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Financial System & Its Financial Stability

Abstract

The events of the past few decades, particularly those in the 1990s, emphasized the significance of financial stability as a key challenge and a crucial goal for monetary authorities worldwide in their economic policies. Despite the focus and abundant scholarly literature on the topic, it is challenging to pinpoint a universally recognized concept of financial stability. Financial stability is defined by leading scholars and colleagues as a collection of decisions and policies that address macroeconomic, monetary, supervisory, and regulatory aspects of financial markets simultaneously. After conducting a study on financial stability, I can summarize it as the state in which the economy's mechanisms for evaluating, distributing, and managing financial risks operate well, leading to a strong economic performance.



This notion suggests that the financial system can effectively perform three primary roles simultaneously.

- Firstly, to effectively allocate economic resources throughout time.
- Secondly, to precisely recognize and handle financial risks.
- Thirdly, to calmly absorb unexpected events and disturbances from financial markets and the actual economy.

Keywords: Financial, Money, Bank

1. Introduction

"Modern currency is no longer based on precious metals like gold. It is no longer a necklace made of shells, tobacco leaves, or a group of animals. Money is defined by economists as a "means of payment" that is exchanged for commodities and services. Bank of Albania

Money is the medium of exchange used to buy goods and services. Advances in financial technology have expanded the types of assets that can be classified as money or methods of payment. Payment methods vary in terms of return to liquidity time, expenses, form, usability, transaction speed, and other factors.

The presence of a substantial informal economy has consistently hindered the expansion of the Albanian economy. The estimates, estimated by the Bank of Albania, are concerning and are considered to represent 30–60% of GDP. Currently, over 30% of currency is in circulation outside the banking sector, which is 10% higher than in comparable transitioning European countries. Based on these indicators and analyses by local and foreign experts, Albania has shown a relatively stable economic development trajectory. However, the country remains entrenched in a cash-based economy, with a significant portion of transactions conducted in cash and limited circulation of money through the banking system.

Tax authorities and social security do not keep records of the informal relationships and activities carried out by self-employed people or families that operate without licenses. Furthermore, each of them disrupts the market by providing their own goods or services at a competitive price, often attracting a more affluent customer base than licensed and tax-compliant businesses. The effects on macroeconomic, microeconomic, and social issues are what determine negative consequences. High tax rates can diminish the tax base and overall tax income by impacting activities beyond the formal economy. The decrease in revenue leads the government to increase taxes and, in cases where the informal economy is significant, reduces the quality of goods and services. Insufficient tax revenues may lead governments to resort to funding through Treasury bonds or fresh currency issuance, thereby destabilizing the economy. The existence of the informal economy might hinder the effectiveness of macroeconomic measures. These factors, in turn, hinder the attainment of macroeconomic sustainability.

An extensive informal sector leads to distorted official economic indicators, such as the unemployment rate and income level. The Bank of Albania's monetary policy decisions, based on official macroeconomic statistics, could prove to be unsuccessful.

The underground economy fosters unfair rivalry among enterprises from a macroeconomic perspective. Businesses in the informal economy operate without regulation and can offer more competitive pricing compared to officially recognized businesses. Businesses operating in the informal sector might provide their goods and services at rates below the standard market rate, which can lead to higher sales and profits. The underground economy can negatively impact the financial status of social security agencies and decrease tax collections, leading to potential limitations on social assistance for individuals with low earnings.

Another consequence of the cash-based economy, closely linked to the Bank of Albania, is the impact of the high volume of money in circulation on the efficacy of monetary policy actions. Currently, just one-third of monetary transactions in our country are processed through the banking system.

The banking system, a crucial component of the financial system, is responsible for managing the cash levels in the Albanian economy. The biggest drawback of the company in the current cash-based economy is the limited range of alternative currency products they provide. Additional factors include

the scarcity of public information on the banking sector, along with economic and financial criminal activities.

Many believe that the introduction of foreign banks into the banking sector enhances the quality of financial products, including cash substitutes. Foreign banks may lack motivation to provide advanced products in challenging environments like Albania.

The efforts made so far deserve appreciation. The advancement of the banking system has created opportunities to reduce reliance on physical currency. One option is the utilization of electronic currency. The Bank of Albania's campaign, "Beyond Money," aims to decrease the informal sector. In late 2005, all budget institutions implemented the electronic payment system for the first time. However, despite these great initiatives, over 85-88% of employees continue to get their payments in cash.

Many banks have started to utilize ATMs for electronic transactions and other functions. In late 2004, there were 93 ATMs and 155 POS machines. The fact that each bank runs its own network of equipment and card acceptance places restrictions on ATMs. The government aims to overcome this impediment by introducing a national card to streamline financial transactions.

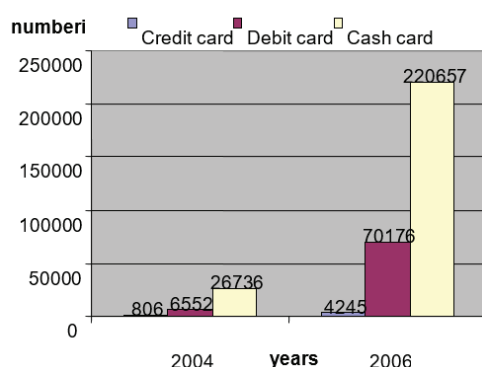
Electronic currency, in and of itself, is not flawless. As with other medications, there are potential negative effects:

Table 2: Advantages and disadvantages of electronic money

The main actors	Positive effects	Negative effects
Regulators	More controllable at the time of transaction	It leaves no trace, tax evasion Regulatory framework in motion
issuers	New and profitable markets	forgery
CLIENTS	More practical to use	Failure to protect the client's anonymity
DEALERS	Access to global markets, Efficiency in actions	forgery

Source: Central Bank of Albania, Economic Bulletin, volume 9, December 2006

The increase in the number of electronic money users in Albania has been parallel to the increase in bank transactions. The chart below illustrates this:



Source: Central Bank of Albania, Economic Bulletin, volume 9, December 2006

The Albanian economy, despite being labeled "fragile," has shown progress towards stabilizing and creating a conducive atmosphere for attracting investors. Both foreign and local policies should aim to support the establishment of a robust and impactful financial system while also fostering the economic growth of the nation. The significant presence of the informal economy continues to be a worry for future economic advancement. To understand the impact of the economy on the financial system, it is necessary to evaluate the system and all its components.

2. Materials and Methods

2.1. At what level of development are some of the links of the financial system?

You acknowledge the financial system as a catalyst for growth and economic development, emphasizing the significance of the impacts of each of its component connections. The system's operations and effects depend on the integrity of its components. To function properly, a dynamic network of flows and relationships requires coordination and regularity in each section. Without this, negative consequences might spread throughout the cycle, hindering the system's operation.

The elements of the financial system and the quantity of institutions within it in Albania:

Banks and branches of foreign banks	17
Non-bank financial institutions	6
Currency exchange offices	60
Savings and credit companies	125
Union of savings and credit societies	2
Insurance company	10
Pension funds	3

The data shows that there are 17 banks with local and/or international capital, indicating the growing importance of banks in the financial sector. The banking system is the most advanced component of the financial system, as we will discuss more. There is a proliferation of savings and credit institutions that have steadily expanded their operations. 60 foreign exchange outlets indicate progress in formalizing the Albanian foreign exchange market, but more work is still to be done. Despite the abundance of insurance businesses in our small country, they are still in the early stages of development.

2.1. How are individual finances related to the financial system?

Individuals are the primary source of surpluses to meet the financial requirements of economic entities. They participate in money market and capital market activities through different financial intermediaries. An individual's involvement in management, direction, participation, and relationships within each unit determines their role within the family, business, and state. From the perspective of an individual involved in economic activities, such as an investor or someone earning income, it is important to examine the extent to which their finances are intertwined with the overall financial system. The person is linked to the banking system, intermediaries, fiscal system, customs system, capital markets, insurance market, and pension funds. In the Albanian context, banks are the primary mediators individuals engage with.

3. Discussion

The financial sector must enhance its structure, particularly in banking supervision, and have a more significant impact on the country's economic development.

Governments can prevent the occurrence of pyramid schemes in the future by implementing a robust and official financial system and developing a regulatory framework that encompasses both formal and informal markets, with clearly defined responsibilities for supervision and enforcement. Preventing pyramid schemes may not be the primary motivation for establishing good governance, but the existence of pyramid schemes serves as a powerful reminder of the significant social consequences of inadequate governance.

The financial system in Albania has always relied on the banking system. The development of financial markets is required. This involves enhancing the institutional environment by decreasing the criminal economy and cash transactions.

The social security sector needs to be reinforced. In the long term, this industry will serve as a primary source of long-term investment capital. Banks provide short-term loans. They are not in the business of providing long-term loans. Insurance firms are the primary investment institutions in most countries' financial markets, supplying long-term capital. We are excited about the growth and improvement of this area.

Our country lacks a developed economy and the capital to establish and sustain a national stock exchange. One effective approach is to establish a regional exchange specifically for Balkan countries, including Albania, to engage in a unified platform with countries of comparable size and development.

Increased support is needed to facilitate the growth of institutions nationwide, particularly in the banking sector. This includes the establishment and enhancement of new banking products and their widespread distribution. Consideration should be given to supporting the creation of a private bank to specifically aid agricultural production, agribusiness, or investment purposes.

Advancing and enlarging the non-banking business is vital at this point. I want to highlight the effective operations of non-banking organizations, including property and life insurance firms, newly established pension companies, and the growing importance of supervisory institutions, not just through amalgamation. Effective enforcement of current legislation in the private insurance and pension sectors can facilitate the market's liberalization, particularly in property and wealth insurance. Enhancing oversight to encourage fair competition and enhancing the market's operations and growth through legal enhancements can accomplish this.

The establishment of private pension businesses signifies the initiation of non-bank financial intermediaries, particularly those inside the indirect circuit. When non-bank lending intermediaries like leasing companies, factoring companies, consumer credit companies, or participating intermediaries of the financial holding type, merchant bank venture capital, begin operating, we are establishing a market for non-banking financial intermediaries in the indirect circuit.

The non-banking financial market would be significantly reduced if both non-banking financial intermediaries from the indirect circuit and those from the direct circuit, such as securities brokers, savings management companies, investment funds, insurance, and mutual fund investment companies, did not operate.

Enhancing the infrastructure is another crucial factor in making alternative payment methods more appealing. Authorities primarily focus on enhancing information security and promoting businesses to share information.

Develop marketing strategies to enhance the reputation of insurance firms and increase awareness of their services. Expanding the scope of services offered within and beyond Albania to enhance customer service.

Regional cooperation aims to advance our region's progress towards achieving EU integration. Implementing financial market development strategies facilitates the integration of domestic financial markets with worldwide markets, thereby laying the groundwork for economic and social reforms.

Constant vigilance is necessary to prevent financial fragility, uphold financial stability, prevent financial shocks, and maintain open borders.

4. Conclusions

The financial system, consisting of markets and financial intermediaries, is a dynamic entity constantly in motion due to relationships manifested in traded flows occurring at any time and location.

The primary functions of a financial system include resource transfer and risk management.

The economy and its financial system are intricately linked, with the level of development and the role of the financial system determining the stage of economic growth in a country. The notable phases are the empirical phase, the credit economy period, and the financial markets phase.

A developed financial system necessitates a stable economy, integrated markets, sufficient infrastructure, a civic and work culture, and a robust rule of law.

The Albanian financial system, along with other areas of the country's progress, has been undergoing a transition period for over 15 years. The first stage of financial system development involves establishing a two-tier banking system. Pyramid schemes had a significant impact on the system, causing long-lasting negative implications in the Albanian financial sector.

The Albanian economy is deemed unstable and unconsolidated; however, it is noteworthy for its strong growth rates. In 2004, this country had the greatest growth rate of 6.2% among Southeast European countries. The primary issue facing the Albanian economy is the significant amount of cash in circulation, indicating a low degree of participation in the country's financial system.

The Albanian economy's savings are not currently being effectively integrated into the financial system for circulation. There is an informal integration of personal and commercial funds into the system. Individuals and corporations establish informal financial connections with other participants in the financial system without complete engagement, therefore keeping a substantial portion of their finances outside the system. Around 50% of the country's population lacks banking services. The majority of business funding comes from internal sources, accounting for approximately 75–80%. Financial intermediaries play a minor role, meeting just about 10–15% of these demands.

The banking sector is a robust component of our financial system, but it alone cannot drive the entire system forward.

The Albanian banking system plays a crucial role in the financial sector, holding 90% of the total financial assets. Its growth in banking services, network expansion, and deposit volume has significantly contributed to the country's economic development. There are currently 17 banks operating in the country, with a total of 190 branches, 101 agencies, and 3 branches located abroad.

Financially sound banking institutions are essential for maintaining a robust financial market and preventing financial catastrophes.

The Albanian fiscal system relies predominantly on value-added tax (VAT) and customs duties for revenue. The primary sources of revenue in the state budget are the value-added tax and the personal income tax. The fiscal system is nevertheless hindered by a significant level of tax evasion, which accounts for 11% of the gross domestic product (GDP). The primary reasons are small firms operating in the informal sector, having little integration in the banking system, and conducting economic activities independently without official monitoring or reporting.

The absence of a functioning stock market hinders the accurate representation of firms' true market values, which exceed the values recorded in their financial statements.

In financial markets, the timing of information transmission is as crucial as the information itself.

Albania's financial system seems resilient to sudden macroeconomic or financial system disturbances. Sound monetary and fiscal policies have helped create a stable macroeconomic environment, making the Albanian financial system conducive to the growth of a sustainable bond market.

The insurance market in Albania is small and primarily centered around mandatory insurance. The extent of voluntary insurance reflects the vitality of the insurance market, which remains limited in Albania. Multiple enterprises in this industry have a broad geographical reach, although their efficacy is deemed inadequate.

The financial systems of the countries under consideration show that the banking system is the most advanced and complex part, promoting the credit economy, economic development, and attracting foreign investments in the financial sector.

Foreign banks are enhancing the stability of the financial system by sharing their experience in credit evaluation and risk management practices.

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