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Albania; Transition to a Market Economy

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Introduction

1.1 Objective of the PhD research

Albania is geographically located in Europe and is one of the poorest countries of the continent. It had one of the most centralised and repressive regimes in the world from mid-1940 until late 1990. This country started its transition process long after economic reforms were initiated in other centrally planned economies.

Since starting its transition to a market-based economy in 1991, Albania has experienced dramatic oscillations attributable to both the success and the failures of adjustment. The initial downfall was steep, with the output dropping to half of its 1989 level in 1992, inflation in triple digits, and the external current account deficit equivalent to almost two thirds of the GDP. The rise in 1993-1995 was also steep, with a GDP growth averaging near double digits, single-digit inflation, and sharply reduced external imbalances. By 1996 the rapid growth was supported more by activities related to financial pyramid schemes. The collapse of these pyramid schemes in 1997 caused a deep economic and social crisis, bringing the economy to a standstill.

The transition process in general, and that of the Albanian economy in particular, are the aim of this project. We first analyse if and how macroeconomic regularities differed between the transition economies and developed Western economies and check whether or not there is a convergence of these regularities during the transition period. Then we focus our analysis on Albania by discussing its

macroeconomic stabilisation process in detail and comparing it with successful transition economies like Poland and less successful ones like Bulgaria. We apply an integrated framework for measuring the consistency between fiscal and monetary policies in the Albanian case, given the output growth rate. The results from this application show us the weak points of the macroeconomic stabilisation process in Albania. In particular we focus on the reform of the financial sector and other factors that led the country to its economic crisis and we suggest future ways out of the crisis. We continue our analysis with the economic and political implications of the development of the Ponzi schemes in Albania. We test the theoretical conditions that influence the start and development of these schemes under controlled laboratory settings.

1.2 Outline of the Book

This book is divided into two main parts. The first part covers the macroeconomic issues of transition and consists of four chapters. The second part discusses the financial collapse of Albanian and the Ponzi schemes in particular.

Chapter 2 analyses how reforms altered the macroeconomic fluctuations in the recovering transition economies. Albania is excluded from this analysis, not only due to lack of the needed data, but also due to its performance, which has not reached the level of the advanced transition countries. We study if and how macroeconomic regularities differed between these transition economies and developed Western economies. An analysis of these questions can help not only to understand the ongoing transition process, but also to highlight problems that exist in transition countries and to suggest possible policy options as these countries integrate with the rest of the world. Furthermore, a direct implication of the empirical study in this chapter is that the increasingly similar macroeconomic regularities in the Central European transition economies and the Western European developed economies provide a support for using the standard economics for market economies. In the fourth chapter we test the sustainability of the Albanian budget deficit based on this finding. We use a standard

portfolio model of the demand for currency, demand deposits, time deposits, and foreign currency deposits. In a standard portfolio theory fashion, these asset demands are function of interest rates on the various deposits and inflation.

In chapter 3 we direct our analysis to Albania. We first analyse the macroeconomic stabilisation process until 1996, by highlighting the weak points of the reform. The policies behind the recovery of the country are identified and analysed and the outcome is compared with outcomes in other countries, in particular Poland, as an example of success, and Bulgaria, as an example of a less successful stabilisation process. We analyse the process of structural reform and its impact on economic activity. Then we discuss the sustainability of the high and fast output growth and the strong influence of institutional uncertainty, which can be seen as one of the factors that led the country to its crisis in the beginning of 1997. We try to explain the main factors that helped the economy to rebound and inflation to decrease to such low levels. The importance of the price liberalisation, substantial external assistance, and restrictive fiscal monetary and financial policies is emphasised. Further we investigate whether these achievements are sustainable in the long run or not. We analyse in detail the fiscal and monetary policy implemented by the government, which is the main factor that brought inflation down in the last four years, by highlighting the problems that already existed with respect to the sustainability of the fiscal deficit and the growth. At the end of this chapter the “unfinished business” of the financial sector reform is analysed.

In chapter 4 we continue our analysis by testing the sustainability of the Albanian fiscal deficits and examining factors that led the Albanian authorities to pursue a successful stabilisation policy, until 1996. First, we show that the fiscal deficit is not covered in a sustainable way, and can, therefore, lead to problems in the long-run. The non-inflationary means of financing the fiscal deficit in an unsustainable way could lead to further accumulation of the public debt and might induce an unstable process of public debt accumulation, necessitating larger monetization in the long run. Therefore, even though the stabilisation process had been successful, there were weak and very vulnerable points that could lead to

contrary effects. The close links among monetary and fiscal policy, long-run growth and the financial sector reform are the main factors that can affect the final outcome.

In 1996 signs of disequilibria began to accumulate. The budget deficit widened, inflation rose to 17%, and the current account deficit grew as the export recovered only slowly to pre-transition levels while the import surged. The worst sign of the disequilibria was the high interest rate offered on deposits by foundations operating on the basis of a pyramid scheme system.

In Chapter 5 we explain the ground on which those Ponzi schemes developed and spread so quickly over the whole country. Their consequences for the political and economic system of Albania are outlined. We attempt to explain what made the country so vulnerable. Therefore, the chapter first gives some background information on Albania, as a crucial starting point to understand why the reaction of the people was so violable. Then we return to the analysis of the macroeconomic reforms and the development of the informal market during the stabilisation process. Here, we show that the existence of the informal financial market became a fertile ground for the widespread acceptance of the pyramid schemes.

In chapter 6 we analyse whether the Ponzi schemes in Albania were rational or not. We first give an overview of the literature on the possibility of running rational Ponzi schemes. The analysis continues with the investigation if the Albanian Ponzi games meet the conditions of a rational game. We present two theoretical models; in the first model the asymmetric information is the force that ensures the start of the game, while the noisy information generated by utilising a 'search' model, is the driving force behind the existence of the scheme. The strategy of the investors who own incomplete information is to follow the movements of the ones that possess complete information. In the second model the asymmetric information is again the force that ensures the start of the game, but the uninformed investors in this version are treated as rational individuals and therefore they build a strategy to predict the optimal time of getting out. Here we work with the strategic interaction between individuals. We continue our analysis with the comparative statistics of both models and compare their predictions.

In chapter 7 a Ponzi experiment is introduced, conducted in a controlled laboratory setting. The settings of the experiments include an extremely high interest rate, the possibility of keeping the scheme alive by using invested funds to pay out interest and an increasing probability of bankruptcy as time passes. In addition, as in both models of chapter 6, two types of investors exist: informed and uninformed ones. Besides having a first move advantage, the informed investors have specific knowledge about the viability of the scheme, i.e., they can calculate when it is time to withdraw. Our experiments study three treatments, to wit, group size, interest rate and the relative number of informed investors. The results show that group size does not matter in our case, but both the interest rate and the number of informed affect the behaviour of the player. Especially the behaviour of the uninformed is affected in a way that it is predicted by the first but not by the second model in the previous chapter: they tend to show a herd-like behaviour by reacting to the choices of the informed, i.e. they follow the moves of the informed investors.

Finally the main conclusions of this thesis are summarised. We show that, additional to the implementation of a strong macroeconomic stabilisation reform, the development of an efficient financial sector, a strong supervision and the implementation of anti-corrupted policies are crucial factors for a successful and complete stabilisation reform of the Albanian economy.

