

Ardian Fullani: Summary of the latest macroeconomic developments in Albania

Address by Mr Ardian Fullani, Governor of the Bank of Albania, to the meeting "The banking system over 2007: the Governor communicates with the market", Tirana, 26 March 2007.

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Distinguished participants,

Considering the today's meeting of a special importance in line with our institutional tradition and intensive communication with the general public, particularly with the main market stakeholders, I would like to thank you for your participation. I think that such meetings further increase the degree of mutual understanding, aiming at enhancing the financial market efficiency.

Allow me to start my address, making a brief summary of the latest macroeconomic developments. Likewise in 2005, the Albanian economy, even during the last year, continued its path towards macroeconomic consolidation. The country's GDP is estimated at 5 percent growth in real terms. This growth has been associated with price stability, denominated in an average annual inflation of 2.4 percent. The monetary conditions, characterised by historically low interest rates and a stable exchange rate, have favoured the rise of investments and consumption in the economy. Particularly, they have been reflected even in the rapid credit growth, further sustaining the economy growth.

The fiscal developments have resulted within the programmed levels, contributing to further consolidation of the public finances and to budget deficit control.

The extension of the country's economic activity has been associated with increased foreign trade exchanges. The balance of payments for 2006 has recorded positive terms, sustaining the exchange rate stability.

From the BoA's monetary policy viewpoint, I would like to underscore that year 2006 coincided with a change of the previous direction. Initially in July and later on in November 2006, the BoA's Supervisory Council rose key interest rate by 0,25 pp, leading it to 5,5 percent, from 5 percent at end of June 2006.

The Bank of Albania decisions were a **reflection** of a number of risk factors, whose presence constituted a potential risk on the long-term inflation performance, which, I re-emphasise, from the legal viewpoint, **constitutes our primary objective**. The Bank of Albania is confident that its decisions were appropriate and they have served to orient inflationary expectations within the target range.

End-2006 and first quarter of 2007, as well as current inflation forecasts indicate that we have been successful in this direction. However, I avail myself of the opportunity to re-emphasise that we remain totally committed to successfully monitor the current developments and the implications they may entail in future development. Our focus will continue to be the control of inflationary pressures in the economy.

To this end, I would like to attract the banking system attention to a new project of the Bank of Albania, which is going to assist us a lot in this regard. Our researches, the business and consumer sentiments do not succeed in attaining appropriate dimension under the conditions of lacking the financial market expectations on inflation, exchange rate and key interest rate. In the near future, a new requirement will be made to the banking system, having to do precisely with what I previously said: **Which is the bank's expectation on inflation, exchange rate and repo rate in the short and long run**. Personally, I consider it as a new challenge for the banking system; therefore I would insist that the whole banking system should deal seriously with this problem, to timely incorporate scientific analysis and research centres into its organisational structures.

I am confident that the banking system has already understood that, inter alia, it is just the time for such institutions to pay attention to developments of the economy, intensifying the analysis on current and future developments.

Another issue I will deal with in this address is the monetary policy decision-making perception and implementation. Given the current stage of financial market development in Albania, high level of euroization and other objective and subjective factors, I would say that the monetary transmission efficiency is not yet in the parameters of the developed financial markets. The currency market is still

concentrated; its specific segments are characterised by insignificant trading volume and high volatility.

Effective liquidity management is an important element for us, which, as in other central bank, goes beyond a mechanic management of excess liquidity withdrawal or injection in case of shortage. By managing the liquidity, we have aimed at implementing the monetary policy decisions made by the Bank of Albania Supervisory Council to the market. Liquidity management intends controlling short-term interest rates, keeping them in line with monetary policy decisions. Concretely, the frequent use of other instruments, besides the main instrument of the Bank of Albania, reflects the Bank of Albania's determination in terms of controlling short-term interest rates.

I would also like to point out that preventing or solving situations of liquidity shortage or excess are not sufficient for achieving the liquidity management goal by the central bank; the effective liquidity management should ensure its smooth re-allocation among banking system operators. As a result of liquidity concentration, this would reduce the short-term interest rate volatility.

In this framework, in 2007, the Bank of Albania will start the application of a new Regulation "On repurchase and reverse repurchase agreements" which will bring about a novelty on interventions for a more effective distribution of banking system liquidity.

This development of the regulatory framework will foster the repo market among commercial banks. It will contribute to the establishment of a more active inter-bank liquidity market and more active liquidity management by commercial banks. Not only the information but also the real time of its transmission is of unquestionable importance to the financial market. In this context, I would like to emphasize that though the central bank has the necessary statistics to estimate the banks' positions and their operations, we expect from them to work more for enhancing the transparency in this regard.

To encourage banks in terms of enhancing the transparency, the Bank of Albania has provided to the system the Regulation "On calculating fixed interest in interbank currency market", whose application shall be of importance not only to the Bank of Albania, but also to commercial banks for active liquidity management. In the same line, the central bank, through its active participation in the "Dealers Association" is supporting even the creation of a code of conduct for interbank relationships, which is deemed to lay another stone to market development in Albania.

As I mentioned above, the political decision-making of the Bank of Albania is forward-looking. From this viewpoint, I would require from the banking system to adopt the same philosophy: "React today to prevent undesirable events in the future! **As Alain Blinder has stated: "Frequently the decision-makers only look through the window and make case decisions, based on current circumstances"**". Therefore, the banking system should adopt the same philosophy for assimilating and factorising the Bank of Albania's decisions into the short- and long-term operational strategy.

Another issue is an argument, which given the importance and the current stage of the economic-financial development of the country, assumes an extremely high importance. The financial stability has become a central topic of current practical-academic debate. I would like to bring to your memory the regional conference of the Bank of Albania organised in October of the last year related to this issue. While the debate continues for determining a number of qualitative and quantitative indicators to measure the vulnerability of the economy, I would like to attract your attention to a higher attention we jointly should pay in this direction.

The macroeconomic stability is of primary importance, but without doubt, even the **financial stability is of the same vital importance**. We should not forget that the segment represented in this audience constitutes the most developed and regulated part of the whole financial sector. The banking system in Albania has been transformed into a promoter of the country's economic sustainability, by extending funds to the economy. At the same time, the variety of financial products it supplies is being increased year on year.

At end-2006, the banking system was presented in a good financial position. Its assets were to ALL 624.3 billion, or about 25.7 per cent more than in end-2005. The banking system deposits have amounted to ALL 520.3 billion, reaching 20.2 percent on annual basis. The loans portfolio is estimated at ALL 197 billion, 55 percent higher than year-end 2005. About 28 percent of the loans portfolio has been extended in ALL, while the rest in foreign currency. At end of 2006, the loans portfolio quality resulted to 3.05 percent. In December 2006, the capital adequacy ratio was 18.1 percent; while the banking system profit was ALL 7.45 billion. Return on assets was 1.36 percent, whereas return on equity was 20.2 percent. It is my pleasure to observe the increased number of branches and banking agencies and the ever increased geographic covering of the territory with banking services and

products. The entry into the market of distinguished European banks is another accomplishment of the last year, which is expected to continue even during the current year. Being driven by competition, banks have been more aggressive in lending, using new segments of the lending market, such as consumer credit or real estate loans.

In spite of what I mentioned earlier, it does not mean that we are automatically immunized against various risks, which may occur from one moment to the other. Furthermore, the rapid credit growth is an argument for more prudence, particularly in terms of its quality. Being completely aware for our role as a decision-making and regulatory institution, we have decided to raise our vigilance in this direction. We will create a specialised unit, i.e., the Financial Stability Department, as a first step.

The safeguarding of the banking and financial system stability will be given a new dimension relating to the policy of licensing the conduct of banking business by the Bank of Albania. Once more, the Bank of Albania emphasizes its objective related to licensing and the presence of sound institutions in the banking system: which are backed by influential and experienced shareholders in the banking industry; which apply the best standards of accountability in management; which conduct a balanced business with well-administered risks; which are able to cope with and develop under the competition provided in an open and integrated market into the international financial market; which boost the country's economic development and which, transparently provide to the public qualitative and efficient banking products and services.

The Bank of Albania is confident that only financially stable banking institutions guarantee the foundations of a financial market, which develops dynamically and which is able to avoid systemic financial crises. Therefore, the Bank of Albania sustains and encourages the process of transformation and consolidation of the activity of banking institutions. They naturally come to help the banking institutions which are faced with difficulties during their own activity and others which intend to expand the business through a more effective use of ample financial sources.

In this framework, the Bank of Albania, based on the new banking system law, cooperating with other financial market authorities, will work for enriching and stratifying this market with efficient financial institutions specialised in financial activities, which sustain the banking activity and ensure a better covering of the population needs with financial services.

Regardless of the above, I think that the system should be more committed to this direction. Banks, particularly those that are more active and of systemic importance, should set up and strengthen their risk management structures, mainly in terms of market risks (interest rate and exchange rate), credit risk and operational risk. This implies not only the ensuring of human capacities, but also the establishment of necessary systems of information and technology. This process should not be considered as a cost-advantage relationship in material level and in the short run, but as an indispensable process, which hedges the bank from risks, which, under certain market conditions, may be intensified, resulting to fatal circumstances.

While the supervisory attention is focused particularly on large banks that are of systemic importance, the same importance is assigned even to small banks, which are faced intensively with the consequences brought about by enhancement of market competition. In view of this, the Bank of Albania requires from the management of these banks to act quickly for protecting their business. The necessary operations should intend the qualitative improvement of banking services to the public, development of joint projects with larger banks and with other financial institutions inside the country and abroad, establishment of a more suitable work environment and provision of necessary promotions to their staff. In the meantime, their boards of directors and shareholders of these banks should strengthen the monitoring and should be ready for a larger financial support for the bank's activity.

In particular, I would like banks to be cautious with regard to:

- The continuous monitoring and controlled conduct of lending activity, focusing on setting realistic development objectives, on the exposure to related persons, exposure to foreign currency – in particular, to borrowers with insufficient financial assets in foreign currency, exposure to new loan products, such as consumer loan, etc. It is crucial for banks to rigorously observe the lending and loans' quality analysis procedures. Moreover, they should maintain a conservatory stand, in terms of being insured with pledges and collaterals, and of providing for reserve funds, required in cases of non-performing credit risk. In this context, the Bank of Albania expects commercial banks to duly observe the final amendments made to the regulation "On managing credit risk".

- The consolidation of internal control systems of their activity, in view of the adoption of best accounting standards in management, as well as the careful formulation and analysis of financial statements by the banks' structures and their internal and external auditing. With regard to the latter, we are under the process of enhancing the reporting system, by shortening the reporting time of the financial data, periodically reported by banks to the Bank of Albania. We think that banks should qualitatively improve the method of preparing and reporting these data to the Bank of Albania. These issues will be the topic of discussion in a special meeting to be held in the near future.

From the legal viewpoint, the issues related to the conduct of a safe banking business have been addressed at a higher level, in the new law "On banks in the Republic of Albania", passed by the Albanian Parliament on 18 December 2006, and becomes effective on 1 June 2007. Some of its important amendments are the following: a more complete addressing of banking business supervision issues, including the organization, the risk monitoring, the provision of prudential supervision norms, the clarification of procedures related to the management and liquidation, the inclusion of some general principles related to the client's protection (consumer of banking products) etc. Following the notification sent by the Bank of Albania on January this year, the banks should speed up the steps to duly and timely carry out the necessary changes in their internal procedures, which ensure the complete consistency of their business with the requirements of the new law.

I take this opportunity to draw your attention in terms of applying the legal requirement for the observance of international financial reporting standards, starting from 2008. This is an issue banks belonging to European Union banking groups are more prepared for. However, these banks, and in particular other banks not availing of this opportunity, should co-operate with external auditing companies, in order to define the concrete measures to be taken in their activity for the observance of this legal requirement.

Dear participants,

I believe today's meeting is a good opportunity to communicate with one-another; therefore, I invite you to keep on exchanging effective ideas and thoughts. On behalf of the institution I represent, I would like to reassure you that the Bank of Albania remains fully committed and accountable in fulfilling its legal mission, capable and willing to loyally co-operate with any institution or stakeholder influencing on the country's economic and financial development

Thank you.