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**THE FINANCIAL AND REAL ECONOMY:
TOWARD SUSTAINABLE GROWTH**

**THE ROLE OF FINANCIAL SYSTEM
IN THE ECONOMIC DEVELOPMENT OF ALBANIA**

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***Abstract:** The main role of a financial system is to encourage economic growth through an efficient distribution of financial resources. Naturally, this is achieved through a stabilized financial system. Fast transformation of the financial system, especially in countries with economies under development, like Albania, takes particular importance after the '90s. If during the '90s, restructuring and consolidation of banking system was slowed down due to the adverse economic and political developments, from year 2000 and on, it has taken off as a result of a more stable climate. The effects of such transformation are crucial not only in the financial sector. In a study carried by the European Bank for Reconstruction and Development, transformation of the banking sector in the economies of post communist countries promotes competition in non-financial sector, encouraging the entry of foreign financial resources, both in terms of increasing the quantity, as well as reducing borrowing costs, thus facilitating access to markets of goods and services. Therefore, maintaining financial stability is an important prerequisite for future growth, especially in a transforming environment. In 2007, macroeconomic grounds were improved further as a result of splicing the stable political environment and improving consumer's and investor's confidence. At present, even after two decades of system's transformation we may convince observe that our financial system belongs to the first model that based on banking sector. This feature, dominance of the banking system and relatively undeveloped capital market, is seen as a common element of all SEE countries. As result, these countries have supported important reforms in banking system. With the assistance of international organizations important efforts have been made to improve legal and regulatory framework, implement and strengthen the skills of banking national authorities. In Albania we find a banking industry which is well prepared to support market growth, while the Central Bank operates speedily towards modernization of the system. Banking sector is already privatized. The presence of internationally recognized banking groups has brought confidence and security in the country, a fact that may realistically contribute in the achievement of future challenges, most importantly, promoting and updating financial markets.*

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1. Literature Review

Usually a higher lending rate indicates a greater economic development and is part of the increased financial intermediation. But in many cases, higher lending caused the banking and financial crisis¹. Rapid credit growth has its supporters and opponents. On one hand, it is argued that a rapid credit growth, going from low levels of credit is a positive step for countries moving to a market economy. After showing financial system development and convergence towards developed countries. On the other hand, critics remain for credit growth, who suspect that a rapid increase (which could end in a credit boom) can lead to banking crises or even wider. (Matraku 2009).

A high rate of credit growth certainly has its costs. Consequences and risks may not appear immediately, but obviously that will appear after several periods.

- Relationship banking crises and exchange rate crises. According to an IMF study (2004), the data of recent decades shows that 75 % of boom lending that occurred in developing countries are associated with the banking crisis. Also 85 % of lending boom are associated with exchange rate crises. (Matraku 2012)
- The deterioration of the current account deficit. If banks are unable to meet their funding needs through domestic savings, then will address parent banks for external financing. Thus worsen the current account deficit in the balance of payments (Kiss, 2006). Sa (2006), argues that if the expansion of bank credit it is used to finance imports of capital goods (which in turn will increase productivity and exports) this is not a problem. But if the loan is used to finance consumer goods, it can cause inflation and affect the sustainability of the current account. The problem extended to a further decline in international reserves and increase external borrowing.
- Deterioration of loan portfolio quality. Another result of rapid credit growth is the deterioration of credit quality after the end of the boom. During the expansion of banks' portfolio loans, banks also give loan to borrowers (individuals or businesses) that in normal periods considered at risk. According to an IMF study (2006), initially during rapid credit growth , the share of nonperforming loans to total flop. This is caused by the fact that a new portfolio takes time to manifest problems. But as the portfolio matures, the ratio of nonperforming loans begins to rise even above previous levels. In literature this is known as " aging effect ", loans reach peak 3-4 years after granting loans.
- The weakness of the banking system. In case the credit expansion is accompanied by economic growth, banks take on more risk. If these risks are not well diversified can lead to bankruptcy of banks (How, 2006).

In the theoretical literature recognize that credit growth can be divided into three components:

1. The tendency is usually determined by macroeconomic variables
2. Cyclical component, linked to economic cycles
3. An excessive increase (a potential boom), identified as the difference between actual growth of credit and the level set by the other two components.

¹ Matraku D, Financial crises and the warning models. Albania case” LAP LAMBERT Academic Publishing (August 23, 2012). Germany ISBN 978-3659220296

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How can identify if there is an increase lending beyond the parameters that macroeconomic models suggest? So, what is the equilibrium level or potential stars of credit that an economy can afford, without then transformed into a process that threatens stability and economic financier? In the economic literature there are several answers.

- Despite the economic fundamentals a fixed limit value can be assigned. If the loan grows beyond this value then it is considered dangerous. But setting a limit is arbitrary, inflexible and does not take into account a country's economic development.
- Based on historical data and assuming a range of time, the potential level of lending can be defined in the form of a trend. This model assumes that in the long run explanatory variables are fully included in the loan balance. But we cannot be confident in our calculations since the data series are not long enough to enable the calculation of the equilibrium potential.
- To determine the equilibrium levels of lending rely on econometric methods. This is the method most used nowadays as it takes into account the economic models and explanatory variables

A rapid credit growth is concern for financial and macroeconomic stability. For this reason the empirical literature on credit booms, is trying to find a definition of what should be called an excessive growth of credit growth. Theoretically credit growth may be called excessive if:

- a. Financial stability risks by financing those projects that cannot meet the requirements and can become bad credit
- b. Affects macroeconomic stability through deteriorating external position, leading to instability of the external debt (Boissay et al., 2005).

Overall credit growth is considered excessive if it is higher than the levels that justify development and macroeconomic indicators of the country. However, we must emphasize that the measure overcoming identification is difficult.

2. Facts on Loans in Albania

Intermediary role of banking system became more apparent after 2004. Some of the key features that accompanied the economic and financial development, especially in the years 2004-2008 were:

- inflation at low levels and within the limits specified by the Bank of Albania
- rates relatively high and stable economic growth
- high level of capitalization of banks
- lending mainly in foreign currencies
- expanding lending to individuals, but without reaching the level of lending to businesses
- high interest rates on loans
- low level of problem loans.

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Lending by banks is the main source of external financing to businesses in transition countries. This is true for Albania, where borrowing from banks is second largest funding after internal funds / retained earnings. (Albulescu, 2009).

Despite rapid growth rates after 2004, lending to the Albanian economy first in relation to GDP remains low, because he started from very low levels. As shown in the chart below, rapid credit growth in the years 1999-2011 is supported by the country's economic growth. Dushku (2010) highlights a double bond between financial development and economic growth in the long term for Albania. We can say that speeding up the pace of lending has come as a result of convergence with macroeconomic conditions and greater need the economy to be credited.

If we compare some data we conclude that the rate of credit growth has been higher than the growth of deposits (exception 2010 where the rate of credit growth was 9.7 % while that of deposits, 18.5 %) since the credit started from low levels. The speed of growth of loans / deposits ratio (from 9.4 % to 62 %) indicates a faster growth of the loan portfolio than deposits. Also this is a sign of a more lucrative investment funds collected from depositors Albanians. With this proves that the banking system has begun to consolidate its intermediary role.

After 2008 there is a change in the upward trend of the credit report / deposit. This lack of trust is influenced by information coming from international markets and informal noises that have circulated in the country. The contraction is evidenced in the significant decline of customer deposits, particularly deposits of individuals. Banks faced liquidity problems due to the withdrawal of deposits, which lasted from the last quarter of 2008 to the second quarter of 2009. However at the end of 2009, deposits reached the levels of the early 2008. From the source of Bank of Albania it is shown a low growth in total deposits during 2014. The reason is related with the low value of the rate of interest and the other instruments. Individual deposits remain 87.5% of the total and the business deposits remain 9.8%.

It seems that between GDP, loans and deposits, there is a strong relationship. To better understand the links between these indicators after 2008 the banking system came under pressure and the global crisis changed the pace of lending. Banks were more cautious in granting loans and borrowers were unsure of their abilities to pay. Table 1 presents the correlations between them. From the resulting values indicated that these indicators are highly correlated and significantly affect the values of each other.

Table 1. Correlation between probability and loans, deposits and GDP.

Korrelacioni	Depozita	Kredi	GDP
Depozita	1.0000		
Kredi	0.9743	1.0000	
GDP	0.9697	0.9435	1.0000

Source: Bank of Albania, Annual Report (2011).

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Linking welfare lending rate of a country is explained by Sa (2006). When the economic situation is also optimistic expectations for the future are good. Individuals and businesses expect more revenues and profits, it also leads to an overstatement of assets (real estate prices).

3. Factors that Led to the Credit Growth in Albania

In this issue I'll outline the factors that brought about rapid credit growth in the years 2004-2008 in Albania, which is considered as the demand and the supply side.

Deepening financial intermediation. Developments that occurred in the financial system and in particular in the banking system, which are: the privatization of the largest bank in the country (Savings Bank), the entry of foreign banks, or even the creation of new banks, have led to increased financial intermediation and mitigation of credit conditions. Banks expanded range of loan products and gave customers the opportunity to choose different types of loan. In addition to business loans, suffered significant increase lending to households, especially for home loans. This increase lending except, that there were positive effects on economic growth.

Another development of the banking system belonged to customer service, which through electronic terminals was accompanied by the increasing number of electronic cards in circulation. It significantly increases the number of ATMs and credit and debit cards. These cards use won an increasingly large part of the population. Enough POS (points of sale) are installed at sales outlets where customers can perform transactions electronically. Internet banking spanned many banks. Starting from June 2009, the banks put in use international bank account number (IBAN) as payment instead of international ones as well, offering all their customers to use its facilities.

The convergence process. Levels of credit in the years 1999 - 2003 were too low. Therefore credit expansion, the launch of these levels is negligible, was a normal and expected process for Albania moved from a centralized economy to market it. This rapid credit growth was expected due to the country aims to integrate and converge with developed countries.

Wealth effect. The rapid increase in the price of real estate was put individuals belief that an investment in real estate (although funded with loans) was a profitable investment. Demand for the purchase and construction of houses (especially for the metropolis where the concentration of population is high) was high. This led to increased demand for mortgage loans, and its weight in the portfolio of loans to banks. (Bank of Albania).

Exchange rate. Exchange rate stability, provided security for the borrower and was given the opportunity to take loans in foreign currencies (especially the euro) were not endangered at the time of changes in exchange rates. Borrowers receive more loans in foreign currencies for several reasons:

- Interest rates on foreign currency loans were lower
- For individuals borrowers purpose of obtaining credit in foreign currency was mainly for the purchase of housing (housing prices are denominated in foreign currencies)
- Businesses took this kind of credit for trade with other countries (which transactions were conducted in foreign currencies)

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The negative effects of this borrowing, in those cases where borrowers were vulnerable to exchange rate risk, was observed after 2008. Strengthening of the currency in which the loan was received reduced solvency of borrowers.

Figure 1. The performance of the exchange rate for the euro and the dollar in the years 2004-2012



Source: Bank of Albania (2012).

In looking at the chart above that the two main foreign currencies, the euro and the dollar suffered depreciation in the period 2004-2008. Some reasons:

- Employment and income. Employment growth and expectations of higher incomes, that borrowers did borrow more, in the hope that it will repay in the future when their financial situation was better.
- M3 aggregate. The growth of broad money in the years 2004-2008 respectively 13.9 % , 16.6 % , 12.8 % and 7.2 % impacted positively on the ability of banks to give loans to their clients.
- Interest rates. Despite that interest rates have been high, credit demand has been high and is not adversely affected by interest rates. The difference between interest rates on loans in domestic and foreign currency increased lending in foreign currency.

4. Reasons of slowdown in credit growth. The methods of calculation.

After the onset of the global financial crisis in 2008, the banking system significantly slowed its lending activity. Some of the factors that may have caused this behavior are shown below:

- Albanians experienced negative experiences from the 1997 pyramid schemes and banking panic in 2002 (Matraku 2012). Their confidence in the financial system tottered again when the global financial crisis of 2007-2008 hit financial institutions worldwide. Albanian depositors began withdrawing deposits. This condition, which lasted from the fourth quarter of 2008 to the second quarter of 2009, reduced the funding sources available to banks to lend.

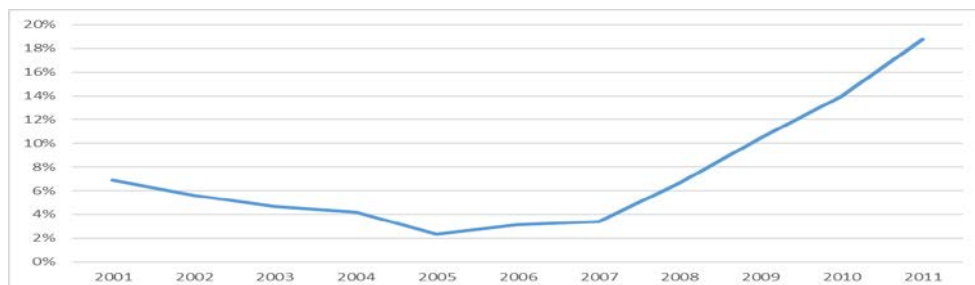
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- The financial crisis had an impact on the real sector of the economy and the rate of economic growth slowed. Consequently fell borrower solvency of customers, this made banks more reluctant to grant new loans in this period.
- Loans experienced a rapid growth and the quality of the loan portfolio deteriorated significantly. This phenomenon can be caused by two main phenomena.

First, exchange rate fluctuations, since about 50 % of foreign currency loans were vulnerable to exchange rate risk. (Bank of Albania).

Second, the emergence of problems in its loan portfolio was due to his maturity. This was an expected phenomenon that probably coincided with the global crisis, but had no direct connection with.

Figure 2. The ratio of nonperforming loans to total gross loans.



Source: Bank of Albania (2012).

In the chart above we see that by 2005 we have had a limited exposure to the banking system to credit risk. In 2011 we had an increase in exposure of the banking system to credit risk as a result of greater growth of nonperforming loans to outstanding loans growth. As a result, increased quality indicator loan portfolio by about 4.8 percentage points, reaching 18.76 %, from approximately 13.96 % in late 2010. Nowadays the rate of non-performing loans is around 24%.

Loan portfolio quality has deteriorated as loans to businesses and for those giving individuals. In late 2011, the share occupied by non-performing loans in the loan portfolio of businesses providing results in about 20.8 %, versus 15.5 % by weight of a year ago. The indicator for households is about 15.8 % from 11.7 % in December 2010. (Bank of Albania, Annual Report 2011, f.82).

Meanwhile, the foreign currency loan portfolio results in problematic compared to the portfolio in local currency. Quality indicators for loans to foreign currency and credit given in local currency resulting in about 19.6 % respectively and 16.9 %, from 13.8 % and 14.4% at the end of 2010. The situation is more worrying for loans in foreign currency, since the risk and consequences that accompany this portfolio are of the highest importance. The loan in foreign currencies was 52.7% in 2014 and the loan in local currencies was 47.7%. In the first quarter of 2014 we notice a grow with 3.8% in the loan in the local currencies, and a decrease with 4.6% in the loan in the foreign currencies.

4.1 Method of Calculation

Authors are regularly use different methods to distinguish between a situation where credit is growing rapidly and a situation where the economy is experiencing a boom in lending to. While the first situation is an integral part of financial deepening (especially developing countries), the second situation is growing outside the normal parameters and unstable over long periods of time.

Scholars who have dealt with this issue have identified the equilibrium level of the credit / GDP, using mainly two types of methods: statistical methods and econometric methods.

Statistical method refers to method Hodrick Prescott (HP) Filter. This is a filtering method that divides the time series into short and long term components. This technique of smoothing the data used in order to remove short-term fluctuations associated with business cycles and thus highlights the long-term trends. It is the method often used in literature boom lending.

Kaminsky and Reinhart (1996) define the limit of 9.3 % of GDP for annual changes in the ratio loans / GDP. So the boundary that maximizes the ratio signal / noise predictions banking crises in a group of industrialized countries with market economies.

Gourinchas et al. (2001) in a study conducted for 91 countries in the years 1960 to 1996, suggest the use of two indicators to identify a potential credit boom. Absolute deviation and relative deviation from the long-term trend measured by the method HP Filter. Absolute deviation is calculated as the difference between the actual ratio loans / GDP ratio and the value of the credit / GDP taken by HP Filter (this difference is expressed in percentage points of GDP). Relative deviation, expressed in percentage , and is calculated as the ratio of the absolute deviation of actual credit report / GDP.

The H-P filter is an algorithm that “smooth” the original time series y_t to estimate its trend component, τ_t . The cyclical component is, as usual, the difference between the original series and its trend, i.e.,

$$y_t = \tau_t + c_t$$

where τ_t is constructed to minimize:

$$\sum_1^T (y_t - \tau_t)^2 + \lambda \sum_2^{T-1} [(\tau_{t+1} - \tau_t) - (\tau_t - \tau_{t-1})]^2$$

The first term is the sum of the squared deviations of y_t from the trend and the second term, which is the sum of squared second differences in the trend, is a penalty for changes in the trend's growth rate. The larger the value of the positive parameter λ , the greater the penalty and the smoother the resulting trend will be.

If, e.g., $\lambda = 0$, then $\tau_t = y_t$, $t = 1, \dots, t$.

If $\lambda \rightarrow \infty$, then τ_t is the linear trend obtained by fitting y_t to a linear trend model by OLS.

5. Conclusions

This paper analyzed an extremely important issue in a country's economy lending (especially for developing countries). Reviewing the literature we understand the importance of acknowledging the credit phenomena that causes problems in banking sector. Seeing the diversity of behavior of credit in Albania, it was necessary a detailed analysis to understand its reasons and a tendency to judge whether it was a normal behavior based on macroeconomic development, or a deviation from the long-term trend. This is a work to continue, because the two models will be applied for Albania in the near future.

Albania during the last decade has been in a phase of adjustment, therefore lending rates were very rapid in its infancy. Similar results showing that Albania was at the stage of adjustment of credit. The slowdown in credit growth after 2008 coincided with the global financial crisis but it seems that there was a direct consequence of it. The slowdown in credit growth was due to the possible rapprochement with potential dictated by macroeconomic development of the country.

Albania after 2004, has narrowed the difference between credit /current GDP with credit / potential GDP, it is still far below that level to be imposed by developed countries. So we can say that judging by its macroeconomic growth, Albania still has room to expand lending in relation to GDP and to converge towards levels of this report to countries thought to have reached equilibrium lending.

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ULOGA FINANSIJSKOG SISTEMA U PRIVREDNOM RAZVOJU ALBANIJE

Rezime: Osnovni cilj finansijskog sistema je da podstakne ekonomski rast kroz efikasnu distribuciju finansijskih sredstava. Naravno, to se postiže kroz stabilan finansijski sistem. Brza transformacija finansijskog sistema, naročito u zemljama sa privredom u razvoju, kao što je Albanija, dobija poseban značaj nakon 90tih. Ukoliko je tokom 90tih godina restrukturiranje i konsolidacija bankarskog sistema bila usporena zbog nepovoljnih ekonomskih i političkih dešavanja, od 2000. godine i nadalje nije takav slučaj, što je rezultat stabilnije klime. Efekti ove transformacije su od ključnog značaja, ne samo u finansijskom sektoru. U studiji koju je sprovedla Evropska banka za obnovu i razvoj, transformacija bankarskog sektora u postkomunističkim zemljama promovise konkurentnost u nefinansijskom sektoru, podsticanje ulaza stranih finansijskih sredstava, kako u pogledu povećanja obima, tako i u smislu smanjenja troškova zaduživanja, čime se olakšava pristup tržištima roba i usluga. Zato je održavanje finansijske stabilnosti važan preduslov za budući rast, naročito u promenljivom okruženju. 2007. godine makroekonomski uslovi su dodatno poboljšani kao rezultat spajanja stabilnog političkog okruženja i poboljšavanja poverenja potrošača i investitora. Sada, čak i nakon 2 decenije transformacije sistema, možemo videti da naš finansijski sistem pripada prvom modelu koji je baziran na bankarskom sektoru. Ova karakteristika, dominacija bankarskog sistema i relativno nerazvijeno tržište kapitala, zajednički je element svih zemalja jugoistočne Evrope. Kao rezultat, ove zemlje podržale su bitne reforme u bankarskom sistemu. Uz podršku međunarodnih organizacija, učinjeni su značajni naponi da se poboljša pravni i regulatorni okvir, kao i da se sprovede i ojača sposobnost bankarskih nacionalnih organa. U Albaniji imamo bankarsku industriju koja je dobro pripremljena da podrži tržišni rast, dok se Centralna banka ubrzano kreće ka modernizaciji sistema. Bankarski sektor je već privatizovan. Prisustvo međunarodnih priznatih bankarskih grupacija doprinosi pouzdanosti i sigurnosti u zemlji, što je činjenica koja može doprineti dostizanju budućih izazova, i što je najbitnije, promociji i ažuriranju finansijskih tržišta.