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Post-socialist financial fragility: the case of Albania

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The 1997 collapse of the Albanian economy caused by the collapse of economy-wide Ponzi schemes contrasts sharply to its success status as a post-Socialist transition country in the years 1992–96. In this paper, an attempt is made to explain this 'Albanian Paradox'. The specific Albanian conditions for the growth of Ponzi schemes are identified. Theoretically, the Albanian Paradox can be interpreted as one version of the 'Financial Instability Hypothesis' suggested by Minsky. Investigation of the underlying factors that render financial markets fragile suggests that the Albanian case is extreme but not unique in the region. It is emphasised that sustainable growth is predicated on the quality of government, on proper financial-sector regulation, on actual microeconomic restructuring and on the development of market institutions through which adequate market information is disseminated.

Key words: Albania, Ponzi schemes, Financial instability hypothesis, Transition economies
JEL classifications: E12, G18, O5, P27, P34

'The transition in Albania is likely to be particularly akin to a laboratory experiment.'
Anders Åslund and Örjan Sjöberg (1992)

'For the moment, just assume Albania doesn't exist.'
Albanian newspaper *Koha Jonë* (20 March1997)

1. Introduction

The aim of this paper is the analysis of economic policies applied in post-Socialist Albania. Despite its modest size, the country caught the world's attention when the Albanian economy and society collapsed early in 1997. This breakdown was remarkable in the light of Albania's recent economic history. Following its profound economic reforms in 1992, the country had been celebrated in much of the literature on the economics of transition as the classic example of sound post-Socialist economic policy in line with the 'Washington consensus' (Williamson, 1994). By mid-1993, it could be claimed of Albania that is was the only country in Central and Eastern Europe to meet every IMF criterion. In the years 1992–96, Albania initiated the most free market policies in Europe, and was

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considered a model country and a master student of the international institutions (Hall, 1994, p. 276; McAdams, 1997; *Albanews*, 1997; Lyle, 1997; Vaughan-Whitehead, 1999, p. xvii). Such praise was justified by reference to Albania's macroeconomic indicators. In the years 1993–96, officials figures indicated that inflation was contained, GDP increased and unemployment decreased considerably.

These trends could be applauded until the shock of early 1997. Ponzi schemes had been operating in Albania for some time on an ever increasing scale, and their collapse dragged the country within weeks into anarchy, widespread violence, plundering and food shortages. The popular perception of this event was surprising from an analytical point of view. While Albania's IMF-inspired economic reform policies had been extensively credited for its exemplary post-Socialist performance, the sudden collapse of its economy was viewed as merely a result of 'Albanians' mistaken notion of capitalism' (*Wall Street Journal*, 24 March 1997).[1]

In this paper, an attempt will be made to challenge that explanation. Its point of departure is what could be called the Albanian Paradox: the curious fact that a post-Socialist country could implement the standard transition 'package' with unrivalled adherence to the prescribed policies and show an outstanding macroeconomic performance—and simultaneously move ever closer towards collapse. Both its policies and its performance were at the extreme end of the spectrum of Eastern European transition experiences. Albania might therefore, as the first quotation at the start of this paper suggests, present an instructive case, if not a 'laboratory experiment'. The focus in explaining the Albanian Paradox is on the nature of financial markets in transition economies from a post-Keynesian perspective. The argument is that the high incidence of Ponzi schemes and other financial-market aberrations in the region was no mere idiosyncrasy, but was inadvertently fostered by the combination of restrictive monetary policies, a lack of market regulation, large capital inflows and weak governments. These features have indeed been, to varying extents, typical of transition economies.

2. Albania in transformation: policies and performance[2]

Albania, the smallest and least developed of the Eastern European transition countries, is located by the Adriatic Sea, bordering on Greece to the south, Macedonia to the East and rump Yugoslavia to the north. It has a population of 3·2 million, 56% of which is employed in agriculture.

Albanian post-Socialist history commenced in early 1992, when the first 'free and fair' elections were won by the Democratic Party, the one substantial opposition group to the ex-Marxist–Leninist Labour Party. The previous 48 years of socialist rule under Enver Hoxha and (since 1985) Ramiz Alia had isolated the country in every respect, keeping its standard of living the lowest in Europe. Late compared with other countries in the region, in 1991 Albania entered the international community when it joined the Conference on Security and Co-operation in Europe, the European Bank for Reconstruction and

[1] Neither was there, to the best of my knowledge, any serious economic analysis published in the two years following the collapse. Only in spring 1999 did an excellent book on the crisis by Vaughan-Whitehead appear. He also 'had been unable to find any convincing, only misleading overall explanations of the recent crisis' (Vaughan-Whitehead, 1999, p. xxii). This empirically rich volume confirms most of the factual observations in the present paper.

[2] Based on *Albanews* (1997, 1998), *Albanian Times* (1997), Äslund and Sjöberg (1992), Blejer *et al.* (1992), Commission on Security and Cooperation in Europe (1994), Elbirt (1997), EBRD (1997), Frank and King (1997), Haderi *et al.* (1999), Hall (1994), Hashi and Xhillari (1999), OECD (1996), OMRI (1997), Pashko (1993), Reuter (1997), Vaughan-Whitehead (1999, pp. 3–17).

Development, the World Bank group and the International Monetary Fund, among others. Hesitant reforms, introduced in 1991, were reinforced politically in 1992 as Democratic Party leader Salih Berisha succeeded Alia as President and formed a new government.

Drastic economic reform was seen as inevitable as Albania found itself in the trough of recession, with a rapidly contracting economy, waves of poverty-induced emigration, a third of consumption coming from humanitarian aid, nearly a third of the labour force unemployed, and inflation peaking to 45% monthly in August 1992 (see Table 1 for more figures). In mid-1992, the government introduced IMF-advised wide-ranging reforms. These included the liberalisation of price controls and of trade, tight fiscal and monetary policies and, starting in July 1992, a floating exchange rate. Agricultural land was completely privatised, as were many small and medium-sized industries. With the introduction of unemployment benefits and pensions, a social safety net was installed. Various specialised state bank branches were commercialised, and a two-tier banking system was established. The Albanian currency, the lek, was made internally convertible, and brought into line with black market exchange rates, depreciating from 50 to 110 to the US dollar.

By the end of 1992, macroeconomic circumstances stabilised. Microeconomic restructuring by then also began to show results. The number of private businesses in the capital had increased from just 398 in March 1991 to 8,321 in December 1992. Tax revenues, which had fallen from 42% of GDP in 1990 to 28% in 1991, began to rise in Tirana District by the end of 1992, signalling both an increase in private sector activity and a functioning of the tax administration, upon which the government now depended for revenues. With World Bank support, the government started preparations for privatising 30 weak and large state enterprises. At the start of 1993, many economists read the beginning of an economic recovery in the main economic indicators. In the subsequent four years, this recovery continued. Official Albanian GDP rose dramatically (although from a very low base), official unemployment nearly halved, inflation was brought to single-digit levels, and foreign direct investment came in (Table 1).

In late 1996, the trade and fiscal balances started to worsen, and inflation rose to 20%

Table 1. *Albanian economic indicators, 1989–98*

Year	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
GDP (% change)[a]	–9·8	–10·0	–27·7	–7·2	9·6	9·4	8·9	9·1	–7·0	8·0
Consumer prices (% change, average)	0	0	35·5	226·0	85·0	22·6	7·8	12·7	32·1	20·6
Exchange rate (lek/US$, end–year)	8·9	24·2	25·0	98·7	100·9	95·0	94·5	103·7	149·8	141·4
Unemployment (% labour force, end-year)	7·3	9·8	8·3	27·9	29·0	19·6	16·9	12·4	14·9	17·8
Budget balance (% GDP)	n.a.	–15·4	–30·7	–23·1	–15·5	–12·6	–10·1	–12·1	–12·6	–10·4
Foreign investment (million US$)	0	0	0	20	58	53	70	90	48	45

[a] Nominal GDP estimates are subject to a high degree of uncertainty. Annual changes in GDP should there fore be taken as indicative rather than precise.

Sources: OECD (1996, p. 167), EBRD (2000, p. 37), World Bank (1997), IMF (1996, unpublished), Albanian Ministry of Finance, Albanian Institute of Statistics.

p.a. The decisive break in positive trends came in February–March 1997. Ponzi[1] (or pyramid) schemes had been operating on an ever larger scale since 1992 (*Albanews*, 1997). In February they collapsed, swallowing a large share of the population's savings. Social unrest spread rapidly as masses of demonstrating Albanians demanded compensation from the government and strong suspicions existed about its involvement in the schemes. These protests, six weeks of looting, the plundering of army arms depots and the emergence of irregular, armed bands caused the government to lose control over the larger part of Albanian territory. The ex-socialist political opposition joined in and politicised rebel demands.

A wave of refugees attempted to flee, mainly to Italy. In response to the unrest, PM Aleksandr Meksi was replaced by Bashkim Fino. President Berisha, staying in office despite widespread misgivings, invited a World Bank/IMF team to investigate the Ponzi schemes issue and help with restructuring of the banking sector. In April, Albania's dismal situation led EU leaders to discuss the formation of a military intervention force. This 6,000 Italian-led force arrived in mid-April to carry out 'Operation Alba', designed to assist in humanitarian aid operations. In early July, election results—dubious but accepted—brought the Socialist Party (formerly the Labour Party) to power again. A new Parliament was formed, and Rexhep Mejdani succeeded Berisha as President. Peacekeeping forces started to leave the country, and new economic reforms, especially in the privatisation process and the banking sector, were initiated. In the year following the crisis, Albania suffered heavily from its aftermath. Significant parts of Albanian territory remained controlled by irregular, armed bands, the economy shrank considerably, the incidence of random violence increased, and poverty rose dramatically.

3. Reconstructing the crisis

Obtaining and assessing the relevant information on the Ponzi crisis is difficult because of the informal and politically sensitive nature of the development and collapse of Albanian Ponzi schemes. A reconstruction of the Ponzi period , however, suggests that the schemes were able to prosper through a combination of circumstances: restrictive monetary policies, large capital inflows, and financial-market policies that were very strict for official banks but extremely lax for informal financial intermediaries.

3.1 Prelude

In the period from the middle to the end of 1992, the economy was stabilised and inflation decreased dramatically. The main objectives of the financial system reforms in 1992–96 included inflation monitoring, minimising the budget deficit, solving the foreign debt problem, and the creation of a two-tier banking system (World Bank, 1997). In order to realise these priorities, the Bank of Albania committed itself to restrictive monetary and fiscal policies. Over the years 1992–95, these included a considerable decline in official credit expansion, in government expenditures, and in broad money relative to GDP (Table 2). In addition, reform policies limited the emergence of officially recognised financial intermediaries in several ways, facilitating the rise of an informal financial sector.

[1] 'Ponzi finance' can be defined as 'a situation in which cash payments on debts are met by increasing the amount of debt outstanding' (Minsky, 1982, p. 67). In standard modelling terms, that is only feasible when either the population is infinite or individuals are uninformed and/or irrational (O'Connor and Zeldes, 1992, p. 147).

Table 2. *Albanian monetary and fiscal developments, 1990–95*

Year	1990	1991	1992	1993	1994	1995
Money (% change from previous period unless otherwise indicated)						
Broad money	23	104	153	74	41	52
Real broad money	23	–	–25	34	21	43
Domestic credit	22	100	113	54	31	24
Broad money/GDP (%)[a]	37	69	54	40	38	48
General government (in % of GDP)						
Revenues	47	32	24	26	25	24
Expenditures[b]	62	62	44	40	37	34
Overall balance[c]	–4	–44	–20	–14	–12	–10
Domestic financing	4	44	20	9	7	6

Note: Nominal GDP estimates are subject to a high degree of uncertainty. Ratios to GDP should therefore be taken as indicative rather than precise.
[a]End-year broad money divided by annual GDP.
[b]Including on-lending.
[c]Including net repayment of arrears.
Source: McNeilly and Schiesser-Gachnang (1998).

First, there were few official banks because of the strict requirements for the founding of banks in Albania. Except for a few former branches of the state bank and an Italo-Albanian bank (which did not engage in lending, only in administering a payment system), no licenses were granted to Albanians wishing to set up a bank, since 'no one showed the financial capacity to sustain a private bank' (ACER, 1996). Another potential capital source, the Tirana Stock Exchange, did not open until May 1996, and then proved unable to attract capital for business growth. Secondly, the banks that did operate were severely handicapped in two ways: both the defective payment system and the 'bad loan' problem left official banks with too little liquidity for adequate lending. And thirdly, strict monetary and budgetary policies limited the official supply of money to the economy further still. Enterprise subsidies decreased from 16% to 2% of GDP in 1992–93, and tight credit control on public enterprises was introduced in 1992. Broad money growth decreased from a high of 182% p.a. in early 1992 to less than 45% p.a. in 1994. Between early 1992 and mid-1993, real wages decreased by 26·6% (increasing by only around 4% annually in 1994 and 1995), while public sector employment decreased by two-thirds (Haderi *et al.*, 1999, pp. 131, 133). Table 2 shows the impact of tight monetary and fiscal policies and restrictive bank legislation in 1990–95.

While all this was very effective in containing inflation, official money-market operations were thus limited to the point where this came to be a main constraint on the mobilisation of savings for investments and for growth of productive activities (Sadiraj, 1999, p. 45; Vaughan-Whitehead, 1999, pp. 62–6). Official nominal interest remained far below inflation levels until 1995 (see Table 5 below). In the absence of well-developed stock and real estate markets, this induced people and firms to revert to transactions on informal markets. The demand for financial intermediaries was especially large because of a considerable cash flow to the population in the transition years, which came from three sources.

The first was the Albanian workforce abroad, mainly in Italy and Greece. They numbered three to four hundred thousand in the years 1992–96, which is over 10% of the domestic population, or about 15% of the labour force. According to the most conservative estimates, income from remittances amounted to 15–20% of annual GDP in 1992– 96, totalling an estimated US$1 billion in these years (Mancellari *et al.*, 1996, p. 478; *Albanian Times*, December 1996; Elbirt, 1997; Frank and King, 1997; Lyle, 1997; Haderi *et al*, 1999, p. 134). The second source of inflow resulted from the blockade imposed on the warring Yugoslav successor states by the international community, which created opportunities for lucrative smuggling, mainly of fuel and cigarettes, for their Albanian neighbours. And thirdly, over half the 1992 GDP and about a third of 1996 budget revenues were provided by various foreign sources. Albania received the highest per capita level of EU aid of any East European state in this period (Lyle, 1997). Although much of it was provided in the form of food and commodity aid, there still was a large positive effect on savings (McNeilly and Schiesser-Gachnang, 1998, p. 22). Table 3 presents details from the current account in the years 1990–95 that indicate the relevance of foreign investments, emigrant wages and aid inflow relative to GDP. Note that this excludes illegal, possibly sizeable, inflows.

As a result, household savings rose from virtually zero in the last pre-reform year to US$350 million in 1995, US$600 million in 1996 and US$700 million in 1997 (Elbirt, 1997). Paradoxically, in the same period, both access to investment credit for firms and access to deposit accounts for the population were severely constrained in the official market, for reasons mentioned above (see also Vaughan-Whitehead, 1999, pp. 55–71). These circumstances drove first business people, and later many more non-entrepreneur citizens to the informal markets, where Ponzi-like firms and foundations had started to operate.

3.2 Ponzi schemes: strategies and environment

Among the first schemes were the prominent Albanian company 'Vefa' and the foundation 'Sude', which both reportedly started banking with Ponzi methods in 1992. The schemes operated earliest and mainly in the south-west of Albania, which is the region where most emigrant workers come from, and which generated the largest per capita emigrant remittance inflow. It is also the area where later protests were most violent and which long remained incompletely controlled by central authority. Table 4 presents some of the features of these and other organisations running Ponzi schemes.

Table 3. *Capital inflows in Albania, 1990–95 (in million US$)*

Year	1990	1991	1992	1993	1994	1995
Current non-IMF transfers	15	107·6	148	230	265·7	300
of which: official transfers (non-IMF)	–	*80*	–	–	–	–
private (worker's remittances)	*15*	*27·6*	*150·2*	*274·7*	*379·1*	*384·7*
Bilateral/multilateral flows	–	–	399	356	148	159
of which: grants	–	–	*343·8*	*302·2*	*134·2*	*55·7*
medium/long term loans	–	–	*55·2*	*53·8*	*13·8*	*103·3*
Foreign direct investment	0	0	32	45	52·9	70
Total registered capital inflows	15·0	107·6	581·2	675·7	580·0	593·7
GDP	1,130	1,139	710	1,228	1,984	2,422
Registered capital inflows (% GDP)	13	9	82	55	29	25

Note: Nominal GDP estimates are subject to a high degree of uncertainty. The trend in ratios to GDP should therefore be taken as indicative rather than precise.

Sources: IMF and World Bank data, EBRD (1998), McNeilly and Schiesser-Gachnang (1998, p. 23), Haderi *et al.* (1999, p. 135).

Table 4. *Characteristics of Ponzi schemes in Albania*

Name	Xhaferri	Populli	Sude	Vefa	Kamberri	Gjallica
Alleged status		Charitable foundations			Companies	
Duration of operation (years)	3	1	4	5	3	3
Max. deposit accepted (thousand lek)	3	10	unlimited	unlimited		
Denomination of deposit		leks only			leks & foreign currency	

Source: World Bank (1997).

This informal financial sector was not considered problematical by the economic authorities. The money-borrowing firms did not have to report on their sources of capital, and loans were not recorded in their balance sheets. They could use the accounts of the official Savings Bank and National Commercial Bank to place and withdraw their deposits without any account monitoring. Their loans were considered to sustain normal business activities. As late as February 1996, they were mentioned neutrally in an offical publication as 'mutual agreements between the borrower and lender', as provided for in the new Civil Code (ACER, 1996). Hence, these transactions were subject to the Civil Code rather than to the strict banking law, and licensing was not required (Elbirt, 1997). The banking activities of, notably, the well-known firms 'Vefa' and 'Gjallica' were interpreted as conducive to the mobilisation of savings for investment in ex-state properties (ACER, 1996).

This view was partly justified: these firms, in contrast to schemes presenting themselves as 'charitable foundations', made up for a sizeable part of the Albanian economy. 'Vefa' undertook business in trade, tourism, transport and food processing. It operated more than 200 businesses and employed 10,000 people. The 'Vefa' and 'Gjallica' organisations acquired real assets in Albania. Likewise, 'Kamberri' operated in agriculture, food processing and tourism, and 'Gjallica' owned enterprises in trade, medicine and tourism. In addition, the 'foundations' also made some real investments, financing the construction of supermarkets, office complexes and gas stations. Over the years 1992–96, productive activities were increasingly funded with 'Ponzi money' (Elbirt, 1997; McAdams, 1997, *Albanews*, 28 February 1997).

The main advantage that Ponzi schemes offered to savers was, naturally, high interest rates. In the last quarter of 1996, interest rates of many schemes were between 30 and 50% monthly, with some small foundations offering 100% monthly (*Albanian Times*, December 1997). Interest rates differed widely between funds. In consequence of the more extensive real sector activities of the companies, the interest rate they paid was 'only' 8% monthly, in contrast to the 60% of, for example, the large 'Populli Foundation' scheme. Table 5 compares formal with informal (probably Ponzi) interest rates in the 'Ponzi period', demonstrating that the latter were indeed the only agents that could offer attractive interest rates, given the high inflation in the early transition years. It is also shown that the nominal interest rate they offered decreased as inflation was contained over time.

In addition to offering high interest rates, Ponzi firms and foundations employed effective marketing and advertising strategies with full use of the state television service (Nivat, 1997). The funds extracted much of Albanian household money from under the

Table 5. *Annual interest rates on short-term deposits in the formal and informal financial sector in Albania, 1992–95*

Year	Formal sector: interest for different maturities			Informal sector
Deposit maturity	quarterly	six-monthly	annual	(15 days–1 year)[a]
1992	18	25	32	240
1993	12	17	23	144
1994	7	12	14·5	120
1995	10	12	13·5	72

[a]No evidence of the informal market accepting medium or long-term deposits was found. The informal sector figures are averages over various maturity terms. Companies in this period offered 8–12% interest monthly for a six-month investment. Foundations offered a 50–100% interest for three and six months deposits.
Source: ACER, 1996.

proverbial mattress and, starting in 1993, even caused a shift from consumption to saving (McNeilly and Schiesser-Gachnang, 1998, p. 22). Importantly, the absence of warnings from the government, the frequent appearance of pyramid managers and government officials side by side at public meetings and on television, and the association of pyramid managers with the Democratic Party, lent state credibility to the schemes. Not only were much of the population's savings and (domestic and external) income 'invested', but many people also took out loans and mortgages on their house or land in the expectation of quick gains. As a result, by the last quarter of 1996, the schemes had accumulated more than US$250 million in their accounts, a sum representing only 40% of their liabilities. By early 1997, the total value of received deposits reached US$1·2 billion, or 50% of annual GDP, excluding accrued interest at the time of estimation (Elbirt, 1997).

The long period (and hence large size) of Ponzi operations turned the detrimental side effects of schemes into threats to the economic system even while the schemes were operating. Given an average monthly salary of only US$70 in 1997, astronomical Ponzi gains competed with wage income. One entrepreneur interviewed saw his work force of 130 slip to just 70 in just a few months. Another cost was that money that could have been invested in sustainable growth was now swallowed by the funds (McAdams, 1997; Frank and King, 1997).

3.3 Collapse

The end to large-scale Ponzi operations came in January–February 1997. By October 1996, the IMF had realised the dangerous proportions that Ponzi schemes had assumed and warned the government against them, as the World Bank had been doing publicly since mid-1996 and earlier in government circles (*Albanian Times*, 1997; Reuter, 1997; Elbirt, 1997). On 10 January, the National Bank of Albania under IMF pressure ruled that the 'money firms' were limited to daily withdrawals of US$300,000 from their official accounts. Fund managers protested, claiming that they could only meet interest but not principal claims under this condition (ACER, 1996).

In the next week, first 'Gjallica', then the smaller fund 'Sude', set dates to repay principal, but failed to do so. On 18 January, the 'Sude' top manager was jailed. 'Vefa' and 'Kamberri' announced they would stop repaying principal for the next 3–6 months. On 19 January, public disorder broke out in Tirana, which was subdued by the police. The government froze the foundations' bank accounts. Open protests in the south started on

21 January in Shkodër, and spread to other cities in the subsequent days. On 22 January, the public prosecutor announced that 'Xhafferri' and 'Populli' were Ponzi schemes, and their presidents were jailed. The presidents of 'Vefa' and 'Kamberri' were interrogated by the police. One 'Gjallica' president was imprisoned on 7 February, another fled Albania. On 5 and 6 February, these companies were also labelled Ponzi schemes. Meanwhile, the Savings Bank had started to distribute what was left of the funds of former 'Populli' investors, while protests spread further through the south and turned into uncontrolled violence. In April, more than a hundred government officials were sued for using their position to foster the schemes for their private enrichment. Over 1997 and 1998, a total of 17 schemes were dismantled or (if they were owned by companies like Vefa), monitored by auditing firms, and had part of their assets sold (*Albanews*, 1997, 1998). Nevertheless, the larger part of Ponzi funds vanished, which increased their already very large net liabilities. According to first estimates by an auditing firm in 1998, debts of the five principal Ponzi companies totalled US$475·9 million, while their assets amounted to only US$49·9 million; hence their net liabilities were twice the value of Albania's annual GDP. These 1998 figures compare with US$250 million found in the bank accounts of only two of these ('Xhafferri' and 'Populli') when their accounts were frozen in early 1997 (Vaughan-Whitehead, 1999, p. 202). The crisis brought down the President and the government, and induced new reform policies, with a focus on the financial sector.

3.4 Causes

Although many economies have Ponzi schemes, nowhere else were they observed to crush the economy and temporarily dissolve society as they did in Albania. Among the features of the Albanian experience described above, the following can be identified as direct causes for the dramatic impact of the Albanian schemes.

First, instead of fighting Ponzi scheme operators, Albanian government officials lent state credibility to them. Secondly, a lack of political diversity in Albania precluded serious opposition to and checking of government members' self-enrichment. It also left foreign governments, the EU and monitoring institutions with no alternative political partner, a circumstance which increased the discretion of Albanian government officials. Thirdly, a (partly 'black') money inflow into the schemes, large in relation to the size of the economy, and originating in smuggling gains, emigrant wages and foreign aid, allowed the schemes to tie their fate to that of the economy, and drew a large fraction of the domestic population into the schemes. And fourthly, the policy-induced informalisation of financial markets allowed 'money firms' and 'foundations' of every sort to start and operate. The striking contrast is that, while the authorities imposed very strict conditions on the growth of the official financial sector, there were no regulatory impediments for those 'banking' with Ponzi methods.

Two additional impacts of the Albanian schemes on the economic system relate not to their functioning, but to their collapse. The schemes did not die with a whimper, but collapsed suddenly. There was little effort by, or opportunity for, operators to protract their functioning; this caused maximal redistribution and impoverishment. Finally, the political consequences (anarchy and random violence) of the Ponzi collapse were caused by the already polarised political scene and the ready availability of arms in the many army depots throughout the country—an inheritance resulting from Hoxha's fear of a foreign invasion. The Ponzi problems were eagerly exploited by the ex-Socialist opposition to win the population's support. It supported rebel claims for a 'political solution' to the problems, i.e., the removal of Berisha as President and new elections (McAdams, 1997).

These circumstances allowed a sudden and widespread economic problem to turn quickly into a political and (almost immediately) also a physical, territorial battle.

3.5 The welfare effect

The economic impact of the Ponzi period on the Albanian economy was certainly large and disastrous, but also inherently difficult to estimate. Direct indications of the welfare effects of the episode include an estimated 500–1,500 victims of the continuing violence (as of February 1998), much material damage during the protests, a large amount of savings and income lost, and serious reductions in income and employment. The share of the total population involved at the moment of collapse is estimated at between one-sixth and one-half. Estimates of the amount of money swallowed by the schemes run between US$300 million, US$0·5 billion, US$1·2 and US$1·5 billion. The latest figure at the moment of writing, US$1·2 billion, is roughly equal to total wage remittances from overseas in 1993–96, or to half the average annual Albanian GDP in those years. The figures on the volumes of schemes are, however, problematical both because of the informal nature of schemes and because people tended to include the virtual interest on their money in reported losses. Only an insignificant part of investments (US$11 million as of June 1997) was returned (Gomez, 1997; Vaughan-Whitehead, 1999, p. 207; McAdams, 1997; *Albanews*, 1997; World Bank, 1997). Hence, the longer-run impacts of the Ponzi period include the burden of debts, mortgages and loss of jobs that many citizens had to cope with.

Various economic figures give an indication of the impact of the collapse (also see Table 1). As a direct consequence of the crisis, the lek depreciated by 25% to the US dollar over the first six weeks of 1997 and by 50% over the year. GDP decreased by around 7% through 1997, and the annual rate of inflation shot up from 13% to nearly 50%, averaging 32% in 1997. Between 30% and 50% of enterprises were either totally destroyed by the crisis or had to close down without any hope of starting again. Between March and August 1997, 150,000 families were newly registered for unemployment assistance, which brought the official number to 165,00 families (representing about 650,000 persons) dependent on state assistance in early 1998. The actual unemployment number in late 1997 is estimated by Vaughan-Whitehead (1999, p. 292) as 50% of the working population. If registered, they received on average US$21 monthly, and an estimated 600,000 of them only US$15. However, many social assistance payments were interrupted in early 1997. After the collapse, the 500,000 urban and rural pensioners received US$22 and US$7 monthly, respectively, while the corresponding incomes for 1996 had been US$38 and US$10. By the end of 1997, poverty had increased by 30% and affected one million Albanians, or about one-third of the population (*Albanews*, 1998; Vaughan-Whitehead, 1999, pp. 287, 304). The Albanian economy as a whole certainly shrank, but Lyle's (1997) statement that it shrank 'to less than its size in 1990' overstates the decline, since even the peak 1996 GDP was still at only 85% of pre-transition levels (Vaughan-Whitehead, 1999, p. 11). Nor did the crisis cause a loss of what growth was achieved during the transformation. The 1997 decrease in GDP was less than any of the annual growth rates in 1993–96, while 1998 GDP growth was positive again (see also Table 1). Apart from such GDP fluctuations (which are based on questionable calculations anyway), there were other, more important consequences of the crisis for Albanian economic prospects. For one thing, if trust is the major asset of an economic system, Albania has a huge liability to pay.

Crucial to the real-sector impacts of the whole period (not just of the financial crisis) are the large opportunity costs that Ponzi schemes have: they immobilise money that could have been used (more) productively. In the extreme, capital inflows in a Ponzi-dominated economy have no effect on welfare, but merely increase the amount of money in circulation, driving up nominal wages and prices at constant real incomes. In contrast, increases in real welfare can be realised either through domestic production or through imports. One important question, therefore, is: how did the presence of Ponzi schemes in Albania affect investments, trade and real incomes?

Ponzi money is typically concentrated in the hands of a few. This reduces both investment and demand. Much of Ponzi money is likely to be channelled to foreign bank accounts or consumed, given the short time horizon of Ponzi operators, while domestic money also will translate into low effective demand if held in concentrated ownership. Still, the Albanian Ponzi schemes had limited but positive spin-offs, as some of the largest were managed by domestic firms which were active in business, trade and (marginally) in production.

However, what growth in welfare was achieved in 1991–96 in Albania derived mainly from imports, largely financed by the sizeable capital inflows of the period rather than by increased exports. One obvious drawback of such growth is that it is inherently temporary: welfare will fall as soon as cash inflows and related imports cease. There is growth but not development. Table 6 shows the trade balance for these years, indicating the divergence between exports and imports.

In line with this observation, the welfare level as measured by real wages did not change materially or even declined during the 'growth' phase. Aggregate IMF data for 1997 show that, while indexed nominal wages rose from 100 in the base month December 1990 to over 6,500 index points in January 1996, real wages remained roughly stable during the whole period. Analysis by Sadiraj (1999, p. 47) also indicates that Albanian growth consisted of 'level changes rather than productivity increases'. Vaughan-Whitehead (1999, pp. 99, 111), in contrast, shows on the basis of enterprise-level data that average real wages actually declined by about 50% in 1991–96 (while in the same period wage arrears built up rapidly), and by another 50% in the aftermath of the crisis. Together with the depicted decline in exports, the decrease in productive employment during the Ponzi period reported in casual observation (Frank and King, 1997) and the sharp increase in unemployment after the collapse, this suggests that increased imports may at best have balanced a decreasing share of domestic production in GDP. In this interpretation, Ponzi schemes damaged the economy in two ways. Not only did they facilitate imports at the cost of domestic production while in operation, they also implied a blow to the real sector when 'financial markets' collapsed because of the increasing dependence of what domestic production there was on Ponzi finance.

Table 6. *Albanian trade balance, 1991–98*

Year	1991	1992	1993	1994	1995	1996	1997	1998
Exports	73	70	112	141	205	244	167	205
Imports	281	524	602	601	680	922	685	826
Trade balance	–208	–454	–490	–460	–475	–678	–518	–621

Source: EBRD (2000, p. 37).

4. The Albanian Paradox reconsidered

The theoretical problem posed by the 'Albanian Paradox' is how an economy could seem sound in terms of macroeconomic figures (GDP, unemployment, inflation and budget balance), while moving ever closer towards serious distress or collapse. That definition of the problem is actually relevant to more Central and Eastern European countries than just Albania. Albania was the only national economy in the region to suffer so seriously from Ponzi schemes; but Ponzi schemes were prominent features of most Central and Eastern European economies for some time during the 1992–96 period. This suggests that they were no mere idiosyncrasies, but rather a result of the one common factor of these economic systems: their post-Socialist reform situation and policies.

4.1 Ponzi finance in Eastern Europe

Verdery (1996, p. 169) reports schemes in the Czech Republic, Slovakia, Bulgaria and the former Yugoslavia (notably Serbia). Most prominently, 'Caritas' in Romania and 'MMM' in Russia became conspicuous parts of their respective economies.

'Caritas', opened in April 1992, reached its heyday in the autumn of 1993. According to the most frequent estimate, 4 million Romanians, or roughly 20% of the population, deposited money. 'Caritas' is said to have received 1·4 trillion lei altogether (compared with government expenditures in 1993 of 6·6 trillion lei). In autumn 1993, it held a third of the country's banknotes. After over one and a half years of operations, 'Caritas' collapsed in early 1994—but slowly, since its initiator attempted to restructure the fund, meanwhile continuing to meet obligations. 'Caritas' did not suddenly fall, but died with a whimper, a circumstance that decreased investors' losses considerably, and softened the destructive impact of the collapse of this scheme (Verdery, 1996, pp. 168–204).

The Russian fund 'MMM' was set up in the early transition years. In its initial year of operation, 'MMM' managed to attract 5 million investors. It advertised on television with share prices increasing twice every week, and 'MMM' shares were traded in the stock market. When the scheme collapsed in the summer of 1994, its 'share price' fell from US$62 to US$0·50 within one week. 'MMM' was the largest, but not the only scheme operating in the Russian economy. The collapse of other 'investment companies' like Tibet, Ruski Dom Selenga, and Khopor Invest resulted in many more millions of Russians losing their money (Spicer, 1996; Federal Commission, 1996).

The final collapse of the Albanian funds had even more destructive impacts, for reasons given above. If the high incidence of Ponzi schemes in transitional countries suggests a common, systemic background, they are not to be viewed as specific to particular countries, but as symptoms of specific shortcomings in the financial side of the economic system in transition countries. In this view, Albania is the extreme, and thus instructive, case for analysing non-sustainable financial market development in the region.

Theoretically, the interesting issue is *why* such non-sustainable developments were not halted, not *how* financial market instability and seeming macroeconomic success could combine. The latter question can be answered straightforwardly by inspecting the definition of the relevant variables—unemployment, inflation, GDP, budget deficit and exchange rate. Given substantial capital inflows, there is financial room for stable or rising employment. Inflow of foreign currencies may also sustain the domestic money base and finance the imports necessary to realise a real welfare increase as well as the wages that provide the matching purchasing power. Moreover, as GDP measures the value added in both the financial and real sectors, GDP figures rise even if a boom in financial markets has no spillover effects in the real sector. Since GDP growth increases the tax base, while none of the above developments in themselves necessitate large government spending, the budget deficit may be sustainable or actually decrease. All this was realised in 1991–96 in Albania, as shown in Table 1, but those figures need not indicate productivity growth. Indeed, they were based on the methodology employed by the IMF and the World Bank, which calculated GDP on the basis of investment and income rather than on real production. The method did not take into account the collapse in industrial output which totalled 80% in 1990–94 and continued throughout the 'boom'. In addition, agricultural output—the share in GDP of which rose from 40% in 1990 to 56% in 1995—was overstated by about one-third in the initial growth years (Vaughan-Whitehead, 1999, pp. 9, 12). Nice aggregate figures were only possible because real-sector problems were largely defined away.

This accounting perspective, as mentioned, leaves unanswered a number of questions as to the *why* of financial market deformations in transition countries. Why did the authorities not recognise the danger in time, or in any case not implement policies designed to halt scheme growth? Why did the population participate on such a large scale? At issue here is how the economic system is perceived both by policy-makers and by economic agents, how that information is processed, and what actions follow. The theoretical perspective on financial market instability developed by Minsky (1972, 1977, 1978) is helpful at this point.

4.2 The Financial Instability Hypothesis

Ponzi schemes are located at the extreme end of a spectrum of financial markets, classified according to their 'fragility' (Minsky, 1978). Fragile financial markets are prone to a non-sustainable boom, ending in financial distress or even a recession. The explanation of that periodic instability in financial markets builds on Keynes's notion of money as a financing 'veil' between the real asset and the wealth owner, which explains why capitalist economies are 'so given to fluctuations' (Keynes, 1952, p. 169). In this view, the monetised economy is inherently dynamic, since the key economic transaction is the exchange of money today (current goods) for money tomorrow (financial assets).

Financial commitments on capital markets reflect such transactions, and have to be made in the face of intractable uncertainty (as opposed to calculable risks). This implies that views about the future can undergo marked changes in short periods of time, generating instability (Minsky, 1977, pp. 60, 62; 1978, p. 102). At any point in time, financial commitments break down into three categories. First, 'hedge finance' includes assets with cash flow revenues equal to or larger than cash flow commitments in both the short and the long run. Secondly, capital assets held in 'speculative finance' have short-term cash flow revenues that fall short of short-term commitments. These are met instead by rolling over or refinancing debts in the expectation that long-run revenues will be large enough to meet outstanding commitments. This is typical for banking activities. And thirdly, 'Ponzi finance' assets are characterised by cash flow commitments that are larger than cash flow revenues in both the long and short run, and hence need perpetual rolling over, which is naturally not sustainable. Over time, the market share of speculative and Ponzi finance tends to rise through a shift in risk preferences due to a gradual decrease in the value of insurance that the holding of money provides. A consequent shift in portfolios towards the more rewarding, and more risky modes of speculative and Ponzi finance sets off a boom.

During the boom, expectations grow optimistic to the point of euphoria. (An economy that is ruled by expectations of perpetual expansion is characterised as euphoric.) Hence, lenders accept assets that would previously have been considered (risk-corrected) low-yield. The demand for money can be met either by an increase in the money supply by the monetary authorities, or by banks' money creation, which will be larger as financial markets are more sophisticated. As these are both limited sources, financing needs inevitably cause a rise in interest rates, lowering the value of long-term debt. When this fall initiates doubts about the validity of euphorical expectations, a reconsideration of investment programmes occurs, and portfolios are hedged. This, as well as the inelasticity of aggregate supply in the real sector, yields a shortfall of the investing units below the more optimistic profitability levels of the euphoric expectations. The result is a combination of cash flow commitments from the burst of euphoria and of cash flow receipts based on lower-than-expected income: an untenable debt structure.

Depending on the dominance of Ponzi/speculative finance and on financial policies, the unwinding of euphoria may occur with little trouble, and a new boom may begin; but it may also involve financial instability, and become the source of deep depression and stagnation. Financial crisis occurs if units need or desire more cash than is available from their usual sources and they resort to unusual ways of raising cash, such as liquidating positions. To the extent that businesses are funded by financial assets, every position on the financial market that is liquidated cuts off businesses in the real sector from investment channels. Thus financial instability may cause serious declines in production and employment.

4.3 Post-Socialist financial fragility

Before applying this model of financial fragility to the nature of Ponzi finance in Central and Eastern Europe, its relevance should be considered. The model includes assumptions on the financial system, the nature of the real sector in the economy and the stock market which originally characterised Western, not post-Socialist countries. However, the similarities are more striking than the differences. Consider this claim in the Albanian context.

First, there was no sophisticated financial system, which is the type of economy Minsky writes about. This implies that it is not possible to finance investment in the short run by portfolio transformations in which money is created in the financial market independent of monetary policy; yet this is the motor of asset price increases. The alternative route, an exogenous increase in the quantity of money, is not part of the standard model. However, it modifies the model but not its results, as Minsky (1972, p. 134) points out. This route was taken in the Albanian money market. Investment opportunities largely depended on cash inflow in the national market rather than money creation by intermediaries. In addition, after the initial stage of establishment, the schemes started to form a financial market of their own, where many citizens choose to create more 'money' by reinvesting astronomical gains on earlier investments. Both real and such 'virtual' money quantities increased dramatically, financing the continuing shift towards and increase in high-yield, high-risk Ponzi finance.

Secondly, there was no capital-intensive economy in the physical sense. In Minsky's account, physical capital generates instability by attracting money as investment. These assets then become overvalued and precipitate financial crisis. However, in so far as a break in the link between realised profits and financial commitments on capital assets generates an unsustainable debt structure, Albania fits the model: in the end, the expected return on Ponzi 'assets' fell inevitably short of available 'profits'. Money was not attracted to real investment opportunities but to Ponzi schemes which just made a pretence of investing money; but that did not alter the money accumulation mechanism from the perspective of the investor.

Thirdly, the end to euphoria came not as a result of falling stock prices, but as a result of the announcement of the non-sustainable nature of the schemes. This dissemination of information played the role that falling stock prices play in normal financial markets, spreading doubt about investment profitability and inducing a reconsideration of financial positions. In financial markets, this means a portfolio shift to safer assets; in the Albanian setting, it meant masses of citizens besieging banks and firms in order to get their money back.

Having argued the relevance of the model for post-Socialist financial aberrations, it is also important to stress its systemic nature. After a crisis, it will always be possible—by emphasising the triggering effect or institutional flaws—to argue plausibly that accidents, mistakes or easily corrected shortcomings were responsible for the disaster (Minsky, 1972, p. 118). The popular reaction to the Albanian crisis provides an example. In contrast, in the view elaborated above, instability is an *inherent* feature of the interplay of investment and financial intermediation, causing the self-destructive tendency of financial tranquillity (Minsky, 1978, p. 111; 1972, p. 144). However, it must be noted that this approach does not imply strict determinism with respect to the actual materialisation of potential instability or its real-welfare effects. Both can be influenced by policy and through the ability of institutions to modify the behaviour of the economy (Minsky, 1978, p. 112).

It is also essential to the Minsky framework that there are common tendencies in all financial markets, be they Ponzi schemes or conventional stock markets. The difference is in the strength of the tendency to instability, not in the existence of that trend or in the mechanism by which it is generated. Instability is driven by ever changing expectations, which are controlled by the available information and the way it is processed. One extension of this approach, therefore, is to investigate the perception and processing of information and consequent actions by economic agents and policy-makers in transition economies. Hence, in the next section, aberrations in post-Socialist financial markets in general are considered, of which Ponzi schemes are the extreme, but not the only example.

5. Information, expectations, and policy

As an application of Minsky's model, three factors can be suggested which tended to foster unrealistic expectations on returns to financial assets, creating a climate in which market aberrations such as Ponzi schemes could thrive. These are both related to the central role of expectations and information in financial markets and are typical of the post-Socialist setting.

5.1 Experience, expectations and information

The traditional view of the microeconomics of investment behaviour asserts that people invest in search of the highest risk-corrected pay-off. However, the risk-corrected profitability of Ponzi investments is negative for the majority of participants. Crucial to understanding why a large share of the population participated in schemes nevertheless is therefore an account of how people asses profit and risk. Plausibly, the experience-based ability as well as the inclination of economic agents to assess pay-offs depends on the nature and history of the relevant economic system. After all, Ponzi schemes appear to offer huge gains. It takes calculation and, most of all, either experience or information on previous experiences to realise that such gains only materialise when the scheme lasts long enough, that they are made at the cost of others, that the chances of a breakdown during one's involvement are considerable, and that such collapse implies a total loss of the investment.

The habit of caution and calculation when dealing with financial intermediaries may be something that is acquired over time and by experience, as all habits are. It may therefore be a typical trait of economic agents in mature market economies, but not necessarily in post-Socialist transition economies. Specific for the latter set of economies, especially in the early transition years, was people's trust in 'the market', fostered by hazy, and primarily rosy notions of what capitalism was. This misplaced trust was the breeding ground for schemes that Kindleberger (1978, pp. 79–80) characterised as relying on 'misrepresentation or violation of an implicit or explicit trust'. Ponzi schemes fit perfectly into the misleading picture of capitalist countries, where 'the streets are paved with gold and everyone is rich' (Verdery, 1996, p. 176)—a perception of the new economic system that was only too general among the population in the early transition years, and one which may have dictated investment and risk-assessment norms for many citizens.

One indication of the relevance of this elusive factor is the fact that stories explaining the high and continuing profitability of schemes circulated widely wherever Ponzi schemes were prominent features of the economy, rationalising trust in the schemes. Characteristically, the Romanian 'Caritas' success was commonly explained by profits made in private foreign trade, that novel symbol of capitalism. The unusual high 'interest rates' of Albanian schemes were explained by their operators as resulting from high profits from a Californian hotel, or from operating non-existent mines. More spectacularly, the Albanian 'Sude' foundation was led by a woman who claimed to be able to forecast the financial future by looking into a crystal ball. Many investors 'bought' this. And when the schemes collapsed, many indeed were unaware of just how much they had lost (Verdery, 1996, p. 177; Gomez, 1997, p. 2; McAdams, 1997; Elbirt, 1997).

5.2 The role of the state

In addition to expectations in the population as a whole, the role of national policy-makers also facilitated financial market aberrations. In our example, it is not difficult to understand why Albanian policy-makers did not intervene in informal financial markets while there was still scope to unwind the Ponzi crisis less dramatically. The evidence in the empirical section clearly points to government involvement and officials' profiting from Ponzi growth. In all probability, they recognised the destructive impact of Ponzi schemes; but equally probably they had every private disincentive to discourage further growth. To varying extents, this is typical for all of the economies mentioned where Ponzi schemes assumed disruptive proportions. Given the importance of government action in the creation and enforcement of legislation and the dissemination of information concerning the destructive nature of Ponzi schemes (Verdery, 1996, p. 270), the failure to intervene where necessary was a decisive factor. In general, the development of market aberrations was facilitated by the conditions of 'state desertion' or 'state collapse' that characterised post-Socialist reforms (e.g., see Abel and Bonin, 1993; Ellman, 1997).

Furthermore, in the absence of early and decisive action, Ponzi schemes are hard to contain. Once a scheme sets off, the government is soon beyond the point of no return even if it wanted to combat scheme growth. The stakes that the population has in the schemes are then typically so high that effective government intervention grows too costly politically: schemes soon grow 'too big to fail'. Moreover, as Ponzi profits pervade society, local government will not be unaffected and may then be not only hardly able, but also unwilling to act. The only effective signal that the central government can give at that point is to allow the scheme to tumble with much noise and loss—for example, by sponsoring or setting up competing schemes, as the Romanian government did in 1993 in order to minimise political damage (Verdery, 1996, p. 199). Active government encouragement from the beginning until almost the end, as in Albania, is the extreme case, and produces the extreme result.

An additional note on the role of government concerns the perception of pervasive government responsibility in post-Socialist societies as a stimulating factor for schemes' operations. Even if people in Albania had doubts about the nature of the schemes, a general expectation, based on experiences with pervasive state paternalism, was that the government would bail them out if anything went substantially wrong (Elbirt, 1997). The combination of the absence of structural regulation of financial markets and frequent *ad hoc* interventions in financial crises has been a typical problem for post-Socialist states.

5.3 Transition policies

In addition, economic policies in the transition years tended to facilitate the growth of Ponzi and speculative finance. Fragile financial market are likely to develop in countries that (1) aim at reforming their economic system rapidly, (2) stress the development of a market for financial assets at the cost of real-sector development, (3) are able to attract sizeable capital inflows (remittances, investment, loans or aid), and (4) have monitoring almost exclusively directed towards macroeconomic variables. These were typical features of post-Socialist economic policies. First, fast reforms, which have been the dominant option in the transition debate (e.g., Gros and Steinherr, 1995, p. 98), often stress speed at the cost of institutional balance (McKinnon, 1992; Nuti, 1996; Tsang, 1996). This may lead to the creation of financial investment opportunities in the absence of tangible productivity increases in the real sector. A view on post-Socialist restructuring in which financial intermediation is assigned a central role, as has been common (e.g., Gros and Steinherr, 1995, p. 199), is conducive to the development of such disparity.

This trend is reinforced if privatisation does not imply microeconomic restructuring (for which it allegedly is instrumental). There is ample evidence that the relation between ownership and efficiency-enhancing restructuring was both a main reason for the privatisation programmes in Central and Eastern Europe and proved problematical when they were implemented.[1] Nominal privatisation that does not lead to real restructuring and increased efficiency may give the economy the false appearance of a decentralised model with good profit opportunities for the foreign investor. When, in contrast, restructuring incentives, efficiency increases and hence profit opportunities are much lower than investors and lenders are led to expect, sizeable capital inflows in investment, loans or aid may be followed by disappointing performance, adjustment of expectations and a growth slowdown or recession along Minskian lines.

Albanian reforms indeed did not promote sustainable growth, not even in the real sector. The increase in economic activities that boosted GDP figures was concentrated in a small range of activities by very small firms, resulting in a 'kiosk economy'. Overemployment persisted throughout the years 1993–96 in all sectors of the economy, with

[1] See Bolton and Roland (1992), Aghion (1993) and Aghion *et al* (1994), among others, for initial expectations. For actual outcomes in Central and Eastern Europe, see Earle and Tegdely (1998) for Romania, Carlin *et al.* (1995) and Bornstein (1999) for Poland, Hungary and the Czech and Slovak Republics, Djankov and Pohl (1998) for the Slovak Republic, and Marcincin and Van Wijnbergen (1997) for the Czech Republic.

dramatic figures even in 1996 of 34% and 28% in the chemicals and mining sectors, respectively. The single exception was the security services sector, which employed 7% of the labour force (Vaughan-Whitehead, 1999, pp. 76–81). Albanian reforms moreover facilitated even less sustainable 'growth' in the financial sector, where a complete disparity between financial and real profit expectations resulted in the population investing in virtual projects, followed by collapse and crisis. That was the extreme case. However, with the benefit of hindsight, the divergence between expected and real profits is observable in most of the economies that privatised their productive structures in comprehensive programmes. One well-known example, the Czech experience, was both the role model for other countries (among them Albania) and later led to disappointment regarding its effects. The 1991 voucher privatisation was, for some years, thought to have achieved a very decentralised, outsider-dominated, and hence efficiency enhancing ownership structure, and relatively large foreign investments boosted the Czech stock market in 1992–97. It is now clear that this privatisation model in fact preserved economic power for an élite, as citizens' vouchers were bought on a large scale by a few so-called investment funds. These were largely owned by the four banks that dominated the financial sector, in which the government in turn had a controlling share. Between them, they managed 60% of the vouchers that represented ownership titles of the country's industrial firms, either directly or through investment funds. The large interdependence between the banking and industry sectors facilitated corruption and largely forestalled corporate restructuring and much of the potential efficiency increases in the transformation period to 1997. This resulted in a tumultuous restructuring operation which uncovered more ties between commercial banking, industry and the polity, resulting in a severe economic slowdown (Harris, 1997; Cook, 1997; Schwartz, 1997).

Although not all post-Socialist countries implemented voucher privatisation, post-reform ownership-and-control structures are likely to create similar pressures, since typically a few large banks cover most of the market for financial intermediation. The interlinkage of government, banking and industry prevents disciplining of the financial sector by the government and constitutes a disincentive for banks to discipline industry through corporate governance mechanisms. The result is pressure on the government for 'soft' budgets to industry and banking, little restructuring in industry, and inefficient credit allocation by the banking sector. In sum, typically the newly capitalist economic systems have been creating expectations that their systemic flaws made it very hard to live up to. In Minsky's terminology, it is plausible that much of capital inflow in the region was speculative rather than hedge finance, facilitating an unsustainable boom rather than longer-term productive investments.

5.4 Macro monitoring deficient

Taken together, the above factors account for the growth of Ponzi schemes and other unsustainable financial structures in post-Socialist reforming economies; but they do not explain why such aberrations often were not speedily corrected. Given the identified weakness of governments typical of many post-Socialist reforming economies, their lack of action, if perhaps not of perception, is understandable. Still, it is puzzling why warnings on the policy level did not come earlier and more effectively from the international institutions. Again, Albania provides a good illustration. Through the IMF and (to a lesser extend) the World Bank, the international community contributed significantly to Albania's growth in the Ponzi period. In line with conditionality requirements, both institutions were involved in and, as a consequence, extensively credited for, Albania's apparently successful reform policies. Presumably, these institutions had some influence on economic policies. In any case, they were in a position to voice their concerns, as they did late in the Ponzi period. The question is: why did they not detect the Ponzi schemes earlier and advise policies that might have impeded their further growth, or—if that was not an option—warned against schemes earlier than they did?

It may have been the particular way of monitoring the economy, with excessive attention to macroeconomic (particularly monetary) indicators, which misled observers. We have seen for the Albanian case how Ponzi growth may leave macroeconomic figures unaffected, while at the same time 'only macroeconomic indicators were being monitored by domestic and foreign experts'(Vaughan-Whitehead, 1999, p. xx). In this respect, Albania is again extreme but not unique. The economics of transition in general does indeed seem to have suffered from such a 'dominant reductionist tendency of discussing reforms in terms of two or three key variables' (Aligica, 1997 p. 46), which leaves the development of fragile financial markets and structural real problems unnoticed. Zecchini (1997, p. 2) notes of transition policy designers that 'the focus of their policy strategies often shifted towards pursuing the elusive objective of macroeconomic balance'. Laski and Bhaduri (1997, pp. 103–104) likewise lament 'the collapse of the communist economies and the drawing up of transition programmes in a period when economics was dominated by free market ideology'. Significantly, they note that '[t]hese ideas can perhaps find their best expression in the overall expression that by controlling the proper value of some crucial financial variables, especially a low budget deficit, low inflation and a stable exchange rate, the government can decisively influence the real economic variables'. Ellman (1997, p. 28), in the same vein, points out that 'neglect of the interrelationship between monetary and real variables' was one of the major weaknesses of 'shock therapy'.

6. Summary, discussion and conclusions

In this paper, an empirical description of the 1997 Albanian crisis has been provided, and its direct causes and effects identified. Theoretically, the unsustainable Ponzi-boom has been analysed in the framework of Minsky's Financial Instability Hypothesis, in which investors' expectations based on information and experience have a tendency to generate instability. For the Albanian example, it is shown that Ponzi schemes could prosper through a combination of circumstances. First, there were the expectations and experiences of the population specific for the history of the economic system. Secondly, transition policies relied on formal ownership changes and on restrictive monetary policies in the absence of substantial restructuring and investment opportunities. This may generate expectations of excessive returns on and large inflows of capital. Thirdly, government involvement in, rather than containment of, the schemes constituted a deceptive credibility signal to the population. Fourthly, a focus on macroeconomic variables rather than the structure of the economic system in monitoring the economy may have caused observers to lose sight of the development of structural real-sector problems and of fragile financial structures such as Ponzi schemes.

These features are, to varying degrees, typical for post-Socialist transition economies in the region. Hence, several conclusions that are complementary and corrective to the early reform consensus follow straightforwardly. On the microeconomic level, the emergence of markets is based on the development of market-conforming behaviour of economic agents, for whom previous experiences mould expectations and actions. Hence, fully fledged markets cannot be installed suddenly but must mature. In that process, the quality of government and the quality of market information that guides investment behaviour control success to a large extent. On the macroeconomic level, financial liberalisation may cause instability even when macroeconomic stabilisation has been achieved. Proper regulation (especially in financial markets) and government integrity are as essential to successful reforms resulting in sustainable growth as are traditional factors such as correct prices, healthy competition and private-sector development. Arguably, neglect of the role that financial markets have in post-Socialist instability has been a main sequencing error in reforms.

Furthermore, voluminous capital inflows are not always a blessing, but can destabilise transforming (and developing) economies. With regard to the effect of such flows, the economic structures into which they are fed are more important than their size; and in general, a characterisation of the economic system by macroeconomic variables alone is a poor monitoring tool. Finally, country-specific factors (such as the effect of the Albanian emigration on economic development) cannot be ignored in reform policies. All these points have by now been made repeatedly in other studies on reforming and emerging economies, both theoretical and empirical.[1] This paper provides another illustration of their validity, detailing the genesis of market aberrations and their effects in one specific case.

Although such observations are now no longer novel, neither are they yet superfluous. In the case of Albania, 'by the end of 1997, over-optimism once more began to dominate all economic reporting, as if the crisis had never happened' (Vaughan-Whitehead, 1999, p. xx). Indeed, subsequent analyses of previous Albanian policies still tended to disregard the adverse effects of earlier reforms. Typically, McNeilly and Schiesser-Gachnang, writing in 1998 and investigating the 1992 inflation reduction policy in Albania, ascribe its success to trade liberalisation, extensive external assistance, tight fiscal policy, increased savings and hard budget constraints—but fail to note the perverse effects on financial market developments that these very policy instruments and their responses can have, and clearly had in Albania. With no attention to such factors, it seems unwarranted to 'hope that, following the devastating economic crisis Albania suffered in 1997, high inflation can again be quickly reduced and the basis created for sustained growth' (McNeilly and Schiesser-Gachnang, 1998, p. 3). Hashi and Xhillari (1999, p. 100), in a study of privatisation and transition in Albania, see an 'opportunity to *renew* the momentum for reforms'(my italics). Haderi *et al.* (1999, p. 127) note that 'political stability and control of the informal financial sector are also crucial' but there are no policy implications to that observation. In contrast, I suggest that future reform policies should be informed by the lessons from transition policy failures rather than only by those from the successes.

Specifically, the above conclusions suggest the following policy recommendations. Reform programmes should focus on actual restructuring mechanisms rather than proceed from the assumption that restructuring incentives are fully implied in ownership structures. The involvement of financial intermediaries in enhancing the performance of the real sector in the economy is indispensable, but cannot be seen to replace the process of restructuring itself. Neither FDI nor donor money is a substitute for transition policies aimed at regeneration of domestic production, or for the development of domestic

[1] On capital flows to transition countries, see Schönfelder (1996) and Calvo *et al.* (1995). On financial liberalisation and instability, see Nuti and Portes (1993), Arestis and Demetriades (1993) and Demirguc-Kunt and Detragiache (1998), among many others. See also EBRD (1998) for an overview of cross-border capital flows and the financial sector in transition.

demand that sustains such production. Moreover, as the financial sector has a decisive role in the dissemination of information on profit opportunities to investors, the quality of that information can be improved by proper financial-sector regulation, rather than by a stress on liberalisation only. Regulation is also desirable because of the large effects on growth that perverse developments in financial markets can have, especially in the presence of sizeable capital flows. Finally, reform policies should take into account the constructive role that the state must have in market development if it is to succeed.

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