

# Kornai’s “main line of causality”: The case of socialist Albania and SFR Yugoslavia, with a special focus on their banking sectors’ ownership structure

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## ABSTRACT

Based on the structure of János Kornai’s ‘main line of causality’, two unique country cases are compared within the former European socialist bloc: Albania and the Socialist Federal Republic of Yugoslavia. The research provides a comparative analysis with an overview of the two countries’ development between World War II and the fall of the socialist regimes. Special attention is paid to the period following the 1970s as the underlying reforms had been implemented in Yugoslavia by then, leading to fundamentally different socialist prototypes. Regarding the differences, the analysis also gives an insight into the structure of the two respective banking systems. Kornai’s ‘main line of causality’ provides the framework for the current research, supplemented by the respective literature. The analysis concludes that despite the fact that all blocks of the causality line differed in the two systems, similar challenges had to be addressed during the transition period. Furthermore, Albania and the successor states of Yugoslavia reflected a range of common characteristics, which implies the relevance of path dependence.

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## KEYWORDS

banking sector, economic history, socialism, Albania, Yugoslavia

## JEL CLASSIFICATION INDICES

G21, N24, P34, P52

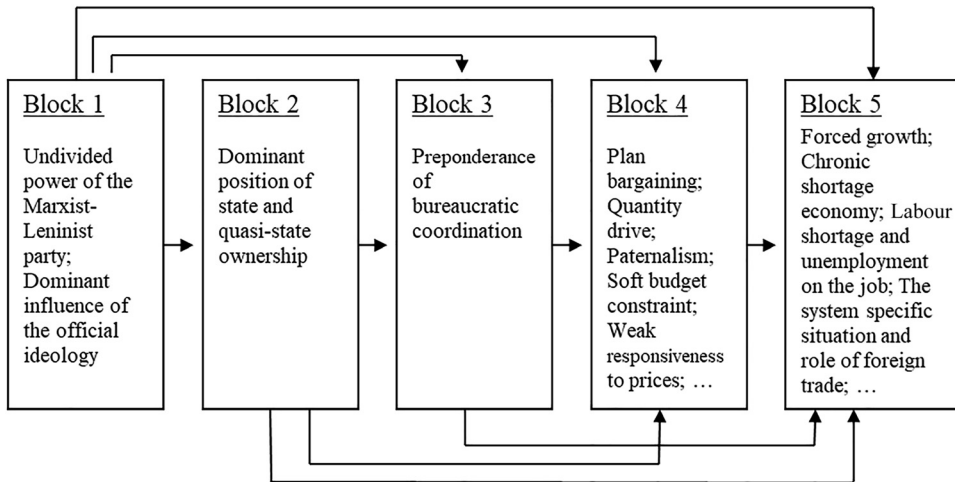
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## INTRODUCTION

János Kornai's pioneering work unfolded how socialism<sup>1</sup> worked in practice, and highlighted such systemic dysfunctionalities, as the phenomenon of the soft budget constraint or the shortage economy (Vahabi 2021). In *The socialist system: The political economy of communism* (1992) – Kornai provided a logical framework on the socialist systems' underlying phenomena, creating a coherent structure of the 'main line of causality' (see Figure 1). The current paper uses this scheme as a guideline for a comparative overview on the banking system of two distinctive countries, namely Albania and the Socialist Federal Republic of Yugoslavia<sup>2</sup> (SFRY).

Following World War (WW) II, both countries started to implement the classical, Soviet-type socialist system, including the first steps of collectivisation. Nevertheless, the two countries' development paths soon started to diverge, and by the late 1970s, they gradually created two completely different socialist prototypes. Albania remained loyal to the orthodox dogma and implemented the so-called 'self-reliance' concept for its external policy. As for SFRY, it created its peculiar systemic prototype via a number of underlying reform waves. This led to a specific ownership structure and coordination mechanism, including certain market economic elements. As a non-aligned country, SFRY built good relations with the 'West', but broke its ties with the Soviet bloc over the years. As a result, the two countries' political and economic sphere were completely reshaped, which led to the transformation of the respective banking sectors.



**Fig. 1.** Kornai's 'Main Line of Causality'

Source: Kornai 1992 (p. 361).

<sup>1</sup>Based on the respective literature, both the phrase of 'communism' and 'socialism' could be applied. However, the latter term will be used, due to the fact that a full-fledged communist system rather remained a theoretical expression.

<sup>2</sup>Following World War II, the country was named as the Federative People's Republic of Yugoslavia. In the 1960s, the country was renamed the Socialist Federal Republic of Yugoslavia (SFRY).



The primary aim of the paper is to highlight the fundamental differences of the two countries' banking systems. The system's structure, institutional<sup>3</sup> mechanisms, and commercial banking aspects are being analysed, while the respective monetary policies are only briefly mentioned. As a secondary goal, the paper intends to reflect the similarities regarding the banking systems' ownership structure following the transition period, which also indicates the potential significance of the path dependence theory.<sup>4</sup>

The paper also includes relevant aspects from the transition period, and specific outcomes from the 2000s. For the post-socialist era, the comparative analysis includes Albania and all of the successor states of Yugoslavia; namely Bosnia and Herzegovina, Croatia, Kosovo,<sup>5</sup> Montenegro, North Macedonia, Serbia and Slovenia.

## METHODOLOGY

As reflected by [Figure 1](#), Kornai's 'Main Line of Causality' groups the classical socialist system's political and economic phenomena into five blocks, whereas the arrows among them demonstrate the dominant causal connections. Thus, block 1's one-party system and official ideology can be considered as the foundation of this coherent scheme. This determines the second block's specific dominant ownership structure, which is the state and quasi-state ownership in case of the classical dogma. Kornai regards these first two sections as the systemic 'seeds', which create the preponderance of the bureaucratic coordination formed by block 3. The fundamental elements of these first three blocks lead to block 4, representing the agents' behaviour and motivation. Here the phenomenon of 'soft budget constraint'<sup>6</sup> can be highlighted as a specific representation of systemic dysfunctionalities, and an outcome of the state's paternalism. The final block collects long-lasting and typical phenomena that stem from all of the previous blocks ([Kornai 1992](#)).<sup>7</sup>

This paper focuses on the time period between the end of WW II and the transition period. It compares Albania's and SFRY's general economic system, with special attention on the two countries' banking sector. As mentioned already in the introduction, this study highlights the developments rather from a commercial banking aspect, as the monetary policy's design is merely mentioned. Special attention is given to the period from the 1970s, due to the fact that

<sup>3</sup>Institutions in this paper mean formal and informal institutions as well.

<sup>4</sup>From a simple approach, according to the path dependence theory, the past events form the future ones, and causal links can be detected between them. Via these events, self-reinforcing sequences can be differentiated from reactive sequences, but sequences and conjunctions can also be pinpointed ([Mahoney 2000](#)). On top of the institutional sequencing, [Bednar and Page \(2018\)](#) linked also culture to path dependence. Though the current paper focuses primarily on the socialist time period, but it is noteworthy that [Roland \(2010\)](#) mentioned the potential influence of the pre-socialist era.

<sup>5</sup>This designation is without prejudice to positions on status, and is in line with UNSCR 1244 and with the ICJ Opinion on the Kosovo Declaration of Independence.

<sup>6</sup>To read more on this phenomenon, see [Kornai et al. \(2003\)](#).

<sup>7</sup>For further details on the 'main line of causality' and its implications, see [Kornai \(1992\)](#) or [Kornai \(2008\)](#). For a further insight into the classical socialist system, and specific country cases, see, for instance, [Kozłowski \(2008\)](#) or [Roland \(2000\)](#).



in SFRY the outcome of a number of reform waves could be underlined by these years. The post-transition period is also being briefly covered in order to refer to the subsequent developments.

In the case of Albania, according to Kaser (2001), the country generally lacked statistical datasets, or the existing data were published to support merely propaganda purposes. However, certain datasets for both of the reviewed countries have been included to this study to underline specific indications. Generally, the financial statistics for this socialist era are incomplete or they are missing. Still, the available time series are suitable for highlighting specific messages, which underpin selected statements of the qualitative analysis.<sup>8</sup>

## THE POLITICAL AND ECONOMIC LANDSCAPE

Starting with block 1 – namely the undivided power of the ruling party and the dominant influence of the official ideology – similarities and differences can be detected. On the one hand, after years of power struggles, in both countries a one-party political system was built up by the elimination of the opposition. It is noteworthy that both countries were led by charismatic heads almost over the complete social era; Enver Hoxha (1908 – 1985) in Albania and Josip Broz Tito (1892 – 1980) in SFRY. On the other hand, though the two official ideologies started from a common ground after WW II, they gradually diverged over the decades. Albania remained loyal to the Stalinist dogma, and rejected any fundamental economic or political reforms during the socialist time period (Uvalic 2010). Regarding the international relations, it broke its strong ties with the Soviet Union in the 1960s. Then it turned to China, but by the late 1970s cut its relations with Beijing as well (Varsori 2012), opting for the ideal of ‘self-reliance’ (Vaughan-Whitehead 1999). Thus, Albania could be considered the most autarkic and isolated country within the socialist bloc from the 1970s (Sjöberg – Wyzan 1991), regarded by the western powers as a ‘bizarre reality’ (Varsori 2012: 619).

As for SFRY, several underlying reform waves took place (Ramet 2006), and became incorporated into the official ideology. These reforms fundamentally reshaped the economic system, for instance, by implementing a specific ownership structure, curbing central planning, or ordering the establishment of commercial banks (Lydall 1984; Gligorov 1998). By the 1970s, SFRY implemented even a number of market-oriented components to its system, though with restrictions. As a result, SFRY created a unique system, which could be considered neither classical socialist nor market economic one. SFRY’s international orientation also completely differed from the Albanian, as it gradually opened to the West, after its relations with the Soviet bloc deteriorated and broke in 1949. SFRY became a member of the World Bank and the International Monetary Fund (Gligorov 1998), while by the 1980s its main trading partner was the European Community (Uvalic 1992). Based on these facts, regarding block 1, both Albania and SFRY had a one-party system and a dominant official ideology, but in SFRY the latter was inconsistent with the Marxist-Leninist dogma.

As for the second ‘seed’, referring to the dominant position of state and quasi-state ownership, fundamental differences can be detected. Following WW II, both countries started collectivisation. Due to its rapid pace in Albania, private property was eliminated by 1947 (Schnytzer 1982).

<sup>8</sup>More information on the exact data is provided in the upcoming sections that are dedicated for the banking sectors’ development.



However, in case of SFRY, the nationalisation process remained incomplete, and the reforms of the late 1940s and early 1950s led to a unique ownership structure in the country; the ‘workers’ self-management’. This indicated that the non-state social collectivity became the owner of the centralised state property. Based on the interpretation, this was supposed to mobilise the collective entrepreneurship, but in a more just way than in the market economies (Gligorov 1998). Nevertheless, this peculiar ownership type could be considered neither direct nor concrete, as if properties were not owned by anyone (Gligorov 2004).<sup>9</sup> It remained unclear, whether the private or the public law should have been stressed. There were disagreements regarding the subjects of this law. It was also unclear if this social property is a legal, economic, sociological or non-definable concept of quasi-property (Horvat 1971). As a result, referring to the block 2, in both countries the private ownership remained low or marginal<sup>10</sup>, as in Albania state ownership, whereas in SFRY ‘social’ ownership dominated the economies.

Turning to block 3’s coordination mechanism, in the Albanian case, the state ownership determined the need for a bureaucratic coordination mechanism. This was run by the nine-month central plans between 1947 and 1951, which were then followed by the classical socialist five-year plans (Schnytzer 1982). Competition among the actors, or the coordination of market mechanism were inhibited by the system, also via the centrally set prices and exchanges rates, which rather had accounting than allocative purposes (Vaughan-Whitehead 1999).

Unlike in Albania, in SFRY the role of central plans significantly shifted over time. Following the introduction of the self-management<sup>11</sup> system, the central plans’ practical relevance decreased, but was not completely abolished. These plans focused on priority sectors, or intended to mitigate the macroeconomic imbalances (Schrenk et al. 1979). As for the system of self-management, the self-managing units, the associations and the units were supposed to negotiate on all levels, and reach an agreement on the tasks. This mechanism intended to create mutual willingness in the light of social responsibility (Kornai 1992). As an outcome, the system remained vague on the responsibilities and objective functions. Nevertheless, these managerial responsibilities were transferred to the firms’ level (Gligorov 2004), and provided the notion that workers are running the companies (Kornai 1992). It is important to stress that the introduction of these elements did not imply market economic mechanisms, as they were limited by the administrative barriers, such as territorial restrictions, regulated prices or interest rate ceilings (OECD 1990). Finally, still related to the bureaucratic system, the decentralisation can also be mentioned in the case of SFRY, as the republics, provinces, counties and municipalities gained more room by the 1970s (Gligorov 2004).

Taking into account the characteristics of the first three blocks, the relations between the actors can be outlined by block 4. In Albania, the preponderance of bureaucratic coordination created a vertical dependence among the agents, as the subordinates depended on their superiors. However, SFRY was peculiar in this respect as well, because the system created double dependence. Indeed, as managers were re-elected by the companies’ employees, they depended

<sup>9</sup>It is noteworthy that this created difficulties even during the transition period, when in certain cases assets had to be nationalised before privatisation in order to make property rights clear (Lavigne 1999).

<sup>10</sup>For specific statistics, see Kornai (1992) or Papazoglou (2005).

<sup>11</sup>According to Horvat (1971), the self-management concept was not a Yugoslav invention, as since the Paris Commune specific attempts could be occasionally detected to provide control to workers.



on their workers as well, which was on top of the classical vertical dependence. The latter provided various benefits for managers, as investment credits or state subsidy. Parallel with this, the dependence on employees enforced the maximisation of wages and benefits, but limited the reinvestment of savings. Likewise in Albania, the employees in SFRY were not motivated in the companies' long-term development, because investments could not be moved if they switched firms. This boosted short-term consumption and interests (Kornai 1992). Components of these mechanisms led to the fact that the phenomenon of 'soft budget constraint' existed not only in Albania, but in SFRY as well.

The 'main line of causality's' last block lists typical lasting phenomena that stem from the previous sections. These macroeconomic shortcomings can be reflected by such indicators as the inflation rate, foreign debt or unemployment rate. Starting with the Albanian case, as the country opted for 'self-reliance', foreign aid was no longer financing investments for the forced industrialisation, and was not compensating the lack of domestic savings or import needs any more (Sjöberg – Wyzan 1991; Vaughan-Whitehead 1999). From this perspective, one can state that a real self-reliant system was never attained (Schnytzer 1982). On the other hand, as an exemption within the socialist bloc, Albania entered its transition period debt free (EBRD 1996). Generally, the exchange rate of the Albanian lek also remained stable due to the administrative controls, apart from a planned devaluation in the 1970s (Kaser 2001).

As it has been stated, SFRY's external relations completely differed. The country turned to the West for credit lines and trade relations already from the 1950s. Trade has been gradually liberalised via the reform waves, and attempts were made to provide the Yugoslav currency's – the dinar's – convertibility (Schrenk et al. 1979). However, the increasing production and export volumes (OECD 1962, 1990), the growth of remittances, and the flourishing tourist sector were not able to offset the current account deficits (Gligorov 2004). From the 1970s, SFRY experienced the exponential growth of external debt (OECD 1990; Mrak 1992), whereas the fixed exchange rate of the local currency collapsed by the early 1980s (Gligorov 2004). One of the main contributors to this increasing amount of foreign debt was the banking sector itself, as the foreign capital inflows were among the key financing sources of the credit activities during the 1970s. These loans supported the industrialisation process, but also household indebtedness rose (Četković 2015). During the period of international turmoils – which also stimulated interest rate growth – SFRY had to require debt restructuring programs, and took restrictive measures for stabilisation during the 1980s (Mrak 1992).

Regarding inflation, in Albania prices and wages remained under control by administrative measures. In SFRY, the control over prices was incomplete, and the composition of the list of centrally regulated prices changed over time. Furthermore, the already mentioned workers' motivation and the managers' double-dependence led to a wage-price spiral, leading the economy to major inflation spikes<sup>12</sup> (Kornai 1992).

Referring to the labour market, Albania–true to the classical socialist ideal–intended to achieve full employment. Taking into consideration the rapid pace of its population growth,<sup>13</sup>

<sup>12</sup>SFRY had double-digit inflation rates already in the 1960s. These rates surged in the 1980s, reaching almost 200% in 1988, and leading to hyperinflation in the next year (OECD 1990: 15).

<sup>13</sup>In 1960, the number of employed people amounted to 384 thousand (Sandström - Sjöberg 1991: 936), while by 1990 this number reached 1,433 thousand (INSTAT 1991: 76). The population grew from 1.2 million to 3.3 million between 1950 and 1990 (INSTAT 1991: 35).



this led to lower productivity levels, which could be interpreted as a kind of hidden unemployment (Sandström – Sjöberg 1991). In the case of SFRY, the implied policy was not in line with the classical socialist dogma from this aspect either. Namely, curbing unemployment was not among the key political goals from the 1950s. Thus, unemployment rates increased over the years, but great differences could be detected among the republics and provinces<sup>14</sup> (Woodward 1995). In SFRY, to increase the workforce's income, the firms rather chose capital-intensive investments via negative real interest rate bank loans or state subsidies. These tendencies led to the co-existence of inflation and unemployment in the country (Kornai 1992). Still, SFRY was among the richest countries in the socialist bloc, while Albania remained the poorest European country during the reviewed time period (Kaser 2001).

The list of the respective phenomena could be continued, but here the intention was to highlight the fundamental differences between the two reviewed countries' economies via the building blocks of Kornai's 'main line of causality'. This overview served the understanding of the banking systems' development.

## TWO DIVERGING BANKING SYSTEMS

In Albania, in 1945, specific decisions were taken to wind up the foreign-owned banks' operations. Indeed, foreign banks were closed and liquidated, private-owned banks did not exist. From 1945, in line with the classical socialist structure, the country had a one-tier banking system, thus the State Bank of Albania managed both the monetary policy and the commercial banking activities. To fulfil the central bank's tasks, this monobank issued the banknotes and held the state's reserves. As an institution in charge of the commercial banking tasks as well, it also collected households' deposits, while it issued credits for the state-owned companies and the public sector. Based on the developments, private sector credits were generally extinct. Furthermore, this single bank controlled the payment system both on the domestic and the international level. Over the years, three further banks were established for dedicated purposes. The Agricultural Bank began operating in 1970, and provided services for the agricultural sector. A specific institution was dedicated for managing savings, and later a fourth institution was labelled as the commerce bank (Balliu 2012). However, referring to Kornai's third block in the 'main line of causality', the banks had merely limited room for these specific operations, as the activities were generally based on the respective central plans<sup>15</sup> (Vaughan-Whitehead 1999).

Based on the specific reform waves, the banking system of SFRY was transformed multiple times.<sup>16</sup> Prior to WW II, both private and state-owned banks operated in the country. Following the war, the private-owned banks were abolished, and the state-owned ones were restructured. Republican level banks were established and then merged, creating a central bank, and a bank for investments and foreign loans (Četković 2015). Then, beginning from the 1950s, SFRY created a two-tier banking system (Bonin 2004), which could be considered as a unique socialist systemic case. The monetary authority, the National Bank of Yugoslavia, was located in

<sup>14</sup>For instance, in 1985, the country-level unemployment rate was over 15%, but in Slovenia this rate was merely 1.5%, while in Macedonia or Kosovo it was more than 30% (Woodward 1995: 4).

<sup>15</sup>For further details on the Albanian banking sector's development, see Balliu (2012) or Cani (1997).

<sup>16</sup>For a detailed chronological overview, see Četković (2015), Hauvonen (1970) or Horvat (1971).





Belgrade. Later, based on the decentralisation efforts of the 1970s, the six constituent republics and the two provinces established their own central banks (Četković 2015). These institutions were in charge of the implementation of the monetary policy, which was set by the single federal-level central bank in Belgrade. This latter agent had further dedicated purposes as in other socialist countries. Indeed, in line with the political intentions, it provided support for the export and the agricultural sectors, whereas budget financing remained rather hidden (Rant 2004).

As for the level of the commercial banks in the two-tier system, SFRY had a large number of small banks<sup>17</sup> on the republics' level. This was the result of the already mentioned reform waves, as the enterprises had to establish their own banks in order to manage the respective credit channels for the companies (Bonin 2004). Regarding the ownership of these mini banks, generally they were owned by the communes via the enterprises. Structural weaknesses did occur in the system. Starting with the fact that—as it has been reflected in the previous chapter—the firms in SFRY had motivation for maximising the short-term benefits. As the profits had to be channelled to the investors, in practice, the banks had limited control over their profits. Adding to this feature that as the banks were owned by their respective enterprises, the bulk of the credits that covered the firms' financial needs were provided with preferential conditions, often with negative interest rates (OECD 1990). As an administrative restriction, ceilings on domestic loans were also applied from 1978 (Borio 1990). As a result of these mechanisms, by the 1980s, the great spikes in the inflation rates led even to the double-digit range of the negative rates (OECD 1990).

A further systemic weakness could be linked to the exchange rate risks. Namely, as domestic sources – including foreign exchange (FX) deposits – were not able to cover the strong investment activities by the 1970s, SFRY had to rely on foreign funds, which also fuelled the already mentioned high current account deficits. From the banking sector's aspect, the credits – which financed the investment needs – were funded by these external channels (Četković 2015). From 1967, the commercial banks were permitted to borrow from abroad directly (Hauvonen 1970). Thus, the banks' net borrowing position steadily increased from the 1970s. Furthermore, when the dinar depreciated during the 1980s, the debt-burden rapidly grew in dinar-terms. Indeed, the banking sector's indebtedness went hand in hand with the country's striking external debt (Četković 2015).<sup>18</sup> Nevertheless, even though the companies were able to de facto shift their losses to their respective banks, government guarantees for the banking sector sustained the system. Therefore, this financial laxity kept the operation going for non-viable firms and their financial institutions (Borio 1990).

Unlike in Albania, structural segmentation was not a specific characteristic in the Yugoslav system – though banks with dedicated purposes did exist – most banks participated in various activities, as for instance, for agriculture, investment or foreign trade (Hauvonen 1970).

Turning to a further peculiarity in SFRY, the payments settlements system was unique, as it was separated from the banks. The state-level Social Accounting Service (SAS) conducted, controlled and supervised the internal payment system. This institution was responsible for

<sup>17</sup>Based on the frequent restructuring of the system, the exact number of the banks varied over time, e.g., the total number of banks amounted to 217 in 1964, but dropped to 74 by 1968 (Horvat 1971: 136).

<sup>18</sup>Četković (2015) provides graphs and sectoral data on these developments.





all domestic transactions. As an outcome of the decentralisation process, regional-level SASs were also established, thus the institution maintained around 400 branches (Hauvonen 1970). The republican level central banks also had their own accounts at the SAS as a channel to fulfil the monetary policy requirements. Nevertheless, the money issuance right was kept centralised on the federal level (Rant 2004). The fact that this internal payment control and supervisory system was not an integrated part of the banking system, it generated specific challenges during the successor states' transition process.

It is an important characteristic that unlike in Albania, in SFRY specific market economic elements did function in the banking sector as well, but only to a limited extent. For instance, banks could compete with each other in the theory, but in practice, there was lack of motivation to do so. This was also due to the above-mentioned interest rate ceilings, which were determined by the bureaucratic apparatus. Giving a relevant example, banks in SFRY were able to fulfil one of their primary roles in a market economic institutional system. Namely, they functioned as a channel between the actors providing savings and the investors requiring loans. As an example for the capital market, the possibility of issuing corporate bonds existed, though the limitations kept the system underdeveloped (Singleton 1976; Lydall 1984).

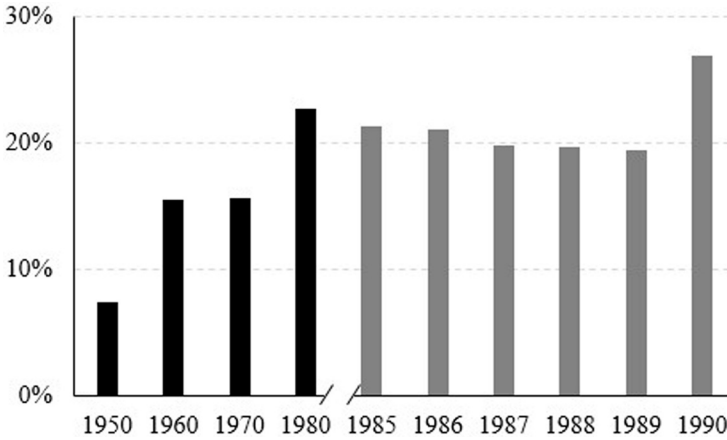
It is worth mentioning a mechanism in SFRY, which led to a specific puzzle during the transition period in the successor states. As SFRY emerged as an open economy – opposite to Albania – the volume of the FX transactions grew, and culminated in the 1980s. The majority of the FX deposits had to be transferred to the Belgrade-based central bank from the republic-level banks in exchange of dinar-denominated loans. However, following the secession of Croatia and Slovenia, the National Bank of Yugoslavia froze the republic banks' FX deposits in the two newly formed countries in 1991. This caused large holes in their balance sheets, leading to a specific challenge during the transition period, dubbed as the case of 'frozen deposits' (Bonin 2004; Bonin et al. 2014).

When we turn to a qualitative approach, the level of financial deepening is often measured by the indicator of the banking sector's total assets in per cent of the economy's production. In the case of Albania, this indicator might be somewhat misleading, as it could have been considered as an outcome of the planning process. Moreover, reliable time series for the banking sector's total assets are not available. Thus, merely as a simple indication of financial development, and taking into consideration the available data, the volume of outstanding short-term credits in the percentage of the total gross social product (GSP)<sup>19</sup> is being presented by Figure 2. These data express an intensifying – though still modest – credit activity in the economy, which was valid for all Albanian economic sectors. Namely, over the decades, the amount of loans increased in the industry, construction, agriculture, trade and other sectors, but the volumes remained modest compared to their output levels (INSTAT 1991).

Based on the OECD statistics, specific time series are available for SFRY. Figure 3 provides information on the financial deepening from 1970. The numbers must be treated with caution, because the data for total assets contain the central bank's balance sheet as well. This might be somewhat misleading, but Borio (1990) published similar results for the level of financial deepening, and the share of the central bank's assets might be considered low. Figure 3 also

<sup>19</sup>GSP was similar to gross material product, which was used in many socialist economies (Gligorov 2004). Relative to the gross domestic product (GDP), it excluded specific groups of services (Borio 1990). Nevertheless, both variables can be used to indicate a country's output level.

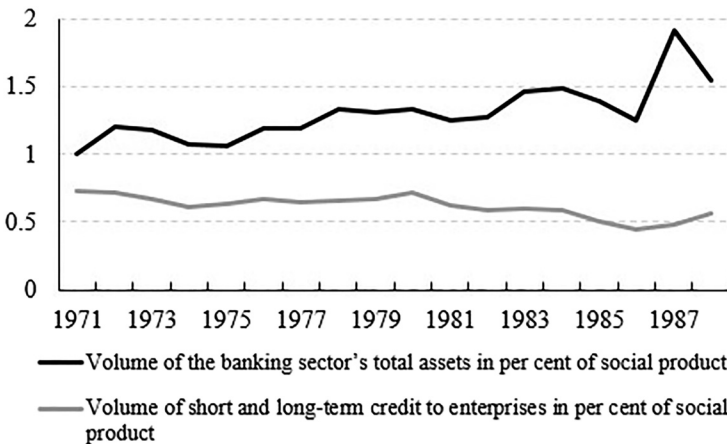




**Fig. 2.** Volume of outstanding short-term credits of social product in Albania (%)

Note: The black bars refer to the end of the decades, while the grey ones reflect yearly end of period data.

Source: INSTAT (1991), own calculations.



**Fig. 3.** Volume of total assets and total credits to enterprises in per cent of social product in SFRY (%)

Note: Between 1980 and 1988, the data for total assets in SFRY refer to the consolidated balance sheet of all banks excluding financial and other organisations and internal banks.<sup>23</sup> From 1980, the category of enterprises is labelled as 'organisations of associated labour performing economic activities'.

Source: OECD (1980, 1990), own calculations.

contains data that refer to the volume of credits to enterprises. This variable has been included to indicate the level of the commercial banks' primary assets. Indeed, based on the statistics of Borio (1990), or OECD (1962, 1990), loans to companies had an overwhelming share within the total volume of loans.



Based on the numbers of [Figure 3](#) – except for the years before the transition period – the total assets in per cent of GDP was between 100% and 150%, with an increasing trend. This level of financial deepening could be considered comparable to the higher-income countries, such as Spain or Canada<sup>20</sup>. As for the amount of the loans to enterprises, the graph underpins the fact that banks indeed provided high volumes of credits to their companies. In the percentage of the GDP, the volume does not show an increasing trend, whereas the turmoils during the pre-transition years is also visible. It is worth highlighting that the level of financial deepening could lead to false conclusions regarding SFRY's overall financial development. Indeed, the country's financial system remained at an early development stage, whereas the range of instruments was narrow. Securities, for instance, remained nearly non-existent, due to the government's balanced-budget policy, and the banks' crediting activity for companies. Furthermore, shares were considered inconsistent with the official ideology ([Borio 1990](#)). Therefore, like in Albania, bank deposits and corporate credits remained the primary financial instruments in SFRY, and the level of financial deepening was relatively high in the latter country. In both cases, the guarantees led to the moral hazard and soft budget constraint phenomena, which were features of the general economy, and specifically the banking sector as well.

To sum up, at the fall of the socialist regimes, Albania had four centrally controlled banks. SFRY had a large number of tiny commercial banks, parallel with high market concentration ([Bonin et al. 2014](#)). In both countries, banks had limited experience of profit-oriented bank management, as they were generally merely the financial service providers for their specific firms. The banking system was weakly capitalised, and the banks accumulated high ratios of non-performing loans. The ownership structure in SFRY created a further unique challenge, which often led first to nationalisation before privatisation during the transition period. Generally, just as the general economy, the banking sector also had to address various challenges upon the fall of the socialist era in Albania and the successor countries of Yugoslavia.

## BANKING SECTOR AFTER THE SOCIALIST ERA: SECTORAL CHALLENGES AND OWNERSHIP STRUCTURE

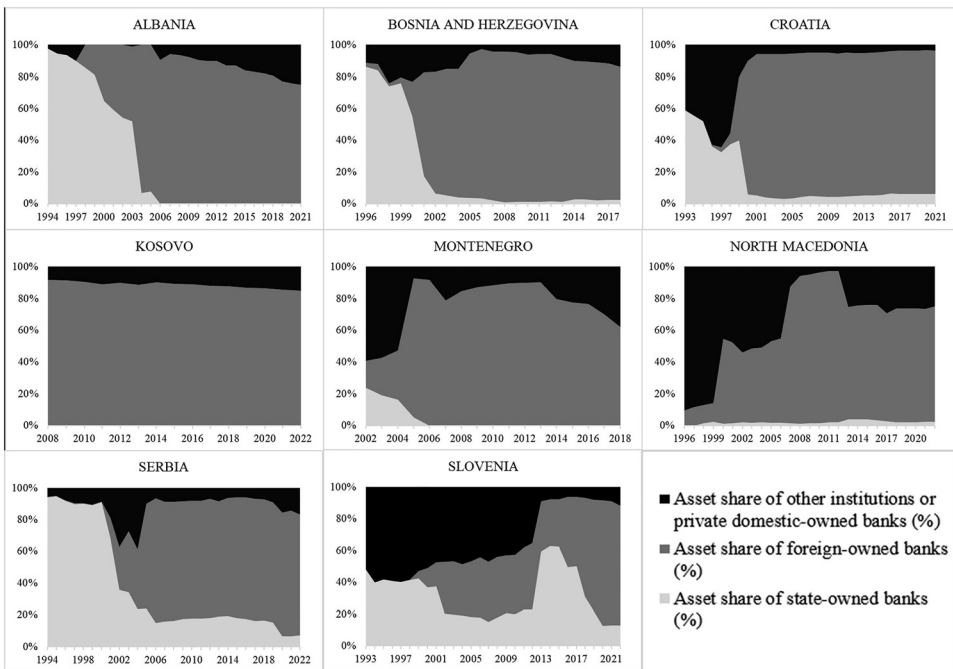
Despite the fact that Albania's and SFRY's development paths diverged over the decades of the socialist era, still the countries had to address similar problems. If we take into consideration five basic functions for the banking sector highlighted by [Levine \(1997\)](#), one can conclude that the commercial banks did not fulfil their market economic roles. Namely, efficient risk management was not conducted during the socialist time period, the same applied for the efficient resource allocation. As a third role of the system, the monitoring of the management and the exertion of corporate control did not function as in a profit-oriented market economic approach in either of the two socialist countries. A further function, the mobilisation of savings, partly worked in SFRY, but not in Albania. Besides these shortcomings, a fifth role, the facilitation of the exchange of the goods and services functioned in both countries, though the separate payments settlements system should be mentioned in the case of SFRY. Based on the socialist legacy of the institutional systems, a well-functioning market economic banking sector had to be built by completely reshaping the inherited structures.

<sup>20</sup>For comparative data, see [Borio \(1990: 5–6\)](#).



In the specific case of Albania, in 1990 the country launched its transition process with its four state-owned banks. The State Bank of Albania was transformed into the Bank of Albania, the national bank of the country. In the new two-tier banking system – where a central bank and commercial banks operate with different roles – the three remaining state-owned banks formed the commercial banking sphere. Still at the beginning of 1995, the former specialisation of these three banks could be notified by their market shares. Thus, the bank for savings held 80% of the total households’ savings amount, and 19% of the total loans, whereas the bank for commerce had 85% of the firms’ deposits and 39% of all loans (Cani 1997: 158). The former agricultural bank was a monopoly in the agricultural sector. It was 1993, when the first private bank was established in a joint venture form with the former commercial bank and an Italian institution (Cani 1997). Over the years, the share of foreign-ownership in the sector grew over 50% by 2004 (see Figure 4).

In the case of the successor states of Yugoslavia, all country had their own specific transition processes. These differed from one another due to a number of factors. Each country entered the transition period with different development levels and impacts of armed conflicts. Also, the various dates of independence implied that the start of the transition process, and specifically



**Fig. 4.** Asset share of state and foreign-owned banks, and of banks with other ownership

*Notes:* Based on the available data, and dates of independence, the time series cover different time periods. Data for Serbia before 2000 refer to FR Yugoslavia. The graph for Kosovo’s state-ownership is not visible as its share amounts to 0%.

*Source:* Statistics and reports published by the respective central banks and EBRD (1998, 2000, 2002, 2004).



the restructuring of the financial sphere differed. The exact actions, the pace and the sequencing of this transition also varied among the country cases. The development was occasionally halted by an overwhelming domestic banking crisis, or by a financial meltdown generated by the collapse of expansive pyramid schemes. Two cases can be viewed as special exemptions. Firstly, Kosovo's banking sector was nearly non-existent, and was established under the auspices of international institutions. Secondly, Slovenia was the single country, which did not experience a massive banking crisis, and could maintain the dominant position of the domestic ownership until 2018.<sup>21</sup>

This leads us to an underlying characteristic of the region's banking sector; the high level of foreign ownership.<sup>22,23</sup> By 2018, the asset share of foreign-owned banks was over 60% in all cases, and was over 80% in Albania, Bosnia and Herzegovina, Croatia and Kosovo. Furthermore, even in the case of North Macedonia and Serbia this share reached over 70%. In the same year, the ratio of state ownership was 0% in Albania, Kosovo and Montenegro, but was at a low level in other cases as well (see Figure 4), where the graphs reflect certain volatility, but an increasing trend of the foreign ownership and the decreasing of the state ownership. Generally, due to the lack of domestic capital, banks were privatised to foreign owners during the transition process.

There is a broad literature for different aspects and country groups on the banking sector's ownership type. For instance, Cull et al. (2017) find evidence for increasing foreign-ownership share on a global scale since the 1990s, based on the post-socialist transition period and privatization process, financial liberalisation and rapid globalisation. The authors find that in the developing countries foreign-owned banks are generally more efficient, while they foster competition in the host countries. These banks are also able to promote credit stabilisation. On the other hand, foreign-owned banks can be the channels of external shock. As for the state-owned banks, they rather have a negative impact on the domestic competition and performance, while there is mixed evidence for their effects on credit expansion. Nevertheless, certain cases support their potential credit growth stabilisation impact. Bertay (2012) also find that state-owned banks can even have a countercyclical effect, but the respective countries' development level and governance quality do have an impact on these results.

These general findings in the academic literature are valid for the reviewed region as well. Following the socialist era – with Slovenia being a specific exemption from certain aspects – a common template could be outlined for the banking sector's development in the region. Namely, after an overwhelming systemic meltdown, foreign-owned banks – primarily head-quartered in the EU – penetrated the markets. They were able to foster the local competition, transfer know-how, provide financial resources and develop the technology (Cani 1997; Barisitz 2008). The product range widened, and the level of financial deepening increased. However, as it

<sup>21</sup>For more details of the transition period of the region's banking sector, see, for instance, Šević (ed. 2002) or Barisitz (2008). Country level analyses are also available; see, for example, Cani (1997) for Albania or Fink et al. (2007) for Serbia. Regular reports and statistics are available on the respective central banks' homepage.

<sup>22</sup>Based on Figure 4, the asset share of the foreign-owned banks was over 80% in Croatia by 2000, in Albania, and Bosnia and Herzegovina by 2004, in Montenegro by the next year, in North Macedonia by 2007, and in Kosovo from 2008. But this share was over 75% from 2006 also in Serbia. As a unique case, in Slovenia the ratio was over 60% only from 2018.

<sup>23</sup>Internal banks were established during the late 1970s, as a third category of commercial banks besides the basic and united banks. They provided services for the so-called basic organizations of associated labour (BOALs) (Četković 2015). From 1971, SFRY's production was fragmented into these BOALs (Borio 1990).



has been mentioned by Cull et al. (2017) as well, in cases of external shocks, the dominance of foreign-ownership can carry the risk of systemic negative spillovers. This became particularly relevant during the period of the 2008 crisis, when the risk of foreign-banks pulling out of the region was present. Even such international cooperation as the so-called ‘Vienna Initiative’ took efforts to prevent the owner banks from such actions, but the potential risk was not elusive anymore (Allen et al. 2017). Thus, one can conclude that as the financial sectors of the reviewed countries are dominated by foreign-owned banks, the ownership structure is a double-edged sword; it can enhance economic development, but it also carries potential systemic risk. Thus, indeed, as Kornai considered the dominant ownership type a fundamental characteristic in an economy, its importance is also relevant in case of the reviewed countries’ banking sector.

## CONCLUSIONS

One can conclude that the official ideology differed in Albania and in SFRY during the socialist era. Furthermore, already in the second ‘seed’ of the ‘main line of causality’- referring to the dominant ownership type – fundamental differences could be underlined while comparing the two countries. From the 1950s, Albania’s economy was dominated by state-ownership due to the rapid collectivisation process. As a peculiar characteristic, the country became the most isolated state within the socialist bloc from the 1970s, based on its goal to achieve the ideal of ‘self-reliance’. As for the financial sphere, in line with the classical socialist dogma, Albania had a one-tier banking system. The operation of the state-owned bank was based on the central plans, set by the bureaucratic apparatus. Over time, specific activities have been detached from the single central institution for dedicated purposes, but the central coordination mechanism remained.

As part of the ‘Yugoslav social laboratory’ (Horvat 1971: 161), SFRY implemented fundamental changes over the decades via a set of reform waves. Already in the 1950s, a unique ownership type was established in line with the ‘workers’ self-management’. This implied that the ownership of the formerly collectivised state-owned assets was transferred to the so-called social collectivities. SFRY’s banking system also experienced regular underlying restructurings. First, the country’s economic system was reshaped, which led to independent economic institutions. As a subsequent step, independent financial intermediaries were established in line with the institutional framework. Features of a market economy were present in the system, but the bureaucratic control was never completely abolished, thus creating a unique socialist prototype. This system could be considered as a hybrid institutional form, incorporating both classical socialist and market economic characteristics. In SFRY’s bank-based financial system, the level of financial deepening was at a level of more developed countries, though the capital market remained undeveloped.

Table 1 summarises the key common and differentiating characteristics of the two banking systems. To sum up, one can underline that just as the general economies, the Albanian and SFRY’s banking systems fundamentally differed, and their development paths diverged. Still, one can conclude that the sector in Albania and in the successor states of Yugoslavia had to address similar shortcomings during the transition period. This proves that the half-measures were not sufficient to keep the systems viable. On top of the transition, the post-Yugoslav systems also had to deal with the aftermath of the former country’s dissolution. In all cases, building a well-functioning banking sector had to start almost from scratch.



**Table 1.** Main common and differentiating characteristics of the Albanian and SFRY's banking sectors from the 1970s

Albania	SFRY
<i>Different characteristics</i>	
One-tier banking system	Two-tier banking system
Bank management led by bureaucracy	Double dependence
No disposal over the banks' own profits	Theoretical disposal over the banks' own profits
No competition	Theoretical existence of competition
The sector does not function as a channel between savers and investors	Channelling savings to investors
Lack of capital market	Narrow, underdeveloped capital market
Integrated payments settlements system	Payments settlements system separated from banks
Structural segmentation	Partly existing structural segmentation
State-level operations	Federal/republic divisions
Low level of financial intermediation	High degree of financial intermediation
<i>Common characteristics</i>	
Lack of private ownership	
Existence of soft-budget constraint and absence of bankruptcy threat	
Narrow product range	
No efficient resource allocation, risk management and corporate control	
Facilitating the exchange of goods and services	

Source: Own compilation.

On the one hand, the countries differed regarding their initial development levels, their dates of independence or their outcomes from military conflicts during the transition period. On top of these, the transition processes' sequencing, starting dates, duration and exact methods also reflected great variety. On the other hand, one can note that the fundamental restructuring had to handle the second 'seed', namely the ownership structure in all country cases. Furthermore, by 2018 all of the reviewed banking systems became dominantly foreign-owned, despite the fact that during specific time periods in certain country cases there were different intentions. This common outcome supports the concept of path dependence theory, as challenges and developments are being influenced by their historical legacies.

The current analysis could be pursued in multiple forms. Firstly, further country cases could be added to the research. In the case of Asia, the unique systems of China or Vietnam could provide an interesting base for comparison, to prove or disprove the theory of path dependence at the same time. Furthermore, they could even challenge the 'main line of causality's' coherence. As [Mihályi and Szelényi \(2021\)](#) stresses, Kornai himself elaborated the peculiar shifts in China among





the first. As a further option to develop the current research, one could choose only a single country for more in-depth analysis. Finally, even a different time period could be picked. All of these options could focus on the banking sector, but also on the broader economic developments.

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