

ALBANIAN FINANCIAL SYSTEM IN TRANSITION PROGRESS OR FRAGILITY?

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Abstract

This paper analyses the developments in the banking system, as the most important part of our financial system, which are considered in the context of and relationship with macroeconomic developments, highlighting two moments of crisis and turbulence of this system in 1997 and 2002. While the first financial crisis was a crisis ignited by pyramid schemes and not closely related to the banking system, the second moment represents a pure disturbance of the banking system, which marked the threshold of a banking crisis.

In this paper, we analyze the essential features of the banking system and various factors that stand in the foundation of the banking sector developments, reaching the conclusion that in spite of the significant progress, the banking system remains fragile and exposed to serious crises and disturbances that may be transformed into banking crises. The analysis of the financial crisis ignited by pyramid schemes and the consequences it brought about, especially in forming the public expectations, serves as basis for explaining even the recent shocking in the banking system.

The banking system development and the increase of public confidence in it relates not only to its development and invigorating through the privatization of state-owned banks, encouragement of competitiveness, perfection of payment systems and strengthening of supervision, but also to real economy development and political stability of the country.

Introduction

In the process of transforming a country with centralized economy into a country with free market based economy, besides major problems such as coping with the inflation and ensuring stable economic growth paces, which comprise the fundamentals of a successful transformation, a special place is occupied by the transformation and the reform of the financial system, especially in the banking sector. Given that in 2001 the financial market and other non-bank financial institutions occupy a rather insignificant weight of 5 per cent of the whole banking system (Ibrahimi, Salko, 2001), we will focus on the banking sector analysis.

During these 12 years in transition, a significant progress is marked not only in the direction of macroeconomic stability but also in the implementation of intensive structural reforms, including the banking sector reform as well. Notwithstanding the unfavorable conditions of starting the Albanian economy and the banking sector¹ (Haderi, Ibrahimi, 1996), the Albanian banking system is developed step by step by being extended with other private banks, through privatization and restructuring of state-owned banks, through the extension of the banking network, perfection of legislation and payments system, perfection of technology and the banking services, increase of crediting level, increase of fruitfulness and increase of other banking services.

Notwithstanding the progress of the Albanian economy² and the banking sector, the latter is still exposed to crises and is characterized by the wavering of public confidence in it, inappropriate level of payments systems, insufficient competition and domination of the

¹ The inheritance from the centralized system where money served merely as an account unit and played a limited role as an exchange tool constitutes one of the important causes of relative backwardness of the banking sector in transition.

² Albanian economy has testified that macroeconomic consolidation is still fragile, with external and fiscal imbalances, with the lowest income per capita in Europe, with relatively high poverty and relatively weak institutions. The macroeconomic consolidation may be ruined as soon as it is placed (1997), trade deficit is dis-balanced, budgetary deficit and debt in considerable levels, financial market continues to be in low development levels, etc. (Kule, Haderi 2001)

system by only one bank³, lack of a developed banking market, lack of a completely efficient legal framework, etc. The most clear evidence of the banking system fragility are the crisis of the financial year 1997, ignited by the pyramid scheme collapse, and the crisis of the banking deposits at the beginning of 2002.⁴

Our paper focuses precisely on the analysis of these highly negative moments, aiming at answering the questions highlighted by the banking system development during the years of transition. The Albanian transition testifies that the banking system, vis-à-vis a relatively stable economic development, measured in terms of inflation and economic growth, also reveals weaknesses and remains exposed to hits. Furthermore, the financial crises have appeared in such moments that are frequently called the “Albanian paradox” too. The financial crisis that associated the collapse of pyramids erupted when Albania displayed an impressive macroeconomic performance (IMF, World Bank) and was considered as successful in implementing the reforms, whereas the withdrawal of deposits occurred at the moment when the banking system was in better performance levels than ever before.

Under these conditions, the question raised is which are the factors that condition the banking system fragility? Does the instability spring from the nature of the system or from factors outside it? Which are the most long-term impacts of the pyramid crisis that was relatively slightly affected and that influenced the banking sector to the same degree at the moment of its explosion and solution? Why the “Albanian paradox” was repeated with almost the liquidity crisis, which erupted at a time when the banking system had its best performance during the transition years? How were such crises managed and which was the role of the Bank of Albania in the liquidity crisis?

BANKING SYSTEM DEVELOPMENTS IN '91 – '96

Socialist banking system inheritance

The transition found Albania as the poorest country in Europe (Table 1⁵), as a communist country with features similar with other socialist countries and especially with those of Southeastern Europe but also with underlined features that distinguish it from other ex-communist⁶ countries. Albania was the only European country of the communist block that did not undertake any important economic and political reform such as decision-taking decentralization, increase of market role and the democratization of the country, which applied the Marxist ideology and Stalinist practices rigorously for 45 years. Albania entered transition as a least prepared country from economic, political, social and cultural viewpoint for carrying out radical reforms towards market economy. (Kule, Haderi 2001)

³ In April 2002, the Savings Bank occupied 59.2 per cent of the banking system.

⁴ In the last 20 years, many world countries have been hit by different financial crises where are evidenced crises in Nordic countries during the start of 90's and later, Asian crises (Korea and Thailand) at the end of '90s. In this period, special place is occupied by the crises that attacked economies in transition, such as Bulgaria in '96-97, which went through one of the most intensified crisis of the countries in transition, Lithuania earlier, in '94-95 and Mongolia in 1996 that experienced a crisis similar to that of other countries in transition.

⁵ You will find the referred tables attached to the material.

⁶ The Albanian model was characterized by the elimination of all private property forms through the complete nationalization of industry and agriculture collectivization; by the complete support on centralized planning and management, leaving no role at all for the allocation of resources by the market; by the extreme application of the principle of being based on one's own forces and on economic independence; by a somewhat total lack of democratic tradition and by the extreme application of the principle of struggle against classes, which maintains the consequences even in the transition years. For more details, see IMF (1992), Pashko (1994), Muço (1997), Haderi et al.(1999), Kule, Haderi, 2001.

During socialism the banking system was a completely centralized system and until 1976 it was composed of only one bank, the Albanian State Bank, which served at the same time as a monetary authority and as an authority of credit to economy. Meanwhile, its role as a financial intermediary was rather limited, since either the monetary policy or the credit distribution, were guided according to a centralized plan. The Bank served as an institution of recording the transactions among the producing enterprises. Except the Albanian State Bank, there also functioned the General Directorate of Savings Cash Offices and Insurance, which collected the savings of the population and dealt with the property insurance, mainly the insurance of co-operative⁷ property. In 1977 the Agricultural Bank was established as a separate bank, through the separation of one section of the Albanian State Bank, which covered the supply of agricultural sector funds. In 1990, the Department of Foreign Relations of the Albanian State Bank served as a basis for founding the Albanian Commercial Bank that performed the function of financing and encouraging the exports and foreign payments. (Cani, 1995)

In a summarized way, the socialist banking system, on the threshold of transition, was characterized by serious deficiencies for a banking system of free market economy such as (i) its role as a financial intermediary was rather limited since the banks served merely as an institution of recording transactions among producing enterprises; (ii) under these conditions the credit evaluation was lacking and therefore even the risk management was lacking; (iii) the exchange rate was calculated but not its risk; (iv) the accounting system had the recording and monitoring of the fulfillment of the overall plan objectives as its main function, and in this sense, it changed radically from the international accounting practices, a change that was reflected especially in the banking sector; (v) the lack of banking experience in the activities of a market economy constitutes another negative factor and the banks' directors lacked the international experience.

The period on the threshold of transition was accompanied with a significant decrease of GDP by 13 % in '90 and 27.7 % in '91, a decrease that had started to be felt since mid of '80s. The current account was worsened apparently due to drastic reduction of exports and significant increase of imports specifically for consumer's goods. The trade deficit reached the level of US\$ 150 million in '90 and US\$ 308 million in '91.

Upon the starting of transition, the budgetary deficit, which during the last years of communist regime was financed by deposits with the State Bank, showed an immediate increase due to the collapse of the collection system of obligatory state income and expenditure for salaries and subsidies of state –owned enterprises with losses. The budgetary deficit in '90-92 reached 15, 31 respectively and 44 % of GDP. The monetary expansion went out of control because the Bank issued money without restriction because of the governing pressure for crediting the enterprises with losses. This impacted significantly on the increase of bad loans in these banks, after the starting of reforms in '92. The credit interest rates were rather low, 3 %, and 5-8% in '90, '91 and until mid of '92, whereas the penalties for non-performing loans were not applied any more. As a consequence, the broad money increased with a rather high annual rate, 21 %, 152 % and 180 % in '90, '91 and mid of '92 respectively. (IMF Economic Review 5, 1995).

Transition reforms and structural changes of banking system in '91-97

⁷ The Directorate of Insurance and Savings Cash Offices did not represent a bank because it did not extend loans and the monetary assets deposited by the population were used by the budget.

The banking system reform, being a part of economic reform initiated in 1992, started as an institutional reform with the alteration of the legal basis. In April 1992, the People's Assembly approved the law "On the Bank of Albania", and the Law "On the Banking System of the Republic of Albania". These laws marked the passing of the banking system from one-level to two-level banking system. On the basis of these laws, the way was open to licensing new private banks and regulating the banking system by the central bank.

The Bank of Albania was created as a first tier bank, the country's central bank, while the three other banks: the Savings Bank, the National Commercial Bank, and Agrarian Commercial Bank, constituted the second tier of the banking system. The Savings Bank was successor of Savings Institute with a new status as a universal bank. The National Commercial Bank was an amalgamation of the domestic commercial activity of the Albanian State Bank with the Albanian Commercial Bank.

Also, in 1992 two other banks with joint capital (foreign capital and Albanian Government capital) were licensed: The Italian Albanian Bank and Arabic-Albanian Islamic Bank. In 1993 the Government of Kosova established Dardania Bank and in 1996 two banks with Greek capital were licensed: Tirana Bank and Branch of National Bank of Greece.

During these years, the domination of state-owned banks characterizes the banking sector development, in spite of the slight increase noticed in the weight of G2 and G3 group from one year to the other. Table 3 shows the weight each group occupies in the banking system according to the capital ownership⁸.

Notwithstanding the insufficient knowledge on banking inherited from the centralized economy, there can be noticed, though with slow paces, the tendency of banking system activity growth. (Table 4). In 1994 there operated 6 banks in the country with total assets of Leke 146.2 billion, which comprised 79 % of GDP of that year, where the main weight was occupied by National Commercial Bank (77 % of the system assets).

In 1995 we have a reduction of the total assets of the system in Leke 80.8 billion (or 35 % of GDP). This reduction was influenced by the National Commercial Bank, whose main assets (Bank's other assets) were reduced to Leke 6 billion in 1995, from Leke 90.7 billion that resulted in 1994⁹, while the other banks indicate their rising activity as compared to the previous year.

In 1996 the total banking system assets reached to Leke 128.8 billion or 46 % of GDP. The increase of the banking system assets by Leke 48 billion belongs mainly to National Commercial Bank (with Leke 41 billion), since the other banks reflect slight increase. This increase of National Commercial Bank assets is due to the increase of current accounts and demand deposits by the pyramid schemes¹⁰.

During this period a number of efforts were made for the restructuring and preparation of the legal basis for banks' privatization, which generally did not result effective¹¹.

Problems and difficulties of the banking system in the first years of transition

⁸ The group of banks on the basis of capital ownership is the criterion that will be used until the end of the material. So, G1 includes the banks with state-owned capital, G2 includes joint ventures and G3 includes private banks.

⁹ This reduction is due to clearing of some old accounts from the balance sheet of this bank.

¹⁰ Rentier firms, as they were called at that time, opened current accounts and demand deposits with NCB in 1996, at about Leke 38 billion.

¹¹ For more details see: Cani "Restructuring of the Banks in Albania" in Restructuring Eastern Europe, The Microeconomics of the Transition Process, edited by Soumitra Sharma, Edward Elgar 1995.

Besides the positive but fragile developments, the banking sector was accompanied also by many deficiencies and negative developments, which though accepted not to be the main cause of the '97 crisis (Jarvis 2001, Cani and Vika, 2002), they helped in its appearance and deepness. First, the level of financial intermediary was limited. The state-owned banks that dominated the deposits market by about 90 % performed restricted functions of the financial intermediary, whereas the new private banks were limited in number, rather slow and non-interested in attracting deposits in Leke, being focused mainly on trade credit. The level of deposits did not depend much on the real interest rates because the central bank determined such interest rates that ensured positive real rates levels. The rather low level of credit to economy constitutes another deficiency of the banking system, which indicates the low intermediary scale.

Another underlined deficiency of the banking system in this period was the low level of the payments system. So, for example, at year-end 1996 the performance of payments for transactions through accounts in different branches of the same bank needed 5-6 days on average, whereas for transactions through different banks 15 days were needed. (Cani 1995, Jarvis 2001). Due to these reasons, the currency off banks, at the hands of the public was at very high levels (Table 1).

The absence of a regulatory and supervisory system as well as the absence of culture and tradition for loan repayment, influenced on increasing the level of bad loans. The first years of transition were accompanied with a reduction of economic activity due to the weaknesses of state-owned enterprises, especially in the industry branches with outdated technology and with downward requirements, branches that represented important consumers of state-owned banks. The continuation of credit to these enterprises with low production, in most cases even with the intervention of the government, impacted significantly on the increase of bad loans in these banks. As the fiscal situation got worse, the political impact on the lending decisions increased, due to the destruction of traditional sources of budget income and dept increase during the first years of transition. The overdue loans increased from 14 % of the stock of credit in '93 to about 60 % in '97. (Cani 1995, Ibrahim and Salko, 2001).

In this period the role of banks as financial intermediaries between lenders and borrowers was limited even due to the absence of a proper mechanism of bankruptcy and liquidation. That is why the state-owned banks were less motivated to be prudent in interest rates offered to depositors as well as in following the substandard loans.(IMF 2002).

In the period of centralized economy, the accounting system had the recording and monitoring of the fulfillment of overall plan objectives as the main function and in this sense, it changed radically from international accounting practices, a change that was reflected appropriate accounting treatment of overdue loans, which did not reflect immediately and clearly the worsening situation of the bank.

The supervisory experience of the central bank was rather limited either due to the lacking of this experience in the conditions of a market economy or due to the restricted supervisory authority and the slowness in placing this authority. On the other hand, the directors of state-owned banks and private banks were not interested in the increase of supervision role, while even the employees of central bank supervision were unmotivated, above all materially, to fight with the directors of these banks. Furthermore, in cases when this supervisory system was at the proper level and stipulated the infringement of rules, these were not accompanied with the charging of penalties foreseen. On the basis of these phenomena stayed the political and economic power of the bank's directors, who, in many cases, were people with power that represented the interests of the party in power. In the first years of transition, when the law itself and its application were weak, the fear from the law was minimal for these individuals.

On the other hand, the lack of requirements to minimal capital and the lack of appropriate rules of classifying loans from the losses as well as the provisioning rules themselves, deformed the real position of banks in the reporting system.

The inappropriate legal framework in the first years of transition constitutes another weakness of the banking system development. This is expressed either in the power of the central bank to determine prudential rules in licensing, in the absence of bankruptcy law, in its poor implementation by the law courts, in the absence of collateral law or in the non-enforcement of laws when they existed.

The lack of banking experience for the activities of a market economy constitutes another negative factor. Many of banks' directors lacked the international experience and came from other state-owned sectors, even from sectors without financial experience. The difficulties in managing the bank and the replacement of the senior political officials was frequently accompanied with the replacement of the banks' directors, who in some cases rotated from one bank to another. This created the possibility that the new directors laid the responsibility on the previous director, not bearing responsibility for the problems they themselves had caused in the other banks.

On the other hand, even the foreign banks that started gradually to enter into the banking market were focused for a long time on activities without risk and on employing the most qualified staff. In this way they narrowed the profitable possibilities for the domestic banks to a certain extend, by maintaining a good performance even during unstable periods, such as that of 1992 – 1997. (IMF 2002)

PYRAMID SCHEMES AND `1997 FINANCIAL CRISIS

Macroeconomic framework and financial crisis

During the period of '92-'96 the developments in the real sector were characterized by a significant economic growth of 9 % per year, a decline of inflation by 17.5 % on the average level and a significant improvement of the current account and budgetary deficit, which however, remain in high levels. The progress in the macroeconomic stabilization has its basis on the compilation and implementation of tightening monetary and fiscal policies and on the rapid-paced privatization in agriculture, wholesale and retail market, small- and mid-size enterprises, which enlivened the economic growth¹². A significant step was marked in the central bank's independence with the new law of 1996, which reinforces the maintenance of price stability as the primary objective of the Bank of Albania. However, the monetary policy attended was based on the control of money growth through direct instruments such as loan ceilings and control of interest rates on deposits.

Vis-à-vis the fact of economic growth by 9.1 % in 1996, this year, with its negative political and economic developments such as the contested elections that were preceded by large budgetary expenses for electoral purposes, ungrounded increase of salaries, encouragement of VAT entry in the fiscal package, galloping extension of pyramid schemes, not only contributed in the deep economic crisis of 1997 but in many macroeconomic indicators, the crisis appeared apparently since year-end 1996 with the tripling of inflation in 17.4 % as compared to year-end '95 and the increase of budgetary deficit in 12.9 %. (Kule, Haderi, 2001). After the winning of elections by the party in power and their vast international contest,

¹² During this period, the privatization of agricultural land reached at 93 % at year-end 1993, the reform of taxation system made a headway with the entry of VAT (value added tax) in 1996, the treasury bill market and the massive privatization bonds market started to function, while most of small size enterprises were privatized.

it was more difficult for the party in power to take appropriate important decisions because they were contrary to its fragile authority.

The low banking system development level and especially the negative macroeconomic developments of 1996 contributed in the eruption of 1997 crisis, which was also impacted by the acting of other important factors that lead to the development and collapse of pyramid schemes, such as the informal credit market, the insufficient legal framework and the political factors.

Informal loan market and pyramid schemes. Why?

The backwardness of the banking system development and its deficiencies nourished and were limited by the emergence and development of informal loan market since the beginning of transition. This market that appeared as a result of the tolerance of state authorities and the absence of the legal framework was composed either by the non-licensed exchange dealers of the foreign exchange market or by the companies that collected deposits and made loans with them, which were illegal because they were not licensed for collecting deposits. The banking system with its inefficiency as a financial intermediary made room for pyramids to absorb the growing savings, especially the savings of emigrants¹³. The interest rates supplied by these companies for the deposits were rather high and moved from 6 – 8 % per month, but however under the level of the loan rates, on which the data are lacking. The large interest rates increase in 1996 even because of the prevention of sanctions towards Yugoslavia got the interest rates offered by the banking system out of game and, as a consequence, the monetary policy effectiveness became non-existent.

The high interest rates lead to large deposit inflows at the counters of these firms while their investment in production and securities was minimal as compared to the amount collected. On the other hand, the phenomenon of re-investing the principal along with interests from clients appeared. The impossibility of managing deposits by the firms lead to their depositing by the firms in current accounts with the commercial banks, creating to them excess reserves in large amounts, which went directly to the purchase of treasury bills, in response to high requests of the budget for liquidity.

Initially, this informal loan market was assessed as positive by the Albanian authorities, since under the conditions of deficiencies of the formal banking system, it was deemed that the companies that operated in this market carried out a financial intermediary by urging profitable investments and economic growth.

Along with informal credit firms that started to operate at the beginning of transition, other firms that received loans with high interest rates started to operate too, which “invested” within themselves, without making loans to others. As the time passed by, these were turned into pyramid firms. These firms, which offered 4-5 % interests per month until year-end 1995, used the money in an unclear way. In some cases they invested them in producing activities whereas in some cases it is believed that they financed criminal activities such as smuggling, illegal emigration, drug, prostitution and arms traffic¹⁴.

¹³ In this period these savings are evaluated to be at about \$ 300 million per year. The system of informal credit was comprised mainly of private loans that the emigrants provided to family and friends, loans which generally reached US\$ 30 thousand and were not accompanied with collateral, but with very high interest rates.

¹⁴ Given their nature, it was difficult to determine their solvency with accuracy, that is the fact whether they earned more money from illegal activities than they paid at the depositors. Some of them might have been as such right from the moment of their creation, whereas some others became pyramid firms during 1996.

In spite of distinctions among them, which were difficult to be highlighted, in both cases the domestic savings and the remittances that occupied considerable amounts served as sources for these firms. When the extension of informal market reached vast magnitude, the international bodies started to express their concern on their nature¹⁵.

The absence of the proper legal framework comprises one of the main causes of the pyramid schemes development and the financial crisis of 1997. The associations that operated in the informal market were based on the civil code that allowed them the borrowing on the association basis, but without being obliged to be supervised by an authority which was indispensable for institutions that accept deposits and extend loans. Though in 1996 the new banking system law stipulated clearly that all the entities that accept various deposits had to be licensed and supervised by the Bank of Albania, yet these associations were not subjected to licensing and supervision. Some senior officials, who supported the viewpoint that the new law of the banking system is not valid for the loan-taking associations, also opposed the Bank of Albania requirement to license and supervise these firms, while the state bodies stayed indifferent or even worse, they supported the development of these associations.

The political factor that consists in the support the government gave to pyramid firms constitutes another cause of their development. This support had the source in the relations of important officials with these firms, in the financing they made for the party in power, such as the elections of 1996, and it was expressed in most diversified forms, by being engaged in promoting activities of these firms, making declarations in their favor and considering their activity as pure and useful. The support was reflected also in the fact that they were not required to pay fiscal obligations or they were never investigated for fiscal evasion.

The political factors that operated in 1996 encouraged also the boom of these associations, preparing the reduction and crisis at the same time. It was just these developments that were related even with the contested elections, with the political decisions that worsened the macroeconomic indicators such as increases in salaries and budgetary expenses, in the function of winning the governance mandate, which, after the contest of elections of May 1996, were turned into a boomerang.

The need to verify the fairness of these elections did not allow the government to take actions against pyramid schemes, considering the local elections of October as a test that would certify the fairness of elections of May. In spite of the growing pressure, especially of international bodies, the government stood passive. Furthermore, in many times, it protected these pyramid schemes openly naming them as "the purest pyramid schemes in Europe", revealing that the problem was wider than the political support, since it was *governmental inability to manage the situation in time*¹⁶. The collapse of pyramid schemes at the beginning of 1997 led to a general crisis, which started as a financial crisis. The country passed through a total anarchy. The government lost the control over the country, the revolts were turned into an armed uprising and the financial system was heavily hit. (Jarvis, 2001)

¹⁵ For example, at year-end 1995, the IMF mission on financial sector problems studied the possibilities of improving the financial formal system through integration of positive elements of informal market.

¹⁶ The unreliable governance, which is expressed in the high corruption level and in the institutional and market vulnerabilities, as well as the backwardness of structural reforms, especially in the banking sector, constitute other very important factors that helped the crisis. According to EBRD (Table 5) the index of banking sector reform in 1996 was 2.0, while the index of competition policies and reform of non-bank financial institutions was 1.7.

The expectations of the public and their role during the crisis

The analysis of the financial causes for the crisis of 1997, which appeared as a pyramid firms crisis has in its foundation the analysis of expectations and information on the financial market and the characteristics of the economic environment. Rightly a question is raised: Which are those factors that urge the non-realistic expectations regarding the very high return rates that the investment in financial assets that are offered by pyramid schemes may bring about?

In order to realize why a great number of people invested in these firms that offered such high interests, analysis should be made with regards to how they evaluate the profit and the risk. The experience coming from the nature and history of the economic system serves as basis for forming the method of this assessment. According to this logic, most of previous experience or information suggests that such high return rates may only damage the others and sooner or later these firms that offer such rates go bankrupt, bringing about the complete investment loss. Surely, the formation of such way of behavior needs time and experience and it is normal for the economic agents having history in the market economy, but not for the socialist countries where other factors operate.

First, the lack of tradition and experience from the communist regime reduced the perception of risk by the population regarding the associations that offered very high interest on deposits. The lack of depositors' knowledge on risk influenced on their alluring through high interest rates, notwithstanding the entity risk. This was one of the factors that facilitated the creation of informal activities outside the banking system, which in Albania, unlike many other countries, lead to a general political and economic crisis with extremely heavy consequences.

Secondly, the absence of any period of bankruptcy in the first period of transition had formed the expectations of an implied government protection for the depositors. The socialist inheritance regarding the offering by the state not only of the income, but also of all other guarantees such as work, pension, education, health, maintains the confidence of individuals that the state is responsible and accountable even for decisions taken individually in a market economy. This confidence of individuals in the state and the support the state provided to these associations formed the expectation that these high profits were real. On the other hand, even if Albanians doubted on the nature of pyramid schemes, the expectation based on this inheritance was that the state would compensate them in the event the schemes went bankrupt.(Elbit 1997)

Thirdly, in these countries, especially in the first years of transition, people believe that the market and capitalism offer such possibilities. This wrong confidence serves as the basis of the creation of pyramid schemes that in the economic literature are considered as based on "the wrong impression or on the prevention of an implied or defined confidence" as well as on the wrong viewpoint for the capitalist countries as countries where "the road is surfaced with gold and everyone is rich". There exist many indicators of these illusive factors expressed in stories, which explain the high profits of schemes during the time they flourish¹⁷.

Crisis aftermath and solution. Lessons

The economic effects of pyramid schemes are large, even though with the statistical information available they are difficult to be measured accurately. The deep political and economic crisis, which erupted as a result of pyramid schemes collapse, and which in fact had started to appear since 1996 and had a larger basis, lead to production decrease at 7 %, inflation increase at 42 % and worsening of current account and fiscal deficit. In mid 1997 the

¹⁷ For example, the extremely high interest rates in pyramid firms in Albania were explained with such stories as high profits that derived from a hotel in California, from exploitation of mines that did not exist or from predictions based on fortune-telling.

domestic currency, Leke, was depreciated at about 100 per cent, while the monetary policy was placed directly in the service of ensuring liquidity for the state budget¹⁸.

Not going into details on other macroeconomic implications, what should be emphasized is that this crisis impacted obviously on the public confidence loss in the banking system, which led to an inevitable money hemorrhage. The pyramid schemes had different impacts on the monetary indices and the banking system before and after the crisis. Before the collapse of schemes, especially in 1996, as presented in table ..., an increase of broad money is noticed due to deposits increase, which during seven months of this year were increased by Leke 37.3 billion. All this increase in deposits came from pyramid schemes and therefore, the money-deposit ratio underwent a sharp reduction from 68 % in June, to 43 % in November of 1996. At the meantime, the other deposits changed very slightly. On the other hand, the large deposits increase was not associated with monetary expansion, since the bank's lending activity was also limited by the Central Bank. In this way, the banks resulted with excess reserves, which were used for purchasing treasury bills but not for increasing the private sector credit.

After the crisis, the impacts on monetary indices were reverse, but fortunately they had limited impacts on the real economy and the banking sector. Initially, in 1997, as it comes out in table..., a massive reduction of deposits in the private sector is observed. The sequestration and the gradual distribution of financial assets of pyramid schemes as well as their withdrawal by the operators led to a roughly double increase of money-deposit ratio, which indicates that the people prefer to keep their money in *cash*.

After mid 1997 the new government, supported also by the international donors, applied a post crisis program and deepened further the structural reforms, especially in the field of privatizing the mid- and large-size enterprises, as well as the strategic ones. In order to reduce the fiscal deficit by increasing the budget income, which had dropped significantly as a result of the deep crisis, the government increased the VAT significantly in 20 %, exerting pressure on prices increase, for the moment, which, however, was not much verified. An important part of the program was the closure, management, transparency and liquidation of pyramid schemes¹⁹. One of the most important factors that reduced the negative consequences of the crisis and impacted on rapid stabilization was the **courageous decision taken by all governments for not indemnifying the creditors from the state budget**.

The central bank, within the framework of measures taken to prevent the crisis effects on the banking system and to stabilize the macroeconomic indices, suspended the extension of loans for the banks which had the level of bad loans over 20 % and increased the minimal annual interest rates on deposits at about 30 %. These measures restrained the extension of risky loans and improved the banks' portfolio and made possible that the deposits level be increased again. This increase, which reflected a growth of confidence in banks, ensured the possibility for the banks to have sufficient liquidity, which was mainly used for the purchase of treasury bills and a small part for increasing the credit to the private sector.

One of the important measures for solving the crisis was the deepening of the structural reform in the banking system. The underlined deficiencies of this system, which were shown also in the increase of bad loans rate, which in special banks such as the Agrarian Commercial Bank reached to 90 %, was associated with measures that aimed at their strengthening. The Agrarian Commercial Bank was liquidated, the Trade Commercial Bank was privatized, while the Savings Bank was entered into the privatization preparation process, working with the assistance of foreign advisors in a management agreement. In order to

¹⁸ For more details see: Chris Jarvis "The Rise and Fall of Pyramid Schemes in Albania" IMF Staff Papers, Volume 47, Number 1, 2000.

¹⁹ For more details see: Chris Jarvis "The Rise and Fall of Pyramid Schemes in Albania" IMF Staff Papers, Volume 47, Number 1, 2000.

deepen the banks' restructuring process, the license of Agrarian Commercial Bank was revoked and a part of this bank's assets was transferred to the Savings Bank, while the assets with problems were transferred to the National Commercial Bank and to the Agency of Treating the Loans (an agency that was established for treating the bad loans of state-owned banks). The measures taken for strengthening the banking system consisted in legal improvements, which aimed at enhancing the prudential role of the Central Bank, preventing the emergence of informal credit sector and improving the payments system and the banking infrastructure.

In conclusion, the pyramid crisis was a crisis that was helped by the banking sector weaknesses, but did not stem from the banks and none of the banks was included in pyramid activities. Neither did they support them, as it happened with other segments of the government. On the contrary, the central bank was the only warning voice on their risk.

Deficiencies in governance, inability to manage the situation created by the tolerance and the state support, lack of legal framework and the wrong expectations of the public, which had an inherited basis, but also relied on the wrong information limited for the capitalist society, all these constitute the breeding ground where the pyramid schemes were nourished and grown up, which brought about comprehensive consequences in the Albanian society.

BANKING SYSTEM DEVELOPMENTS, AND THE '97 - '02 CRISIS

Macroeconomic framework

During this period the macroeconomic stability was re-placed quickly and the structural reforms marked progress regarding the deepening and finalizing of small and mid enterprises privatization and the compilation of the strategy of the privatization of large enterprises and the public services. The monetary and fiscal policies pursued and the deepening of reforms lead to an average annual increase of GGP of 7.4 % and to the inflation dropping at the level of 3.5 % in 2001. In spite of the downward tendency of the budgetary deficit and the current account they remained at relatively high negative levels, respectively 8.5 % and 7.4 % of GGP in 2001. Initially, the stabilizing policies pursued after '98 followed up the increase of interest rates and, after the rapid and proper reaction of the public, very soon lead to a significant inflation decline at the level of 8.7 %, at year-end '98.

Upon the sharp decline of inflation up to 3.2 %, reaching even negative levels in '99, we have a mitigation of the monetary policy, reducing the interest rates sharply. During this period, the monetary policy instruments evolved because the role of credit limit fell obviously until in '99 it was extinguished as an instrument, using only the interest rate of deposits with state-owned banks, which soon enough were replaced only with the market instruments, where the main instrument is the interest rate of repurchase agreements (Kule, Haderi, 2001).

Banking system developments and problems, '97-02

In this period, even the reforms of financial sector have marked an important progress, which relate with the privatization of state-owned banks and the entry of new private banks, which have impacted on the deepening of financial intermediary and increase of quality of the banking services. A greater attention and commitment in the deepening of the restructuring and the reform in the banking system characterize the years '97-02.

The first characteristic of these developments was the increase of the number of new private banks, which currently reach the figure of 14. In 1997 another bank was licensed with totally foreign capital, the International Commercial Bank, while in 1998 there was licensed the American Bank of Albania and the Tirana Branch of Alpha Credit Bank. In 1999 three other

banks started their activity, the First Investment Bank and the InterCommercial Bank²⁰ and Fefad Bank, while in 2002 the Albanian Credit Bank was licensed, a foreign private bank with Kuwait capital. The domination of foreign private banks, where currently only the Savings Bank remains with state –owned capital constitutes another feature of the Albanian banking system²¹. Currently Albania has 4.5 banks for one million inhabitants while Bulgaria has almost the same indicator, Rumania has 1.5 banks for one million inhabitants, Hungary has 3 banks and Croatia has 10 banks.

Another important characteristic in this period is the reduction of domination of banks with state-owned capital, either through the liquidation of Agrarian Commercial Bank and the privatization of National Commercial Bank or through the entry of new private banks. The table below indicates clearly this inclination regarding the assets weight of group of banks according to years: The first group, which includes the banks with state-owned capital, after the privatization of National Commercial Bank in '99, is constituted only by the Savings Bank and has been reduced gradually from 89.9 % of the banking sector total assets in '97 to 59.2 % in 2001. While the group 3, where the banks with totally private capital are included has undergone a continuous increase from 3.6 % in '97 to 35 % in 2001. The same tendency appears also in the weight the deposits occupy according to the classified groups. G 1 has been decreased while G 3 has been increased²².

The banking activity has been extended along with the extension of banks in the market, increasing the banking deposits as an activity. The total assets of the system of '98 mark an increase of Leke 39 billion since 1997²³ reaching to Leke 206 billion or about 44.7 % of GDP. In '99 the banking sector assets increased in Leke 250 billion or at about 49.3 % of GDP. This increase comes either from the Savings Bank or from the entry of three other foreign capital banks²⁴ in the market. In the year 2000, though no new bank is added, special banks have experienced significant changes. The total assets of the system, in spite of the reductions taking place at the National Commercial Bank, evidence an increase of Leke 21 billion²⁵ since 1999, resulting to Leke 271 billion at year-end 2000, or 50.2 % of GDP. At year-end 2001 the total assets of the system results in Leke 318 billion or 54 % of GDP. In this increase of Leke 47 billion since '2000, the G1 and G3 group of banks have mainly influenced with approximately Leke 33 billion. On the other hand, the deposits level has marked a continuous increase from Leke 178.2 billion in '98 to 282 billion in 2001.

The level of financial intermediary is further deepened, reflecting the positive tendency of the banking sector developments. The ratio of total deposits to GGP, which is one of the main indicators of the level and depth of financial intervention, has been increasing during the whole transition period, especially following '1998, marking the level of 47.9 % in 2001. The same tendency is indicated by the ratio of time deposits to GGP, as the most significant indicator of intermediary, which is increased apparently from 12.8 % in 1994 to 29.3 % in

²⁰ Upon changing its name, this bank is currently named the "Commercial Bank of Greece, AI".

²¹ The Savings Bank is under privatization process and is offered to foreigners for purchase.

²² The G1 weight has dropped from 93 % in '97 to 68 % in September 2002. (See Table 7).

²³ The data on 1998 comply with the new accounting system, upon its entry into force at year-end 1998. Hence, the comparison with 1997 could not be considered as completely accurate, but, as the total statements of balance sheet items between the two systems change slightly, the comparison is performed. The considerable change between the two systems exists in the loans classification method and for this reason the starting period in the moment of analyzing the loan portfolio quality will be 1998.

²⁴ As it is also mentioned previously, the Fefad Bank, the Commercial Bank of Greece and the First Investment Bank started their activity in 1999.

²⁵ The banking system deposits have been increased by Leke 20.4 billion since 1999, and the shareholder's capital (as a banking system) evidences an increase of Leke 9.1 billion as compared to year-end 1999.

1998 and 38 % in 2001. This tendency is reinforced even by a larger indicator of intermediary, the ratio of broad money to GGP, which has been increasing and currently reaches the level of 66.7 % (Table 1).

Another characteristic of positive developments of the banking sector is the improvement of the credit market. Two are the most positive tendencies noticed in this market: the first is the continuous increase of the private sector credit and the second is the reduction of the bad loans to the total credit (NPL), which in June 2002 reached the level of 7.4 % and excluding the Savings Bank, which occupies the main weight in this ratio, the tendency becomes clearer. This ratio has moved from 10.8 % in 1998 to 6.9 % in 2000.

The continuous improvement of the banking supervision, either through the legal improvement or through the compilation and perfection of regulations in the field of licensing and supervision and regulation constitutes another positive phenomenon of this period. Currently, the Bank of Albania uses an updated evaluation system of second tier banks (CAMELS), a system which applies on the basis of relevant structures of human resources and legal basis.

Nevertheless, a series of deficiencies appear in the developments of this period, which constitute challenges to be sorted out. First, the domination of the banking market where only one bank occupies about 55 % of the banking sector, whereas the two main banks occupied about 70 % at year-end 2001. This situation limits significantly the competitiveness in the banking system, bringing about consequences either in the Bank of Albania monetary policy and in the internal dept management or in the development of the banking sector and enhancement of its effectiveness²⁶.

The low competitiveness of the system is reflected also in the level of services, either by the parameters of the existing one, which is otherwise called "classic", or by the entry of new services more efficient than the banking investments, etc. The banking services are related, to a certain extend, even with the perfection of the payments system, which is under the process of big changes, especially with the entry of RTGS system.

In spite of the fact that banks are the soundest institutions in the country and the supervision regulation of the Bank of Albania has been constantly improved since '97, ²⁷with the establishment of Deposit Insurance Agency as one of the most recent developments, the banking system is assessed to have made a faster progress than the Bank's regulatory framework.²⁸ (Treichel, 2001).

Notwithstanding the increase of the level of credit to economy, it remains in relatively low levels and much lower than those of the advanced countries. So, the ratio of private sector credit to GGP, though increased, was only 4.6 % in 2001, whereas this credit to the total credit occupied only 14.1 % in 2001. This is obvious if we take into consideration the asset structure, where the treasury bills occupy an important weight in the banking system with over 51.7 % of its assets. Meanwhile, only the Savings Bank occupied 71 % in 2001. However, the private banks reflect the tendency to be more aggressive either in the credit to economy or in the treasury bills.

Banking system situation on the threshold of deposits crisis

²⁶ For more details, see Baleta et al., "Dominimi i Tregut Bankar Shqiptar", Banka e Shqiperise, Material Diskutimi, Nr. 3/(4)/00,2000.

²⁷ Finally, on March 29, 2002 the Albanian Parliament passed the law "On Deposit Insurance".

²⁸ According to Treichel, 2001, the diversification of the banking activities requires the fostering of modern techniques of risk management by the commercial banks.

The evaluation of the banking system at year-end 2002, measured in its performance indicators (Table 6) indicates that its "health" has been improving in all these indicators. This is obvious if we consider in more details the quality of the banking system assets and of the separate banks, the capital adequacy, the liquidity indicators and the banking system gains.

The quality of the banking system assets can be analyzed by being focused on the risk of investments in securities²⁹ and the credit risk. The investments in securities are found only in the portfolio of some banks, which are not obliged to report at the Bank of Albania regarding their rating. Meanwhile, it is the Bank of Albania, which examines on place the banks of the system, highlighting the quality of their activity, which at year-end 2001 results high because they present mainly government securities of Zone A³⁰. The credit portfolio quality is the most important indicator that is measured with a series of indicators³¹. In calculating these indicators, except the system in general, calculations have to be made even for the system without the Savings Bank, as the only bank with state-owned capital and with some features that derive from the fact that a good part of the bad loans are accounts conveyed from ex Bank of Albanian State and Agrarian Commercial Bank and that after the placement of the rate of 20 % as a limit for making loans, the excess credit for this bank was reduced significantly by worsening the indicator statistically³².

The performance of this indicator, where the bad loan occupied a high level against the excess credit until 2001, when the clearing of the bad loans was performed with provisioning due to the preparation of the Savings Bank for privatization, expresses a high risk scale that is filled with a high provisioning level, which really reduces this risk. (Table 5). Even though the level of this indicator compared with the standards, remains high, 6.9 % in 2001, the insolvency did not constitute concern for the system because of the low level of loans in the total assets (Table 1)³³.

The part of credit risk, to which the banking system is exposed, is the foreign currency credit weight to the total credit. The foreign currency credit exposes the banks to the credit risk, when this related to loan-takers that possess income in Leke, since a worsening of the exchange rate, that is a depreciation of Leke, would weaken the solvency of the loan-takers. This would impact on increase of loans with problems in the banks' portfolio.³⁴ The loans in foreign currency at year-end 2001 constitute 81.7% of the total excess credit, but meanwhile the foreign currency loans with problems to the total foreign currency loans occupy 7.9 %.

²⁹ Excluding treasury bills.

³⁰ Meanwhile, if this portfolio of securities is classified "tradable and simultaneously meets the other condition, over 5 % of the balance sheet, then the banks are obliged to fulfill the Regulation "Market Risks", through which it comes out clearly how much are the banks exposed to these risks.

³¹ The ratio of (gross) bad loans to credit balance serves as a measurer of the management effectiveness of this portfolio. Meanwhile, the ratio of net bad loans to net credit balance serves as a measurer of the banking system exposure to the credit risk. The analysis based on the net indicator (deprived of provisioning) evidences the net size of risk to which the banking system is exposed.

³² In the bad loans balance of Leke 12.9 billion in '88, the Savings Bank occupies the amount of Leke 10.9 billion or 84.8 % of the bad loan balance of the system. So, the ratio of bad loans to (gross) credit balance results 35.4 % for the whole system, while in the Savings Bank this indicator is calculated 59.7%. If we exclude the Savings Bank, the above indicator results 10.8 %.

³³ Furthermore, if we observe the two banks that underwent withdrawal of deposits during the panic, the Savings Bank and the National Commercial Bank, their loans occupied less than 0.5 of the total assets.

³⁴ For making a more accurate assessment of the ratio of bad loans correlated with the exchange rate performance, the work for creating a regression equation is in initial phases, where the ratio of bad loans is considered as a dependent variable and the exchange rate as an independent variable. It is spoken about a work in initial stages, since its time series is needed with more than 30 data, which are currently lacking because the loan classification by the banks takes place once in three months and the new accounting system entered into force at year-end 1998.

At year-end 2001, the ratio of loans with problems to the (net) excess credit is 4 % (which is still considered in low levels). In conclusion of analysis of the quality of the banking system assets, it can be stated that the banks, though limited in foreign investments in international markets, they are extending their lending activity in the domestic market from one period to another, maintaining a satisfactory level of the quality of their portfolio quality.

The shareholders' capital constitutes the bank's own funds, whose sound level ensure public confidence in the stability of banks and banking system in general, support the banks' activity, ensure steady support for the inherited losses and unforeseen losses and provide possibility to the banks to constantly fulfill the requests for loans.³⁵ The banking capital influences as a depreciator about the banks' concern regarding the solvency, preventing their bankruptcy. Let us analyze the two main indicators of the banking capital level: the financial leverage and the capital adequacy ratio.

The financial leverage that indicates the structure of funds of an institution is given as a ratio of shareholders' capital of the bank to the total assets. This indicator results in 6.3 % for the banking system at the end of 2001, while in the banking sector the interval of 5-9 % is considered as a standard level. (BoA)

The ratio of capital adequacy determines the bank's ability to face possible losses. The calculation of this indicator is based on the methodology set forth pursuant to Basle Committee Agreement on the Banking Supervision in 1998,³⁶ according to which this ratio, in our country, is stipulated by the supervisory authority to be 12 %.

The ratio of capital adequacy, calculated aggregately for the whole banking system results 35.3 %³⁷ at year-end 2001, which is rather higher than the minimum rate. The performance of this indicator for the system shows clearly its downward tendency, which, however, surpasses significantly the minimum rate and does not presume less abilities of banks to face the possible losses, but speaks about ever larger extension of the banking system in riskier activities such as lending. In conclusion, it may be stated that the banks of the system, being in their growing stage and undertaking few risky activities on their side, are characterized by a high rate of capital adequacy, which does not serve the emergence of a financial crisis at all, what is more they leave space for further developments.

The profitability measured with its indicators ROA and ROE, represents another important indicator that serves the assessment of the bank's historic performance and on this basis, the assessment of its ability to pay future liabilities to its depositors. After a period of losses until '99, during the recent years the banking system results with profit,³⁸ respectively Leke 5.4 billion and Leke 4.3 billion in '00 and '01.

ROA (return on assets), which is an indicator of managerial efficiency and indicates how competent banks have been in converting their assets into net income results 1.15% on annual basis, while ROE (return on equity) results 18.6 %.

³⁵ According to Cani and Vika 2002, the reduction of capital adequacy constitutes one of the characteristics that associate the financial crisis in many cases studied.

³⁶ Hence, according to this risk assessment framework, the banks should define their assets in one of the 4 categories (from 0% to 100 % risk) on the basis of the credit risk of the borrower and the regulatory capital of the bank should not fall under 12 % of the total of these risk weighted assets.

³⁷ Meanwhile, each bank of the system individually evidences high ratio for this indicator. The banks with lower values (it is understandable, over the rate) are the most active ones and which speak about increase of competitiveness.

³⁸ Excluding the Italian Albanian Bank and the National Bank of Greece, which result with losses, the other banks of the system evidence positive financial results at the end of this period.

The liquidity constitutes another important indicator for analyzing the banking system soundness because it relates directly to the solvency of the bank and the bankruptcy risk. The analysis of liquidity³⁹ indicators at end 2001 indicates that on the threshold of the crisis the banking system liquidity position was relatively sound, which is expressed in the level of these indicators, where the liquid assets occupied about 90 % of the total assets and more than half of them were treasury bills, while the ratio of liquid assets to total short-term liabilities was over 98 %. This indicator is presented as more improved at the bank where the banking panic started and had the highest intensity, precisely at the Savings Bank, where all its assets were liquid.

In conclusion, it can be stated that the threshold of the crisis could not be assessed as such at all by the economists and supervisory authorities if base on the practices studied and the indicators signaling the crisis. The macroeconomic indicators and the banking performance indicators were at such levels that they did not reveal any crisis in horizon, except.....

Loss of public confidence, deposits crisis and the Bank of Albania

The banking system was faced with the panic of deposits in March 2002, which comprises the heaviest event for the Albanian financial sector after '97 and what is more important, it is a pure banking sector event. The analysis of the causes that lead the banking system to a banking panic and to the threshold of a financial crisis indicates not only the banking system fragility that springs from its internal nature as a system which is based on the public confidence but also the Albanian banking system fragility of the transition that is based on the fragile public confidence.

The history of figures that reflects the starting and intensity of the panic is given in the summarized table (Table 8), which presents the outflow of deposits for the system and banks affected by it. The panic started and was extended mainly in the Savings Bank, which was on the eve of privatization and occupied the largest part of the banking system and less in the National Commercial Bank as the second bank in the country as far as the size is concerned.⁴⁰

The deposit outflow from these two banks reached to Leke 12 billion in March and Leke 9.4 billion in April, while the Savings Bank occupied 96.3 % of them, which brought about even the reduced weight of this bank in the banking system from 59.2 % at year-end '01 to 56.6 % in April '02.(BoA)

Beyond the history of figures and the positive environment of the banking system, the panic became a fact and as such, it has its own causes, which should be required in other circumstances of this period and in the factors that form the public expectations and its confidence on the banking system. The lack of information and its asymmetry has a significant impact on forming non-accurate public expectations. It is not accidental that the deposits withdrawal started and got extended initially in the rural areas, where the knowledge on the banking system and its evaluation and the information on it are rather limited.

The Albanian public won an experience in 1997, which cost a lot and made the public more sensitive to the risk of loosing the deposits. However, after the crisis of 1997, the public addressed the banks, especially the banks with state-owned capital to deposit their savings. (Table 6, 7). This phenomenon is based on the fact mentioned above that the banks were not

³⁹ The liquidity indicators are various, such as the ratio of liquid assets to the total assets, liquid assets to short-term liabilities, net credit balance to average deposits, maturity gap until one month.

⁴⁰ This bank, which was privatized in 1999 is likely to be regarded still as state-owned by a part of the public that is not informed, especially in rural zones, where the panic started and had its highest intensity.

included directly in the pyramid schemes and the impact of the latter on them was very slight, which contributed in the increase of public confidence in the banks and led to the fact that deposits with the state-owned banks implied their implicit security by the state as the proprietor.⁴¹

In this context the interweaving of two events, that is the offering of the Savings Bank for privatization and the approval of the law on deposit insurance at this time, interwoven even with political factors, shocked the public confidence in banks, leading to a massive deposit withdrawal. The Savings Bank privatization, at a moment when the government was characterized by serious problems and lack of stability, and on the other hand, the argument of the opposition that the privatization and its offering to foreign banks would infringe the deposit insurance, as a tool of political struggle, associated even with the decrease of confidence in the implicit security due to discussions on the amount of the level of deposits to be insured by law, encouraged the formation of inaccurate expectations on these banks, leading to panic.

In conclusion, because of the inheritance from the socialist system, the negative developments of the transition period, the insufficient public education on the banking system, the asymmetric information and the lack of information, the floating political developments, the fragility of the whole Albanian economy development including even the real economy, the public expectations and on this basis the confidence level on the banking system remain fragile. Under these conditions, the banking sector performance, vis-à-vis its positive developments and positive upward indicators is exposed to risks and possible crises and as such, even it remains fragile.

On the other hand, the deposits crisis had consequences even on the real economy, since the deposits decrease was associated with the increase of currency off banks, increasing inflationary pressures and creating liquidity problems for second tier banks. Under these conditions, the Bank of Albania, having the responsibility of the monetary and supervisory authority, through the available instruments intervened by affecting on extinguishing the crisis and preventing its consequences. The Bank of Albania intervention, accompanied even with the operation of other factors especially international ones, resulted very effective because currently the panic is considered as overcome and the deposit level at end of September was Leke 4.8 billion more than the level foreseen in the monetary program. (BoA)

The Bank of Albania, being in the role of the compiler and executor of the monetary policy and the supervisor and banking system regulator took the important role of temporarily giving up the primary objective by being focused on the maintenance of the banking system liquidity level, in its function as a lender of the last resort. That is why repo and fortnight deposits, which served for withdrawing liquidity from the banking system, were given up, using largely the reverse repo instrument and other facilities such as the lombard loan and the overnight loans through which the liquidity was injected in the market. In order to cover the government liquidity needs, the direct loan was used for a short time, without affecting the limits stipulated by law.

Another measure in the function of encouraging the public for restraining the liquidity withdrawal was the increase of repo interest rates up to 1.5 %, which urged the banks to increase the deposit interest rates and other interest rates. Meanwhile, the Bank of Albania was willing to intervene in the foreign currency market in order to affect on the stability of

⁴¹ After the bankruptcy of pyramid schemes, the wavering of the inherited confidence in the state because of the support the state provided to them, was not extended in state-owned banks, perhaps due to the fact that the state declared sharply and maintained the attitude of not compensation the depositors for their losses from the pyramid schemes, considering the investment in them as issues of the individuals with the private firms.

foreign currency rate, which was under the pressure of depreciation from increase of foreign currency request.

The Bank of Albania established an everyday cooperation with the banks for following up the situation and undertook an educational campaign in cooperation with the academic world, distinguished field personalities, non-governmental organizations, politicians, etc., which had their own impact in restraining the public. The support of international factor had a considerable influence in this direction.

As a result of this Bank of Albania intervention and the operation of other factors, the panic was overcome. The deposit level is re-placed. The inflation, notwithstanding its increase as compared to the target of a year ago, is showing dropping signs and it is hoped that the target will be reached at the year-end. The rate had slight fluctuations, reflecting even the confidence of the market in the Bank of Albania.

CONCLUSIONS

The financial system during the transition decade, in spite of the apparent progress, remained in a fragile position. The answer to the question raised in the title, progress or fragility, would be fragile progress. This fragile progress has its basis not only on the domestic banking system developments, bad inheritance, reform slowness, pyramid schemes, emphasis on macroeconomic developments, but also on the Albanian economy fragility itself, in micro and macroeconomic level.

The fragility of the banking system development appears in two most difficult moments for it, such as the financial crisis ignited by the collapse of pyramid schemes and the deposit crisis. The pyramid crisis was a crisis helped by the banking system weaknesses, but it did not stem from banks and non of the banks was included in pyramid activities or supported them, as it happened with other segments of the governance. On the contrary, the Bank of Albania was the only warning voice on their risk. The deficiencies in governance, the inability to manage the situation created by the tolerance and state support, the lack of legal framework and the wrong expectations of the public which had an inherited basis and the wrong and restricted information on the capitalist society, constitute the breeding ground, where the pyramid schemes were nourished and grown and which brought about comprehensive consequences for Albanian society.

Meanwhile, the deposits panic had in its foundation the expectations formed from the pyramid crisis, but it occurred in a situation that is more developed and sound for the banking system reflecting either the well-known fact that the banking system is very sensitive vis-à-vis the public confidence, also the factors that operated in that period, such as the offering of the Savings Bank for privatization, the approval of the law on deposit insurance and the political factors, which shocked the public confidence in the banks, leading to a massive withdrawal of deposits.

In conclusion, due to the inheritance from the socialist system, the negative developments of the transition period, the insufficient public education on the banking system, the asymmetric information and lack of information, the oscillating political developments, the fragility of the whole Albanian economy development, including even the real economy, the public expectations and on this basis the confidence level in the banking system remain fragile.

The lessons revealed from this analysis are that the developments of real economy, the deepening of reform in the banking system stand in the foundation of the establishment of a sound, competitive financial system, capable of responding to the economy needs in general and the private sector development in particular. In this framework, the financial market restructuring and strengthening and the encouragement of banking service enhancement

constitute two basic directions of the strengthening the banking system, which require fastest privatization of the Savings Bank as the largest bank in the country and with a dominating position in the banking market, reinforcement of supervision system and the banking system regulation in compliance with international standards, promotion of competition among the banks, fostering of payments system through the installation of Real Time Gross Settlement (RTGS), establishment of Credit Information Office and the promotion of the extension of savings-credit schemes and the banking system network in the territory of the country.

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APPENDIC: Tables

Table 1. Selected economic indicators

Nominal GDP												
Real GDP												
GDP per capita in USD												
Nominal GDP increase (in %)												
Real GDP increase (in %)												
CPI annual change in % (inflation)												
Money supply (M3) (mln Leke)												
Money supply growth (in %)												
Money supply/GDP												
Currency off banks (mln Leke)												
Currency off banks/ M3												
Emigrants' income (mln USD)												
Credit to economy (mln Leke)												
Credit to economy/Total credit (%)												
Credit to economy/GDP												
Credit to private sector (in mln Leke)												
Credit to private sector/GDP												
Total deposits (in mln Leke)												
Total deposits/GDP												
Time deposits /GDP												
Monetary base (mln Leke)												
Multiplier (M3/Monetary base)												
Money market interest rates (TB 6 M)												
Exchange rate (average period, Leke/USD)												
Internat. Reserves + gold (in mln USD)												
Net foreign currency assets / monetary base (in %)												

Total foreign currency assets (not net)

Source: BoA

Table 2 Albania-Main Transition Indicators 1991-2000

	1991	1992	1993	1994	1995	1996	1997	1998	1999
EBRD Index of price liberalization	1.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalization	1.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD Index of small-scale privatization	2.0	2.0	3.0	3.0	4.0	4.0	4.0	4.0	4.0
EBRD Index of large-scale privatization	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0
EBRD Index of large enterprise reform	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD Index of competition policy	1.0	1.0	1.0	1.0	1.0	1.7	1.7	1.7	1.7
EBRD Index of banking sector reform	1.0	1.0	.3	2.0	2.0	2.0	2.0	2.0	2.0
General government expenditure	66	46.7	40.4	36.4	33.4	30.3	29.4	30.7	32.6
General government balance	-31	-23.1	-15.5	-12.6	-10.1	-12.1	-12.6	-10.4	-11.3
Privatization revenues	Na	1.1	1.8	3.0	3.1	3.3	3.6	3.6	3.9
Private sector share in GDP	5.0	10.0	40.0	50.0	60.0	75.0	75.0	75.0	75.0

Source: EBRD Transition Report, 2000

Table 3. Banks' share according to banking market classification, '94-'02

Share in % to the banking system according to years	G1	G2	G3
1994	97.8	1.9	0.3
1995	95.1	4.2	0.8
1996	93.7	4.7	1.5
1997	89.9	6.5	3.6
1998	85.6	5.1	9.3
1999	81.4	5.8	12.8
2000	64.8 ⁴²	6.2	29
2001	59.2	5.8	35
April 2002	56.6	5.9	37.5

Source: Bank of Albania

Table 4. Banking system assets structure

Assets structure	Total	Total
Index (in percentage to the total assets)	December' 00	December '01
1. Treasury and interbank transactions	88.4	85.7
2. Operations with customers (net)	6.1	8.6
3. Securities transactions (net)	2.9	3.3
4. Other assets	0.6	0.4
5. Fixed assets	1.9	1.8
6. Accrued interests (net)	0.1	0.3
Total assets	100.0	100.0

Source: Bank of Albania

⁴² Savings Bank evidences reduction from its share in the system from 67.9% at year end 1999.

Table 5. Banking system performance indicators

	Dec. '98	Dec. '99	Dec. '00	Dec. '01	Jun '02
Capital adequacy ratio (% , system)	0.0	8.2	42.0	35.6	32.2
Risk weighted asset (mln leke, system)	24.9	48.6	39.6	46.4	51.8
Assets growth rate (% , system)	-	21.1	8.6	17.6	-1.2
Growth rate of credit balance (% , system)	-	17.7	55.6	0.22	17.9
Growth rate of system deposits (% , system)	-	19.5	10.6	19.2	-4.6
NPL rate (% , system)	35.5	32.1	43.1	6.93	7.4
Reserve rate for loss loans to NPL(% , system)	96.3	109.5	95.0	44.1	53.8
After-tax rate of return on assets (% , system)	-1.8	0.5	2.1	1.5	0.9
NPL Rate of the system without SB (% , system)	10.8	9.7	9.4	6.9	7.3
Reserve rate on loss loans to NPL(% without SB)	82.2	133.7	52.7	42.2	52.3
After-tax rate of return on assets (% without SB)	-12.8	1.4	3.3	8.7	6.1

Table 6. Banking system deposit performance

Deposits balance (in mln Leke)						
SB						
ACB						
NCB						
AIB						
AAIB						
DB						
TB						
NBG						
ICB						
AB						
ABA						
FEFAD						
FIB						
CBG						
System						

Source: BoA

Table 7 Banks' share according to banking market classification on deposits, '97-'02

G1 deposits weight to total system						
G2 deposits weight to total system						
G3 deposits weight to total system						

Source: BoA

Table 8 Deposits performance during the panic

Deposits balance (mln leke)										
Savings bank										
Alpha Bank										
American Bank of Albania										
Arab Albanian Islamic Bank										
Dardania Bank										
FEFAD Bank										
First Investment Bank										
Albanian-Italian Bank										
National Bank of Greece										
National Commercial Bank										
International Commercial Bank										
Commercial Bank of Greece										
Tirana Bank										
Banking system										
Banking system without SB and NCB										

Deposits balance (mln Leke)										
Savings Bank										
National Commercial Bank										
Banking system										
Banking system without SB and NCB										

Source: BoA