

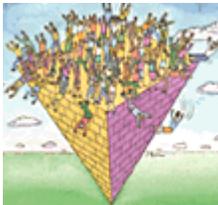


International Monetary Fund

- Home |
- What's New |
- Site Map |
- Site Index |
- Contact Us

- About the IMF
- What the IMF Does
- Country Info
- News
- Data and Statistics

- Publications



FINANCE

DEVELOPMENT

A quarterly magazine of the IMF

[March 2000, Volume 37, Number 1](#)

The Rise and Fall of Albania's Pyramid Schemes

[Christopher Jarvis](#)

During 1996-97, Albania was convulsed by the dramatic rise and collapse of several huge financial pyramid schemes. This article discusses the crisis and the steps other countries can take to prevent similar disasters.

Search Finance & Development

[Advanced Search](#)
[About F&D](#)

[Subscribe](#)

[Back Issues](#)

[Write Us](#)

[Copyright Information](#)

Use the free [Adobe Acrobat Reader](#) to view a pdf file of [this article](#)

[Albania](#) and the IMF

The pyramid scheme phenomenon in Albania is important because its scale relative to the size of the economy was unprecedented, and because the political and social consequences of the collapse of the pyramid schemes were profound. At their peak, the nominal value of the pyramid schemes' liabilities amounted to almost half of the country's GDP. Many Albanians—about two-thirds of the population—invested in them. When the schemes collapsed, there was uncontained rioting, the government fell, and the country descended into anarchy and a near civil war in which some 2,000 people were killed. Albania's experience has significant implications for other countries in which conditions are similar to those that led to the schemes' rise in Albania, and others can learn from the way the Albanian authorities handled—and mishandled—the crisis.

Why the pyramid schemes grew



Free Notification

Receive emails when we post new items of interest to you.

[Subscribe](#) or [Modify](#) your profile

The wide appeal of Albania's schemes can be attributed to several factors, including Albanians' unfamiliarity with financial markets; the deficiencies of the country's formal financial system, which encouraged the development of an informal market and, within this market, of the pyramid schemes; and failures of governance.

When Albania started the transition from central planning to a market economy, it was the poorest and most isolated and backward country in Europe. For centuries, Albania had been largely unknown and inaccessible, and, from 1945 to 1985, its isolation was compounded by the rigid communist dictatorship of Enver Hoxha, which eliminated almost all forms of private property and virtually cut the country off from outside influences and information. When transition began in 1991, the country had been reduced to desperate poverty, and the vast majority of its population was unfamiliar with market institutions and practices.

Although Albania's transition to a market economy was rapid and quite successful, financial sector reform was very limited. Albania's formal financial system was rudimentary. There were few private banks. The three state banks, which held 90 percent of deposits, offered positive real interest rates but had growing portfolios of bad loans, prompting the Bank of Albania to impose tight credit ceilings on them. With the banks unable to satisfy private sector demand for credit, an informal credit market based on family ties and financed by remittances grew. The informal lending companies were initially regarded as benign and even as making an important economic contribution. Operating alongside them, however, were deposit-taking companies that invested on their own account instead of making loans. These companies were the ones that turned into pyramid schemes.

There were also governance problems, both in the financial sector and more generally. The regulatory framework was inadequate, and it was not clear who had responsibility for supervising the informal market. Even after the approval of a banking act in February 1996 that appeared to give the Bank of Albania the power to close illegal deposit-taking institutions, the central bank could not obtain the government's support. Indeed, the government was supportive of the companies: senior government officials frequently appeared at company functions, and, in November 1996, even as the pyramid schemes began to crumble, the prime minister and the speaker of the parliament accepted medals in honor of the anniversary of one of the companies. During the 1996 elections, several of the companies made campaign contributions to the ruling Democratic Party. There were allegations that many government officials benefited personally

from the companies.

How the schemes operated

In a typical pyramid scheme, a fund or company attracts investors by offering them very high returns; these returns are paid to the first investors out of the funds received from those who invest later. The scheme is insolvent—liabilities exceed assets—from the day it opens for business. However, it flourishes initially, as news about the high returns spreads and more investors are drawn in. Encouraged by the high payouts, and in some cases by showcase investments and ostentatious spending by the operators, still more people are drawn in, and the scheme grows until the interest and principal due to the early investors exceeds the money paid in by new investors. To attract new investors, a scheme may raise interest rates, but the larger interest payments soon force it to raise rates again. Eventually, the high rates begin to arouse suspicion or the scheme finds itself unable to make interest payments. When investors try to get their money out, they discover the truth about the scheme, whose demise is swift—and usually accompanied by acts of outright theft by the operators, if they are not caught first.

Some of the Albanian companies meet this definition exactly: they were pure pyramid schemes, with no real assets. Other cases are more ambiguous. Some of the largest of the companies—in particular VEFA, Gjallica, and Kamberi—had substantial real investments. They were also widely believed to be engaged in criminal activities—including violating United Nations sanctions by smuggling goods into the former Yugoslavia—that were thought to be the source of the high returns they paid. And they had been in business for a long time, in some cases since 1992. However, even if they had not been pyramid schemes from the outset, at some point, probably during early 1996, these companies too became pyramid schemes. When they collapsed, it was clear that their liabilities massively exceeded their assets.

Mania: the events of 1996

Two events set the stage for the pyramid-scheme mania of late 1996. First, at the end of 1995, United Nations sanctions against the Federal Republic of Yugoslavia were suspended, eliminating an important source of income (smuggling) for the companies. In January 1996, the leading companies increased their interest rates from 4-5 percent a month to 6 percent a month, or almost 100 percent annually in real terms. (Annual inflation in Albania was 5 percent in 1995 and 17 percent in 1996.) Second, the uncertainty created by approaching

parliamentary elections, which were to be held in May, prompted the companies to raise their rates again, this time to 8 percent a month, or a real annual rate of well over 100 percent. During the same period, new schemes entered the market, offering even higher rates. In early 1996, two new pyramid schemes—Xhafferi and Populli—were created, and an already existing scheme that had no real investments—Sude—stepped up its activities, offering interest rates of 12-19 percent a month.

The proliferation of schemes had baleful effects. First, more depositors were drawn in. Although VEFA had the largest liabilities, it had only 85,000 depositors. Xhafferi and Populli between them attracted nearly 2 million depositors—in a country with a population of 3.5 million—within a few months. Second, the investment funds felt pressured to compete and began to offer higher interest rates on deposits. In July, Kamberi raised its monthly interest rate to 10 percent. In September, Populli began offering more than 30 percent a month. In November, Xhafferi offered to treble depositors' money in three months; Sude responded with an offer to double principal in two months. By November, the face value of the schemes' liabilities totaled \$1.2 billion. Albanians sold their houses to invest in the schemes; farmers sold their livestock. The mood is vividly captured by a resident who said that, in the fall of 1996, Tirana smelled and sounded like a slaughterhouse, as farmers drove their animals to market to invest the proceeds in the pyramid schemes.

Throughout the year, the government was a passive spectator to the unfolding crisis. Although the enormity of the problem became clear when the Bank of Albania discovered that VEFA's deposits in the banking system were equivalent to \$120 million (5 percent of GDP), and despite repeated warnings from the IMF and the World Bank, the finance ministry did not warn the public about the schemes until October. Even then, however, it drew a false and misleading distinction between companies with real investments, which were believed to be solvent, and "pure pyramid schemes." When it was suggested that some companies might be surviving by laundering money, President Sali Berisha came to their defense. Press and public reaction was mostly negative: the IMF was accused of trying to close down Albania's most successful firms. In November, in response to outside pressure, the government set up a committee to investigate the schemes. The committee never met. On November 19, Sude defaulted on its payments, and the collapse began.

Collapse

Sude's collapse shook the public's confidence in all of the companies

and new deposits dried up. An attempt by VEFA, Kamberi, Silva, and Cenaj to convince depositors of their soundness by lowering monthly interest rates to 5 percent failed. In January 1997, Sude and Gjallica declared bankruptcy, triggering riots. The other schemes soon also ceased to make payments. The government belatedly took some useful steps. First, it refused to compensate depositors for their losses, which made achieving economic stabilization after the crisis much easier than it would otherwise have been. Second, it began to move against some of the companies. In January 1997, it froze the bank accounts of Xhafferi and Populli, which amounted to \$250 million (10 percent of GDP). The Bank of Albania, on its own initiative, began to limit daily withdrawals from bank accounts to prevent other schemes from emptying their accounts. In February, parliament passed a law banning pyramid schemes (but not defining them). However, the government continued to differentiate between companies with real investments and pure pyramid schemes and did not move against the largest companies.

By March 1997, Albania was in chaos. The government had lost control of the south. Many in the army and police force had deserted, and 1 million weapons had been looted from the armories. Evacuation of foreign nationals and mass emigration of Albanians began. The government was forced to resign. President Berisha agreed to hold new parliamentary elections before the end of June, and an interim coalition government was appointed.

The interim government inherited a desperate situation. Some 2,000 people had been killed in the violence that followed the pyramid schemes' collapse. Large parts of the country were no longer within the government's control. Government revenues collapsed as customs posts and tax offices were burned. By the end of June, the lek had depreciated against the dollar by 40 percent; prices increased by 28 percent in the first half of 1997. Many industries temporarily ceased production, and trade was interrupted. Meanwhile, the major pyramid schemes continued to hang on to their assets, proclaim their solvency, and resist closure.

Winding up the schemes

Despite the many obstacles it faced, the interim government, aided by the international community, made impressive progress in restoring order and stabilizing the economy. Winding up the pyramid schemes proved to be more difficult. The government encountered resistance from both the operators and the outgoing parliamentarians, many of whom were reported to have invested in the schemes. Thus, it was not until July that the newly elected parliament passed a law,

drafted with assistance from the IMF and the World Bank, mandating the appointment of foreign administrators from international accounting firms to liquidate the schemes.

The administrators appointed under the new law were required to report regularly to the government but otherwise had complete independence. They were given broad powers to carry on the companies' businesses, pay their debts, sell their assets, fire staff and managers, seize the assets of individuals connected with the schemes, and hire experts to trace assets abroad. However, by November 1997, when the administrators took up their duties, the schemes' liquid assets had shrunk considerably. The schemes' owners challenged the new law in the courts and tried to intimidate the administrators with threats of violence. It took several months to dislodge the owners, partly because the administrators needed their cooperation in finding the companies' assets. The administrators did not gain full control of all of the companies until March 1998. Owners who had not fled were jailed, and whatever assets remained were prepared for sale. But much had been lost already.

Effect on the economy

Few studies have been done on the macroeconomic effect of pyramid schemes on the scale of those in Albania, which, fortunately, are extremely rare. The closest analogy to such schemes is the asset bubble, whose economic impact is due to changes in perceived wealth. As a bubble expands, people believe themselves to be better off than they actually are, and their demand for goods and money increases, leading to a deterioration in a country's external current account as well as increased output or accelerated inflation or both. If the bubble attracts foreign investors, capital inflows might be sufficient to fund the current account deficit. After the bubble bursts, perceived wealth falls dramatically. Demand for goods and money, as well as output and inflation rates, can be expected to decrease, while the current account balance is likely to improve.

Some of these effects were observed in Albania but appear to have been limited and short lived. Although the current account of the balance of payments (excluding official transfers) deteriorated by about 2 percent of GDP in 1996, to 9.1 percent of GDP, because of a 35 percent increase in imports, this consumption boom seems not to have been the main factor driving inflation. The impact of the schemes' rise on output, which grew at nearly the same rate—9 percent—in 1996 as in the previous three years, is also unclear.

The collapse of the schemes seems to have had a major short-term

economic impact, but the most damaging effects came from the civil disorder it precipitated. Output fell by about 7 percent in 1997, with most of the decline being due to interruptions in production during the civil disorder. The increase in the inflation rate to more than 40 percent in 1997 can be attributed almost entirely to the depreciation of the lek and the sharp rise in the fiscal deficit caused by the loss of government revenues during the period of civil disorder. Recorded imports fell by more than 25 percent, reflecting not only the loss of savings but also the disruptions in trade and increased smuggling. Capital inflows declined but did not turn into net outflows.

The long-term effects of the pyramid scheme phenomenon are likely to be limited, reflecting not only the resilience of the Albanian economy but also—and, perhaps, most important—the government's adjustment efforts and its refusal to bail out depositors. Prices and wages are extremely flexible in Albania; as a result, the government was able to cut real public sector wages substantially in 1997 (by leaving nominal wages unchanged), and the economy suffered no loss of competitiveness when the lek appreciated. The new government's willingness to tackle the budget deficit and undertake long-overdue structural reforms was also crucial. However, the social effects were profound. In addition to the loss of life, thousands of people were impoverished either by their unwise investments in the pyramid schemes or by the destruction of their property in the ensuing violence. Less tangible, but also significant, are the effects on confidence in Albania. The resilience of the Albanian people is considerable and has been more severely tested in the past. But the pyramid scheme phenomenon was a sobering setback.

How to deal with pyramid schemes

Albania's experience contains some important lessons for other countries. There are steps governments can take to make the growth of pyramid schemes less likely. These include establishing a well-functioning formal financial system, setting up a regulatory framework that covers informal as well as formal markets and has clear lines of responsibility for supervision and action, and tackling general governance problems. Although preventing pyramid schemes is not the most important reason for establishing good governance, the Albanian experience is a powerful reminder of the social costs of unchecked criminality.

When pyramid schemes emerge, they should be dealt with swiftly and firmly. Companies believed to be operating pyramid schemes should be investigated. By definition, the liabilities of pyramid schemes exceed their assets, and the schemes fund payments to

investors out of new investment inflows. To determine whether a company is operating a pyramid scheme, it is necessary to find out if it has real investments and if these investments are likely to be sufficient to cover its liabilities. The investigation can be conducted by the police, a government ministry, or the central bank. The key point is that the investigators should be able to recognize financial fraud and also to assess the value of company assets. If such expertise does not exist in the country, then the investigation can be conducted by outsiders; the IMF and the World Bank should be prepared to help governments find qualified outsiders, if necessary, either from other governments or from large international accounting firms with expertise in this area.

The investigation should be swift. If a company is found to be operating a pyramid scheme, it should be closed immediately. Allowing schemes to continue will result only in more inflows of deposits and greater losses. Governments can close these companies for a variety of legal reasons: the companies may be taking unlicensed deposits or operating businesses without licenses; they may be evading taxes; or they may be liable for prosecution for straightforward fraud.

If there is a strong presumption that companies are pyramid schemes, the government should freeze and, if necessary, seize their assets during the investigation. Once an investigation of a pyramid scheme has begun, the operators will try to steal as much of the assets as possible before the truth comes out. This cannot be entirely prevented, but freezing any assets held in the formal financial sector and seizing other assets that can be easily disposed of may save depositors a great deal of money.

Once a scheme is closed, all assets should be seized and turned over to administrators, who could be government accountants or, if these officials do not have sufficient independence or expertise, accountants from an international firm with an insolvency practice. Legislation may be needed to void contracts made by the companies in the last several months (to prevent theft by transfer to associated parties) to give administrators full control over the assets of the companies and protect them from legal challenges.

The government should make it clear from the outset that it will not compensate depositors for their losses. If this is not done, the fiscal costs are likely to be ruinous, and the moral hazard considerable.

Finally, the IMF and the World Bank should be aware of the possibilities of pyramid schemes emerging when the conditions for

their growth are present and should be vigilant in warning governments about them. When they can, the IMF and the World Bank should insist on action.

This article is based on Christopher Jarvis, 1999, "The Rise and Fall of the Pyramid Schemes in Albania," IMF Working Paper 99/98 (International Monetary Fund: Washington).

Christopher Jarvis is a Senior Economist in the IMF's Policy Development and Review Department.



[Home](#) [What's New](#) [Site Map](#) [Site Index](#)
[About the IMF](#) [What the IMF Does](#) [Country Info](#) [News](#) [Data and Statistics](#) [Publications](#)

[Copyright and Usage](#) [Privacy Policy](#) [How to Contact Us](#)