

# The Effect of Institution Efficiency in Developing Albanian Economy

Ermir Shahini

Lecturer and PhD Candidate in Economic Science, Department of Economic Science,  
Aleksander Moisiu University of Durrës, Albania

**Abstract:-** *On the basis of the contribution of the Bank of Albania, the report examines the development in the economy of Albania. The report emphasizes on the role of banking system in the development of an economy. The efficiency of the financial institutions of the country was an important part of the Albanian economy. The global financial crisis had a gradual impact on the economy of Albania, affecting all the factors that form the economy. The major issue for the country was the financial instability, which was eventually having an impact on the working of the banking system of Albania. Using the recent years results derived from researches and studies, the report has detailed the measures taken by the Albanian bank with the support of the government to bring stability in the economy as well as develop the economy.*

**Keywords:** - *Bank efficiency, economic growth, financial development, macroeconomic stability*

## I. INTRODUCTION

The economy of any country grows at different rates. The empirical growth literature come up with various explanation of cross country differences in growth including institutional and educational development, human and capital resources, legal system effectiveness, degree of macroeconomic stability, international trade etc. One critical factor that has begun to receive more attention recently is financial markets in growth process. The positive link between financial market and economy growth is obvious. More developed countries have more developed financial market. The growth of any country depends on the level of financial market and financial institutions. Therefore it would seem that policies to develop for financial institution would be expected to raise economic growth.

Economic development of any country depends on financial development of that country. The purpose of this paper is to examine the effect of institution efficiency in developing Albanian economy. Albania is applying the multiparty democracy, pluralism and market economics in according to Article 1 of the agreement establishing the bank. Albania was one of the south-eastern European countries that avoided a recession in recent year [1]. GDP growth of Albania currently forecast by the bank fall about 1.2 percent in 2012 but with modest increase in 1.8 per cent in 2013. Under this baseline, growth is expected around 3 to 4 per cent in 2014-2015. Over the past two decades Albania has made steady progress with structural reform despite having institutional weaknesses.

## II. THEORETICAL BACKGROUND

It is essential to assess the relationship between financial market development and economic growth. Two causal relationships were identified between financial development and economic growth, the first– called “demand following” – views the demand for financial services as dependent upon the growth of real output and upon the commercialization and modernization of economic sectors. Thus, the creation of modern financial institutions, their financial assets and liabilities are a response to the demand for these services by investors in the real economy. The financial system can help and sustain the leading sector in growth process. Thus financial system induced as a consequence of the real economic growth.

### I.1. Efficiency of the Albanian Banking Market

To possess an efficient Banking system is a major requirement of a developed economy as the banking system is the backbone of the economy of the country. The Bank of Albania has emerged as a strong institution that contributed in making the banking sector of Albania healthy. The efficiency of the sector depends on the financial ratios like net interest margins (NIM), cost-income ratios, overhead costs to total assets, operating expenses to operating revenues and return on investments. The efficiency of a bank is considered to be low when the net interest margin and the overhead costs are high [2].

The cost incurred on these ratios is high as well as there is a higher wedge between the borrowed and deposited interest which reduces the efficiency of banks. Moreover high ratios of cost income ratio, O/H cost to

total assets, operating expenses to operating revenues also indicate poor efficiency of banks. However, the ROA is considered as the basic tool to evaluate the performance of the banking system as a whole and indicate the profitability of the bank. The use of ROA for indicating the performance of Bank of Albania has shown positive results continuously for the time period of 2002-2007 [3].

Although the bank incurred high operational expenses in expansion, still the financial results of the banks from the main operations were positive. The trend of positive performance broke in the year 2008 when the performance of the Albania banking system weakened. By the year 2010, the Albanian banking system again geared up experiencing a swift rise in its net profits whereas the increase in the average assets was a minute one, but this growth could not continue in the next year. The Albanian banking system again had a poor performance graph in the year 2011.

Year	ROA	NIM	Operating expenses to operating revenues	Cost to income ratio	Overhead costs to total assets
2002	1.2	2.91	55	66.01	2.46
2003	1.24	3.23	49	64.88	2.16
2004	1.28	3.08	61	66.74	2.36
2005	1.4	3.75	56	54.64	2.26
2006	1.36	4.22	54	61.02	2.33
2007	1.57	4.09	51	56.06	2.19
2008	0.91	4.13	57	52.67	2.42
2009	0.42	4.04	57	55.82	2.44
2010	0.72	4.32	53	51.86	2.30
2011	0.22	4.27	62	49.01	2.09

**Figure 1-Fig. 1 Efficiency indicators for Albanian banking system (in %)**

*Source: Bank of Albania (2003-2012).*

## I.2. Stabilizing the Microeconomic Environment

The Government of Albania implemented the Economic and Fiscal Program (EFP) for 2012-2014. The aim of implementing the program was to bring stability in the macroeconomic environment of the country and fiscal consolidation. The program also made attempts to maintain public investment at a substantial level and economic growth to match the EU income levels. The effect of the global financial crisis (2008) was less on the Albanian economy in comparison to its neighboring countries. The GDP of the country grew each year but at lower rate relative to the pre-crisis period. For instance GDP in 2009 and 2010 was 3.6% and 3.8% respectively. This shows that the growth was only by 0.2%. Gradually the demand from foreign countries started to fall which reduced the exports. The domestic market also got affected by the crisis. The non-performing loans formed about 19% of the total loans. The government and Central bank took steps to control the instability in the microeconomic environment of Albania. The country experienced a speeded inflation rate in the first quarter of the year 2011, which was controlled by the bank by the second half of the same year. The Central Bank aimed to reduce the inflation rate to 2-4% in the year 2012, but the results were unexpected as the inflation rate fell below the target of the Central Bank [4].

On the other hand, to improve the economic growth rate, the Bank of Albania announced another cut to the policy rate, making it 4.5% in January 2012. Various other reforms by the bank with regard to fiscal policy have made it possible for the bank to control the inflation rate. The current account deficit of the country was 10% of GDP in 2007 that incremented to 15% in 2008. Authorities have forecasted the deficit to reduce to 7.1% by 2015. The country experienced a slight fall in its unemployment rate in the year 2011 resulting into 13.3%

unemployment but again in the year 2012 the rate increased by approx. 1.6 but at a rate less than the previous years [5].

Methods were applied for promoting the employment of women in need and first time job seekers. However, the employment promotion programs' budget in 2010 reduced in the consecutive years and by 40% in 2012, this demotivated the participants. Almost 3.5% of the total unemployed officially registered population which was 4,880 in number got the opportunity to receive public vocational training in 2011. To increment this % the country has nine vocational training centers along with a mobile vocational training centre in North-Eastern Albania. Measures to deal with informal employment have also been an important part of the employment in Albania [6].

The Albanian economy applied the Small Business Act in respect to company registration and business start-up. To promote Industrialization an innovation fund of almost € 285,000 was announced for the time period of 2011-2014. To provide financing for the SMEs, actions were taken under the Credit Guarantee Fund. Financial schemes provided by the Italian government were implemented along with the preparations for the second phase of the scheme for the year 2012-2014.

### **I.3. Financial Development and Economic Growth in Albania**

Prior 1990, the banking system and the Albanian economy was a purely centralized system. There was an Albanian State Bank- the monetary and lending authority was a one-tier banking system and the Agricultural Bank which provided funds to the agricultural department. Various limitations were identified in banking sector prior 1990 on the basis of the performance of banking system. These included: a) there was a limited financial institution that includes limited range of products and services where bank played the role of recording transactions among producing enterprises, b) there was a lack of risk evaluation techniques and management of credit risk, c) the accounting system was inconsistent with international accounting standards as accounting system includes only recording and monitoring process and hence excluding the analysis process and d) lack of modern governing, international banking and management practices [7].

Albania's agricultural sector and farm land was rapidly privatized and small household businesses were established. Albanian market is mainly concentrated on goods' marked as far as in financial intermediation concerned it was at very low level. A two tier banking system implies the focus of monetary authority at the first level- with the Bank of Albania being mandated as a responsible authority and focus of commercial function at the second level. When two tier banking system was established, the second level consisted of three banks i.e. Saving Bank, National Commercial Bank and Agricultural Commercial Bank.

By the end of 1996, five other banks were open two of which Greek Capital-owned, one bank owned by Bank of Kosovo and two other joint venture bank of Albania with an Italian bank and an Arabic one. In 1997, during pyramid crisis which affected both economic and social aspect of Albania, the financial system entered at another development stage. At present time the Albanian financial system consist of 16 banks, 7 non-banking financial institutions and 10 insurance sectors. In order to increased number of banks, the Albanian banking sector evidence the privatization of the National Commercial Bank, the Saving Bank.

The American Bank of Albania was merged with Italian-Albanian Bank. Albanian banks have lack of specialization in certain area like investment banks, saving banks or commercial banks. Economic growth is one of the basic factors of economic development and also social development of any country. A stable macro-economic situation is the basis for the development of economic condition and financial condition. The performance of economic growth in Albania is around 6% in recent years. Despite, there is more reduced level of poverty, one fifth of the total population still lives in poverty. In comparison to other regional countries Albania has same GDP growth [8].

### **I.4. Strategic Direction**

The Albanian Bank's priorities for next years will focus on sustainable development of private sector banks and banking sector also focuses on high priority public sector banks. In the light of challenges faces by banking sector, banking activities focuses on the following areas. Albanian banks will work on environmentally sound investment. Albanian banks work with Albanian authorities which is an independent regulator to enhance the regulatory and administrative framework for private sector banks. Banks through its dedication and focused facilities will increase energy efficiency and renewable energy resources. Banks will support the energy generation. The Banks will assist the Albanian Authorities to increase private sector involvement in commercialization including road maintenance, municipal services etc.

The banks will support an active investment policy and development of more private sectors. The banks active investment policy includes agricultural sectors, manufacturing units and services, tourism and so on, all of which have potential to modernize the Albanian economy. The Banks will support the financial market with credit lines and Medium Size Co-Financing Facility (MCFF). The Banks with Albanian Bank's respond in a timely way to need of the financial sectors. The Bank will integrate closely with European Union and with

other financial institutions in all its operation and function in order to achieve maximum and integrate Albania to European Union.

### III. FINDINGS AND ANALYSIS

After discussing effects of institutional efficiency on Albanian economy, this report has provided quantitative analysis to support the topic and highlight the effects of various financial elements and its role in growth of the economy. Along with the banking and financial development in the economy, various factors such as Freedom from corruption, Fiscal freedom, Business freedom, Labor freedom and Trade freedom are considered as independent variables showing institutional development in Albania. Foreign direct investment in the country was although having negative growth over the last few years, but it has resulted in the growth of domestic business development and production level. Overall GDP of the country was \$12.90 billion in 2013 wherein FDI was 2.99 %. Considering FDI as the dependent variable, data were found to highlight the growth on factors mentioned above.

Financial Freedom score for Albania's is 66.9 that make it world's 54th nations for free to business in the 2014 Index. Its general score has expanded by 1.7 focuses, with eminent enhancements in trade as well as investment freedom. It led for venture opportunity and exchange flexibility. Albania is positioned 25th among the 43 nations in the European marketplace making it over the world's average score.

Over the 20-year history of the Index, Albania has progressed its monetary flexibility score by around 17 focuses, a main 20 change. With score expands in nine of the 10 financial opportunities, Albania has climbed bit by bit into the "respectably free" class. Prominent structural changes have included exchange liberalization, privatization, execution of focused level expense rates, and modernization of the nature's turf. Alongside the compelling support of low expansion, more noteworthy money related strength has likewise been attained. The legal stays subject to political obstruction, and deeper institutional changes to annihilate waiting defilement and expand legal autonomy are discriminating to guaranteeing more noteworthy financial opportunity in Albania. Climbing monetary shortages lately have expanded open obligation to over 60 percent of GDP, as far as possible set in 2008.

#### a. Understanding Correlation

Table 1: Correlation based on different economic variables Correlations

		Freedom From Corruption	Fiscal Freedom	Business Freedom	Labor Freedom	Trade Freedom	FDI
FreedomFromCorruption	Pearson Correlation	1	.806**	.162	.447	.853**	-.773**
	Sig. (2-tailed)		.000	.495	.196	.000	.000
	N	20	20	20	10	20	20
FiscalFreedom	Pearson Correlation	.806**	1	.370	.025	.915**	-.638**
	Sig. (2-tailed)	.000		.108	.946	.000	.002
	N	20	20	20	10	20	20
BusinessFreedom	Pearson Correlation	.162	.370	1	.100	.403	.211
	Sig. (2-tailed)	.495	.108		.784	.078	.371
	N	20	20	20	10	20	20
LabourFreedom	Pearson Correlation	.447	.025	.100	1	.317	.045
	Sig. (2-tailed)	.196	.946	.784		.372	.901
	N	10	10	10	10	10	10
TradeFreedom	Pearson Correlation	.853**	.915**	.403	.317	1	-.665**
	Sig. (2-tailed)	.000	.000	.078	.372		.001
	N	20	20	20	10	20	20
FDI	Pearson Correlation	-.773**	-.638**	.211	.045	-.665**	1
	Sig. (2-tailed)	.000	.002	.371	.901	.001	
	N	20	20	20	10	20	20

\*\* . Correlation is significant at the 0.01 level (2-tailed).

From the above results, it can be understood that keeping FDI as the dependent variable, all the other element of institutional growth gets changed. There is a strong relation of FDI's with the change in Freedom from corruption, Fiscal freedom, Business freedom, Labor freedom and Trade freedom. There is significant correlation between freedom from corruption and fiscal freedom at 0.01, significance level. Similarly at this point of significance level, it can be seen that there is a significant correlation between all the independent variable. Along with the change in growth of FDI, such factors play its role. In the marketplace of Albaian economy, such a significant level of growth in FDI has led to the development of freedom for doing business and generating employment. Government has also played an important role in it.

Regression Analysis Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.989 <sup>a</sup>	.978	.950	.24555
<b>a. Predictors: (Constant), Freedom From Corruption, Labor Freedom, Business Freedom, Trade Freedom, Fiscal Freedom</b>				

From the results, it is clear that 95% variation in FDI is explained by independent variables. When in an economy, there is relaxation for global players to enter and less political interfere, it results in less corruption, business freedom, labor freedom, fiscal freedom and trade freedom. In Albanian economy over the last 10 years, we can see that score in financial freedom was about 30 earlier, but it increased to 70 now in 2013. Banking and financial development in the economy has resulted in expansion of domestic business in retail and manufacturing. This is why, it has affected the FDI level as well. Now various global players are looking forward to expand business in Albania for lowering down its cost of production and maximum use of resources.

ANOVA <sup>a</sup>						
Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	10.543	5	2.109	34.971	.002 <sup>b</sup>
	Residual	.241	4	.060		
	Total	10.784	9			
<b>a. Dependent Variable: FDI</b>						
<b>b. Predictors: (Constant), Freedom From Corruption, Labor Freedom, Business Freedom, Trade Freedom, Fiscal Freedom</b>						

Model is fit as “F” value is significant.

Coefficients <sup>a</sup>						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-70.852	11.333		-6.252	.003
	Fiscal Freedom	.467	.093	1.816	5.032	.007
	Business Freedom	.112	.016	1.018	6.987	.002
	Labor Freedom	1.151	.145	1.375	7.937	.001
	Trade Freedom	-.169	.042	-1.375	-4.068	.015
	Freedom From Corruption	-.693	.060	-2.330	-11.463	.000
<b>a. Dependent Variable: FDI</b>						

From the results above, it is clear to at P<0.05, there is a positive and significant impact on FDI from Fiscal freedom, Business freedom, Labor, Trade freedom has positive and significant (P<0.05) impact on FDI.. However, corruption freedom has negative impact on FDI at significant level of P<0.05.

#### **IV. CONCLUSION**

The economy of Albania although was not majorly affected by the global financial crisis yet the affects came forward gradually. The various elements that form an economy started showing loopholes for example the GDP was at a very low %, exports started to fall, etc. These factors as a whole contributed in the poor economic growth. However, the government of the country along with the support of the Central Bank and Bank of Albania took measures to overcome this situation of crisis. Therefore, the banking system of Albania plays an important role. Efficiency of the banking system has been a significant part of the development of the Albanian economy. The Bank of Albania has framed policies to bring stability in the economic environment of Albania. For this purpose the institution has worked on every sector like finance, agriculture, industrial, etc. The Albania bank in co-ordination with the Albanian authorities and European Union have been working and developing strategies which have been discussed in the report, to make the economy of Albania a developed economy. Amid the previous five years FDI-s have expanded pointedly from 250 million € in 2006 to 827 million € in 2010, while FDI-s have developed with 17% contrasted.

Albania economy profited from the FDI inflows in these potential segments either in giving distinctive administrations yet in the meantime offering to buyer cost proficient benefits through rivalry. From the statistical data, business freedom, financial freedom, trade freedom and corruption level of the Albanian economy were the major factors that resulted change in FDI level. FDI inflows animate monetary improvement and have helped creating nations for example, Albania when confronted with monetary hardship beforehand. FDI in Albania are considered as one of the fundamental patrons on the monetary development of the nation. Our GDP and fare development rates were the quickest developing in South East Europe from 1997 to 2008. FDI-s in Albania has expanded essentially amid the most recent years, reflecting an expanded inclination of remote financial specialists in Albania creation elements and danger lessening.

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