

Ardian Fullani: Bank of Albania – progress during 2006

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the “Round Table on Target Inflation 2”, Tirana, 8 December 2006.

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Ladies and gentlemen,

I want to conclude this Round Table by thanking you all for your contributions. We are really happy that you came to Tirana for discussing the monetary policy strategy of the Bank of Albania. This Round Table on Inflation Targeting was an excellent follow-up of the Open Forum. At the Open Forum last year in December we globally discussed the many preconditions for Inflation Targeting. During these two days of the Round Table, yesterday and today, we went far deeper on these complex issues. These issues need to be solved before the Bank of Albania can put a fully fledged Inflation Targeting regime into place.

At this Round Table we have discussed the progress that the Bank of Albania has been making during 2006. One of the discussed topics was the econometric modeling and forecasting. The Bank of Albania uses now a reliable analytical framework that provides information useful to the monetary policy decision making. Under Inflation Targeting more information would be needed about the expected inflation developments in the future.

As laid down in the central bank law, the primary objective of the Bank of Albania is to achieve and maintain price stability in Albania. For keeping prices stable we need to be able to forecast the development of prices in the future. Our current econometric models provide us information about these future developments. Our internal studies show now that the Bank of Albania is able to make reliable forecasts.

We also discussed the consequences of situations where the consumer price index increases, let us say, more than 3% at an annual basis. This may for instance happen due to higher electricity prices, or higher oil prices. These energy prices are a main share of our daily expenditures. Therefore, they are a main share of the total basket of consumer prices for the “average” Albanian household. However, the focus of our discussions was the analyses of the further impact on the Albanian macro-economy.

Higher prices will lead to a lower purchasing power. Households will buy less in case of a price increase, under the condition of unchanged household income. Then, if many households in Albania start consuming less, the Albanian economic growth will suffer. The Albanian production will slow down due to the overall lower demand for goods and services.

This process can take some time. But, anyhow, each economist will agree that strong increases in prices are bad for the economy. A high inflation, that is another way of saying a strong increase in prices, will harm economic growth.

The Bank of Albania aims at an average increase of the consumer price index of 3%. The Bank of Albania will set the interest rate for keeping expected price increases to 3% plus or minus 1 percentage point. It has built a macro-econometric model with all these channels that transmit monetary policy in the Albanian economy. The main purpose of the model is to analyze the reaction of prices, private consumption and business investment and so on, in reaction to changes that may take place. We call these changes in analytical terms “shocks” to the economy.

Our macro-econometric model is promising. Very promising. But for building econometric models we need statistics. Albania has statistics, but we need better statistics. For the year to come, the Bank of Albania wants to improve the statistical framework. The Bank of Albania needs better statistics, I said. With “better” statistics I mean here “more” statistics, “reliable” statistics and “user-friendly” statistics.

We need to measure all macro-economic developments in the economy better. And we need to keep track of these developments. Our Albanian history is still short. We only have time series for about 15 years. In time we will logically have longer time series. Our time series need to become timely available and they should be fully understandable.

Inside the Bank of Albania we can work more on statistics. In the year 2007 the Bank of Albania will improve its own database on monetary and financial statistics, and on the balance of payment

statistics. But, for other statistics we depend upon our national statistical office, INSTAT. We also depend on other institutions for providing us with relevant information.

Next to the broadening and deepening of the statistical framework the Bank of Albania will improve upon its communication with the public. We discussed during this Round Table the transparency of the Bank of Albania. We concluded that significant progress has been achieved.

But next to transparency, the Bank of Albania wants to improve upon the information that it provides to the public. The Bank of Albania aims at making monetary policy understandable to everybody. We know already that money matters. The more money we possess, the more we can buy, and the more our economy will grow. The more our economy grows, the more people can share. Poverty will be reduced. But what about monetary policy?

We all know that higher wages or lower prices are beneficial for our personal pockets. The higher the wages, or the lower the prices, the more we can buy. But for the Albanian economy as a whole, there is a flipside. This flipside is inflation.

More spending will lead to higher prices in the medium to long term. And these higher prices, I can also say "higher inflation", is damaging for the Albanian economic growth. For this reason the Bank of Albania safeguards price stability. Our main task is to keep prices stable. In order to do so, we set the main interest rate.

The Bank of Albania wants to communicate better on all these monetary policy issues. It wants to explain the monetary and financial benefits at the micro and at the macro level. It wants to explain better why it is aiming for an inflation rate of 3%. The communication strategy of the Bank of Albania is to explain the working of the monetary policy issues and its own tasks, to you all.

The understanding of the public is needed for a good conduct of Inflation Targeting. Credibility has to be gained. As said before, a solid statistical framework is also indispensable. Reliable statistics can tell us about the past and the present. On the basis of this, the Bank of Albania can use its econometric models to forecast the future. The Bank of Albania can conduct monetary policy, and can target inflation better, in case of better forecasts.

We can stress the preconditions. But the fulfillment of all preconditions for Inflation Targeting depends also on others in the Albanian economy. Under Inflation Targeting, the monetary policy aims at a precise inflation target in the medium term. The Bank of Albania can only reach this target in case the interest rate setting affects the deposits, credits, private consumption and business investment, GDP, like in a developed market economy. Only in this case can monetary policy be effective.

Therefore, some preconditions for putting full fledged Inflation Targeting in place can not be met ONLY by the Bank of Albania. They depend upon the development of the Albanian economy, they depend upon the provision of statistics by INSTAT and others, they depend upon the understanding of the public. They also depend upon other key players like the Ministry of Finance and they depend upon the efficient working of the financial markets. Other preconditions for Inflation Targeting can partly be met by the Bank of Albania.

The full implementation of Inflation Targeting can therefore take place ONLY conditionally.

One can compare this situation with the tailoring of a suit for a special occasion. Let me make this comparison.

One can find a good tailor and ask him to make a suit for a special occasion. All measures can be taken, such as the length of the arms and the length of the legs. The suitable materials can be found. One needs the appropriate fabric, in the appropriate color. Upon all these preconditions of (1) the good tailor (2) the precise measures (3) suitable materials, the tailor can start the tailoring of the suit.

But, there is still no guarantee that the suit will fit you perfect. Or, it may happen that you look appealing in the tailor-shop, but not at the day of the special occasion. For instance, the temperature may have fallen so that you need an additional coat, or even a different fabric. Or, the environment of the special occasion may make you look overdressed. You tried to make it perfect, but the environment is lagging behind. Factors that you could not influence yourself can make you look different from how you had wished to look with the new suit. Conclusion: The suit is not suitable, or better, the suit is not (yet) suitable.

For this reason we have to try the tailored suit regularly. All preconditions for Inflation Targeting need to be checked and re-assessed on a regular basis.

At this Round Table we discussed econometric modeling, statistics and communication, also the legal framework, the internal governance at the Bank of Albania and the arranged agreements with the Ministry of Finance and INSTAT. During this year we drafted the new Banking Law. This law increases customer protection, sets the legal grounds for credit information registry, introduces new rules for risk administration, bringing more confidence in the banking system as well. With the assistance of the IMF legal department we revised the agreement with the Ministry of Finance. These agreements were standardized to emphasize the role of the Bank of Albania as fiscal agent. Moreover this agreements aim at creating a cooperative and partnership environment. We remain committed to further increase cooperation with major governmental agencies to ease their proper understanding of monetary policy process, its implications and the need for harmonized and coordinated policies.

Concluding I would like to underline that we are carefully evaluating the degree to which these preconditions are met before shifting to fully fledged inflation targeting in the medium run. Such strategy will further increase the effectiveness of the monetary policy in Albania further consolidating the price stability and contributing to sustainable economic growth. We will re-assess all preconditions regularly through these types of meetings with foreign professionals. In the meantime we are establishing a professional dialog among central bank, INSTAT, Ministry of Finance and other government institutions.

Once more, ladies and gentlemen, I thank you very much for your contributions. I wish you a safe return back to your home countries.