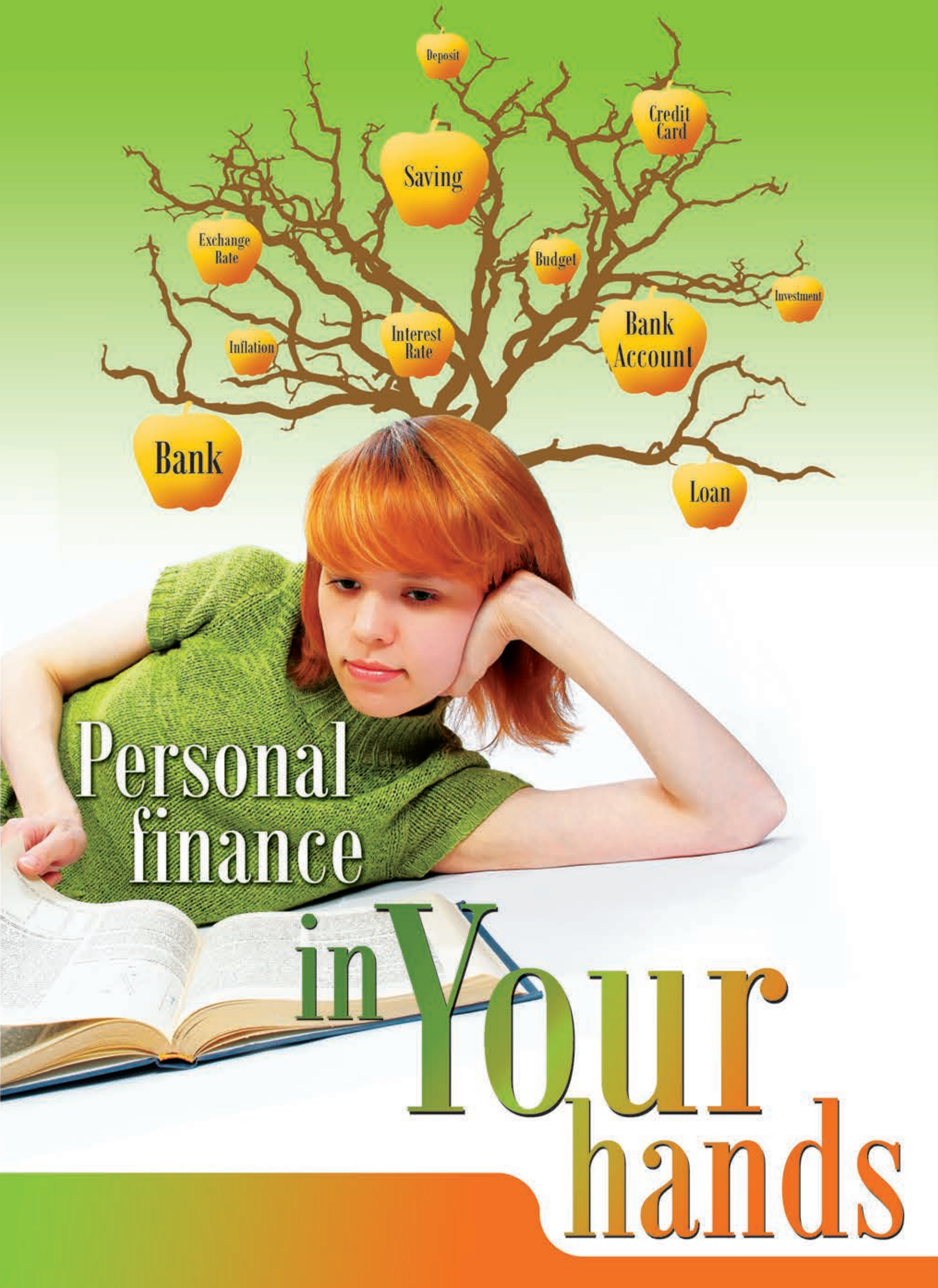

Personal finance in Your hands

Personal finances in Your hands

Students!

Elect the optional module
"Personal finances in your hands"!
This module will help you:

- in your life as consumers,
- in your future relationships with banks and financial institutions,
- in your university career,
- in your entrepreneurial skills,
- in administrating your income,
- in successfully planning your finances,
- in fulfilling your long-term objectives.

Learn how to use your money!
It is your future.

Approved by the Ministry of Education and Science, July 2011

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Comments and suggestions are welcomed at the Bank of Albania email address: public@bankofalbania.org

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CHAPTER 1:

ECONOMICS AND FINANCE, AN OVERVIEW

1. FINANCIAL EDUCATION STARTS AT SCHOOL

Money does not grow on trees! We may have heard this expression from our parents a thousand times without paying much attention! We have always thought our parents had a tree, and all we had to do was reach out and get the money we needed to buy the sneakers we saw the other day, or the latest smart phone. As we grow older, however, we realize that money is hard to make, and needs to be carefully managed.

Money doesn't grow on trees, where you can simply reach for it…

What is financial education and why is it important?

Economists describe financial education as the process by which consumers enhance their understanding of financial products and associated risks, in order to develop the skill to make smart choices based on accurate information. On the other hand, consumers learn where to turn for help and take other concrete actions to improve their financial well being. In this light, consumer education implies providing them with facts, data and specific knowledge to help them become aware of various financial opportunities. Through individual training and guidance, financial education in schools aims at teaching the knowledge and skills needed to understand financial concepts.

Counselling means providing advice on general financial products and issues, for consumers to be able to use at best the information and instructions and guidance received.

In simple terms, financial education is the ability to understand money and manage it in a way that leads to financial decisions that yield benefits at the present and in the future. Financially-literate persons possess the ability to make informed decisions regarding:

- **savings** - to meet the short and long-term goals
- **credit** – to use it responsibly and wisely
- **financial risk managemen**t

Financial education serves not only the individual, but also the society. It improves the public's ability to properly assess the national economic, political and social development and, consequently, take prudent economic decisions. Therefore, financial education contributes to and facilitates the better functioning of the society. Being financially literate is like speaking a foreign language. If we are with people who speak in a foreign language we do not speak, we will feel left out. But, if we have some basic knowledge of this language, we will be able to at least pick up the topic of the discussion and ask some questions, hence, understand and learn more.

Being financially literate is like speaking a foreign language.

Anyone should have some basic knowledge on how the national economy and finances work. We must be familiar with the various economic systems and their characteristics; main institutions that develop economic policies and their impact on the national economy; products and services that are offered by banks and other financial institutions and how to deal with them; importance to save and the key saving instruments; investing and prudent investments; and finally, investing in ourselves and how to find a good job.

Some societies, including Albania's, often pay more attention to making money and to spending it, overlooking the management aspect pertaining to the best use of our income. It is important to understand that financial literacy is necessary to recognize the surrounding environment and that management of personal income is something to be learned, just like driving a car, cooking or using a computer. Management of money or personal finances is a skill, mastered through education and experience.

Responsibility is the key word in the management of personal finances. Despite the amount available to us - whether it is ALL 100, ALL 1,000 or ALL 100,000 - we are equally responsible for its spending. Each of us is responsible for our own financial future, which encompasses the awareness of the true value of money and wise use to achieve life goals.

Introduction to economics and finance

Let us start with some basic concepts that help us understand the difference between the two sciences that are often confounded: economics and finance.

Economics is the social science that studies the production, distribution, and consumption of goods and services. This science tries to explain how economies behave and interact. Knowledge on economics serves also other fields like finance, business, governance, education, justice and politics.

Finance is the science that studies the management of funds; distribution and management of financial resources, savings and investments. The basic principle of finance is to create and manage any asset that increases in value and generates income. Finance may consist in three main areas: personal finance, business finance and public finance.

Responsibility is the key word in the management of personal finances

- **Personal finance** – in simple words, personal finance implies management of money used for day-to-day spending (e.g. to pay bills), savings, and investments. Personal financial decisions include estimation of the amount of money needed in each stage of life, as well as bringing spending in line with income; choosing a bank that offers the most favourable conditions; using bank accounts; obtaining a loan for house purchase, studying, car purchase, vacations; investing savings by selecting the most profitable instrument; and paying taxes and insurance.

- **Business finance** – consists mainly in finding and managing the funds needed to support a business activity.

- **Public finance** – entails funds from the State, local government units and other entities or agencies related to the state, whose main activity is to estimate the necessary expenditure and find the financial resources to fund the pledge for such expenditure or investments.

This module builds knowledge on the key elements of economics and dwells at length on personal finance. This knowledge will help us take the right financial decisions.

Personal finance means management of your money

QUESTIONS?

1. Explain in your own words the concept of financial education.

2. Provide arguments on how personal finance may be wisely managed.

3. How does being financially literate affect different aspects of your daily life?

4. Compare the concepts of economy and finance and give examples from everyday life!

5. What are the three main types of finance?

6. What are the main areas of personal finance?

GLOSSARY

Consumer is the final buyer of products and services for his/her own needs or of persons under his care, and not intending to resell them.

Financial products and services are offered by financial institutions. Examples of these products and services include loans, deposits, current and savings accounts, bank cards, money payment and transfer services, and foreign exchange operations.

Financial risk is the possibility of financial loss resulting from the occurrence of a certain event.

Major financial risks include: a) changes in taxes, tariffs (e.g. higher taxes may lead to lower profit), b) exchange rate fluctuations (e.g. fluctuations in the exchange rate of the Albanian lek against the euro may be advantageous or disadvantageous to the domestic economy as well as to import & export companies), c) interest rates (e.g. higher interest rates burden creditors with additional costs and worsen their economic condition).

Financial intermediary is an institution (such as bank, insurance company, pension fund) that borrows money from households and businesses and lends it to others.

Investment means the use of money at a given moment with the expectation of increasing the value or generating additional income in the future. Forms of investment include bank deposits, treasury bonds, securities and immovable property.

Money management / personal finance management is the process of planning, organizing and taking care of personal property and income, with the view of meeting financial targets and generating benefits .

Asset – any item of economic value owned by an individual or corporation, especially an item that may be easily converted to cash.

2. ECONOMIC SYSTEMS

The way an individual lives in a society and his economic decisions depend, inter alia, on the economic system implemented in the respective country. The economic system consists of individuals and bodies acting to fulfil the needs of the society through various resources.

Government is the key actor in command economy.

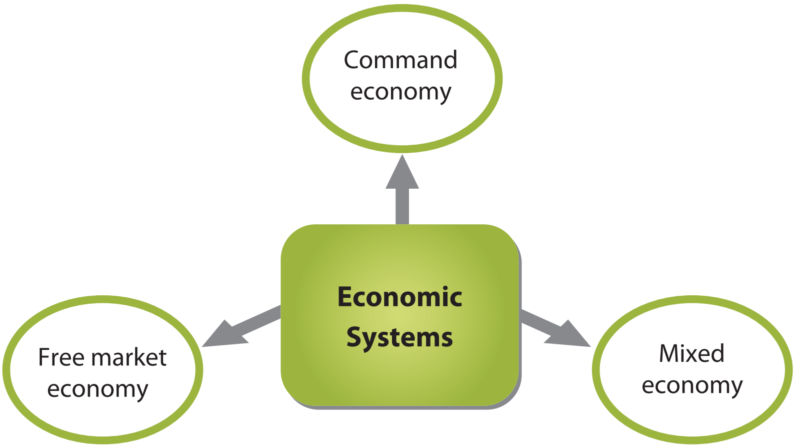
Three are the main economic questions that a society must respond to:

1. **What** should be produced with the limited resources available? (What type and quantity of products must be produced?)
2. **How** should these products and services be produced? (Who should produce them, combining what resources and using which technology?)
3. **For whom** will these products and services be produced? (Who will consume them and how will they be distributed to the various groups of society?)

The answers that societies give to these questions define the economic system they implement.

There are three main economic systems

- Command economy (planned economy)
- Free market economy
- Mixed economy



Command (planned) economy

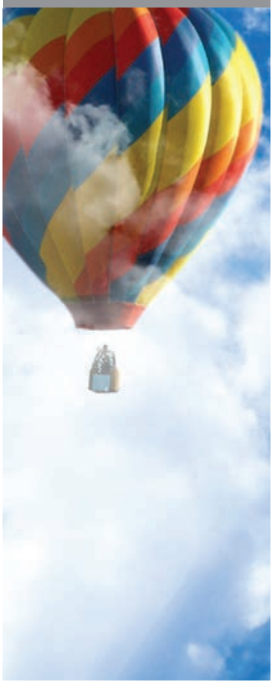
In a command economy, the three questions above are answered by the central governing bodies of the country. These bodies own and control all factors of production (i.e. resources – land, capital and labour) as well as their use and distribution to the final consumer. In this type of economic system, private ownership is very limited.

Product output is determined by government plans, not by consumer needs or preferences. Also, the government decides how production is made, how goods and services are distributed, and the producer's wages. As decision-making is not driven by consumer needs, output may exceed demand, thus leading to increased stocks. For the same reason, there may be a shortage of products in the market despite the existing demand and need for them.

In the 20th century, the command economies existed mostly in the self-proclaimed socialist states, which were, in fact, communist dictatorships. This is why the concept of planned economy is often associated with communism.

Planned economies failed and nowadays there are very few purely planned economies. Even countries that continue to be under communist regimes, like Cuba and China, have launched economic reforms to progressively move towards mixed economic systems.

Free market economy



The government plays a neutral role in the market economy.

Free market economy is an economy in which the three questions receive the response from the market, i.e. the interaction of demand and supply. This system is the opposite of the command economy. The government plays a neutral role, with no intervention in economy.

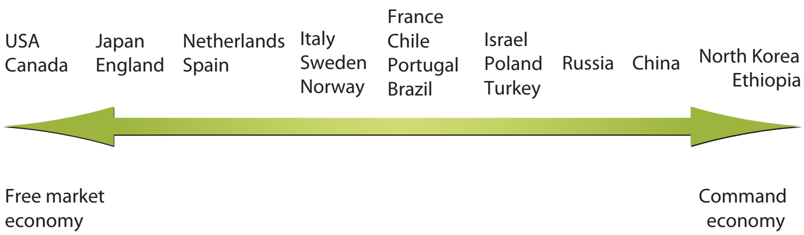
In practice, totally free market economies are quite rare. Not all markets in an economy can be left without government intervention or regulation. In general, the term 'free market economy' implies an economy with justified government intervention.

Mixed economy

Practically, there exist no pure free market economies or pure command or planned economies. Virtually, all the economies in the world are mixed, combining, at various extents, the characteristics of market economy and command economy. So, government plays a regulatory role in the mixed economy.

Among the industrialised countries, the US economy is considered to have the lowest government intervention in the market, followed by Canada, England and Japan. In Scandinavian countries, the government plays an active role, while in Russia it exerts greater control.

Below is a graphic with the positions of some countries in the axis of economic systems.



In general, government intervention in economy is justified for two main reasons:

1. Supply general public goods

Examples include the supply of certain products and services which would not be supplied by a private company or would be supplied at an unaffordable price: think of the health care, public education and national defence.

2. Ensure reallocation of income in economy

Market economy may lead to unequal distribution of income and wealth in an economy, concentrated at the hands of a few rich people, leaving the rest of the population without sufficient income resources to make a living. In this case, government intervention by taking from the rich (through taxes) to give to the poor (through unemployment benefits, social payments, free services, etc) is justifiable from the social point of view.

BOX:

Overview of the history of the development of the Albanian economy

In early 1990s, Albania moved away from a command economy towards a free market economy, becoming a country with an open economy, participating actively in the world trade and investment.

The reforms implemented during this period included:

- *Significantly reducing government's role in economy;*
- *Establishing private property as the cornerstone of the new economic system;*
- *Price liberalisation;*
- *Stimulating private entrepreneurship in agriculture, industry and services;*
- *Building up an efficient and sound financial system, able to keep up with the needs of the market economy.*

These reforms created new opportunities for Albania, which quickly became an attractive destination for foreign investors and donors, thanks to its rich natural resources and geographical proximity to European markets. Once dominated by industry and agriculture, Albania's economy gradually started to shift towards services and construction.

This rapid development in the first years of transition was interrupted by the pyramid scheme crisis in 1997, which grew into a political and economic crisis. However, the country's economy quickly recovered and returned to normality.

Since 1998, the Albanian economy experienced 6% annual growth. From a country with low income per capita (about 290 US dollars in 1992), Albania became a middle-income country (3,950 US dollars in 2010). This marked the highest increase of the standard of living among the Central and Eastern European countries. However, the income level in Albania remains low, standing only at 27% of the EU average in 2009.

QUESTIONS?

1. *What are the main economic systems? Describe the features of each economic system.*

2. *Explain the differences between the main economic systems.*

3. *Which of the three economic systems explained above best describes the Albanian economy before and after 1990?*

4. *Which is the best economic system that a country should adopt?*

5. *When is government intervention in the economy considered as justified? Give examples of government intervention in our economy.*

GLOSSARY

Goods are products that meet a human need (by being consumed or invested) and may be sold or purchased.

Services are activities not materialised in tangible objects and satisfy personal needs of households and businesses. For example, services meeting the needs for education, health care, entertainment, state/financial/banking management and maintenance (such as cleaning and decoration of streets, premises.)

Capital consists of the total financial means invested in a business with the scope of generating profit.

Demand represents the amount of a good or service that consumers are willing to purchase at a certain time in the market and at a given price.

Supply means the amount of goods and services produced and offered in an economy to meet the demands of society.

3. ECONOMY AND INFLATION

3.1 ECONOMY

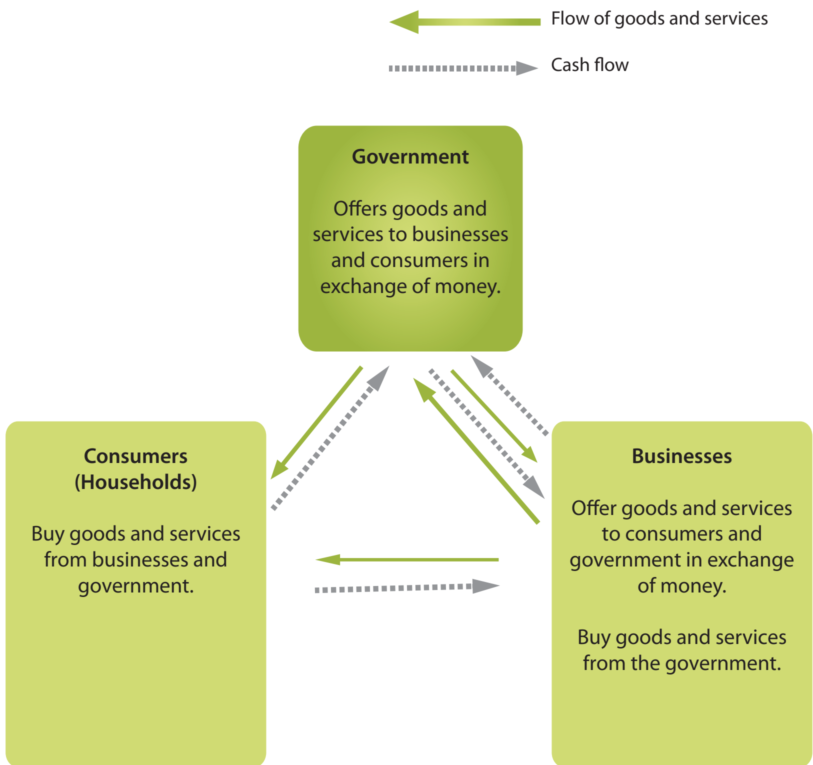
Our parents earn money through work and spend part of it to buy goods and services that are needed in everyday life such as food, water, electric energy, bus fares. Part of the income is used for major-but-rare purchases such as a new washing machine or TV set. Then they save the rest of the money earned. Our parents and we, as consumers, comprise only a part of the economy. In this view, the **economy can be defined as the total of activities at the workplace, shops, offices, enterprises, banks, even at home and school.** The economy is made up of consumers, businesses and the government.

Economy may be defined as activities that include anything we do.

Our parents and we are considered as consumers. **Consumers** purchase goods and services for their daily consumption (foods, clothes, electricity, etc.) and for long-term consumption (furniture, washing machine, refrigerator, pension funds, etc.)

Businesses produce most of the goods and services we consume. They purchase raw materials and other products and make investments, in order to produce the products that are later sold in the market. Their products are purchased not only by consumers (foods, clothes, home appliances), but also by other businesses (leather, steel, wheat, machinery) and the government.

Government is both a consumer and producer in economy. It buys goods and services (medical equipment and medicines for hospitals; weapons, food and clothes for the army and security forces), makes investments (construction of roads, bridges, schools, parks), but also provides products to the public which mainly consist in services, such as: healthcare services, education, transport, public order, cleaning.



The total goods and services that consumers, businesses and the government wish to buy for consumption or investment represent the **domestic demand of** an economy for goods and services.

Did you know?

Household consumption is the main component of domestic demand in our economy. In the last decade, it accounted for around 61% of domestic demand. Investments also have a *significant share of about 31%. The remaining 8% is made up of government consumption.*

Our economy is an open economy: we trade goods with other countries freely. When we buy products from other countries, we import. Products produced abroad, we buy and consume in the country constitute our imports. When we sell our products to other countries, we export. All products produced domestically and sold abroad constitute our exports.

Albania is mainly an importing country, i.e. it imports more than it exports. In other words, the difference between exports and imports is negative. This difference is known as trade deficit.

Did you know?

Our imports are about 4 times higher than exports.

Albania's main trading partner countries: Italy, Greece, Germany, Turkey and neighbouring countries (Kosovo, Macedonia, Serbia and Montenegro). During 2005 - 2010, 27% of imports originated from Italy, 15% from Greece, 7% from Turkey, 2% from the neighbouring countries and around 28% from other European countries. In the same period, Italy accounted for 68% of Albanian exports, Greece 9%, neighbouring countries 10% and Germany 5%.

Most of our imports in the last five years include: machinery and equipment (22%); food, beverages and tobacco (17%); construction materials (16%); minerals, fuel, energy (15%); textiles and footwear (11%). For this period, our exports consist mainly in textiles and footwear (50%); construction materials and metals (16%); minerals, fuel, energy (13%); food, beverages and tobacco (7%).

The entire goods and services produced by the economic sectors constitute the **supply** of goods and services in an economy, also known as **gross domestic product (GDP)**.

Economic sectors

The economy of a country is divided into three main sectors, depending on the distance of the economic activity from the natural environment. Agriculture is the primary sector, followed by the secondary sector, i.e. industry, and the tertiary sector, i.e. the services sector.

In Albania, the agriculture sector accounts for 18% of GDP.

Agriculture includes economic activities seeking to obtain from nature useful and indispensable products. These activities include: cultivating land, exploiting forests, breeding animals and fish, and hunting.

Industry includes activities concerning extraction of raw material, processing and production of different products. It includes sub-sectors such as the extractive industries, manufacturing, generation and distribution of electricity, gas and water, as well as construction.

Services include economic activities that do not produce tangible goods, but satisfy personal needs of people and economic units, such as: trade, public administration, transport, telecommunications, tourism, financial services, data processing, education, health and social activities, leisure, free professions.

Did you know?

During the past decade, gross domestic product was dominated by the construction and services sectors, which constituted more than 60% of GDP. "Trade, hotels and restaurants" make up the bulk of the services and have contributed to 25% of the domestic production in the last 15 years.

Expansion of these sectors was driven by the high demand combined with the rising productivity and remittances.

On the other hand, the industry sector maintained its share of GDP to around 9%, primarily due to the increased textile and footwear production destined for export and, lately, due to the growing share of the construction materials (cement production). Despite reduced importance of agriculture in the economy, the share of this sector is still high compared with the countries in the region. Agriculture accounts for 18% of GDP and over 40% of employment in Albania. This suggests that there are still opportunities to increase overall agricultural productivity and output by providing incentives and facilitating the continuous circulation of the labour force among the different sectors of the economy.

3.2 INFLATION

Your grandmother bought you a pair of snickers on the occasion of the school year start, which cost ALL 3,000. On the way back home, she starts saying: “Prices only go up. I remember when your brother was your age, 10 years ago. At that time, a pair of snickers would cost only ALL 1,500.” Most of the things the grandmother buys now cost more than they would 10 or 20 years ago, such as bread and clothes.

In our economy, some prices increase and others decrease at certain times, depending on the factors that affect prices of goods or services. But, there are periods of times when prices of most goods increase. In these cases, there is inflation. Inflation is the general and persistent increase of the level of prices in economy.

The level of price increase is measured every month. This is called the inflation rate. The inflation rate includes changes in the prices of hundreds of products purchased by most people: bread and other food items, clothing, oil, electricity, vacations.

In Albania, the official inflation rate is measured by the Institute of Statistics (INSTAT[1]) and is published monthly. Depending on the calculation method, there are two types of inflation: monthly and annual inflation. The monthly inflation measures the level of price change from a month earlier. The annual inflation measures the level of price change compared to the same month a year earlier.

Example: the monthly inflation in December 2010 was 2.2%. The annual inflation in December 2010 was 3.4%. A monthly inflation of 2.2% means that in December 2010 prices are

Inflation is the general and persistent increase of the level of prices in economy.

[1] For further information, visit the website of the Institute of Statistics at: www.instat.gov.al

averagely 2.2% higher than in November 2010. An annual inflation of 3.4% means that in December 2010 prices are 3.4% higher than in December 2009.

In general, low inflation is necessary for the development of economy. In our country, the Bank of Albania, our central bank, is responsible for achieving and maintaining price stability. This objective has been translated in quantitative terms, in keeping the annual inflation in the medium term, at the level of 3% with a tolerance band of +/-1 percentage points.

Did you know?

During the early years of transition in Albania, 1995 – 1999, the annual inflation rate was highly volatile. It peaked 42.1% in 1997, due to the serious economic crisis following the collapse of the pyramid schemes. Thanks to appropriate macroeconomic policies, in the last 10 years inflation has ranged around an average of 2.8%, close to Bank of Albania's target for the stability of prices.

What causes inflation?

One day, on the way back from school, you overhear the administrator of the supermarket in your neighbourhood talking to his acquaintance. He was happy because the business was good and people were buying increasingly more from his supermarket. He was thinking of hiring another person to cope with the additional workload.

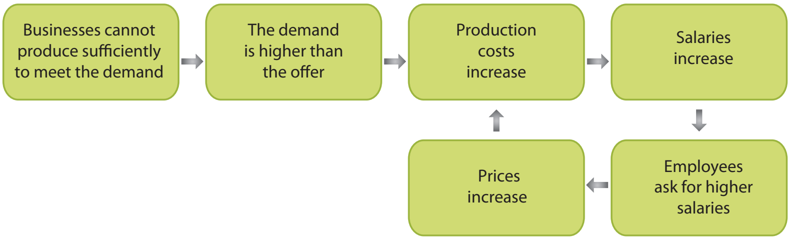
Such times, when consumers spend a lot, seem to be good for everyone. Businesses are doing well and hire more people.

People feel safer about their work and the demand for goods and services continuous to increase. Higher income makes people more optimist and they feel safer about the future. Therefore, they feel less worried about spending money; they may even take a loan to purchase a new car or refurnish their house.

But, a fast increase in consumption within a short period of time may cause an unwanted increase of prices, i.e. a higher inflation than the desired one. How does this happen?

Fast increase of consumption within a short period of time may cause unwanted increase of prices.

Facing a higher demand from consumers, businesses (producers of goods and services) may have difficulties to increase production in order to immediately meet the demand. This would mean a high cost for them. They would need to procure new machineries and space. Furthermore, their employees would have to work overtime and be paid more. The raw material may cost more as demand for them goes up. When facing higher production costs, businesses start raising the prices of their products. Thus, prices of most goods increase. In these circumstances, people start asking for higher salaries to cope with the price increase. If businesses agree to increase employee salaries, the cost of their products will increase again (due to the raise of salaries). Consequently, business companies may again increase the prices of products, and the economy enters into a closed cycle of cost and price increase.



Therefore, a higher demand compared to the producers' capacity to produce (offer), leads to the swift and general increase of prices. Producers may increase the production capacity through making new investments and increasing the number of employees, hence producing a larger quantity of goods. However, this requires time and cannot be achieved in the short term. Therefore, it is better when the increase of the demand is constant, affordable for businesses and does not cause pressure to increase costs and prices.

BOX:

Inflation, deflation and price stability

We have all heard from our grandparents or older people about how different things were when they were our age. One loaf of bread was ALL 5. A cinema ticket was ALL 12. With time, prices have gone up and lek has lost its value. Now days, a loaf of bread costs ALL 80 and a movie ticket for a movie costs ALL 500. This is inflation.

In this lesson we learned the meaning of inflation. In principle, inflation is defined as a general increase in the prices of goods and services during a long period of time, leading to a reduction of the value of money and of its purchasing power. In a market economy, prices drop or increase over time, thus reflecting the choices and preferences of consumers, as well as the changes in costs.

The opposite of inflation is deflation, which is defined as a general decrease *in the prices of goods and services during a long period of time. Deflation happens as demand for goods and services decreases. In turn, companies are forced to sell their products at a lower price.*

Large fluctuations in prices cause insecurity and harm the economy. Therefore, price stability is an important precondition for a healthy economy.

*The world economy has seen many cases of people experiencing real situations of uncertainty and despair due to large price fluctuations. For example, the value of a building was reduced, within a short time, to a monthly average salary. Following, there are some historical examples of inflation/deflation in various countries of the world.**

France, in the 1790s

- *During the revolution, the French Government sold considerable amounts of government bonds to pay its debts.*
- *But, the high debt and lack of food caused an increase in prices.*
- *In 1796, inflation increased to 1,153%.*

United Kingdom, during 1921-33

- *Termination of the financing of the war and return to the gold standard in 1925, caused pressure for price drops.*
- *Prices dropped almost every year during 1921-33.*
- *In 1933, prices had dropped by 38%.*

Germany, in 1923

- *In December 1923, wholesale prices were 85,000,000,000% higher compared to a year earlier.*
- *The banknote with the highest denomination was 1,000,000,000,000 marks.*
- *In October, more than 99% of banknotes stayed in circulation for less than 30 days.*

Russia, in 1923

- *In the years after the Russian Revolution, the country suffered social and economic turmoil.*
- *Some economy historians believe that the Government invented*

inflation to impoverish those who were better off.

- *In 1923, inflation reached 60,804,000%.*

Greece, in 1944

- *In October 1944, 99% of government expenses were covered by printing new money rather than by taxes.*
- *Inflation peaked in October, reaching 130,000%.*
- *Trust in the value of the currency was lost.*
- *In November 1944, Greeks would keep a Drachma banknote for only 4 hours, on average.*

Hungary, in 1946

- *Hungary has experienced the highest inflation rate ever recorded within a day.*
- *During the peak month, July 1946, prices would double in a bit more than just 12 hours.*
- *The banknote with the highest denomination was 100,000,000,000,000,000,000 Pengo.*

China, during 1945-49

- *The civil war began in 1945.*
- *Military expenses were high, reaching 80% of the state budget.*
- *Prices, measured in the Chinese national currency, rose by 2,372% until March 1948.*

Argentina, in 1980s

- *During the 1980s, inflation was on average 750% per year, reaching its peak in December 1989 with 4,924%.*
- *The main cause of inflation was the constant budget deficit of the government.*
- *The deficit was financed by the Central Bank, thus leading to inflation.*

The Federal Republic of Yugoslavia in 1993-94

- *In January 1994, the inflation rate reached 331,000,000%.*
- *The largest denomination of the banknote in circulation at the time was 500,000,000,000 dinar.*

- *The causes of inflation were the dissolution of the former Yugoslavia in 1992 and loss of the monetary and fiscal control.*

Zimbabwe, in 2006-2008

- *In December 2007, the inflation rate reached 66,212%, the world's record high until then.*
- *The largest denomination of the banknote in circulation at the time was 10,000,000 Zimbabwean dollars.*
- *Shops were issuing new price tags every day.*

* http://www.bankofengland.co.uk/education/Pages/inflation/map/map.aspx

QUESTIONS?

1. Describe the content and the meaning of the following terms. Indicate the connection between them.

- *Economy*
- *Consumer*
- *Business*
- *Domestic demand*
- *Import*
- *Export*
- *Gross Domestic Product*
- *Inflation*

2. Which are the main sectors of economy?

3. Group the following economic activities by the main sectors of economy:

- *production of automobiles*
- *hunting*
- *banks*
    - *construction*
    - *metal processing*
    - *restaurants*
    - *textile production*

- *health*
- *pharmaceutics*
- *farming*
- *notary*
- *shipbuilding*
- *media*
- *energy*
- *fishing*
- *tourism*

4. What causes inflation?

5. How does inflation affect the salary-price, price-salary spiral?

6. How is inflation measured in Albania?

7. What is the target of the Bank of Albania about inflation?

8. The following table shows the monthly and annual inflation rates during the 12 months of 2010. Interpret them. Explain the performance of inflation in Albania during this period. Is the inflation rate in these months within Bank of Albania's target for inflation?

	Monthly	Annual
January	0.9%	4.3%
February	1.1%	4.7%
March	0.1%	4.1%
April	-0.4%	3.7%
May	-1.2%	3.3%
June	-0.7%	3.2%
July	-0.5%	3.4%
August	0.8%	3.5%
September	0.7%	3.4%
October	0.2%	3.0%
November	0.2%	2.8%
December	2.2%	3.4%

Home/Class work

Visit the INSTAT website (www.instat.gov.al.). Find the recent publication on inflation and discuss about it, using what you have learned about inflation so far.

GLOSSARY

Cost - is the entirety of expenses for the production and sale of a product. It includes the expenses for buying raw material, salaries of employees, taxes and insurance, and any other expenses incurred by the business for the production of goods or provision of services.

Price – represents the value of goods and services, or the quantity of money that a buyer pays to the seller for a purchased unit of a good or service. For example: the price for 1kg of apples, for a haircut, or for one hour at the gym.

Remittance - money emigrants who live and work aborad send to their families. This money is valuable contribution not only for the families, but also for the Albanian economy.

4. MACROECONOMIC POLICIES

Macroeconomic policies are actions taken by certain state institutions of a country to influence its economy. They aim to achieve the following main objectives:

- stable economic growth, which increases the living standards of the population;
- low unemployment;
- price stability.

There are two macroeconomic policies: the monetary policy and the fiscal policy.

The fiscal policy is drafted and implemented by the government through the Ministry of Finance and it aims, among others, to achieve economic growth and adequate employment.

The monetary policy is drafted and implemented by the central bank, Bank of Albania in the case of Albania, and its main objective is to ensure price stability. A proper combination and good coordination of these two policies enables control over the country's economy, in order to fulfil the above-mentioned objectives.

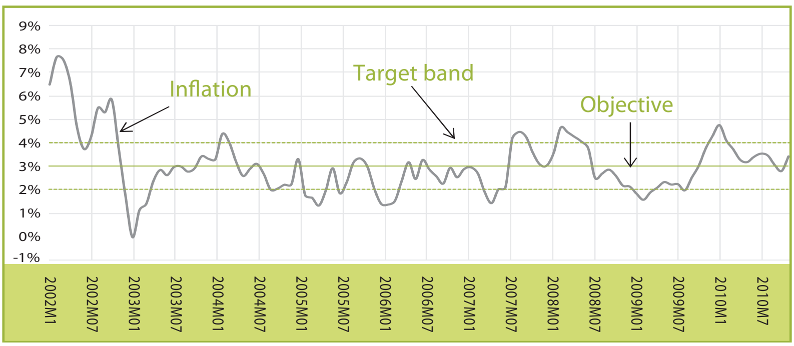
The main objective of the Bank of Albania is to maintain price stability.

4.1 MONETARY POLICY AND THE BANK OF ALBANIA

The monetary policy is drafted and implemented by the central banks, which are also known as monetary authorities. The purpose of the monetary policy is to ensure price stability in the country.

In Albania, the central bank is the Bank of Albania. Like other modern central banks, its main objective is to achieve and maintain price stability. To achieve price stability means to achieve low inflation rates, i.e. low consumer price volatility. To maintain price stability means to provide low positive inflation rates for relatively long time.

The Bank of Albania's target is to maintain inflation at the level of 3% +/- 1 percentage points in the medium term. The following chart helps us understand the fluctuation in inflation in Albania during 2002-2010, vis-a-vis the target of the Bank of Albania.



BOX:

About the Bank of Albania

When was the Bank of Albania established?

The National Bank of Albania (today "Bank of Albania") was established on 4 October 1913, upon an agreement entered into between the Government of Ismail Qemali, representatives of the Wienner Bank Verein, and representatives of the Banca Commerciale Italiana. Due to the political developments following the onset of the Balkan wars and WWI, the Bank operated for a very short time. It ceased its activity after having carried out some transactions with the Government of Ismail Qemali and some other private entities.

On 2 September 1925, an agreement was concluded between the Albanian Government and an Italian financial group to establish the National Bank of Albania, with its headquarters in Durrës and the Administrative Committee seated in Rome. In 1926, it put in circulation the first Albanian national currency.

After the WWII until end of 1990, the State Bank of Albania supported the development of the socialist economy. A characteristic of this period was the extreme centralization of this system in the hands of the state. The State Bank of Albania - the central bank - continued to be the central institution for the issuance of currency. It served as the treasury and carried out transactions on behalf of the state budget, managed the state's foreign currency reserve, performed economic and financial transactions on behalf of the state with other countries and foreign banks. It also extended loans to enterprises, agricultural cooperatives and to private individuals; served as a centre for current accounts, accepting saving deposits and keeping them in the form of money, securities, gold and silver coins; and performed foreign exchange transactions for its account or for third parties.

At the beginning of the 1990s, the change in the political system of Albania brought about fundamental changes to the banking system. The main features of this change were: separation of the functions of the central *bank from the functions of a commercial bank; increase in the number of commercial banks; extension of their credit activity to several branches of the Albanian economy; and introduction of new capital flows in the banking system.*

Which are the main functions of the Bank of Albania?

The Bank of Albania is governed by the Supervisory Council, which is chaired by the Governor. It represents the only institution in the Republic of Albania, responsible for drafting, approving and implementing the monetary policy. This policy is drafted with the aim of fulfilling the main objective of the Bank of Albania: achieving and maintaining price stability.

It is important to understand that the Bank of Albania does not have the same functions and does not offer the same services as commercial banks. To put it simply, it does not serve directly to the citizens and private businesses; does not extend loans to them; does not hold personal banking accounts; and does not issue debit or credit cards. Thus, it is like a bank without cash desks. "Clients" of the central bank are the commercial banks and the government.

In addition to drafting the monetary policy, it has other functions and duties related to guaranteeing financial stability in the country, licensing and supervising the activity of the commercial banks, issuing national coins and banknotes, and administering the foreign-exchange reserve.

Earlier, we said that inflation is caused by the more rapid increase of the general demand in economy compared to the supply, i.e. when the demand for buying goods is higher than the production capacity of businesses at a given time. We also noticed how this may lead to a closed circle, where the cost increase leads to price increase, and so on. There is a moment when this vicious circle has to be broken. If inflation is allowed to rise considerably, its later decrease may result in a painful and unpleasant process for participants in the economy.

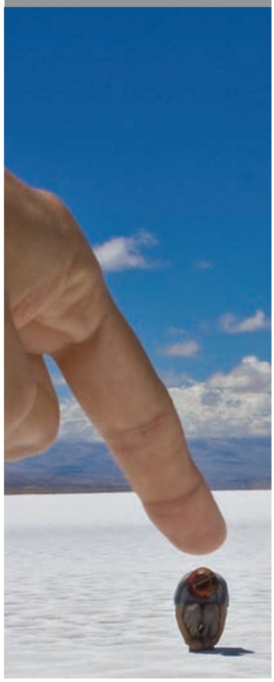
This would require a drastic and immediate decrease of the demand for goods and services in the economy, which would lead to economic downturn and rise of unemployment. To avoid this, the Bank of Albania intervenes in due time to keep inflation within its target.

How does the Bank of Albania keep inflation within its target?

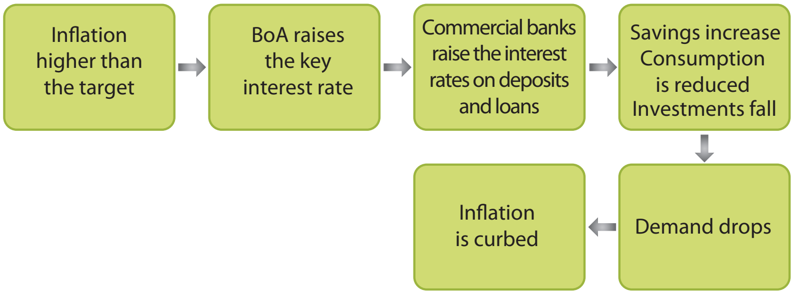
To keep inflation within its target, the Bank of Albania ensures that the general demand for goods and services in the economy increase steadily, neither too rapidly, nor too slowly, so that the supply may meet the demand. How is this achieved?

This is done by changing the key interest rate it applies to commercial banks, thus influencing on the interest rates commercial banks apply on deposits and credit. In turn, the change influences decisions to save, consume or invest in the economy, i.e. the general demand for goods and services.

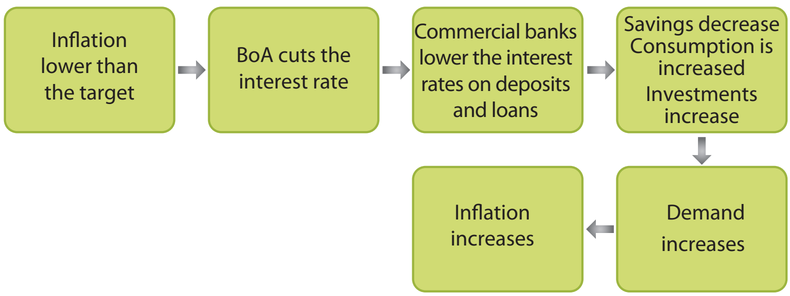
If the Bank of Albania deems that the demand is increasing quite rapidly and that it may take inflation above its target, which is 3%, it raises the key interest rate. When the interest rates rise, people tend to save more, thus consume less. Higher interest rate means higher interest on loans. Thus, people spend less, i.e. buy less goods and services. The general demand is slowed down and inflation drops. This is an example of a tight monetary policy employed by the central bank when demand increases more rapidly than it should and inflation is expected to rise above the objective set by the central bank.



The Bank of Albania is the institution responsible for keeping inflation under control.



The Bank of Albania applies an easy monetary policy when it deems that the demand in the economy is rising very slowly and inflation is expected to drop below the Bank's target. In this case, the Bank of Albania cuts the key interest rate. The loan repayments fall and new loans become cheaper. Meanwhile, lower interest rates make savings less appealing and thus people save less and spend more. The aggregate demand rises and inflation rises as well, getting closer to the objective.



Therefore, when you hear the Governor of the Bank of Albania saying in a press conference that the Supervisory Council has decided to increase or reduce the interest rate, you will know why: to keep inflation closer to its target of 3% +/-1 percentage points. Furthermore, you already know why this is important to all of us.

4.2 FISCAL POLICY

The fiscal policy is the control over the government's revenue and expenditure, with the aim of impacting the economy. The fiscal policy is drafted and implemented by the government through the Ministry of Finance.[2]

In the lesson on "*Economy and inflation*", we said that the government buys goods and services in a similar way like consumers. On the other hand, it also makes investments. All of these constitute the government's expenditure. These expenditures are financed through the revenues the government collects from the taxes we all pay. We will learn more about taxes in the lesson on "*Taxes in Albania*".

Like all of us, even the government should be careful in administering its finances, being careful with the revenues and expenditure. If the government plans to spend more than the revenue it collects, its budget is in deficit. In this case, the government borrows money to finance its deficit and pay interests on the debt. If the government spends less than the revenue it generates, its budget is in surplus and the government may use the surplus to pay part of the debt from previous years.

A contractionary fiscal policy is achieved by reducing expenditure or raising taxes.

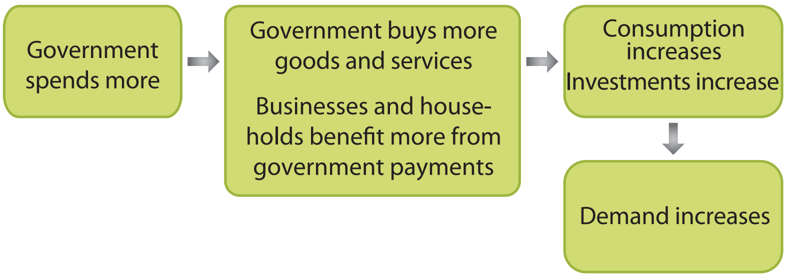
How does the fiscal policy affect the economy?

The government influences the economy through two instruments:

Its expenditure and the taxes it gathers from the citizens.
A fiscal policy may be expansionary or contractionary.

[2] www.minfin.gov.al

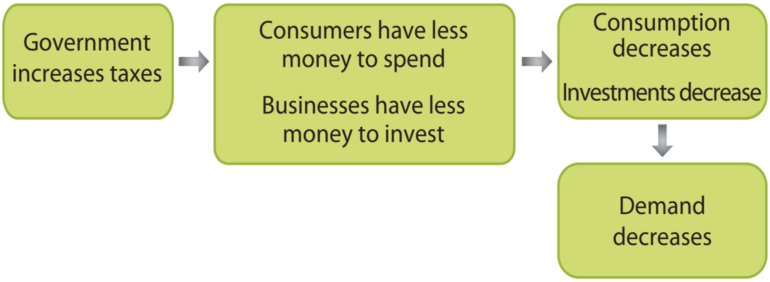
An expansionary fiscal policy is a policy, which stimulates consumption in the economy and raises the general demand. This policy is applied when the economy is not growing sufficiently and/or the unemployment rate is high. It may be achieved in two ways: by increasing expenditure and reducing taxes. If the demand of all the participants in the economy does not match supply, the government decides to buy more goods and services. Since the government is part of the demand for goods and services in the economy, the aggregate demand will increase directly. An example of an expansionary policy by increasing the expenditure is shown in the following figure.



The expansionary policy, through reduction of taxes, functions similarly: if your parents paid fewer taxes on their income, your family would have more money to spend. In this case, your family would spend more, i.e. the consumption would increase, and as a result, the aggregate demand would increase as well.

A **contractionary fiscal policy** is achieved by reducing expenditure or by raising taxes. A reduction of the government's expenditure reduces directly the demand for goods and services from the government and, therefore, the aggregate demand drops.

When taxes are increased, consumers have less income to spend. They will buy fewer goods and services, thus the general demand will decrease. The following chart shows the impact of the tax increase on the aggregate demand.



QUESTIONS?

1. Describe the two macroeconomic policies and their objectives.

2. What is the monetary policy? Which institution is responsible for the monetary policy in Albania?

3. What is the objective of the monetary policy of the Bank of Albania?

4. How does the Bank of Albania apply the monetary policy?

5. When does the Bank of Albania apply a tight monetary policy and when does it apply an easy monetary policy?

6. What are some of the tools through which the fiscal policy achieves its objectives?

7. Explain the expansionary and the contractionary fiscal policies.

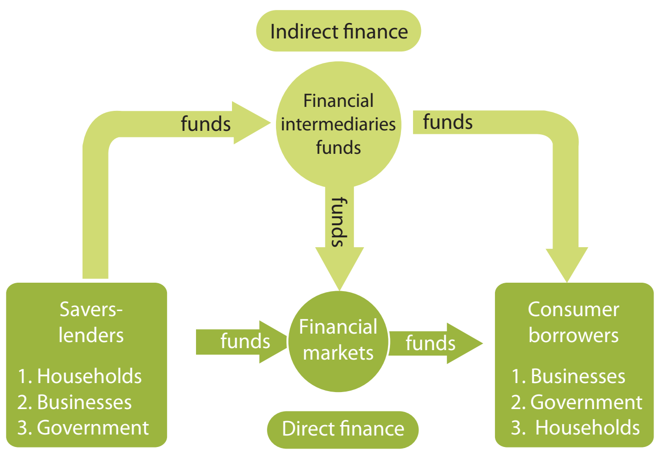
8. Describe through a chart the impact of tax reduction on aggregate demand.

9. Describe through a chart the impact of expenditure reduction aggregate demand.

5. FINANCIAL SYSTEM[3]

The financial system is very important to the economy. It brings together the savers (those who spend less than they earn) and the borrowers (those who spend more than they earn), thus enabling the transfer of funds from those who have in surplus to those who need them. Generally, individuals (households) are the typical savers who lend their savings to businesses and the government. The largest typical borrowers in a market economy are businesses and the government. However, households individuals may be borrowers for a certain period of time (for example, when we take a loan to buy a house or car), or businesses or the government may lend to other businesses or households.

Flow of funds among the lenders (savers) and borrowers, through the financial system.

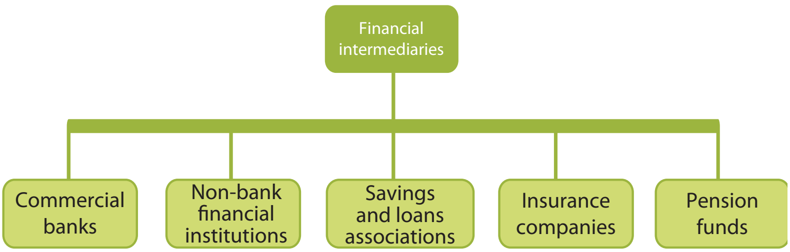


[3] Note: the data on the number of financial institutions mentioned in this lesson, are as at July 2013.

The transfer of funds from the lenders to the borrowers is enabled through the financial markets and financial intermediaries.

The financial markets enable the direct transfer of funds from the lender to the borrower. Often, the financial intermediaries are the link between the lenders and the borrowers.

The financial intermediaries comprise all institutions which offer financial services. The most important financial institutions are the banks, non-bank lending institutions, savings-credit companies, and insurance and pension funds companies.



Commercial banks are financial institutions that accept deposits and use them to give loans.

Did you know?

The banking system in Albania is the most developed segment, comprising more than 90% of financial intermediaries.

Currently, there are 16 commercial banks operating in Albania, of which two have completely Albanian private capital, while the others banks are Austrian, Greek, Italian, Turkish, German and French-owned.

Non-bank credit institutions are financial institutions which give loans, but do not accept deposits. Except for the fact that they may not accept deposits from the public, their activity is similar to that of the banks.

Did you know?

Currently, there are 21 non-bank credit institutions operating in Albania. Two of them are microcredit institutions. The name itself indicates that these institutions are specialized in giving credit to households and small businesses for up to ALL 600,000. They are important because they finance households and businesses that operate in areas that are not covered by the commercial banks.

Savings and loans associations are financial institutions, which accept deposits and use them to give credit only to their members.

Did you know?

Savings and loan associations are established by various social groups joined together based on a common feature, such as their vocation (teachers, farmers, bee-farmers, etc.), and community.

The main principles of the functioning of savings and loan associations are the mutual help and volunteering. The savings and loan associations may establish their unions as well.

In Albania, there are 129 savings and loans associations. They are organized in two savings and loan unions.

Insurance companies are financial institutions, which indemnify losses incurred from fire, accidents, illness, theft, death, etc.

Did you know?

Currently, there are 9 non-life insurance companies and 3 life insurance companies. They provide life, accident and human health, auto, property and equipment insurance.

Pension funds are financial institutions, which provide income during the retirement age from contributions paid during the years of employment.

Did you know?

In Albania, the basic pension scheme is the state-run scheme. Employees pay periodical contributions, which are gathered and administered by the Social Insurance Institute. A legally-employed person must be enrolled in the state pension scheme.

In addition to this scheme, anyone may adhere to private pension schemes, on a volunteer basis. There are three private pension funds operating in Albania, two of which have domestic and foreign capital and one has foreign capital.

The financial system should be safe and stable, in order for the transfer of funds from the savers to the borrowers to function properly. The mandate for maintaining the stability of the financial system in general is given to Bank of Albania.[4]
Meanwhile, the responsibility for licensing, regulating and

[4] For more information, visit the official website of the Bank of Albania www.bankofalbania.org

overseeing the various segments of this system is shared between Bank of Albania and the Financial Supervisory Authority.[5]

The Bank of Albania supervises the banking system, the non-bank financial institutions and the savings and loan associations.

The Financial Supervisory Authority supervises insurance companies, pension funds and the securities market.

Both these institutions enjoy full independence in exercising this function. They report to the Assembly of Albania, i.e., to the representatives elected by the people through a free vote.

The mandate to maintain the stability of the financial system in general rests with the Bank of Albania.

[5] For more information, visit the official website of the Financial Supervisory Authority: www.amf.gov.al

QUESTIONS ?

1. Which is the role of the financial system in economy?

2. Which is the role of the financial intermediaries in economy?

3. Which are the most important groups of financial institutions? Describe the characteristics of each of these groups.

Home/Class work

Divide into five groups. Each of the groups should gather information about a group of financial intermediaries (by visiting one of them). Discuss and share the information you have collected.

GLOSSARY

Financial intermediaries – are institutions (such as banks, insurance companies, pension funds) that borrow money from individuals or businesses and lend to others.

Banks – are financial institutions where various actors of the economy deposit money and earn interest, while others borrow money and pay interest to them.

CHAPTER 2:

PERSONAL FINANCES

CHAPTER 2: PERSONAL FINANCES

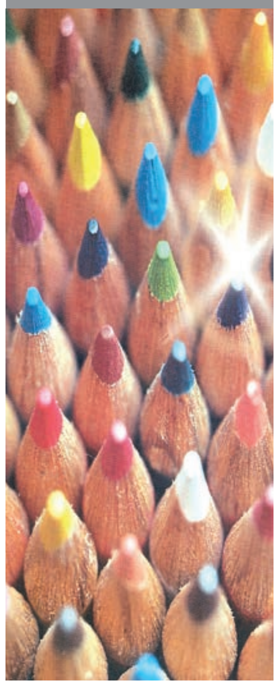
In Chapter I, you were provided with some basic knowledge on economic issues and were introduced to the key economic institutions affecting your lives and financial decisions. Chapter II details various aspects of your personal finances, as follows:

- Money and its time value
- Effect of inflation on the value of money
- Exchange rate
- Personal budget
- Drafting a savings plan
- Banking products and services
- Investment of savings
- Customer's rights and obligations
- Pension schemes
- Insurance
- Taxes

At the end of Chapter, you should be able to:

- Draft a small individual budget and savings plan
- Know various banking products and their costs
- Select the most suitable bank products for your savings
- Calculate the interest you can earn on bank deposits
- Know the different types of bank loans, costs and principles of their use

- Know the main taxes you have to pay in your life as a citizen of this country and their calculation
- Know the different types of insurance and benefits from their use
- Know the options you have for better financial conditions once in retirement.



1. WHAT IS MONEY? ITS FUNCTIONS

Money has been different in different times, but it has always been important for the people and economy. The word "money" is often used in everyday language and it takes various meanings, but, for the economists, money is everything that is generally accepted as a means of payment for purchasing goods and services, as well as for paying obligations.

Shells are one of the most ancient forms used as means of exchange.

Coins and banknotes of today match this definition and, when people refer to money in their daily language, they mean exactly this form of money. However, throughout the history of humanity, money has taken different shapes. Shells (in Ancient Egypt), or widely used items such as corn, tobacco, tea, sugar, coffee, cacao, as well as precious items such as pelisses and precious metals have been used as money.

In most of today's economies, coins and banknotes, known as cash, are the most widespread form of money. But, "money" is not restricted to the entirety of the issued coins and banknotes. With the development of society, invention of computers and internet, other forms of money have been developed. Thus, in today's world, the cheque, a massively used instrument in the last century, electronic money and electronic payments are used as money.

The cheque

The cheque is an order you give to your bank to transfer money from your account into someone else's account. The cheque enables transactions without having to transport large amounts of money with us.

Electronic payments

Electronic payment has substituted cheques in making payments.

You may have noticed your parents or others in shopping centres no longer using cash but banking cards, which are connected to their bank accounts electronically and in real time. Thanks to internet technology, now you may make payments and transactions with your bank account without having to go to the bank in person. You simply need a computer, internet connection and a security code.

Electronic money
Electronic money replaces coins and banknotes. It is saved in an electronic device in the form of a chip card or computer memory and allows the holder to make electronic payments and transfers in limited amounts. You may imagine it to be used like a pre-paid phone card, with a certain number of credits, which can be used until it runs out of credit.

Money functions

Regardless of its form, money has three functions in economy.

Money serves **as a means of exchange** in purchasing and selling goods and services; **as a measurement unit** or as a standard of value; **as a store of value**.

Almost in all market transactions in our economy, money in the form of coins and banknotes is used as a means of exchange, to pay for the goods and services we purchase. Use of money as a means of exchange reduces the time needed to exchange goods and services. To understand this, imagine a place called Tramba, where money does not exist.

Money is used as a means of exchange to pay for the goods and services we purchase.

Ina, a psychologist, lives here. She needs to find a farmer in order to find food, but not only. She has to ensure that the farmer needs her services as a psychologist, so that she can "pay" for the food through some psychotherapy sessions.

Imagine how difficult it is for Ina to find food in this economy. Maybe, she will have to quit her job and become a farmer. Imagine now what would happen if a smart person in Tramba invents money. Ina would be paid with money for the services she offers to her clients, who did not have to be farmers. With this money, she would buy food from the farmers who, on the other hand, would use this money to purchase goods and services they need. Thus, money increases economic efficiency by eliminating the time used for the exchange of goods and services and by enabling people to specialise in what they do best.

The second function of money is its use as a measurement unit, i.e. as a standardized measurement of value in economy. We use money to express the value of goods and services, as we measure weight by kilograms or distance by kilometres. To see the importance of this function, let us go back to our imaginary place, Tramba, before the use of money. If there are only three goods in Tramba: apples, psychotherapy sessions and a recreational centre, we need to know three prices in order to determine the quantity required for exchanging one good with another: the price of apples vis-a-vis psychotherapy sessions (i.e. how many psychotherapy sessions are needed to purchase 1 kg of apples), the price of apples vis-à-vis hours spent in the recreational centre and the price of a psychotherapy session vis-à-vis hours spent in the recreational centre.

The second function of money is its use as a measurement unit.

But, if there were 10 goods in Tramba, then we would have to remember 45 prices.[1] And if our economy had 1000 goods, we would have to remember 499,500 prices.

The moment money starts being used in Tramba, the prices of all goods are determined in money. If there were only

[1] The number of prices in an economy with n goods, which does not use money, is $n \times (n-1)/2$.

three goods in Tramba, we would not benefit tremendously by the use of money. But, if the number of goods and services reached 1000, we would have to remember only 1000 prices and not 499,500 ones.

Money is also used as store of value. It enables the storing of purchasing power in time, from the time of receiving the income until the time they are spent. This function of money is very useful because many of us do not want to spend all our income as soon as we receive them, but wait until we have the time, desire and need to purchase goods and services. Money is not the only medium offering store of value. Other means such as: land, apartment, art, jewellery, treasury bonds, may be used as store of value. Actually, many of these items play this role very well and not only do they preserve, but may also increase the value of your wealth.

Why do people keep money?

The answer to this question relates to an important concept in economy: liquidity – the speed with which an item (house, vehicle, etc.) may be exchanged with money. The exchange of items with money includes transaction costs. For example, if you want to sell your house, you have to pay a fee of 2.0-3.0% of the value of the house to the procurer who enabled the sale. Furthermore, if you have an urgent need for that money, you may sell the house at a lower price than its real value, so that you may receive the value in money as soon as possible. Thus, we do store money, even though it is not the most attractive medium to store the value of our wealth.

Money is also used as store of value.

Did you know?

Where does the word coin come from? The first silver coins in ancient Rome were struck in the temple of goddess Juno Moneta. This is the reason why this word is found in many languages even nowadays such as: moneta (Italian), money (English), monnaie (French), etc.

In Albania, the coinage originates from IV century BC in Dyrrhachium (modern Durrës) and Apollonia (modern Pojan in Fier), where various cities in Illyricum had their own coins.

QUESTIONS?

Discuss

1. Which of the following expressions relates to the definition of money used in this text?

- *"How much money do you earn in a month?"*
- *"Before going to the store, I must make sure to have enough money with me."*
- *"Money leads to ruin"*

Explain

1. Three people live in a small country where they produce three goods, as follows:

Goods	**Producer**
Apple	*Orchardist (of apples)*
Bread	*Baker*
Fish	*Fisherman*

If the Orchardist eats only bread, Baker eats only fish and the Fisherman eats only apples, is it possible to trade in *this economy? How would these inhabitants / producers benefit from the use of money in their economy?*

2. Why prehistoric people, who lived in caves, did not need money?

3. The inhabitants of ancient Greece used gold coins as money. Why was not wine as good as gold, as a medium of exchange?

4. Discuss the ability to maintain and increase the value of your property and cash liquidity of the following assets:

- *bank deposits;*
- *coins and banknotes;*
- *paintings;*
- *precious old items;*
- *cars.*

GLOSSARY

Purchasing power of money – shows the amount of goods and services money can buy at a certain moment.

Asset – everything that serves as a source of economic value for its owner. The means may be financial (intangible) or physical (tangible).

Financial asset –assets that have a financial value, which derives from the obligations of an agreement.

These assets are called intangible because they do not have physical qualities such as those of a house or a car. Examples of financial assets are: bank deposits, securities, treasury bonds.

Conversion – shows the process and concrete actions of turning or converting an asset into another asset.

For example, it may be used in the case of converting a share of an immovable property into money or in the case of currency exchange.

2. TIME VALUE OF MONEY

You are your grandpa's favourite nephew/niece. On your fifteenth birthday, he asks you to choose between two gifts: (1) ALL 5,000 today or (2) ALL 7,000, after 3 years. The second amount is bigger than the first one. But, you may take the first amount today, while you would have to wait three years for the second amount. Is it worth giving up ALL 5,000 today in order to get ALL 7,000 after 3 years? You will know how to answer this question at the end of the lesson.

The answer to the above question depends on the time value of money, which is the topic of this lesson. In general, the term "time value of money" relates to the fact that ALL 1 owned today is worth more than ALL 1 promised to be received at a future time. One of the most important reasons is that the ALL 1 you have today may be deposited and earn interest, thus becoming more than ALL 1 in the future. The connection between money today and money in the future depends on the interest rate you would earn by investing the money and on the time period of the investment.

The first concept we will deal with is the future value of money. The future value of a certain amount of money is the quantity of money we will benefit after investing this amount, with a certain interest rate, for a certain period of time. We will begin with the simplest example of this exercise, investment for 1 year.

The concept of money is strongly related to the concept of time.

The case of 1 year

Suppose you deposit ALL 1,000 in a savings account, which pays you an interest of 10% per year. How much money will there be in this account after one year? The answer is simple: you will have ALL 1,100 in your savings account after one year. The original amount of ALL 1,000 will be added the interest of ALL 100 (10% x 1,000 = 100). The amount ALL 1,100 at the end of the year is the future value of the original amount of ALL 1,000. Therefore, ALL 1,000 today are worth ALL 1,100 after a year, if the interest rate is 10% a year.

The case of multiple years

Continuing further with the above example, how much money would there be in your account after two years, if the interest rate continues to be the same? Remember that, at the end of the first year, you have ALL 1,100 in your account. This amount will be invested for another year, with an interest rate of 10% per year. The interest earned will be: 10% x 1,100 = 110. The value at the end of the second year will be 1,100 + 110 = ALL 1,210.

Better ALL 5,000 today or ALL 7,000 after 3 years???

With the knowledge you have received until now, you may answer the first question raised at the beginning of this lesson: accept ALL 5,000 today or ALL 7,000 after 3 years? To answer this question you should compare the above amounts. But, be careful to compare these two amounts you should compare the amount of ALL 7,000 with the value you would benefit if you deposited the amount of ALL 5,000, which you get today, into an account for 3 years. Suppose the interest rate is 9% per year, in all three years.

Interest at the end of the first year = 5,000 x 9% = 5,000 x 0.09 = ALL 450

Amount of money at the end of the first year = 5,000 + 450 = ALL 5,450

Interest at the end of second year = 5,450 x 9% = 5,450 x 0.09 = ALL 490.5

Amount of money at the end of second year = 5,450 + 490.5 = ALL 5,940.5

Interest at the end of third year = 5,940.5 x 9% = 5,940.5 x 0.09 = ALL 534.65

Amount of money at the end of third year = 5,940.5 + 534.65 = ALL 6,475.15

Therefore, if you choose to get ALL 5,000 today and deposit them into an account, after three years you will have ALL 6, 475.

This amount is smaller than the second alternative of the gift of ALL 7,000, promised by the grandfather after three years.

QUESTIONS?

1. *What do you understand with the time value of money?*

2. *What influences the time value of money?*

3. *What is the future value?*

4. *Fill in the last column in the table. Compare values between point 1 and point 2, point 3 and point 4, point 5 and point 6. What conclusions derive from these comparisons?*

	Current value	Interest	Period	Future value
1	20,000	5%	1 year	
2	20,000	8%	1 year	
3	25,000	10%	2 year	
4	30,000	10%	2 year	
5	15,000	6%	1 year	
6	15,000	6%	3 year	

5. *Choose from the following alternatives. The interest rate is 10% in all cases.*

- *ALL 10,000 today or ALL 11,500 after 1 year;*
- *ALL 10,000 today or ALL 12,100 after 2 years;*
- *ALL 10,000 today or ALL 13,000 after 3 years?*

GLOSSARY

Investment – means the use of money at a certain moment, in order to increase the value or generate additional income in the future. Some forms of investment are treasury bonds, securities, or immovable property.

Interest rate – is the price which a borrower pays to the lender for using the money of the latter. Simply said, it is the price for the borrowed money or for the money saved in a savings account. In case of a loan, the borrower takes an amount of money which s/he will use for a certain period of time, while the lender hands over these funds, giving up temporarily from using them. Since the lenders sacrifice the immediate use of funds, they request an additional compensation for the amount of money they lend. This is one of the reasons why, when taking a loan, we pay the bank a certain interest rate, while when we open a deposit it is the bank that pays us the interest rate.

3. INFLUENCE OF INFLATION ON THE VALUE OF MONEY

When we spoke about money and its functions, we said that money serves also as store of value. We also learned that often money is not the most appropriate means to maintain the value of your property compared to other means (house, paintings, precious items, etc.); however, people keep money for liquidity purposes.

The ability of money to preserve the value of a property depends on the level of prices, because its own value relates to the quantity of goods it can purchase, therefore, to the price level of these goods. For example, doubling the price means that the quantity of goods and services we may purchase with the same amount of money is halved. Vice-versa, it means that the quantity of goods we may purchase with this amount of money is doubled. Therefore, the ability of money to maintain its value depends on price changes over time or on the inflation rate.

Before we address the effect of inflation on money, refresh your knowledge about inflation, which you learned in the lesson on “Economy and Inflation”!

Inflation “erodes” the value of money!

Effects of inflation

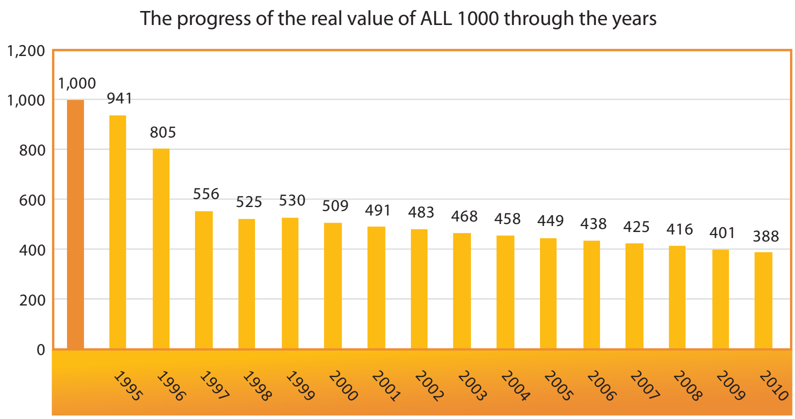
Inflation reduces the ability of money as store of value of a property. If our income does not change, while prices of goods increase with the years, we will be able to buy fewer goods compared to today. In this case, the purchasing power of money has dropped: we buy less goods and services with the same amount of money. In other words, we say that the real value of income – the value of our income expressed in/measured with the quantity of goods we may purchase with them – has dropped.

We will show an example to measure the effect of inflation on the real value of money: calculate the real value of the amount of ALL 1,000, owned at the end of 1994, over the years. The second column of the table shows the annual inflation rate at the end of each year, starting from 1995. The third column of the table shows the real value of ALL 1,000 at the end of each year. The fourth column explains how the real value is calculated.

Year	Annual inflation	Real value	Calculation of real value
1994		ALL 1,000	
1995	6.3%	ALL 941	= 1000/(1+6.3/100)
1996	16.9%	ALL 805	= 941/(1+16.9/100)
1997	44.6%	ALL 557	= 805/(1+44.6/100)
1998	6.0%	ALL 525	= 557/(1+6.0/100)
1999	-1.0%	ALL 530	= 525/(1+(-1/100))
2000	4.2%	ALL 509	= 530/(1+4.2/100)
2001	3.5%	ALL 492	= 509/(1+3.5/100)
2002	1.7%	ALL 484	…
2003	3.3%	ALL 468	…
2004	2.2%	ALL 458	…
2005	2.0%	ALL 449	…
2006	2.5%	ALL 438	…
2007	3.1%	ALL 425	…
2008	2.2%	ALL 416	…
2009	3.7%	ALL 401	…
2010	3.4%	ALL 388	= 401/(1+3.4/100)

From the end of 1994 until the end of 1995,one year has passed. During this year, the inflation has been 6.3%, which means that prices have increased on average by 6.3%.

The ALL 1000 we had at the end of 1994, cannot buy the same amount of goods and services at the end of 1995. To be more precise, at the end of 1995, the real value of the ALL 1,000 owned at the end of 1994 is 1,000/(1+6.3/100) = ALL 941. At end-2010, the real value of ALL 1,000 is ALL 388. The following chart reflects the progress of the real value of the ALL 1,000.



As a hedge against inflation, some employers increase the annual salaries of their employees at least equally to the annual inflation rate.

It is often said that inflation is the best friend of a borrower and the worst enemy of the lender. To understand this, suppose a year ago you borrowed ALL 20,000 from a friend of yours, which you will return today, without paying interest. During the year, the economy suffered from a high inflation of 15%. You return the borrowed ALL 20,000 to your friend. But, actually, you have returned to your friend less than the amount you borrowed.

Because of the price increase of 15%, he cannot purchase the same amount of goods and services he would purchase at the moment he lent you the money. Actually, he may now buy as many goods and services as he would have bought with ALL 17,391 at the moment he lent you the money, a year ago [20,000/(1+0.15) = 17,391].

Inflation “erodes” the value of your savings!

Suppose you deposit ALL 10,000 today in a bank account earning 5% interest per year. At the end of the first year, you will have ALL 10,500 [10,000 x (1.05)]. During this year, the inflation rate was 7%. This means that with the amount of ALL 10,500 in your account you will anyway purchase less goods and services than a year ago, even though you earned interest for your savings. You can buy 10,500/(1+0.07) = ALL 9,813 goods and services with the prices of a year ago. However, the interest helped you maintain part of the purchasing power. If you did not earn interest with your savings, you would have only ALL 10,000 in your account, whose worth would be ALL 9,345 [10,000/(1+0.07)] of goods and services with the prices of a year ago. To maintain the purchasing power of your savings, you should invest them with an interest rate of at least equal to the inflation rate.

QUESTIONS?

1. Explain the effect of inflation on the value of money.

2. Mention some of the ways to be protected from inflation.

3. Bring an example where inflation is not harmful to you.

4. Using the data of the table in the text, calculate the real value of the amount of ALL 1,000 for the period 2002-2009.
Check your score to the one presented in the table.

5. Your parents have just invested ALL 20,000 in a 12-months deposit. The annual interest rate is 5%.

a. How much is the interest earned for a year?
b. How much is the amount of money in the bank after one year?
c. Calculate the real value of ALL 20,000 after one year if the annual inflation rate were 3%, 5%, 7%. What do you note?
d. Calculate the real value of the amount found in "b", for three annual rates of inflation. What do you note?
e. What conclusions can derive from the comparison of results obtained in "c" and "d"? To have easier comparisons, complete the following table with the values found.

Inflation	The real value of ALL 20 000	The real value of the amount found in "b"
3%		
5%		
7%		

GLOSSARY

Indexing – is the connection of the level of one economic-financial indicator with another one. In case of inflation, to maintain the living standard of the employees from the price increase of goods and services, some employers do index (connect) the salaries with the inflation rate. Thus, every year, the salaries are increased at the same rate as inflation.

4. EXCHANGE RATE AND ITS IMPACT IN OUR LIFE

Almost every country in the world has its own currency. The lek is used in Albania, the euro is used in the euro area countries, the US dollar is used in the USA, the British pound is used in the UK, the Japanese yen is used in Japan, and so on. Furthermore, trade between countries includes the exchange of various currencies. When an Albanian company purchases foreign goods (imports), for example from Greece, it must pay the seller of these goods in euro. Therefore, the company must exchange Albanian lek for euros. Thus, trade between different countries leads to the need to exchange the currencies of these countries with each other.

The exchange of currencies is done in the exchange market also known as the foreign exchange market. In this market, foreign currencies are bought and sold as if they were goods and their price is the exchange rate. The amount of money needed for buying 1 euro, is exactly the price of euro expressed in the national currency. As in many other countries, the exchange rate regime in Albania is free, which means that foreign currencies may be traded without restrictions and that their price in lek is determined by the demand and supply for these currencies, i.e. the market.

In a free regime of the exchange rate, the values of various currencies fluctuate over time. Thus, suppose 1 euro today costs ALL 135.0, but after a year it may cost ALL 125.0 or ALL 145.0. In the first case (125.0), we need less money to buy 1 euro and so we say that our currency is appreciated against the euro, while euro is depreciated against the lek.

In a free regime of the exchange rate, the values of various currencies fluctuate freely.

Why is the exchange rate important?

The exchange rate is important because it affects the prices of imported and exported goods and services. The price in ALL of a good from Italy is determined by the interaction of two factors: price in euro and the EUR/ALL exchange rate. Suppose Ada wants to buy a box of Italian cheese, which costs 10 euros. The EUR/ALL exchange rate today is ALL 135.0 for 1 euro. The price in ALL for the cheese is EUR 10 x 135.0 ALL/EUR = ALL 1,350. Ada likes the cheese very much and after two months she would like to buy another box. The price for a box of cheese continues to be 10 euros, but the price in ALL will vary also from the exchange rate. Suppose during these months, the ALL depreciated and 1 euro is sold at ALL 145.0. Purchasing the second box of cheese would cost Ada 10 x 145.0 = ALL 1,450 ALL or ALL 100 more than the first purchase.

...what if the exchange rate reaches the value 125.0 ALL/EUR?

At the same time, let's take the example of an Italian student, Marko, who likes Albanian fish. The price of fish is ALL 3,000 per kilo. The price in euro, which Marko would have to pay for 1 kg, is 22.22 euro, when the exchange rate is 135.0 ALL/EUR (3,000/135) and 20.69 euro (3,000/145) when the exchange rate is 145.0ALL/EUR. Exposed before the same fluctuation of the exchange rate – depreciation of the Albanian lek – the Italian product became more expensive for Ada, while the Albanian product became cheaper for Marko.

The above example leads us to the following generalisation: *When one country's currency appreciates (its value increases compared to other currencies), the goods of that country become more expensive for the foreigners and the foreign goods become cheaper for the locals.*

Conversely, *when one country's currency depreciates, the goods of that country become cheaper for the foreigners and more expensive for the locals.*

Determinants of the exchange rate

We mentioned that in a free regime of the exchange rate, the latter is determined by the supply and the demand for the foreign currency. To put it simply, the more goods we import, the more foreign currency we need to pay to foreign partners; and the higher the foreign demand for Albanian goods, the more foreign currency will enter our country from the sale of these goods. In Albania's case, an important part of the supply is determined also by the remittances or the foreign investment inflows.

Effects of exchange-rate fluctuations on the economy

We discussed earlier that the depreciation of the local currency makes, among others, foreign goods more expensive. For a mainly importing country like Albania, this correlation is very important. The depreciation of the lek would lead to an higher import prices in lek for the consumer goods.

In addition to the above effect, the exchange rate is of special importance to the Albanian economy as salaries of employees or profit from a business may be in a foreign currency and foreign currencies may be used as store of value. For some of the Albanian families, part of the income used for purchasing goods come from their relatives who live and work in Italy, Greece or other countries.

... what if the exchange rate reaches the value 155.0 ALL/EUR?

Furthermore, a number of individuals are paid in a foreign currency. The amount of goods and services these individuals may purchase with, for example 200 euro, will depend on the rate of exchanging euros into Albanian lek. If 1 euro is exchanged for 135.0 lek, they may buy 200 x 135.0 = ALL 27,000 of goods and services in Albania. If the exchange rate is 145.0 ALL/EUR, they will buy 200 x 145.0 = ALL 29,000 of goods and services. Furthermore, there are people whose savings are in foreign currency or they have items which are traded in foreign currency (for example, apartments or vehicles). The exchange rate is important for them because it determines the value of their savings and property in the local currency, Albanian lek.

Example 1: Imagine you own a 100 m^2 apartment, which currently may be sold at 500 euro/m^2. In this moment, your apartment is worth EUR 50,000. With today's exchange rate of 135.0 ALL/EUR, your apartment is worth ALL 6.75 million (50,000 x 135.0 = ALL 6,750,000). After 10 months, the price, in euro, of your apartment has not changed, but the exchange rate went up 145.0 ALL/euro. Now, your apartment's value has jumped to ALL 7.25 million (50,000 x 145.0 = 7,250,000ALL). Your property has increased its value by ALL 500,000 (7,250,000 - 6,750,000) only because of exchange rate.

An important effect of the exchange rate is also shown in repaying a loan in foreign currency. In Albania, since the interest rate was lower for euro than for Albanian lek, many households and businesses have taken loans in euro, even though their income is in Albanian lek. Despite the advantage of the low exchange rate, such an action made the borrowers face the fluctuations in the exchange rate, as it is shown in the following example.

Example 2: You have taken a loan to buy a house. The loan is in euro and the monthly instalment you have to pay to the bank is EUR 250. With today's exchange rate of 135.0 ALL/EUR, you need ALL 33,750 (250 x 135.0) per month to pay the instalment. After 10 months, when the exchange rate goes up 145.0 ALL/EUR, you will need ALL 36,250 (250 x 145.0) or ALL 2,500 more.

... sometimes, one may even benefit from exchange rate fluctuations...

The above examples help us understand that the exchange rate fluctuation may yield profit or loss to you. To avoid such situations, consumers are advised to:

Take heed of the effects of exchange rate's fluctuations, every time they make transactions in currencies other than Albanian lek.

Especially: the loan's currency should match the currency of their income. If the income is in lek, the loan should be in lek. If their income is systematic and continuously in euro, they should take the loan in euro!

QUESTIONS?

1. Describe the exchange rate and its determinants

2. Explain the importance of the exchange rate in the economy

3. Visit the website of the Bank of Albania and get the latest data on the exchange rate of lek against various currencies. Explain them.

4. Visit the website of the Bank of Albania and collect information on the exchange rate. Discuss in class.

5. Fill in the missing information in the following table:

	Value in euro	Value in ALL	ALL exchange rate for 1 euro
Loan payment in euro	377.48	?	138.6
Price of a painting	?	5000	136.5
The value of an apartment	50000	?	135.7
Price of an Italian wine	30	?	137.3

GLOSSARY

Import – goods produced in a foreign country and sold in our country for consumption or investment. Imports bring money to the producing country, and take that money from the country where the goods are sold.

Export – represents goods produced at home and sold abroad.

5. PERSONAL BUDGET

A personal budget is crucial in decision-making and in our daily life. But, before speaking about the importance of drafting a personal budget, it is important to understand what a personal budget is.

A personal budget means: **a financial plan which calculates the income and expenses of a person or household, for a certain period of time**. Thus, the personal budget is a mirror of your financial situation, which helps you organise better in order to achieve an objective. The objective might be purchasing a new mobile phone at the end of the month or saving the money for enrolment at university. When you set a goal and time line to a budget, you become even more aware of its importance and understand better the required discipline and compliance with some criteria, in order to administer your income.

A wise saying: "You may stretch your legs, but keep your feet inside the blanket!"

Why is it important to develop a personal budget?

Having a personal budget is one of the most important and meaningful steps to achieve your financial goals. Having a personal budget enables you to be more skilled and careful in controlling expenses and increasing your savings. The budget is somehow your financial conscience, telling you how much you earn and how much you are spending.

Developing a personal budget provides several advantages, which affect directly your life style and quality.

Advantages of having a personal budget:

- Identifies on what you spend your money;

- Clarifies the most proper way to spend money;
- Tells you that you cannot spend more than what you have;
- Provides directions on the ways to use money for increasing your wealth.

Other advantages are:

- Develops and improves organisational skills by providing information about all the transactions with your money;
- Develops and improves your communication skills and confidence when you share your money or create a joint budget with someone else, giving you an opportunity to find common grounds about spending money;
- Develops and improves your knowledge on how to categorise your income.

Having a budget provides directions on finding ways to spend money wisely.

How to draft a budget and stick to it?

The budget should contain two main areas: income and expenditures. Income shows all the money you earn from various resources, which might be: monthly salary, bonuses, social aid from the state or your relatives, pensions, income from renting an immovable property or investing your savings. On the other side of the budget, we find expenditures, that is, the money you spend to make various payments. They may be used to pay the monthly rent or a loan, utility bills, school fees, food, clothes and recreational activities.

In drafting a personal budget you should follow these steps:

1. **Identify the income you will earn during the given period** (salaries, bonuses, economic state benefits or income from investing your savings);

2. **Calculate all your costs starting from recurring ones** (rent, utility bills, health or social insurance, loan payment, various subscription fees, food);

3. **Calculate the balance of your budget** (easy: apply the formula: Balance = Income– expenses). Your balance is what is left after you have paid all your dues. You may save them, so that you may buy your new mobile phone in the future, pay your vacation, school fees, or invest them to earn more in the future.

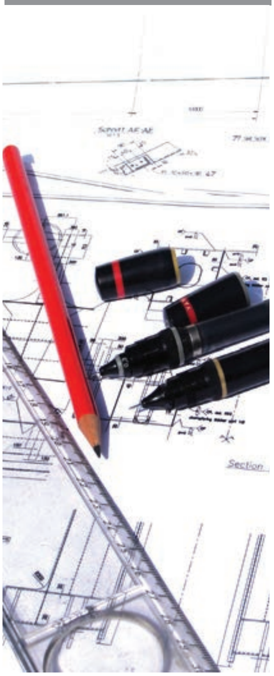
The golden rule to keep your budget in check is to that you should never spend more than your income.

Remember to calculate all expenses while drafting a budget!

Make sure your personal budget is simple and reflects the reality of your income and expenditure, and make relevant adjustments in case it changes.

The following table reflects the schematic aspect of drafting a budget. As you will see, the schematic drafting is simple but also efficient to understand how a personal budget is drafted. However, it is more important to assess and stick to it. The ability to draft a personal budget is important, but if we are not careful and accurate in drafting and adhering to that budget, it would be worthless.

Therefore, it is very important to record regularly all the income and expenses and be faithful to your goals. This would help you be successful in controlling and allocating better your money.



Evaluate the importance of following a personal budget.

Net monthly income	
Income from work	
Bonuses	
Economic state aid	
Income from rent	
Income from investing savings	
Total income	
Core expenses	
Food	
Water	
Electricity	
Rent or loan payment	
Total core expenses	
Other expenses	
House maintenance (dry cleaning, plumbing, and repairs)	
Transportation (vehicle fees, bus fares, taxi, fuel, insurance, taxes, parking)	
Clothes	
Books, internet services	
Entertainment (cable, satellite, rented movies, theatre, vacations, travel, etc)	
Loans (education, mortgage, etc.)	
Other monthly expenses	
Total expenses	

Net monthly income-(Core expenses + Other expenses) = Total amount left to save or invest

QUESTIONS?

1. What is a personal budget?

2. Why is it important to draft a personal budget?

3. Explain the advantages of a personal budget

4. Which are the three steps of drafting a personal budget?

Home/Class work

1. Build a simple budget scheme and, with the help of your parents, try to record all the income and expenses of your family in a month. What is the amount of money saved at the end of the month?

2. In another table, record all the income you get over a month and your expenses. Certainly, at the end of the month you will be surprised on how much you spend.

6. DRAFTING A SAVINGS PLAN

After you learned how to draft a personal budget and assess the importance of adhering to it with discipline and accuracy, the second step is to draft a savings plan.

This lesson will show you how to draft an individual savings plan. Later, in the lesson on "Investment of Savings", you will learn about various options to invest your savings.

The reasons we save money are many and relative, depending on the purposes and priorities each of us sets. However, the reasons to draft a savings plan may be classified in:

- unpredictable /urgent- cases involving illness, accident, loss of job, etc.
- expenditure for purchasing a house / car
- education
- retirement
- vacations

Drafting a savings plan renders you automatically more capable to achieve your goals, short or long–term ones. A savings plan helps you fulfil not only your wishes and needs, but also have the needed psychological tranquillity to solve financial problems you might face in the future. The sooner you decide to draft a savings plan, the more valuable it will be for your life.

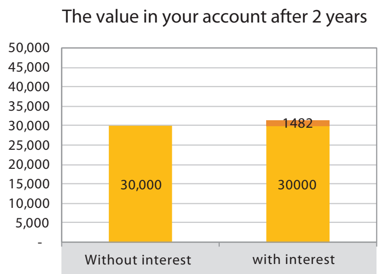
Drafting a savings plan renders you automaticallymore capable to achieve your goals

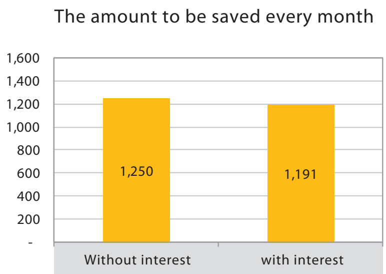
It is important to know that if you deposit your money into a savings account, you will benefit more than from depositing them in your personal savings box. The reason is the bank not only saves your money, but returns them to you together with some interest on the original amount. The longer your money remains in the savings account, the more interest you earn.

Here is an example to help us have an idea on the “power” of interest. Suppose you want to buy a new mobile phone which costs ALL 30, 000, within 2 years. To achieve this goal, you need to deposit in your savings box ALL 1,250 (30,000/24=1,250), every month for 2 years.

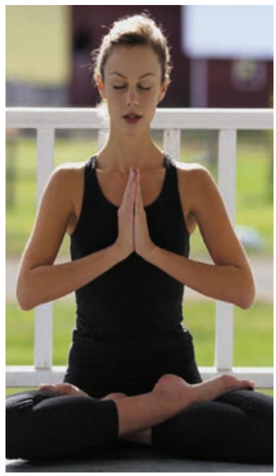
Targeted amount	= ALL 30,000
Deadline	= 24 months
The amount you need to save each month	= ALL 1,250

If you decide to deposit ALL 1,250 every month in your savings account, with an annual interest of 5%, thanks to the interest accumulated in your savings account, after 2 years you will have in your account not only the targeted ALL 30,000 but also ALL 1,482 as earned interest (the following figure on the left). You may as well use this amount of money to buy a cover to protect your new mobile phone. As you know, the more the years, the higher the interest.





There are three key concepts to bear in mind when drafting a savings plan: targeted amount, time to maturity and the amount to save each month. Do not forget the “power” of interest!



Drafting a savings plan gives you the needed psychological tranquillity to solve various financial problems.

It is also possible to calculate the amount you need to save every month so that at the end of the two years you have reached the amount of ALL 30,000. If the interest rate is 5%, this amount would be ALL 1,191 or ALL 59 less than the amount of ALL 1,250, which you would have to save if you did not deposit your savings in the bank.

As sticking to a savings plan requires that we start saving, following are some practical ideas:

1) Open a savings account and evaluate the advantage of a personal deposit. Consider depositing money in the savings account regularly as an indispensible expense, such as the electricity bill.

2) Obtain a Student Card and try to shop in stores, which offer discount prices for students.

3) Use public transport. You will spend less compared to using a personal car.

4) Make a list of items you really need before you go shopping. This will help you avoid impulsive buying, and, subsequently, spend less.

5) Do not keep all your cash with you when going out with friends in bars or discos, and if you own a credit card, leave it in the drawer, at home!

Do not forget the "power" of interest

QUESTIONS?

1. *What is a savings plan?*

2. *What does a savings plan serve for?*

3. *What steps should you follow to draft a savings plan?*

Explain

Why is it important to keep your savings, even if it is just a little, at the bank? Illustrate your reasoning with examples.

7. BANK PRODUCTS AND SERVICES

We learned from the lesson on financial intermediaries that banks intermediate by facilitating the transferring of funds from those who have surplus funds (mainly households) to those who need them (mainly businesses). Banks offer a variety of products and services to all actors in economy: households, businesses and public institutions. In this lesson, we will see the products and services offered to households.

Banking products and services for households may be grouped as follows:

- Current account
- Savings account and time deposits
- Loan
- Banking cards
- Banking transfers
- Foreign exchange

Banks offer various kinds of products and services for all actors of economy.

Current account

Your relationship with the bank usually starts with opening a current account. The current account is used to deposit income from work or other regular activities. The main purpose of current accounts is to use the money deposited in them to make payments (for example, to pay electricity bills or to transfer money into someone else's account), but not to save them.

Funds in the current account may be used at any given time and usually the owner of the current account does not earn interest from this money.

The current account may be used for the following transactions:

- receive the monthly salary by your employer;
- withdraw and deposit money in bank cash desks or ATMs using a debit card;
- pay bills (telephone, electricity, rent, etc.);
- repay the loan or credit card;
- make different debit card payments linked to current (bank) account (for example in shops, restaurants, etc.);
- pay by cheque;
- authorise in country and cross-border transfers.

Current account and time deposit

If you want to save, you would choose to deposit your money either in a savings account or in a deposit. You will learn more about these two products in the next lesson on investing your savings.

Loan

A loan is a financial product, which allows you to use the bank's money, against payment of interest. A bank loan is a very important means as it enables us to purchase goods and services when we need them, even though we may not have the money to buy them. To purchase these goods and services in time, the borrower has to pay a price, i.e. interest.

You may conduct many transactions through a current account.

On the other hand, a loan has to be used in a smart and responsible manner. You will learn more about loans, types of loans and the way to manage a loan, in the lesson on loans.

Banking cards

Banking cards are means of electronic payment issued by commercial banks. They replace paper money and are used to make payments or withdraw cash from the account of the card owner, through an ATM. Depending on their function and characteristics, banking cards are divided into debit cards and credit cards.

Usually, when opening a current account the bank gives you a **debit card**. The debit card may be used to withdraw money from your current account through an ATM or to make various payments in shops or restaurants that have a POS, provided there is sufficient money in the current account.

There is a limit to your credit card!

The **credit card** may be used for all transactions done with a debit card. A significant difference is that when you pay or withdraw cash with a credit card, you are not using your funds, but the funds that the bank has deposited in your account. Thus, the use of a credit card is similar to a loan – you use the bank's money to purchase goods and services and, later, you pay your debt to the bank for these purchases.

In exchange of using the bank's funds you pay a fee and, in certain cases, even interest.

When giving you the credit card, the bank also gives you the right to use its money to make various payments. The maximum amount you may pay is called the credit card limit. The credit card limit is mainly determined based on your income and your relationship records with the bank.

Most of the credit cards offer a time limit during which no interest is paid for your debt. It is usually 30-45 days. At the end of this period, you have to pay your obligation. But, the bank offers you the possibility to pay only part of your obligation, for example only 10% or 20%. For the rest – unpaid obligation – you have to pay interest, which is usually high.

Be careful! If you fall into the trap of "paying only partially", it will be very difficult to discipline yourself and fully pay your debt to the bank.

Credit cards are a very good company when travelling abroad. They replace the cash you'd have to take with you when travelling, which may be lost easily.

You may use your credit card to withdraw cash in a foreign country or pay for things you buy in shops.

The following table answers some of the most frequently asked questions on the functions and characteristics of the two kinds of banking cards.

	Debit card	Credit card
Is it used to withdraw cash?	(ATM) of your bank when there is cash deposited in the account In and outside the country	Only in ATMs, but not on the bank cash desks In and outside the country
Is it used to buy goods and services?	Yes, in shops, shopping centres, and restaurants that have a POS	Yes, in shops, shopping centres, and restaurants that have a POS
Is it a loan?	No	No
How do you make the payment?	Directly from the funds in your account	The bank's funds. Within a certain time limit (1 month) you have to go to the bank and pay your debt, fully or partially
Is there a fee against their use?	In most cases no, in some cases yes (for example, withdrawing cash from ATMs of other banks)	Usually yes. In some cases no. It depends on your bank.

Bank transfers

A bank transfer is an action the client authorises to send an amount of money from his/her bank account into the bank account of another person or business firm. The transfer may be done between accounts within the same bank, between banks in Albania, and between banks in different countries. The first two kinds of transfers are called domestic transfers, while the third one is an international (cross-border) transfer. Modern technology has enabled a bank client to order a bank transfer even through an ATM, phone, or internet, without having to go in person to the bank cash desks.

A bank transfer is usually offered against a fee, called a transfer fee. In most cases, transfers between clients of the same bank within the country are not subject to a fee. It is your right to ask for information about transfer fees, from the bank, before you instruct the bank to make a transfer.

Foreign exchange

The foreign exchange is a financial service which includes at the same time buying of a currency and sale of another currency. For example, if you want to take a trip to Italy you will need to buy euro. You buy euro against a certain amount of Albanian lek. You are exchange a currency if you "change" the US dollars you received as a gift from your aunt who lives in USA. You give dollars and receive Albanian lek in exchange. You may do this at a bank, or at the foreign exchange bureaus. It may usually be more profitable to address the foreign exchange bureaus.

Warning! You should never exchange currency with people or bureaus, which are not licensed for this service.

QUESTIONS?

1. What are the main products and services offered by banks?

2. What is a current account? What is it used for?

3. What are the differences between the current account, savings account and time - deposits?

4. What is a loan?

5. What are banking cards? What is their purpose of use?

6. What is the difference between debit and credit cards?

7. What is a bank transfer? How many types of them do we have?

8. What is the foreign exchange? Give examples of foreign exchange.

GLOSSARY

ATM (Automated Teller Machine) - Electromechanical equipment, which enables the owner of a debit or credit card to withdraw or deposit cash, make payments for services, or transfer funds between accounts. You may find this equipment near bank branches and in all big shopping centres or main business centres.

POS (Point of Sale) - a physical device, which enables the use of banking cards to pay for the products or services that are bought. These devices may be found in all commercial outlets such as: shops, travel agencies or supermarkets.

8. INVESTMENT OF SAVINGS

You should know by now that the goods and services you want to buy are endless, but your income is limited. Furthermore, you know that some things such as a new mobile phone may not be purchased with the money you are given by your parents every week or month. You need to keep apart a certain amount of money, every week or month, in order to buy it. On the other hand, you may want to always have some money apart to use it for unexpected expenses. This process is called saving.

Saving is the process of putting aside a part of the income we do not consume (we do not use now to buy goods and services), to either use it later or to cover unexpected expenses.

You learned about saving in lesson 6, together with some practical advice on how to draft a personal savings plan.

A question arises, what to do with the money we saved? One possibility is to keep them at home in a savings box. This may be normal when we are very young, when we save only small amounts and, because we are younger than 18 years old, we may not make any financial transactions. However, the savings box does not seem to fit us when we are adults and our savings are higher. Furthermore, besides saving , it would be even better if there were a way to increase the value of our savings. This is done by investing the savings.

What to do with the money we saved?

Investment is the process of using your savings to buy financial products or other items in order to increase the value of your savings.

There are many ways to increase the value of savings by investing them. Following, you will learn about some of these ways. The alternatives have their advantages and disadvantages, and each of them may be more appropriate than others in certain situations.

A. Bank deposits

The simplest way to invest your savings is by depositing them in a bank. There are two main alternatives of investing your savings in a bank: **savings account** and **time deposit**. Generally, the bank pays you interest for the money you deposit.

The pillow does not produce interest for the money you deposit under it!

The savings account, also called demand deposit, is one way of depositing funds in the bank for an unlimited amount of time, in order to save them. In the savings account, money may be deposited and withdrawn at any time, but its funds may not be used to make payments. The bank pays interest for the money deposited in this account. Usually, this form of saving is used when the consumer wants to save, but s/he is not sure about the amount of savings and/or the time period of the savings.

If the consumers are sure that they would need a certain amount of money for a given period of time, it is advisable to choose time deposit as a more appropriate form for their savings.

Time deposits are funds deposited by customers in the bank for a specified term, also called maturity term. Funds may be deposited in various currencies. The customer earns interest on the money deposited in time deposits. The longer the maturity, the higher the interest rate paid by the bank for the deposit. In contrast to the savings accounts, the customer may not freely withdraw money from time-deposit accounts before the end of the maturity term. If the customer wants to do this, s/he has to pay a penalty which is set forth in the credit agreement signed between the bank and the customer. In the worst case, the customer will take only the principal amount deposited in the time-deposit account in the beginning and will lose the interest earned until the moment the time deposit agreement is terminated.

Did you know?

The institution that protects citizens' savings from the risk of a potential bankruptcy of banks is the Deposit Insurance Agency (DIA). It insures and compensates all deposits denominated in Albanian lek and foreign currencies up to ALL 2.5 million, for each depositor in every bank operating within the territory of Albania. For further information visit DIA's website at: www.dia.org.al

Publication of the interest rate and terms of deposits

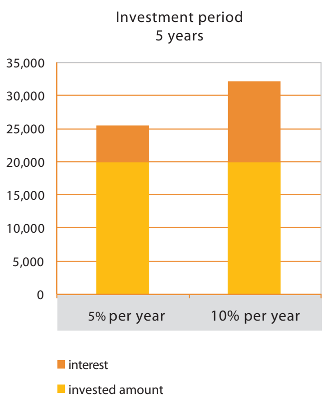
The following table shows some information on the interest rates for demand deposits (saving accounts) and for deposits with maturity terms from 1 month up to 60 months (5 years) in ALL. This table is similar to the one published by commercial banks, but simplified.

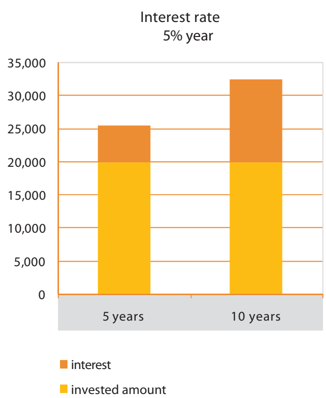
Type of deposit	Savings account	Time deposit							
Term	Demand	1-month	3-month	6-month	12-month	24-month	36-month	48-month	60-month
Interest rate	3.00%	3.60%	3.80%	4.30%	5.40%	6.50%	6.70%	6.80%	7.00%

You should keep in mind that the interest rates issued from banks for various maturity periods are expressed in annual values. For example, with a 1 month maturity time deposit you do not earn 3.6% interest per month. The rate 3.6% is an annual interest rate. In one month you will earn 1/12 of it. Likewise, the interest rate you will earn for the deposit with 6 months maturity is not 4.3%, but ½ (= 6/12) of it. Using the same logic, the interest rate you see for the deposit with 24 months maturity is not the interest rate you will earn from depositing your savings for 24 months, but only for the first 12 months.

In the table you may notice that the longer the maturity, the higher the interest rate paid by the bank. This is because the bank pays for "freezing" your money for a long time, i.e. it pays you more when the time you relinquish to use your savings is longer.

The higher the interest rate the more you earn (chart on the left)!!!
The longer you deposit your money, the more you earn (chart on the right)!!!





Calculation of interest

You learned how to make a simple calculation of the interest in the lesson on the value of money. Refresh the knowledge you learned in this lesson before you continue reading further.

Example 1: Calculation of interest on deposits with maturity less than 1 year

Suppose you deposit ALL 10,000 in a 3-months maturity deposit. The annual interest rate (from the table) is 3.8%. How much will you earn after 3 months? The interest rate for periods shorter than one year is calculated as follows:

The (annual) interest x (the number of months of the deposit)/(number of months in one year).

Interest rate for 3 months = 3.8% x 3/12 = 0.95%

Interest earned for **3 months** = 10,000 x 0.95% = 10,000 x 0.95/100 = ALL 95.

At the end of the 3 months, the value of your deposit will have become: 10,000 + 95 = ALL 10,095.

Step 1: find the declared annual interest rate for the deposit with a maturity of x months.

Step 2: divide by 12 and multiply by x.

Step 3: find the interest earned for x months.

Step 4: sum the deposited amount and the interest earned.

Example 2: Calculation of interest on time deposits with maturity longer than one year

Suppose you deposit ALL 10,000 in a deposit with a maturity of 24 months. The annual interest rate (from the table) is 6.5%. How much will you earn after 24 months?

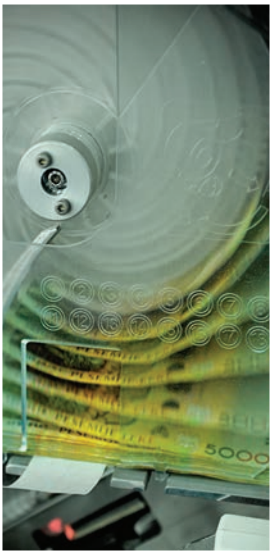
The published interest rate is annual. Therefore, for the first year you earn 6.5% on the amount of ALL 10,000 you have deposited:

...1>3!

Interest for the first year = 10,000 x 6.5% = 10,000 x 6.5/100 = ALL 650.
At the end of the first year, the value of your deposit will have become: 10,000 + 650 = ALL 10,650. This amount will be invested for another year, with an annual interest rate of 6.5%.

Interest for the second year = 10,650 x 6.5% = 10,650 x 6.5/100 = 692.25 ALL.

At the end of the second year, the value of your deposit will equal its value at the end of the first year plus the interest earned during the second year, i.e. 10,650 + 692.25 = ALL 11,342.25.



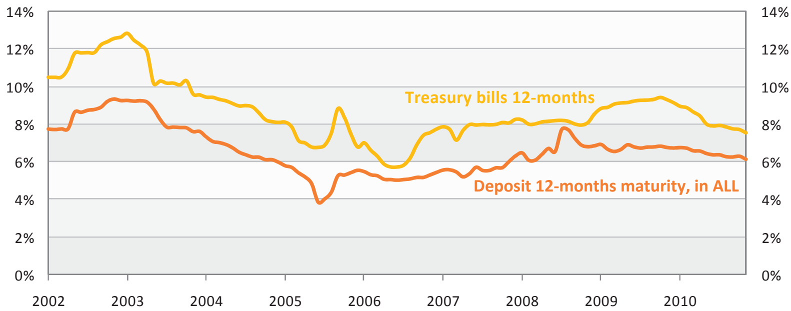
The longer the maturity, the higher the profit.

***Step 1:** find the published annual interest rate for the deposit with a maturity of y months.*
***Step 2:** find the interest earned for the first year using this rate.*
***Step 3:** find the value of the deposit at the end of the first year.*
***Step 4:** find the interest earned for the second year using the same interest rate.*
***Step 5:** find the value of the deposit at the end of the second year.*
***Step 6:** find the interest earned for the third year using the same interest rate.*
***Step 7:** find the value of the deposit at the end of the third year.*
.... and so on, until the last year of the maturity of the deposit.

B. Investing in treasury bills

Putting your investments in bank deposits is a very safe way to maintain your savings. Another safer alternative is to invest your savings in treasury bills.

Treasury bills are government securities, with a maturity of up to one year. Buying them means you lend money to the government to finance its investment projects. In exchange, the government will return the amount you lent together with interest.



The Albanian government issues treasury bills with a maturity of 3, 6 and 12 months. For further information on treasury bills and how to invest in them, read the brochure of the Bank of Albania, published on its website:

http://www.bankofalbania.org/web/Te_njohim_Bonot_Thesarit_5715_1.php

Investments in deposits and treasury bills are made by individuals who do not have large amounts of savings, and from those who prefer high security for the value of their savings. While the savings do not multiply rapidly, they are very safe.

C. Investments in real estate

At an older age, maybe in the 40s, if you have been successful in your job and career, you may have accumulated a considerable amount of savings.

You may be happy keeping them invested in bank deposits or treasury bills. Your savings would be safe and you would earn interest. But, what if you were not satisfied with the interest earned but want to earn more? A good alternative would be to invest in real estate: an apartment, house, store, business premise (offices, storehouses), etc.

***Example 3:* Successful investment in real estate**
At 45, you have managed to save ALL 8 million. Some friends, who have good knowledge of the real estate market, advise you to use these savings in buying an apartment in a new neighbourhood of the city. The value of apartments in this neighbourhood is expected to increase in the future, thanks to the improvement of infrastructure in that area. You decide to follow your friends' advice and use the ALL 8 million to purchase an apartment in that area. Your friends were right, after 5 years the value of the apartment has increased. You may sell it for ALL 12 million. Your savings increased ALL 4 million in 5 years.

If you had invested your savings in a deposit with a 1 year maturity, with an interest rate of 6% for 5 years, the value of your savings would be: 8 x (1+0.06)5 = ALL 10.7 million. Thus, in a deposit, your savings would increase ALL 2.7 million in 5 years.

A wise financial choice may bring you large benefits.

The value of your savings increased more by investing them in the real estate. However, this is not the only benefit you get from this kind of investment. During these 5 years, you could have rented the apartment. The income from the rent would add to your savings. If the rent were ALL 30,000 per month, for 5 years (60 months), you would have benefited additional income of 30,000 x 60 = ALL 1,800,000, which you could have saved or used, thus improving the quality of your life. If you were to save this amount, the value of your savings would have increased by another ALL 1.8 million, in addition to the increase by ALL 4 million from the increase of the apartment's value. In total, your savings would increase by 1.8 + 4 = ALL 5.8 million.

In a developing country like Albania, investing in real estate has been very profitable in the last years. But, in general, you should keep in mind that the value of real estate is not always increasing. There are times when the value of real estate decreases. Therefore, investing in real estate has to be thought carefully. It may offer a swift and high increase of your savings; however, there is the risk of not earning at all or even losing part of the money.

Example 4: **Not a very profitable investment in real estate**
Following the above example of investing in real estate, suppose the value of apartments in the area where you bought one does not increase during the 5 years. The value of your savings has not changed. Even if you had saved the income from rent, the value of your savings would have increased only by ALL 1.8 million. Investing in a deposit would have been a better alternative for your savings, because it would have yielded you an increase of ALL 2.7 million for those 5 years.

Investment in the real estate market is usually done by consumers above 35-40 years old, who have accumulated a considerable amount of savings and wish to increase the value of their savings rapidly and considerably.

But, even this investment has a risk and it should not be made without having good knowledge about the real estate market or without consulting a specialist of this market.

You have to be careful in choosing how to invest your savings.

BOX:

Other alternatives of investing your savings

Albania is a developing country and, as such, it offers various business opportunities, but few alternatives to invest your savings.

In developed countries, investing in securities of private and state companies is very common. By buying them, the consumers lend money to or become owners of these companies. Buyers of securities benefit, in exchange to the money they have invested, interest or a similar income. These investment opportunities may be profitable, but the risk of consumers losing part of their savings may be high. Such investment requires thorough knowledge of finance. Therefore, many common consumers trust their savings to a company specialised in investments of savings, with a satisfactory interest rate, by also avoiding potential loss from lack of knowledge.

D. Supplementary (private) pension scheme

You are very young to think about retirement, but you may have heard your parents or relatives "calculating" how to obtain income in addition to the state pension, when they reach the golden age. After many years of work and fatigue, everyone deserves to have a financially safe retirement, and, why not, making oneself happy by travelling to favourite places.

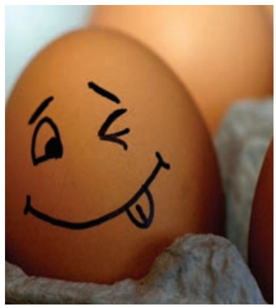
To achieve this, you have to save and invest your savings at a good interest rate and in a safe way. You will learn how to achieve this in a specific lesson on supplementary pension schemes.

Diversification of investments

A wise saying: “Do not put all the eggs in one basket!” This wise saying applies to investing as well. Earlier in this lesson, you learned about bank deposits, treasury bills, investment in real estate or retirement plans and other alternatives of investing savings, which may not currently exist in Albania, but will be introduced in the future. With what you have learned so far, you should have understood that each investment is accompanied, in addition to the interest rate, with a certain level of risk of losing part of the value of the savings. So, prices of real estate properties may drop, banks or pension-fund companies may go bankrupt and, consequently, you may lose your savings. To avoid this, a last piece of advice would be to diversify your investments.

Diversification of investments is distribution of savings in different alternatives of investment.

This may remind you of the TV show “the millionaire”, where the player who is not sure of the answer, divides the amount among some alternative answers in order not to risk losing all of it.



A wise saying:
“Do not put all the eggs in one basket!”.

QUESTIONS?

1. List the various forms of savings investments. Rank them by their ability to increase your savings. Rank them by the security they provide for your savings.

2. Explain the types of deposits that exist in the banking system. Which is your preferred? Why?

3. What are treasury bills? Why are they a more attractive option compared to bank deposits?

4. Learn more about treasury bills in the brochure of the Bank of Albania. Discuss in groups about this form of investment.

5. Which are the advantages and disadvantages of investing your savings in real estate?

6. Which are the two ways real estate investment affects the value of your savings?

7. What is the diversification of investments? What do we achieve through it?

Home/Class work

1. Use the information given in the table below; calculate the interest earned and the value at the end of the maturity term of 1-month, 6-month, 12-month and 36-month time deposits, for a total of ALL 20,000.

Type of deposit	Time deposits month							
Term	1-month	3-month	6-month	12-month	24-month	36-month	48-month	60-month
Interest rate	4.00%	4.20%	4.50%	5.00%	6.00%	7.00%	8.00%	9.00%

2. Your parents have managed to save ALL 5 million. They buy a downtown shop, which was given on rent (leased) for ALL 40,000 per month. The other alternative is to invest this amount in a deposit with 1-year maturity, with an annual interest rate of 5%. After 2 years, the sale value of store has increased to ALL 8 million.

a. Calculate the value of your parents' savings after 2 years, assuming that the value of the shop has not changed and rental income are consumed.

b. Calculate the value of your parents' savings after 2 years, assuming that the value of the shop has not changed and rental income are saved.

c. Calculate the value at the end of two years if the savings were not used to purchase the shop, but were instead deposited in the bank deposit.

d. Compare the value of savings at point "c" with the values calculated at points "a" and "b"?

e. Suppose that two years after the acquisition, the shop is worth ALL 4 million. On the outskirts of the city, a big shopping centre is opened and the city centre is no longer a favourite place for shopping. Calculate again the points "a" and "b". Compare them with the savings value of "c".

f. What message do we get from the exercise above?

9. LOANS

Do you remember the last time you bought something for yourself?

You used your savings for that. But, once you graduate and get a job, you may take a loan to buy the things you want, or go on holidays. Or, you may borrow money from your parents and return them later. Don't you think that they have already done enough for you, though? Besides, you should learn to manage your own finances.

A loan is a sum of money you borrow from an individual or institution with the promise and/or obligation to return it with interest, within a specified period.

The repayment period is one of the main elements of a loan.

The sum of money you borrow is called the principal. The interest, together with the commission and transaction cost, is the cost of the credit, or the amount of money you pay in exchange for using other people's money. The repayment period is the period during which you have to pay back both the principal and the interest.

When you take a loan, you enter a "debt". You may also borrow money from friends, family, people you may know or not, but the most advisable thing to do is to borrow money from the specialized institutions: banks and other credit institutions (refresh your knowledge about banks and other credit institutions referring to the section on the financial system).

There are several types of loans. Each of them may be used for different purposes, but the principle for all of them is the same: you use an amount of money that you do not have NOW and return it LATER. At first sight, it sounds quite profitable, but remember: There's no such thing as a free lunch in a market economy.

If you do not use the loan carefully, you may get into a lot of trouble. Therefore, it is important to know how to manage your loan, in order to enjoy the benefits, and minimize its costs.

The price of the loan – its interest

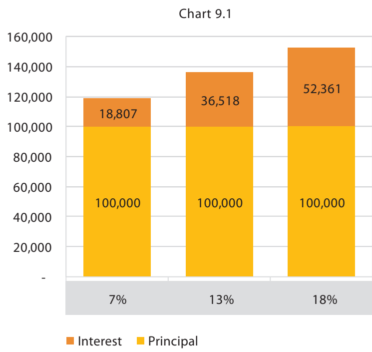
The higher the interest rate, the more you pay for using the loan!!!

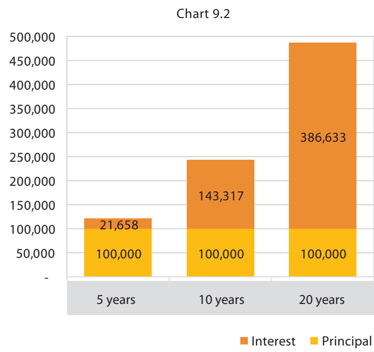
While the interest rate works in your advantage when you invest, it works against you when you borrow money. Chart 9.1 compares three loans, each ALL 100,000, to be returned monthly for 5 years. The first has an interest rate of 7%, the second 13%, and the third 18%. The total interest you pay to the bank in 5 years increases with the increase of the interest rate.

Repayment period

Both the interest rate and the repayment period work against you in increasing the costs of a loan: the longer the payment term, the higher the total interest you will pay during the loan term! Prolonging the repayment period is even more significant than an increase of the interest rate. We see this through this example. We may take a loan of ALL 100,000, at an interest rate of 8% per year, and we may choose one of the three repayment periods: 5 years, 10 years, and 20 years. As you see from Chart 9.2, the total interest is higher than the principal, when the term is 10 years, and 3.8 times higher when the payment term is 20 years.

The higher the interest rate, the more you pay for using your loan!





Other loan costs

In addition to its interest, a loan has other elements as well, which increase its costs. Such elements include: the disbursement commission, early redemption fee, and account maintenance costs.

The disbursement cost is a commission, which is paid by the person who takes the loan the moment the loan is given, also called the disbursement moment. The commission is equal to a percentage of the loan amount, usually varying from 0% to 5%.

You may decide to repay the loan before its repayment period, i.e. repay it earlier. In this case, the bank may require you to pay an early redemption fee. This commission is expressed as a percentage of the outstanding amount of the loan.

Benefits of loan use

Having mentioned the costs related with taking a loan, you may naturally ask: what is the benefit of taking a loan?

As with many other things in life, this also depends on your situation. A loan may be a very good means of improving your living conditions; however, you have to do your calculations well and use it responsibly.

One of the advantages of taking a loan is the immediate financing of major purchases. Once you graduate and get a job, you may want to leave your parents' home. You may rent a house, alone or share it with somebody else. It would also be nice if you could buy your own house. If you decide to save in order to buy a house, it may take you many years to collect the money you need for that. Maybe, you may even neglect during the saving period, and spend some of the money for consumption. Taking a loan, on the other hand, enables you to buy a house right now, and you pay both the loan and its interest in the coming years.

In general, a loan is useful if you use it for investments or long-term consumption (buying furniture, a car, or home appliances), but not for short-term consumption (holidays, clothes). Buying an apartment or a car, renovating your old house, or freshening up your furniture, is a responsible way of using a loan. Taking a loan to go on holidays or to buy new clothes may sound attractive, but it is not a smart financial decision.

Very soon, you may want to go on holidays again and buy more new clothes, but you risk finding yourself drowned in debt.

Do not dream too much...

Credit registry

In order for banks to take informed decisions, they consult the credit registry. It is a database with information on persons that have applied for a loan. For more information about the Credit Registry, click on the following address:

http://www.bankofalbania.org/web/regjistri_i_kredive_3306_1.php

Types of loans

You may hear about a series of loans being advertised, but the loans for households are divided into: personal (or consumer) loans and house-purchase loans (mortgage).

Personal (consumer) loans

If you need a loan to buy a car, a new computer, a TV set, pursue a Master's course, or go on holidays, you may apply for a personal loan. A personal loan has a well-determined principal, interest rate and repayment term. In order to pay back the personal loan, you make regular payments, usually on monthly basis, called loan instalments. An instalment consists of the principal, and the interest.

The repayment period is short, about 1-2 years, but in special cases, it may even be up to 7 years.

House-purchase loans (mortgage)

... you risk finding yourself drowned in debt.

The way a house-purchase loan works is the same with that of a personal loan, but the total amount you get is much bigger, the payment term is significantly longer, up to 30 years. In addition, in exchange of getting a mortgage loan, you are required to put an immovable property as a guarantee for the bank, which is called collateral. The collateral guarantees the bank that you will pay back your loan. If you take a loan to buy a house, usually, it is the house you buy that is put as collateral. If you are not able to pay back the loan you take, the bank will sell the collateral, and get the money that match your obligations to the bank.

Since the house loan is secured through collateral, its interest rate is low. In fact, house loans are the loans with the lowest interest rates.

In the case of house-purchase loans, you have to pay regular monthly instalments to the bank, consisting of the principal and the interest.

How can you apply for a loan? What documents do you need? Is it necessary to have collateral to secure the loan? All these questions are answered in the following chart.

One type of personal loan is the loan for buying a car.

Steps for taking a loan

Fill the application form and give your personal data to the bank

↓

The bank clerk tells you what documents you have to bring to the bank to support your loan application.

The list of documents is different for different types of loans

↓ ↓

Personal loans

1. Identification document
2. Family certificate
3. Income statement
4. Certificate of domicile
5. Certificate from the Credit Registry
6. A guarantor (usually a close relative),
7. A car purchasing contract (in the case of a loan for buying a car)
8. Collateral to secure the loan, which could be a car, valuables, or even a house or a shop.

House-purchase loan

1. Identification document
2. Family certificate
3. Income statement (salary, rent)
4. Certificate of domicile
5. Certificate from the Credit Registry
6. A house purchase contract
7. A guarantor or a co-borrower for your loan (usually a close relative)
8. Collateral to secure the loan, which is generally an immovable property – a house, a shop, etc.

The file of documents is reviewed by the bank, which decides whether to give you a loan or not. The decision depends mainly on:

- Your ability to pay back the loan (sufficient income)
- Your records as a borrower (from the Credit Registry)
- The quality of your collateral (if necessary)

The effective interest rate

Be careful! It is important for you as a client to know the effective interest rate, the cost, or the total amount to be paid, so that you are able to choose the bank product.

The effective interest rate (EIR) includes all the payments that the borrower has to make for taking the loan. This includes the interest, the loan commissions, and account maintenance commissions. Therefore, this norm is likely to be higher than the declared annual norm of the loan. It is expressed in annual percentage of the amount of the loan. Knowing its value makes it easier to compare the loan conditions offered by different banks.

Your rights and responsibilities

When you take a loan, you agree to respect the conditions specified in the loan contract: you commit to pay the principal and the interest, within an agreed term. Before you sign the contract, read carefully both your rights and responsibilities, and the conditions of the loan: interest rate, payment period, periodicity of instalments, and all other bank commissions.

QUESTIONS?

1. Describe what a loan is. Which are the elements of a loan?

2. Explain whether using a loan is a good or a bad financial decision. Give different examples for each explanation.

3. What are the costs of taking a loan?

4. What are the advantages of using a loan?

5. How does the increase and decrease of the interest rate influence the total amount of interest you will have to pay during the payment term? What about the prolongation of the payment term?

6. Which are the different types of loans?

Home/Class work

Going through the internet sites or the brochures of the commercial banks, try to find out the conditions on which banks may give a personal loan of ALL 200,000. Collect information and fill the table below. Compare the banks among them. Which one offers the best conditions?

Terms	Bank 1	Bank 2	Bank 3	Bank 4	Bank 5
Interest rate					
Maturity					
Instalment					
Disbursement commission					
Early redemption fee					
Other commissions					

10. CONSUMER'S RIGHTS AND RESPONSIBILITIES

Why should we become aware as consumers?

Every day, whether we want it or not, we take part in the functioning of the economy. Buying bread, or anything else, is in itself a commercial relationship that we establish with the person who sells the bread. In most of these exchanges, we are the "contracting" party, which needs goods and services, but does not or may not produce those goods and services itself. The "contracted" party is the professional one, which is capable of producing or supplying the goods and services we need. We are the consumers, while the other party is the professional trader.

Thus, ***a consumer*** *is any person, who buys or uses goods or services to meet his personal needs. The consumer may also use them for purposes that are not related with any commercial activity, or with exercising his profession.*

A consumer is a person, who buys or uses goods or services to meet his personal needs.

The consumer is not present in how the products are produced or distributed. Taking into consideration that the consumer is a weak party, precisely because of his inability to control the type and quality of the products, he should be protected against any problems that may be related with these products. The problem becomes even sharper considering the wider and free circulation of goods not only in Europe, but also in global markets. This may be problematic, because they may not be subject to control by the competent bodies.

In these circumstances, the role of the state is very important: through its bodies (Consumer Protection Commision[2], Consumer Protection Office[3], Ministry of Agriculture, Food and Consumer Protection, and relevant Inspectorates), it controls the quality of products and services that are sold; controls the provisions of the contracts signed with the consumers, so that they do not abuse the latter; and monitors the information that (professional) producers and suppliers need to provide to the consumer. This helps consumers to be well informed about the goods they buy with their money, and they may even put their health at risk if such goods are harmful.

Below is a list of some of the main responsibilities of the professionals, which are, at the same time, consumers' rights:

Every product traded in Albania must provide information in the Albanian language.

- Inform the consumer about the content of the goods and contracting obligations (among others, the product labelling, which includes its name, quantity, quality, origin, distributor, content, etc.);
- Tell the consumer the exact price;
- Issue a tax receipt (this is a very important legal obligation, because it is connected to the right of returning a damaged or harmful product);
- Provide information in the Albanian language;
- The publicity should be accurate. Comparative publicity is allowed, but it should not be degrading or untrue;
- The contract conditions must not be abusive to the consumer.

In addition to the active role that the state and its institutions should play, the state should also work towards raising

[2] For more information, visit the website of the Consumer Protection Commission: http://www.kmk.al

[3] For more information, visit the website of the Consumer Protection Office: www.konsumatori.org

the consumers' awareness, because the state and public institutions are not always present where consumers' rights are not respected. Awareness starts with informing the consumers about the state and quality of services they get, and the respective complaint procedures. Comprehensive information and financial education helps us choose the best product we need, and be protected in case of potential problems.

What is consumer protection in the case of financial products and services?

Banks and financial institutions are not very different from other businesses. With the products and services that they offer, they have a direct impact on meeting some of our needs, in exchange for a profit they make. In this relationship, the final objective of both parties is profit, and if they are not clear about each-other's rights and obligations, they may later have conflicts.

However, do not be afraid, and do not see yourself as a mouse facing a lion. Albania has an extensive legal framework aiming at ensuring an effective consumer protection. In order to ensure such protection, consumers have certain rights, translated into obligations for suppliers of various services. Consumer protection consists in rules, authorities responsible for supervising the market, and implementation of the relevant legislation.

The authorities that regulate and supervise certain parts of the financial market (which we learned in the previous sections), are at the same time responsible for consumer protection.

The state controls the quality of both products and services that are sold.

Some advice

The book you are holding in your hands focuses on PERSONAL FINANCES. Therefore, we would like to give you some advice about your behaviour as financial consumers, and about your relationships with the banks.

- **Compare the offers of different banks!**

Before you decide whether to take a loan or invest your own savings, do not go to the first bank you see. Knock on various banks and compare their offers.

- **Read before you sign!**

Do not rush into signing everything you are asked. Be careful and read well what the contract says about your relationship with the bank about a certain product.

- **Read the announcements posted on the ATM!**

Before you use the ATM or the POS of a bank, read the announcement.

- **Keep evidence!**

You should keep the accompanying documents of the transactions you make, so that if something goes wrong, you have supporting facts.

- **Do not hesitate to ask!**

Every time you have doubts about any transactions with your account, every time the balance does not correspond with what you expected, or if you think there are changes of the interest rate, do not hesitate to ask about the things you do not understand. The bank is obliged to answer your questions.

➢ **Voice your concerns!**

If the person you address is not responsible for answering your questions, try to talk to his supervisor. You may complain about your dissatisfaction, and ask for a review of your practice.

➢ **Advise your parents!**

At the end of this module, you will feel more confident in your relationship with the banks and other institutions that offer financial products. Share this knowledge with your parents, and you will see that they will also benefit.

QUESTIONS?

1. What does it mean to be a consumer?

2. What are the main institutions that ensure consumer protection?

3. Find their official websites on the internet and bring to class information about the functions of each of them.

4. What are the three most useful pieces of advice that you would give to a friend, before addressing a financial institution?

GLOSSARY

Tax receipt – a document that proves the transaction of a commercial activity, and that includes the calculation of the tax obligation. A tax receipt contains an ordinal number and the taxpayer's identification number, the date and place of issuance, name and address of the parties, date of purchase or delivery of a service, their exact name, quantity, full price, as well as the addition or discount applied to the declared amounts.

Contracting obligation – an obligation emerging from the parties involved in a contract or agreement, upon its signing.

11. SUPPLEMENTARY PENSION SCHEMES

The supplementary pension schemes are nothing else but contracts. According to these contracts, contributions are deposited periodically and may be withdrawn together with the earned interests at a later stage. The characteristic feature of pensions is the periodical depositing of contributions (e.g. every month) for several years. After many years, when the individual retires, or when, because of an accident, he is no longer able to work, he is entitled to withdraw the amount of contributions, together with the interests earned.

The stakeholders of a supplementary pension scheme are the promoter of the scheme, the participant, and the beneficiary.

Promoter of the scheme is the company which promotes and offers participation in a pension scheme. In the case of a supplementary pension scheme, the promoter is a stakeholder of a financial institution (crediting institution, insurance company, or pension fund).

Participant is the person who deposits the contributions with the purpose of benefiting a supplementary pension in the future.

Beneficiary – is the person who is entitled to the scheme benefits. He can be either the participant himself or a third person, who inherits the scheme's benefits in the case of the death of the participant.

The supplementary pension schemes are a very good opportunity for collecting savings for a long-term period, and for ensuring a satisfactory future at the end of the working age.

Main advantages of these schemes are:

- **A good way of saving through discipline**

Being committed to save a small sum every month or every few months, you will manage to save a large amount, without depriving yourself of consumption throughout your life.

- **The opportunity to earn high interest on payments made**

Your payments shall be collected and invested by specialized financial companies, which are capable of finding the most profitable way of investing them. Besides, these contributions are usually invested for a long term, and the interest rates are higher when money is "frozen" for a longer time. In addition, the financial companies dealing with their investment collect the contributions of thousands of individuals. The bigger the amount of money these companies may invest, the more opportunities there are to negotiate a good interest rate for their investment. These companies invest the collected funds in government securities, but may also invest them abroad, if they manage to get a good interest rate against a low risk of their loss.

Supplementary pension schemes are a very good opportunity for collecting savings in a long–term period.

- **Investment of contributions is accompanied by a very low risk of savings loss**

In addition to securing a good interest rate for the collected contributions, the financial companies, i.e. the promoters, have very good knowledge in the field of finance, which enables them to minimize the risk of loss from unsafe investments. This is also achieved through investment diversification techniques.

Contributions

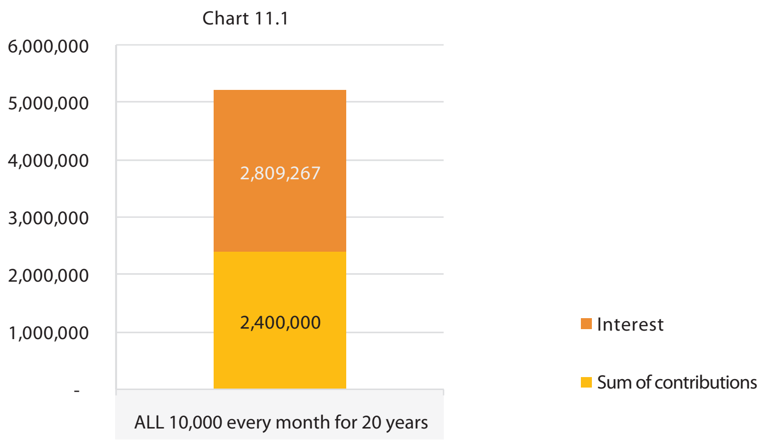
Contributions are the amounts of money paid periodically to the supplementary pension scheme . The participant enjoys a lot of flexibility to determine how much and how often to pay his contribution. This plan is suitable for people with different economic possibilities. Thus, the participant pays the predetermined amount of contributions periodically (monthly, quarterly, etc.) through the bank, being able to make changes as he wishes.

Contributions are the sum of money paid periodically to the supplementary pension scheme.

How does the pension scheme work?

The contributions paid by the participants are invested by the promoter, earning an interest. At the end of the contribution payment period, the collected amount of contributions is bigger than the amount of original contributions, as this includes also the interest earned. The earned interest may be even bigger than the sum of contributions, because contributions are paid and invested over a long period of time (try to recall the investments section: the longer the investment period, the more interest you earn).

This is illustrated by Chart 11.1, which shows the funds collected from contributions of ALL 10,000, paid every month, for 20 years. The annual interest rate is 7%.



The sum of paid contributions is ALL 2.40 million (10,000 x 12 months/year x 20 years). The total interest accumulated in the account from investing monthly contributions is approximately ALL 2.81 million.[4] In total, after 20 years, the participant will have ALL 5.21 million in his account (ALL 2.40 million of contributions + ALL 2.81 million of interests).

Cases of benefits

The objective of a pension plan is to secure in the long term, an amount of money for the future in the following cases:

- Retirement;
- Premature incapacity for work (e.g. in case of an accident);
- Death of the participant (in this case, the beneficiary is a family member of the participant (spouse, children, etc.).

[4] Calculation of interest in the case of depositing contributions and withdrawing the pension benefits are complicated and elaboration of such calculations goes beyond the purpose of this text. Therefore, we are simply giving you the results for illustration purposes only.

Benefits

The benefits of pension schemes are monetary values that may be withdrawn either all at once (single payment), or in instalments.

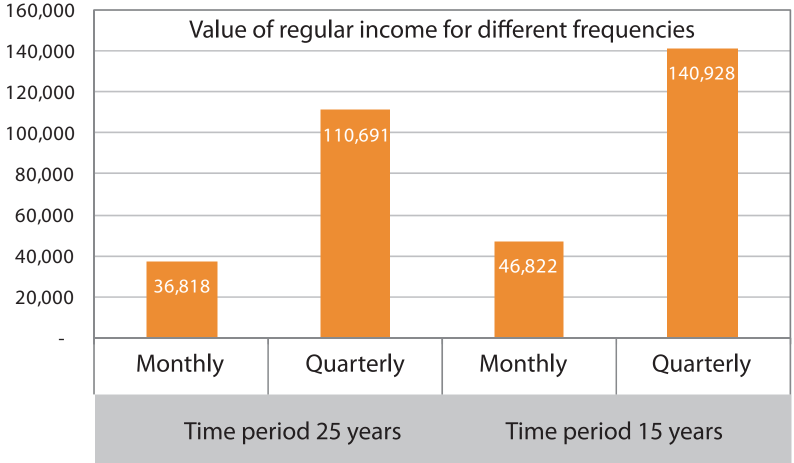
Single payment

Let us continue with the above example. At the end of 20 years, about ALL 5.21 million would have been accumulated in the participant's account. The beneficiary may withdraw them all at once.

Instalments

Payment in several instalments made on regular or irregular basis. If payment is done on regular basis, the beneficiary gets a fixed periodical amount. Let us assume that in the above example, the beneficiary would like to withdraw the accumulated ALL 5.21 million on monthly basis for the 25 coming years, at a fixed amount per month. In this case, he would get 300 (25 years x 12 months/year) equal monthly payments of ALL 36,800. The following chart shows the value of periodical payments that the beneficiary would get on a monthly or quarterly basis within 15 and 25 years.

Benefits of a supplementary pension scheme may be withdrawn all at once or in several instalments.



In addition to these two "clean" schemes of withdrawal of benefits, the beneficiary may create other schemes together with the promoter, which would fit better the beneficiary's needs.

QUESTIONS?

1. *What are supplementary pension schemes? Which are the stakeholders involved in a supplementary pension scheme?*

2. *Explain what are the main advantages of a supplementary pension scheme?*

3. *How is it possible that you may ensure a larger increase of your savings by participating in a supplementary pension scheme compared with investing them yourself?*

4. *Why does participation in a supplementary pension scheme provide a better protection of your savings from the risk of losing them?*

12. INSURANCE – A WAY TO CONTROL RISK

Insurance is one of those arguments that may sound very boring until something unexpected happens and we realize that we really need it. Maybe you did not feel you needed it so far. Maybe it is your parents, who take care of paying insurance. But, you might very soon think about buying a car, and that is exactly when you get to know the world of insurance.

What is insurance?

In simple words, being insured means paying a small amount of money every year, so that when something unpleasant and unexpected happens, you do not have to pay a big amount of money to repair the damage. It is a safety cushion that helps you mitigate the cost of risks that you might face in the future.

Unexpected things happen every day, and they may vary from a car accident to an accident in the workplace, or the burning of your house or business. You may insure yourself against all the above and other events, and minimize the resulting financial loss. For example, in case of serious damage to your car, the insurance company shall pay for its full or partial repair.

Before you learn more about insurance, you first need to know the concept of risk. **Risk** means the probability that an unexpected event may occur/be verified.

Unexpected events take place every day.

Risk control includes all the ways in which you may control – minimize or avoid - financial loss that may result from the unexpected event.

How can risk be controlled?

You may control risk in three ways:

-Avoid risk!

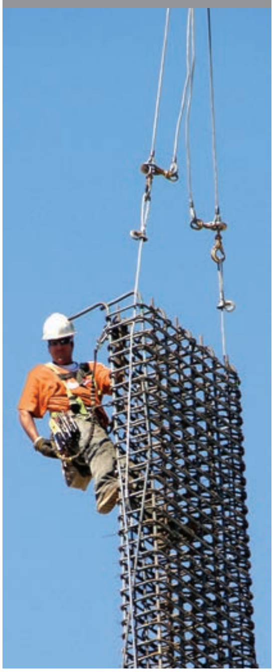
Never get on a car, so that you are not involved in any car accidents, or never go on winter holidays, so that you never risk having a skiing accident.

-Minimize the risk!

Install a good fire-protection system in your house, so that in case of fire, your house is damaged as little as possible.
Do not speak on the mobile phone while driving, so that you avoid the car accidents caused by distraction.

-Pay someone else to cover the risk in which you might get involved!

Ask for the service of insurance companies.



... minimize risk!

Features of the insurance process

Insurance policy

An insurance policy is a contract signed between the insurance company and the insurance buyer. It contains details about the agreement between you and the insurance company, like: who is the insurance beneficiary, what is the maximum amount of compensation, which are the conditions in which the company compensates you; which are the conditions when the company does not compensate the insured person for the damage, etc.

Premium

The premium is the periodical amount that you pay to the insurance company in exchange for protection from looses in case the unexpected happens.

Compensation request

If the unexpected occurs and you are insured, you submit a compensation request to the company. The insurance company will assess your request, and inform you whether your request was accepted or rejected.

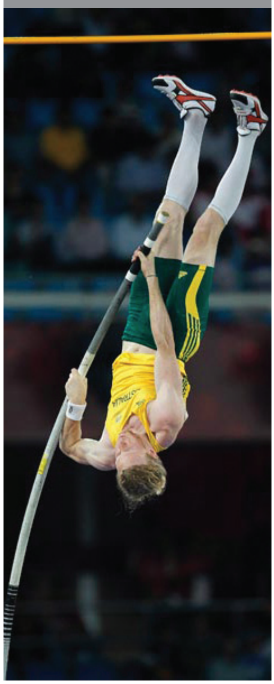
Compensation

In your compensation request is accepted, you will get a financial compensation for covering the loss you have incurred. You may take this amount either all at once, or in several payments.

Maximum compensation

Generally, the insurance policies have a maximum limit of the amount that is paid to you in the case of an unexpected event (maximum compensation amount).

This means that regardless of the financial damage that you may incur, the insurance company will not pay more than this maximum limit. As you may also guess, the higher the amount of maximum compensation, the higher is the premium that you pay.



The insurance policy has a maximum compensation limit.

Parties involved in an insurance process

In order for you to understand how insurance works against risk, you must know which are the parties involved in an insurance process. They are: the insurance company, the buyer of the insurance policy, the insured, and the beneficiary.

The insurance company

An insurance company is a company that offers the insurance service, i.e. the party that takes over to pay the financial loss caused by an unexpected event against pre-paid premiums.

Buyer of insurance policy

A buyer of an insurance policy is the person who buys the insurance policy, i.e. the one who pays the insurance premium.

The insured

An insured person is the one who is protected from a potential unexpected event.

The beneficiary

A beneficiary of compensation is the person who benefits the compensation specified in the insurance policy.

The chart below presents the four parties described above. In most of the cases, the insured and the beneficiary are the same person, and in many other cases, *the Buyer*, *the Insured*, and *the Beneficiary* are the same person. In order to better understand the relationship between the parties mentioned above, let us look at some examples.

Example 1: **The buyer, the insured, and the beneficiary are the same person**

A typical example of this case is the insurance of a car by its owner, who is at the same time the driver. He is the buyer of the insurance policy, the insured in case of a car accident, and the beneficiary of the compensation for the loss caused by the accident.

Example 2: **The insured and the beneficiary are the same person**

Let us take the example of a private health insurance, which a bank buys for all its employees. Through this policy, the banks cover all the costs of the examination and health treatment of its employees, who are affected by unexpected serious diseases.

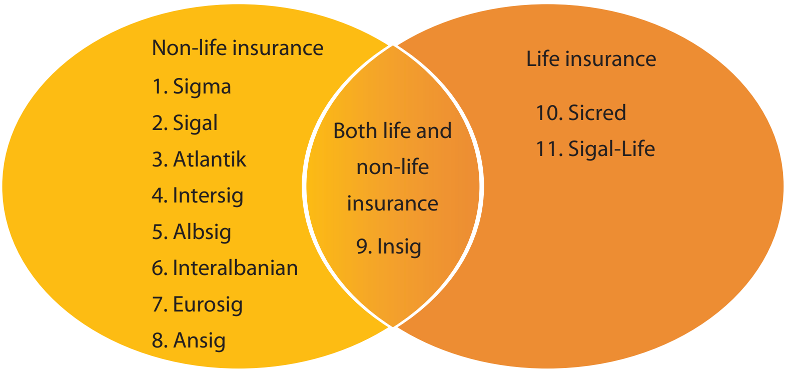
The bank is the buyer of the insurance policy, and bank employees are both the insured persons and the beneficiary of compensation for private health services in case they are affected by any serious and unexpected disease.

Example 3: **The buyer, the insured, and the beneficiary are three different persons**

An example of a buyer, an insured person, and a beneficiary being different persons is that of a life insurance policy bought by a company for its employees. The company is the buyer, and each of its employees is an insured person. Being that this is about life insurance, i.e. payment of a financial compensation in case of the death of an employee – the insured identifies a beneficiary of this compensation, who could be a family member or any other persons close to the person who dies.

Insurance companies in Albania[5]

There are 11 insurance companies operating in Albania with both domestic and foreign capital, offering a series of insurance services.



Types of insurance

In order to cover the different types of losses that an individual or a business company may incur as a result of unexpected events, there are various types of insurance. Below are some of the main ones.

- **Car insurance**

  Having a car has its own risks. Cars may cause damage to other cars, other people, or even to their property. As a car driver, you are responsible for the damage that you may cause when you are driving. This is a big risk you have to face, especially if you accidentally hurt or kill someone. In addition to the damage you may cause, there is also the probability of your car being stolen or

[5] The data used in this lesson about the insurance companies and the types of insurance they offer are as at July 2013.

damaged by natural agents. In order to protect yourself against all these risks, the car insurance comes to rescue.

➢ Life insurance

Life insurance protects the persons who are financially dependent on the insured, in case of death of the latter. If you are single, and no one depends on you financially, you might not need to buy life insurance. But, once you have a family and a lot of bills to pay, it might be appropriate to think about life insurance. In this way, the person(s) who benefit from your insurance, will get an amount of money in case of a fatality, which will help them to financially cope with life in your absence.

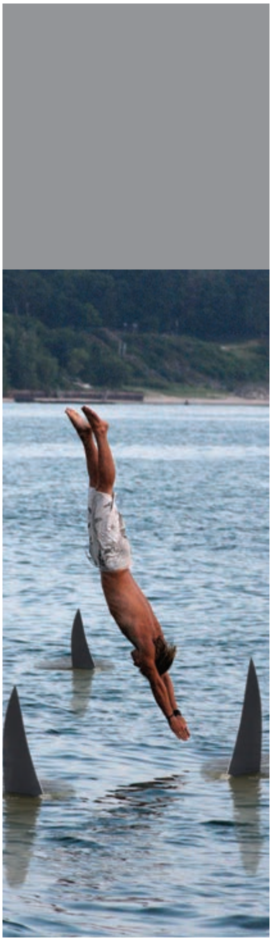
➢ Property insurance

You often hear about different disasters, caused by nature or people, intentional or unintentional, like the flooding of the warehouses of a business company, the burning of a residential building or business offices, their destruction from earthquakes, the stealing of valuable items and work of arts owned by a person, etc.

In such cases, property insurance enables a full or partial compensation for the losses caused by such events. Property insurance includes protection of houses, shops, warehouses, offices or other objects, machinery, equipment, and valuables against the above-listed risks.

➢ Private health insurance

You now know that there is a public health insurance scheme, through which you may be entitled to examinations and check-ups, and treatment for free or against a small amount of money in public health care institutions. But, in case of very severe diseases, the public health service may not offer the service, and it could cost you a fortune to go to a private clinic or hospital. Private health insurance offers you protection against the financial costs and consequences in case of such unexpected diseases. In addition, through private health insurance, you can have your health checked more frequently, as all the health and hospital expenditures are covered by the insurance company.



"... but you should not be the one who deliberately causes it!

You must know that the above services are not offered by the insurance companies for everyone. Thus, for example, a smoker would find it difficult to get a health insurance by the insurance companies, because s/he is very likely to suffer from diseases caused by smoking. Such diseases are no longer unexpected, but highly probable events. Or, if someone suffers from a severe disease, which is known to be terminal, no insurance company would offer life insurance to this person.

Also, the insurance companies do not cover the financial losses of every event that might occur, even though you might be insured against such losses. They agree to compensate you for the unpleasant events, as long as you are not the person who deliberately caused them, or as long as they do not happen as a consequence of your negligence. Thus, for example, the companies might not compensate you if:

- You have insured your house against fire, but it is proven that it was you who set it on fire in order to get the compensation;
- You own a valuable painting and you have bought an insurance policy against its theft. The insurance contract is signed on the condition that you have a very good security system against unauthorised entry in your house. If you forget to activate your security alarm system, and your painting is

stolen, the insurance company is very likely not paying you.

QUESTIONS?

1. What is risk? How can we control it?

2. What is insurance? What are the different types of insurance?

3. List the main parties involved in insurance. Give some examples of the relationships between these parties in different types of insurance.

4. Describe the main features of an insurance process.

Explain

1. When doesn't an insurance company agree to offer you insurance service? Illustrate by examples.

2. When may an insurance company not accept a compensation request? Illustrate by examples.

Home/Class work

1. Collect information about the insurance services offered by the insurance companies in Albania by visiting their websites or their premises. Learn about the features of the insurance service they offer and present them to your class mates.

2. Try to find copies of some insurance policies. Split into groups, and analyze their features. Find out who is the buyer, the insured, the beneficiary, the maximum compensation amount, the cases when the insurance company pays compensation, etc.

13. TAXES, FEES AND SOCIAL AND HEALTH INSURANCE

In one way or another, we all pay taxes. Tax is an important aspect of our life. Our salary is “corrected” by the taxes. Buying or selling a house, saving or investing your savings, and starting up a business are processes that are affected by the tax and fee system in force.

13.1 TAXES AND FEES

In order for the state to fulfil its duties, it needs money. Taxes and fees make up the main share of the state revenues, and the right to impose taxes and fees on the citizens of a country is a monopoly of the state alone. Historically, the money collected through taxes is paid for various purposes, which start from covering war costs to strengthening the law and order, protecting property, and building public infrastructure.

Did you know?

We have to go back in time to find the first tax system. About 3000-2800 before BC, in ancient Egypt, the Pharaoh used to take a two-year trip through his kingdom to collect the tax from the people. Facts talk about tax records on limestone and papyrus. Later, in the Persian Empire, we find an established and sustainable tax system, which Darius the Great in 500 BC had adapted to each Satrap (an administrative unit managed by a satrap or a governor).

In addition to financing the expenditures and investments undertaken by the state, taxes and fees exercise also two important economic-social state functions: the redistribution and the repricing functions.

The redistribution function is exercised by using the tax and fee system to transfer a part of the wealth from the richer to the poorer parts of the population (for example in the form of social benefits). The repricing system is related with the influence of prices of certain products through the tax policy. For example, tobacco and alcoholic drinks are subject to high excise tax, which makes them more expensive, discouraging thus the excessive consumption of these products, considered as harmful for our health.

Types of taxes and fees

There is an important distinction between taxes and fees.
A fee is an obligatory and non-refundable payment, which the citizens pay in exchange of benefiting a public service. The revenues from fees go to the state for providing such services. For example, the cleaning fee is a fee imposed by local government. This is a fee paid by all the citizens of a municipality for the city cleaning services. The revenues from this fee are used by the municipality for buying the necessary cleaning equipment, and pay the people or business operators who actually do the cleaning.

A tax is also a financial obligation of the natural and legal persons of a country, but this is not directly related with the provision of a certain service. The revenues from taxes are used for enabling a series of public goods and services like defence, infrastructure, education, etc.

In your daily life as citizens of Albania, you will face a number of financial obligations in like fees and taxes to be paid to the state. Below we will see some of the most important ones.

Tax on employment income

Any individual, who is employed, is subject to tax on employment income. Such income include both the salary and other bonuses received for the work done. Since 2006, the rate for this tax in Albania is 10%, which means that 10% of the gross employment income (salary + bonuses) is withheld by the employer on behalf of the state, as a tax on income.

***Example 1:* Calculation of tax on employment income**
Your father works as a finance officer for a private company. His gross monthly salary is ALL 50,000. In addition to that, once a year, after the closing of the financial report of the

company, he also gets a bonus equal to two gross salaries. What is the employment income tax that your father pays per year?

The employment income tax is 10%. Every month, your father has to pay 10% of his monthly gross salary.

> *Tax on salary = 10% x Gross Salary = (10/100) x 50,000 = ALL 5,000 per month*

Your father pays also a tax on the bonus he gets every year, which is equal to two monthly gross salaries, i.e. ALL 100,000. This tax is calculated as follows:

> *Tax on bonus = 10% x Bonus = (10/100) x 100,000 = ALL 10,000*

Every year, your father pays a tax of ALL 70,000 on his employment income (ALL 5,000 per month x 12 months + ALL 10,000 at the end of the year).

In Albania, starting from 2006, tax on employment income has been 10%.

Tax on other personal income

In addition to the tax on employment income, consumers are also subject to tax on other personal income, like income from renting immovable properties. Also in this case, the tax rate is 10% and tax is calculated in the same way with the tax on income from employment.

Consumers are also subject to profits made from selling immovable properties, cars or other items, investing their savings in bank deposits or treasury bonds. The tax rate in this case is again 10%.

Example 2: **Calculation of tax on profit from selling an immovable property**
Your parents bought an apartment 5 years ago for ALL 5 million. Today, they resell this apartment for a price of ALL 7 million. What is the tax on profit that your parents have to pay?

$$\text{Tax on profit} = 10\% \times \text{Profit}$$

The profit made by your parents from selling the apartment is equal with the difference between the selling and the purchasing price.

$$\text{Profit} = \text{ALL 7 million} - \text{ALL 5 million} = \text{ALL 2 million}$$
$$\text{Tax on profit} = 10\% \times \text{ALL 2 million} = (10/100) \times 2{,}000{,}000 = \text{ALL } 200{,}000$$

Example 3: **Calculation of tax on deposit interest**
Erjona has deposited ALL 50,000 in a bank for one year at the interest rate of 6%. What is the tax she will pay on the interest earned from this deposit?

$$\text{Interest} = 6\% \times 50{,}000 = (6/100) \times 50{,}000 = \text{ALL } 3{,}000$$
$$\text{Tax} = 10\% \times \text{Interest} = (10/100) \times 3{,}000 = \text{ALL } 300$$

Tax on personal income and profit is a **direct tax**. In our life, we are also subject to another form of tax, **indirect tax**. The indirect tax is added to the purchasing price of goods or services.

Profit made from selling an immovable property is subject to a 10% tax.

The most frequent indirect tax is the value added tax (VAT), which we pay every time we buy most of the goods and services. The value added tax in Albania is 20%. Certain goods, though, like books and medications, are subject to a lower VAT rate. Thus, you pay ALL 120 for a box of candy.

This is the final price of a candy box, which includes the VAT. The price of the candy box excluding VAT is ALL 100. The VAT is equal to 20% of the price (VAT excl.), i.e. 100 x 20% = ALL 20. You may notice in the tax receipt you get from the shopkeepers three items: price excluding the VAT, the VAT, and price including the VAT or the final price.

So far, we described the different types of taxes applied to consumers' income and profits. In the meantime, you or your family pays also some fees, such as the fee for cleaning or green areas, the fee for the public television, and the fee for real estates.

Taxes reduce the disposable income for households, but they are collected in order to provide the community with a series of public goods and services. A lower level of taxes would mean fewer services offered by the public authorities. In order to better understand which government level offers which public services in Albania (financed mainly by our taxes), take a look at the table.

Public services offered by central and local government

Central Government	Local Government Units
Road infrastructure	Public transport
Civil engineering works (hydro power plants)	Kindergartens
Public health system	Cleaning and waste removal
Education	Green areas
National defence	Urban planning
Public order	Social services, housing
Prison administration	
Fire protection services	

13.2 SOCIAL AND HEALTH INSURANCE

The pyramid of needs, as described by the American psychologist Abraham Maslow, the need for security (security about health, work, and property) comes second in terms of importance after the vital needs like eating, sleeping, breathing, etc.

Social insurance (together with health insurance) is a system that provides both economic assistance and access to the basic needs (education, hygiene, and health system) to everyone (except for cases of natural disasters and catastrophes). Social insurance is part of the social policy of a state, which is integrated within the public policies.

In Albania, we have two separate systems: the social insurance system, which is managed by the Institute of Social Insurance[6] and the health insurance system, which is managed by the Institute of Health Care Insurance.[7]

The general social insurance system is a non-profitable system, which is supported by the income of the economically active people. These contributions serve to finance payments in cases of: temporary disability for work because of illness; maternity; old age; invalidity, and loss of the family breadwinner; work-related accidents, and occupational disease; unemployment.

The social insurance scheme is financed by the contributions of the employers, employees, self-employed, and state. The

[6] For more information, visit the website of the Institute of Social Insurance: www.issh.gov.al

[7] For more information, visit the website of the Institute of Health Care Insurance: www.isksh.com.al

contribution paid for the obligatory social insurance to the insurance funds like insurance for diseases, maternity, and pension, includes:

- for employers, 15% of the gross salary of each employee;
- for the employee, 9.5% of the total gross salary.

In addition to the obligatory insurance, individuals may also pay voluntary and/or supplementary contributions in order to guarantee additional pension benefits for their future. These types of payments go beyond the amounts specified by the "Law on social insurance in the Republic of Albania", and are not required by law.

The income received from social insurance, e.g. the income you get during maternity leave, are not subject to taxation.

Health insurance system aims at providing a basic health service to every insured citizen.

The obligatory health insurance system is a non-profitable system that covers the expenses for:

- a part of the price of medications in the pharmaceutical network;
- the service of the general practitioners or family doctors for all the citizens of Albania who have paid contributions;
- all the services of examinations, medical treatments and consultations, approved by the Council of Ministers.

Insured persons are provided with a health book. Employed people pay 3.4% of their monthly gross salary as health insurance contributions, of which 1.7% is paid by the employer, and 1.7% is paid by the employee.

The health insurance system covers the expenses for some of the medications in the pharmaceutical network.

BOX:

Social and health insurance contributions

The contribution to be paid by the self-employed people in cities is 7% of the minimum salary, while the self-employed people in villages pay 3% (high lands and hilly areas) and 5% (in the low lands).

The social and health insurance contributions are calculated by taking into consideration the minimum and maximum salaries. They are determined by the Council of Ministers and are reviewed from time to time, in order to ensure a fair redistribution of the income.

Currently, as of 1 July 2012[8], for insurance calculation purposes, the minimum monthly salary is ALL 18,295 while the maximum monthly salary is ALL 91,475. This means that people, who have a salary lower than ALL 18,295, pay their contributions according to a percentage specified by law, while the remaining part of the contribution paid for the minimum salary is paid by the employer. People, who have a salary higher than ALL 91,475, pay the same social and health contributions as those, whose salary is ALL 91,475.

How is the social and health insurance calculated?

Payment of social insurance and health insurance contributions works in the same way as the tax on employment income. They are calculated and withheld directly by the employer on behalf of the state. Thus, the employer deducts the tax on income (10%), the social insurance contribution (9.5%), and the respective health insurance contribution (1.7%).

[8] This value refers to the maximum salary applicable as of July 2012.

The remaining amount is our net salary, and this is the amount that is transferred to our bank account.

Example: Following his graduation, Ilir starts working for a small real estate office and his employer informs him that his monthly gross salary will be ALL 40,000. Can you help Ilir calculate his net salary?

We explained above that:

Net salary = gross salary – tax on personal income – social insurance – health insurance

Net salary = 40 000 – (40 000 x 0.1) – (40 000 x 0.095) – (40 000 x 0.017) = 40 000 – 4 000 – 3 800 – 680 = ALL 31 520

QUESTIONS?

1. Describe the types of taxes you hear more frequently about. Distinguish between taxes and fees.

Explain

What is the purpose of collecting taxes and what are taxes and fees used for?

Home/Class work

1. Calculate the value of social and health insurance that an employer pays for an employee, whose monthly gross salary is ALL 45,000.

2. A new businessman is preparing his business plan, and he has to calculate, among others, his employees' *salaries. He intends to employ three people for three different job positions, and pay them a monthly gross salary of ALL 32,000, ALL 37,000, and ALL 40,000. Calculate:*

a. The social and health insurance contribution to be paid by each employee;
b. The net salary for each of the three employees;
c. The total contribution that this businessman has to pay to insure his employees;
d. The total costs that the businessman has to pay for employing these three people.

3. Calculate the tax on income/profit in the following situations:

a. Profit from the sale of a 100 m^2 shop at a price of ALL 100,000 /m^2. The shop was bought previously at a price of ALL 70,000/m^2.
b. The incomes from renting an apartment for ALL 50,000 per month.
c. The interest earned from depositing an amount of ALL 60,000 for one year at an interest rate of 7%.

GLOSSARY

Gross income – incomes from employment or other profitable activities, without deducting taxes and social and health insurance obligations. This is what is generally declared in an employment contract.

Net income – incomes from employment or other profitable activities, after deducting taxes and social and health insurance. This is the amount transferred to our bank account at the end of the month.

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