

**Institutional Development of a Market Economy in Albania:
Some Observations Based on the Experience of the
Financial Services Volunteer Corps**

**Remarks of
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At the outset, I would like to note that we are meeting here on the second anniversary of the terrorist attacks on the World Trade Center and the Pentagon. Our topic at this conference, the performance of the Albanian economy, may seem quite far afield from those terrible and sad events and their repercussions. But strengthening emerging market economies everywhere can help to reduce poverty, improve the quality of people's lives, and address the conditions of hopelessness and despair that can serve as a breeding ground for terrorist ideologies. The forces of market capitalism and globalization have improved the material well-being of hundreds of millions of people, but most of the world's people have not benefited in any meaningful way. Working together, we must somehow find a way to change that.

It is a pleasure and an honor for me to be here today to speak about the institutional development of a market economy in Albania. The focus of my presentation will be on financial market infrastructure. But before considering the pieces of financial infrastructure that are most important for supporting a market economy, I would like to step back and consider more broadly a fundamental question whose answer most of us

take for granted. Namely, why should Albania or any other country in transition seek to develop a market economy? I believe that the case for doing so is compelling, but there are risks in pursuing that course as well. I would like to consider some of those risks, as well as steps that Albania and countries in similar positions can take to reduce their vulnerability and maximize the benefits they can receive from going the market route.

I. The Case for Developing a Market Economy

What is the case for developing a market economy? The most powerful reason for heading in that direction, I believe, is the potential to improve standards of living within a country for the broadest portion of the population possible. The market mechanism, while by no means perfect, has proven over time to be the most efficient and reliable allocator of economic resources. It offers prospects for economic growth, and a better quality of life, that directed and state-planned economic systems cannot duplicate. When working properly, it offers consumers a vastly broader range of choices, and a greater variety and quality of services, than would otherwise be available. Market-oriented countries also have the opportunity to join the global economy, and to benefit from the advances in technology, the quantum improvements in the speed of processing information, and the access to new markets that now characterize the highly interdependent modern world.

The benefits of a market system also apply to the financial sector. Within the banking sphere, the market mechanism works to allocate financial resources to the most creditworthy borrowers, and to projects that are most likely to produce the highest economic returns. A market-oriented banking system can serve as a powerful catalyst to

economic growth, funneling credit to the most viable and promising endeavors. A modern, healthy banking system offers further support for economic growth through the money multiplier effect of bank lending. If the system is functioning properly, and banks are lending based on arm's length decisions about creditworthiness, then a country should be able to achieve significantly higher rates of growth than would be otherwise possible.

But there are also risks. For a country such as Albania to operate a true market economy, it must open its economy and its borders to a vast array of powerful forces. At least in the short run, not all of the consequences are likely to be positive. Throughout much of Eastern Europe and Russia, for example, living standards actually declined in the early years of market reform before beginning to rise again. In the experience of emerging market countries in other parts of the world, there is further ample evidence of the risks. We at FSVC have recently undertaken work in Morocco, where structural weaknesses and the removal of market protections are adding to the uncertainties as that country becomes increasingly open to the world economy. Foreign companies may start to become significant players in sectors that were once the sole domain of local businesses. Substantial job displacement is likely to occur, and large-scale creation of new jobs will need to be an urgent priority. Inevitably, as further liberalization occurs in Albania, some sectors of the Albanian economy will lose jobs, and in a country already burdened with a high unemployment rate, this is no small matter.

Within the banking sector, the tradeoffs can be quite stark. On the one hand, a closed banking sector may be able to employ more people, and it may also be able to maintain a level of profitability that would be severely challenged if the sector were more competitive and/or if foreign institutions were attracted to the market. But a closed

banking system can also quickly become a complacent one, and the goal of providing credit and other important banking services in a quality way may become of secondary concern or lost all together. Whole sectors may not be serviced. For example, a critical sector in any economy, whether advanced or emerging, is the small- and medium-sized enterprise (SME) sector. It is often the key engine for a country's economic growth. If competition in the banking sector is weak, and if the infrastructure for banking and accounting/financial reporting is not well developed, experience strongly suggests that the SME sector will fail to get adequate credit.

II. Argument for Strong Institutions

I would like to make the case to you that strong institutions can help Albania weather the storm of developing a market economy, and, in a broader sense, of joining the global economy. "Institutional Development" covers many constituent components, and I would like to provide a definition of what I mean by this phrase. Specifically, I have in mind all of the infrastructure -- physical, legal, conceptual, skill-based, and even cultural -- that must be in place in order for a market economy to function. At the core of this institutional infrastructure is a sound, healthy banking system and the rule of law.

Let me begin with the banking component. A healthy banking system serves as the central nervous system of a market economy, providing a reliable repository for people's savings, a critical source of credit to support entrepreneurial activity and ultimately economic growth, and an efficient means of transferring financial resources to facilitate day-to-day commercial transactions in the real economy. A healthy banking system is not built overnight, and I have come to hold considerable respect for the

complexity of the institutional components that must be present to enable such a system to work efficiently and reliably. These components include bricks and mortar, but they are the easiest part. Also included are laws, complex systems -- ranging from management information systems to the entire payments system -- and trained personnel. Ultimately, these must exist a “culture of banking” that reflects intangible qualities such as professionalism, integrity and trust. Some of these components can be developed in a few years. Others can take a generation or longer to build.

A banking system, no matter how well-built, cannot function without the rule of law. Commercial transactions beyond the level of barter will never flourish without respect for contracts. There must also be reliable and widely trusted means of resolving disputes. Critical here is a court system that operates with integrity, and whose judgments are routinely enforced.

III. Where is Albania in this Quest?

We at the Financial Services Volunteer Corps have made an earnest effort over the last seven years to help build stronger financial infrastructure in Albania, and to promote the institutional development of the Albanian financial system. We believe that tremendous progress has been made, but there is still much work to be done.

A rough picture might appear as follows. Albania’s transition poses unique challenges due to its legacy as an isolated country during communist times. Poor physical infrastructure, including transportation, communication, power, and water shortages, has compounded underdeveloped financial infrastructure to create roadblocks to business and economic development. Lack of rule of law and a reliable court system

are deterrents to economic growth, as is corruption. Foreign investment levels have fluctuated in the past few years, but are generally low by regional standards. Geographic concentration of exports is very high, with the top two trading partners receiving more than 80 percent of all Albanian exports. Commodity diversification is low, leaving the economy more vulnerable to external and internal shocks. In 2002, Albania imported *four times* as much as it exported.

The grey economy is large. Conservative estimates suggest that one-third of total economic activity is informal, while higher estimates range from 50 to 60 percent of the economy. This negatively affects tax revenue and the circulation of money in the banking system and economy. Albanians working outside of Albania greatly impact the economy. In 2002, remittances comprised 13 percent of GDP. The Albanian economy is highly dependent on these remittances, which are used mostly for consumption rather than capital investment.

Albania's banking sector is arguably the least developed in the region. A "culture of banking" does not currently exist, and many citizens keep savings under their mattresses rather than in banks. According to Bank of Albania statistics, the ratio of private sector lending to GDP is only 7.2 percent, which is similar to lending in Romania but much less than in other nearby countries. The number of banking offices per capita in Albania is also one of the lowest in the region.

These factors are all hurdles to overcome in order for Albania to develop a strong market economy. However, Albania *has* been making strides toward development. The government has crafted a market-oriented legal and regulatory framework. Macroeconomic stabilization has been relatively successful. Albania has one of the

highest growth rates in the region, inflation has been brought generally under control (after a temporary spike last spring), and the banking sector is indeed developing. Currently there are fourteen privately owned banks, while there were only four operational private banks six years ago. The Bank of Albania is a strong institution that is dedicated to promoting the safety and soundness of the banking sector. And there is evidence that the banking sector can handle a serious problem -- the run on the Savings Bank last spring due to the new deposit insurance law did not cause a widespread banking crisis. Lending to the economy is on the rise, albeit slowly, and the level of bank loans classified as non-performing decreased last year. Albania has privatized or liquidated nearly all of the formerly state-owned SMEs, and is working to privatize remaining state-owned enterprises (including the Savings Bank).

In many ways, Albania is well positioned to attract foreign direct investment. Ports on the Adriatic, a literate and educated workforce, competitive salaries, and natural resources all are attractive elements for investors. As is evident here in Saranda, a beautiful coastline could also be a source of tourism revenue, but physical and financial infrastructure must be developed to attract international tourists. Tourism can be a large boost to an economy, and one need look no further than Italy and Greece to observe how positive the impact can be.

Albania has many opportunities for growth, as well as many hurdles that must be overcome along the way. Strong financial market infrastructure, comprised of physical infrastructure, systems and processes, the rule of law, a trained workforce, and a culture of banking, can help stimulate domestic and foreign investment, promote economic

growth, and help establish the conditions needed to promote a flourishing market economy.

IV. What Does the Future Hold?

The course that Albania is now pursuing points inextricably toward development of a market economy. It also points toward eventual integration into the European Union and the broader global economy. The road is certain to be rough at times, but strong institutions can play a critical role in helping Albania to stay the course.

Some of the needed components of infrastructure are already in place, such as a central bank committed to reform and a banking system that is beginning to function as it should in a market economy. Other pieces of institutional infrastructure will take a much longer time to develop. The cultural or more intangible elements are among the ones that may take the longest. The trust of citizens in the banking system, for example, is likely to be firmly established only after the system itself is well-established and functioning smoothly. This could take years. It will take political will and enormous discipline to stay the course, but the benefits of doing so will justify the effort.

Thank you.