

## Shkëlqim Cani: The monetary programme of 2004 - its cohabitation with the fiscal policy

Discussion by Mr Shkëlqim Cani, Governor of the Bank of Albania, in the Parliamentary Commission of Economy, Finance and Privatizations, Tirana, 15 December 2003.

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### 1. 2003 in figures

The Albanian economy during 2003 seems to have returned to its potential growth rates, leaving behind the deceleration of 2002. Various indicators generally point out that the economic growth forecast for 2003 - of **about 6 percent** - is a real opportunity. Developments such as: stability in the agricultural production, the positive performance in the branches of services, industry and transport, the increase of the trade transactions volume verified in the first 6 months of the year, the greater number of tourists, the stable and favourable energy situation, stability of remittances and other factors, are reliable arguments in achieving the economy growth objective.

2003 is believed to mark another year of the consumption price stability. As in the 3-4 previous months, **the Bank of Albania's expectations speak about an annual inflation rate within the target interval of 2-4 percent**. According to the latest data, the **12-month difference of consumption price index by the end of November 2003, marked the figure of 3.4 percent**, while the annual inflation, calculated as the average of the last twelve months, reached the level of **2.24 percent**, reinforcing thus its clear downward trend.

The Bank of Albania - in its recent analyses - has been underlining the fact that its monetary policy has been a careful, financial, budgetary policy, where special emphasis has been given to the budget expenditures control versus the realized revenues ratio. Consequently, the government's liquidity needs, up to the present moment, have been completely covered by the banking system, and therefore, the Bank of Albania financing was unnecessary. Under these circumstances the fiscal pressures on the monetary policy are weak. Following this reasoning, it could be concluded that the move of both policies (monetary and fiscal) has been in harmony and in conformity with the general economic-financial development program of the country.

**Domestic budget deficit financing from the banking system during 2003 is estimated to be almost at the same level as the one of 2002, being about 2.2 percent of the GDP.** The stable level of the internal government borrowing, facing the rapid increase of Lek deposits, was another factor, which influenced the immediate reduction of treasury bills interest rates.

The monetary policy of 2003 has continued to be careful, characterized by smoothing tendencies. This is reflected in the reduction of interest rates three times throughout the year. Watching attentively the inflation performance and the liquidity indicators in the banking system, the Bank of Albania reduced, all in all, the Repos rate by **1.5 percentage points** during 2003, bring it by the end of October at the pre-crisis liquidity level of the previous year.

The real interest rates in positive terms have not changed the attitude of households and agencies in depositing their savings in the banking system. This helped keeping up the liquidity ratios in the system. Monetary developments show that the deposits hemorrhage of spring 2002 has been completely overcome, which is reflected in a liquidity surplus of the banking system, fluctuating round the level of Lek 5.3 billion during 2003. Worth underlining is the fact that, the surplus liquidity brought about the reduction of financial intermediation costs, expressed in the reduction of the difference between the treasury bills and Lek deposits interest rates.

**Also, considering the appreciating tendencies of Lek during 2003, the Bank of Albania has been present in the foreign exchange market. The foreign exchange activity of the Bank of Albania resulted in the injection of Lek 3.9 liquidity billion, in the market.** However, considering the surplus liquidity performance in banks, the Bank of Albania sterilized the foreign exchange purchasing effect. It performed outright selling of treasury bills from its portfolio, at a value of Lek 4.07 billion. The rest of the surplus liquidity was withdrawn through the repurchase agreements. In support of the economy growth, this year seems to have marked a greater support towards the economy crediting. **Banks' credit portfolio for the private sector of the economy increased by Lek 10.1 billion during the first 10 months of the year. During this period, a new credit of Lek**

**70.6 billion (USD 660 million) was extended to the economy, or 45 percent more than the same period in the previous year.**

Based on the developments noticed during the first ten months, on the current developments of the banking system liquidity, etc., it could be summarized that monetary developments of 2003 will be a greater contribution to the consolidation of the overall macroeconomic equilibrium of the country. In order to have a clearer view of the expected economic situation by end of 2003, following is given a table showing the general indicators of the country's economic development, including here the monetary ones as well.

Table 1: General economic indicators

	1996	1997	1998	1999	2000	2001	2002	2003*
Real growth of the GDP (in %)	9.1	-10.3	12.7	8.9	7.7	6.8	4.7	6.0
Number of employees (in thousand)	1,116	1,107	1,085	1,065	1,068	920.5	920	927
Unemployment percentage	12.4	14.9	17.8	18.2	16.8	16.4	15.8	15.2
Inflation percentage (y-o-y)	17.4	42.1	8.7	-1	4.2	3.5	2.1	3.0
M3 aggregate growth	44	28	21	22	12	20	6	9.5
M3 aggregate velocity	1.82	1.72	1.92	1.73	1.64	1.51	1.58	1.66
MoB growth	14	52	-6	19	22	20	10	-3.3
New credit to the economy (Lek billion)	7.4	3.98	5.8	8	24	40.6	62.6	70.6
Lek deposits (Lek million)	72,831	89,495	130,940	158,326	165,261	186,211	193,886	223,500
Budget deficit (in % of the GDP)	-11.4	-13.2	-11.3	-11.9	-9.1	-8.3	-6.2	-4.6
Domestic debt (in % of the GDP)	30.7	36.18	35.12	36.31	41.01	39.42	38.49	39.1
Current account (in % of the GDP)	-11.5	-12.03	-6.12	-7.34	-7.1	-6.1	-8.9	-8.5
Internal debt (in % of the GDP)	29.2	33.2	31.8	29.1	30.2	28.2	24.9	23.7
Average exchange rate lek/usd	104.5	148.9	150.6	137.7	143.7	143.48	140.15	123.1**
Average exchange rate lek/euro				146.9	132.58	128.5	132.4	137.9**

Note:\* The GDP calculation is made by INSTAT with a different methodology, only for 1996-2000.

\*\* 2003 average until November 2003.

\* Almost all the 2003 data are forecasts.

Source: INSTAT, Ministry of Finances, Bank of Albania and IMF estimations.

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As a conclusion, I would like to underline once again that the Bank of Albania does not make its policy decisions separately, but following carefully all the developments of the economy, and this is really important for the public to understand. As it is now a tradition, the monetary policy of the Bank of Albania is part of the general economic development program of the country. As such, it can't be but a range of decisions and measures, which in good harmony with the other policies, the fiscal one, etc.,

aim at economy growth and reduction of the poverty in the country. The coordination of monetary and fiscal policies could be achieved in the mid-term development program of the country, a program covering a three-year time span. The extensive logic of this program gives a crucial importance to keeping up macroeconomic stability. Keeping up macroeconomic stability serves as a bridging gap between the monetary policy and the fiscal one. Hence, the monetary policy is committed in keeping up price stability, whereas the fiscal one controls the budget deficit. These macroeconomic indicators are strongly related to one another: fulfilling each of them requires, as a basic condition, the observance of the other objectives. Following this idea and backing it up in figures, please allow me to shortly through a glance back in the past.

The soundness of the Albanian state in these last years, the economic growth and amelioration of the tax and customs entities performance, enabled the reduction of the budget deficit. This deficit fell from 11.4 percent of the GDP in 1998 to 6.9 percent in 2002. In 2003, it is expected to fall at the level of 5.8 percent of the GDP, whereas the draft-budget for 2004 has an even more ambitious objective: the reduction of the general budget deficit at the level of 4.8 percent of the GDP. This fiscal discipline has given its own results. It influenced the reduction of treasury bills interest rates, bringing about an overall reduction of interest rates in economy. The reduction of interest rates and the government's demand for funds gave a greater respiration to economy crediting. It has extended more funds - at lower interest rates - to be used by the public sector. According to the data provided by the Bank of Albania, economy crediting increased at an average of 90 percent per year during 1999-2002. ***On the other side, the reduction of the Bank of Albania's financing to state budget, gave positive impacts on the liquidity indicators in the system. Now the long-term monetary assets gave a straightforward contribution on keeping inflation at low levels. Inflation fell from 8.7 percent in 1998 to 2.1 percent in 2002. In these last three years, it was within the interval of 2-4 percent, as targeted by the Bank of Albania.***

## **2. Monetary program of 2004**

Pursuant to drafting and implementing the monetary policy, the Bank of Albania designs each year the monetary program, which is a financial plan aiming at disciplining the funds circulation in economy, in conformity with the development objectives of the country. The main objective is meeting the needs of the economy for monetary assets, without influencing the balance of demand-supply for monetary assets, generating thus inflation or shrinking the economy.

The monetary program of 2004 has also been set up on the same premises. Its not a secret the fact that in the coming year as well, as in the previous ones, the two main decision-making institutions of the country in the field of economics and finances, the Albanian Government and the Bank of Albania, have agreed upon the general objectives of the country's development, including also the so called harmonized cohabitation between the fiscal and monetary policies. This process, albeit all, was part of a constructive consultation with institutions such as IFM and the WB, enabling thus a new financial agreement between these two institutions for 2004.

Table 2. Main macroeconomic indicators<sup>1</sup>

	2000	2001	2002	2003	2004
<b>Real economy indicators</b> (in point percentage)					
GDP growth	7.8	6.5	4.5 - 5	6.0	6.0
Annual CPI (average)	0.0	3.1	5.2	2.3	3.0
Nominal GDP (Lek billion)	539.2	590.2	678	745	823
<b>Fiscal indicators</b> (in percentage versus the GDP)					
Fiscal deficit	-8.9	-8.2	-6.9	-5.8	-4.8
<b>Monetary indicators</b> (in percentage point)					
M 3 Growth	12	19.9	7.0	9.5	10.6
3m TB Interest rate	7.8	8.0	10.6	7.6	

## 2.1 Inflation and monetary policy in 2004

The monetary policy of the Bank of Albania during 2003 was characterized by easing trends of the monetary conditions, in compliance with the lessening the inflationary pressures and improving the monetary indicators. The Bank of Albania took up the implementation of an easing monetary policy since April 2003 reducing the core interest rate by 0.5 percentage point. In July and October 2003, there were two other reductions by 0.5 percentage point each, bringing the core interest rate at the level it was at the beginning of the previous year. At the end of November 2003, the core interest rate was 7.0 percent; the annual inflation rate for that month was 3.4 percent, whereas the average annual inflation by the end of October was just 2.24 percent.

The Bank of Albania has been present in the foreign exchange market throughout 2003 by buying foreign exchange. The foreign exchange activity of the Bank of Albania helped in injecting liquidity in the market and it has smoothed the Lek appreciating tendencies during the year.

The forecasts for the main trends and inflation for 2004, suggest that the Bank of Albania should apply a similar policy in 2004, too. Developments in the consumption prices are characterized by low inflationary pressures. Our forecasts show that the inflation target of the Bank of Albania will be met during 2003. In case no shock phenomena emerge, inflation will be under control also for 2004. Besides, the expectations on the economy seem to speak about an inflation level sticking to the present one. Liquidity ratios and structures seem to be near their historic levels, whereas interests rates were characterized by downward trends during 2003. Therefore, the Bank of Albania might reconsider the possibility of a further reduction of interest rates, a possibility consisting in the future performance of the monetary and inflationary indicators. This will be in support of the economic activity or inflation target. Judging from the analysis of actual trends, we could say that interest rates during 2004 will be generally stable or in downward trend.

The analysis of monetary indicators for 2004 shows that the Bank of Albania is going to be present in the foreign exchange market so as to impede the further appreciation of Lek. Judging from the monetary indicators of these recent years, we notice that Lek supply (M2 growth) in the internal market has been declining due to the lack of government's privatization incomes, which the Bank of Albania converted in Lek by injecting liquidity in the market. The reduced Lek supplies, together with its increased demand (due to the high interests rates of financial assets in Lek during 2003), have been exercising pressures on the Lek appreciation during 2003.

<sup>1</sup> Foreign sector forecasts belong to June 2003.

### 3. Main suppositions of the monetary program of the Bank of Albania for 2004

In designing the monetary program for 2004 particular attention was given to the Bank of Albania's target, that is **keeping up the annual inflation rate within the limits of 2-4 percent**. In hitting this target, the monetary program aims the control of money supply growth so that the level of real monetary assets responds to the real needs of the economy for a **6 percent economic growth**. The economy demand forecast does still rely on the quasi-constant velocity forecast of money circulation. This forecast, judging from the nominal GDP level, is the bridging gap between inflation and money supply growth (intermediate objective).

The monetary program guarantees the observance of quantitative objectives set by the Bank of Albania, the level of NDA and NIR of the Bank of Albania within the limits and the control of government's domestic borrowing **at the level of 2.7 of the GDP**.

#### 3.1 Money supply and its constituents

Money velocity is forecasted to be relatively stable during 2004. This assumption is based on keeping up the monetary developments trends of 2003 even for 2004. Thus:

- Inflation is expected to be within the target of the Bank of Albania
- Interests rates are expected to be stable or in downward trend
- The government demand, which is also the main source of requiring funds, is expected to be at the same level, 2.7 percent of the GDP
- The growth rate demand for the economy is expected to be almost the same as the 2003 one.

Based on these considerations, the M3 circulation velocity - as to trimesters - is presented as follows:

Table 3. Money circulation velocity in 2004. (GDP as to trimesters\*100 / M3)

Dec '02	March	June	September	Dec '03	March	June	September	Dec '04
42.9	43.9	43.9	42.9	42.9	44.1	43.3	43.2	43.1

Based on this forecast, the money supply is expected to grow by 10.6 percent or by Lek 47.4 billion.

##### 3.1.1 Money supply constituents

The ratio of money outside banks versus the money supply noticed during 2003 is not expected to undergo significant changes during the coming year. However, an upward trend of the foreign currency deposits ratio versus M3 is expected, bringing about a decrease of the Lek deposits weight versus money supply. Foreign currency deposits are expected to have a considerable annual increase, of about 18.2 percent, or Lek 17.7 billion, by the end of 2004.

Table 4. Money supply growth as to trimesters (in Lek billion)

	T1	T2	T3	T4	2004
Money supply	10.9	11.0	11.5	14.0	47.4
Money outside banks	1.7	3.1	3.2	6.9	14.9
Lek deposits	4.1	3.6	3.7	3.4	14.8
Foreign currency deposits	5.1	4.3	4.5	3.7	17.7

Generally, the M2 aggregate growth will follow the performance of the economy demand for monetary assets. This demand is expected to higher in the first trimester of the next year.

Table 5. M2 and monetary assets demand growth (in Lek billion).

	T1	T2	T3	T4	2003
Deficit financing	7.2	4.2	3.6	5.0	20.0
Credit to the economy in Lek	0.5	0.5	0.5	0.5	2.0
Foreign currency reserve growth	0	1.8	2.4	1.2	5.4
<b>Sum</b>	<b>7.7</b>	<b>6.5</b>	<b>6.5</b>	<b>6.7</b>	<b>27.4</b>
<b>M2 growth</b>	<b>5.8</b>	<b>6.7</b>	<b>7.0</b>	<b>10.2</b>	<b>29.7</b>

Achieving equilibriums of monetary indicators and the reduction of the core interest rate down to the levels of early 2002, are expected to provide the normal growth of the M1 aggregate. Demand deposits in Lek are forecasted to be slightly higher in the coming year. However, the strongest impact on the M1 aggregate growth will be the growth of money outside banks. Money outside banks is forecasted to increase by Lek 14.9 billion in the next year. *Money outside banks ratio versus money supply is assumed to be round the level of 28.0 percent.* Such a forecast is based on the fact that this ratio has generally appeared as an equilibrium level in the Albanian economy. Also, the forecast for a stability (or fall) of interest rates, gives a greater back up to this assumption. However, considering the historic trends, this ratio is expected to have an upward trend in the last trimester of the year.

Money outside banks performance according to the monetary program will also enable the observance of NDA objective of the Bank of Albania. Taking it for granted that the NIR performance of the Bank of Albania will stick to the program, the forecasted NDA realization would be as follows:

Table 6. Net Domestic Assets Objective (in Lek billion).

	December '03	March '04	June '04	September '04
Objective	93.1	80.1	82.1	84.1
Forecast <sup>2</sup>	77.0	78.7	82.5	84.7
Difference	-16.1	-1.4	-0.4	-0.6

The annual increase of Lek deposits is forecasted to help meeting the economy demands for domestic monetary assets from commercial banks. The Lek deposits increase in the next year is forecasted to be Lek 14.8 billion, while the demand for monetary assets in Lek of the government and that of the private sector is forecasted to be Lek 14.5 billion. This will provide a stable situation of liquidity in the banking system during 2004.

The banking system is forecasted to meet completely the needs of the private sector for loans in Lek as well as the demand of the government for deficit financing up to **62.5 percent of the total financing of Lek 20.0 billion.** *The Bank of Albania might finance up to 5 percent of the average government revenues in these three last years, or nearly Lek 7.5 billion.* As a result, borrowing or investment of free funds of second-tier banks at the Bank of Albania will ease the misbalance effects between the demand and supply for domestic monetary assets on the liquidity performance during the year.

<sup>2</sup> Forecasts on the NDA and NIR objective growth during 2004 are based on the growth of gross foreign currency reserve by USD 45 million and the growth of the reserve money by nearly Lek 17.9 billion until the end 2004.

Table 7. Liquidity performance during 2004 (in Lek billion).

	T1	T2	T3	T4	2004
<b>M2 growth</b>	5.8	6.7	7.0	10.2	29.7
Money outside banks	1.7	3.1	3.2	6.9	14.9
Lek deposits	4.1	3.6	3.8	3.3	14.8
Deficit financing from the Bank of Albania	1.9	1.9	1.9	1.9	7.5
Deficit financing from banks	5.3	2.3	1.7	3.1	12.5
Credit to the economy	0.5	0.5	0.5	0.5	2.0
Borrowing from the Bank of Albania <sup>3</sup>	1.9	-0.8	-1.4	0.3	-/-

### 3.2 The demand of the economy for monetary assets

#### 3.2.1 Currency position of the banking system

Net foreign currency assets of the banking system for the next year are forecasted to increase by nearly Lek 8.6 billion or 5.1 percent from the previous year. The increase of NFCA of the banking system will mainly come due to the increase of net foreign currency assets of the Bank of Albania, which will increase by Lek 7.1 billion. This is a 7.2 percent increase of the NFCA as compared to the 2.2 percent increase forecasted for 2003.

The forecasted increase of foreign currency reserves of the Bank of Albania during 2004 *at the level of Lek 5.4 billion* will be the main source of the NFCA increase. Denominated in foreign currency, this increase is **USD 45 million**. Most part of this increase is expected to be the outcome of the foreign currency purchase from the Bank of Albania.

Table 8. The difference as to trimesters of the gross foreign currency reserve of the Bank of Albania. (USD million)

December 2003	T1	T2	T3	T4	December 2004
973.8	0	15	20	10	1018.8

The remaining part of **Lek 1.7 billion** is expected to come from the increase of the commercial banks reserves at the Bank of Albania.

Net foreign currency assets of commercial banks will increase by *Lek 1.5 billion, or 2.2 percent*. The NFCA increase of commercial banks is forecasted to be at a low level, despite the annual increase by *Lek 17.7 billion of deposits in foreign currency*. From this sum, nearly Lek 14.5 billion are expected to be used in financing the private sector borrowing, while the remaining part will raise the commercial banks reserves at the Bank of Albania.

#### 3.2.2 Credit to the government

During 2004, the internal borrowing of the government in covering the budget deficit is forecasted to be *Lek 22.6 billion*, while privatization is expected to cover nearly *Lek 2.8 billion*. Participation from

<sup>3</sup> Borrowing from the Bank of Albania is presented in a positive sign; investment of free funds by the Bank of Albania is presented in negative.

institutions and households in the treasury bills market has demonstrated upward trends in the last two years. In the coming year, their deficit financing is expected to reach the value of Lek 2.6 billion. **Budget deficit financing from the banking system in 2004 is forecasted to be Lek 20 billion or 2.3 percent of the GDP.**

*The law provided the Bank of Albania to finance the budget deficit up to the level of 5 percent of the average budgetary government revenues during these three last years. In absolute value, this limit is estimated to be Lek 7.7 billion.* The monetary program for 2004 forecasts that the Bank of Albania financing of the budget deficit will be Lek 7.5 billion. This financing by the Bank of Albania is necessary in covering the budget deficit, considering a small growth of the M2 and Lek deposits. The monetary program forecasts that the increase of Lek deposits during 2004 will be sufficient in covering the other part of Lek 12.5 billion of the deficit financing from the banking system.

The following table shows the allocation as to trimesters of the budget deficit financing for the banking system.

Table 9. Allocation of the budget deficit financing (Lek billion).

	T1	T2	T3	T4	2004
Banking system financing	7.2	4.2	3.6	5.0	20.0
- Bank of Albania	1.9	1.9	1.9	1.9	7.5
- Commercial banks	5.3	2.3	1.7	3.1	12.5

The Bank of Albania financing is assumed to be the same throughout the four trimesters, providing thus the financing performance from commercial banks according to the demand forecasted by the government. However, the allocation of the Bank of Albania financing may undergo potential changes depending on the liquidity performance of the banking system from one trimester to the other.

### 3.2.3 Credit to the economy

The business needs for borrowing to support their businesses have been growing in these recent years. The same tendency is expected for 2004, too. **Credit to the economy for the next year is forecasted to increase by Lek 16.5 billion.** Compared to the credit balance increase in 2003, this one is nearly **Lek 3.6 billion, or 28 percent higher.**

The credit to the economy forecast is based on its performance during the last nine months. Albeit the high-level of liquidity during this year, the credit balance increase was lower than in the previous years. In the next year, the credit balance increase in Lek is expected to keep the same rates, marking an annual increase of **Lek 2 billion** in absolute value.

Foreign currency credit increase is expected to be nearly **Lek 14.5 billion**, or 88 percent of the total increase of the credit to the economy. The difference between the credit interest rates in Lek and those in foreign currency is assumed to be one of main reasons of the slow increase of credit in Lek. Moreover, the high level of the banking system liquidity during 2003 does not seem to have influenced the increase of the credit balance in Lek.

The higher increase of the credit balance to the economy forecasted for 2004 is based on the upward tendency of private sector financing needs. *Meanwhile, the forecast for a small increase of Lek 2 billion, or 12 percent of the Lek crediting, is based on higher interest rates of Lek rather than foreign currency crediting.*

The assumption to approach the crediting interests rates in Lek and in foreign currency, would also alter the forecasts on the credit balance increase, for the respective currencies in the future.