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D7.2. Submission of research papers

Description:

This deliverable contains the Abstracts of the Research Paper of the Diploma thesis of the three students sent in the list with D7.1. Full papers will be submitted upon which will be sent with D7.3

While along the abstract with the research papers sent with this deliverable, we have included also the Acceptance letters for publication of the papers.

Names of student, mentors and the topics confirmed again in the table below.

No	Mentor	Student	Diploma Thesis
1	Prof.Asoc.Dr. Elvin Meka	Lira Sinani	Developing the market for Contingent Convertible (Co/Co) Bonds in Albania – The European Union Experience
2	Prof.Asoc.Dr. Elvin Meka	Gregora Luft	The Albanian Banking System in Albania and the EU Integration Process – Far and Near.
3	Prof.Assoc.Dr. Selami Xhepa	Julian Nura	Tregtia e jashtme dhe integrimi në BE: vleresimet ex post te efekteve te MSA

Banking System on the Albanian Path to European Union Integration

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Abstract

Albania's journey towards European Union integration involves continuous reforms aligning with EU standards. This article aims to assess the contribution of the Albanian banking system to the European Union integration process by analysing its progress and challenges in alignment with accession criteria and compliance with EU acquis. The research spans 12 years (2011-2022) of monitoring by the European Commission. The methodology involves a thorough review and content analysis of annual EU integration progress reports for Albania, uncovering banking system-related criteria, requirements and recommendations enhanced by a thematic analysis identifying recurring themes and report patterns over the years.

The article confirms the hypothesis that the Albanian banking system has made significant progress in aligning with EU accession criteria, as evidenced by positive evaluations of the European Commission, mainly in macroeconomic and financial stability. However, it also highlights areas of non-compliance, stagnation, and persistent concerns. Notably, access to finance is a critical economic criterion contributing to a market economy with ample room for lending and financial inclusion improvement. These enhancements can be realised through effective financial education. While progress in public debt reduction and non-performing loans (NPLs) is acknowledged, ongoing concerns persist regarding the extensive use of the Euro in the economy.

I. INTRODUCTION

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

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

I.1 Aim and Objectives

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

(1) To analyze the essential criteria and recommendations set forth by the European Commission in the yearly progress reports related to the banking system.
(2) To provide insight into the implications of the banking system compliance with EU criteria on Albanian integration prospects.

(3) To identify any challenges or areas of improvement encountered by the Albanian banking system in its pursuit of EU alignment.

I.2 Hypothesis and Research Questions

Hypothesis:

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

Research questions:

(1) How has the Albanian banking system evolved over the years in response to the European Union's economic criteria and recommendations as documented in EU progress reports?

(2) What are the key areas of compliance, improvements and concerns that must be addressed?

I.3 Methodology

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

II. LITERATURE REVIEW

II.1 From the Bonn Conference to the opening of negotiations

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

For Albania, this process culminated with the entry into force of the Stabilization and Association Agreement (SAA) in (2009), a pivotal moment in Albania's European future. The Agreement legitimised mutual commitments and paved the way for a detailed process with clear objectives in political cooperation, economic collaboration, and alignment of Albanian legislation with the EU acquis (2009).

The common denominator of the integration process, included in all the documents mentioned above, is the *existence of a functional market economy* as a requirement for being a reliable EU member.

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

Table 1. Economic Criteria and Acquis Chapters for Banking System

II.2 Copenhagen criteria and the conditions and requirements of SAA

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

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

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

II.3 Convergence Criteria

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

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

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

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

II.4 Financial development and access to finance

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

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

III. Banking System in Albania

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

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

IV. Evaluation of Economic Criteria

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

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

IV.1 Macroeconomic and Financial Stability Criteria

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

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

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

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

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

Financial stability is a vital pillar of a nation's economic well-being, ensuring the smooth functioning of the financial system and its resilience to shocks, strictly impacted by the soundness of the banking sector and the implementation of BoA macroprudential and supervisory policies. Over the years, from 2011 to 2022, the Albanian financial system has consistently demonstrated stability, well capitalised and liquid, above the Basel III requirements, as confirmed by the reports. The banking sector's profitability has also remained positive, as reflected in return on assets and equity, except during the grave COVID-19 crisis in 2021. The budget deficit and, consequently, the public debt has posed significant concerns for the country's economic and financial stability, with peaks (70-72.3% of GDP) observed during 2014-2017 and temporarily during the pandemic. However, there's been a remarkable improvement, as public debt by the end of 2022 stands at 63.3% of GDP, closer to convergence criteria, and is expected to continue its downward trend. Furthermore, the Albanian government's issuance of Eurobonds has changed the composition of public debt by reducing the domestic one. Nevertheless, persistent concerns outlined in progress reports include the substantial portion of the public debt held by the banking sector (25%).

VI.2 Acquis Chapter 17: Economic and Monetary Policy

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

IV.3 Acquis Chapters 4 & 9: Free Movement of Capital and Financial Services.

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

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

IV.4 Access to Finance

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

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

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

IV.5 Acquis Chapter 9 & 4: Financial Services and Free Movement of Capital

Albania's ability to meet the accession requirements for chapters 4 and 9, related to financial access, involves payment system, financial education and inclusion. 2011 Albania, primarily a cash-based economy, faced payment system challenges and the first steps were regulations for the clearinghouse and interbank payment system to promote non-cash payments. Enabling banks to establish branches and conduct cross-border transactions in 2012 and the first-ever meeting of the National Payment Committee in 2016. Over the years, Albania has made significant and constant advancements in aligning with EU acquis in this area. The 2022 report recognises Albania's progress in implementing the National Payment System. The Bank of Albania (BoA) introduced a new platform for domestic interbank euro payments in January 2022, facilitating retail payments. During the pandemic, the BoA eased payment procedures and reduced online transaction costs, increasing financial inclusion. The number of adults with bank accounts reached the targets set in the financial literacy strategy, and online payments tripled.

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

V. Conclusion and Recommendations

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

- The monetary and macroprudential policy decisions and implementation have positively contributed to maintaining stability and upholding the convergence criteria.

- Continued progress has been made in aligning with the Basel III and other financial stability requirements. The constant improvement of the payment system has played an essential role in increasing financial inclusion.

- There has been a significant improvement in the NPL rate and decreasing public debt; although the effects of crises have not yet fully materialised, authorities should remain vigilant.
- Significant concerns are the economy's persisting high euroisation and the immediate need to be removed from the grey list for money laundering.
- Since 2002, there has been no progress in amending the law regarding the independence of the BoA in line with the ECB standards. While it is part of the BoA's vision, it is not included in the medium-term objectives of the ERP.

Based on these conclusions the article makes two recommendations:

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

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

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Contingent Convertible Bonds (CoCo bonds) and their market development in Albania

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Abstract

CoCo bonds are important financial instruments for the stability of the banking and financial system in general. The role of innovative financial instruments is crucial to help address the challenges posed by these critical situations. One of these reintroduced instruments with ambitions to enhance the stability of the banking sector is the "Contingent Convertible Bond," abbreviated as "CoCo." This paper aims to explore the impact of the use of Convertible Contingent Bonds (CoCo) in financial crisis situations and their effect on avoiding the domino effect of a bank failure. Starting from the critical factor of the stability of the financial system, this analysis aims to shed light on the potential of these innovative instruments in improving the stability of the banking sector as well as the need for their modeling in the Albanian banking sector, taking into account the lack of treatment particular of these instruments in the current legislation. The analysis of the possibilities for their application in the Albanian banking system shows that, if implemented successfully, they can increase the regulatory capital of banks, strengthen financial stability and reduce the risk of government intervention in cases of crises. In conclusion, the use of CoCo bonds in Albania should be accompanied by the improvement of legislation and the encouragement of financial institutions' investments in these instruments, in order to create a safer and more stable environment in the country's banking sector.

Keywords: Contingent Convertible Bonds (CoCo bonds), Basel III, resolution, financial crisis.

I. INTRODUCTION

Financial shocks have been a persistent event in the global economic landscape, significantly impacting the stability of the financial system. In this context, the role of innovative financial instruments is crucial to help address the challenges posed by these critical situations. One of these reintroduced instruments with ambitions to enhance the stability of the banking sector is the "Contingent Convertible Bond," abbreviated as "CoCo."

Contingent Convertible Bonds, also known as CoCo or CoCo bonds (Contingent Convertible bond), are hybrid debt securities that exhibit characteristics and features of both equity and debt. According to Basel III rules, these value papers are recognized as regulatory instruments under certain conditions. This complex instrument aims to serve as a regulator in times of financial crises. CoCos are issued as bonds and, in financial crises or bankruptcy risks, have the ability to convert immediately into shares (equity) or be written off (De Spiegeleer, Schoutens & Van Hulle,
2014). Thus, they display loss-absorption qualities, creating a cost advantage. The conversion of the CoCo bond occurs when the financial institution, specifically the bank, hits the minimum regulatory capital level. This conversion is accompanied by a devaluation or weakening of existing shares and shareholders. On the other hand, investors in these bonds, in the best-case scenario when their bond converts to equity, automatically become shareholders with voting rights (De (De Spiegeleer, Schoutens & Van Hulle, 2014). Meanwhile, the bank increases the likelihood of not defaulting, also enhancing its repayment ability, which would otherwise be very difficult or impossible in other circumstances.

The objectives of this paper are:

1. Highlighting the positive effects brought about by the use of contingent convertible bonds.

2. Exploring how these types of bonds would function in Albania.

Research Question:

- How would the utilization of CoCo bonds impact the financial market in Albania during a financial crisis?

This research project aims to examine the influence of employing CoCo bonds in the context of a financial crisis. To achieve this goal, we will explore a primary hypothesis:

Hypothesis:

The use of Contingent Convertible Bonds in the Albanian banking sector contributes to better financial stability and protection against the impacts of financial crises.

This prediction is based on the belief that employing CoCo bonds can help enhance the resilience of banks in challenging financial situations. This positive impact may result from the capacity of these instruments to alter the capital structure of banks and automatically convert a portion into common equity in case of a specified capital loss.

The research project aims to thoroughly explore this hypothesis and provide a better understanding of the impact of utilizing CoCo bonds in financial storm scenarios. By reviewing relevant literature and analyzing the situation in Albania, we aim to shed light on the potential of these instruments to improve the stability of the financial sector during difficult times.

Methodology

The analysis used in the methodology of this paper is a qualitative one. This analysis will employ a combination of relevant bibliography research and data analysis concerning Albania's regulations, extraordinary interventions, and public offerings. The analysis will evaluate how the use of CoCo bonds is linked to banks' responses to financial crises. The expected results may confirm the formulated hypotheses, demonstrating the positive impact of CoCo bonds on bank stability and their ability to mitigate the spread of the domino effect in case of bankruptcy. These results will contribute to the current discourse on financial crisis management and the role of innovative financial instruments in enhancing the resilience of the financial sector during challenging times. The qualitative analysis methodology in studying CoCo bonds will assist in a better understanding of the impacts and opinions of investors and provide a comprehensive perspective on this complex financial instrument.

II. LITERATURE REVIEW

Historical background

CoCo bonds, or contingent convertibles, combine debt and equity features by activating loss absorption mechanisms when a bank's capital falls below a certain threshold, preventing bankruptcy (Avdjiev et al., 2015; Bolton et al., 2012). Robert Merton conceptualized CoCo bonds in 1990 to provide investor guarantees during financial crises, influencing regulatory changes post-
2008 financial crisis (Sundaresan et al., 2010; Pelger, 2012). Lloyds Banking Group (LBG) issued the first CoCo bonds in 2009, addressing challenges from its acquisition of Halifax Bank of Scotland, with subsequent issuances by Credit Suisse, UBS, Rabobank, and Allianz. CoCo bonds gained prominence in 2014 due to Basel III capital requirements but faced scrutiny after Banco Popular Espanol's case in 2017 (Basel III, 2014; Reuters, June 7, 2017).

Hybrid Instruments

Hybrid instruments blend equity and debt features, offering a predictable return with conversion options (Kimmel P., & Warfield T., 1995; Wiedermann-Ondrej, 2006). Hybrids are subordinated to traditional debt but rank above equity in insolvency (Liberadzki, K. & Liberadzki, M., 2016). Hybrid securities are favored for financial protection but can be challenging due to complexity (Johannesen, 2014). Convertible bonds allow conversion into equity, usually with lower coupon rates. They offer potential equity conversion, coupon payments, and tax advantages. Conversion occurs when profits from equity exceed face value and interest payments (Lewis & Verwijmeren, 2011). Convertible bonds benefit young companies with low coupons and tax deductibility. CoCos differ by converting to equity only when bank capital falls below a threshold.

Basel III Regulation

Basel regulations, starting with the 1988 Basel Accord, aimed to increase banks' capital to absorb losses and reduce risky behavior (Baily, Litan & Johnson 2008).

The crisis revealed flaws in dealing with complex financial instruments and high bank leverage ratios (Admati & Hellwig, 2014; Koziol & Lawrenz, 2009). Basel III was introduced in the EU to improve loss absorption capacity and address financial vulnerabilities (Basel III, 2014). Lehman Brothers' bankruptcy in 2008 triggered a financial collapse and highlighted the inadequacy of capital standards, exacerbating the crisis (De Haas & Van Horen, 2012; BCBS, 2010b). Governments globally took unprecedented measures to stabilize the financial system, including providing liquidity and capital support, and established supervisory bodies like the European Banking Authority (EBA). Basel III, coordinated by the G20, increased capital requirements, introduced measures to mitigate leverage and liquidity risk, and aimed to improve the quality, consistency, and transparency of banking activities. It also sought to reduce procyclicality and prevent government bailouts (BIS, 2013; BIS, 2018).

Basel III includes the countercyclical capital buffer to curb credit extension during economic peaks and contingent convertibles as additional Tier 1 capital (BCBS, 2015). Basel III's primary objectives are to limit excessive bank risk-taking, bolster capital reserves, and enhance financial stability to prevent future financial collapses.

CoCo Structure and Design

CoCo Bonds function like regular bonds during prosperous economic periods for the issuing institution but convert into common equity when the capital ratio falls below a specified threshold (De Spiegeleer et al. 2014). This conversion aims to lower the bank's debt-equity ratio significantly, thus reducing the probability of the bank defaulting. Furthermore, upon conversion, the bank automatically recapitalizes, mitigating bankruptcy costs (De Spiegeleer et al. 2014). As a result, CoCo Bonds are widely regarded as a valuable regulatory tool for decreasing the likelihood of bank defaults, minimizing bankruptcy expenses, and internalizing the consequences of poor performance (Maes and Schoutens, 2012). These characteristics, coupled with high expectations, make CoCo Bonds and their structure both economically and politically intriguing for further examination (Maes and Schoutens, 2012).

Design

CoCo bond design significantly influences their intended objectives. Key design elements include the trigger event, threshold value, loss absorption nature, and bond volume (Avdjiev, Kartasheva
& Bogdanova, 2013). The trigger event marks when the loss absorption mechanism activates, with one or more triggers possible. Decisions regarding trigger basis (book or market values) and the use of mechanical or supervisory authority-driven triggers are essential (Flannery, 2010).

Mechanical triggers activate when capital falls below a specified ratio of risk-weighted assets, triggering automatic conversion or write-down (Maes and Schoutens 2012). They are clear and observable but lack consideration of additional information (BCBS, 2015). In contrast, discretionary triggers rely on supervisory judgment of a financial institution's solvency prospects. They offer flexibility but may suffer from timing uncertainty and market signals (Pazarbasioglu et al., 2011). CoCo bonds can also employ a mix of trigger types, like a mechanical trigger based on specific bank assets coupled with a discretionary trigger considering broader financial system conditions (BCBS, 2015). In the EU, CoCos typically use accounting value triggers to align with prudential requirements, reflecting regulators' preference (Maes and Schoutens 2012; Glasserman & Nouri, 2012).

Purpose

CoCo bonds serve multiple purposes in the financial industry. They are issued by financial institutions to enhance their loss-absorbing capacity alongside CET1 Capital, allowing banks to bolster their ability to absorb losses before a financial downturn occurs, all while paying a lower market price for risk assumption and without diluting the control of the owners' rights during a crisis (Flannery, 2010).

CoCo bonds are recognized for their cost advantages compared to CET1 capital, helping prevent banks from restricting their lending activities (Pazarbasioglu et al., 2011). These cost advantages are attributed, among other factors, to the tax deductibility of coupon payments, especially in most European Union countries (Albul, Jaffee & Tchistyi, 2010).

Moreover, the conversion feature of CoCo bonds aims to provide financial institutions with additional CET1 capital when needed, helping to prevent deterioration in the bank's balance sheets (Pennacchi et al., 2011). The use of CoCo bonds is also intended to enhance supervision and risk management through a customized contractual structure.

The primary purpose of these hybrid instruments is to reduce the risk for individual banks and, consequently, for the entire banking system, lessening the need for government rescue measures at the expense of taxpayers and contributing to stabilizing the overall economy (Glasserman & Nouri, 2012).

Loss Absorption Mechanism

CoCo bonds have a crucial loss absorption mechanism determining conversion or write-down outcomes (Martynova & Perotti, 2016). The conversion rate in CoCo bonds is significant, representing the dilution of equity holders' claims and the CET1 capital CoCo bondholders receive (Pennacchi et al., 2011).Dilution involves a shift in control rights and profit/loss distribution, depending on fixed or variable conversion rates, but once conversion occurs, it's irreversible (Avdjiev et al., 2015).

Significant dilution redistributes profit and loss claims to CoCo bondholders, possibly prompting original equity holders to avoid conversion by selling their bonds in advance, causing price declines (Albul, Jaffee & Tchistyi, 2010).CoCo bonds encourage better risk management and determining when substantial dilution is needed (Henkel & Kaal, 2012).

Regulatory perspective favors substantial dilution to incentivize responsible risk management (Johannesen, 2014). Principal write-down reduces bank debt via CoCo bonds but doesn't grant equity, with options for partial or full write-down specified in the contract. It motivates equity holders and bank management to take risks, leaving control and participation rights unaffected (Pennacchi et al., 2011).CoCo bonds with conversion mechanisms are generally preferred, but contract specifics on full or partial conversion/write-down and gradations are essential (Avdjiev, Kartasheva & Bogdanova, 2013).In European markets, around 49% of CoCo bonds feature principal write-down, likely influenced by bank equity holders' decision-making power (Admati & Hellwig, 2014; Albul, Jaffee & Tchistyi, 2010).

Advantages

CoCo bonds serve as effective instruments for financial market regulation, benefiting both issuers and bondholders. They shift the burden of risk-taking from taxpayers to bank owners and enhance bank stability (Goodhart & Taylor 2006; Pennacchi et al. 2016).The key difference from standard convertible bonds is the trigger mechanism, initially proposed as a single trigger but later studies suggested multiple triggers (Huertas 2009; Albul, Jaffee & Tchistyi 2010; Pennacchi 2011; Plosser 2010). CoCo bonds gained prominence after the financial crisis, addressing the need for a capital buffer and reducing the "too big to fail" problem (Blundell, Wignall & Roulet 2013).They offer a cost- effective way to recapitalize banks, replacing the bankruptcy process (Bolton & Samama 2012) and improving bank solvency under specific conditions. Effectiveness depends on managerial caution and supervisory autonomy, and CoCo bonds are seen as a useful instrument when capital needs and regulatory actions are inversely related (Hilscher and Raviv, 2014). In summary, CoCo bonds have the potential to enhance financial stability, although their impact may vary depending on circumstances (Flannery 2014).

Disadvantages

CoCo bonds, while praised for their potential to enhance financial stability, face skepticism and concerns in the financial literature. Critics argue that simpler solutions like increased equity may be more effective and that CoCo bonds' complexity can complicate financial systems. Concerns also revolve around the conversion mechanism's potential to spread economic distress and create incentives for risky behavior. Some worry that CoCo bonds may not completely avert bank failure and that their trigger mechanisms may be inefficient. Additionally, they could exacerbate bank weaknesses during crises, lead to destabilizing effects in markets, and generate negative externalities. Overall, CoCo bonds remain a topic of ongoing debate in the financial community.

III. Development of the CoCo Market in Albania

Regarding the Albanian legislation, contingent convertible bonds are financial instruments that have not received specific treatment in Albanian law. Not only for CoCos, but for many other financial instruments, Albanian legislation does not anticipate their treatment, as the economic development and the absence of a well-established securities market make them less of a priority. Consequently, since Albania does not have a well-established stock exchange, financial institutions such as banks will find it harder to issue contingent convertible bonds. This is because investors would be hesitant to risk their portfolios for value papers that have a higher probability of being written off than being converted into shares.

The law on recovery resolution outlines how banks and investors should handle dematerialized bonds in cases of extraordinary intervention. The custodian plays a crucial role in this process and has the right not to pay the bonds until their issuer has fulfilled its obligations. The regulation requires custodians to inform their investors about the purchase and sale prices of dematerialized bonds in over-the-counter markets, including any commission or fee. This information is crucial for investors to make informed decisions regarding their bonds. The regulation also specifies the criteria and procedures for converting liabilities into capital for banks. This is an important tool for recapitalizing banks when needed to maintain financial stability. It sets the criteria and minimum requirements that banks must meet to ensure an adequate level of regulatory capital and accepted liabilities. This is a crucial aspect of bank supervision to mitigate financial risks. It sets the criteria and conditions that must be met to recognize financial instruments as accepted liabilities. This process ensures that the instruments banks use to fulfill their obligations are reliable and meet necessary standards. If banks meet the minimum requirements for regulatory capital and accepted liabilities using first-tier capital instruments, they can fulfill the macroprudential capital buffers.

The Resolution Authority (Bank of Albania) is responsible for developing and updating methodologies and policies related to meeting the minimum capital and accepted liability requirements. This ensures continuous updates and effective intervention by authorities in the banking sector. Overall, extraordinary intervention in Albanian banks is essential to ensure financial stability and protect the interests of investors and depositors. The defined regulations and procedures are the primary means to achieve these goals.

Minimum Requirements for Regulatory Capital Instruments and Accepted Liabilities

According to Regulation No. 78/2020 of the Bank of Albania, a minimum requirement for the levels of bank capital and accepted liabilities has been established. This requirement concerns the absorption of losses and the need for recapitalization. For banks that, according to the extraordinary assessment represents the losses that the bank must be able to withstand, reaching the regulatory capital requirement. At the same time, there is also a recapitalization

value, which is the amount of capital the bank must hold (after extraordinary intervention) to ensure compliance with licensing conditions and continue licensed operations. Banks that, according to the extraordinary intervention scenario, will be subject to mandatory liquidation, must primarily fulfill the absorption of losses requirement, but they are not required to fulfill the recapitalization value.
In accordance with Article 6 of Regulation No. 78/2020, the value for absorbing losses is calculated as follows:

Loss Absorption Value = Risk-weighted Exposures t-1 * (Capital Adequacy Ratio (12%)t + Additional Capital Buffer Rate (%)t

In accordance with Article 7 of Regulation No. 78/2020, the value for recapitalization is calculated as follows:

Recapitalization Value = Risk-weighted Exposures t-1 * (Capital Adequacy Ratio (12%)t + Additional Capital Buffer Rate (%)t)

According to Regulation No. 78/2020, the Bank of Albania has the possibility to adjust the recapitalization value by considering a significant reduction in the bank's balance sheet size after an extraordinary intervention, as well as restructuring plans and measures. This adjustment is based on a detailed analysis for each bank. One of the methods to consider the reduction in the bank's balance sheet size is by incorporating the credit risk magnitude into the bank's overall risk profile. For example, if the bank's repayment ability is affected by credit risk losses, the bank may have a smaller balance sheet. The impact of reducing the balance sheet size on the regulatory capital requirement is more significant when credit risk has a substantial contribution. However, the reduction in the balance sheet size should not exceed 10% of the total bank assets. Reducing the balance sheet size through divestments and planned sales in restructuring plans can be considered to adjust the recapitalization value by removing high-risk-weighted assets from the balance sheet.

This activity is appropriate when the bank is not in default. If the planned restructuring actions are mandatory and have restricted timelines, the Bank of Albania may influence the determination of the recapitalization value.
The Bank of Albania has the right to regulate the bank's balance sheet size based on recovery plans, in extraordinary cases and in accordance with the specified conditions. Recovery measures can be considered only if they are seen as reliable, achievable, and immediate after the extraordinary intervention, with a positive impact on loss scenarios. The Bank of Albania has the possibility to intervene to reduce the balance sheet size after an extraordinary intervention, reducing it by up to 5% of the balance sheet size.

Issuing of Bonds

According to the issuance guidelines by the Government of the Republic of Albania, in force since

25.01.2014, bonds have the following characteristics:

• Have a maturity period of more than one year, issued in the local currency (Lek), as well as foreign currencies (USD/EUR).
• Are sold in auctions conducted by the Bank of Albania, in the name and on behalf of the government represented by the Ministry of Finance.
• Are issued at par value, meaning the purchase price is 100% of the nominal value, excluding bonds issued in reopened auctions.

The coupon (interest earned from investing in bonds) is paid every 6 months and calculated as: $C = Vn * i * 180/360$ C- coupon Vn- nominal value i- interest **In the secondary market, bonds have a 30/360 basis for coupon calculation and price.**

Reopened bonds are calculated as: Price = Clean price + Accrued interest
It is worth noting that the variable interest of the bonds is determined by the average of the 3 yields of the last 3 auctions (held before the auction of these bonds) of treasury bonds with a maturity of up to one year. If the maturity date is a holiday, the payment is postponed to the next working day without adding interest or incurring additional delay charges. Entities eligible to participate in the auction are individuals and legal entities, who can be domestic or foreign, and their requests can be competitive or non-competitive. The minimum value for participation in the auction is ALL 500,000 in the national currency and Eur/USD 3,000 in foreign currency. If the demand is equal to or greater than ALL 50,000,000 or Eur/USD 100,000, the demand will be classified as competitive regardless of the entity. As for taxation on income from bonds, it is retained at the source for individual investors and non-profit subjects. Tax resident entities that are subject to income tax and entities registered as local tax-paying subjects for small businesses are not withheld at the source, as they are recorded as income in the balance sheet. Exempt from tax or those with concessions are those with disabled status (according to the respective law), except in cases where the investment is made through economic activities.

The Ministry of Finance exempts itself from liability for delays in bond redemptions or negative market impacts due to the following cases:

• Natural disasters
• Actions caused by other authorities (threat of war, war, or popular uprisings)
• Events affecting the continuity of the Ministry of Finance's work
• Other major forces with widespread impact

All securities are sold in the primary market, which is the auction conducted by the Bank of Albania. The secondary market, or the retail market, includes any transactions carried out on these securities after they have been traded once in the primary market. In the Republic of Albania, we can mention these secondary markets: the interbank market for government securities, the retail market for government securities, and the market on the Tirana Stock Exchange.

Transactions that can be conducted by financial institutions and other licensed entities in the capital market are as follows:

1. Acquisition of treasury bonds in the primary market (through auction) by the investor through a bank or licensed entity.
2. Sale of government securities to the investor from the bank's portfolio or licensed entity.
3. Purchase of government securities by the bank or licensed entity before the maturity date from any investor, regardless of whether previous transactions were not conducted by the same bank or licensed entity.
4. Use of government securities as collateral for other loans or other financial transactions.
5. Redemption of the nominal value of government securities on the maturity date.

Public Offering

A public offering of securities is considered public when it is made to more than 100 individuals (Albanian Financial Supervisory Authority).

Companies with a public offering are companies that distribute their shares to the public through stock exchanges or other legal means. The need to increase capital is associated with the goal of expanding activities and improving technology, aiming to become strong competitors in the market. One of the ways to increase capital is by issuing and selling securities by the company. These new issuances, which can be shares, bonds, or securities, are usually traded publicly in what is known as the primary market.

Offerings in the primary market can be offered for sale in two ways:

- Public offering, which includes a public offer to communicate to the public the distribution of securities to a minimum of 100 individuals (based on the Capital Markets Law).
- Direct allocation, which includes an offer to distribute securities only to a small group of large investors or a limited number of institutional investors.

To consider an issuance as public, the following conditions must be met:

1.The offer must be distributed to more than 100 investors.

2. The company must be listed simultaneously on the Stock Exchange to enable small investors to convert their investment into liquidity.
3. During the initial public offering, an advertising campaign must commence in the media. Companies aiming to finance their business activities by involving the public must be organized as publicly traded companies. This results in a complex set of additional rules related to publication, transparency, control, and other aspects of public company management.

The "Traders and Companies" Law stipulates that private offering companies must have a minimum registered capital of ALL 2 million, while those with a public offering must have this minimum capital of at least 10 million lekë (Article 1052). On the other hand, the Law "On Capital Markets", in Article 245 defines public companies as those which offer their securities via Public Offerings, either initial (IPO) or secondary (SPO), at an amount of ALL 130,000,000, to more than 100 investors.

Initial Public Offering (IPO) involves the distribution of a private company's shares to the public for the first time and their listing on the stock exchange to raise capital as an effective way of financing operations. IPO is an obligation for the company offering shares to the public and allows investors to convert shares into liquidity if they wish to exit their investment after a specified period. This is a common way for companies to secure additional funding by distributing portions of their ownership to the public.

Secondary Public Offering (SPO) is the distribution of securities of a company that has previously distributed securities in a public offering. The purpose of this offering is to increase capital to make investments in the company or to fund previous debt. The securities distributed through an SPO are also listed on the stock exchange to create liquidity for their investors. The procedures for conducting an IPO include several important steps, starting with the gathering of shareholders, selecting the form of the registration statement, preparing the necessary documentation, and approving the prospectus. After these steps, the marketing period begins, along with the sale of shares on the capital market. If market conditions are favorable, IPOs can be an efficient way for companies to secure the necessary funding to develop their business activities and increase the company's value.

If contingent convertible bonds were to be issued in Albania, a complete restructuring of legislation would be necessary, also supported by "Basel III Agreement". However, considering what happened with these bonds at Credit Suisse Bank, their implementation in Albania would be even more challenging. Investors would not be eager to enrich their portfolios with these high-risk bonds, regardless of the yield they possess. Furthermore, to invest in contingent convertible bonds, institutional investors would be needed, who must have a well-diversified portfolio.

Another difficulty encountered in the Albanian market is that banks in Albania cannot yet offer public offerings. A public offering brings improvements in financial conditions by ensuring permanent funds that improve the financial situation. The company benefits from the distributed shares as public information about products and services is higher. It increases access to secure capital, thus increasing financing resources and making it easier to obtain loans on favorable terms. Public offerings bring facilities for securing additional capital from banks, offers of shares and bonds, and use easier registration forms for additional capital. Since banks cannot offer public offerings, they cannot issue contingent convertible bonds either. For a country like Albania, the implementation of contingent convertible bonds would increase the minimum regulatory capital requirement and contribute to the development of the banking network. It would provide security for bank depositors and taxpayers because immediate government intervention would not be needed in case of bankruptcy. The bank would be "rescued" from these bonds. Other benefits that the bank will have are: increasing the first-tier capital, higher valuation of shares during the life of the CoCos, improving liquidity position during banking stress periods, and strengthening the bank's balance sheet.

IV. Conclusions and Recommendations

Conclusions

1. Albanian legislation has not specifically addressed contingent convertible obligations and many other financial instruments. This has rendered these instruments unenforceable in the financial practice of Albania.
2. The absence of a well-established securities market has made it difficult for financial institutions, such as banks, to issue contingent convertible bonds and other securities. Investors are not inclined to risk their portfolio with securities that do not have a developed market.
3. Regulations and procedures related to extraordinary interventions in the banking sector are crucial to ensure financial stability and protect the interests of investors and depositors in emergency situations.
4. Naming government bonds is an important and well-regulated process, where the nominal value, coupons, and payment conditions are clearly defined.
5. The limitation in the Albanian banking sector, where banks are unable to offer public offerings and contingent convertible bonds, poses a significant obstacle. This restriction hinders the improvement of financial conditions, access to secure capital, and favorable loan terms. It also restricts the distribution of shares and the ability to capitalize on public awareness of products and services.

Recommendations

1. Improvement of Albanian legislation to specifically address contingent convertible bonds and other financial instruments. This would aid in the development of the securities market and increase interest in such investments.
2. Encouragement of establishing a fully functional securities exchange in Albania to facilitate the issuance and trading of various securities. This would make investments in securities more attractive and help increase available capital for financial institutions.

3. Continued improvement of regulations and procedures related to extraordinary interventions in the banking sector to ensure they align with international standards and maintain financial stability.
4. Encouragement of banks and financial institutions to explore the possibility of investing in contingent convertible bonds, viewing them as a means to raise capital and strengthen their position in the financial market. This could be done through incentives and rewards for institutions that utilize these instruments with long-term maturity.
5. Advocate for regulatory reforms that allow Albanian banks to conduct public offerings and issue contingent convertible bonds. These changes would enable banks to enhance their financial stability, access additional capital, and improve their overall financial situation. Additionally, it would facilitate the dissemination of public information about their offerings, attracting more investors and contributing to a more robust financial market.

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Foreign trade and integration in the European Union – Ex-post evaluations of MSA effects.

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Abstract

Albania has been long involved in a series of integration processes and the country is still working on building functioning institutions, compatible with the principles and requirements of the internal market. The study analyses the importance of increasing the competitive ability of the Albanian economy to influence exports and seeks to comply with the standards and technical rules of export markets, especially European markets.

This study uses the empirical analysis, which aims to verify in practice the basic hypothesis which is that the entry into the European Union and the removal of customs barriers brings development to a country's foreign trade and therefore affects economic development. We have used several statistical methods, such as the gravity model and time series analysis. The study concludes with the finding that the process of liberalization of the trade regime hase significantly affected the demand for imports, so trade liberalization and economic integration bring more development to a country. Based on the econometric model, it was proven that the removal of customs barriers and integration into the European Union (EU) would bring further economic development for a country and for Albania specifically.
We do recommend that liberalization and integration must be accompanied by a number of other policies in order to function properly. Also, the Albanian economy needs to expand the sources of growth and strengthen competitiveness.

Keywords: Foreign trade, gravity model, EU integration.

I. INTRODUCTION

One of the main elements that affect the economic growth of a country is Foreign Trade, so there are many studies related to that, that are continuously being made. Trade exchanges started very early back then, even though they were not the same as today's, meaning, they cannot be compared in terms of quantity and form.

All attempts at trade liberalizations, especially during the last decades, have been based on the solid ground of the benefits it brings through a more efficient allocation of productive resources and the reduction of transaction costs, but also for each particular economy - through growth in national well- being, increasing the competitiveness of the economy in international markets, and reducing the costs associated with active commercial policies. According to Hertel and others (World Bank, 2002), after
2005 (the time when the deadlines for the escalating implementation of the commitments defined in the Uruguay Round) end), by a further reduction of 40% in tariffs and subsidies on agricultural exports, an increase in real global income of UD 60 billion per year would be obtained. If these liberalization measures are added to a 40% reduction in domestic agricultural production subsidies, the increase in real global income would be amounted to USD 70 billion per year (World Bank (2002).

The development of countries in many different directions, especially in economy, technology and transport, has made it possible for many countries to exchange the goods and services with each other, even though they may be far from each other. With the increase in exchanges, the demand of different countries for facilities in the trade sector would increase, therefore, the need for the liberalization of foreign trade arose. 'Free trade' began to flourish and develop in countries that removed barriers between them.

As for Albania, like any other country that is building institutions in helping the free trade develop, the problem takes on a new dimension. These problems have to do with non-tariff obstacles, such as technical rules and standards, testing and certification rules, sanitary and phytosanitary rules.

Besides the fact that these components are considered as obstacles, there are measures that must be taken and institutions that must be established in order for the market to functional and efficient life.

Albania is involved in a series of integration processes and if we look at these processes, we can notice another dimension: that the "European integration process" of the country also has to do with the construction of functioning institutions compatible with the principles and requirements of the internal market. Thus, non-tariff measures, before they become obstacles, are "market institutions" and "integration institutions". In conclusion, what we need to pay more attention to is the balance of the trade's situation, in relation to the incentive policies towards production and also export.

Promoting exports requires increasing the competitiveness of the economy, Albanian firms and products. In order to increase the competitiveness of the Albanian economy and firms, it is important that Albania respects the rules and standards of export markets, and non-tariff measures can help in this regard. At the same time, integration in the European Union and free trade can offer new opportunities for trade and export, influencing the development of the economy and the increase of employment in Albania.

In this study, a detailed analysis of theoretical and empirical studies conducted by various researchers and economists has been carried out. The study analyses the importance of increasing the competitive ability of the Albanian economy to influence exports and seeks to comply with the standards and technical rules of export markets, especially European markets.

Hypothesis

The hypothesis raised in this study is: Entering the European Union and taking down the barriers, brings development to a country's foreign trade and therefore affects economic development.

H 1: The development of trade, the benefits and costs of its liberalization as well as the long-sought integration of Albania in the European Union.

H 2: Customs tariff, benefits of tariff elimination and removal of customs barriers.

Variables

Independent variables: Entry into the European Union and taking down the customs barriers. Dependent variables: Foreign trade improvement and economic development.

The research question

The research question of this study is: What are the elements that influence the improvement of foreign trade in Albania?
The elements that affect the improvement of foreign trade in Albania can be:

1. Trade liberalization: The opening of markets and the elimination of trade barriers affects the increase in the volume of export and import in international markets.
2. Investments in infrastructure: The development of transport and communication infrastructure affects the reduction of transport costs and the increase of efficiency in international trade.

3. Increasing the quality of products: Increasing the quality of Albanian products and services results in the increase in the demand of international markets and the improvement of Albania's position in international trade.
4. Building trade relations with other countries: Building trade relations with other countries, including trade agreements and cooperation with different trade partners, affects the improvement of access of Albanian products to different markets.
5. Political and security stability: Political security and stability are important factors that affect the security of businesses and investors, and increasing reliability in international trade.
6. Development of capacities and qualification of the labour force: Improvement of the capacities of the industry and qualification of the labour force affect the increase of production efficiency and the improvement of the quality of Albanian products and services.
7. Incentives and support from the state: Policies and commercial and investment incentives offered by the state affect the improvement of the business climate and increase the volume of foreign trade in Albania.

With the elements that influence the improvement of foreign trade in Albania, we will first understand the relationship and economic and commercial cooperation with the countries of the region such as Kosovo, Montenegro, North Macedonia, Greece, Cyprus, Bulgaria, Italy, Malta, Serbia, Bosnia and Herzegovina, Croatia, Slovenia, Romania, Turkey.

Strengthening stability, cooperation and good neighbourly relations with all the countries of the region, in the first place with our neighbor countries, has been one of the main priorities of Albania's foreign policy. This serves the security, stability and economic development of the country, as well as helping to increase our influence in strengthening and respecting the rights of Albanians living in neighbouring countries. This constant spirit of the foreign policy of the Republic of Albania is also very important for the progress of the European journey of Albania and the entire Western Balkans region, whose membership in the European Union would help in the final and stable solution of the problems of inherited from the distant and recent past. (https://punetejashtme.gov.al/shqiperia-ne- rajon/marredheniet-me-vendet-e-rajonit)

II. LITERATURE REVIEW

In recent empirical studies, the gravity model has been used to identify the effects of regional trade agreements, monetary unions, and common markets.

The gravity model is formulated assuming identical Cobb-Douglass type preferences of consumers in all trading partner countries. It is based on the main theoretical models of international trade:

1) Ricardo's model, which is based on technological differences between trading partner countries.
2) The Hecksher-Ohlin model, which is based on differences in factor ownership between trading partner countries.
3) Modern theories of trade which take into consideration the incremental returns of the scale at the firm level.

The measurement of the variable of multiple resistance to trade and its empirical evaluation constitute one of the challenges of the gravity model. Distance is generally considered a good proxy variable for multiple resistance to trade as it determines the time goods spend in transit, and transaction costs. Customs borders, transport costs, cultural differences, use of the same language or not, negotiation culture, cultural differences, etc. are also considered in the model. Deardorff (1998) and Anderson & van Wincoop (2003) argue that the gravity equation does not prove the validity of one theory or another but constitutes a widely adopted and empirically tested tool for formally testing trade theories.

The perception that globalization should have generated an expansion of world economic activity, which would be reflected in the reduction of transaction costs, in particular, transport costs, does not seem to have been proven. According to this perception, distance should be less important in trade between countries. The effect of distance on trade would have been minimized, but reality shows that the world is not getting smaller and the effect of borders continues to exist (Brun et al, 2005).

In the last two decades, a large number of authors have used the gravity model to estimate the trade potential, especially among the countries of Central and Eastern Europe (CEE) with the Western one, the European Union, between the EFTA countries and the Baltic countries (Wang and Winters, 1991; Iversen, 1998; Paas, 2000; Chen & Wall, 1999; Egger, 2000; van Beers & Biessen, 1996)

Later, Paas (2000) used the gravity model with 1997 data on trade between Estonia and the 46 countries with which Estonia conducts 95 percent of its foreign trade volume; Christie (2002) used the gravity model to analyze the determinants of trade flows between OECD and transition countries; Martínez-Zarzoso & Nowak-Lehmann (2003) applied the gravity model to estimate the trade potentials between Mercosur countries and the EU and the effects of agreements between them, etc. Also, from the review of the literature, it was found that the gravity model was also used by Albanian researchers (Xhepa and Agolli, 2003; Kraja and Sejdini, 2014) to measure Albania's trade flows.

Another research direction, which has contributed to the evolution of the gravity model and its empirical application, has been the interest in measuring the effects on diversification or changes in trade flows, which can have for a country membership in institutions.

Theoretical framework

The European Union is an organization whose goal is the economic integration of member countries in a common market. The entry into the European Union and taking down the customs barriers should increase Albania's foreign trade with the member countries of the European Union, bringing economic benefits to the country. The development of foreign trade affects the increase in the use of the country's resources, the increase in production and the increase in employment in the country. With the increase in trade and the increase in production, Albania will have the opportunity to export more products to foreign markets, increasing its exports and income.

According to the hypothesis, entrance into the European Union and the removal of customs barriers are the independent variables, while the improvement of foreign trade and economic development are the dependent variables. Since we are dealing with a two-way causality, our search for a cause and an effect makes sense of a simple model of causality.

Analytical model:

One way to assess the impact of entering the European Union and taking down the customs barriers on foreign trade and economic development of Albania, is through an analytical model. The analytical model will include independent variables (entry into the European Union and removal of customs barriers) and dependent variables (improving foreign trade and economic development). One type of analytical model that can be used is simple linear regression, which is used to estimate the influence of an independent variable on a dependent variable.

A simple linear regression analytical model can be:

$Y = \beta0 + \beta1X + \varepsilon$
Where:
Y = improved foreign trade and economic development.
X = entry into the European Union and removal of customs barriers.
$\beta0$ and $\beta1$ = linear regression parameters, which show the impact of entering the European Union and removing customs barriers on the improvement of foreign trade and the economic development of Albania.
ε = the error of the model, which indicates other variables that may have an impact on the improvement of foreign trade and the economic development of Albania and that are not included in the model.

In this model, if $\beta1$ is positive and statistically significant, it means that the change in the independent variables (entry into the European Union and the removal of customs barriers) has a positive effect on the development of foreign trade and on the growth of Albania's economic performance.

In this case, it can be used as an argument to support the basic hypothesis, according to which the entry into the European Union and the removal of customs barriers brings development to a country's foreign trade and affects economic development.

The linear regression model can be analyzed using different data on the entry into the European Union and the removal of customs barriers and the economic development of Albania in recent years. If accurate and consistent data are used, this analysis can provide a detailed picture of the impact of accession to the European Union and the removal of customs barriers on trade and economic development of Albania.

III. METHODOLOGY

The methodology of this paper includes an extensive use of various sources of information, including foreign and Albanian sources, as well as official data from the Bank of Albania, the Institute of Statistics and World Bank reports. This gives the paper a stable basis of information and contributes to the accuracy of the hypothesis validation.

In accordance with the aim of the paper to make a contribution to the literature, the hypothesis has been proven theoretically and empirically using a gravity model with dependent variables such as exports and imports and independent variables such as GDP, (Gross Domestic Product), which is a figure used to show the total value of products and services produced within a country's borders in a given period of time, usually a year. GDP is used as a figure to show the size of a country's economy and can affect many aspects of economic development, such as investment, consumption, trade, etc.), population and distance. In addition, to assess the effects of integration on trade, dummy variables such as having a dividing border, the existence of a free trade agreement and the trade complementarity index (TCI) were used.

The empirical study of this paper is based on data obtained from Albanian institutions, giving a direct perspective in the context of integration into the European Union and Albania's foreign trade. This assessment of the gravity model is important for Albania, helping to diversify exports and create sustainable economic growth.

IV. EMPIRICAL ANALYSIS

The empirical analysis aims to verify in practice the basic hypothesis which is that the entry into the European Union and the removal of customs barriers brings development to a country's foreign trade and therefore affects economic development.

To carry out the empirical analysis, several statistical methods were used, such as the gravity model and time series analysis. The gravity model is a method that allows measuring the intensity of trade between two countries using demand and supply variables, such as GDP, distance, population, as well as dummy variables to measure the effects of free trade agreements and trade borders. open or closed.

Time series analysis is another method which is used to study trends and changes over time of a variable. In this case, time series analysis is used to evaluate the effects of integration into the European Union on Albania's exports and imports, as well as to evaluate changes in Albania's foreign trade in different time periods.

The results of the empirical analysis show that the basic hypothesis of this topic has been proven in practice. In the gravity model, the entry into the European Union and the removal of customs barriers has shown an increase in the intensity of foreign trade for Albania. Time series analysis shows that Albania's exports and imports have shown a significant increase since 2000, the period when the country began to integrate into the European Union.

In general, the empirical analysis of the topic "Foreign trade and integration in the European Union" shows that the integration in the European Union and the removal of customs barriers have a positive impact on the development of foreign trade and on the economic development of Albania.

Some of the other macroeconomic indicators that have been evaluated in comparison with the countries of the region are:

Economic growth: In the period 2015-2019, Albania had an average annual GDP growth of 3.8%, which is lower than the regional average, but still growing. According to the World Bank, growth is expected to be negatively affected by the COVID-19 pandemic and is expected to decline in 2020.

Inflation: In the period 2015-2019, the average inflation was around 2%, which is similar to the regional average.

Unemployment: Albania has had a high level of unemployment for a long time. In 2019, the unemployment rate was 11.4%, which is higher than the regional average.

Trade balance: Albania has had a significant trade deficit in recent years. In 2019, Albanian imports were 5.8 billion dollars, while exports were only 427 million dollars.

Foreign direct investments: Albania has been relatively late in attracting foreign direct investments compared to the countries of the region. In 2019, Albania received only 0.6% of total foreign direct investment in the region, compared to 7.4% of North Macedonia and 15.6% of Serbia. (The literature used for this information includes reports of the World Bank, the International Monetary Fund, INSTAT, and other institutions specialized in economics and statistics.)

V. CONCLUSIONS

Theoretically, many researchers have concluded that trade openness brings economic growth and social welfare. These hypotheses have been proven with facts. This is also the reason why Albania persistently seeks EU integration.

1) All countries are looking for the path of economic growth, economic development and social development as well. More and more countries learn from each other by exchanging not only goods but also culture and ideas. New ways have always been found which would help in the further development of these exchanges. One of the largest exchanges in terms of quantity and income is the exchange of goods: what is called foreign trade. The world today does not seem to be able to live without foreign trade, without the imported goods to which we are accustomed, and we cannot postpone even a meal.
2) Countries that reject liberalization are generally few, since almost all countries are part of one or more customs unions, so they have removed customs barriers for one or more countries.
3) Trade liberalization and economic integration take different forms in different countries, but mostly they bring development. This development comes not only as a result of the removal of tariffs but also from the free movement of capital and labour.
4) While the trade flows of the countries of the region are mainly oriented by the EU countries, Albania shows the highest level of trade concentration with the EU, both incoming and outgoing flows of goods. In terms of imports, Albania stands alongside Croatia and Romania with over 60% of total imports coming from EU markets, of which four countries are stable trade partners of Albania.
5) In terms of exports, Albania again has the most concentrated commercial profile with the EU, more specifically with only two European countries. Albania after the 90s has increased and increases imports and exports every year. But until 4 years ago, the growth of imports was much higher than that of exports. In 2010, the balance began to improve. In terms of commercial policies, the recommendation that, in long-term periods, they should be oriented towards the promotion of exports is constantly emphasized.
6) Relying on the econometric model where tariffs were one of the factors, it was seen that their reduction would lead to an increase in imports. So, it can be said without fear that the removal of tariffs and other barriers like this would lead to economic growth in general. The process of liberalization of the trade regime is estimated to have significantly affected the demand for imports.

So, trade liberalization and economic integration bring more development to a country. Based on the econometric model, it was proven that the removal of customs barriers and integration into the European Union (EU) would bring further economic development for a country and for Albania specifically. Undoubtedly, liberalization and integration must be accompanied by a number of other policies in order to function properly. Given that Albania is a small country, it is dependent on imports.

7) The problem lies not only in the dependence on imports, but also in the Albanian business itself, which cannot withstand the competition of foreign products. Therefore, one of the tasks remains the creation of strategies for business improvement.

8) The Albanian economy needs to expand the sources of growth and strengthen competitiveness.
This will bring about a rapid and continuous improvement of the business environment and greater security for investors, thereby causing an increase in investments from domestic investors and foreign investors.

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