

Fatos Ibrahimi: Macroeconomic developments and the characteristics of the Albanian financial system

Speech by Mr Fatos Ibrahimi, First Deputy Governor of the Bank of Albania, at the Crans Montana Forum "The Albanian banking system in front of the international financial crisis", Tirana, 27 March 2009.

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Dear participants,

Let me start by thanking the organizers of this meeting, for enabling this joint discussion regarding the status of our financial sectors and the measures which are necessary to sustain its resistance to the negative effects of this unprecedented global crisis. Indeed, what started as financial crisis in the US, has transformed itself into an economic crisis, that is having dire consequences in real sectors of the world economy. The hope is that, like earthquake bands, the magnitude of the crisis effects will fade out as it widens and is confronted with measures taken by countries to resist it.

I will start by describing the main macroeconomic developments of our economy and the characteristics of our financial system. Then I will mention some of the related measures taken by Bank of Albania, in its role as the monetary and supervisory authority of the country, and our expectations for the foreseeable future.

Our economy has been in a solid path of growth for the last decade, with an average annual growth of around 6 percent. It has benefited from economic reforms that have provided development opportunities for our business sector, have opened markets, have increased competition, have stimulated flexible labor markets and have increased social revenues. Both fiscal and monetary policies have been cautious in providing the necessary stimulus to the economic growth, by being consistent and disciplined in the pursuit of their objectives to achieve fiscal consolidation and ensure a low-inflation environment. The size of the annual budget deficit in relation to GDP has been between 3 %, leaping to 5.7 % for 2008, while the public debt has been stable, reaching up to around 55.6 % for 2008. The annual inflation growth rate has been for a long time within the corridor defined by the Bank of Albania of 2 - 4 percent (and close to the Bank of Albania target of 3 percent), indicating success in anchoring market participants expectations for price developments in the economy. This steady good economic performance has been supported by a flexible exchange rate that has been instrumental in supporting and maintaining a balanced growth, by maintaining the right incentives for interaction between domestic and foreign counterparties.

Fundamental changes have occurred in the financial sector too, thanks to consistent and successful reforms in the last decade. Nowadays the banking sector in Albania counts 16 banks, all in private hands, where the foreign capital dominates. During time, the banking sector has increased the number of branches, has improved its products to the public and has increased its intermediating role to provide an important contribution in the economic development of the country. At the same time, the entrance of well-know European banking groups from Austria, Greece, Italy and France, has been associated with consolidation in the banking industry. As it is the case in the entire region, the banking sector dominates the financial sector in our country.

Our supervisory work aims at adopting the best international standards in the field. As a result, our legal and regulatory framework is considered to be consistent in achieving our objective of a stable and sound development of the banking activity, and is continuously improved. From the practical aspect, we combine both regulatory and risk based supervision.

The data reported from the banking sector are analyzed off-site and verified on-site. We also try to stay in close contacts and cooperate with foreign supervisory authorities, as an important instrument in improving the effectiveness of the supervisory work.

Nowadays, the assets of the banking sector represent around 87 percent of the country's GDP. Loan portfolio has reached around 37 percent of GDP. Due to increasing competition after the privatization, its growth has been very strong in the last 4 years, albeit starting from a low base. Deposits represent around 80 percent of the banking sector liabilities, and the loan/deposit ratio stood at around 62 percent. Hence, the banking sector relies heavily in domestic deposits, both in national and foreign currencies, to perform its lending activity. The foreign currency position of the banking sector is quite balanced, as assets and liabilities in foreign currency stand respectively at around 49 percent of total assets, and liabilities of the banking sector to nonresidents (almost entirely in foreign currency) is only 10 percent of total liabilities. The banking sector is well-capitalized and liquid. The capital adequacy ratio stands at around 17 percent, compared to the required minimum of 12 percent. Liquid assets to total assets, is at around 43 percent. In the last 4 years, the average return on equity has been above 20 percent while the average return on assets has been around 1.5 percent. The branch network of the sector counts around 350 branches all over the country. In the last three years mainly, the banking sector has also introduced modern payment infrastructure and products, to allow for increasing usage of electronic payment cards and internet banking.

Despite solid performance in the last years the Bank of Albania has been vigilant to point out areas of the banking activity, related with domestic developments that required attention from the banking industry. Until before the appearance of this international financial crisis, we have expressed our concern regarding the rapid increase in lending which, until 2007 reached up to 8-9 percentage points in terms of annual growth to GDP. The composition of the loan portfolio, which is dominated by the euro dominated loans, is also a point of concern, although this position is supported by a strong presence of foreign currency denominated liabilities in banks balance sheets, a generally supportive environment of exchange rates and interest rates over time and very close trade links to Euro-area countries like Italy and Greece. In this regard, Bank of Albania has been consistent in its approach to introduce regulatory measures that would discourage rapid increase in lending, encourage banks to lend more in domestic currency and increase transparency toward clients on banks products and services.

Since the middle of last year, Bank of Albania has been vocal in its concern regarding the indirect impact of the financial crises, in particular regarding the performance of the real economy. We pointed out risks to economic growth related with a potential decline in credit from the banking sector, an increasing trade deficit (due to a slowdown in exports), a sharp contraction of remittances (due to perception of lower wealth and increasing unemployment in the developed countries). We stated that at these times, there is a much stronger need for a careful monetary policy and responsible fiscal policy. When it comes to the monetary policy, we have been careful in maintaining incentives for promoting savings in local currency assets and anchoring expectations for low and stable inflation rates. From an operational perspective, over the second half of last year, the Bank of Albania took a number of measures:

- strengthening the surveillance of financial market developments, and in particular of the banking sector;
- strengthening bilateral and multilateral meetings with bank representatives, asking them for increased vigilance due to current international market conditions;
- increasing contacts with other domestic institutions that regulate and monitor the financial markets, in particular with the Authority of Financial Market Supervision;
- increasing the number of publications, including the Financial Stability Report 2007 (Sept.) and the Statement on Financial Stability (Oct.), which try to analyze the

elements of the crisis and its potential effects on Albanian Banking Sector and the economy;

- increasing the presence in the Media, to explain the crisis, to clarify the position of our banking sector toward the potential crisis effects, and to maintain public confidence in the banking sector;
- changing and improving the reporting framework of banks, in particular regarding their exposure to international markets (and the mother-banks) and their liabilities (deposits and exposure to credit lines) from mother-banks);
- reviewing our “back-up” plans to assess the possibility of new actions, should we encounter a worsening scenario;
- changing the form of our open market operations and starting to execute “open amount/fixed price” weekly reverse repurchase transactions and longer maturity ones, to better suit the liquidity needs of the banks.

When it comes to cooperation with the home countries, we have very much appreciated their measures to enhance the safety of their banks, as this provides a sense of financial infrastructure security in our host-countries as well. We believe that these measures will be adjusted to a developing environment, and will be instrumental to also target some of the concerns of the host countries related with: a) the importance of maintaining reasonable flow of funds in euro from the headquarters of the banking groups toward their foreign subsidiaries, both for liquidity and lending support; b) the importance of gradually steering the lending portfolio of their foreign subsidiaries toward local currency of the host countries.

Events of the second half of 2008 have shown us the importance of having a balanced economy and a solid financial and banking sector. Despite the increasing effects of the international crisis, the economy showed a solid growth, in an environment of declining inflationary pressure. Impact of the international crisis started to materialize in the last quarter of the year, as shown in developments of the balance of payments and in the banking sector balance sheet. Indeed, a fall in external demand and a rise in unemployment rates in some of the EU neighbor countries caused a decline in the remittances and in exports. In addition, public sensitivity to (sometimes unbalanced) news on international crisis developments, increased the uncertainty about the safety of their savings in the banking sector, and caused some deposits withdraw. In spite of this, due to satisfactory levels of capitalization and liquidity, the banking sector coped well with such developments. In terms of general developments, the banking sector asset annual growth slowed to 12 percent, compared to 19 percent of the previous year. In addition to a decline in loan growth, the loan quality also worsened and non-performing loans reached 6.6 percent of total loans. But the comfortable ratio of loans to deposits still supported a solid annual credit growth of around 35 percent. The financial result of the banking sector for 2008 was positive but lower than the previous year due to a slowdown in profit-making activities. The exchange rate of the domestic currency was stable over the year and with depreciating tendencies versus the euro and the American dollar over the first quarter.

In relation to expected domestic developments for 2009, we expect economy to face greater challenges. Economic growth will be positive, but almost half of what was in 2008. The planned fiscal stimulus will be harder to reach, due to potentially higher difficulties in realizing revenues and in providing other sources for financing the expenditures. Hence, there might be a need to prioritize fiscal expenditures over the year. Financial intermediation of the banking sector, to the public and the private sector, could be lower and potentially with higher cost, due to supply and demand factors. Due to tighter financing conditions, businesses and households are expected to undergo a painful but necessary adjustment process in the short term. This might prove to be beneficial in terms of efficiency gain in the medium term. Inflation may temporarily go under the corridor of the Bank of Albania, but is expected to be within the corridor for most of the year. Monetary policy will make sure that proper incentives

to hold local currency denominated assets are maintained and that inflation expectations are kept anchored at the target of Bank of Albania. This is expected to also be important in maintaining adequate financial intermediation capacity in the medium term. The profitability of the banking sector is expected to be lower this year, due to lower volume of the profit-making activities (lower credit supply/demand), potentially higher financing costs and increasing provisions for non-performing loans. But this is not expected to have a substantial effect on capital adequacy and liquidity indicators. More than sufficient capitalization and liquidity parameter of the banking activity will protect the stability of the banking sector and of the financial system going forward.

While the international crisis is impacting every country, the magnitude of the impact will depend on length of the international crisis and the state of that country's economy. Expectations for the recovery of the world economy, somewhere between end of this year – beginning of next year, if materialized, will remove the uncertainty and the psychological boost will likely support the sense of earlier and stronger economic benefits. In spite of the difficulties ahead, it is deemed that the position of the Albanian economy and of our financial system is balanced and capable of withstanding the impact of this international crisis. In this effort, our economy will find support in factors related with the flexibility of the real sectors and of businesses, the appropriate level of some macroeconomic indicators related with fiscal and monetary areas, the stability of the banking sector and the very limited exposure to nonresident's assets and liabilities, the ability of the public authorities to maintain fiscal and monetary discipline and to act in a decisive and harmonized way to support economic growth.

Thank you!