

## The Financial “Tsunami” of 2008 and its Effects on the Albanian Economy and Financial System

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**Abstract.** This paper will take in consideration the current situation of the Albanian financial system after two decades of transition towards market economy and analyzes the barriers and challenges that lie ahead on the path of development. The analysis considers three segments of financial system: banks, debt market and capital market, without underestimating none of them. Based on the experience of developed countries we have given some consideration and have observed several problems related to the role of the financial system and economy as a whole.

After financial “tsunami” of 2008 the Albanian economy, the financial system is faced to global financial crisis and also faced to consequences of it. That’s one more reason to be more careful now, especially, about banking sector. But how will be transmitted to and affect the financial crisis of 2008 in Albania? What about the financial system and especially the banking sector in Albania after global crisis? Which are the determinants of crisis? Actually Albanian economy has felt a limited impact from global financial crisis. Slow integration to the global markets ,the prudent economic policies and the lack of financial markets have eventually spare Albanian economy by financial crisis but not so much from economic crisis.

**Key words:** financial crisis, financial system, transmission channels.

### Introduction

The structuring of financial system has been a key element of transition reforms. Over 20 years of transition, Albanian financial system and its structure has gone through successes and failures. The successes and failures of this transformation depended from ability to create the conditions that not only maintains macroeconomic stability, but also support a democratic and stable political environment. During 1990s, our country has experienced deregulation, foreign bank penetration, the efforts to create and incite financial markets, and an accelerated process of consolidation and competition in the banking sector. This development of financial system can’t be isolated by historic, political and economic environment where it operates, inside and outside of the country. Currently, the world is faced to global financial crisis of 2008 and consequences of it. Some financial crises have a little effect outside of the financial sector, but the others play a key role in decreasing growth in the rest of the economy. Since the current financial crisis began to spread across the world, questions about its potential consequences on economies began to surface.

The impact of the economic crisis has gone through to all major sectors of the economy, although the magnitude of the impact varies from sector to sector. The depth and size of the downturn depends on the extent of integration of these sectors with the world economy.

### 1. A historical approach of Albanian Financial and Banking Sector.

#### 1.1 Before 1990 Banking Sector

The structure of the banking system in Albania prior to 1992 was typically of a centrally planned economy. In the Albania before 90', the bank deposits were the only tool of saving and the only way of the individual investment too. On the other side, the only source of external financing of the state’s enterprises sector were the credits given by a central planning institution based on decisions relating

to the planned levels of investment and production of these enterprises. Bank of Albania, as the only bank that operated in that period, not take decisions regarding the allocation of loans and not take into account the credit risk assessment.

**Thus there were no equity instruments and corporate markets.** Till 1989 no changes happened in the banking system. The system was characterized by a monobank - State Bank of Albania functioned as central bank and commercial bank too. As a central bank, it was responsible for issuing currency, supervision of monetary policy and fulfill the needs of state enterprises for credit and money depositing by keeping their accounts. Another bank that operated in the agricultural sector was Agricultural Bank.

### **1.2. Post '90 Banking System...**

Important first step in reforming of the Albanian banking system was splitting of monobank system and creation of a two-tier banking system. This reformation was became a reality through the law of the Bank of Albania, approved by Parliament in April 1992. Law of 1992, set up a wide autonomy for Bank of Albania. The adoption of the new legal framework of banking system in 1992 marked the creation of a new banking system with the Bank of Albania as a central bank, as the existence of three state banks, on the second level, Savings Bank (SB) National Commercial Bank (NCB) and the Agricultural Commercial Bank (ACB). Commercial banks of second level inherited the activity of former banking sector.

The entrance of new private banks began on 1992-1993, but in this time they had a restricted activity and no more clients. They began to work intensively after 1996. So for a long period the group of state-owned banks have dominated the market.

The last step in process of transformation of banking sector was privatization of the largest state-owned banks too. The privatization process started in 1995 when the law "on privatisation of banks" was approved by parliament.

The original programme of the privatisation of banking sector has foreseen fast privatisation however the process turned out to be much slower than planned, mainly due to its political sensitivity. 10 years after the entrance of the first private banks in the banking sector, the dominance of state-owned banks was still considerable. Savings Bank was dominant on the whole performance and almost all activities of the banking system, like as credits, deposits and treasury bills. *Dilemma: Liquidation – Reconstruction – or Privatization* relating to following performance of state-owned capital banks, after financial crisis of 1997, caused by pyramid schemes awaited to be solve. The next steps were: Agricultural Commercial went into liquidation and its assets was distributed to other banks, while bad loans, were transferred to the Agency of Credit Restructuring; National Commercial Bank was privatized too, after a long debate to be liquidated or privatized; and finally after a restructuring process before privatization Savings Bank was privatized. The privatization of SB has been a difficult challenge and was faced successfully at the end of 2003. Actually there are 16 banks that act on banking sector, all private and 14 of those have foreign capital ownership.

*Observation 1. The privatization of the banking sector in Albania and the banking system reformation are related directly, considering the other indicators ceteris paribus. Albanian banking system is characterized by a continued increased trend, both in terms of number of private banks and in reformation of banking activity.*

### **1.3. The challenges of Albanian Financial System during the Transition.**

We can distinguish three important segments of the financial sector: banks, debt market (the loans of the private sector) and equity market. The structuring of financial system has been a key element of transition reforms. During 20 years of transition Albanian financial system, has gone through impressive changes, successes and failures, transformation, reformation and consolidation and changes in the institutional framework too.

On economics theory are well-known two main patterns of financial sector structure:

- Bank dominated financial sector
- Capital market oriented financial sector

*Observation 2. After two decades of transition, we confirm that the Albanian financial sector structure belongs to the first pattern “Bank dominated financial sector”.*

Although the banking sector dominates the financial system, the other segments debt market and equity market, should not be undervalued and underdeveloped.

For many years economists have shown their appreciation vs. the advantages of the bank dominated model, but on the other side the underdevelopment of the financial markets, may impede a normal development of market economy.

Albania characterizes by a low scale of development of financial market. Capital market doesn't exist. Practically no securities transactions are executed in Tirana Stock Exchange. The only securities being trade are T-bills, and the T-bills market has functioned as a pure money market. T- Bills are trading from Central Bank as means to finance budget deficit.

*Observation 3 .The financial system almost can be identified by the banking sector. The banking sector dominates the financial system. The financial markets are undervalued and not developed.*

It is well known fact that the financial markets and especially the stock market provide a very important source of capital for economic operators. To measure the financial system performance, a very important indicator is stock market capitalization too. But in Albania, this indicator is not calculated. This is not related to the lack of the data but with the fact that in **Albania Tirana Stock exchange doesn't function**. Until now all attempts to develop this market have been concentrated only on the formulation of laws and constructions of institutions that will participate in it.

*Observation 4. The stock market capitalization almost doesn't exist. Albania is the only country in Europe where Tirana Stock Exchange does not function as an official stock market.*

The failure of mass privatization is one of the reasons that the stock market was not able to function properly.

An important relationship exists between the development of the capital market and the massive privatization process

Almost in all the Middle-East European countries the developing of the capital market has occurred parallel with the massive privatization process. The capital market is independent and follows the privatization process. This at least means that the difference in the ownership causes, stimulate the necessity of specified markets.

The influence of the privatization in developing of the capital market consists in two directions:

- In composing the privatization scheme in the way that the public supply plays a big role.
- Through incentives, by creating of investment funds that offer to their investitures the possibility to take part in stock exchange without the need of special knowledge for it.

Mass Privatization in Albania is biased on the delivery of vouchers to people without paying for them. The instrument used for the realization of this method was public auction. This method will results on quick transfer of ownership from state to new shareholders and indirectly it should foster the development of capital markets. However, in Albania, from the first 20 companies privatized through vouchers there are companies in which all the shareholders have 1-10% of shares. Whereas, there are others, where individuals possessed 40-50 % of the shares.

*Observation 5. The under-developed Albania financial market reveals that the privatization methods applied in Albania, has not accomplished a good impact in developing of the financial markets.*

*Why the Albanian method of privatization, didn't stimulate the development of the capital market?*

Meanwhile, it can be clearly concluded that the Albanian model of privatization did not achieve its goals towards the creation and the consolidation of the capital market. This is related to some characteristics that had Albanian model of privatization in comparison to the other countries.

- During of privatization process only a small part of vouchers have been used.
- Vouchers as securities were easily tradable in open market not in stock exchange. Those who possessed the vouchers can exercised their right to buy shares in companies and in turn can sell them to the free market for cash. The emergency for money and the lack of information about the mechanism of using these instruments, made them sell vouchers almost immediately in the free market increasing its supply. Meantime the Stock Exchange was not established and there were no other options in the market; and till November 1996, foreign investitures were prohibited by law to participate in the privatization of enterprises through the vouchers.
- The function of the Investment Funds as financial intermediaries has not been accomplished. Three Investment Funds were registered; “Anglo-Adriatica” Investment Fund, “Shqiperia e Re” investment Fund and “Nobel” investment Fund .The existence of a free vouchers market, at the same time, created a parallelism between the Investment Funds and them. From one side Investment Funds were subject of many limitations imposed by the law, while in the other side the other institutions and persons which were not subject of such limitations, could freely collect and invest vouchers.
- Devaluation of vouchers-the securities in the opened market was considerable too. Devaluation of them could happen for some technical and conceptual reasons too, related to the lack of experience and the actual stage of economic reform development in Albania. Opened market attracted the vouchers at a low price that varied from 15-25 % of their face value. The exchangers that operated with vouchers were only brokers. They profited just the price difference because they did not invest the vouchers directly in buying of stocks in auction.
- The public didn’t put their trust in such securities. This is related with the deficiencies in providing the information and education to the public about the process of mass privatization too.

*Observation 6. The lack of the developed financial markets encouraged the informal markets.*

There are some reasons that encouraged the informal markets:

- The contradiction between the needs of economy for credits and fragility of banking system to fulfill the needs.
- The restrictive monetary policy followed from Bank of Albania through the direct instruments has made difficult the lending process too.
- Increase the volume of transactions in the foreign currency markets.
- The money sending from abroad, remittances, was easier to use in the exchange informal markets.

The lack of a functioning formal banking system, combined with an inadequate regulatory and supervisory framework, contributed :

- to invest in gray economy- which translates into less savings available to invest to official economy;
- to keep money under mattresses-which translate into fewer saving to invest;.
- to incite the mushrooming of informal financial schemes during the 95-97’ years. These included the pyramid schemes , the collapse of which triggered the civil crisis that erupted in early 1997, which eroded many of the achievements made during the early years of transition. However the events triggered by the collapse of the pyramid schemes may have represented a break-point for the reform of the banking sector. After this situation ,in Albania, banks and capital market suffered the lack of public confidence.

**Lastly something about the non-banking financial intermediaries.** In Albania has been not so good progress with development of non-banking financial institutions. Non-banking financial intermediaries in Albania presents from:

- Insurance market
- Pension Fund
- Social Insurance Institute
- Private Pension Fund

*Observation 7. The non developed financial markets in Albania naturally associated with under-developed of non-banking intermediaries.*

Actually there are ten insurance institutions operating in Albania. The main characteristic of the Albanian insurance market is the predominance of the local capital (nearly 85 %). The Insurance Institute INSIG was the first public financial institution in the area of the nonbanking intermediation. It was created in 1991 as a public company of insurances, creating the opportunity that the insurance activity to be considered and practiced for the first time in Albania. The entrance on the insurances market of the first private companies “SIGMA” and “SIGAL” created a new situation in this area, where the competition begun to be evident. The licensing of the insurance private companies was a necessary process for the proceeds and the efficiency of this system.

The main characteristics of insurance market are:

- Insurance market, differently from other elements of financial system, is relatively new element for the Albanian economy.
- Revenue structure is highly concentrated on engine primes and property (95%) while life insurance has only 5%.
- Until the 2004, the insurance market was totally dominated from the local capital.
- There is still legislative and institutional instability.
- The insurance companies with local capital are directed and managed by their owners.
- Insurance market has expanded its activities in the other countries of the region too.
- Foreign companies, mainly Austrian ones, but also Greeks and Italians, have invested in the insurances market in Albania.

Another form of the nonbanking intermediation are the pension funds.. In Albania until to 2006 the only institution that deals with social insurance is “Social Insurance Institute”. So for a long period the “Social Insurance Institute” with state-owned capital is dominating the market. The entrance of three private pension funds began on 2006. Present all over the world, the pensions private schemes have resulted to be the best alternative for all they who does not consider enough the revenues offered as a pension from the public scheme.

The pension private funds are closely related to the capital markets functioning. The action is mutual. The capital markets can create the conditions to canalize the investments of the pension funds, on the other hand the private pension funds can be an important source of investments in these markets, too.

The better ways to achieve this pension fund investment that act dependently from the no developed financial markets, and also to minimize the above risks are:

- The international capital markets investments
- The T-bill investments with 0 risk or state obligation investments

Concluding, financial sector structure in Albania like as the others transition economies differs from that in developed countries:

- During the last 20 years of transition the market structure of banking sector has changed significantly. Our banking sector has gone through liberalization, privatization, foreign bank penetration, and an accelerated process of consolidation and competition in the banking sector. Banking sector remains the most dominant segment on the Albanian financial System. After two decades of transition, the Albanian financial sector be classified as a model that “*The financial sector is dominated by the banks sector*”.

- Capital market is under-developed and non- estimating. Capital markets barely exist and regulatory capacity remains weak. Albania’s capital markets remain embryonic. The Tirana Stock Exchange was established in 1996, but no companies have yet been listed. . A natural first step would be the establishment of a secondary market for government bonds (and at a later stage for corporate bonds).

- Debt markets are hugely underdeveloped and they hardly exist. In late 2007, the stock of outstanding loans to the private sector was still a mere 28 percent of GDP. Credit is constrained by difficulties to assess credit-worthiness (a credit registry does not yet exist), the lack of collateral (especially land titles) and limited institutional.

- Insurance: Albania has ten insurance companies, three of which provide life insurance. With a total premium income of less than one percent of GDP the sector is even less developed than in neighboring countries. Growth has been volatile in recent years and amounted to about 6 percent. State-owned insurance company INSIG enjoyed a monopoly until the late 1990s, but competition has reduced its market share to 20 percent. Since 2005, Albania has two private pension funds, but as the pension system lacks a compulsory private pillar, this segment of the capital market is also slow to evolve.

## **2. The current situation in Albania pre and post financial “tsunami” of 2008**

In nowadays, we are faced to global financial crisis and also faced to consequences of it. Some financial crises have little effect outside of the financial sector, like the Wall Street crash of 1987, but other crises are believed to have played a role in decreasing growth in the rest of the economy. Since the current financial crisis began to spread across the developed world, questions about its potential consequences on different economies or developed and developing countries began to surface. Initially, the discussion is focused on the existence of a possible decoupling of business cycles. Currently the debate centers rather on the intensity of the impact, that is, whether the outcome will turn out to be a significant slowdown of growth or a recession, and on the possibilities of the region’s governments to effectively find solutions to overcome the crisis. From another point of view, one fact is evident: the current financial crisis in rich countries is transmitted as an adverse external shock to many developing countries.

**But what about Albania like** one of Europe's poorest countries? **After financial “tsunami” of 2008** the Albanian economy has undergone the global crisis “fairly well so far”.

### **2.1. Macroeconomic situation in Albania**

During the last years macroeconomic situation in Albania in contrast to most other transitional economies, is almost accompanied by rapid non-inflationary economic growth. These years, Albania has continued to pursue a policy of an economic permanent development as demonstrated by macroeconomic data. Albania's economy had resisted shocks waves from the global financial crisis and is estimated to have grown by about 6% in 2008 and and have registered some 3 percent growth in 2009 too. Despite severe economic downturns and confidence shocks in much of Europe and other advanced economies, and associated drops in Albanian exports and remittances, Albanian GDP is estimated to have registered some 3 percent growth in 2009. The budget deficit rose from 3% of GDP in 2007 to 5.7% in 2008, and 7 % in 2009. This is not only due to huge expenditures from state budget for investment in infrastructure, but due to high expenditure of electoral campaign of elections of June 2009 too. This was an important factor in pushing public debt to close to 60 percent of GDP (59.5% of GDP in 2009), and in 2009 generated an accumulation of expenditure arrears of 0.4 percent of GDP. These trends risk crowding out private investment and undermining debt sustainability. Inflation had been anchored at the level of 3 percent, which is the target of the Bank of Albania. (Annual Reports of BOA. 2008,2009) The channels that expose the Albanian economy most to the shocks from the world economic environment consist of falling hard currency inflows and the tightening of financing in general.

### **2.2. The situation on Albanian Financial System**

The structuring of financial system has been a key element of transition reforms. The main features of Albanian financial sector structure that helps it, to deviate the financial crisis and to keep in check, its effects are :

(i) The dominance of banking sector in Albanian financial system, and embryonic developments of the other segments of financial system. The privatized banking sector is highly concentrated. The Albanian economy is still largely cash-based.

(ii) The financial markets are not developed. Practically no securities transactions are executed in Tirana Stock Exchange. The only securities being trade are T-bills, and. T- Bills are trading from Central Bank as means to finance budget deficit. We observe that primary market for government

securities is well-developed vs. secondary market for government treasuries that are poorly-developed.

(iii) The foreign exchange market remains the more highly developed market while the derivatives are almost never used by corporations.

(iv) Debt markets are hugely underdeveloped and they hardly exist. Credit is constrained by difficulties to assess credit-worthiness, the lack of collateral (especially land titles) and limited institutional framework.

(v) The lack of financial market complexity it means restricted sources for investments and lack of diversity of broad spectrum of financial services. The lack of capital market bring that speculations are rather limited. The majority of individual's savings are still channeled into T-bills.

(vi) The banking sector diversification is almost non-existent. The sources of bank's profit are acquired from very high interest rates of loans for mortgages or from investment on the treasury bills. The lack of investment in foreign assets characterizes banking sector. The banks are centered in the domestic market, and only 10% of their portfolio is invested in foreign markets.

(vii) The non-developed financial markets in Albania associated with under-developed of non-banking intermediaries restrict the activity of financial crisis in a broad spectrum.

### **2.3. How will be transmitted to and affect the financial crisis in Albania?**

We will be conscious the situation post crisis from three main channels that will be discussed here:

(i) Banking failures and reductions in domestic lending, (ii) reductions in export earnings, and (iii) reductions in financial flows to Albania.

(i) The biggest initial fear from crisis was financial contagion. In Albania foreign owned banks are significant players on banking sector although there are no bankruptcy of banks. Between end-September and mid-December 2008, 8 percent of banking system deposits were withdrawn and are only gradually returning. Immediately post financial crisis, Albania in October 2008, suffered a run on its Banks that were followed by banking panic. Banking panic ended in January, but was not accompanied by a significant increase in deposits. The lack of liquidity remains the biggest problem, despite strong interventions by the Central Bank. There are high levels of non-performing loans, about of the 6.4% on 2008 and 10.4 % on 2009. During last year, banks have mostly financed businesses involved in trade activities(38.1%), industry (26.1%) and construction(21.1%). Agriculture remains the least financed sector by the banking sector, absorbing only 1.2% of business credit. Reductions in bank lending will have the impact of reduced investment, lower growth and an increase in unemployment.(13% in 2008 – LSMS, 2008 INSTAT). "After an 11-month period, the banking system's performance is presented stable. The position of liquidity in the market has recovered substantially and bank deposits have grown at stable rates as a result of the improved public confidence"-declared the governor of Bank of Albania on press conference on march 2010.

(ii) The crisis is likely to lead to a substantial decline in exports earnings. This will be results of a decline of commodity prices, a decline in demand for exported good from Albania to the other countries and a decline in tourism. Relating to earning from tourism, there are no decline in it. Tourism has been boosted significantly by ethnic Albanian tourists from throughout the Balkans. Otherwise Albania's trade imbalance is severe. Albania continues to be an import-oriented economy and the export base remains small, narrow, and undiversified, due mainly to a lack of price competitiveness, poor infrastructure, and a challenging business environment. In 2008, Albanian imports amounted to \$5.25 billion and exports were \$1.35 billion.(World Bank's Poverty Assessment 2008)The trade deficit continues to widen and, according to the estimates of the Ministry of Finance, reached 26% of GDP for 2008, up from 23.3% in 2006. In 2009 comparing with 2008 the imports fell down to 2% ; the exports with 8.6%. while the trade deficit increased with 2%(INSTAT Albania).

(iii) Albania as a developing country needs financial inflows from the other countries or international organizations to facilitate and accelerate economic growth, trade and development. These flows include :investment flows including and foreign direct investment(FDI), trade credits and flows of remittances. Remittances from Albanian emigrants fell 16 percent in 2008 compared to 2007 and by

6.1 per cent to 394 million euro during the first half of 2009, compared to 2008, data published by the central bank. But despite the financial crisis in countries where Albanians are employed, remittances have remained high. The reasons are the high deposit interest rates (for one year deposits) in domestic currency (6% in Lek) and foreign currency (5% in Euro and 2% in USD) that attract emigrants to bring their money in homeland.

On the other hand, Albania had a positive growth rate of FDI flows in 2008 versus 2007. FDI growth in 2008, showing a 45% growth in FDI flows (UNCTAD World Investment Report 2009). The significant growth in FDI flows, is mainly due to the “privatization of large previously state-owned companies and improvement of the business environment” says the report, in its chapter focusing on the South-East European region. So FDI in Albania contributes to positive economic growth, and are a source of capital for developing countries such as Albania but recorded not a high figure account for GDP, only 7.6 % in 2009. (World Bank Report 2009).

**Final Observation :** *Actually Albanian economy has felt a limited impact from global financial crisis. Slow integration to the global markets ,the prudent economic policies and the lack of financial markets have eventually spare Albanian economy by financial crisis but not so much from economic crisis.*

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