

Ardian Fullani: Economic outlook and important developments in Albania

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at The Economist's Conference – First Business Roundtable with the Government of Albania: Identifying new business opportunities, Tirana, 14 September 2006.

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Honorable Chairman, Distinguished Participants,

I am very pleased to be here today to share and discuss with you our views, future macroeconomic and financial market developments and outline our policy orientation. I was looking forward to converse to this forum. It is a great opportunity that such well known institution, focus their attention toward Albania. I would like to thank The Economist Conferences and express my deepest and highest appreciation for this venture.

I am confident that members of all communities, foreign and domestic, gathered here today will leave this forum with a clear image on the economic reality and business opportunities Albania has to offer. Assisted by geopolitical conditions and actual state of affairs, although small at a glance, Albanian economy presents numerous financial and economic advantages and incentives.

Recently Albanian economy has reached a commendable macroeconomic equilibrium, sustained by an economic growth of 5-6 percent, low inflation levels well contained within a 2-3 percent band, and continuously shrinking budget deficits. It is my pleasure to emphasize that the Bank of Albania and its policy has been rightfully credited and earned accolades by established foreign and domestic institutions for its notable role in such accomplishments. Monetary policy has been designed and implemented in line with midterm country's macroeconomic program: with specific focus on price and financial stability

Let me now briefly summarize what I believe are the latest most important developments, and outline our economic outlook.

Economic growth

After the significant electricity shortages at the end of 2005, it appears that traditional growth promoting industries like services (tourism) and construction are growing at a stable pace, contributing at a sustainable economic growth. Building upon these developments as well as other positive indicators, we expect the economy will grow at a solid rate of 5-5.5 percent. The main challenge remains ensuring sustainability of these growth rates, even higher in the long run. I believe that respective Albanian authorities have already identified the major priorities of these challenges which fully converge with Bank of Albania views. Just to remind you I would briefly summaries some of these priorities. Building new, preferably alternative, energy sources and improving the efficiency is top priority. In our view, sufficient and reliable energy supply remains a main concern to achieving economic growth. Providing a solution to this problem is a priority in the verge of increasing global demand and energy prices. Speeding up the privatization process of the remaining state assets is another important step forward. Special attention should be paid to structural reforms, particularly property rights and legal framework. In our opinion services, construction and in particular agriculture will remain driving forces of the GDP growth in the coming years.

Therefore I would strongly agree with any initiative that encourages FDI's in these sectors through attractive laws and other measures. I believe FDI's are very important for providing long term stability of the foreign sector. Moreover the productivity growth that usually follows FDI's inflows will play e significant role in reducing current account deficit. Our economy needs more foreign direct investments hence Country Credit Ratings constitute a chief priority for our economy.

It is my belief that FDI's represent a regional rather than an individual challenge for the South East Europe. Countries in the region must coordinate their efforts toward creating a regional market. Regional infrastructure projects will significantly increase attractiveness and competitiveness as well as international financial market awareness toward our region. It will improve confidence and provide necessary economic incentives to enter in the region leading to higher FDI's inflows for each economy.

Inflation

Our economy has experienced a relatively long period of stable prices. Annual inflation figure as measured by the consumer price index, for the last 12 months is reported at 2.4 percent. Both monetary and fiscal policies have been important factors in keeping inflation low. However, recently inflation pressures have accelerated. The fast growth of credit to economy, the steep increase of oil prices, administrative increase of energy prices, as well as other risks have the potential to create inflationary pressures and pose risk to elevate inflation expectations. Bank of Albania will take all necessary actions to ensure an inflation rate of 3 per cent with a tolerance band of ± 1 percent, in the short and long run.

Interest rates

During the recent years interest rates have dropped reflecting the ease of monetary policy. This has been a general trend for all financial assets either in Lek or foreign currency. On average banking system applies 9.7 percent for loans in domestic currency. The yield of 12 month Government securities dropped at a minimum of 5.74 percent in June 2006. However, following the last decision of the Bank of Albania and latest trends in global markets, a modest increase in interest rates has been observed during the last three months for both domestic and foreign financial instruments. We expect this trend to persist within the next 6-12 months.

Banking system

The Albanian banking system continues to expand. It is solid, consolidated and fully capitalized. The system consists of 17 banks, of which only 3 are entirely domestically owned. Banking network has been extended continuously including remote areas. Banking products increased in number and improved in quality. Entrance in the market of important European financial groups created a better competitive environment and further enhanced efficiency. The expansion of lending portfolio and more competitive lending rates has deepened financial intermediation. Latest data show that in June 2006, the assets of the banking sector reached 60 per cent of the Albanian Gross Domestic Product (GDP).

Rapid changes in the banking system in light of credit boom, and global market financial integration impose the need for higher standards of transparency, accountability and governance from the banking system itself. Not only with regard to Bank of Albania, but public as well. Banks should behave responsibly and must integrate the stability of the entire system into their utility function.

Financial system reforms

Since years the banking systems has been in a constant process of transformation. The Financial Sector Assessment Program (FSAP) marks a significant moment in this process. On behalf of the Bank of Albania I would like to thank IMF and WB, for their excellent efforts on this professional and transparent financial certification of the Albanian Financial System.

Bank of Albania remains very much focused in fulfilling the recommendations of the FSAP following the priority and institutional hierarchy.

- Bank of Albania has increased the access and investment opportunities of commercial banks in the securities market.
- The draft on Banks Law is completed.
- Automated clearing house system is operational.
- The number of electronic transfers has increased significantly. There is concrete evidence that shows a continuous reduction of cash economy.
- Bank of Albania has extended its supervisory authority over all non-bank financial institutions that operate within the economic territory of the Republic of Albania.
- Supervisory Board of the Bank of Albania has further increased the transparency of its decision making process. Minutes are released regularly and Bank of Albania website provides fresh info on daily activity.

- There is significant progress on establishing the Credit Information Bureau. We hope by the end of next year that will be fully operational.
- Last but not the least I would stress out that we have already presented a detailed action plan for the remaining part of the FSAP recommendations.

Honorable participants,

Designing and implementing monetary policy has become more challenging. Globalization in particular has exposed our economy to foreign shocks. In addition policy actions of ECB and FED, exert their impact on Albanian economy mainly due to high extend of currency substitution.

Rapid growth of lending activity is the most notable development among domestic factors. According to our figures over the last two years credit to economy has expanded by an equivalent of 10-12 GDP percentage points. At this rate it is expected to reach 18-20 percent of GDP at the end of current year. Is worth mentioning that approximately 30 percent of the outstanding credit represents consumer credit, moreover 75 percent of the outstanding stock is loaned in foreign exchange currency.

This represents a very important development and deserves scrupulous attention. Our main concerns relate to inflationary pressures and non-performing loans that such credit expansion might generate.

In the light of these developments Bank of Albania assessed that existing stance of monetary policy was not providing enough stimulus to curb aggregate demand. Therefore in July 2006 Bank of Albania decided to shift the course of monetary policy by raising the base rate (7 days repo rate) with 25 basis points. We are happy to observe that market is reacting following our decision. However based on our short term inflation forecasts and in presence of several risks, some of which I already explained above, Bank of Albania perceives that inflation pressures for the next 12 months remain elevated. Currently we are cautiously evaluating the extend of market response and assessing whether further action is needed.

Simultaneously Bank of Albania is becoming increasingly concerned regarding the quality of loan portfolio. The accelerated pace of credit expansion, is posing challenges to both banks and to supervisory authority. The response to these challenges will aim at achieving macroeconomic stability, by means of a well capitalized banking system. With this goal in mind, the Bank of Albania, as the supervisory authority, has intensified the dialogue with the banks in order to find an adequate consensus for: setting realistic objectives of annual activity growth; containing the credit expansion and maintain good credit portfolio quality; strengthen the internal control and risk monitoring systems; and monitor carefully the capital indicators.

I would like to use this floor to emphasize that Bank of Albania will be very firm to follow strictly all requirements that derive from the law and regulatory framework. On our part, we will make the necessary modifications in the supervisory and regulatory framework that target the above mentioned issues with a realistic and flexible approach. The sole purpose of this conformist approach to supervisory rules, is to provide a cushion for avoiding potential future disturbances in the financial stability.

Finally I would like to strongly emphasize for all business community, households and all other economic agents that Bank of Albania will make all efforts to ensure and further consolidate the general macroeconomic equilibrium in Albanian Economy, with specific role on financial stability.

I believe that business community comprehends this important mission. Bank of Albania intends to be vocal regarding its prospects for economic developments, so that none of its actions should come to you as a surprise. Therefore I invite you to interpret our signals fairly and smoothly integrate them into your decision making process. I would like to remind you that our medium term agreement with IMF and focused policy orientation toward EU and European Exchange Rate Mechanism (ERM) provides additional collateral for our pledge.

Thanking The Economist Conference for giving me this opportunity I am open to take questions and share comments.