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Albania among Bank Based System's Countries

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Abstract

The Albanian financial system has entered a new phase of its development. Financial system in Albania is bank oriented, as financial market is not active. Because of the important and deep changes that have altered the image of the banking system, the conditions for more dynamic development of non-banking intermediaries and capital markets have been created. The analysis is based on the standard indicators of size and activity of banking intermediaries. The results of the analysis show that the size and activity of Albanian banking system is growing faster but limiting the crediting process only on banks. However, the achieved level of development of banking intermediaries is still below of other advanced transition economies. Albanian financial system needs to develop quickly the activities of pension funds, investment funds and bond/asset markets in order to create great opportunities to the Albanian economy.

Key words: Albanian financial system, bank-based system, financial development

1. Introduction

The financial system encompasses all financial intermediaries and financial markets and their relations with respect to the flow of funds to and from households, governments, business firms, and foreigners, as well as the financial infrastructure. Financial infrastructure is the set of institutions that enables effective operation of financial intermediaries and financial markets, including such elements as payment systems, credit information bureaus, and collateral registries.

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The main task of the financial system is to channel funds from sectors that have a surplus to sectors that have a shortage of funds (Haan, Oosterloo, Schoenmaker, 2009).

King and Levine (1993a, b) were among the first to argue that financial development is related to economic development. King and Levine (1993b) suggest that current financial depth can predict economic growth over the consequent 10–30 years and conclude that 'better financial systems stimulate faster productivity growth and growth in per capita output by funneling society's resources to promising productivity-enhancing endeavors' (King and Levine, 1993b, p. 540).

Rajan and Zingales (1998) argue that financial development should be most relevant to industries that depend on external finance and that these industries should grow fastest in countries with well-developed financial systems. Using various measures of financial development of a country (the ratio of market capitalization to GDP, domestic credit to the private sector over GDP, and accounting standards), they report a strong relation between economic growth in different industries and countries and the interaction of financial development of countries and the financial dependence of industries. Rajan and Zingales (1998, p. 584) conclude that their results 'suggest that financial development has a substantial supportive influence on the rate of economic growth and this works, at least partly, by reducing the cost of external finance to financially dependent firms'.

Papaioannou (2008) points out that evidence based on cross-country cross-sectional regressions faces various problems in establishing causality. First, it is almost impossible to account for all possible factors that may foster growth. Second, the effect of financial development may be heterogeneous across countries. Third, there can be reverse causation: financial development can be both the cause and the consequence of economic growth. Finally, the indicators of financial development as generally used in these studies (such as private domestic credit to GDP and market capitalization as a share of GDP) lack a sound theoretical basis.

Other important studies include Levine et al. (2000), who address the endogeneity problems inherent in finance and growth regressions, and the papers in Demirgu-Kunt and Levine (2001) that use a number of different econometric techniques on datasets ranging from micro-level firm data to international comparative studies. All these studies, and many others, report evidence that financial development stimulates economic growth (Levine, 2005; Papaioannou, 2008).

However, some other studies voice concerns about this conclusion. For instance, Driffill (2003) questions the robustness of some well-known studies, arguing that a number of results hinge on the inclusion of outliers, while the

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inclusion of regional dummies, especially those for the Asian Tigers, also renders coefficients on financial development insignificant. Trew (2006) argues that most empirical evidence on the finance-growth nexus is disconnected from theories suggesting why financial development affects growth.

The financial system transforms household savings into funds available for investment by firms. However, the importance of financial markets and financial intermediaries differs across Member States of the EU, as will be explained in some detail in this paper. In addition, the types of assets held by households differ among the various European countries.

In the countries under system transformation, it was the banking system, which had to take over the role for lack of other financial intermediaries. However, in the early 1990s the development of banking in Albania was very poor as compared with industrialized countries and could not properly perform the mentioned functions in the newly forming market economy.

The fact that in developing countries the banking sector, plays a major role and is a bigger foundation, supporting the economic development, as compared to the securities market and the non-bank sector. Theoretical disagreement exists, however, about the importance of stock markets for economic growth. Typically, there are some other differing academic views, which do stress that, "many transition economies have to focus on developing the basic infrastructure for a financial system". In this regard, "these countries should aim to develop their overall financial sector, starting with their banking systems. This will also be the most effective way to foster the development of small and medium-size enterprises, a key source of economic growth. Generally, banks dominate the financial system in most developing countries, and the early stages of financial development, including that of securities markets, takes place through them. Because a bank is simultaneously a borrower, a lender, and a provider of payment services, it possesses a significant information advantage over specialized borrowers and lenders, particularly in a developing market where information is scarce. In many developing economies, there are a few banks and these banks are large relative to the firms in the economy. Therefore, the credit needs of the business sector can be met by the banks, and there is no compelling reason for firms to turn to alternative sources of financing.

The paper is organized in two sections. The first one presents the importance of bank-based system. The second part analyses the indicators that measure the size and the performance of Albania as a country with a bank based financial system and compare its performance with a selected group of countries.

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1. Bank-based financial systems

A financial system may be defined as a group of institutions, markets and regulations enabling the allocation of resources within time and space. The financial system fulfills this fundamental goal through five main functions: savings mobilization, resource allocation, corporate control, risk management and facilitating the exchange of goods and services (Levine, 1997). There is no doubt that financial development presents an important determinant of transition process, which to a large extent determines the speed and efficiency of transition. The importance of financial development in transition countries is of particular significance, as it also includes, in addition to restructuring existing banking intermediaries in line with the needs of the market economy, the creation of heretofore missing parts of the financial system, i.e. a capital market and some of the non-banking intermediaries. Hence, all transition countries are faced with an imbalance in the structure of their respective financial systems.

For instance, the size of financial markets and the importance of bank and non-bank financial intermediaries (such as mutual funds, private pension funds, and insurance companies) differ substantially across countries (see Figure 1). If we take a look inside Europe countries, we can state that new Member States differ significantly from the 'old' Member States. For instance, average stock- market capitalization as a ratio to GDP during 1995–2004 was 150 per cent in the United Kingdom, while in Austria stock market capitalization amounted to only 17 per cent. Similarly, over the same period, German bank credit was 188 per cent of GDP, while in Greece this ratio was around only 51 per cent (Haan, Oosterloo, Schoenmaker, 2009). The post-war high growth rates of Germany and Japan – where banks are dominant in the financial system – was often considered as 'evidence' that bank-based systems outperform market-based systems. However, more detailed empirical work, using micro-level data, has frequently failed to identify the superiority of bank-based systems. Also the much better growth performance of Anglo-American countries during the 1990s raised skepticism about the acclaimed advantages of bank-based systems (Carlin and Mayer, 2000).

The competitive process between commercial banks, investment banks and brokers in the US stimulated a process of disintermediation and securitization. Caps on short-term bank deposits led to the emergence of higher yielding money market mutual funds. Banks responded by transforming liabilities in negotiable certificates of deposits, on which interest could be paid without restriction. In order to get a share of the profitable loan market, investment banks stimulated corporations in securitizing their loans. As a result, balance sheets of banks became disinter mediated and securitized, and with this

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disappeared relationship banking. The growth of a deep and liquid money and capital market had deprived relationship of its implicit insurance value, and made valuations more important. The key principle of transparency that underlies US financial, securities and accounting law, emerged.

In continental Europe, the universal banking system has remained dominant, and was taken as the model in the EU's financial market liberalization under the Single Market program. There was no incentive for banks to securities debt, and capital markets remained underdeveloped. Furthermore, the regulatory framework for direct issues on capital markets left much to be desired, and differs from one country to another. For example, corporate bonds were until recently discouraged in Germany through very strict emission criteria, with, for example, the obligation to issue only in domestic currency on the local market, and unfavorable tax treatment. Governments wished to keep close control of the local debt securities market to ease public finance. Regardless of the various results achieved in capital market development, the financial systems in the more advanced transition countries are also dominated by banks; in other words the financial systems in all transition countries are bank-based. And, due to the mentioned changes, as the Albania has gone through banking improvement, questions arise frequently as to whether and to what extent a bank-based financial system is a factor limiting financial development and economic growth in general.

Over the years, Albania has developed into a modern market economy with, among other things, a move away from agriculture to services and construction. The economy grew on average by approx. 4% annually in the years 2008-2012. Albania was one of the few countries in Europe to register growth in GDP even during the financial crisis of 2009[1]. Albania has strong trade links with Greece and Italy and so the problems in these two countries are also having an impact on the development of its economy. It is nonetheless anticipated that in the next few years, growth rates will more or less return to the levels achieved before the financial crisis. The main reason for the growth in the economy in 2012 was the high demand from abroad, with investments already made in the energy sector or in infrastructure, for example, also contributing to growth. This led to a reduction in the historical dependence on money transfers from emigrants and on construction.

The Albanian financial system is relatively new, developed mainly during nineteenth and twentieth centuries. Historically, it is based mostly in the banking sector, more than in the non-banking one. The current architecture of the Albanian financial system provides a model, which continues to be deeply rooted in banking foundations, where the banking sector remains,

[1] Financial Market Report Albania, Raiffeisen Bank search, Aussenwirtschaft Austria, April 2013

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unquestionably, at monopoly sector positions, in terms of providing financial services in the country. The banking sector pillar, has, within a relatively short period of time, been successful in providing a rapid, but careful development, by building his professional, financially sound and well capitalized profile, providing customer services and various banking products and financial, from the traditional ones, such as loans for business, housing and consumer, to electronic cards and e-banking. The second pillar, of non-bank financial sector, is still in developing phase and at a pre-modern period, where the most striking absence is the active securities (stock) exchange. This dwarf profile is largely shaped by the narrow range of financial products and services and foremost, the modest level of development of the financial institutional infrastructure.

As it can be seen, the financial intermediation by non-bank financial institutions continues to grow with anemic rates, as banks always thrive to increase their share in financial intermediation and the volume of financial assets under management. Their balance sheets are focused predominantly on short-term assets, thus reflecting the absence of long-term financial instruments, as well as the underdeveloped stage of securities market in Albania. In this architecture of the financial system and infrastructure, the only institution established as a theoretical framework, remains the Tirana Stock Exchange (TSE), initially designed to serve as an organized securities market in Albania. Even thou sixteen years have lapsed since its official opening back in 1996, it has failed to fulfill its natural mission, a typical securities exchange could provide: trading debt and equity securities. It used to operate a simple money market (primary and secondary T-Bills market) for the first three years; no more transactions recorded, hereafter. The international experiences by developed or developing countries, witness or point to the development of a relatively balanced financial system, despite

Logically, the economic development model, pursued by Albania follows the model employed by many developing countries, and it is essentially a model proposed by international organizations, such as the World Bank (WB), which has always and obviously emphasized the developing role of financial institutions and the banking system. Following this model for financial system development, the promotion and development of non-bank financial institution was left unattended and in shadow, by focusing all energies on banking intermediation, thus neglecting the fact that, "the chronic problems of country and corporate over indebtedness have brought home the dangers of combining too much short-term debt with too little long-term equity". In this way, "the evolution of the bank-centered systems under government regulation has displayed major deficiencies. Past and current experiences have shown that most developing countries require greater variety in institutions and instruments than bank-centered financial systems allow. In this perspective,

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one important fact is that, the same attention must be given for the two pillars of the financial system (market), despite different contribution and commitment of national resources assets, those sectors provide to economic development. Banks, securities markets, and a range of other types of intermediary and ancillary financial firms all contribute to balanced financial development. A radical preference in favor either of markets or of banks cannot be justified by the extensive evidence now available. Instead, development of different segments of the financial system challenges the other segments to innovate, to improve quality and efficiency, and to lower prices. Practically, both bank and no-bank sectors offer different financial services to the general public, but quite complementing in their nature. The stock market liquidity and banking development both predict long-run growth, capital accumulation, and productivity improvements.

2.1. Empirical Research on Bank System Activity

The non-bank financial sector is less developed in Albania where there are many challenges with which this sector has to be faced in order to develop in the near future (see Table 1). There is almost an absent capital markets activity. The money and capital markets consist only of primary issues and a narrow secondary market (almost inexistent) for T-bills and T-Bonds. As a matter of fact, donors' development and consulting policies for were focused on banking sector, indirectly "cornering" the parallel development of the non-banking sector. On the other hand, lack of domestic political will was an important obstacle on the development of the non-bank sector in Albania. Thus, different from the experiences of the CEE[2] or SEE[3] countries, privatization process in Albania did not pass through capital markets, killing the opportunity for creating the initial supply for equity securities in the market. The only stock exchange licensed by the Albanian Securities Commission (ASC) was left alone without support by financial authorities, functioning only in a juridical way and not in operational one. Because of the high level of informality on the economy, local businesses are not interested on using stock exchange as a finance alternative (Gjergji, 2006). Despite this, financial developments in Albania appear stable. The banking sector is well capitalized and liquid. Profitability figures have increased; however, assets have grown at a lower rate during years. The annual growth rate of loans is lower, while deposits continue to grow at stable rates. Non-bank financial institutions, savings and loan associations (SLA's) and insurance companies have expanded their activity. The private supplementary pension market shows a positive, albeit limited,

[2] Central Eastern Europe
[3] Southeast Eastern Europe

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performance, reflected in the asset increase of pension fund managing companies. The level of financial intermediation in Albania, as measured by the ratio of financial system assets to GDP, was estimated at 92.8% at end-June 2012, compared to 89.5% at end-2011 and 86.9% in the same period of 2011. The volume of financial institutions' assets grew by about 4.2% compared to 2011 H2 and by about 11.6% compared to 2011 H1. The banking sector remains the dominant segment of financial intermediation in Albania. Its assets account for about 93.9% of total financial system assets and about 87.2% of GDP.

Table 1: Financial system segments as a percentage of GDP across the years

Licensing and Supervisory Authority	Financial System 2	2007	2008	2009	2010	2011	2012 H
Bank of Albania	Banking system	75.9	76.7	77.5	80.9	84.7	87.2
	Non-bank institutions	1.5	1.7	2.2	2.7	2.5	2.5
	SIAs[4] and their Unions	0.6	0.7	0.8	0.8	0.7	0.7
Albanian Financial Supervisory Authority	Insurance companies	1.4	1.4	1.5	1.4	1.5	1.5
	Pension funds	-	-	0.01	0.01	0.01	0.01
	Investment funds						0.86

Source: Bank of Albania, Albanian Financial Supervisory Authority.

Non-bank financial sector continues to share a small weight in total financial system. Total non-bank financial sector assets[5] account for about 6.1% of the financial system, hence higher compared to 5.3% at end-2011. This increase attributes to the entry of 'Raiffeisen prestige' investment fund into the market during the period under review (BOA, 2011). At the end of the period, non-bank financial sector's activity as a percentage of GDP was 5.6%. [6]

At end-2011, loans accounted for about 50% of total banking system assets and its growth rates accelerated. The loan portfolio of the banking system was up by ALL 75.35 billion or about 15.35% during 2011, compared to about ALL 44.45 billion or 9.07%, a year earlier. The credit value increased throughout the quarters and reached the highest level in the last quarter of the year.

[4] Saving and Loan Association

[5] The information on total pension fund assets has been obtained from the latest AFSA's publication of 19 June 2012.

[6] Financial Stability Report 2012 H1, Bank of Albania

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Developments point to higher exposure of the banking system to credit risk, as a result of higher non-performing loan increase than the total outstanding loans increase in 2011. Consequently, the loan portfolio quality indicator, non-performing loans to total outstanding loans in the banking system was up by 4.8 percentage points, settling at 18.76%, from 13.96% at the end of 2010.

Loan portfolio quality deteriorated for loans to both businesses and households. At end-2011, the share of non-performing loans to the loan portfolio to businesses was about 20.8%, from about 15.5% a year earlier. This indicator for households was about 15.8%, from about 11.7% in December 2010. On the other hand, the quality of the foreign currency loan portfolio was more problematic than that of the national currency one. Quality indicators for foreign currency loans and national currency loans were respectively 19.6% and 16.9%, from about 13.8% and 14.4% at end-2010. By share to total assets of the banking system, the treasury and inter-bank transactions ranks second to loans, with about 29.9% of total assets. At end- 2011, this item was ALL 333.25 million, up by about 12.5%, year-on-year. This item's growth rates were almost equal to those of total assets; therefore, the share of this item to total assets did not register essential changes.

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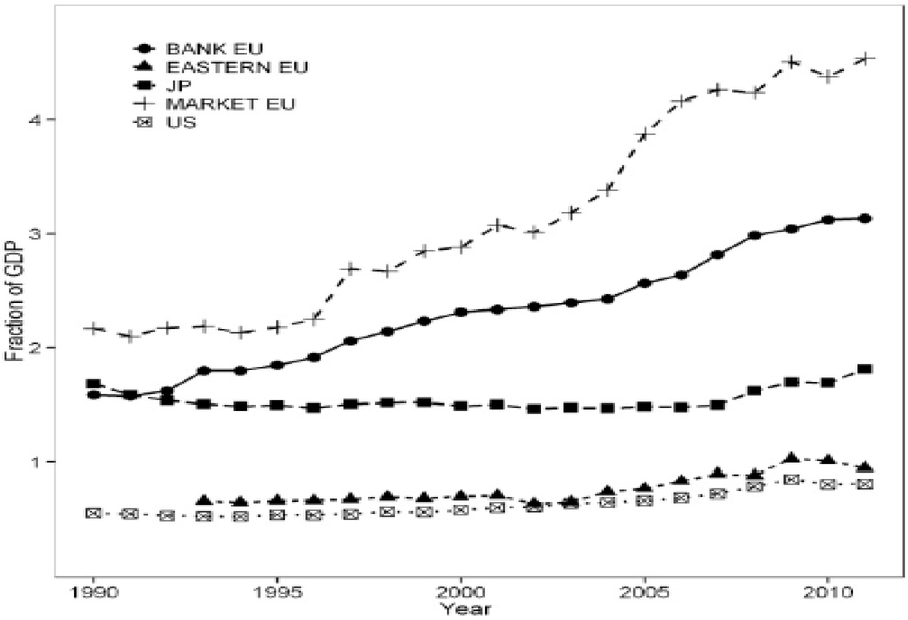
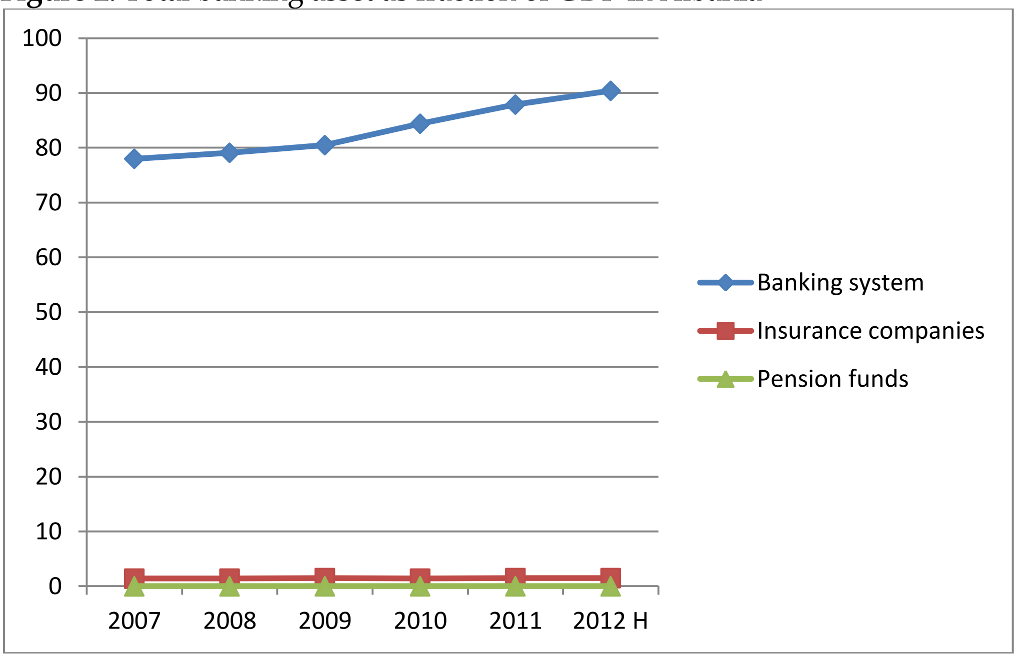
Figure 1: Total banking asset as fraction of GDP worldwide and in Albania



Source: Bijlsma, Zwart, 2011

Figure 2: Total banking asset as fraction of GDP in Albania



Source: Data calculated by author, BOA, 2011

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If we take a look to the four groups of European countries, Japan and the US, Figure 1 and 2 shows the developments of financial system between 1990 and 2011. In accordance with the size of bank credit to the private sector, the US has a relatively small banking system (82 percent of GDP in 2011) compared to Bank based EU (314 percent in 2011), or Market based EU (465 percent GDP in 2011), while Japan is located in between (182 percent of GDP in 2011).

Banking assets in Europe have increased substantially as a percentage of GDP, with the exception of Eastern Europe. In general, the banking sector in the new member states in Eastern EU is still relatively small. These countries are making the transition towards a more developed financial system (see eg Allen, Bartiloro and Kowalewski, 2005 and ECB, 2005). In contrast, for the US and Japan the ratio has stayed relatively flat. The second charter shows a relatively small banking system (87.2% of GDP) almost the same with US banking system and too far away from the percentage of European banking system.

Paradoxically, more market-oriented countries also have the largest banking sectors. For instance, the UK, the Netherlands and France have a large banking sector with assets exceeding 4 times GDP in 2011. As we discuss below, this may be related with the large cross-border activity of banks in market-based countries. Within Europe, there is substantial variation in the size of the banking sector. For example, in 2011, banking assets as a percentage of GDP range from 67 percent for Romania to 840 percent for Ireland (with Luxembourg the outlier at banking assets of over 25 times its GDP). The bar-plot (Figure 3) shows this more clearly.

The ratio of foreign ownership in the CEE banking sectors remained more or less flat in 2011. In CE and SEE, the average market share of foreign-owned banks now stands around 2-4 percentage points below the highest readings seen in the years 2005 to 2008 according to the data provided from Raiffeisen bank Research. Foreign ownership is calculated around 90% of total Albanian banking asset according to this research. In CE and SEE, the average market share of foreign-owned banks now stands around 2-4 percentage points below the highest readings seen in the years 2005 to 2008. This slight decline can be explained by the modestly increased market shares held by locally owned and/or state-owned banks in some markets.

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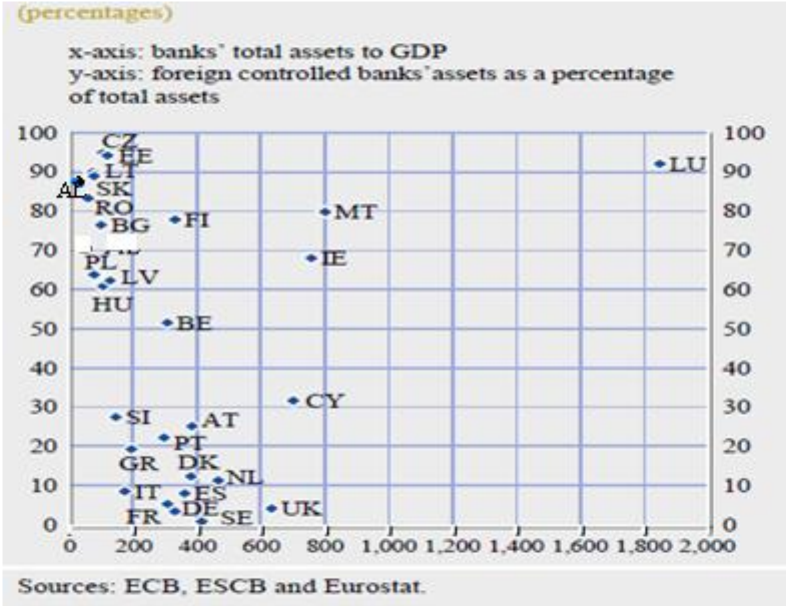
Figure 3: Size and ownership structure of EU banks (end- 2011)



Sources: ECB, ESCB and Eurostat.

The CBD allows to broadly distinguishing four main groups of countries within the EU banking system, according to the size of their banking systems and their bank-type ownership structures (predominantly domestic or foreign banks):

- In the first group, the size of the banking system is predominantly below 200% of GDP and is mainly composed of foreign-controlled institutions. This group mainly includes central and eastern European countries: Bulgaria, Czech Republic, Estonia, Hungary, Lithuania, Latvia, Poland, Romania and Slovakia, but also Belgium and Finland (these two countries having somewhat larger banking systems). Albania is part of this group too with a banking system below of 200% of GDP, and 87.2% of banking ownership are foreign bank asset.
- A second group comprises Ireland and Malta, with banking systems weighting between 700% and 800% of GDP and mainly composed of foreign-controlled institutions.
- The third group includes countries mainly composed of domestic banking groups: Austria, Cyprus, Denmark, France, Germany, Greece, Italy, the Netherlands, Portugal, Slovenia, Spain, Sweden and the United Kingdom. Their banking system size ranges from 149% (Slovenia) to 706% (Cyprus) of GDP.

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Lastly, one can distinguish Luxembourg, where foreign-controlled institutions represent 92% of total assets and the size of the banking system is 1857% of GDP.

This captures the relative size and strength of a country's banking system in the region; therefore, the bigger the banking system of a country the more influence it would have at the regional level, a statement made by Degryse, Elahi, and Pena.

Theoretical and practical evidence show that, "the existence of several large financial institutions, within financial system is fairly counterproductive and leads to a non-competitive financial system. This lack of inter sectorial competition between bank and nonbank sectors of the financial systems easily leads to increased cost of financing for the entire economy, especially for businesses. "Also, the economy is at risk of crisis due to excessive reliance on bank lending. Because banks are highly leveraged institutions, the economy is much more vulnerable to a financial crisis than if more corporate borrowing had taken place in the bond market and the claims were held in well-diversified portfolios. Additionally, banks can be obstacles to economic development in other ways. Despite attractive lending opportunities, and a tradition of commercial and industrial lending, a shortage of bank credit for the private sector develops and persists for years. "In the case of Albanian financial system, which is almost entirely modeled around banks, has already concentrated all possible risks within banking system, thus contributing to establish a permanent systemic risk within it, with no way of possible diversifications on individual or market basis". The impact of the last financial and economic crisis is the best witness how the oversized bank –based economy, could and practically downloads all the issues, pitfalls and inefficiencies of the banking system, on the shoulders of companies and individuals as borrowers, especially in times of economic contraction or crisis (Meka, 2012).

2. Conclusions

The presented comparative analysis indicates that during this year Albania has increased its bank system versus the other countries.

Excellent progress has been achieved in the growth of bank size and activity, enabling the Albanian banking system to be comparable with banking systems of advanced transition countries. However, comparison with bank activities in developed countries indicates that in all transition countries there is still much room for strengthening bank activities towards the private sector.

Banking assets in Europe have increased substantially as a percentage of GDP, with the exception of Eastern Europe. In general, the banking sector in

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the new member states in Eastern EU is still relatively small. These countries are making the transition towards a more developed financial system. Albania has performed almost in the same way as Eastern EU.

In the case of Albanian financial system, which is almost entirely modeled around banks, has already concentrated all possible risks within banking system, thus contributing to establish a permanent systemic risk within it, with no way of possible diversifications on individual or market basis.

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