Center for International Development
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ALBANIA'S CREDIT MARKET

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EXECUTIVE SUMMARY

Credit market activity in Albania has been sluggish in recent years in spite of low and declining interest rates. The economy lost its growth momentum after 2009. Investment and lending activity slowed down substantially despite low interest rates, relative macroeconomic resilience, and available capacity in the private sector to take on more debt. This study analyzes the supply (lenders') and demand (borrowers') sides of the market.

The reason behind the credit market failure is a supply-demand mismatch. Poor financial intermediation is the main problem on the supply side. Despite excess liquidity in the financial sector, banks are excessively risk-averse, bank practices and products are unsophisticated, and non-bank financial market is underdeveloped. Excessive risk aversion translates into tight credit standards, credit rationing and credit crunch for some economic sectors, in particular those dominated by SMEs. On the demand side, firms overall have a low appetite to expand, limited capacity to create bankable and financially viable projects, and are also constrained by infrastructural gaps and economic uncertainty. The mismatch results from the fragmentation of the credit market, with reliable borrowers from traditional sectors having easy access to finance, and other segments being almost fully deprived of credit.

Government and donor-led policies to mitigate the problem have had little success. Albania enjoys access to a number of domestic and external funding schemes primarily focused on alleviating funding constraints for credit-deprived sectors, but these programs have been ineffective. Further study is needed to understand the reasons behind the limited success of these programs.

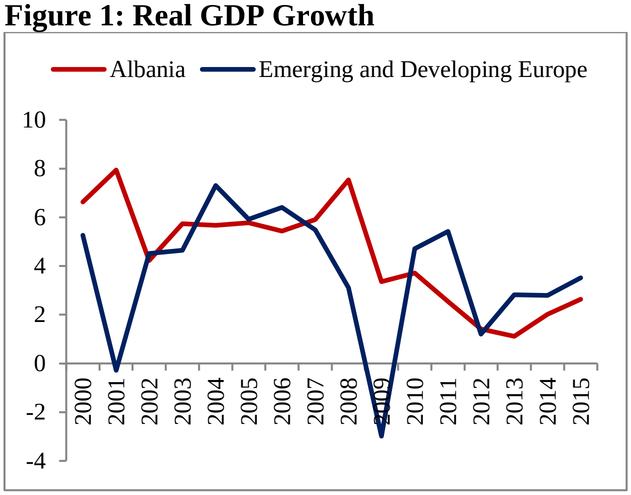
A National Development Bank (NDB) could address some of the observed credit market challenges. While an NDB's ability to directly resolve demand-side constraints would be limited, an NDB could effectively tackle supply-side constraints in the credit market as well as provide surveillance and collect information from the private sector, leverage technical assistance, and develop tailored financial products. Establishing an NDB should be considered carefully, taking into account functional, governance, funding, staffing and other risk factors.

1. MACROECONOMIC OUTLOOK

After a substantial deceleration of growth in 2009-2013, economic growth has been gradually picking up speed since 2014 due to a recovery in manufacturing, construction and retail trade. Albania's GDP growth rate averaged 6% during 2003-2008 fueled by remittance inflows, an expansion in domestic demand, and a credit-driven construction boom. The high growth period went hand in hand with high investment. Since 2009, both the global financial crisis and the Eurozone debt crisis weighed on economic activity. Growth rates declined abruptly after 2008, and the country performed weaker than emerging and developing European countries on average (Figure 1).[1] Since 2014, growth has been slowly recovering, reaching 2.6% in 2015, prompted mostly by domestic demand.

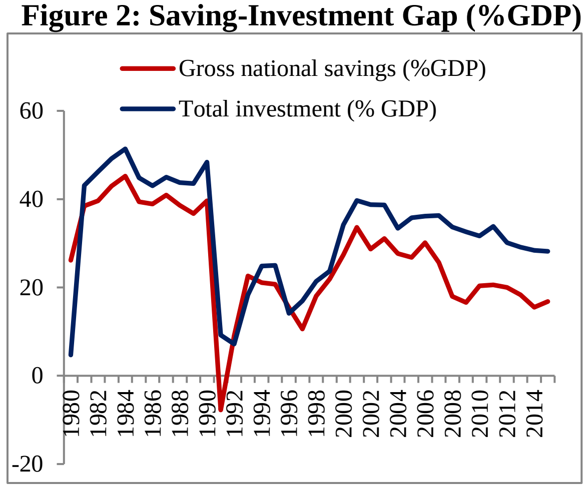
On the internal balances, two issues deserve special attention: (i) the savings-investment gap and (ii) the fiscal outlook. There is a savings-investment gap in the economy (Figure 2). Both savings and investment have been declining since 2001; however, the pace of decline in savings has been faster than that of investment due to fiscal deficits and the fall in remittances. Investment fell for three consecutive years in 2011-2014, before recovering slightly in 2015. Importantly, the decline in investment occurred in an environment of low interest rates. On the fiscal front, expansionary policies of 2012-2013 created a large burden on the fiscal balances, necessitating subsequent fiscal adjustment under an IMF program. Under this program, policy priorities include reviving private sector credit by cleaning up bank balance sheets and continuing the implementation of growth-friendly structural reforms (IMF, 2016)

Figure 1: Real GDP Growth



Source: IMF, WEO 2016

Figure 2: Saving-Investment Gap (%GDP)



Source: IMF, WEO 2016

[1] Further supporting graphs for this section can be found in Annex Figures 1-2.

High current account deficits and external debt stocks are the main problems for the external balance of the economy. Albania has a high current account deficit compared to other emerging and developing European countries[2] consistent with the large savings-investment gap. The deficit is mainly financed by foreign direct investment inflows. Portfolio and bank flows are weak. The gross external debt reached a historical peak of 73% of GDP in 2015 and the share of inter-company lending more than tripled compared to 2007 levels during the same period.

2. REAL SECTOR OUTLOOK

2.1. Enterprise Structure

Understanding Albania's enterprise structure is important for understanding typical clients of the banking sector. As of end-2015, 152,288 active firms operated in the real sector with the following characteristics: (i) 70% of firms specialized in services (e.g. trade, accommodation, transportation, construction etc.); (ii) 95% of all firms had less than 10 employees; (iii) 1,652 firms (1% of firms) that were larger than 50 employees created more than 50% of the total value added and accounted for 40% employment (Figure 3); and (iv) 4% of firms were foreign or jointly owned by foreign investors.[3]

Most firms operate in traditional sectors such as agriculture, trade, and, construction. Agriculture represents the largest shares of GDP and employment – around 20% and 48%, respectively. Outside of agriculture, the economic activity is concentrated in trade and construction. These two sectors account for 23% of value added and 9% of employment. Industry contributes 15% to value added and 10% to employment.

The real sector is dominated by small and medium size enterprises (SMEs), which are here defined as enterprises with up to 50 employees. The business environment of SMEs in Albania can be summarized as follows:

(i) SMEs are typically run as family businesses and face strong competition, especially from the informal sector.

(ii) Most of the SMEs operate in low value added sectors (e.g. retail and wholesale trade, restaurants etc.) (Figure 4). These are also largely non-tradable activities and thus

[2] Emerging and developing European countries include: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Kosovo, FYR Macedonia, Montenegro, Poland, Romania, Serbia, and Turkey

[3] Further supporting graphs for this section can be found in Annex Figures 3-4.

dependent on domestic demand. Moreover, competition and leverage are already high in these sectors.

(iii) There is low sophistication, low diversification and little-to-no innovation. Less than 15% of SMEs are operating in non-agricultural productive sectors and only 2.4% are engaged in exports.

(iv) SMEs have low financial transparency, weak accounting and planning practices.

As a result, most SMEs are not well positioned to be sound investors that can spur economic growth, and most are not reliable borrowers that can create quality credit demand for finance.

Figure 3: Share of Firms (2014)

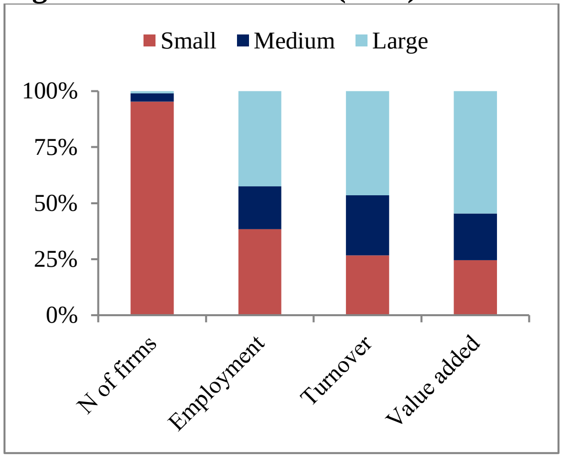
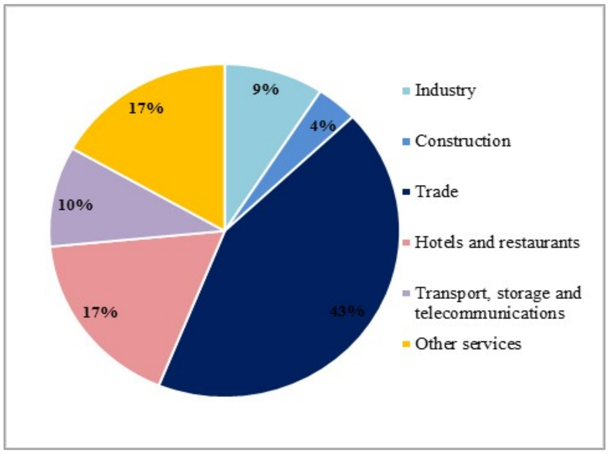


Figure 4: Number of SMEs by Industry (2014)



Source: INSTAT, Structural Survey of Enterprises (2014)

2.2. Investment Structure

High growth periods went hand-in-hand with high investment activity (Figure 5). Construction investment created more than 75% of gross fixed capital formation. During the high growth period, residential housing investments were the main driver of investments and fueled the economic boom (Figure 6).[4] More recently, investment is still concentrated in residential construction but its share is slowly declining (from around 50% of total investment in 2006-2012 to 42% in 2014). In order to increase productivity, capital needs to flow from overinvested industries to underinvested industries. Thus, recent investment increases in machinery, equipment, transport, and minerals exploration present promising picture for the future.

[4] Further supporting graphs for this section can be found in Annex Figure 5.

Outside residential housing, investment is highly concentrated in three capital-intensive industries – electricity, oil extraction, and telecoms – each of which is dominated by large, foreign firms. The 12 largest firms in these industries accounted for 24% of all investment, or 41% of non-housing investment, in 2014. Other industries that are growing – fason, call centers, trade – are primarily labor-intensive and do not require large capital investment.

Figure 5: Contribution of Demand Components to Growth

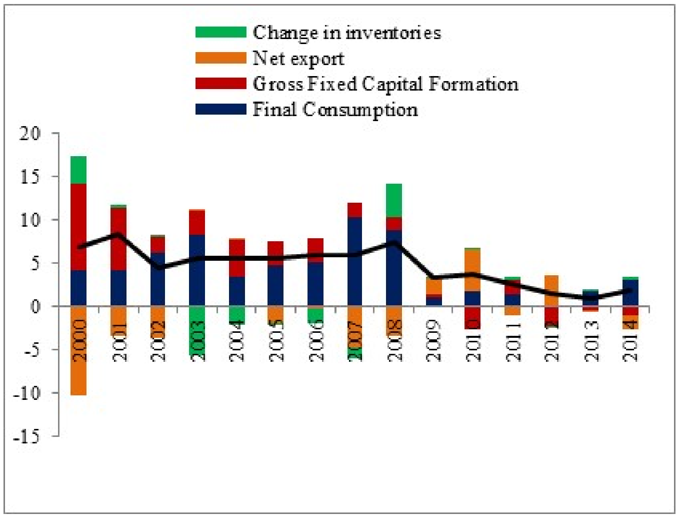
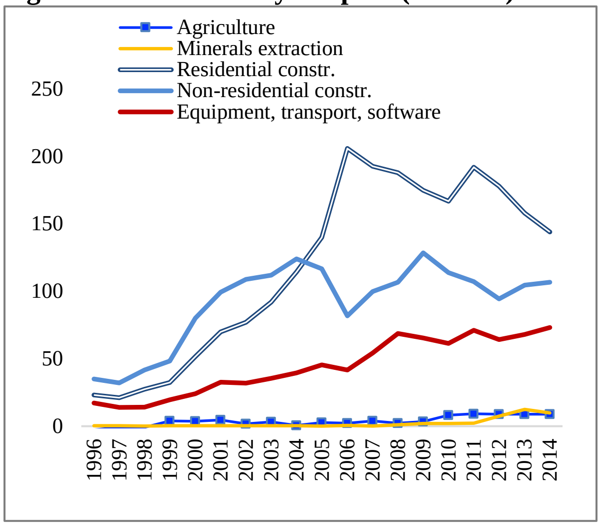


Figure 6: Investment by Purpose (bn ALL)



Source: INSTAT, Structural Survey of Enterprises (2014)

3. FINANCIAL SECTOR OUTLOOK

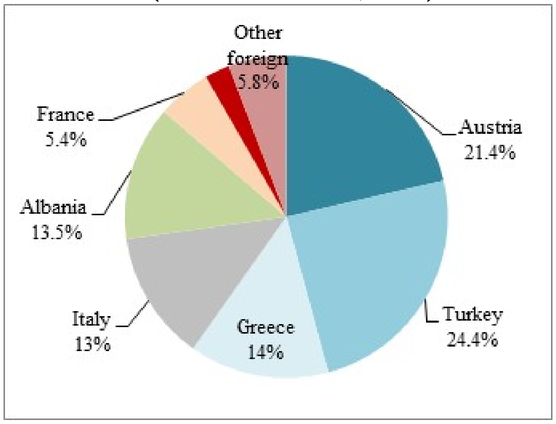
3.1. Banking Sector

Foreign banks are dominant providers of finance to the economy (Figure 7).[5] The banking sector accounts for 90% of the total assets of the financial sector. Currently, there are 16 private banks operating in Albania, out of which 14 were foreign-owned.[6] The top three banks (BKT, Raiffeisen, Intesa Sanpaolo) own 58% of total assets.

Banks are funded domestically and the exposure to foreign-market problems is limited. Dependence on foreign funding is the lowest in Albania compared to Central, Eastern and Southeastern Europe (CESEE) countries (IMF, REO 2016), implying that the impact of any foreign banks' deleveraging on the real economy is likely to be less disruptive (Figure 8).

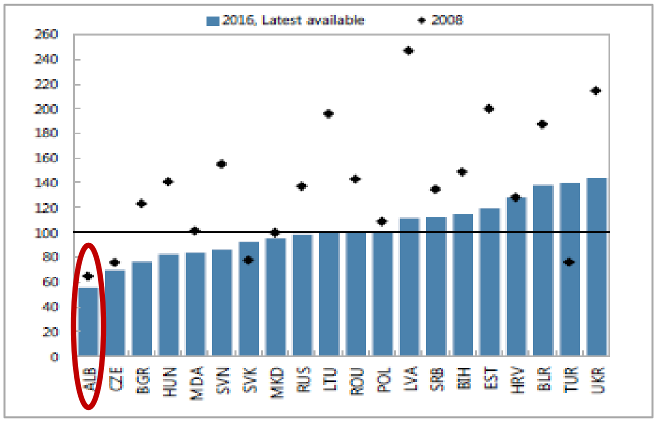
[5] Further supporting graphs for this section can be found in Annex Figure 5.
[6] There are two domestically owned banks. One foreign-owned bank (BKT) is headquartered in Albania.

Figure 7: Ownership Structure of Banking Sector (% of Total Assets, 2015)



Source: AAB, Monthly Bulletin (Dec. 2015)

Figure 8: Domestic Loans to Domestic Deposit Ratios (%)



Source: IMF, REO 2016

Banking practices are not sophisticated, which narrows financing options for the private sector. Banks in Albania offer simple lending products, mostly collateral-backed loans in local or foreign currency at flexible interest rates (Euribor, Libor, T-bill + spread). Banks usually lend against the collateral (i.e. cash, movable property, real estate etc.). Required collateralization is usually 120% of the requested loan. Prices of loans include hidden costs in the form of commissions and fees. Most of the loans available are short-term, catering to operations of traditional sectors in Albania, such as overdraft, working capital, inventories loans and trade finance. Bank clients are also concentrated in traditional segments of the economy such as trade, construction, manufacturing, and electricity. As a result of such banking practices, some segments/industries that cannot pledge collateral or demonstrate debt-servicing capacity (agriculture, tourism, municipal infrastructure) are excluded from the credit market and are greatly underserved by banks.

SME lending is largely "relationship lending", based on soft information. Usage of hard information and hard collateral is limited. Some banks (Raiffeisen, Societe Generale, Credins, Tirana, Union) have leasing companies that partially solve the problem of collateral and can offer alternative financing options to SMEs. Leasing activity, however, does not demonstrate fast growth either.

3.2. Non-bank Financial Sector

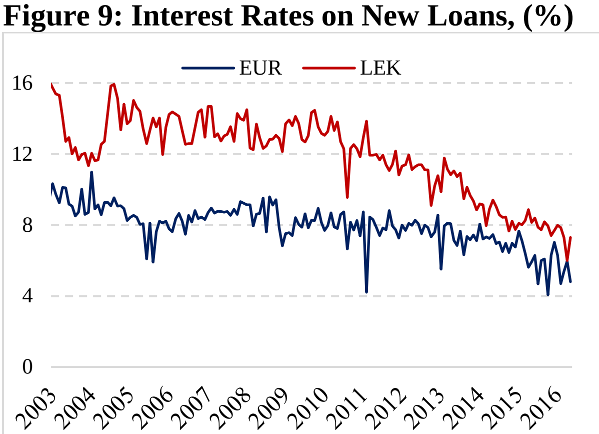
The non-bank financial market is nascent, narrowing funding options for the real sector. Albania's non-bank financial institutions (NBFI) consist predominantly of savings and loan associations, micro-credit organizations, insurance companies, investment funds and leasing companies. In total, NBFI's assets account for around 10% of GDP as of 2015. Lending activities constitute the major part of NBFI's operations, but two investment and three pension funds operating in Albania invest their assets into government bonds and do not play an important role in financial intermediation. Capital markets are virtually absent,[7] and there are no private equity funds or venture investors in the country. As a result, the local institutional investor base is very narrow.

3.3. Credit Market Stagnation

There has been a steady decline in interest rates over the past few years, both to households and the private sector. ALL loan rates fell from 12% in 2011 to 7% recently, and EUR rates dropped from 8% to around 5% (Figure 9). The Bank of Albania has maintained generally accommodative monetary policy since mid-2011, and the current policy rate is 1.25%.

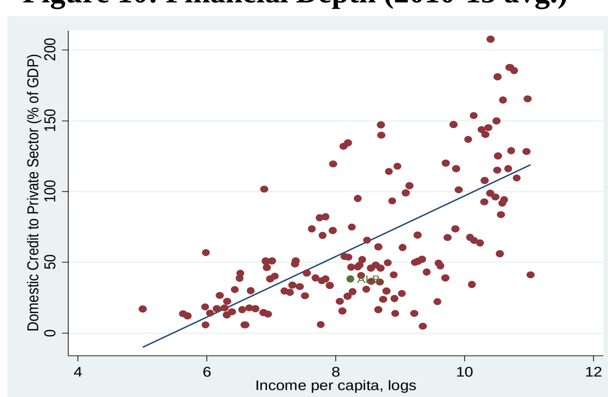
Despite relatively low credit penetration and low interest rates, banking activity has been stagnant. Albania has low financial depth for its development level (Figure 10). The household loan portfolio has been stuck at around ALL 150 billion for almost 7 years, while corporate loan portfolio has been subdued since mid-2012 (both overall and across segments) (Figure 11).

Figure 9: Interest Rates on New Loans, (%)



Source: AAB, Monthly Bulletin (June 2016)

Figure 10: Financial Depth (2010-15 avg.)

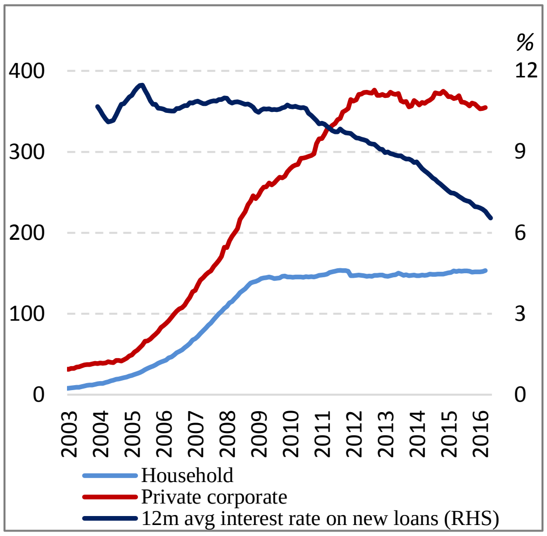


Source: WB, WDI (May 2016)

[7] Tirana Stock Exchange was closed down in early 2015, and there are only a few bond issues placed privately.

The observed credit market stagnation deserves an analysis. Why are banks not extending credit to the private sector? Is the weak corporate borrowing a result of supply constraints (such as inadequate funds in the financial sector, high financing costs, high risk etc.) or is it because of low investment demand (i.e. due to low returns in the economy)? The following section of this report analyzes the demand and supply factors of the credit market and the potential presence of market failures.

Figure 11: Total Loans, by Borrower (bn ALL)



Source: AAB, Monthly Bulletin (June 2016)

4. CREDIT MARKET DEVELOPMENTS

4.1. Credit Supply

The assets and liabilities of the banking sector have been increasing in nominal terms since 2005. Albanian banks have had high levels of deposits for the last 15 years, and the country performs extremely well in terms of deposits/GDP ratios compared to a peer group of countries (Figure 12). However, the share of the outstanding loans is slightly lower than expected given Albania's level of development (Figure 13).

Figure 12: Deposits/ GDP

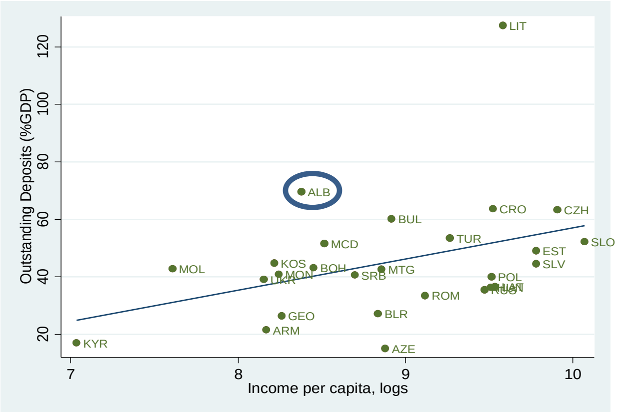
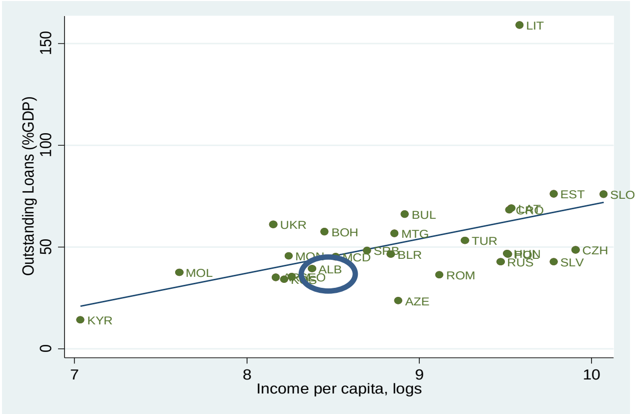


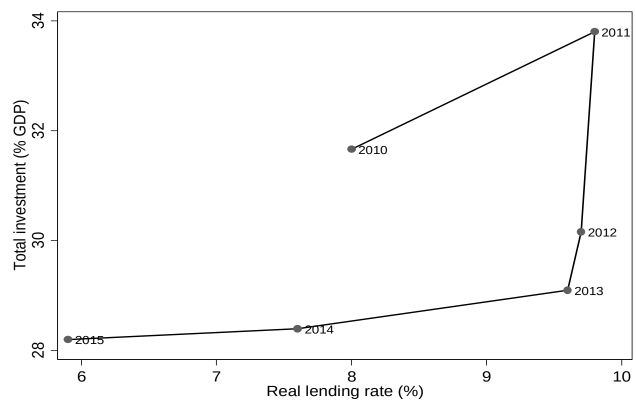
Figure 13: Outstanding Loans/ GDP



Source: WB, WDI (May 2016)

Low financial depth is not necessarily a signal of scarcity of credit, since the quantity of finance supplied in an economy may be low either because of scarce supply or because of low demand.[8] The way to separate these two cases is by observing the price: low quantity and a high price indicate scarcity of supply relative to demand. With this aim in mind, real interest rates can be used as prices. The cost of finance was low for 2010-2015 periods and there was no relationship between real interest rates and investment (Figure 14). Low interest rates did not spur productive investments, which is a signal of low returns in the economy according to the Growth Diagnostics Framework.[9]

Figure 14: Real Lending Rate vs. Total Investment (% GDP)



Albanian firms rely on internal financing. According to recent Enterprise Survey data from the World Bank (2013), external financing is low and firms require high collateral to obtain loans, which suggests that **financial intermediation is low and inefficient**. According to the World Bank (2013, p. 11), "efficient financial markets reduce the reliance on internal funds and on money from informal sources such as family and friends by connecting firms to a broad range of lenders and investors." In this regard, while access to finance is not the major obstacle for the corporate sector overall and for large firms in particular, it has emerged as one the main obstacle reported by the medium-sized firms.[10]

The following observations[11] on aggregate also point towards poor financial intermediation in the Albanian banking sector:

Interest rate spread: The interest rate spread (between lending and deposit rates) indicates the cost of financial intermediation by banks. Generally, high spreads discourage savings, which in turn narrow borrowing levels and, thus, decrease investments in the economy. For the Albanian case, interest rate spreads in both ALL and EUR decreased between 2003 and 2009, increased

[8] Hausmann, R., B. Klinger, and R. Wagner, 2008. Doing Growth Diagnostics in Practice: A 'Mindbook', mimeo, Harvard University

[9] Hausmann, R., D. Rodrik, and A. Velasco. 2005. Growth Diagnostics. Mimeo. Harvard University

[10] Supporting graphs can be found in Annex Figure 7.

[11] Supporting graphs can be found in Annex Figure 8.

only for the EUR denominated loans between 2009 and 2015, and showed relatively stable performance for the ALL denominated loans.

Non-performing loans (NPLs) and loan write-offs: NPLs reached their peak levels in 2014 and began unwinding gradually since then. The ratio was especially high for the corporate sector segment of the market. High NPLs are one of the most important factors that prevent banks to increase lending volumes. Additionally, credit dynamics were also impacted by the loan write-off process, which was estimated at around ALL 27 billion (EUR 20 million). These NPL write-offs consisted mainly of foreign currency-denominated credit and of credit to businesses. Consequently, the total outstanding credit of the banking sector contracted by 1.5% in 2015 in annual terms (Bank of Albania, 2016).

Banking sector profits: The banking sector is relatively well provisioned. However, the increase in provisions impacted the banks' financial performance and resulted in declining profits between 2008 and 2013. During that period, Albania performed more poorly than the CESEE region. The profitability indicators started improving for large and medium-sized banks in 2015 mainly due internal restructuring aimed at cost reduction. Small banks on the other hand, experienced financial losses.

Risk aversion: Banks are risk averse, as reflected in the tight credit standards, credit rationing and credit crunch for SMEs.

- **Tight credit standards:** According to the most recent Bank of Albania lending survey, credit standards were eased only few times during the last 8 years. High NPLs, a stagnant economy and industry-specific risks have been the main factors driving the credit standards. On the other hand, expansionary monetary policies, abundant liquidity and capital and competition among banks helped banks loosen the standards (Figures 15-16).

Figure 15: Change in Credit Standards, Firm Size

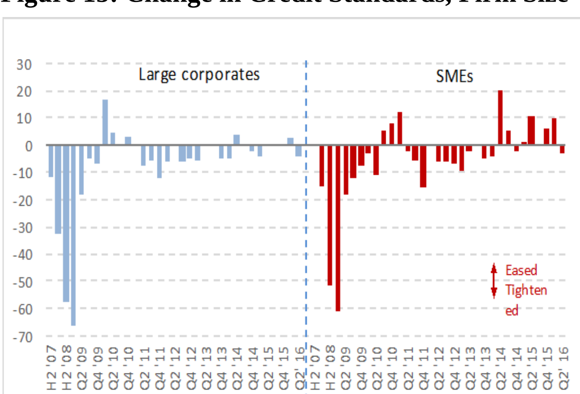
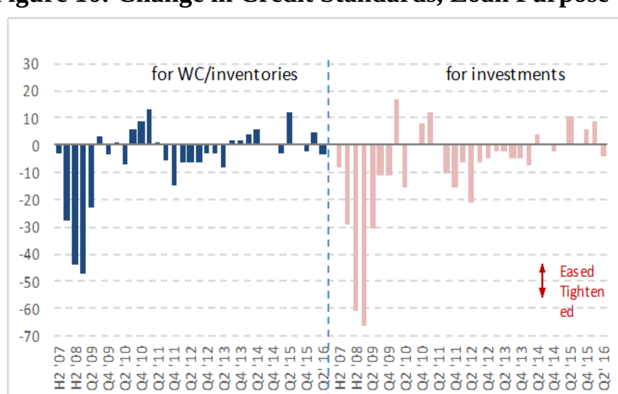
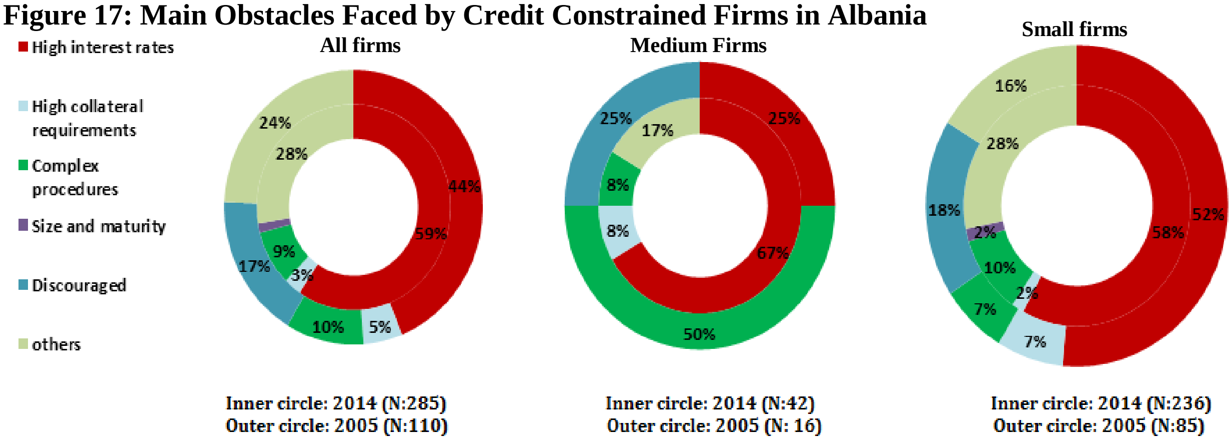


Figure 16: Change in Credit Standards, Loan Purpose



- **Credit rationing:** Loan demand is low in general. However, for the last three years SMEs have relatively higher demand compared to large enterprises. Despite improving loan demand by the SMEs, there is a declining trend both in “outstanding loans” and “new loans” to the SMEs. At the same time, banks choose to finance sectors with lower risk profiles, such as the government sector and large enterprises. Similarly, traditional segments of the market and creditworthy borrowers have had easy access to funding. Scarcity of new bankable projects and the low interest rate environment has led to high price competition for existing “good” clients as some banks aggressively lure clients from other banks by offering lower interest rates.
- **Credit crunch of the SMEs:** According to the EBRD`s Transition Report 2015-2016, credit constrained SMEs in Albania more than doubled compared to the pre-crisis period and those firms mainly complained about high interest rates as a binding constraint for accessing finance (Figure 17).

Figure 17: Main Obstacles Faced by Credit Constrained Firms in Albania



Source: EBRD, Transition Report (2015-2016), own calculations

4.2. Credit Demand

Overall credit demand is weak and of low quality. According to the 2013 World Bank Enterprise Survey, firms do not see access to credit as a major problem. The same survey showed that Albania has the highest proportion of firms reporting no willingness to take a loan (63%) among Western Balkans countries. The Bank of Albania’s Bank Lending Survey (2016) indicates that the credit demand as reported by loan officers is stagnant, and the Bank of Albania’s Survey of Firms’ Financial Situation and Borrowing (2015) shows that around threequarters of surveyed firms do not plan any expansion in their activity and consider their level of borrowing at present as appropriate. A steady increase in corporate deposits over the past 3 years despite ultra-low rates (0-1%) also supports the hypothesis that the corporate sector as a whole enjoys ample liquidity, which can be drawn on to fund profitable investment opportunities. This also gives a clear signal about a *low investment returns problem* in the economy.

More detailed examination shows that the credit demand is fragmented:

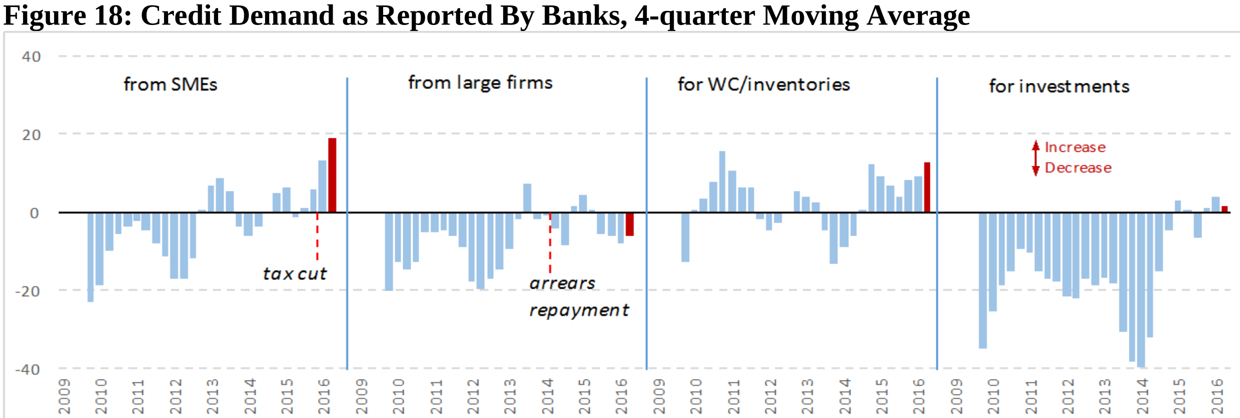
(1) Credit demand from *traditional segments* (large corporates operating in trade, construction, and manufacturing) is subdued,[12] as these sectors are already well penetrated by banks. The flow of new financially viable projects is low due to macroeconomic uncertainty, low appetite for expansion, and in some cases lack of capacity to create such projects.

(2) Demand from *foreign-owned companies* and foreign direct investors is low as they enjoy access to inter-company lending, international capital markets and borrowing from IFIs.

(3) Demand from *SMEs* is improving,[13] but is concentrated in short-term borrowing for existing operations rather than in new investments (Figure 18). Moreover, there is a significant gap in SME's capacities to present and execute bankable projects, ensure debt servicing and provide collateral.

(4) Some sectors of the economy are *under-served by banks*, e.g. agriculture, tourism, municipal infrastructure. The problem with these sectors is similar to SMEs: lack of formal collateral, little-to-none financial transparency, very low quality of projects, and weak capacities to stay financially viable in the long-run.[14]

Figure 18: Credit Demand as Reported By Banks, 4-quarter Moving Average



[12] According to the 2013 World Bank Enterprise Survey and the latest Bank of Albania's Bank Lending Survey
[13] According to the latest Bank of Albania's Bank Lending Survey
[14] Supporting graphs can be found in Annex Figures 9-10.

Source: BoA, Trends in Lending

Firms are unlikely to be constrained by high leverage or missing equity. According to the Bank of Albania's Survey of Firms' Financial Situation and Borrowing (2015), almost 80% of borrowing firms report the value of debt-to-equity ratio at or below 0.5, and 13% of firms report a value above 1.0. For some 70% of firms, debt servicing amounts to less than 20% of revenues, and for 23% of firms debt servicing stands at 20-50% of revenues. This indicates that firms are under-leveraged and have sustainable debt servicing capacity.

Credit demand is low due to low investment demand in the economy. This raises the question of why firms do not want to invest? While the proximate reason of low investment activity is low returns, the underlying reasons may include unskilled labor force, low diversity of the production portfolio, uncertainty of taxation, competition with informal economy and inadequate know-how. Finding the most binding constraint for the low investment demand requires further analysis that is beyond the scope of this report.

5. OTHER FINANCING SCHEMES

Albanian and international institutions offer financing schemes that target certain sectors and SMEs. This section aims highlights several of the most important schemes, without attempting to be exhaustive.

Government Initiatives

On the government side, the Albanian Investment Development Agency (AIDA) and the Albanian Development Fund (ADF) are the main players.

AIDA is the Albanian investment promotion agency. It is a public partner for both Albanian SMEs seeking to enlarge their export markets and foreign SMEs searching for local partnership in the country. According to AIDA's website, the agency provides numerous free-of-charge services to SMEs, such as: market analysis; business plan templates; managerial support; networking; identification of foreign partnerships, importers, and new technologies; and grants. It also has a competitiveness fund and an innovation fund. Much of this support is either recent or nascent. The European Commission (2015) suggests that there is a need for better coordination among AIDA funds and that AIDA's capacity for services to both local and foreign investors should be strengthened.

ADF was established in 1993 in cooperation with the World Bank, with the goal of improving the socio-economic cohesion of different regions in Albania. ADF was designed to foster regional development, both through the implementation of large public projects and through business support in the form of grants, loans and guarantees. However, our understanding is that ADF is mainly implementing infrastructural projects, while the objective of more direct business support has been dormant.

EU Initiatives

As an official candidate for EU accession, Albania has access to various EU funds, such as **Instrument for Pre-Accession (IPA) II** financial assistance during 2014-2020 of around EUR 650 million, a fifth of which will be allocated to supporting firm competitiveness and agriculture in particular. In June 2015, Albania also ratified an agreement to participate in the COSME competitiveness program, which has an EU-wide budget of EUR 2.3 billion. Finally, grant scheme IPARD-LIKE is co-funded by the EU (EUR 6.2 million) and the Government of Albania (EUR 2 million) with the aim of developing the agro-food industry during 2012-2014. This scheme has already been positively assessed in terms of job creation and investment demand (Bezhani, 2015).

Multilateral Development Bank (MDB) Initiatives

Two EBRD projects were recently signed. One is the **Albania Agribusiness Support Facility (AASF) - Procredit Bank Albania Risk Sharing Facility**, with the board date of July 20, 2016. The EBRD is providing an unfunded risk sharing facility of up to EUR 15 million to ProCredit Bank Albania (PCBA), covering up to 50% of a portfolio of eligible loans to the agribusiness sector in Albania in order to promote and enhance access to finance for agribusinesses in Albania. The other is the **AASF - NOA Agribusiness Credit Line**, with a board date of April 6, 2016. The EBRD is providing a senior unsecured loan of up to EUR 5 million to NOA Sh.a., a non-bank microfinance lending institution in Albania, for on-lending to agribusinesses.

Other Schemes

Italian – Albanian Program for the Development of SMEs in Albania: The program started in January 2009 for facilitating lending to SMEs. Financial components of the program include a credit line of EUR 25 million, a guarantee fund of EUR 2.5 million, and technical assistance valuing EUR 1.756 million. The credit line management is done through private commercial banks that are included in the program. Agriculture, agro-food, energy efficiency and projects in less developed areas in the country are defined as priority sectors supported by this program.

SARED Grant Scheme: The program is jointly funded by the Governments of Denmark and of Germany, providing EUR 6.5 million with an aim to increase rural viability during 2014-2018.

6. CONCLUSIONS AND POLICY PROPOSALS

There is a mismatch in the Albanian credit market. There is abundance of liquidity in the banking sector, but banks are not increasing lending activity. There are segments of economy where capital is scarce and returns on capital may be high, but firms are not borrowing more and not investing there.

The demand side of the mismatch (or why firms don't invest more) should be studied in more detail. Descriptive analysis suggests that firms may perceive low returns on investments because (i) there is a general slowdown in domestic demand and traditional exports markets are weak; (ii) there are infrastructural gaps, especially in energy supply; (iii) there are gaps in the private sector (inadequate know-how, lack of managerial and organizational skills needed to develop new products/services, limited scale opportunities, low diversification); and (iv) because of concerns about the appropriation of profits resulting from weak legal protection and taxation uncertainty.

On the supply side, the problem can be defined as "low financial intermediation" due to the following reasons: (i) firms are highly dependent on internal finance; (ii) banking practices are unsophisticated and financial products are rigid, and cannot satisfy all clients equally; (iii) the non-bank financial sector is largely absent; and (iv) banks are risk averse due to the past NPL build-up and unfavorable economic outlook. Excessive risk aversion translates into tight credit standards, credit rationing and credit crunch for SMEs and some sectors of the economy (e.g., agriculture, tourism, and municipalities).

A national development bank (NDB) could tackle some of the constraints, in particular on the supply side of the problem. NDBs are often seen as an effective instrument to provide financing to segments of the market or to separate projects, which are overlooked by the commercial banks, but which can generate significant positive externalities. For the Albanian case, besides closing the financing gap in the credit-deprived sectors, an NDB can also provide: (i) *surveillance*, i.e., accumulate domestic and external know-how, define main obstacles to businesses, monitor trends in the credit markets, identify high and low productivity SMEs; (ii) *technical assistance*, i.e., give constructive feedback from past experience, implement pilot projects, channel external funds, pre-screen and prepare projects for first-tier banks; and (iii) *new and better-tailored financial instruments*, such as equity, credit and collateral guarantees, project finance, fundraising, and venture funds.

The design of an NDB has to address certain aspects, some of which are dependent on the country context. The main aspects to consider are (i) mandate; (ii) operating model; (iii) governance; (iv) staffing; (v) funding sources; and (vi) sunset clause. Ideally, the NDB would operate under the sound banking principle (as opposed to soft lending unless clearly specified), and complement the private sector funding rather than compete with it. Moreover, there are significant downside risks associated with NDBs as evident from developing countries' experiences. NDBs can be politically captured and engaged in directed or insider lending. Badly designed or governed NDBs can accumulate large NPLs and require bailouts. Once an NDB takes off, it can be very difficult to close it down when the purpose of its operations no longer exists.

While an NDB can address market failures in the supply of financing, its ability to tackle demand-side problems is ambiguous. As shown above, the Albanian private sector also suffers from a low returns problem. That is why there is also a need for additional structural policies to eliminate main bottlenecks in the economy in order to reorient structural change.

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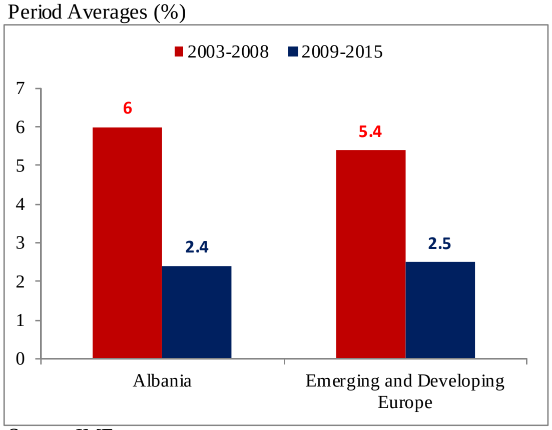
ANNEX

Figure 1: Macroeconomic Outlook

Strong growth performance during 2003-2008…

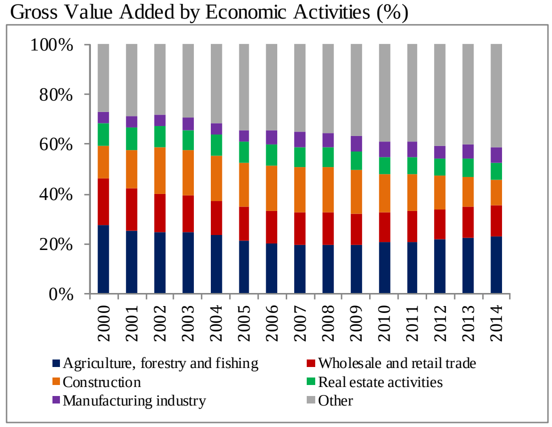
Period Averages (%)



Source: IMF

Agriculture contributes the most to value added…

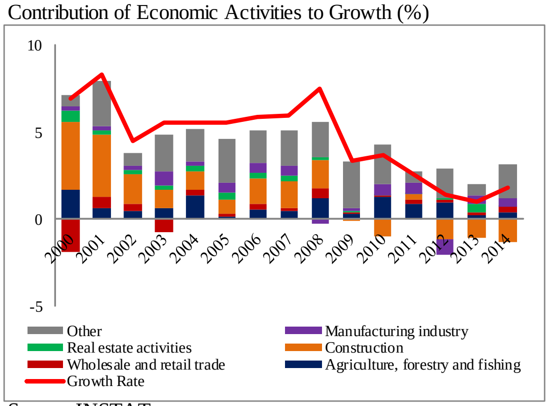
Gross Value Added by Economic Activities (%)



Source: INSTAT

Construction was a main driver of growth during high growth periods…

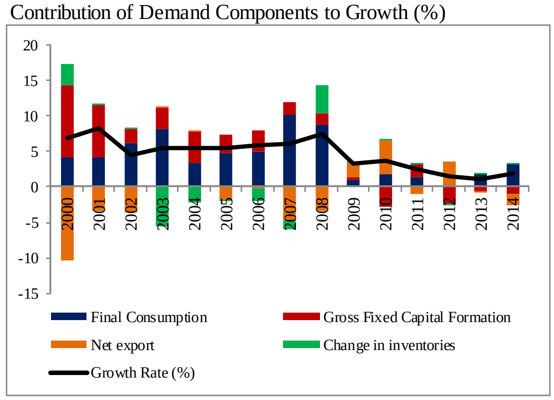
Contribution of Economic Activities to Growth (%)



Source: INSTAT

High growth coincided with positive investment contributions

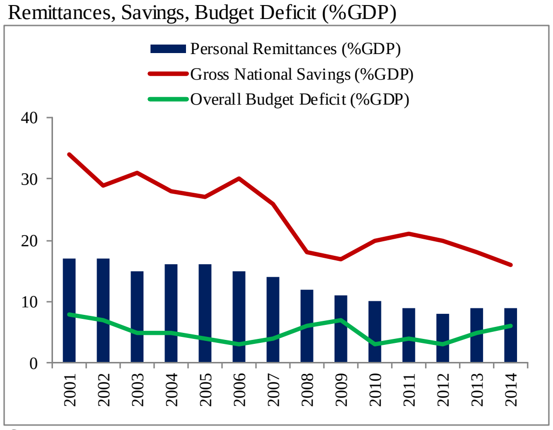
Contribution of Demand Components to Growth (%)



Source: INSTAT

Remittances and budget deficits affected low savings…

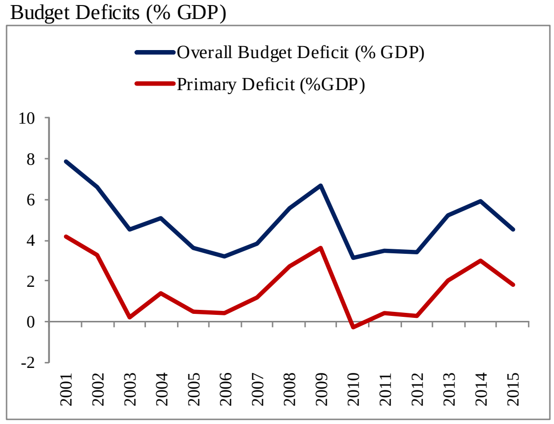
Remittances, Savings, Budget Deficit (%GDP)



Source: WB-WDI

Fiscal outlook is improving since 2014…

Budget Deficits (% GDP)

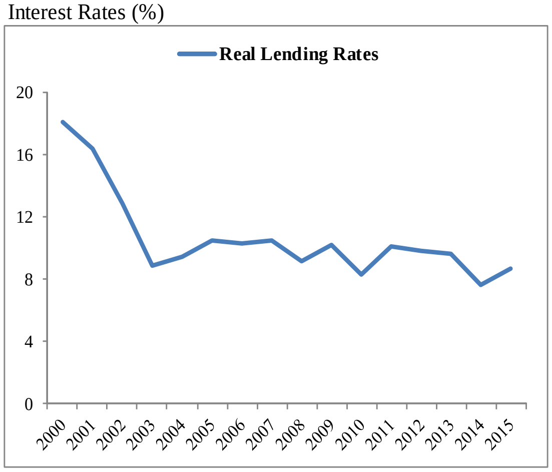


Source: IMF Staff Reports

Figure 2: Macroeconomic Outlook-II

Interest rates have declined in recent years…

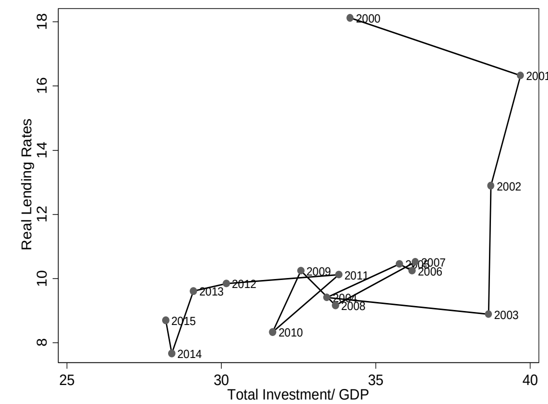
Interest Rates (%)



Source: EIU

No relationship between interest rates and overall investment..

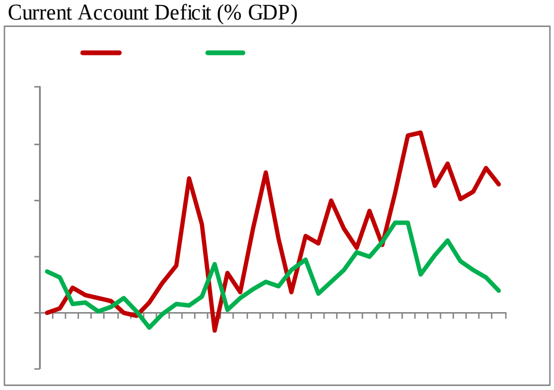
Investment vs. Real Interest Rates



Source: EIU, WB-WDI

High current account deficit…

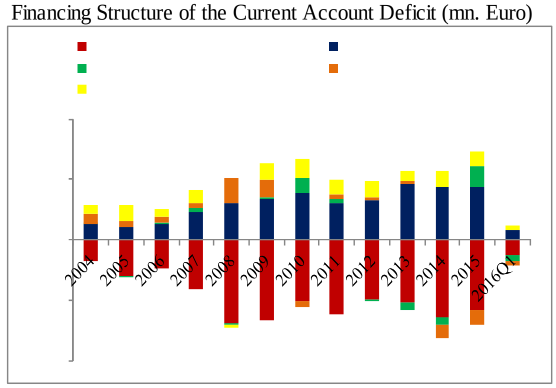
Current Account Deficit (% GDP)



Source: IMF

FDI has been the main source for financing…

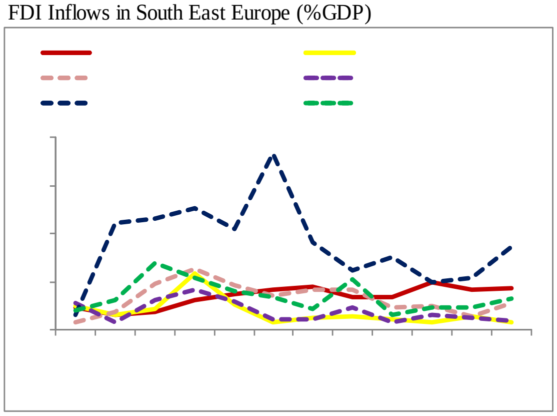
Financing Structure of the Current Account Deficit (mn. Euro)



Source: BoA

Albania is second in the region in FDI inflows…

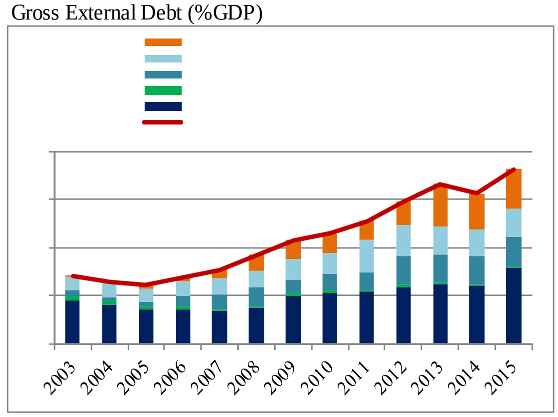
FDI Inflows in South East Europe (%GDP)



Source: UNCTAD

External debt has reached historical peaks…

Gross External Debt (%GDP)

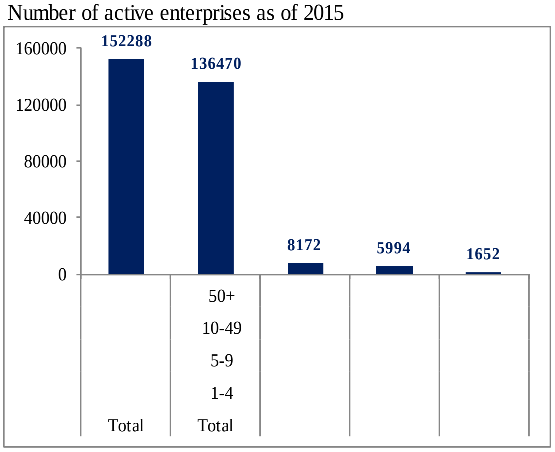


Source: BoA, IMF

Figure 3: Real Sector Outlook

152,288 firms operate as of end-2015…

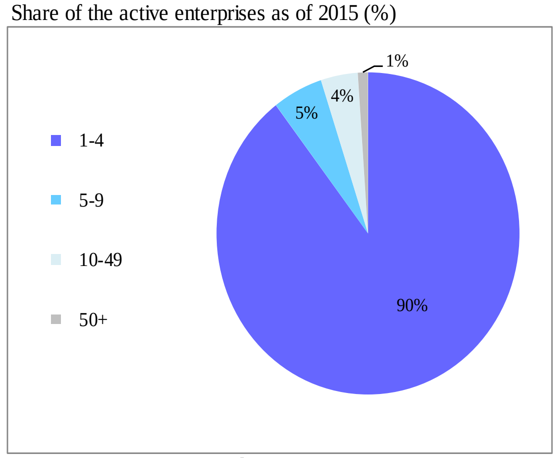
Number of active enterprises as of 2015



Source: INSTAT, Statistical Business Register

95% of firms are small-sized (<10 employees)…

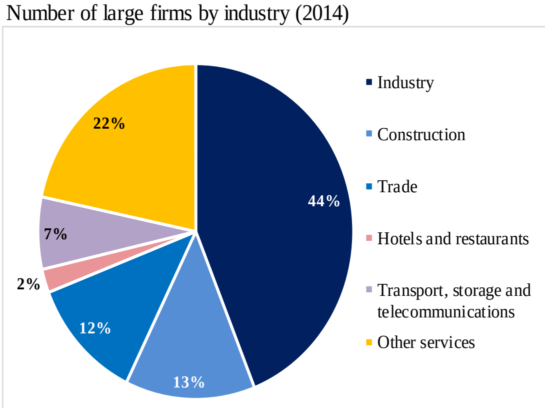
Share of the active enterprises as of 2015 (%)



Source: INSTAT, Statistical Business Register

Large firms operate on industry, construction and trade…

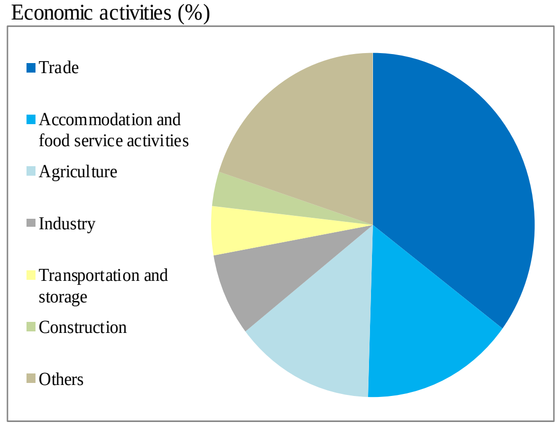
Number of large firms by industry (2014)



Source: INSTAT, Structural Survey of Enterprises

70% of firms work in services…

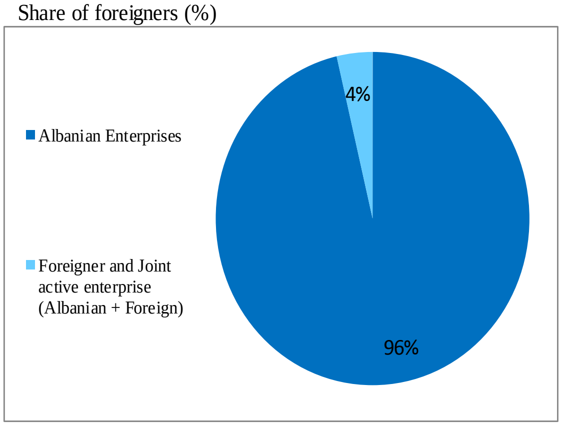
Economic activities (%)



Source: INSTAT, Statistical Business Register

Share of foreign firms is limited…

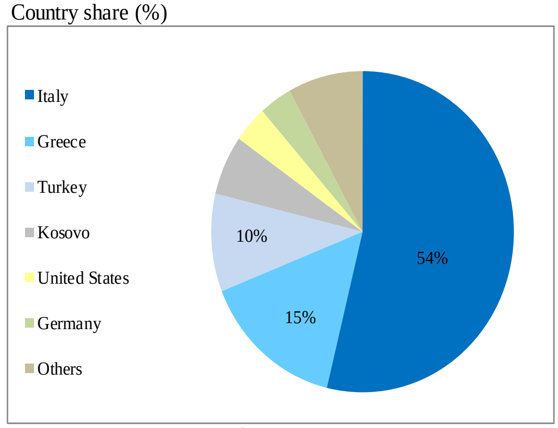
Share of foreigners (%)



Source: INSTAT, Statistical Business Register

Italy, Greece and Turkey are the biggest investors…

Country share (%)

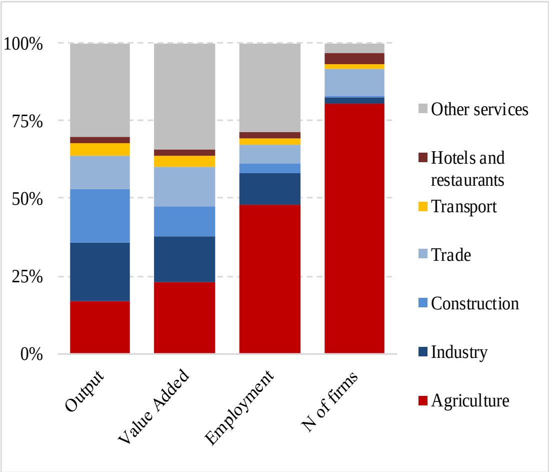


Source: INSTAT, Statistical Business Register

Figure 4: SMEs Outlook

Agriculture represents more than 75% of SMEs and around half of of SME employment but little output…

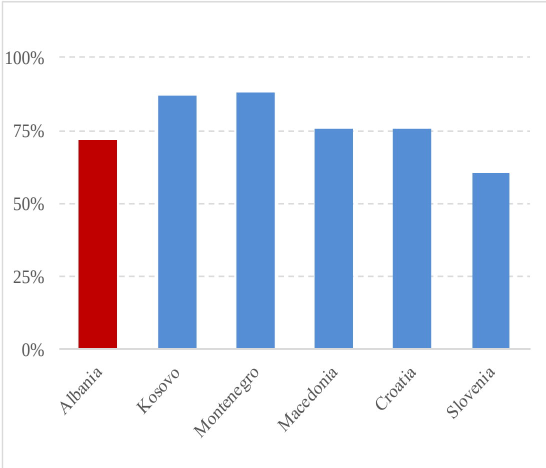
Share of output, value added, employment, firms, by sector (2014)



Source: INSTAT, Structural Survey of Enterprises

SMEs are most often family businesses

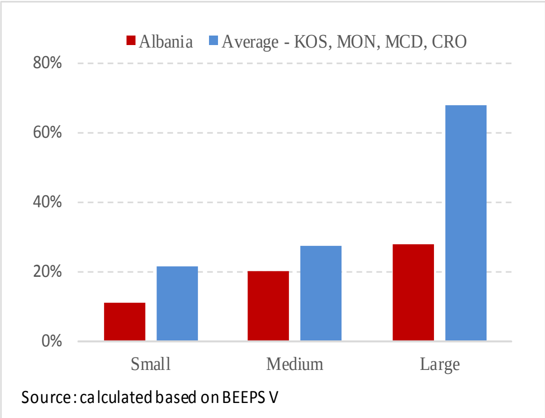
% of SMEs owned by single local owner



Source: EBRD, BEEPS V

Weak quality of financial statements…

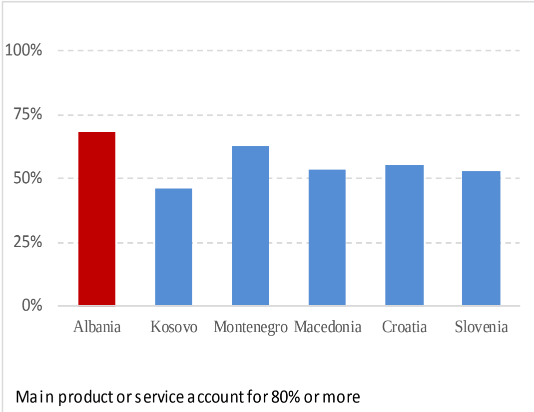
% of firms having audited financial statements



Source: EBRD, BEEPS V

Diversification is low…

% of SMEs with undiversified sales*

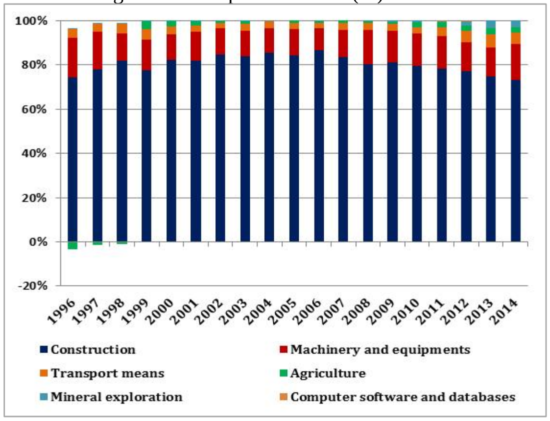


Source: EBRD, BEEPS V

Figure 5: Investment Outlook

Main driver of the investments is construction…

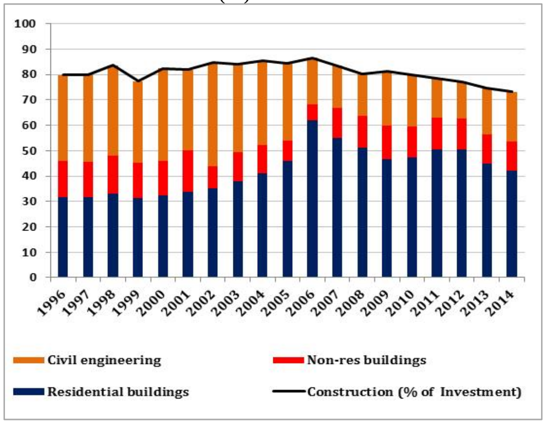
Structure of gross fixed capital formation (%)



Source: INSTAT

Residential buildings have the highest share in construction…

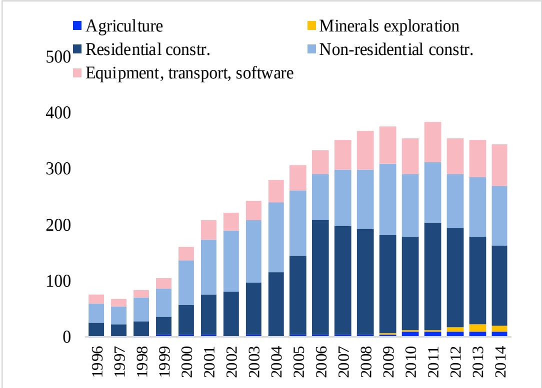
Structure of construction (%)



Source: INSTAT

Decline in residential construction…

Investments by purpose (bn ALL)



Source: INSTAT, Structural Survey of Enterprises

Outside the housing sector, investments are very concentrated…

Selected industries (values in mln US$)	Investments	o.w. SME	o.w. Large	Employment	Value Added	2010-14 growth	GVA per employee
Electricity	470	107	363	7,984	227	-6.0%	28
Extraction of oil and gas	338	27	311	3,736	429	15.9%	115
Construction of buildings	201	117	83	17,360	303	-7.1%	17
Telecommmunication	119	5	114	5,241	119	-7.9%	23
Wholesale trade	111	94	16	29,836	433	3.1%	15
Manufacturing excl. fason	70	37	32	30,547	411	0.9%	13
Retail trade	59	48	11	20,503	256	1.2%	12
Fason	20	4	15	34,284	200	6.5%	6
Hotels and food services	12	8	3	19,500	131	-3.0%	7
Office support services (call centers)	9	1	7	16,593	125	27.3%	8

Source: INSTAT, Structural Survey of Enterprises

Figure 6: Financial Sector Outlook

16 private banks in the financial system...

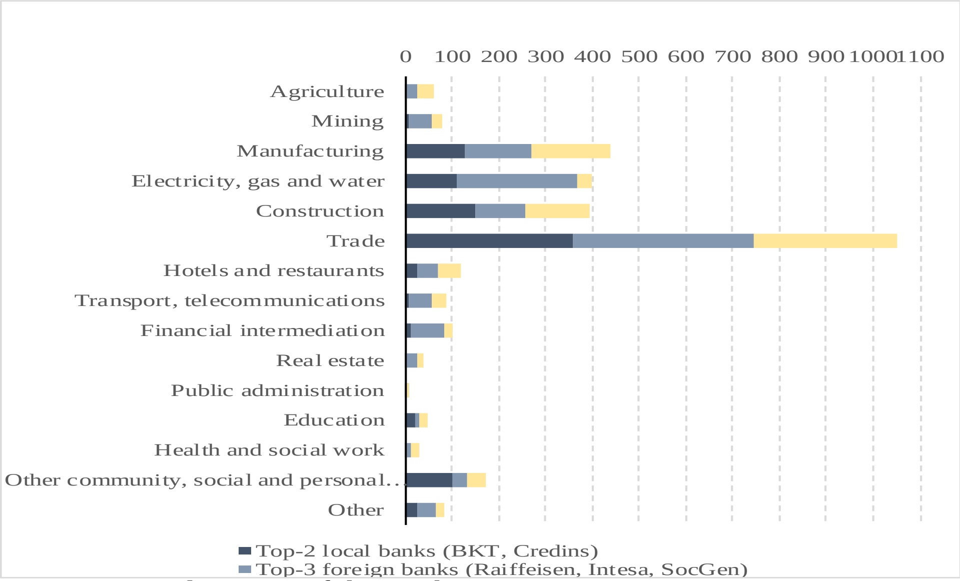
Selected Indicators of the banking system (2015, mn USD)

Bank	Country	Total assets	of which Loans	Securities	Loans to banks	Deposits
BKT	Turkey/local	**2,730**	917	1,113	406	**2,223**
Raiffeisen	Austria	**2,304**	909	609	530	**1,963**
Intesasanpaolo	Italy	**1,185**	357	448	311	**945**
Credins	Local	**1,150**	689	152	121	**981**
Tirana	Greece	**649**	296	162	90	**508**
SocGen	France	**582**	327	158	10	**473**
Alpha Bank	Greece	**550**	285	133	69	**439**
NBG	Greece	**310**	234	41	18	**211**
Union	Local	**302**	133	108	4	**251**
ProCredit	Germany	**279**	178	19	25	**227**
ABI	US	**210**	79	4	12	**182**
Veneto	Italy	**207**	127	5	40	**170**
FIBANK	Bulgaria	**135**	49	58	10	**117**
ICB	Malaysia/Switz	**75**	32	27	2	**55**
UBA	IDB	**50**	18	2	16	**37**
CBA	Kuwait	**16**	2	1	12	**5**
Total		**10,734**	**4,631**	**3,039**	**1,673**	**8,785**

Source: AAB

Bank loans are concentrated in traditional segments of the industry

Loans outstanding ($ mln.) in 2015, by industry

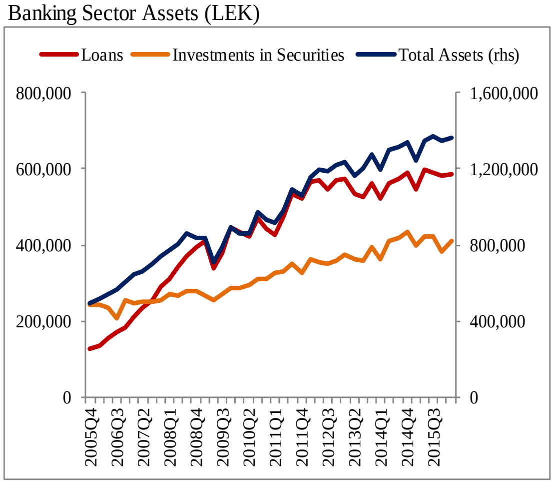


Source: Annual Reports of the Banks

Figure 7: Credit Supply - I

Nominal increase in total assets….

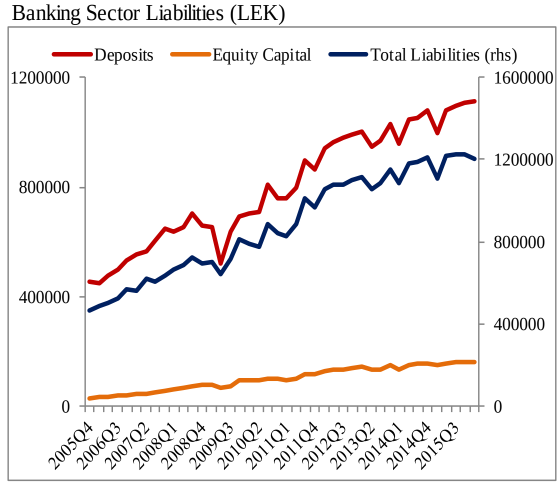
Banking Sector Assets (LEK)



Source: AAB

Nominal increase in total liabilities….

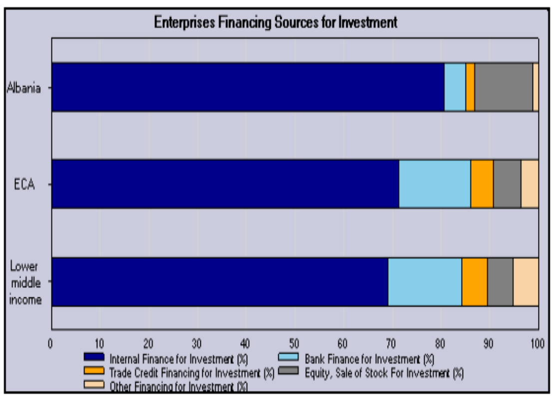
Banking Sector Liabilities (LEK)



Source: AAB

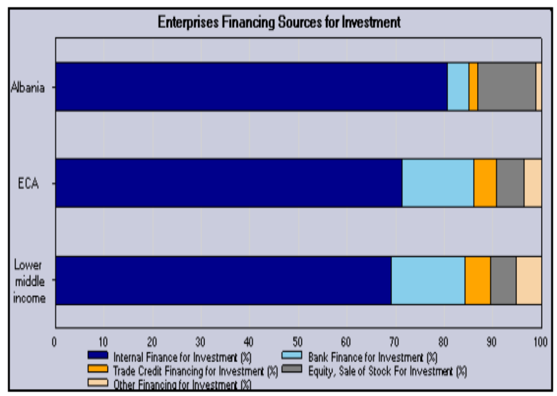
Firms rely on internal financing, share of external financing is low…

Financing sources of investments



WB, Enterprise Survey (2013)

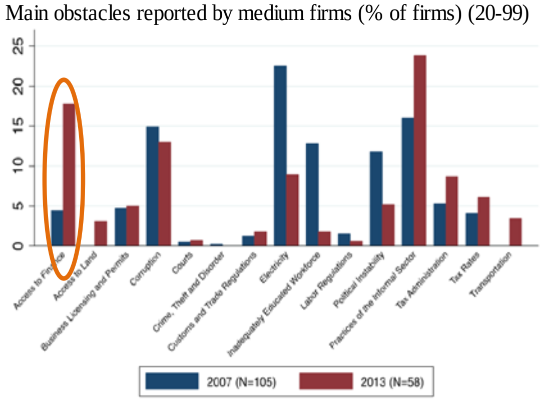
External Financing



WB, Enterprise Survey (2013)

Access to finance has emerged as one the main obstacle reported by the medium firms…

Main obstacles reported by medium firms (% of firms) (20-99)



Main obstacles reported by large firms (% of firms) (100+)

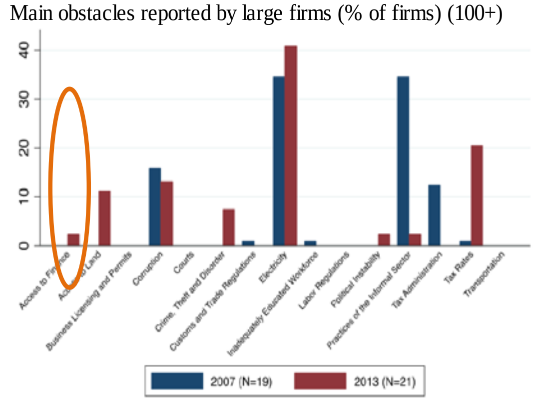
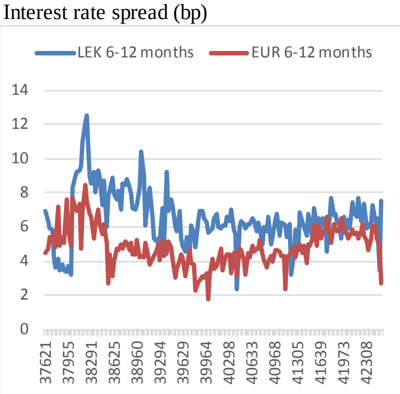


Figure 8: Credit Supply – II

Spreads present noisy picture…

Interest rate spread (bp)

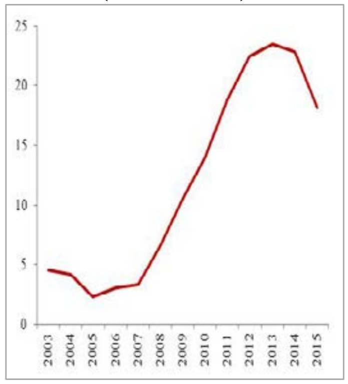


Spread= Lending rate - deposit rate

Source: AAB

High NPL ratios...

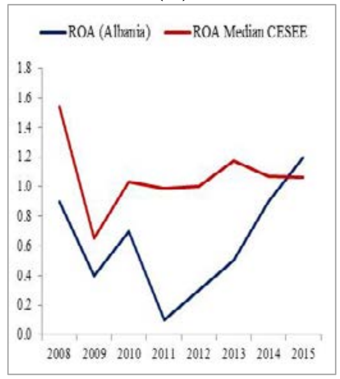
NPL ratio (% of total loans)



Source: BoA

Low banking sector profits…

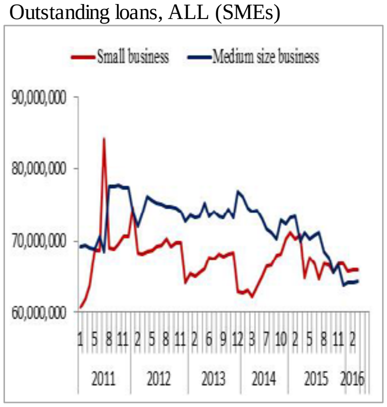
Return on assets (%)



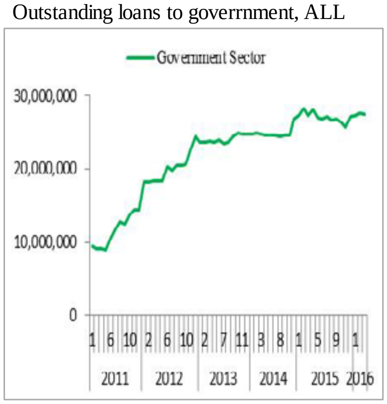
Source: AAB

Declining trend in "outstanding loans" to the SMEs; banks primarily finance government sector and large enterprises…

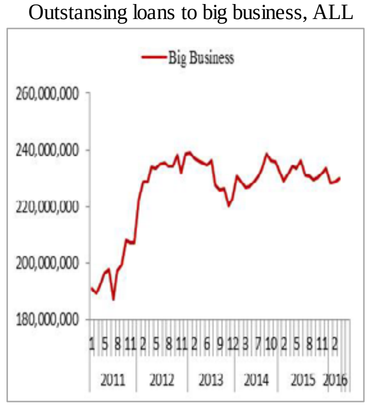
Outstanding loans, ALL (SMEs)



Outstanding loans to goverrnment, ALL



Outstansing loans to big business, ALL



Source: BOA, AAB

Credit constrained SMEs more than doubled compared to pre-crisis period…

Credit constrained firms (pre vs. post crisis)

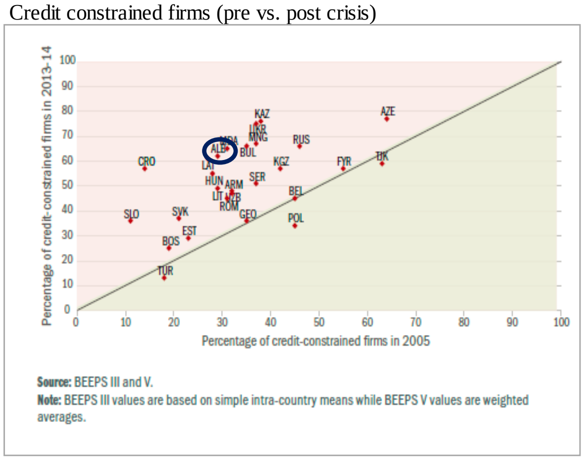
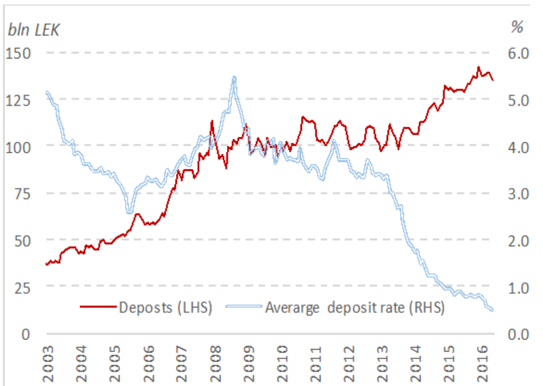
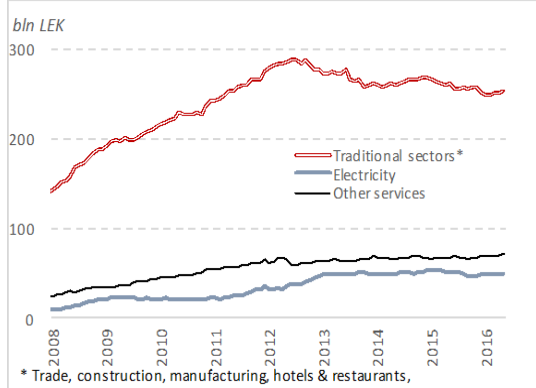


Figure 9: Credit Demand - I

Corporate deposits up by 40% from 2013 despite low rat
Corporate deposits and interest rate (average for EUR and LE



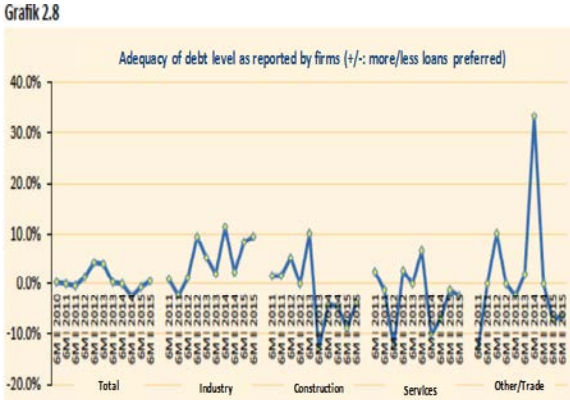
Traditional segments of private sector reduce their debt level
Corporate loans by sectors



Source: Bank of Albania statistical database, own calculations

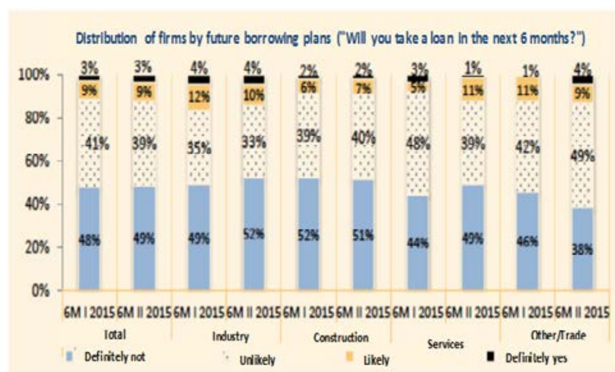
78% of firms report their level of borrowing as adequate…
Net balance of firms' assessment of their level of borrowing

Grafik 2.8



…and are not planning to take a new loan
Distribution of firms by borrowing plans

Grafik 2.23

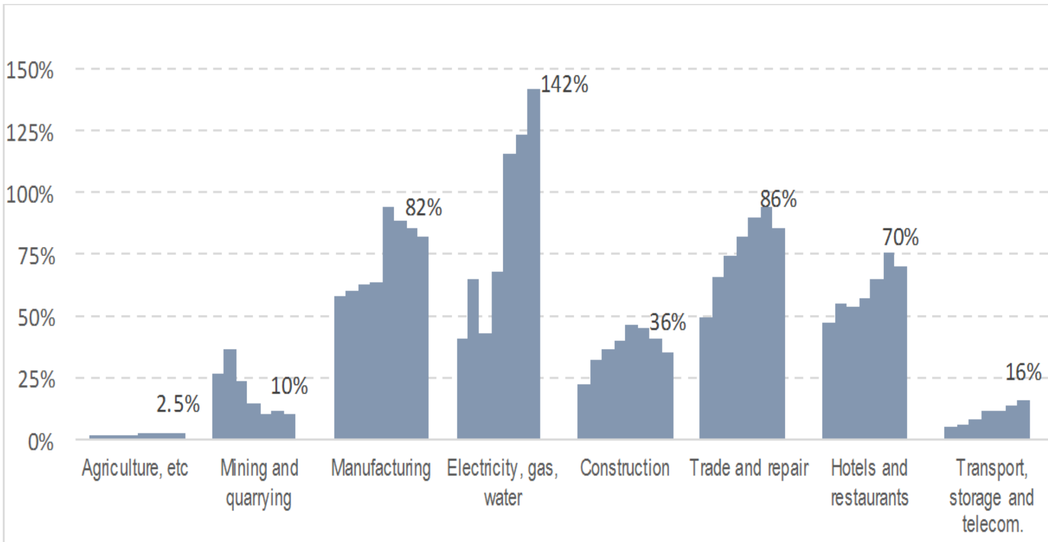


Source: Bank of Albania Survey on Household and Firms Financial Situation and Borrowing, 2015

Figure 10: Credit Demand - II

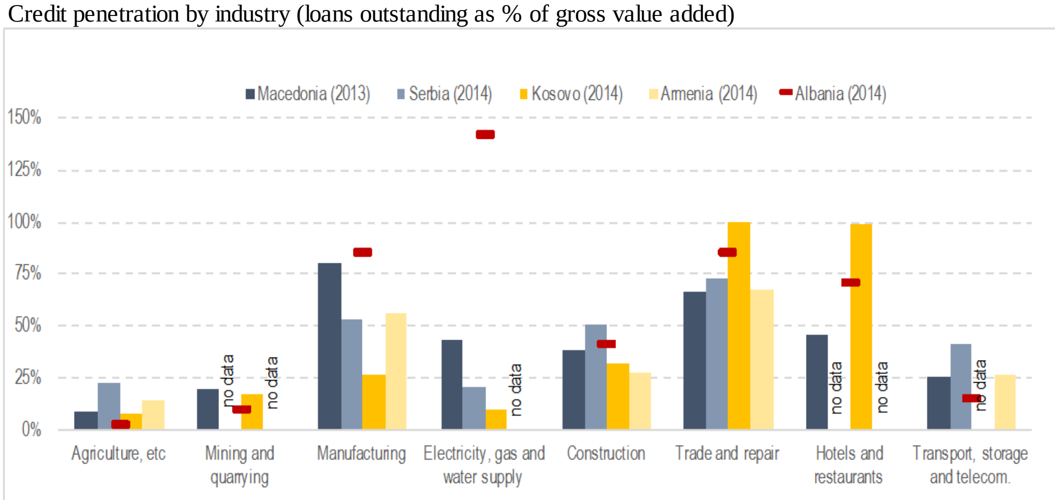
Traditional segments of the private sector are already leveraged

Bank loans outstanding as % of value added (2008-2015)



By regional standards traditional sectors are well penetrated, while agriculture seems underserved by banks

Credit penetration by industry (loans outstanding as % of gross value added)



Source: central banks and statistical agencies of Albania, Macedonia, Serbia, Kosovo, Armenia; own calculations