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A QUALITATIVE EXPLORATION OF EUROIZATION AND ITS RISKS AT BANK LEVEL

UDK / UDC: 336.7(4-12)
JEL klasifikacija / JEL classification: E51, E58, G21, G28
Izvorni znanstveni rad / Original scientific paper
Primljeno / Received: 30. rujna 2016. / September 30, 2016
Prihvaćeno za tisak / Accepted for publishing: 7. prosinca 2016. / December 7, 2016

Abstract
Euroization, which is widely considered a defining characteristic of the banking system in transition economies, has been ignored in the qualitative research literature. This paper aims at exploring euroization and its related risks at bank level through a qualitative analysis in two South East European countries. The research was conducted through semi-structured interviews with risk managers of banks in order to gain a better understanding of this phenomenon from a bank's perspective. The main finding is that macroprudential policy, widely considered a useful response to global financial crisis, is an important determinant of euroization. In addition, the analysis revealed that banks in these countries seem to be concerned with hedging against the risks associated with euroization; however they seem to overly rely on the natural hedging associated with one group of customers, exporters. In terms of the other drivers of euroization the findings of this analysis support the conventional view that deposit euroization and the interest rate differential were the main determinants of credit euroization in these countries.

Keywords: Euroization, Banking, Transition Economies, Macroprudential Policy, Qualitative research

1. INTRODUCTION

The high degree of euroization[1] has been a defining feature of the process of transition to a market system in Transition Economies (TEs).[2] Euroization in these countries was initially explained by the unstable macroeconomic conditions, a high inflationary environment, a loss of confidence in the domestic currency and a high degree of foreign ownership in the banking sectors. However, its persistence, in the face of stabilized macroeconomic conditions, has been explained mainly by the easier access to cheaper funds in foreign currency, currency mismatch risks and interest rate differentials.

The literature on euroization has expanded during the last decade mostly due to its perceived role in the systemic risk, noted only in the aftermath of the 2008 global financial crises (GFC). Nevertheless, in terms of the impact of euroization on the performance of financial system, the existing literature remains inconclusive and its investigation has been ignored in the qualitative research literature. The well-established positive impact of efficient, well-performing banking sectors on the economic development calls for a better understanding of the role of euroization. Given the lack of such literature, to the best of our knowledge, this study breaks new ground in this area and contributes to a better understanding of various aspects of the euroization phenomenon. The aim of the paper is to investigate euroization using the semi-structured face-to-face interviews carried out in the natural settings of individual banks operating in two SEE countries (Albania and Macedonia), and explore in greater detail and depth different viewpoints and mechanisms, general strategies and specific policies and procedures related to euroization at bank level (Healy and Perry, 2000).The country selection was based on the fact that, while having their own currencies, these countries are significantly euroized; however, they differ in terms of their financial systems, exchange rate regimes and economies in general. Consequently, it is expected that these differences might impact the banks' perceptions regarding euroization and related risks. The following research questions are devised to guide the investigation.

- *What is the bank's strategy with regard to euroization? Which factors influence the need for and the nature of an euroization strategy? Does it vary with bank characteristics?*
- *What are the procedures and processes employed by the banks to address the risks related to euroization? Do these vary between banks and over time?*

[1] Euroization (or dollarization) is the substitution of foreign currency (FC) for domestic currency (DC). The focus of this paper is on'financial euroization' which consists of credit euroization (the share of foreign currency loans in total loans) and deposit euroization (the share of foreign currency deposits in total deposits).

[2] The degree of credit and deposit euroization has remained high over the 2000-2013 period, averaging at 50% and standing at above 80% in some countries such as Estonia, Lithuania and Macedonia (Central Banks in respective countries (various years)).

- *What are the drivers of foreign currency lending? Do they vary between banks and over time?*

The rest of the paper is structured in the following manner. The discussion on the design and methodology of the overall qualitative approach including the identified ethical considerations relevant to the nature of the study, with emphasis on the issue of confidentiality and strategies employed to maintain it, is presented in section 2. A summary of the financial setting in Albania and Macedonia is presented in section 3. The main findings and the discussion of the findings and their implications are presented in section 4. The final section concludes the paper.

2. RESEARCH DESIGN AND METHODOLOGY

Qualitative research often relies on the case study method, utilizing multiple sources of information to examine the various dimensions of the research question (Yin, 2003). However, this method almost invariably involves the identification of the subject of study, thus violating the confidentiality agreement and the anonymity of the participants. Similarly, the presentation of any background information or data on the operation of the banks under consideration would have made it possible to directly or indirectly identify these banks. It was therefore decided to use only semi-structured in-depth interviews and to present the background information and other data for the banks under consideration as groups to ensure that the identity of the respondents was not compromised.

2.1. Ethical Considerations

Ethical considerations are essential in all types of research particularly in qualitative research mainly due to the flexible research design and the unstructured data collection method employed in qualitative literature (Denzin and Lincoln, 2000; Hammersley and Traianou, 2012). The main issues that need to be anticipated and planned for when conducting qualitative research ((informed consent, confidentiality of information and anonymity of the respondents) (Kvale, 1996; Creswell, 2012)) were considered from the early design stage to the findings stage. Given that the respondents' discussion on the specific euroization strategy of a bank is a strictly confidential matter, it was absolutely paramount to make the interviews anonymous and take all precautions to maintain the confidentiality of the interviewees and their banks.

2.2. Sample Selection

This investigation employs non-random purposeful sampling which occurs when the sample is chosen in accordance to specific characteristics of the population studied. The sample consists of participants selected from the general population who can best inform the research team about the phenomenon studied (Trochim, 2001; Creswell, 2007). Sampling strategies employed were: maximum variation, specific criterion, critical cases and convenient cases which, according to Creswell (2007) are the most popular strategies. Maximum variation consists of selecting individuals and/or sites that are quite different based on the criteria selected so as to increase the likelihood that the findings will reflect the differences or different perspectives. The critical cases strategy consists of selecting individuals and/or sites which provide specific information about a problem, whereas, convenience cases consist of selecting the individuals and/or sites which the researcher can easily access (Creswell, 2007). Sampling can be at the site level, the event/process level and at the participant level, and one or more levels ought to be present for a better sample (Marshall and Rossman, 2006; Creswell, 2007). In selecting the sample for this investigation, three levels were identified: countries, banks, participants.

In terms of countries, the paper focuses on Albania and Macedonia, countries with their own currencies and both significantly euroized. They differ in terms of their financial systems, exchange rate regimes, and economies in general, which may affect perceptions regarding euroization and related risks. Thus, information obtained ought to be more richly textured and thus more informative.

In selecting the banks, three screening criteria of size, ownership and ease of access[3] were employed to ensure that the selected banks are representatives of the diversity of the banking systems and to increase the likelihood that the findings will reflect differences in terms of strategies, policies, and procedures regarding euroization. Thus, the sample consists of seven banks of which four large and three small banks, all of them foreign owned although to different degrees, currently operating in Albania and Macedonia.

The targeted participants in each bank were persons responsible for the risk operations of their banks at different levels of seniority. They include one chief risk manager, five risk managers or credit risk managers and one non-manager senior risk officer, thus ensuring that the phenomenon could be explored through different layers of responsibility. Out of seven interviewees three were females and four males.

[3] Convenience or ease of access was one of the criteria criterion applied due to the nature of the research: euroization is considered a sensitive matter for banks dataand this which made accessibility to banks and their risk managers a challenge. Although, the participants were not asked for quantitative data regarding the share of credit or deposit euroization (these can be obtained through other Channels), the sensitive nature of the bank specific strategies, policies and procedures regarding euroization are very sensitive and, in general, banks do not wish to discuss them. This meant that, in some cases, we had to use intermediaries who could reassure the bank personnel of anonymity and confidentiality limited us to target banks where we had sufficient connections to gain access. Nevertheless, it must of course be highlighted that all banks that we approached, with exception of one, responded positively.

In qualitative research, the sample size is a matter of judgment. The sample should allow for sufficient in-depth interviews to obtain full understanding of the participants' experiences (Creswell, 2007), thus the focus is not so much on the size of the sample, as it is on the quality of information obtained (Sandelowski, 1995). Although we had initially planned for a sample of ten interviews to achieve good coverage with regard to euroization, in practice we could only complete seven interviews.[4] We believe the number of interviews (seven) is still sufficient to gain an understanding of the strategy and risks of euroization and how banks in the two countries deal with this risk.

2.3. Interview Design

The qualitative research involved face-to-face in-depth interviews with the representatives of the targeted banks using a semi-structured questionnaire. Semi-structured in-depth interviews which are generally organised around a set of pre-specified open-ended questions (see Appendix A), allow the interviewees to build on and explain their responses, giving the researcher more detailed and richer data (Saunders et al, 2003; Bryman, 2006). The partial structure allows for replication of the interviews enabling a certain degree of standardization, which increases data comparability and reliability. Validity is also facilitated through the opportunity to observe other non-verbal indicators, which is particularly useful when discussing sensitive issues (Gordon, 1975).

The interviews had a structured order of different topics related to the key questions about banks' perspectives and attitudes towards euroization and the elements that they believed underpin euroization. Sub-questions were grouped around main themes and were used for reference; additional prompts were used to draw out respondents' opinions if necessary. For instance the interview began with a general question whether the bank had a specific euroization strategy. If they did, then they would be asked to elaborate further, with prompts being used to develop the depth of the information. The development of the discussion on the euroization strategy is presented in Figure 1.

[4] One bank refused to participate in the interview and two interviews in Macedonia had to be cancelled due to civil disturbances in Skopje at the time of planned interviews which made it impossible to move about freely in the city centre. It was not possible to reschedule the interviews later.

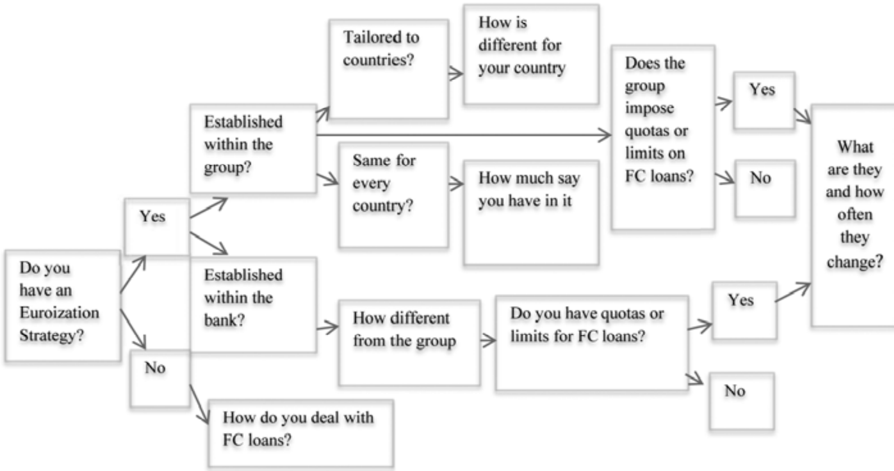

Figure 1 The exploration of Euroization strategy during the interviews

The interview timeline:

- We approached potential participants through intermediaries.
- The participants were provided with the informed consent form, a statement letter, and the questions of the interview in advance.
- The interviews were set up at participants' natural settings, at the date and time of the participants' choice.
- At the beginning of the interview the research project was explained, the consent form was given to the participant again and his/her questions were answered.
- The interviews began after the participants signed and dated the consent forms, which have been retained.

2.4. Secondary Data

In addition to interviews, a number of different legal documents and official statistics have been used as secondary data to provide additional information to strengthen the arguments and also to be used for the purpose of validity, i.e. to triangulate the findings of the study. Legal documents consist of laws and regulations relevant to banking system in the two countries and important documents produced by the regulatory authorities. They were collected from the official web sites of the relevant institutions. They provide information on how the banking system is regulated and supervised in these countries and on the regulatory authorities' policy goals with regard to euroization. In addition to these legal documents, the banks' annual reports were also studied as they provide additional information considered useful for a better understanding of their activities. Additional quantitative data on euroization was collected from central banks in order to check the validity of statements made at the interviews.

2.5. Data Analysis Process

The collected data were analysed employing thematic analysis, which involves examining interview transcripts and finding common as well as uncommon themes, (Silverman, 2011, Creswell, 2012). The main themes were identified *a priori* based on the literature yet, once the data analysis process commenced it was clear that these themes were unable to explain the euroization phenomenon in itsentirety and therefore additional themes started to emerge and in few cases, the hierarchy of previously identified themes became more complex. The full list of themes are presented in Appendix B.

3. THE FINANCIAL SETTING IN ALBANIA AND MACEDONIA

In this section a comparative analysis of the economic indicators are presented for the two countries in order to provide the background and the economic underpinning of the banks' policies on euroization.

3.1. Euroization

A significant degree of euroization is an important characteristic of both countries, justifying the further exploration of this phenomenon. Whilst Albania has experienced a broadly stable high level of euroization throughout the last decade, Macedonia has been characterized with a lower but stable degree of euroization until the global financial crisis when it increased, reaching an all-time high of almost 60 percent in 2009. In the following three years, there was a gradual decline of euroization, followed by a sharp decline in 2012 to 30 percent (see Figure 2).

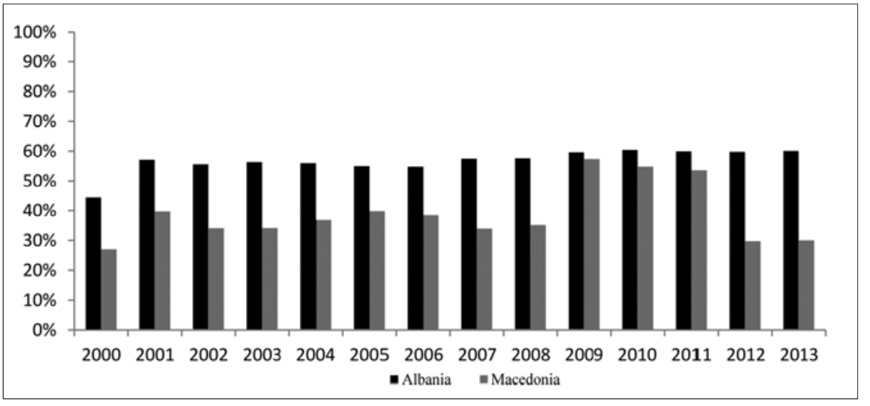

Figure 2 The degree of credit euroization in Albania and Macedonia, 2000-2013

Source: Respective Central Banks

These different trends make the exploration of the implications of euroization in these countries interesting. Prior to 2012, the central banks in both countries were to some extent indifferent to foreign currency lending trends. Since 2012, however, both central banks have undertaken concrete steps to encourage banks to move towards domestic currency lending which, according to our interviewees, have proven successful. This was highlighted more in Macedonia, where the government regarded the sharp increase of euroization during 2009 as a negative change and the Central Bank explicitly stated its strategy to encourage de-euroization of the banking sector through measures presented later in this section under monetary policy.

3.2. Economic Development

The performance of the two economies has been very different in the period under consideration. Before the global financial crisis, between 2002 and 2008, Albania was one of the fastest-growing economies in Europe, with average annual real growth rates of 6%, whereas Macedonia experiencing average rates of economic growth of3.5 percent (see Figure 3), and was underperforming in comparison with other countries in the region. The two economies also differ with respect to how they weathered the crisis: whilst the Macedonian economy contracted by 1 percent during 2009, the Albanian economy was one of the very few economies in Europe that continued to experience positive growth, albeit at half of its previous level. The growth of both economies deteriorated further in 2012 and 2013, reflecting the difficult situation in the Eurozone, but the Macedonian economy rapidly recovered in the following year whereas the Albanian economy stagnated.

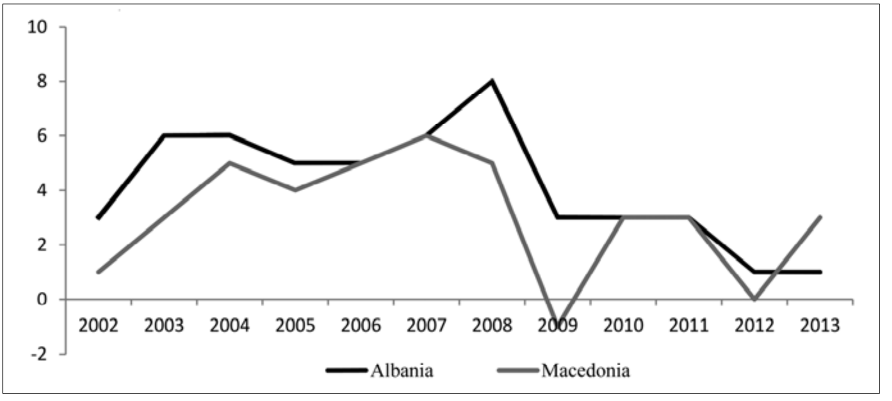

Figure Average annual GDP growth (in percent) in Albania and Macedonia, 2002-2013

Source: World Bank (2015).

The experience of the two countries also differs with regard to inflation. In Albania, the inflation rate has been fairly low, close to two percent, in the past ten years. In Macedonia, although the inflation rate was largely stable between 2002 and 2007, in 2008 it rose to eight percent but then in the following year dropped to a low of minus one percent (Figure 4). Since then the rate has risen to over two percent.

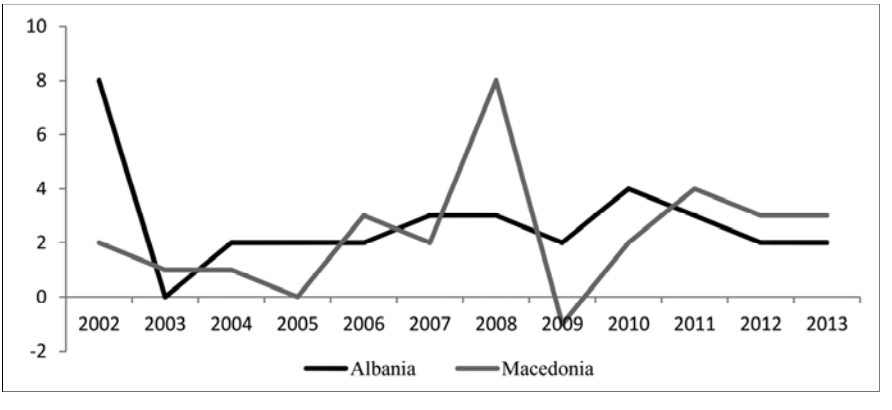

Figure 4 Average annual Inflation rate (in percent) in Albania and Macedonia, 2002-2013

Source: World Bank (2015).

3.3. Exchange Rate Regime

Another important attribute of the two countries is their exchange rate regime. Albania has had a flexible exchange rate regime although the Bank of Albania occasionally intervenes in the foreign exchange market with the aim of smoothing temporary fluctuations and accumulating the necessary reserves. Macedonia has had a fixed exchange rate regime (with very small margins) since 1995, originally against the Deutche-Mark and then against the Euro. As seen in Figure 5, the exchange rate in Macedonia has been relatively stable throughout the years. However, in Albania the exchange rate adjusted during the global financial crisis. As a result, the perceived risks regarding euroization may differ in two countries.

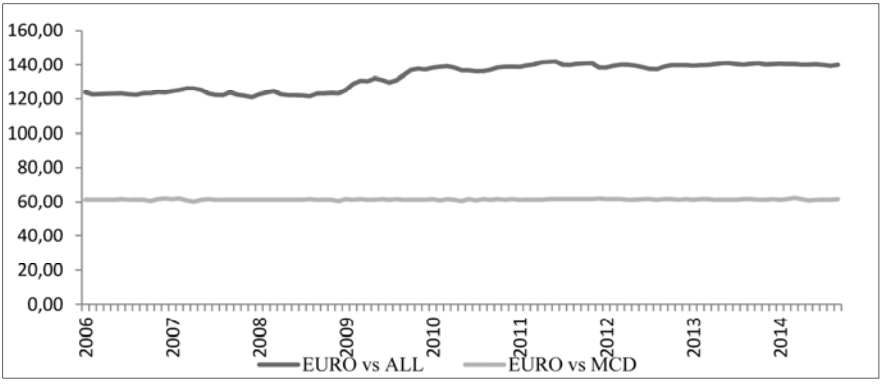

Figure 5 EURO against Albanian Lek and Macedonian Denar, 2006-2014

Source: Respective Central Banks

3.4. Monetary and Macroprudential Policy

The primary monetary policy tool in both countries is the interest rate on central bank bills. Both countries have loosened their monetary policy in the last few years, with interest rates reaching historically low figures in the last year. Both countries have followed the Eurozone trend, although not at the same pace, in reducing the base rate after the global financial crisis in 2009. In comparison to the reduction of the EURIBOR interest rate, Albania reduced the interest rate very gradually until 2012 after which the reduction was greater, reaching the historical low of 2.5 percent. On the other hand, Macedonia followed more closely the Eurozone, with a sharp reduction in the base rate during 2010 and a gradual decrease during the following years, reaching a historical low for Macedonia of 3.5 percent (see Figure 6). However, taking into the consideration the EURIBOR rate has also been at an historical low, the gap with the European base rate remains large.

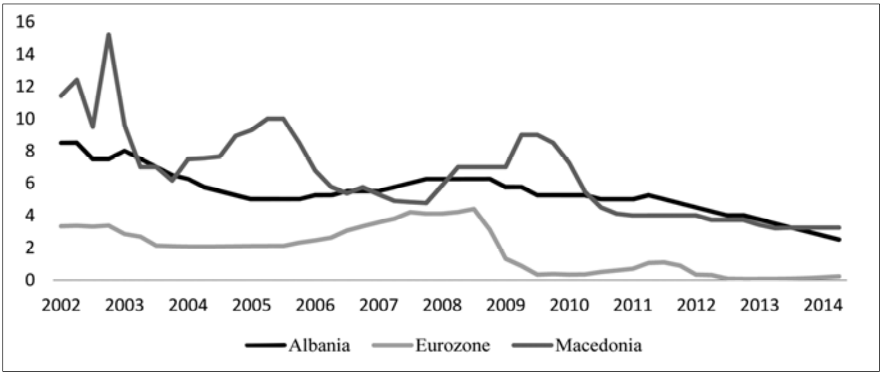

Figure 6 Changes in interest rates in Albania and Macedonia, 2002- 2014

Source: European Central Bank, respective Central Banks

Besides monetary policy, governments in both countries have applied macroprudential policy instruments directly related to foreign and domestic currency throughout the period under consideration. This was mainly due to the possible positive impact of euroization on the growth of systemic risk. These policy instruments include reserve requirements on domestic and foreign currency liabilities, credit growth ceilings, and liquidity ratios. The main aim of these instruments has been to contain or reduce the level of euroization in order to limit the development of the systemic risk in these countries. Both countries changed their reserve requirements on domestic and foreign currency liabilities during 2012. Albania stopped offering remunerations for required reserves in foreign currency. In addition, they increased the required capital holding for the risky assets in foreign currency. Macedonia reduced the reserve requirements for domestic currency liabilities and simultaneously increased requirements for the foreign currency liabilities. These changes seem to be in line with the findings of Xhelili et al. (2016) who found that banks operating in TEs with higher level of euroization seem to face higher costs.

3.5. Banking Sector

Albania and Macedonia have been characterized by financial deepening in the last decade. Domestic credit has risen substantially relative to GDP, however, the ratio remains fairly low, less than 50 percent of GDP. In the years prior to the global financial crisis, both countries were experiencing financial deepening at a fast rate, but this has slowed down. It is worth noting that financial deepening in Albania was faster than in Macedonia before the crisis, but also it slowed down more after 2009. Table 1 illustrates some of the main characteristics of the banking system in the two countries.

Table 1

Banking sector indicators in Albania and Macedonia

	2005	2006	2007	2008	2009	2010	2011	2012	2013
ALBANIA									
Domestic credit to private sector (% of GDP)	15%	22%	30%	35%	37%	38%	39%	39%	38%
Number of banks	17	17	16	16	16	16	16	16	16
Foreign ownership	92%	91%	94%	94%	93%	91%	90%	92%	92%
MACEDONIA									
Domestic credit to private sector (% of GDP)	24%	29%	35%	42%	44%	44%	45%	48%	49%
Number of banks	20	19	18	18	18	18	17	16	16
Foreign ownership (share of FO in total assets)	51%	53%	86%	93%	93%	93%	92%	92%	68%

Source: EBRD, Respective Central Banks, World Bank

The banking sectors of both countries are mainly foreign owned. The share of foreign ownership in the Albanian banking sector has been large and stable, above 90 percent, throughout the period from 2005. In Macedonia, the share of foreign ownership increased from just above 50 percent in 2005 to 92 percent in 2012, but then reduced to 68 percent by 2013. The sharp drop experienced in the last year reflects the fact that one bank was transferred from foreign ownership to domestic ownership. In both countries, the foreign capital is mostly European, with Greek and Slovenian capital dominating the Macedonian banking sector, and Greek and Italian dominating the Albanian banking sector. In 2013 there were 16 banks operating in each country. Since 2005 the number of banks has decreased by one in Albania, but the decrease was larger in Macedonia where the number of banks fell from 20 to 16 (Table 1). The banking sector in both countries has weathered the global financial crisis relatively well and remained largely stable during the Eurozone crisis. Nevertheless, the sector still faces considerable risks from the deleveraging pressures from foreign parent banks, prolonged weak growth, and the continued deterioration of banks' loan quality, particularly in Albania where the NPL ratio at end November 2013 reached 24.2 percent of total loans.

4. DISCUSSION OF THE FINDINGS AND IMPLICATIONS

In this section, the findings of the survey are briefly reported and the connections between the main findings and the euroization literature explored, taking into consideration bank and country contexts. The discussion is structured around the key research questions underpinning this study.

What is your strategy with regard to euroization? What tends to determine or influence the need for and nature of an euroization strategy? Does it vary with bank characteristics?

In relation to the first research question in this investigation, the lack of earlier research made it difficult to construct a comprehensive framework to be used as a basis for comparison. Nevertheless, the analysis revealed that, in general, strategies pursued by banks seem to be sensible in terms of their objectives.

Four out of seven interviewees responded that their bank does have a specific euroization strategy. Three out of seven responded that their bank does not have a specific euroization strategy. However, they pointed out that they dealt with it through different rules and procedures set within their general lending policies. The typical strategy of the banks in the sample is hedging against the risks related to euroization such as currency and currency mismatch risk. In one particular case the strategy is focused on hedging and reducing the level of euroization exposure in terms of volumes simultaneously. Of those banks that had a specific strategy, the majority (three out of four) seem to have it set at their headquarters, suggesting that hedging is being centrally managed. However, all strategies seem to consider naturally hedged customers such as net exporters as fully hedged and thus did not treat them as risky. This is interesting because whilst the risk of default for naturally hedged clients in terms of currency mismatch might very well be negligible, these loans are still extended in foreign currency. Thus by excluding them from their limits, banks may not fully be matching the foreign currency assets and liabilities in their balance sheets. With unmatched currency positions, a change in the exchange rate will have an immediate effect on their books, which is not in line with a bank taking a fully hedged position. What is more, this seems to be in line with the current government policies which allow the exclusion of net exporters from the limits. This is concerning because whilst, from one country's point of view, this may be sensible on the surface because there are limited cases within a country and thus the risk to the bank may be considered minimal. The risk to the overall group may not be that small if all the countries in which the group is present have this policy. This implies that countries in the region might need some sort of regional agreement on limiting this source of risk to their banks.

Various factors linked to the determination of the euroization strategy seem to be linked to both bank's parent group (in six out of seven banks) and the government policies in the countries in which they are present (in all seven). The parent group's focus seems to be an important determinant. It was observed that the only bank in the sample which was independent in establishing its euroization strategy was characterized by a different business model in comparison to the group overall. Every other bank was completely in line with their parent group in terms of how they treat euroization. The study indicates that the previous history with euroization risk is another particularly important factor influencing the setting of the euroization strategy. It seems that if the group has had previous negative experience with the outcome of euroization risk in other countries, the strategy is entirely managed at the group level i.e. centrally. This suggests that banks and parent groupsare not being completely proactive but rather reactive with respect to hedging. In addition, it was observed that the strategy is also constrained by the government policies in the county where the bank operates. Allbanks in both countries which are restricting their foreign currency loans and deposits and moving towards domestic currency, pointed out that they were doing so mostly due to the new government policies, macroprudential policy instruments. This indicates that government policies seem to be effective and an important factor in the determination of euroization strategy.

What are the procedures and processes employed by banks to address risks related to euroization? Do these vary between banks and over time?

In relation to the second research question the literature on euroization argues that currency mismatch risk is the main source of fragility for the financial system in the presence of euroization (Goldstein and Turner, 2004; De Nicolo et al., 2005). In the presence of euroization, banks attempt to hedge against foreign exchange risk in their balance sheets by matching their foreign currency liabilities i.e. deposits with foreign currency assets i.e. loans. Lending in foreign currency is virtually the only hedging instrument for these banks because in SEE countries there are no other well-established financial hedging instruments at reasonable cost. Nevertheless, by lending in foreign currency they are not entirely hedged if their customers have not matched their assets and liabilities in their balance sheets in terms of currency as well. In situations when the customers' assets i.e. income are in domestic currency whilst, their liabilities i.e. loans are in foreign currency they are more vulnerable to the foreign exchange risk. Consequently, their ability to repay their obligations to the banks is affected, making banks more vulnerable to credit risk. All seven banks stated that they consider the currency mismatch risk as the main risk related to euroization. Therefore, the study supports the view that banks recognise currency mismatch risk as important.

The study reveals that typical policies and procedures employed by many banks in the sample seem to be in line with a strategy that is concerned with reducing the foreign currency risk. All banks in our sample seem to be concerned about hedging against the currency mismatch risk. In terms of instruments, procedures and processes used to manage it, the study showed that banks employ limits, and different credit standards and procedures for foreign currency loans. Three out of seven banks have specific limits in terms of euroization, whereas four out of seven seem to employ stricter credit standards and procedures for clients assessed as highly sensitive to foreign currency risk.

Two out of three banks that had explicit limits related to euroization stated that these limits were set within the group level one bank maintained that their limits were set within the bank. Limits related to foreign currency loans are used with regard to total loan stock, new loans, foreign currency deposits or specific sectors. They seem to be usually revised annually, but followed monthly.

In terms of a hedging strategy, this seems to be sensible in a relatively stable environment but it would need to be adjusted quickly in a less stable environment. Whether banks have the right policies and procedures in place to respond quickly in times of turmoil remains to be seen.

The study also revealed that over half of the banks (four out of seven) in our sample seem to employ stricter credit standards and procedures in the presence of currency mismatch in the assets and liabilities of their clients. Some, but not all, either require higher collateral coverage or lower debt to income ratios, or both. However, three banks have standard credit procedures, in the sense that they do not apply stricter credit criteria in the presence of currency mismatch risk, they only decide to extend the loan or not.

Although the study suggests that there is much hedging with regard to currency mismatch risk, all banks acknowledge that a certain degree of currency mismatch is present in their portfolios, particularly in their mortgage portfolio loans. The fact that the highest degree of currency mismatch is in their mortgage portfolios suggests that banks have maturity mismatches in their books as well. The combination of currency and maturity mismatches is worrying given that the first one is considered responsible for triggering the 1997 Asian financial crisis (Chang and Velasco, 2003; Godlstein and Turner, 2004; De Nicolo, et al., 2005) and the second one is considered the major cause of the 2008 global financial crisis (Brunnermeier et al., 2009). Nevertheless, this has not proved to be a problem up to this point in time in either of the two countries. This is not surprising for Macedonia given the exchange rate stability linked to the fixed exchange rate regime. However, in Albania, the exchange rate adjusted during the crisis period and the fact that problems of currency mismatch did not materialize is perhaps surprising. An explanation might be that Albania's economy weathered the global financial crisis quite well because its exchange rate adjusted, so although there was an exchange rate effect, the positive state of the economy meant that there were not a lot of defaults on these debts. Alternatively, perhaps the degree of currency mismatch risk was not large, as these clients were getting some flows of foreign currency in forms of informal remittances, and thus were at least partly hedged, although this is not taken account of by banks in their processes.

What are the drivers of foreign currency lending? Do they vary between banks and over time?

In relation to the third question, the euroization literature identifies the determinants of the persistence of euroization as: interest rate differential between domestic and foreign currencies; bank currency match i.e. matching of foreign currency liabilities (deposits) with foreign currency assets (loans), exchange rate volatility, exchange rate policy and the openness of the economy in terms of easier access to foreign funds (Ize and Levy Yeyati, 2003; Luca and Petrova, 2003; Rosenberg and Tirpak, 2008; Neanidis and Savva, 2009; Basso et al., 2011; Haiss and Rainer 2012; Cuaresma et al., 2013).

The findings in this analysis confirm the existing literature. The interviewees clearly suggested that currency matching by banks is the most important driver of foreign currency lending. All banks listed it as an important determinant of the persistence of euroization, five of them as the first reason, one as the second and one as the third reason. As argued above the underdeveloped banking systems and financial markets in TEs mean that banks operating in these countries can hedge their foreign currency liabilities only by lending in foreign currency. In the literature, the preference for foreign currency as store of value is rational in the presence of high inflation and exchange rate volatility. However, the literature argues that in the long run the domestic currency re-establishes its value (Ize and Levy Yeyati, 2003; Basso et al., 2011). This investigation partly supports these views given that banks maintained that it is the customers who seem to prefer depositing their money in foreign currency initially, because they perceive it as more stable. However, the experience of these countries does suggest that the presence of foreign currency deposits will continue for a long time after currency stability is established. The investigation suggests that for the domestic currency to re-establish itself it may need active involvement of the government in adopting correct policies. The recent policies discouraging foreign currency lending, has encouraged banks to move towards domestic currency lending given that seven banks stated that these policies were discouraging euroization. Banks have acknowledged that the differences in interest rates offered on loans in foreign and domestic currencies are much lower than before, mainly due to such government intervention. The research here suggested that banks are very much affected by government regulations and the movement back to domestic currency seems to require the right policy setting.

The second most quoted reason behind the high level of euroization was hedging: one interviewee gave it as the first reason, four as the second reason and two as the third reason. Due to the perceived higher stability of foreign currency, clients prefer depositing their money in foreign currency leaving banks with large deposit base and over liquidity in euro. Consequently they need to hedge and protect themselves with regard to foreign currency positions by having assets in foreign currency as well. In SEE countries where the banking market is simple, lending in foreign currency is virtually the only hedging instrument for these banks because there are no other well-established financial hedging instruments at reasonable cost.

The study also supports the literature by finding the interest rate differential between the domestic and foreign currency an important driver of foreign currency lending. According to the interviewees, clients are comfortable with depositing their money in domestic currency only with much higher interest rates than in foreign currency because they perceive foreign currency to be more stable. Given the lower interest rate offered on deposits in foreign currency, banks are able to offer foreign currency loans with lower interest rates, making them more attractive to clients than domestic currency loans. The study suggests that higher returns or higher profitability is the third identified driver of foreign currency loans. Seven banks listed it as an important driver, out of which one listed it as the first reason, two as the second and three as the third reason. Although, the interviewees considered that due to cheaper funding foreign currency loans have a positive impact on profitability, not all of them argued that this impact is large. The study showed that for products such as personal loans, credit cards and overdrafts, for which the bank's profit margin is larger, banks are required to offer them only in domestic currency due to the regulatory framework. This then has implications with regard to the profitability of domestic currency assets in comparison to foreign currency assets. We are limited in further exploring or quantifying the profitability of foreign currency assets in comparison to domestic currency assets by product type, due to the lack of data on foreign currency loans categorized by product types.

The exploration of the quality of FC loans was another area of interest in this analysis. In this regard all banks maintained that there are no significant differences in performance between loans in FC and DC. All banks perform stress testing with currency based scenarios and different types of sensitive tests and do not find any particular differences with regard to foreign currency.

Finally, the analysis suggests that once euroization is present in the system, a specific government initiative is needed to change its level, an aspect not highlighted or discussed in the existing literature. The literature has not explained the persistence of euroization once the macroeconomic conditions in terms of inflation and exchange rate volatility have stabilized. All banks maintained that the recent government policies, such as macroprudential policy were discouraging euroization. Thus this analysis has revealed that it is specific government policies such as macroprudential policies that aim to contain or reduce euroization that can actually shift such persistence.

5. CONCLUSION

This paper has focused on a qualitative investigation of the euroization phenomena from banks' perspectives in two SEE economies: Albania and Macedonia. In terms of design and methodology of the study ethical considerations constrained the investigation to the use of semi-structured face-to-face in-depth interviews without supplementing this with additional background data on each bank in order not to compromise the confidentiality of the participants and banks. The semi-structured interviews were conducted in the natural settings of individual banks operating in the two countries.The selection of Albania and Macedonia was based on the fact that they have their own currencies and are significantly euroized; but they differ in terms of their financial systems, exchange rate regimes and economies in general. Consequently, it was expected that they might differ in terms of their perceptions regarding euroization and related risks, and thus, the information obtained would enable a deeper understanding of euroization.

The findings of the analysis provide timely, informative, and enlightening insights into euroization,a topic that has influenced banks in TEs, particularly in SEE countries, over the last two decades. Although the analysis was based on two selected SEE countries, the conclusions may have more general applicability in other TEs, at least in those with similar banking sectors and a considerable degree of euroization.

Initially, and in line with the literature, the investigation demonstrates that euroization continues to be a significant characteristic of banks and banking sectors in TEs. Nevertheless, the main conclusion of this analysis is that government policies such as macroprudential policies related to euroization affect policies and procedures employed by banks. For a long time governments and central banks were indifferent towards euroization and this seems to have allowed the high degree of euroization to continue in these countries, given that banks' and customers' preference for foreign currency in comparison to domestic currency were not in conflict. However, this investigation indicates that macroprudential policies are becoming an important driver of de-euroization.

In addition, the analysis revealed that banks seem to be concerned with hedging against the risks associated with euroization. Furthermore, within our sample, hedging is being typically managed centrally, at each banking group's headquarter, as this is a risk that affects the group as a whole However, most of the banks in the sample seem to neglect the risks associated with one group of customers, exporters, and overly rely on the natural hedging available to this group. They all seem to exclude them from their foreign currency lending limits, which implies that banks are underestimating their own exposures in terms of the risks related to foreign currency. Moreover, there are indications that banks are not being completely proactive but rather reactive with respect to hedging. Banks with the strictest euroization strategy seem to be those that had experienced losses associated with euroization risk in their previous operations in another country.

In terms of other drivers of euroization the findings of this analysis support the conventional view that deposit euroization and the interest rate differentials were the main determinants of credit euroization in these countries.

Finally, in terms of the contribution to methods of investigation, the study showed that future qualitative investigations in this area could result in useful insights if they are carefully designed even though the confidential nature of the data makes this type of investigation difficult.

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APPENDICES

APPENDIX A. INTERVIEW OUTLINE

Abbreviations
FC – Foreign Currency
DC - Domestic Currency

Questions

1. Do you have FC loans or loans that are indexed to or linked in someway to FC (or Inflation)? If ***YES***, do you treat the linked loans as FC loans?and ***WHY***?

□ **yes** □ **no**
(please tick)

2. Does the bank have a strategy regarding FC loans and deposits? If ***NO***, then how does the bank deal with the FC loans and deposits?If ***YES,*** is this strategy established within the group/headquarter or within branch/subsidiary?

□ **yes** □ **no**
(please tick)

If within the group:

3. Is the FC strategy tailored to specific group member conditions? If ***YES***, how does your bank's strategy differ from the group's? If **NO,** does the negotiation process depend on your banks size within the group?

□ **yes** □ **no**
(please tick)

4. Does the group impose quotas or hard number limits for FC and FC linked lending? If, ***YES*** what are they and how often they change?

□ **yes** □ **no**
(please tick)

If within the bank:

5. How does your bank's strategy differ from the group's? Do you have entirely different procedures? Do you offer different conditions in comparison with the group? Do you have different limits in comparison with the group?
6. Why do you lend in FC? Do you lend in FC because you have FC deposits and want to hedge; or because FC loans are more profitable; or because there is a higher demand for FC loans?

□ **Hedge, FC deposits**
□ **FC loans, higher returns**
□ **Demand for FC loans**

(please tick and rank which is more important)

7. Do your banks' credit standards and conditions differ for FC loans/deposits versus DC loans/deposits? What about the FC linked loans/deposits to FC loans/deposits?and if ***YES***, for which category are there more favourable?

□ **yes** □ **no**

(please tick)

□ **FC loans more favourable**

□ **FC indexed more favourable**

□ **DC loans more favourable**

(please tick)

8. How is the favoured category treated? Do you offer only lower interest rates for those loans or also have more relaxed credit standards and conditions for them? Eg. require less collateral.
9. Can you tell us more regarding the performance of FC loans? Do they perform better than DC loans? What about FC linked loans, in comparison to FC loans or DC loans?

APPENDIXB. THE COMPLETE LIST OD THEMES AND SUBTHEMES

a) FC Strategy
   - i. Yes
     - i. Where established and why?
       - 1. Within the group;
         - a. Tailored to countries?
           - i. How different for your country?
       - 2. Same for every country?
         - a. How much say you have in it?
       - 3. Does you group impose FC quotas or limits?
         - a. Yes
           - i. What are they and how often they change?
         - b. No
       - 4. Within the bank:
         - a. How different from the group
           - i. Do you have FC quotas or limits
             - 1. Yes
               - a. What are they and how often they change?
             - 2. No
   - ii. No
     - i. How do you deal with FC loans
   - iii. Factors influencing the FC strategy
     - i. Business focus of the group vs bank
     - ii. Size of the bank within the group

            iii. Previous experience with regard to FC risk

b) Instruments employed to address the FC risks
    i. Limits
        i. Yes
            1. Set at the group
            2. Set at the bank
        ii. No
    ii. Credit standards and procedures
        i. Different treatment of FC loans
        ii. Currency mismatch

c) Drivers of FC lending:
    i. Hedging
        i. FC deposits
    ii. Higher returns
        i. Higher profit margin
        ii. Cheaper funding
    iii. Demand
        i. Currency stability
        ii. Higher return

d) FC indexed lending
    i. Yes
        i. Different treatment vs FC and DC?
            1. Which category is more favourable for the clients?
    ii. No

e) Performance of FC loans
    i. Yes
    ii. No

f) Encouragement of DC lending
    i. Yes
        i. Through base rate
        ii. Through reserve requirements on FC funds
        iii. Different RWA for FC assets
    ii. No

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KVALITATIVNO ISTRAŽIVANJE EUROIZACIJE I NJEZINI RIZICI U BANKOVNOM SUSTAVU

Sažetak

Kvalitativna istraživanja zanemaruju euroizaciju koja se smatra ključnom karakteristikom bankarskog sustava u tranzicijskim zemljama. Cilj je rada istražiti euroizaciju i njezine rizike u bankovnom sustavu kvalitativnom analizom u dvjema zemljama jugoistočne Europe. Istraživanje je provedeno na temelju polustrukturiranog intervjua s upraviteljima rizika u bankama kako bi se dobio bolji uvid u tu pojavu iz perspektive banaka. Ključno je otkriće to da je makroprudencijalna politika, koja se smatra korisnim odgovorom na globalnu financijsku krizu, važna odrednica euroizacije. Analiza je također pokazala da se banke u tim zemljama bave zaštitom od rizika euroizacije. Ipak, čini se da se pretjerano oslanjaju na prirodni hedging povezan s jednom skupinom klijenata, izvoznicima. Glede drugih pokretača euroizacije, rezultati analize podržavaju konvencionalni stav da su euroizacija depozita i razlika kamatne stope glavne odrednice kreditne euroizacije u tim zemljama.

Ključne riječi: euroizacija, bankarstvo, tranzicijske zemlje, makroprudencijalna politika, kvalitativno istraživanje.

JEL klasifikacija: E51, E58, G21, G28