market. Further expansion and consolidation of these funds not only will increase their share in the market, but also will set the conditions for the organization of banking institutional types. An initial step with this regard is the foundation of unions that coordinate and administer the activity of mutual funds better.

In response to these developments, the legal bases for operation of mutual funds has improved and the framework, which will regulate and supervise their activity, is being created. Being the supervisory authority, Bank of Albania has approved the regulating and supervisory framework of mutual funds trying to prevent and avoid the negative factors, which might affect their development.

5.3. STOCK MARKET

It is a well-known fact that in developed countries, financial market and especially the stock market provides the main sources of funds for economic operators. In Albania, so far the attempts to develop this market have been focused on the formulation of respective laws and construction of institutions that will participate in it. The development of stock market is related to many components of economic reforms, especially banking reforms, to non-banking

financial institutions and to privatization of state owned enterprises. After the law "On Securities" was approved, the Tirana Stock Exchange and Securities Commission were established as two important institutions. Tirana stock exchange does not function as a stock market and the only securities being trade are the treasury bills as the only money market instruments. The failure of mass privatization is one of the reasons that stock market was not able to function properly. Although, the of Assets Registration Center exists, transactions related to selling and purchasing shares are recorded outside this center. At present, there are no shares listed in the Stock Market and practically a genuine official stock market does not exist making Albania the only country in Europe without the existence of official stock trade. The trade of treasury bills in Stock Market (till 1999 because afterwards no transaction occurred through this market) is characterized by a small number of transactions in small amounts. Moreover, Treasury bill market has always functions as pure money market (with the exception of 1996).

Transactions in Tirana Stock Exchange

(In 000 Lek).

Instrument	1996 (2 May)	1997	1998	1999	2000	2001
Treasury bills	3,305,000	6,325,000	4,959,000	75,000	0	0
Government Obligations	800,000	0	0	0	0	0
Privatisation Bonds	0	0	0	0	0	0

The progress of privatisation process of strategic enterprises is a prerequisite for the future as the number of tradable instruments in the stock market increases. However, it is expected that there will be a limited number of operators considering the privatisation of companies by a very small number of shareholders. **Main shareholders of privatised enterprises are foreign companies that expect to enlarge their investments in Albania.** The initial public offering of strategic enterprises has not been yet applied as means for privatisation.

The operation of stock exchange is considered a necessity for economic development of the country and therefore attempt to increase its independence are on the way. **Separating Stock Exchange from Bank of Albania, which considers it as one of**

its departments, and changing it into an independent entity is the first step to be achieved. The decision of Supervisory Council to divide Stock Exchange from Bank of Albania and formulation of a law which will sanction stock exchange independence are the first signals of stock market development in the future.

6. CONCLUSIONS

- **Financial system has experienced considerable changes during the last decade with respect to legal improvements, regulating framework, network enlargement and service quality thus reflecting the situation of the economy and responding to its needs.**
- **The most dynamic component of this system has been the banking system which has developed considerably with regard to:**
 - a) **its network and gradual expansion throughout the country;**
 - b) **increase of products offered and improvements of service quality in main cities;**
 - c) **continuous reduction of market dominance, although Savings Bank still maintains a dominant position of 60 per cent of the total assets of the system and this remains the main weakness of banking system future;**
 - d) **further improvement of liquidity and capital adequacy indicators.**
- **Although credit to economy is mainly directed to private sector, credit extended by banking system is still low and accounts for only 5.4 per cent of GDP as compared to far higher figures in other European Countries.**
- **Payment system remains one of the weakest points of banking system. Implementation of RTGS system and improvement of clearing procedure are the challenges of short and medium-term period.**
- **The number of insurance institutes has increased encouraging competition, however this market is still characterized by domination of one player.**
- **Domination can be looked at from two points of view:**
 - a) **the market share of INSIG is very high, almost 90 per cent of the total;**
 - b) **revenue structure is highly concentrated and engine primes and property cover 95 per cent of revenues, while life insurance only 5 per cent.**
- **The actual development status requires that reforms in all three components of financial system continue simultaneously. Stock market remains a priority of these reforms and also a challenge for the future of financial system.**

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