Banking System on the Albanian Path to European Union Integration

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Abstract

Purpose: *This article aims to assess the contribution of the Albanian banking system to the European Union integration process by analysing its progress and challenges in alignment with accession criteria and compliance with EU acquis.*

Methodology: *The research spans 12 years (2011-2022) of monitoring by the European Commission. The methodology involves a thorough review and content analysis of annual EU integration progress reports for Albania, uncovering banking system-related criteria, requirements and recommendations enhanced by a thematic analysis identifying recurring themes and report patterns over the years.*

Findings: *The analyses confirm the hypothesis that the Albanian banking system has made significant progress in aligning with EU accession criteria, as evidenced by positive evaluations of the European Commission, mainly in macroeconomic and financial stability, but still ample room for lending and financial inclusion improvement. The progress reports over the years have consistently ascertained the positive impact of the monetary and macroprudential policy, while progress in non-performing loans (NPLs) is acknowledged, ongoing concerns persist regarding the extensive use of the Euro in the economy.*

Value: *This paper holds multifaceted value as a resource for policymakers, researchers, and those engaged in EU integration. It comprehensively assesses the Albanian banking system's progress and offers practical recommendations, with a particular emphasis on improving financial education as a key factor on the demand side. Using a long-term, data-driven approach, it uniquely examines the system's contributions and challenges in meeting EU standards, making it essential for Albania's European Union integration efforts.*

Keywords: *EU Integration, banking system, convergence criteria, harmonization chapters*

Introduction

It may feel distant, but the powerful statement from the students in December 1990, "We want Albania like all of Europe", was not just a slogan but the aspiration of a nation and a vision for a better future inspired by the standards and values that the European Union (EU) represents - a functional democracy with sustainable economic development. This call marked the most significant event in modern Albanian history: the fall of communism, paving the way for the country's Euro-Atlantic integration. This journey has been long, filled with challenges and achievements, but it remains a national strategic priority and the destination every Albanian wants.

The opening of negotiations in the summer of 2022 brings Albania one step closer to the Union. The integration process involves continuous advancement and reforms in key sectors of the country by meeting the criteria and requirements that align Albania with EU countries. Among these crucial sectors is the banking system, which stands at the core of economic developments, not only as a financial sector but also due to its significance within the institutional and regulatory framework. A developed financial system is destined to create a more productive and efficient economy, playing an extraordinary role in a country's macroeconomic and financial stability, with banks being the most significant institutions in this system (Mishkin, 2016).

Aim and Objectives

This study aims to assess the contribution of the Albanian banking system to the European Union integration process by analysing its progress and challenges in meeting the accession criteria. The research examines progress reports to uncover the multidimensional dynamics influencing Albania's journey toward aligning its banking sector with EU standards. The objectives detail this aim:

(1) To analyze the essential criteria and recommendations set forth by the European Commission in the yearly progress reports related to the banking system.

(2) To provide insight into the implications of the banking system compliance with EU criteria on Albanian integration prospects.
(3) To identify any challenges or areas of improvement encountered by the Albanian banking system in its pursuit of EU alignment.

I.2 Hypothesis and Research Questions

Hypothesis:

The Albanian banking system has made significant progress in aligning with the EU accession criteria, as evidenced by positive evaluation in the European Commission's annual progress reports, positioning it as a constructive contributor to Albania's integration path.

Research questions:

(1) How has the Albanian banking system evolved over the years in response to the European Union's economic criteria and recommendations as documented in EU progress reports?
(2) What are the key areas of compliance, improvements and concerns that must be addressed?

Methodology

This study is a descriptive qualitative research based on secondary sources. The study utilises the annual progress reports since 2011, being the first report on Albania, up to the most recent one in 2022. These reports comprehensively assess Albania's progress in various sectors, including the banking system, and offer valuable insights into the alignment with EU criteria. The study incorporates information from the Economic Reform Program (ERP) and updated data from the Bank of Albania, focusing on critical financial stability indicators and monetary policy developments to gain further insight into the policy changes and recommendations related to the Albanian banking sector. The primary method involves a comprehensive review and content analysis of the yearly progress reports on Albania's EU integration to identify the criteria, recommendations, and policy changes related to the banking system. To complement the document analysis, thematic analysis will be conducted to identify recurring themes and patterns in the progress reports over the years. This analysis will help determine areas of compliance, progress, and persistent concerns.

Literature Review

From the Bonn Conference to the opening of negotiations

The principles of the integration criteria and, consequently, the banking system's responsibilities emanate from the Maastricht Treaty (1992) that established the EU as we know it today and the declaration of the Bonn Conference between the European countries and the former communist bloc (1990). These principles were detailed in specific requirements for aspiring countries at the Copenhagen Conference (1993), known as the Accession criteria. After the turmoil caused by the Bosnia, Herzegovina, and Kosova wars, the Member States confirmed a new perspective for the Balkan countries at the Thessaloniki Summit (2003), 'the future of the Balkans is within the European Union'. The Summit created a specific legal framework to advance the integration process — the Stabilization and Association Process aimed to enhance regional stability and prepare regional countries for European accession.

For Albania, this process culminated with the entry into force of the Stabilization and Association Agreement (SAA) in (2009), a pivotal moment in Albania's European future. The Agreement legitimised mutual commitments and paved the way for a detailed process with clear objectives in political cooperation, economic collaboration, and alignment of Albanian legislation with the EU acquis (2009). The common denominator of the integration process, included in all the documents mentioned above, is the *existence of a functional market economy* as a requirement for being a reliable EU member.

Copenhagen criteria and the conditions and requirements of SAA

The banking system directly affects two out of five requirements needed for the existence of a market economy under the Copenhagen economic criteria, which are (i) macroeconomic stability *and the* proper functioning of the financial market. This last one includes (ii) financial stability and (iii) access to finance (EU, 1993).

In addition to the economic criteria, Copenhagen also has political criteria and a third criterion: the ability to undertake membership obligations, which refers to a candidate country's administrative and institutional capacity to implement the acquis. The acquis includes all the rights and obligations that comprise the legal framework of the Union's functioning. They consist of treaties and laws created to implement these treaties, resolutions, declarations, court decisions, international agreements, policies, rules, and constantly evolving standards. Candidate countries must accept the acquis and align their laws with them before joining the EU. Alignment with the acquis is the primary process during the pre-membership phase, negotiations, and screening (EC).

As a detailed reflection of the Copenhagen Criteria, the SAA fulfils the comprehensive framework of Albania's requirements for integration, including those related to the banking system. The SAA contains a series of provisions grouped into chapters. These chapters, the political-economic criteria, and priorities have been the roadmap for monitoring progress since the signing of the SAA. In 2020, the European Commission (EC, 2020) reviewed the accession negotiation strategy, reorganising the 35 chapters into clusters, the progress of which is monitored and assessed by the EC. With the opening of negotiations, the screening process has begun to align with the acquis and fulfil key priorities. In summary, the criteria and chapters for the banking system are as follows:

TABLE 1. Economic Criteria and Acquis Chapters for Banking System

Cluster I: Fundamentals	I. Macroeconomic Stability II. Financial Market Function: Financial Stability III. Financial Market Function: Access to Finance
Cluster II: Internal Markets	1. Chapter 4 Free Movement of Capital 2. Chapter 9 Financial Services
Cluster III Competitiveness and inclusive	1. Chapter 7 Economic and Monetary Policy

Convergence Criteria

Under the criteria for assessing macroeconomic stability, it is crucial to emphasise the four convergence criteria outlined in the Maastricht Treaty (1992) as transition criteria for the member states to become part of the monetary Union and the adoption of the common currency, the Euro. Even though these criteria do not directly apply to candidate countries, they are the ultimate objective of such countries and provide measurable indicators that guarantee economic stability and cohesion. The banking system strongly impacts the achievement of these criteria, or they influence the financial stability of banks. Adherence to these criteria, detailed below (EU, 1992), is considered crucial for the success of the Union.

Price stability, as the primary objective of central banks and monetary policy, is considered a public good due to its crucial role in ensuring economic stability and impacting the real economy outcome (Mishkin, 2016) as the first convergence criteria requires that the average inflation should not exceed 1.5 % points above the rate of the three best performing Member States. Sound public finances, as the second criterion mandates that the government deficit should not surpass 3% of GDP and government debt shouldn't exceed 60% of GDP. When governments seek credit, they affect the monetary offer, increasing the private sector credit cost. However, they also pose a risk to stability when central banks finance public deficits or inject liquidity in breach of their independence, endangering the stability of the banks holding most of this debt, as Mishkin (2016) explained.

The third criterion on exchange rate stability is the direct responsibility of the central bank, which establishes and implements the exchange rate regime and maintains confidence in the local currency through various mechanisms like foreign exchange reserves requirements. Currency fluctuations impact the assets and liabilities held by banks' public debt costs, significantly influencing prices, balance of payments and trade, and the real economy overall (Mishkin, 2016).

Last but not least is the long-term interest rate, which should not exceed two percentage points above the rate of the three best-performing Member States in terms of price stability. This criterion serves as the leading indicator to assess the durability of the convergence. The long-term bond yield curve is considered the 'economic radar' by Langdana since it is closely linked to market actors' expectations of future inflation and economic risks, expressed in the interest rates- the Fisher effect. Anchoring future inflation expectations is one of the main concerns of the central banks, which highly impacts the country's sustainable growth (Langdana, 2022).

Financial development and access to finance

The financial system's role in economic growth is empirically confirmed from the 1800s to contemporary analysis. Banks, as promoters of savings and facilitators of investments, are essential for economic growth and contribute to the money supply as depository institutions (Mishkin, 2016). The Financial Development (FD) Index assesses financial institutions and capital markets' impact across three dimensions: deepening, access and efficiency. FD combines three dimensions, with depth reflecting market size and liquidity and access indicating individual's ability to use financial services (Sahay, et al., 2015). The index finds that financial development doesn't always guarantee economic growth; its impact varies with a significant effect observed at high deepening levels, as seen in European and U.S. markets.

Enhancing financial access at any level of financial development, particularly for under-served sectors like SMEs and crucial industries like agriculture or innovations, remains highly advantageous. Financial access is fundamental in fostering economic growth, reducing poverty, and promoting overall development. In the analysis of Western Balkan countries by Moder and Bonifai (2017), "access to finance" refers to the availability of quality financial services at reasonable costs, encompassing services such as bank accounts, deposits, ATM usage, online payments, and access to credit. Access Barriers decrease as financial systems become more advanced. Developing economies still have ample opportunities to leverage Financial Development across all dimensions: depth, access, and efficiency, contributing not only to economic growth but also to financial stability and mitigating inequality and poverty (Sahay, et al., 2015).

Banking System in Albania

The Albanian financial system has significantly transformed since the early 1990s, transitioning from a centrally planned economy to a market-oriented one. The system changed from a state-owned banking sector to a two-tiered one comprising the Central Bank of Albania (BoA) and commercial banks, including non-bank financial institutions. In the context of Albania's EU integration efforts, the BoA assumes a pivotal role as the country's monetary authority. It holds responsibility for establishing and implementing macro-financial stability policies and aligning them with the EU's policies and regulatory frameworks as the cornerstone for being a member country of the Union. Albania is home to 11 banks, primarily with foreign capital (75.12%), despite the recent growth of domestically owned ones. Banks with European capital constitute 46.15% of the foreign ones. The commercial banks dominate the Albanian economy, with their assets accounting for 87.95% of GDP, playing a central role in capital circulation and supporting economic activities within the country. Non-bank financial institutions represent 4.14% of the total banking system assets (BoA, 2022).

The Albanian financial system lags behind developed EU countries in developing and diversifying financial services, scoring 0.2 on the FD index compared to the EU average of 0.7 (IMF, 2021). Private sector credit-to-GDP ratios tell a similar story; Albania, for the last five years, has only reached 35.2% (BoA, 2022), while developed countries finance the private sector at 130% of GDP and developing countries at about 50%, accompanied by the lower access to finance ranking, leaving ample room for deepening in the banking system in Albania. Moreover, the capital market is relatively non-existent, a common trait among former communist countries (Sahay, et al., 2015).

Evaluation of Economic Criteria

Macroeconomic - Financial Stability and Access to Finance fall under the Fundamental cluster and constitute the initial package in the negotiation process. They are subject to reassessment at the end of the screening process, influencing the negotiation pace. The European Commission monitors progress through annual reports, assessing the implementation of commitments outlined in the Economic Reform Program (ERP) and evaluating compliance with economic criteria for the three above fundamentals and alignment with EU acquis for the three chapters covered in this paper. The following analysis is based on the EC progress reports from 2011 to 2022, highlighting their key findings and insights (DG-NEAR, 2011, 2012, 2013, 2014, 2015, 2016, 2018, 2019, 2020, 2021, 2022).

In the latest EC progress report (2022, p. 6), Albania received a positive evaluation regarding economic criteria, including the crucial aspects of the banking system. It notes 'good progress and moderately prepared' for the existence of a functional market economy. Albania is assessed as moderately prepared for criteria and acquis related to the banking system, covering the free movement of capital, financial services, and economic and monetary policies. Notable improvement compared to the 2011-2012 report, citing limited structural reform progress. Since 2015, the evaluation has been unchanged to 'moderately prepared' with 'some progress'. The economic criteria remain consistent while the acquis requirements advance, adapting to market developments and EU regulations improvements.

Macroeconomic and Financial Stability Criteria

Throughout the 12 years, the progress reports consistently acknowledge that Albania has maintained macroeconomic and financial stability. Still, global economic events, such as the 2008 financial crisis, the subsequent Greek sovereign debt crisis, and, more recently, the consecutive shocks from the pandemic and rising commodity prices due to the Ukraine invasion, are reflected in macro-financial indicators. Significant challenges in maintaining macro-financial stability were identified during 2013-2014, with stagnant growth, rising debt, and extremely high NPLs. The latest report emphasises Albania's economic resilience, noting its ability to recover faster than anticipated.

The progress reports over the years have consistently ascertained the positive impact of the monetary policy and market interventions in maintaining price stability and contributing to economic recovery as part of the policy mix. The (2022) report acknowledges the effectiveness of the monetary policy response in limiting inflation (4%) compared to other countries in the region and the EU. The tightened monetary policy (3%) transmission has successfully contracted aggregate demand in 2023, and the BoA's goal is to anchor these expectations as closely as possible to the targeted inflation to reduce uncertainty and maintain macroeconomic stability. As per the fourth convergence criteria, the yield curve of bonds is likely influenced by lower inflation expectations and economic uncertainty, supported by the BoA's Inflation Expectations Survey findings. Additionally, investors are seeking safehaven assets amid economic challenges. The steeper long-term end of the curve in July 2023 suggests anticipation of slightly higher inflation (BoA, 2023/III).

Exchange rates have shown seasonal fluctuations over the years covered by the reports. Still, the BoA has effectively maintained the stability of the domestic currency through short interventions when needed. In 2023, the Albanian lek has been notably appreciated against the Euro, and BoA has chosen not to intervene in the foreign exchange market. The report (2022) recommends maintaining the free-floating exchange rate regime and utilising the Euro's depreciation as a shock absorber for external inflationary pressures. BoA interprets this lek appreciation as a consequence of the increased availability of foreign currency, mainly due to higher tourism income, remittances, and foreign direct investments, and they consider the degree of fluctuation within the parameters of the free-floating regime (BoA, 2023/III).

The exchange rate fluctuation becomes more relevant in light of a persistent concern, which, despite minor improvements since 2015, resurfaced as a primary issue in the 2022 report. This concern pertains to the widespread use of the Euro in the economy. Despite BoA's efforts to encourage the use of local currency and reduction in euro-dominated loans (68% in 2012 to 25% in 2022), the risks remain on the upside. The unhedged FX loans, subject to interest rate risks due to lightened monetary policy and variable interest rates, endanger borrowers' repayment capacity with income in lek and impede monetary policy transmissions.

Euroisation also raises concerns about financial stability, significantly affecting non-performing loans (NPLs). A significant concern highlighted in the 2011 -2012 reports as a domino effect of the 2008 financial crisis reaching its peak in 2014 was the escalating number of NPLs. Responding to this, the government and BoA established an interinstitutional group, which initiated legal measures to address this issue. It remained a priority in progress report recommendations and ERP policies (policy 3.1, 3.2 2022 2024 and 3.2 2023-2025 ERP). The report (2022) positively evaluates the BoA financial stability policies during the two years of the crisis and values the significant improvement of assets. The NPL to total loans ratio has dropped to just 5% by the end of 2022, as reported by BoA.

Financial stability is a vital pillar of a nation's economic well-being, ensuring the smooth functioning of the financial system and its resilience to shocks, strictly impacted by the soundness of the banking sector and the implementation of BoA macroprudential and supervisory policies. Over the years, from 2011 to 2022, the Albanian financial system has consistently demonstrated stability, well capitalised and liquid, above the Basel III requirements, as confirmed by the reports. The banking sector's profitability has also remained positive, as reflected in return on assets and equity, except during the grave COVID-19 crisis in 2021.

The budget deficit and, consequently, the public debt has posed significant concerns for the country's economic and financial stability, with peaks (70-72.3% of GDP) observed during 2014-2017 and temporarily during the pandemic. However, there's been a remarkable improvement, as public debt by the end of 2022 stands at 63.3% of GDP, closer to convergence criteria, and is expected to continue its downward trend. Furthermore, the Albanian government's issuance of Eurobonds has changed the composition of public debt by reducing the domestic one. Nevertheless, persistent concerns outlined in progress reports include the substantial portion of the public debt held by the banking sector (25%).

Acquis Chapter 17: Economic and Monetary Policy

At the centre of this chapter lies the monetary policy decision-making and the independence of the Central Bank. The report (2022) assessment of being 'moderately prepared' evaluates the monetary policy's effectiveness in line with the targeted 3% inflation and the floating exchange regime. The chapter highlights the lack of progress in aligning the BoA's law on independence with the EU acquis, a recommendation not fulfilled since 2002. It concerns improving the governor's and supervisory council's independence and limiting public sector financing to ensure a country's macro-financial stability. The report acknowledges BoA's financial autonomy and its instruments, competencies, and administrative capacities for effective monetary policy. Legal independence is assured through the governor and supervisory council's appointment by parliament, which they also report. Albania has the lowest assessment of the independence degree on the 'Limitations on lending to the government', almost half of EU countries and other regions' peers, based on the Central Banking Index measured by Romelli (2022).

Acquis Chapters 4 & 9: Free Movement of Capital and Financial Services

Chapter 4 outlines Albania's obligations on anti-money laundering and counter-terrorism financing, highlighting their role in stability. Given Albania's predominantly informal economy in 2011, it has progressively aligned its legislation with Moneyval's and EU acquis requirements over the years. In 2015, it was successfully removed from the grey list. Regrettably, in 2020, Albania was placed back on this list as a risk country that requires extended monitoring. Despite diligent efforts and the alignment of money laundering laws with the acquis by the end of 2021, coupled with enhancements in regulations and oversight by the Bank of Albania, the country still faces challenges in fully meeting the action plan requests by the FATF-Moneyval. Notably, a key recommendation in this chapter underscores the government's need to abstain from going forward with the fiscal amnesty legislation as underminer of the progress so far.

Chapter 9 receives a positive assessment for its progress in adapting financial service licensing, operation, and supervision to enhance competition and institutional stability. Albania's consistent alignment with Basel II and III regulations from 2011 to 2022, transitioning from micro-prudential to macroprudential policies, is a notable achievement highlighted annually in progress reports. In 2022, Albania continued to harmonise its regulatory framework with Basel III, introducing stricter capital and liquidity requirements and implementing extraordinary measures to ensure compliance. Substantial legislative improvements addressed some NPL issues, and mitigated macroprudential risks; it is recommended to increase the use of the national currency, as detailed in the ERP policies.

Access to Finance

In the 2019 report, improving access to finance and boosting financial inclusion became a priority for the first time. Previously, access to finance was measured solely by the private sector credit to GDP. However, since 2017, the assessment has expanded to include the number of financial service users, particularly adults over 15 with a bank account. In 2021, this indicator significantly improved, jumping from 40% in 2017 to 69%. This progress is attributed to technological advancements and increased demand for online transactions, mainly due to pandemic-related movement restrictions.

The theory section explains that the FD index combines these two indicators to provide a more comprehensive measure of financial inclusion and access to funds. Although the total credit volume has increased over the years, it has declined as a percentage of GDP. By the end of 2022, it reached 33%, compared to its peak of 43% in 2012. Over the past 12 years, financing the economy has been considered insufficient, with banks' perceived risks being a significant factor in tight credit conditions. These conditions result from high-risk premiums, along with challenges in collateral execution and the broader business environment.

As highlighted, the 2019 report marked a turning point by underlining the importance of enhancing access to financing and financial education to stimulate increased demand for funds. It also raised expectations and requirements for the capital market, which is not yet fully operational despite undergoing restructuring since its closure in 2017. Although slowly growing from 6.6% in 2012 to 12% in 2012, the non-banking sector still lags in development.

Acquis Chapter 9 & 4: Financial Services and Free Movement of Capital

Albania's ability to meet the accession requirements for chapters 4 and 9, related to financial access, involves payment system, financial education and inclusion. 2011

Albania, primarily a cash-based economy, faced payment system challenges and the first steps were regulations for the clearinghouse and interbank payment system to promote non-cash payments. Enabling banks to establish branches and conduct cross-border transactions in 2012 and the first-ever meeting of the National Payment Committee in 2016. Over the years, Albania has made significant and constant advancements in aligning with EU acquis in this area. The 2022 report recognises Albania's progress in implementing the National Payment System. The Bank of Albania (BoA) introduced a new platform for domestic interbank euro payments in January 2022, facilitating retail payments. During the pandemic, the BoA eased payment procedures and reduced online transaction costs, increasing financial inclusion. The number of adults with bank accounts reached the targets set in the financial literacy strategy, and online payments tripled.

Chapter 9 on Financial Services identifies finalising and adopting a strategic document on financial education and capital market development as key tasks for Albani to increase financial access. The (BoA, 2022) report confirms that BoA has completed the "National Strategy on Financial Education and Inclusion" in collaboration with the World Bank. While access to finance is ERP Policy 4.1, the banking system is not responsible for implementing this priority.

Conclusion and Recommendations

Albania has maintained macroeconomic and financial stability amid external shocks and domestic adversities, including ongoing inflation. The banking system is recognised for its constructive contribution to the moderate progress of these economic criteria, confirming the hypothesis. Yet, access to finance remains a challenging issue demanding substantial enhancement, as the FD index indicates. In more detail:

- The monetary and macroprudential policy decisions and implementation have positively contributed to maintaining stability and upholding the convergence criteria.
- Continued progress has been made in aligning with the Basel III and other financial stability requirements. The constant improvement of the payment system has played an essential role in increasing financial inclusion.
- There has been a significant improvement in the NPL rate and decreasing public debt; although the effects of crises have not yet fully materialised, authorities should remain vigilant.
- Significant concerns are the economy's persisting high euroisation and the immediate need to be removed from the grey list for money laundering.

- Since 2002, there has been no progress in amending the law regarding the independence of the BoA in line with the ECB standards. While it is part of the BoA's vision, it is not included in the medium-term objectives of the ERP.

Based on these conclusions the article makes two recommendations:

(1) Given the current inflationary environment and currency fluctuations in a highly euroised economy, it is crucial for the Bank of Albania to conduct a comprehensive analysis of these factors. While market-driven influences are apparent, the BoA needs to assess whether the floating exchange regime has had the expected impact on import prices. Furthermore, a deeper examination is necessary to understand the causes of euro depreciation, particularly in light of the high level of informality in the contracting and real estate markets, which might be a vulnerability for the stability.

(2) While profit-oriented, the banking sector also has a public responsibility to alleviate poverty and reduce inequality by distributing the financial capital in the economy. Together with BoA, enhancing access to finance and promoting financial education are crucial avenues to accomplish this objective. These institutions should actively formulate and implement concrete strategies and services aimed at improving this economic criterion. Northern Macedonia serves as a noteworthy example in the Balkans, having achieved commendable outcomes in this sector. It is essential to emphasise that these recommendations necessitate further in-depth examination and strategic planning."

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