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Full Length Research Paper

Banking and creation of Money: the Post Keynesian Theory Case of Albania

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The Post Keynesian approach is one of the Keynesianism Schools, who aimed the endogeneity of money supply. The interest for the Post Keynesians (PK) began more than two decades ago, as a result of deregulation, financial liberalization and many issues raised for the determination of money supply. Monetarist and Keynesians stated that money supply is exogenously determined by the Central Bank (CB), while the Post Keynesians argued that money is determined endogenously as a result of economic activities. The study will be looking into the very concept of the endogenous money hypothesis as this is reflected by the Post Keynesian tradition. The paper will synthesize and compare the existing theoretical and empirical evidences, by exploring the nature of money. The study will test the Post Keynesian Theory based on the available data for the Albanian country. The findings are not generalized for other developing countries. They represent the support for the underlying theory based on the used data.

Keywords: endogeneity of money supply, credit, deposits, financial crisis.

INTRODUCTION

The Post Keynesian approach is one of the Keynesianism Schools, who aimed the endogeneity of money supply. The interest for the Post Keynesians (PK) began more than two decades ago, as a result of deregulation and financial liberalization by raising many issues for the determination of money supply. The PK relies on the Keynesian view of the monetized economy and explores this view in capitalist economies. In capitalist economies banks play an important role, because of the creation of money. The PK is seen as a dual framework, by following the view that “money matters” and the thought that money supply is “credit driven”. Hence, PK approach is a theory of the banks’ role in the business cycles.

The PK theory contrasts from the monetarists and neoclassical economists, who state that money is exogenous and it is a cause of economic activity and not

a consequence of it. Additionally, within the PK theory there are three views such as horizontalists, accommodative, and structuralist, which recognize the endogeneity of money supply (credit driven). Nevertheless, they differ in their perceptions for the role of CB and commercial banks in the credit accommodation process. Thus, the PK theory and the endogeneity of money are not yet determined because of the lack of coherence and unanimity within the PK tradition.

The research will be focused on Albania and will provide support or not for the PK theory, if money supply is endogenous or exogenous. Thus, country analysis will be adapted in order to study the variables and the environment, which will lead to specific results.

Albania is a developing country, which has passed a pyramid scheme crisis on 1997. After the year 2002 the banking system started to introduce new financial products and to develop new services. The Albanian banking system is more protected than the other financial systems in the region, because of the lack of stock

Exchange market. This lack helped Albania to be protected from the bad investment on derivatives and from buying debt from foreign governments.

The financial sector is still considered undeveloped and the borrowed loans are both in the local currency (Albanian Lek) and in European Union currency (Euro). During the last years, the level of bad loans as reached to 24.8% and the level of crediting the economy is very low. Banks are acting on a very discrete way by protecting themselves through blocking the crediting on the economy. So, the study will show the impact of Central Bank of Albania and commercial banks on the determination of money supply.

Post Keynesian Theory and Other Economic Thoughts

Money is one of the most important tools that economists take in consideration while setting economical objectives. Thus, money is an essential task for understanding the contemporary financial systems (banks). Additionally, banks are different from other financial intermediaries because of the capability to produce the means of payment.

The orthodox approach, represented by Monetarists argued that money has been invented as a result of market transactions considering that markets existed before money. However, a question rises claiming why markets decided to use a particular unit of account as a medium of exchange? In contrast, the non-orthodox approach has stated that money existed before the markets, because of the government decision for using a unit of account for paying taxes. Furthermore, fiat money was the first type of unit being issued by the taxing authorities. Thus, the resource of money was the government and money is an asset of it. Hence, the non-orthodox view gave a convincing answer for the above question.

Monetarists believed that the government supplies money and since governments have the power to control the reserves, they control the money supply. Consequently money is exogenously determined and monetary authorities decide for the percentage of increase/ (decrease) of the money supply, as a result of managing the monetary base. Government can issue money to cover the deficit or to give incentives financial institutions to increase the number of loans. Subsequently, the raise of money supply will cause wages and spending to increase as well, thus to increase the demand for money. However, this is not the case since the CB cannot forecast if the chosen target for the money supply will be met by the demand. Furthermore, inflation becomes an issue, which according to monetarists is a "monetary phenomenon". Nevertheless, it is worth mentioning that monetarists did not give reasonable arguments for the relationship between

Money and the economy in 1980s, by raising the interest for the PK theory.

Before two decades, a school of Keynesianism was developed; who labeled itself as the Post Keynesian approach. The PK argued that CB adjusts the money supply based on the demand for loans. If the commercial banks increase the number of loans to enterprises, then the same numbers of deposits are created on the other side of the banks' balance sheet. Hence, the circulation produces money, because the CB has to meet the increase demand for money by raising the money supply. Some studies were conducted in USA and UK (1970-1980) by finding that money was determined by bank loans and the velocity of monetary aggregates has changed based on the demand for loans. Certainly, the CB can control only the federal fund rates, which are exogenously determined, while the interest rates are set by the requirements for liquidity and not by the loanable funds markets (bond markets). Thus, based on PK, inflation is not a monetary phenomenon but a result of "cost plus pricing" of potential firms in the market. Another issue of the PK theory is that savings are determined by investments and not the other way round, because of the role that credit-money (bank money) plays in the economy.

Within the Post Keynesian tradition there are three views: Accommodative, Structuralist, and Horizontalist view. They share the same ideology that money supply is endogenous, but the difference rests on the intervention of CB and the role of commercial banks. To start with, the Horizontalist view defends the thoughts that interest rates are determined exogenously and causality runs from money to reserves. This means that if spending and investments increase then the demand for loans will rise also. The deposits that are created require new reserves by increasing money. Thus, the CB accommodates the extra demand for money for enabling the financial system to be liquid. Furthermore, as a Horizontalist, Moore, stated that when the loan is provided, it will generate unit per unit rise in the money supply.

According to the ISLM model, the Accommodative view is recognized by the horizontal LM curve because the level of loans determines the level of money. Hence, the banks fully accommodate loans demanded at the interest rate determined by the CB.

Structuralist view maintains the position that LM is positively sloped and there is no need to accommodate all the loans. CB does not decide the interest rate but it is determined endogenously, because the high levels of lending can congestion the market. The liability and asset management can diminish this block, although it causes the loan/deposit rates to rise. Consequently, the theory argues that monetary aggregates are determined endogenously, because of the failures of CB to control the supply of money. Meanwhile, the monetary authorities have to target other tools such as interest rates, inflation, and prices. However, based on the

different economic thoughts and on the three views of the PK, there is a need to investigate the existing theory arguing: Is money Supply Endogenous? Which of the views is appropriate for the chosen countries?

County Analysis Albania

The empirical evidence will be based on the accessible data and will focus on Albania by supporting the PK tradition.

If there is a large increase of capital inflows, then this will increase the number of loans by the commercial banks. Hence, with an undeveloped financial system, the increase in lending generates speculative attacks, which affects the supply of money, and causes a reduction of economical reserves. Furthermore, in the case of financial crisis, the increase of money produces inflation by raising the prices of assets and not of consumer products.

This was the case of Albania from the year 1998 until 2012, when the foreign investments were high and public investments too. The level of credit was increased very much, even though the interest rate for credit was high. Also, the deposits were high too because of the politics of banks for collecting the savings of people. In Albania there are 17 commercial banks and because of competition it was a duty for each bank to dominate the market and to have the larger share in territory. The two big banks in Albania were very aggressive in lending and collecting deposits (Raiffeisen Bank and National Commercial Bank of Albania).

Hence, the goal of the research is to analyze and to illustrate the role of CB and commercial banks in relation to money supply.

During '80s, Albania has a fixed exchange rate with the American dollar but after year '91 when the transition period began, the changes brought crisis that could be not be handled with that regime. Hence, the monetary authorities reacted positively by implementing a floating exchange rate regime. This regime allowed the currency to fluctuate and to stabilize the chaos in the economy. As a consequence, the Albania lek was depreciated by making possible the increase in competitiveness and exports. Nevertheless, Albania during the first years of transition had a large fluctuation of the exchange rate, but damages to the financial system were low, since its financial sector was undeveloped and it was only a commercial bank (The Saving Bank of Albania). During the year 1996 and 1997 there were new foreign banks that entered in the Albania market.

During the year 1997 Albania suffered from a civilian war because of the pyramid schemes that operated for three years. All the governmental institutions were destroyed and the state did not function for 3-4 months. On 2002, Albania reached stability and foreign investments start to flow in the country. Many important

investments were done from 2002 until 2014. The public and private sector faced a positive period of time; growth and investment was the primary word at that time.

Although, Albania did not escape the crisis of Europe and especially the Greek one. Crises in this country came as a result of high public debt. The banking system passed a very serious crisis because the biggest part of the debt was held by banks. Since Albania is a neighbor country, the crisis was reflected in the Albanian economy. The main investors in Albania are Greeks and Italians. Due to the crisis, the foreign investors left Albania. Unemployment rose to 24% and many people. Many business and people, who had a loan, did not have the possibility to pay the loan.

Furthermore, the Albania government changed the taxation system on January 2014, from flat to progressive taxation. The new system obliged businesses and people to pay more on income. Hence, many businesses and people did not declare the real income to the state, by increasing the fiscal evasion, up to 60%. So, the crisis was a consequence of Greek crisis and mostly of unsuccessful taxation policy.

Albania experienced a GDP growth of 7% from 2005-2012 and after this period the growth decline until it reached 1.7% at the first trimester of 2015. Inflation is very low, about 1.7% and the business credit toward economy is in very low levels. The credit level is increased for consumers. The capital flows, are volatile and in support of literature, it is suggested that if the variance is large then authorities can implement policies for controlling the flows, then stabilizing the current account deficit would be very difficult.

The fluctuations of the exchange rates and prices in Albania are controlled by the central bank since the businesses and financial institutions learned from the past speculations. However, a slight devaluation of the Albanian lek helped the country to increase slightly the exports.

Another important factor was that Albania banks did not give loans outside Albania and the Albanian banks or government did not buy the Greek debt, thus the crisis did not affect directly the country. The main part of the banks' credit portfolios are short-terms. The financial products are priced correctly and the domestic commercial loans are given based on the CB regulations and collaterals were secure. Moreover, the credit expansion and quality were approached based on the macroeconomic standards.

METHODOLOGY

The study is a cause-effect research by studying the effects of borrowing loans from businesses on the money supply. The Post Keynesian Theory states that the money supply is determined by the economic activity. Hence, the number of loans borrowed from the

commercial banks creates the same amount of deposits on the other side of balance sheet, thus this cycle affects the M^s , ($\Delta L \rightarrow \Delta M^s$). The study uses a quantitative method because it will test the hypothesis if the data will support the PK in Thailand and Australia.

The transmission channel shifts from the borrowed loans to the creation of deposit and then the effect passes into the money supply. The volume of money supply is determined by the demand for loans. Hence, the CB accommodates the demand for money by changing the M^s . Consequently; the study will run a model, which will include the variables that affect the money supply based on the PK theory. The model will be performed by using an E-view Package, by testing the relationship of the dependent variable (M^s) with the independent variables (L, D, E, I) in the short-run. The variables should be stationary, which means that the mean and the variance of these variables move in the same direction over time. The Unit Root Test confirms the stationary of the series by testing the First and Second Difference. If the variables are not stationary in the short-run, then Cointegration Analysis is necessary, in order to test if there is a relation of series in the long-run. Cointegration Analysis establishes the long-run equilibrium of the variables.

The data that will be used are taken from the Bank of Albania and World Bank. Semiannually data from 1995 until 2014 are translated from volume into the logarithm form. The limitation of the study consists on the data, which are taken from internet sites and there is a limited access to them. Thus, based on the dependent and independent variables the mathematical model consists of:

$$\text{Money supply} = f(L, D, E, I)$$

Hence, from the mathematical model, the Econometric Model can be written as:

$$M_t^s = \alpha_0 + b_1 L_t + b_2 D_t + b_3 E_t + b_4 I_t + \varepsilon_t$$

Where M^s = money supply

L = the volume of loans from commercial banks to enterprises

D = the volume of deposit in the commercial banks

E = exchange rate movement towards the US dollar (\$)

I = inflation

ε_t = error term (possible errors that might occur during the regression)

α = the coefficient of the model,

β = the coefficients for each variable

Economic theory suggested that loans are positively affected with the money supply. Thus, an increase/ (decrease) of the loans from banks to the businesses will

bring an increase/(decrease) of the money supply. Deposits are negatively affected, thus, an increase/(decrease) in deposits will bring (decrease)/increase of the moneys supply. Exchange rate is not defined because the devaluation or appreciations of the exchange rate generate unexpected results. Inflation will be also included because of the need for finding the real value of money. Inflation is positively related to money supply because if inflation increases then more money are demanded to cover the loan installments.

Based on the literature, the developing countries (Albania) rely heavily on the government policies; hence the CB is the authority to control and to supply the money. While, in developed countries the financial system is more stabilized and developed, the CB has the power to set policies for targeting other variables (i.e., interest rates, inflation, and prices) and not money since the money is determined by the economic activity and the banking sector.

CONCLUSION

For several decades the problem of understanding money has been a key issue. Monetarists, as mainstream economists stated that CB plays a key role in economy and it has the power to control the money supply by influencing the monetary base and reserve requirements. However, after 1980s, deregulation and financial liberalization brought fundamental changes, so targeting the money supply was not the right tool. The Post Keynesian Theory got more attention during this period because of the different standpoint in the determination of money supply. The Post Keynesian Theory is a school of Keynesianism, which aimed the endogeneity of money supply as a result of economic activity. Endogenous money is determined by the banking sector, because the level of lending affects the demand for money, hence the Central Bank is required to accommodate this change in demand. Furthermore, within the PK theory there are three views: horizontalists, accommodative and structuralist view. These have the same believe on the endogeneity of money, but they treat the role of CB differently, which based on the ISLM model affect the slope of money supply.

Hence, Albania as the case country reflected the outcome without generalizing it in other developing countries. From the literature, the CB plays an important role in the determination of money supply in developing countries, because of the undeveloped financial sector, while in developed countries financial sector and the economic activity determine the supply of money. However, the results are unique for each country, because the period of study and data are limited. The result from the investigation shown that credit is strongly linked with deposits and money supply is determined by

the banking sector through lending. People prefer to deposit when the interest rate is high, but the Albanian CB decided to reduce to base rate, in order to stimulate the credit. This brought a decline in deposits by 0.3% - 0.5% from 2013 to 2014. The credit business level (April 2015: 556.7 mld Lek) is lower than the previous year by 1 mld Lek and money supply is on critical levels. Economy needs stimulation to start growing and crediting the businesses.

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