

## The Level of Euroization of Albanian Economy

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### Abstract

*The use of foreign currency is a widespread phenomenon in all post-communist countries of Eastern Europe including here Albania. Relatively long transition caused the loss of trust of individuals in local currency and also in domestic monetary regime. Foreign currency is perceived as a kind of "protection" from the uncertainties caused by macroeconomic instability that characterizes in general countries that pass from a totalitarian regime to a free open market regime. The realities of these transition years have indicated an increasing preference on the use of strong European currency, which, to a certain extent, has led to a partial euroization of the economy. The predominant opinion, in academic and political circuit, is that the advantages of Euroization, at least for a short period of time are profoundly evident especially in developing countries where the aspiration on EU accession is great. When we analyze euroization as a phenomenon, except for the advantages, we have to examine in detail even the other side of the coin, its costs on the economy and monetary system of a country. Since the beginning of the global crises the amount of deposits in foreign currency, mainly euro, compared to the total amount of deposits has increased. How does the euroization affect the Albanian economy? There are three types of euroization and each has its own relevant measure. First of all there is the euroization of assets of the economy, which is measured by the ratio of foreign currency deposits to local currency deposits. Secondly there is the euroization of the liabilities of an economy, which is measured by the ratio of loans in foreign currency to loans in local currency. Thirdly, there is the euroization of transactions, which is measured by the degree of currency transactions against local currency transactions.*

**Keywords:** euroization, economy, developing countries, foreign currency deposits, loans in foreign currency

### 1. The Advantages of Adopting the Euro

The predominant opinion, in academic and political circuit is that the advantages of euroisation, at least for a short period of time are profoundly evident especially in developing countries where there is a great aspirations for EU accession. The use of the same currency eliminates the strikes in exchange and interest rates.

#### 1.1 The reduction of transaction costs

The reality of these transition years have indicated an increasing preference on the use of the strong European currency, by citizens, which to a certain extent, has led to a partial euroization of the economy. The most tactile advantage of a unilateral euroization is the reduction of transaction costs. Although in itself these costs imply a loss on bank balance sheets, they affect significantly the economy of a country that realises a lot of imports and where the restrictive fiscal policies are pushing businesses towards transparency of their financial capitals through legal channels.

#### 1.2 The reduction of interest rates

The rapid and partial reduction of interest rate would stimulate the increase of investments and will have a positive impact on fiscal policies, with significant reduction on the cost of public debt. Of course, the biggest advantages will be experienced in countries where the Central Bank follows a policy of real interest rates. One of the main claims of the opponents of unilateral euroization (Wojcik) is that the process of adopting the euro does not have to lead to a decline in

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interest rates in the mid and long term period, as it removes the risk of lending money, but it may increase the risk of default. This can happen because devaluation is not available as a tool to enhance the competitiveness of domestic producers. Consequently, interest rates of loans on local businesses and government, may increase in balance as in the case of Argentina.

### 1.3 *The reduction of exchange rate fluctuations.*

The adoption of a unique currency would avoid costs caused by the exchange rate fluctuation in the economy of a country. A constant fluctuation of the exchange rate of a currency brings price instability, uncertainty among investors, high investment costs and an increase of the current account deficit. Wojcik worries about the misfit of exchange rate as a result of inflationary inertia after the conversion of local currency into Euros. According to him, this would make inflation more difficult to control.

A single currency brings more power and new opportunities arising from the integration in the Euro zone economy, making the only market more efficient. Before using the euro, the need for exchange of banknotes meant extra cost, risk and lack of transparency in cross-border transactions. Now doing business in Euro zone means more opportunities, more cost effective and lower risk.

While being able to compare prices more easily, it is promoted the cross-border trade and all types of investments, beginning from the individual consumers searching for the lowest cost of products through the purchase of businesses best value services, to the institutional investors who can invest with greater efficiency in the euro area without taking the risk of fluctuation of exchange rates.

Thanks to euro zone, now there is a huge and integrated market which uses the same currency.

## 2. **Disadvantages of Euro Adoption**

When we analyse the euroization as a phenomenon, except for advantages we should examine in details the other side of the coin, its costs in the economy and monetary system of a country. In all the literature describing the disadvantages of applying a unique currency, the most controversial institution is the Central Bank which faces the risk of continuation of its functions.

### 2.1 *Central Bank and the elimination of its role*

On the home page of the Bank of Albania it is said that it is the only institution in the Republic of Albania responsible for formulating, adopting, approving and implementing monetary policy of the country. This policy is elaborated to fulfil the main objective of the Bank of Albania: achieving and maintaining the price stability. If we would think about the adoption of a single currency, this will "eliminate" almost all its basic functions. Through euroization, states accept the loss of independence in the application of monetary policies by removing Central Bank instruments for the implementation of the monetary policy. The lack of incomes from "seigniorage" and the loss of Central Bank's role as a lender of the last instance are two of the most important phenomena studied in the case of euroization of an economy.

### 2.2 *Loss of the right of "seigniorage"*

When the European Central Bank that issues banknotes, buys goods by using this currency for which it has paid little, it acquires a unique purchasing power.

But not only that, the Central Bank that officially releases money with a very low price, calculates in the PASIV of Balance not real typographical cost (paper and ink), but the numerical value written on coins and banknotes. In this case seigniorage turns to PASIV for the Bank, so it is not taxable and avoids tax payment.

Nowadays, with the introduction of banknotes, the cost of its production is incomparable to its nominal value. Consequently the incomes from seigniorage are very high.

In this way the resign from local currency means the loss of the right to benefit from this source. Although in countries with low inflation rate this income is low, it has to be considered.

### 2.3 Lender of last resort

To prevent the bankruptcy of a bank, which would be associated with many implications for economic and social life of a country, (the recent financial crisis proves it), and to prevent the extent of the crisis in other banks with the result of loss of the banking system, the Central Bank plays the role of lender of last resort as long as a bank is in crisis. In the case of unilateral euroization, Central Bank loses the possibility of acting as lender of last resort.

Critics point out that the role of the monetary authority of the country as lender of last resort could be reduced if the country does not have access to credit facilities by the European Central Bank intended to help banks with liquidity difficulties. However, there are alternative ways to provide the necessary liquidity to banks.

### 3. Level of Euroization in Albania

Since 2003, cars, houses and lands begin to be sold in euro; savings gradually moved towards the European currency, more than half of loans, especially for houses, are in Euros.

Today Albanian economy is considered to have a high level of euroization. More important is that during the last two years there has been a preference to keep the savings in euro. Since the beginning of the global crisis, the deposits in foreign currency, mainly in Euros, has increased continuously compared to the total number of deposits.

According to the Bank of Albania, at the end of December 2013, foreign currency deposits constituted about 48% of total deposits, from 42% in early 2008.

While the euro is attracting savers, it is not the same thing with the borrowers, individuals as well as businesses. They payment have been increased over the past two years, as a result of the depreciation of albanian lek (ALL) against the European currency. Since 2008, the euro has gained consistently point to the Albanian currency, by exchanging currently 140.37 ALL for one euro.

**Table 1:** The average exchange rate

Year	2008	2009	2010	2011	2012	2013	2014
Average exchange rate	123.2	137.2	138.8	138.3	139.7	140.2	140.11

**Source:** Bank of Albania

### 4. How Euroized is the Albanian Economy?

According to the Bank of Albania, there are three types of euroization and each has its own measuring tools.

First it is the euroization of assets of an economy, which is measured by the ratio of foreign currency deposits to local currency deposits.

Second is the euroization of liabilities of an economy, measured by the ratio of loans in foreign currency to loans in local currency.

Third, it is the euroization of transactions, which is measured by the level of transactions in foreign currency to the transactions in local currency.

The first and second can be measured while for the third there are no measures.

**Table 2:** Deposits in the banking system (in million ALL)

	2007	2008	2009	2010	2011	2012	2013	2014*
Total deposits	570,752	627,126	657,690	772,069	869,876	930,228	951,001	958,700
In national currency	333,495	354,491	366,528	403,907	449,855	469,726	496,560	491,373
In foreign currency	237,258	272,635	291,162	368,162	420,021	460,501	454,441	467,327

\* until October 2014

**Source:** Bank of Albania

**Table 3:** The credit to the economy (in million ALL)

	2007	2008	2009	2010	2011	2012	2013	2014*
<b>The total credit</b>	<b>293,864</b>	<b>396,264</b>	<b>440,397</b>	<b>483,130</b>	<b>541,900</b>	<b>554,732</b>	<b>547,928</b>	<b>557,545</b>
<b>In national currency</b>	84836	114053	140480	157283	188926	215317	220189	230499
<b>In foreign currency</b>	209027	282213	299917	325932	353120	339609	327995	327046

\* until October 2014

**Source:** Bank of Albania

In the framework of euroization of the assets, Albania has an average level compared to other countries in the region, with foreign currency deposits at about 48% of total savings. This record is held by Croatia and Serbia, whose citizens prefer the joint currency to keep their savings.

The euroization of liabilities is significantly higher. Albania is ranked second in the region after Croatia, with 60 % of the loans given in foreign currency. In fact, obtaining foreign currency loans has been a significant preference of businesses and individuals in almost all Central and Eastern European countries, especially in Balkan countries.

When we talk about the euroization of an economy, we mean the real sector of the economy, which is the opposite mirror of the financial system. According to the Bank of Albania, if we take in consideration all agents of the Albanian economy, not only businesses and individuals, but also the financial system, the Albanian economy still remains in a liquid foreign exchange position, as long as there is a positive net foreign asset. The second positive element is the structure of foreign currency inflows in the Albanian economy, which has a long-term nature. These flows consist mainly of foreign direct investment or portfolio investment, and according to the Bank of Albania, they are part of the economic development of the country and not to take advantage of the short-term interest rates.

A high economic euroization: reduces the effectiveness of monetary policy, that is the degree of control of the Bank of Albania into Albanian economy and banking system, and exposes the financial system as well as the economic agents (borrowers and lenders) to the risk of exchange rate movements, risk which they cannot neutralize completely through the construction of protecting instruments in the financial market which may create foreign currency liquidity problems for the Albanian economy, the banking system and financial agents.

#### 4.1 Euroization level and performance of foreign currency deposits

The use of foreign currency is a widespread phenomenon in all post-communist Eastern Europe countries including here Albania. Relatively long transition caused loss of confidence of individuals into local currency and also in domestic monetary regime.

Foreign currency is perceived as a kind of "protection" from the uncertainties caused by macroeconomic instability that characterizes countries which pass from a totalitarian regime to a free open market regime. It is also worth mentioning the increasing effects of globalization and the impact that they have on Albanian economy.

Referring to Balino, Bennett & Borensztein study (IMF, 1999) titled "Monetary Policy in dollarization economies", the level of dollarization (in analogy to Euroization) in an economy is measured by the ratio of foreign currency deposits to cash (M3 in the case of Albania). In cases where the ratio is greater than 30 percent then we are dealing with a high level of dollarization. The developments of this report until 2006 show a moderate level of euroization in Albanian economy with an increasing trend.

**Table 4:** Foreign currency deposits to M3

	2006	2007	2008	2009	2010	2011	2012	2013	2014
<b>Foreign currency deposits /M3 in %</b>	<b>26.3</b>	<b>29.1</b>	<b>33.5</b>	<b>34.6</b>	<b>33.6</b>	<b>35.8</b>	<b>39.6</b>	<b>38.9</b>	<b>40</b>

From the table we see that starting from the mid of 2008 and on, foreign currency deposits compose nearly 30 percent or more of the money supply. Based on these developments, the Albanian economy is inclined to a high level of euroization.

#### 4.2 Factors that has influenced the euroization of deposits

Some of the factors that have influenced the euroization of deposits are:

## 5. Increase of Remittances

The performance of foreign currency deposits is favoured by foreign currency inflows in the form of remittances. It is thought that the main source of foreign currency deposits remain the savings of immigrants and their involvement into the banking system. According to a survey of the Bank of Albania (September 2007), based on a study of Lyanos and Glystos 2004, about 1 million Albanians have emigrated mainly in Greece and Italy.

This phenomenon is accompanied by a large inflow of foreign currency in the form of remittances from countries of emigration to the host countries. The transfer of remittances has followed mostly informal channels, which means that immigrants transfer their money personally or through relatives, acquaintances or travel agencies. Based on a survey realised by the Bank of Albania, about 89 percent of remittances are sent unofficially. With the development of the Albanian banking system and specialized operators of cash transfers, recently the remittances have had a tendency to be involved into a formal network.

According to official data of the Bank of Albania, remittances in Albania have increased by an average annual rate of 5.6% during the last 15 years. This rate was much higher in 2007 (about 10:37%) but fell sharply after the global financial crisis, and registered a decline of 15,21%, and 6.56% and 13.06% respectively in 2008, 2009 and 2010. At the end of 2013 they fell by 40% compared to the end of 2012 and this decline continues even nowadays.

We can mention two main factors responsible for the progressive decline of remittances. First, the global economic crisis which affected countries as Italy and Greece. The economic crisis in these countries influenced negatively to the employment opportunities and incomes level of Albanian immigrants.

Secondly, as it is accepted in many studies, remittances have a long-term decline trend.

Over time, immigrants change their status, create a family in the host country or join the rest of the family, which weakens family relations in the country of origin.

**Table 5:** Remittances in Albania (in milion euro)

Year	2008	2009	2010	2011	2012	2013
Albania	833	781	690	665	675	497

**Source:** Bank of Albania

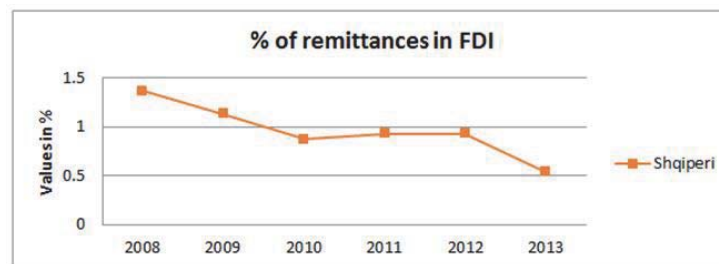
### 5.1 Increase of foreign direct investments and adoption of foreign currency

Foreign direct investments are another source for using foreign currency and increase its turnover in the economy. The increase of foreign direct investment does not suggest the increase of foreign currency deposits, but nevertheless remains a flow indicator of the foreign currency with a high probability to be directed into the banking system.

**Table 6:** The performance of foreign investments (in milion euro)

Year	2008	2009	2010	2011	2012	2013
Foreign direct investments	609.80	688.70	788.50	716.80	727.00	923.00

**Source:** Bank of Albania



**Graph 1:** The weight that makes remittances to FDI

**Table 7:** The ratio of foreign currency deposits to foreign currency loans

(in milion ALL)	2007	2008	2009	2010	2011	2012	2013	2014*
<b>Foreign currency deposits</b>	237,258	272,635	291,162	368,162	420,021	460,501	454,441	467,327
<b>Foreign currency loans</b>	209,027	282,213	299,917	325,932	353,120	339,609	327,995	327,046
<b>Foreign currency loans /Foreign currency deposits</b>	<b>0.88</b>	<b>1.035</b>	<b>1.03</b>	<b>0.885</b>	<b>0.84</b>	<b>0.74</b>	<b>0.72</b>	<b>0.70</b>

\* until October 2014

This kind of relation (if the growth of foreign currency deposits is similar to the foreign currency loans, the ratio goes to one) suggests that to a large extent the high growth rates of foreign currency deposits in the banking system favour the foreign currency loans, and vice versa, the high demand for foreign currency loans is based on the growth of foreign currency deposits.

So, banks can encourage foreign currency deposits as the demand for foreign currency loans is higher, mainly as a result of lower interest rates in foreign currencies. Over 70% and in some cases over 80% of the total credit is granted in foreign currency. While loans are in the balance sheet asset, deposits are on the liability part and their balance is essential to mitigate the risks arising from fluctuations in exchange rates. So, the growth of foreign currency deposits should not be seen as a choice of depositors to optimize their portfolio, but also as a choice of banks, which favour their absorption in order to finance the increasing demand for loans in foreign currency and to avoid the risk of non-compliance of currencies in balance sheet.

## 5.2 The increased use of foreign currency transactions

The inflow of remittances, foreign direct investment as well as the use of foreign currency in the country increases the use of foreign currency in transactions.

If we look at the real estate trade journals, we notice that their prices often are quoted in foreign currency, mainly euros, which are claimed even by agencies and businesses operating in the real estate market. The same thing happens with a part of other commodities with long-term consumption.

At the same time there is an increase in the number of business transactions carried out with foreign currency. Foreign currency demand deposits of individuals and businesses, which generally means those transactions performed through the banking system, have constant fluctuation. These fluctuations indicate the circulation of foreign currency in the banking system, that is in the formal part of the economy. In developing countries a part of the foreign currency transactions is carried out informally, what makes it difficult to be included in the official statistical data of the foreign currency circulation.

The use of foreign currency transactions and daily economic and financial operations, increase the possibilities of directing that money into the banking system in the form of deposits with or without maturity. Hence, it has a significant influence in the increased ratio of foreign currency deposits, and thus in the intensification of the level of euroization.

## 6. Conclusions

In this research we notice that the level of euroization in Albania is relatively high, although there is not an official euroization. The results of the study indicate that in the recent years, the rapid growth rates of foreign currency deposits against domestic currency continue to affect the increased number of foreign currency deposits, and the displacement of the structure of M3 towards its foreign exchange component. Due to the high tendency towards euroization (the ratio of foreign currency deposits to the total is over 30 per cent) and its implications on the economy, the recognition of factors affecting its growth is an advantage. Facts show that Albania has made euro its currency and use it as the main means of transactions within and outside the country. Real estate market and construction industry has been using euro for years. The trade volume of Albania is mainly with countries where euro is the main currency, and is surrounded by neighbouring countries where euro is the official currency.

The adoption of euro will certainly reduce the possibility of crisis as a result of a weak domestic currency; if the ECB extends bank supervision it will also reduce the ability of the banking crisis; and if our business cycle would have a higher correlation with a stable country this would reduce the probability of economic crisis.

Regarding the benefits of monetary union, they are difficult to be assessed because it is a lack of necessary data, but factors such as: a) labour and capital in Albania are stationary and can't protect the economy from short-term strikes

b) Our economy will probably not be able to afford asymmetric shocks in the case of a fixed exchange rate, c) economic structures are different, not only to EU countries, but also to the countries of the region, d) the lack of budget resources to help the economy in crisis, makes us think that the Albanian economy is still unprepared for the unilateral use of the euro and that any reckless experiment would cost too much.

These are some of the reasons why the European Central Bank does not support an early adoption of the euro by economies of Eastern Europe. ECB knows very well the problems that often influence our financial markets, and Albania still needs its Central Bank to intervene to mitigate and regulate its internal or external economic shocks. This means that beyond the slogan "Albania is a European country", the economy should be prepared to be part of the European economy. For this reason the emphasis is placed not only on the stability of macroeconomic indicators, but also on carrying out reforms which would assure sustainability of macroeconomic outcomes.

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