Financial crisis in Albania under financial investor behavior perspective

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Abstract

Financial markets and also the population's psychology of Balkan countries is very similar to one another. Being a Balkan country, studying individual financial behavior in Albania, is of great interest. The potential for future financial development of the countries of the region represents a good motivation to study financial behavior of Albanian investors. The paper displays an analysis of the most critic moments during the transition of the country's financial system from the financial behavior perspective. This paper emphasizes the necessity to study individual's financial behavior in Albania, taking into consideration its significance on market events. The shocks which the financial system has gone through during most difficult transition years under behavioral finance perspective will be analyzed, focusing especially on psychological factors.

Keywords: Financial behavior, financial system, banking system, pyramid scheme, banking panic.

Introduction

Countries of the European continent are recognized for the diversity of different levels of participants, regarding capitalism, knowledge or financial experience. All this can lead to different decision-making which can serve as an ideal platform for studying financial behavior. Even though some European economies have been developing for a long time, others are still in the development stage, where even within this category, these countries belong to different levels of development[1].

[1] According to the level of the size and growth of capital markets, countries are classified into developed capital markets countries and in developing capital markets countries. The last are further classified according to the level of development in descending order, as follows: 1. newly industrialized countries, 2. emerging countries, 3. "frontiers" countries, 4. countries with underdeveloped capital. The rank of these countries within these classifications is subject to constant changes as the country development indicators are dynamic. This classification is made from the most important indexes in the world. The table presents the classification of countries in Europe and the Balkans according to the level of market development, according to Morgan Stanley Capital International Emerging Market Index.

Financial market	Europe	Balkan
Developed markets	Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland	--

Comparing the transitory experiences of some countries, the countries[2] of the Western Balkans region have an underdeveloped economic system and stay very much behind the Central and Eastern European countries which have passed the transition earlier than them (Ganić & Mamuti, 2017). In terms of security, stability, trade and transit routes, considering the geographic location and the significance of the region in the EU, the economic and political future of the Western Balkan countries is one of the main priorities for the EU (Dabrowski and Myachenkova, 2018). Candidate[3] and potential[4] candidate countries, which aspire to regional integration and EU membership, are required to further reinforce their financial system (Ganić & Mamuti, 2017). "The growth that the Western Balkans region experienced during the years of the global financial crisis is evidence of the general economic potential of Western Balkans[5]." This exact potential for regional financial development is a strong reason to study financial behavior of investors of this region.

Studying financial behavior in our country is important because Albania as a Western Balkans country has similarities with other nearby countries. The financial markets of these countries resemble each other in terms of price increases, crisis management, institutional environment, crisis response, and sometimes it has been suggested the creation of a Balkan Stock Exchange, as in the case of the Nordic countries and NORDEX (Dimishkovski 2007).

These countries have also similarities in the socio-cultural aspect. The Balkans seem to suffer from psychological biases more than the other part of the continent because of some tipical personality traits such as being hot-tempered or impulsive, as well as presenting frequent changes in the emotional mood (Stoianovich, 1994). From a social point of view, Balkans are characterized by a more underdeveloped mentality than the rest of Europe do, which can make demographic factors, such as age, gender or location, impact decision-making considerably higher. Another common ground for Balkan culture is their development under the collective socialist communist paradigm, a lifestyle which may have affected people's behavior regarding low risk tolerance or the influence of psychological factors (such as presenting herd bias, low self-confidence, or lack of initiative to take risks from fear of loss). Therefore, knowing and measuring the impact of these behavioral factors is worth studying.

Developing markets	I. Czech, Greece, Hungary, Poland, Russia, Turkey (emerging)	Greece, European Turkey
	II. Bulgaria, Cyprus, Croatia, Estonia, Lithuania, Macedonia, Malta, Romania, Serbia, Slovenia (pre-emerging)	Bulgaria, Croatia, Macedonia, Romania, Serbia
	III. Other (underdeveloped capital market)	Albania, Sarajevo, Kosovo, Montenegro

[2] Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro, Serbia.
[3] Macedonia, Serbia, Albania and Montenegro.
[4] Bosnia and Herzegovina and Kosovo.
[5] Mr.Waiglein, General Director for Economic Policies, Financial Markets and Customs, Ministry of Finance, Austria, 2017.

The financial problems and difficulties of the early transition years

The financial system before the 1990s was based entirely on the banking system, a centralized system consisting of a single bank, the Albanian State Bank, which had at the same time the role of currency authority as well as that of crediting. Albania was the poorest communist country in Europe, very similar to other communist countries in the region. The country was unprepared in the economic, political and socio-cultural point of view, and also unable to perform important reforms towards a market economy (Kule, Hadëri 2001). Almost all the population was not aware on how market economy should function. In 1992, the banking system shifted from one-level to a two-level banking system, which marked the first important step to enable the process of licensing new banks and the central bank supervision on the banking system. In the process of economic decentralization of a centralized government, financial reform and transformation play a key role.

Despite the difficult and suffering start-ups along the path of development of the Albanian economy, the expansion of banking and financial market has contributed to the development of the Albanian financial system. This expansion consists in increasing the number of new commercial banks and non-bank financial institutions, in improving the legislation, payment systems, technology, banking and non-banking services, and the addition of new financial products which contribute to the general growth of effectiveness.

Traditionally speaking, the banking system has been the most important sector in the Albanian financial system. Although the weight of financial market and other non-bank financial institutions is too small compared to the share of the banking sector, this share has been increasing over the years. Despite the small share of financial markets in our financial system, they play an important role in providing different investment alternatives for investors and also in providing liquidity and are very closely related to the banking market. The level of financial market development is a clear indicator of a country's economic and financial development.

Financial crisis in Albania and behavioral factors

During the transition period, two significant moments of crises marked the history of Albanian economy, respectively in 1997 and 2002. The first was a pure financial crisis caused by pyramid schemes and unrelated to the banking system wheras the second was nearly a banking crisis[6]. In both cases, Bank of Albania gave its contribution trying to solve the crisis as *first of all* other banks and as supervising authority.

As a result of the challenges from the transition period, the unstable political situation, the vulnerability of the Albanian economy, the communist culture and tradition, the financial illiteracy, the information asymmetry, presence of psychological factors, the public expectations and its reliability in financial system are easily vulnerable serving as the foundations of the crisis that the country has experienced. Liquidity risk is always present in such critical events, but in banking panic case, this kind of risk spreads more easily, threatening the solvency of operating banks in the country.

Albanian Financial crisis of 1997

During the analysis of the 1997 financial crisis, we highlight some key factors

[6] Cani, Haderi, 2002.

nourishing the "bubble" created by pyramid schemes, such as: government tolerance and inability to manage the difficult situation; lack of legal framework in the banking system; vulnerability from psychological factors; past culture derived by communist regime; financial illiteracy etc.

Rise of pyramid schemes

Despite the rapid progress of the country during the years of transition, there were a lot of problems and difficulties which with the banking system was facing. There was a low level of financial intermediation. State-owned banks dominating the deposit market could not achieve to play their financial intermediation functions, whereas the few private banks weren't interested in attracting domestic deposits in albanian leks, so they mainly focused on financing businesses[7]. System of payments was very restricted by requiring 5-6 days for bank operations between accounts of different branches of the same bank and even over 15 days for those between different banks[8]. That is why, people had the tendency to keep cash while expecting and hoping for other investment opportunities.

On the other hand, bank credit in the country also manifested major problems. Bad credit increased too much mainly due to the deficiencies of the banking system, but also due to the wrong perception that not necessarily state institutional debt should be paid back. One of the measures taken by Bank of Albania was settling *ceiling boundaries* for loans, which did not achieve to fulfill needs of funding for the private sector. Consequently, more and more entrepreneurs headed to informal markets to fund their businesses. Part of this market consisted of foreign exchange market and the rest was made by some unlicensed companies which accepted deposits and lended money. These last ones, because of the problems that the official banks carried, were even considered by foreign observers as best financial intermediaries at that time in the country. Meanwhile, there were some other companies accepting deposits at very high interest rates (4-5% monthly interest), but which unlike the former, did not use these funds to lend, but to invest them in suspicious activities. These served as the embryo for rising of pyramid schemes.

It was difficult at the time to understand the difference between the informal market of loans and pyramid firms, although that difference is really notable. These companies absorbed most of the increasingly public savings, particularly emigrants' remittances. The legal framework was weak and insufficient to come over the pyramid schemes, but the problem was not simply legal, it was mostly a management problem by the government which had supported these schemes. This support derived from the connections that the politicians had with these firms, such as being financed by them, promoting the firm activities as clean, and also creating gaps to help them not to pay tax liabilities. Despite the consecutive warnings from the World Bank and the International Monetary Fund on the dangers of pyramid schemes, citizen and press reaction were incredibly negative by even accusing these important international authorities for trying to close the most successful companies in the country. At this

[7] The International Monetary Fund, Jarvis (1999).

[8] The Foundation for Enterprise Development and Finance (1996).

time, the first pyramid firms began to exhibit problems with their payments within the settled deadline, causing people who began to be affected by the above warnings to begin to lose trust in these firms. Psychological effect was rapid: people stopped depositing their savings. After that, some of the pyramid firms declared bankrupt what prompted organisations of civil protests, until definitely none of the firms could make any kind of payment.
The ruin of pyramid schemes at the beginning of 1997, which began as a financial crisis, degraded into a general political, economic and social crisis. The financial system was hit hard, chaos spread into the entire country, government lost control, organize civild protests turned to armed riots (Jarvis, 1999). The crisis had a significant impact on the loss of public trust in the banking system, time deposits and foreign currency deposits declined and the consequences were comprehensive for the Albanian society. Money kept at hand, double-exceeded the deposit money, implying that people no longer trusted depositing their money and using financial institutions anymore, preferring to keep it in cash.

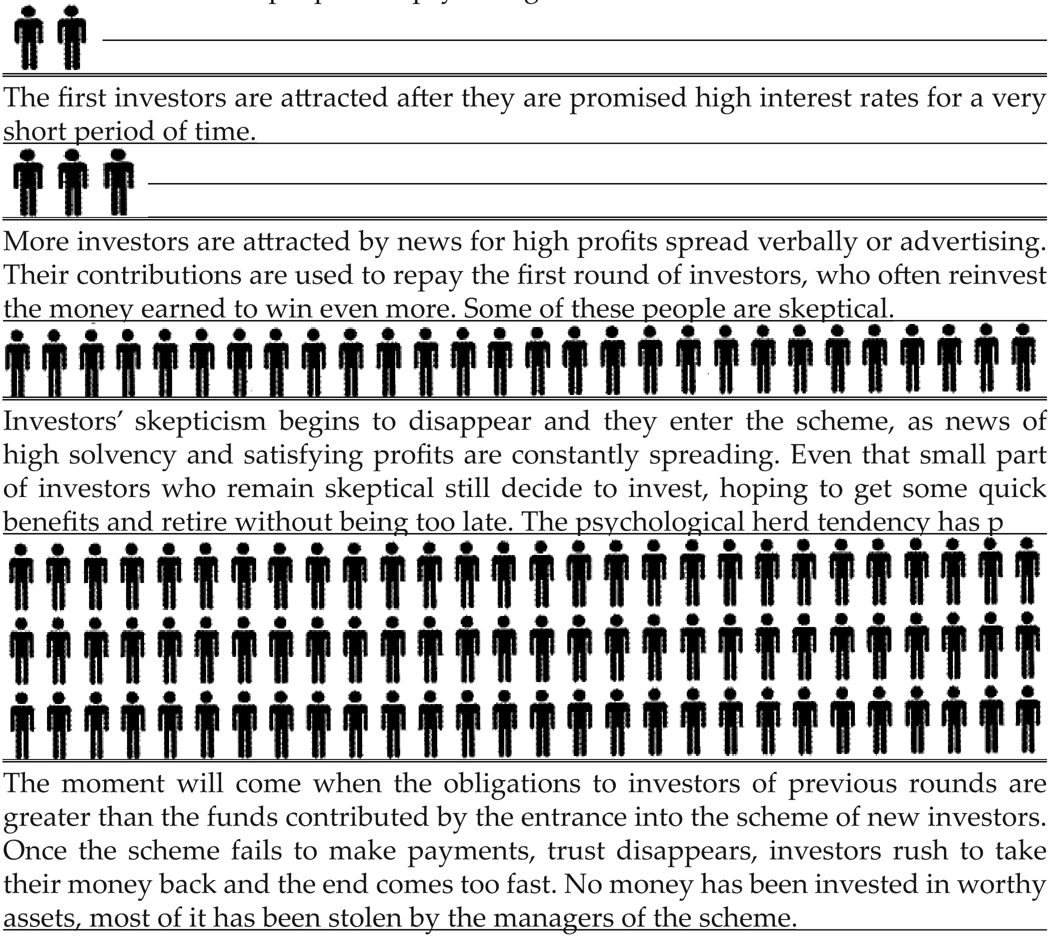
Public expectations during the crises of pyramid schemes

An interesting aspect worth analyzing, is the fact that people created and continued to preserve very high expectations regarding the profits they could make from investing in pyramid schemes. Risk and return are two elements that go hand in hand and the question that naturally arises is: How is it possible that the albanians were expecting to earn very high rates of return without perceiving any level of risk?
This incapacity to feel and perceive the risk served as a basis for rising of pyramid schemes, which used this *weak point* of the public, to exercise their activity. The public's perception of the risk-return ratio evaluation was deformed and there are several reasons that led to this deformation.
First of all, the fact that the citizens did not have any knowledge or experience about concept of risk as a result of the past communist culture, caused depositors to fail to perceive any risk for these attractive investments offering fairly high interest rates.
Secondly, they mistakenly thought that the government would not allow losing their savings by making it responsible, even though these decisions were individually made in a free market economy. This was also influenced by the support government offered for pyramid firms. Even the most skeptical about the existence of pyramid firms were convinced that the state would compensate investors in case the schemes could be bankrupt (Elbirt 1997).
Thirdly, providing opportunities where one can make profits without risking, was the perception citizens had about capitalism, an opinion resulting from the low level of financial literacy characterizing albanians for a long time, as a former communist isolated country.

Psychological factors and investor behavior

There are also some other questions that require answers and analysis: What impact did the first successful investors who joined the scheme, have on other investors?

What was the impact of media on the individual investing behavior? How did the skeptical individuals behave? Did loss of investors' trust affect the rapid collapse of pyramid firms?
The answers to these questions are clearly reflected in the summary below about the way pyramid schemes work, highlighting a significant factor which has influenced the behavior of these people: the psychological factor.



Picture 1: Pyramid Scheme (Jarvis, 1999)

At '96 -97 years in Albania, there were created seven Ponzi schemes, which promised very high profits and collected about $ 2 billion (John Templeman, 1997, p. 59). Named otherwise Ponzi's schemes®, they seduce initial investors who have just earned enough money to showcase their success stories to other young investors in order that they too invest in the scheme. Possible for the scheme makers to compensate previous investors who will continue to show their success stories to other investors, and so on. There will come a moment that the scheme will come to an end, as the arrival of investors cannot increase forever, which is since at the beginning well known by the scheme manager who will try leave the scheme without liquidating the largest and the latest round of investors. The scheme manager promises investors' money will be invested, but in reality, a very small portion of the contributed funds are invested in real assets, as it will be used to reward the first round of investors with the funds received from the second round of investors, a round which is rewarded with the funds received from the third round of investors and so on.

Initial investors are skeptical and invest small amounts, but enthusiasm and confidence in new investors grow when they are convinced that the previous are making profits, which leads to an increase in the number of investors in the upcoming round. The best convincing evidence to support the deception of scheme leaders is to tell investors that others have earned large amounts of money, tremendously impacting their thinking® (Shiller, 2015). Such conversations which cause envy for the financial success of others arise over the rational skepticism of some people who will also finally fall prey to the herd bias and join the crowd.

Media coverage or "word of mouth" reinforces behavior of public to the point that it can turn into an epidemic. As a result of repeated "news", the tendency for stereotype will develop, *availability bias*, which can stimulate not a profound analysis of the situation.

It is difficult to understand what is happening during a crisis or an inefficient market situation, but it is not so difficult to look back in retrospective and understand the mistakes people have made. Only after the event happens, one's point of view changes, but as things are happening, we can just understand and act only within the existing framework, which reflects the wrong understanding of the context in which the events are taking place as a result of framing bias.

Banking panic

Banking panic or the deposit crisis is a situation in which many bank customers take back all their deposited funds at the same time because they do not believe in the bank's solvency and doubt it can become bankrupt. The ironic thing is that the pressure itself from this kind of situation, can cause bank bankruptcy.

When savers deposit money into the bank, the bank does not hold all the money, some of these funds are kept in the bank, whereas the rest is used to lend or pay off the loans received from other banks. Actually, only 10% of this deposited money is kept in the bank. This 10% is called the reserve requirement and is decided by the Central Bank. Since the cash reserve held by a bank consists of a very small part of the deposits, a large number of withdrawals in a short period of time can empty the available amount of money and force the bank to fail. Commercial banks use short-term deposits to finance the long-term loans they provide. The public deposit withdrawal creates a financing gap® for the bank, which directly affects the normal continuity of its activity. The real problem with a bank which comes across this particular situation is not that depositors ask back for their money but that they all demand it at the same time. The more people ask for their funds back, the more they increase the chances of not receiving them, as the bank cannot keep enough money to satisfy all requirements immediately.

Investor psychological factor as basis for banking panic

When the public understands that it cannot predict and control events or important financial results anymore in their lives - panic, a strong negative emotion especially created to promote self-defense actions, is shown up. This kind of emotional response can be seen as an early warning of human adaptation system as a way to "shake us from our common way of doing things, confronting our strong psychological tendency, the status quo bias (Samuelson and Zeckhauser 1988), which is the tendency people have to resist to change and which consequently affects their decision-making.

There is little difference between economic and psychology reality. In a bank run, as an economic event, the psychological aspect lies with the bank's own clients who become part of the problem through their psychology. If investors and savers feel insecure, even the most insignificant event (as can be a rumor) may be enough to urge a massive deposit withdrawal. The issue is not about the news that caused the concern, but about how many of these clients are concerned and how large is the number of clients going straight to the bank to take back their funds.

Banks rely entirely on their clients' trust. If the clients doubt even just a little bit about bank ability to protect their money, they will not think twice to take back all their money.

People are biased to manifest the psychological tendency of panic. Money is really important to them and the fear of losing their money due to the possibility of insolvency and bankruptcy is a very strong reason sufficient to panic. Investor psychological state of mind, is critical in provoking a deposit crisis. Specifically, the feeling of fear increases considerably the chances of withdrawal and deposit crisis and are likely to be higher when the depositor is a female rather than a male[9].

Factors causing the deposit panic crisis

In 2002, the country was again shocked by another crisis which was characterized by deposits' panic and was associated by massive withdrawals in both the largest banks in the country.

The main developments related to banks before the banking crisis of 2002 were characterized by an increasing number of banks through new private banks, decrease of state-owned banks dominating the market, and the considerable increase in deposit ratio to GDP as one the most important indicators for intermediation. Field experts analysis notes that macroeconomic and bank performance indicators were good and did not show any signal for any crises into horizon. However, the Albanian financial system in 2002 experienced a second crisis after the one of '97, but unlike the first, it was a crisis in the bank system: the deposit crises. Only within two months the total value of the withdrawals raised to 21.4 billion Albanian leks, which clearly shows how easily and quickly the banking panic may spread. The Bank of Albania played an important role in trying to impact public psychology and awareness through visual and written media about the good health of the banking system. The goal was to remove the feeling of fear created through the public and prevent further spread of panic. Other measures undertaken by the Bank of Albania were the intervention in open market operations, in order to ensure the necessary liquidity in the market

[9] Dijk, Oege, 2017. "Bank Run Psychology," Journal of Economic Behavior & Organization, Elsevier, vol. 144 (C).

through lending Lombard credit and also increasing the interest rate of ***Repo*** to boost the level of banking system reserve.
Loss of public savings during the financial crisis of pyramid schemes in 1997, led to lack of confidence of investors in the banking system's efficiency and security[10]. Deposit panic was based on the expectations created by the pyramid crisis but emerged in a healthier and advanced banking system, reflecting the fact that the banking system's sensitivity is too high to public confidence.
The lack of information and its asymmetry have a significant impact in molding inaccurate public expectations. It is worth mentioning that the crisis firstly began in rural areas where financial literacy is far more limited. This lack of information was specifically related to important issues in the country for the time, such as the approval of the deposit insurance law, the problems about Savings Bank privatization and also about the ownership of the National Commercial Bank.

Financial crisis of 2008

Albania has multiple economic relations with other countries in the Balkan region as well as with European neighbor countries where a large number of emigrants work and live. As a result, the economic and financial crises affecting these countries will inevitably affect also our financial system. Of course, the global financial crisis of 2008 had its impact on our country, and more specifically its impact on the EU crisis, and especially in Greece and Italy, gave the first effects on the decline of remittances, later on also lying in the decline of GDP growth rates, reducing budget spending, raising the level of unemployment, and so on[11]. However, unlike many of the countries in the region we are a part of, due to Albania's weak connections with the regional financial markets, its effects had a very slight impact. The Bank of Albania has also contributed to a series of measures to mitigate the negative consequences of the crisis, to strengthen the stability of the financial system and to fulfill market demand for liquidity[12].

Conclusions

The potential for financial development of the Western Balkans region in the near future makes a strong reason to study financial behavior of Albanian investors, because of the country connections and similarities with other neighboring countries, both in psychological and financial terms. Studying and analyzing the factors which prompted creating the difficult situations that the country experienced, has helped to better understand the financial behavior of Albanian individuals. During the transition period, two moments of major crises have marked countries 'economic history, respectively the financial crises of 1997 and the 2002 banking crises. As a result of the effect of a number of factors (transition difficulties, political instability,

[10] Cani, Haderi, (2002).
[11] "The financial crisis strikes" Luan Shahollari, (2012).
[12] Banking panic and its impact on the liquidity of the banking system, Zoto, Kruja & Xhakoni, (2015).

ex-communist culture, low level of financial literacy, information asymmetry and psychological factors), public expectations and their level of trust on financial system are prone to vulnerability becoming as such the foundation for the crisis the country experienced. A large number of psychological biases strongly affect individuals' behavior during the operation of Ponzi schemes and the deposit crisis. Today, at great distance of time from the crises, the albanian investor can judge more objectively and can try to understand errors of the time carried out (except of other important factors studied by other authors), also as a result of the influence of their psychological biases about which they have been unconscious until now.

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