

Ardian Fullani: Economic and financial developments in Albania during 2008

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the presentation of the 2008 Annual Report to the Parliamentary Commission of Economy and Finance, Tirana, 8 April 2009.

* * *

Honourable Mr. Chairman of the Commission,

Honourable Ladies and Gentlemen,

It is my pleasure to be among you again in this annual meeting. The Bank of Albania considers this forum not merely as a fulfilment of its legal obligation, but also as an opportunity for enhancing its transparency and accountability.

I will present in my speech an analysis of the Albanian economy over the past year and a summary of Bank of Albania's work on the fulfilment of its legal mission and other commitments in view of strengthening the safety and raising the efficiency of the Albanian banking system. Also, availing myself of the opportunity of this public communication, I would like to share with you our views on the challenges the Albanian economy is faced with and the right path for their solution. The Bank of Albania deems that the addressing of these challenges should be in the centre of attention and a top priority for economic policies.

Preceding the conclusions of Bank of Albania's analyses, I would like to emphasise right from the beginning that the country's economic activity has performed on sound bases. The Albanian economy has fulfilled a number of prerequisites for having a stable and long-term economic growth, giving primary importance to macroeconomic stability of the country. However, in the presence of current challenges the Albanian economy is being faced with, these bases should be safeguarded and further strengthened, compiling appropriate economic policies by relevant authorities and reviewing the economy agents' development plans.

1. Performance of Albanian economy during 2008

Allow me to make in the following a brief retrospective analysis on the performance of the Albanian economy during 2008.

Global background

The world economy experienced a constant deterioration throughout 2008. The world economic growth moderated to 3.4 percent in 2008, from 5 percent it was in the preceding four-year period.

The most striking 2008 highlight was the financial turmoil and its spread to the real economy. The complex nature of derivative financial instruments, employed at most in the latest years, raised uncertainties about assessment of certain institutions' exposure to financial instruments qualified as toxic. This uncertainty shifted into lack of confidence and termination of financial market operation, impeding the smooth operation of the lending system to the economy. Under these circumstances, the real economy was instantly affected by the lack of funding for consumption and loans, leading developed countries to recession. High inflationary pressures over the first half of the year, conditioned by strong economic growth and reflected in price hikes of oil and raw materials, were significantly dampened during the second half of the year. Monetary and financial markets have experienced a great volatility. Risk re-evaluation in financial markets was associated with securities price cut. Also, interest

rates, exchange rates, stock prices and trade volume were obviously volatile, depending on market news and on the perceived risk of the situation.

Economic growth

Against this turbulent global background, the Albanian economy has had a comparably positive performance. Expecting confirmations from official statistics, the Bank of Albania deems that the country's economy has grown in line with the year-start projections. This growth has reflected the dynamic development of some sectors of the economy, supported by increased consumption and investments and constant structural and infrastructural improvements in the economy.

Economic growth of the country has been sustained mainly by strong domestic demand, which remains the main generator of economic growth. Consumption, investments and government spending increased over 2008. External demand in the form of exports increased rapidly during the last years, but it still remains at low levels for sustaining the country's economic growth. The country's economic activity has been financed mainly from domestic sources. Due to its high liquidity during 2008, the banking system has been able to respond to the economy demand for funds through increased financial intermediation. The banking loan portfolio increased by 7.3 percentage points of GDP during 2008.

The economic activity at home was presented in two different pictures during 2008, significantly affected by international market developments.

Official statistics indicate a significant growth in the economic activity volume during the first nine months of the year, reflected in a higher turnover indicator and an increase in credit volume, in budget revenues and in external trade volume. The overall turnover indicator, which is a proxy of the value added in the economy, increased on average by 17% during the first nine months of the year. The highest annual growth rates were noted in construction and trade, while industry, transport and communication present a slowdown of the growth rate compared to the previous year. The last quarter presented a qualitatively different picture of economic developments. Under the influence of the global economic and financial turmoil, the economic activity showed signs of slowdown, while monetary indicators underwent considerable volatility.

The country's economic activity slowdown during the fourth quarter of the year was signalled by a number of indirect indicators, such as: deterioration of the economic trend indicator, resulting from the processing of business and consumer opinions about the current situation of the economy and their expectations; decreased remittances and export slowdown during the second half of the year; and curbing of lending activity during the last quarter.

Consumer price inflation

During 2008 the Bank of Albania fulfilled its legal obligation for maintaining price stability in the economy. Consumer price inflation has fluctuated within the Bank of Albania's targeted rate. Annual average inflation rate settled around 3.4 per cent for 2008, being close to Bank of Albania's target of 3 per cent and within the 2-4 per cent tolerance band of the Bank of Albania. The controlled inflation rate reflected Bank of Albania's appropriate monetary stance and policy. The right monetary policy led to balancing of the demand and supply factors and anchoring of inflationary expectations around the Bank of Albania's target.

Inflation behaviour has not been uniform during 2008. High domestic demand and the shocks from the global economy, in the form of high prices of primary commodities, were reflected in high inflationary pressures during the first half of the year. The annual inflation peaked at 4.6 percent in May, recording the highest inflation rate over last 5 years. These high inflationary pressures were clearly reflected in the increase of core inflation and of non-tradable goods, which are also synthetic indicators of inflationary balances in the economy. The easing of supply shocks and the slowdown of the domestic demand during the last quarter of the year

were accompanied by a gradual fall of inflation rate, down to 2.2 per cent in December. This fall reflects a better balancing of the domestic demand and supply, and lower imported inflation rates.

Balance of payments and external sector of the economy

Year 2008 was characterised by a significant growth of economic and trade exchanges. Domestic demand is reflected in the growth of both, the trade deficit and the current account deficit during 2008. The current account deficit is estimated at 14.9 per cent of GDP, mainly affected by rapid growth of imports and a decline of remittances during the second half of the year, due to increased spill-over effects of the economic and financial crisis on the neighbouring countries' economies. The trade deficit accounted for Euro 2.4 billion, being 13.1 percent higher than in 2007. However, foreign currency capital inflows have been sufficient to contribute to closing of the balance of payments with a positive result for 2008. Foreign reserves of the Bank of Albania increased by about Euro 192 million or by 0.9 percentage points of GDP.

In macroeconomic terms, the high deficit on trade account signals high levels of consumption and investments in the economy, financed from foreign savings in the form of capital inflows. In a longer-term analysis, Albania's current account deficit is a normal phenomenon in the context of the country's development level. Especially positive is the fact that the major share of the country's imports is represented by imports of machinery and equipments and that of intermediate consumer goods. However, current account deficit widening is an element that should be constantly monitored, since its financing sources are not always steady and necessary corrections for the current deficit compliance with the available funds for its financing are frequently difficult. Macroeconomic policies should be prudent to ensure long-term sustainability of the balance of payments, as one of the principal aspects of the macroeconomic stability and long-term growth of the country.

Fiscal policy and indicators

Fiscal policy is one of the main instruments for stimulating and controlling the economic activity. Due to its weight, the public sector is a significant generator of the economic activity and a determinant of the financial conditions of the economy, of interest rates, of the exchange rate, and its liquidity.

During 2008 fiscal policy was more expansionary, thus being reflected in enlargement of the budget deficit and of the public debt.

During 2008 budget deficit to GDP reached 5.7 percent, being expanded by about 2.2 percentage points in a per annum basis. Public debt level amounted to 55.6 per cent of GDP, from 52.2 per cent in the previous year. Budget revenues and expenditures increased respectively by 15.3 and 22.6 percent during 2008, accounting for 27.3 and 32.9 percent of GDP.

Improvement of public debt management in terms of extending maturity time-length and diversifying the financing sources is a positive highlight, which has helped to refinance the debt and control its cost impact on debt indicators. However, the Bank of Albania deems that the fiscal policy should not distract attention from maintaining long-term stability of fiscal indicators and minimizing their impact on financial markets. Fall of budget deficit during 2009 and the commitment for drop of public debt in the long run should be constant priorities of the fiscal bodies. In line with that, the Bank of Albania deems that more endeavours should be made in order to improve the expenditures structure, in view of decreasing the share of current expenses and increasing the capital investments.

Monetary performance

Due to the slowdown noted in the last quarter, the pace of monetary expansion decelerated slightly relative to the previous year. The average annual growth rate of M3 eased to 12.3 per cent, down from 15.8 per cent in 2007. Growth of monetary assets of the economy is attributed mainly to banking system credit growth. The degree of financial intermediation in the economy further increased. Banking system deposits to GDP amounted to 80 percent during 2008, compared to 78 percent for 2007. Credit to GDP amounted to 37 percent, recording an annual growth of 7.3 percentage points.

During 2008 deposit developments were characterized by seasonal volatilities. Deposits level recorded high growth paces mainly in summer and an obvious slowdown in the last quarter of 2008. On the asset side loan portfolio of the banking system for the economy increased by about 35 per cent during 2008. The credit structure performance revealed a slight shifting of the loan portfolio towards foreign-currency-denominated loans. The preference for foreign currency-denominated loans is attributed to their lower interest rates. It would have been accurate in the presence of a stable exchange rate.

It is wrong under Albania's conditions, where the exchange rate is flexible and the possibility for its depreciating movements can not and should not be excluded. Therefore, the Bank of Albania has concluded that commercial banks' clients do not pay due attention to the exchange rate risk, when they choose a foreign currency-denominated loan.

Credit growth pace has been decelerating along the year, reflecting both the tightening of lending standards in response to Bank of Albania's regulatory measures and the tightening of the system's liquidity position. The banks' difficulties in generating adequate liquidity and their more prudential policy in terms of lending, were reflected in the slowdown of credit to the economy growth and of fiscal sector's financing.

Financial markets

Albanian financial markets have reflected not only the performance of economic developments at home, but also those of international financial markets. Under these conditions, their indicators, such as liquidity, interest rates, trade volume and exchange rate, have been characterised by a higher volatility, however, remaining within the normal parameters of operation.

In a general view, deposit interest rates indicated upward trends for deposits in the national currency and those in the euro. On the contrary, credit interest rates reflected downward trend during 2008, bringing about reduced intermediation cost of the banking system. In particular, positive is the latest evidence for drawing attention towards ALL credit and raising the competition through interest rates in this market.

In implementation of its objective for price stability, the Bank of Albania applies a flexible exchange rate regime. It implies that the exchange rate price is market determined, reflecting the balancing of foreign currency demand and supply forces. During the major part of 2008 the lek's exchange rate vis-à-vis foreign currencies was steady, but it started to slightly depreciate by the end of the period. The positive performance of the national currency during 2008 was supported by a number of factors, such as: macroeconomic stability of the country, positive result of the balance of payments, inflation anchor close to Bank of Albania's target and approaching of this indicator to that of the euro area, as well as the positive interest rate spread.

The banking system

Year 2008 was characterised by intensive developments in the Albanian banking system. The banking activity grew further throughout the year, both in the quantitative aspect – geographic coverage of the country and intermediation degree – and in the qualitative aspect

– the variety of services provided and the intermediation cost. In the meantime, deposit withdrawals taking place during the last quarter, tested the system's stability sensitively. Developments over this period testified that the Albanian banking system passed successfully its first test of stability.

This system continues to be committed mainly to collecting deposits and increasing lending activity. Though at moderate paces, the system's assets and liabilities further increased during 2008. The analysis of the system's indicators reveals an upward risk level and its downward financial capacity along the year. The banking system performance recorded a downturn over 2008, from the viewpoint of net result performance. This reflected both, the enhanced competition in the system and the rapid increase of expenditures for provisioning, particularly during the second half of the year. However, the volatility and the non-good performance of some of the main indicators has not put at risk the regulatory capital level needed for covering risks deriving from the system. The performance of above indicators is not regarded as critical, but the dynamics and intensity of development require a more prudent monitoring on an ongoing basis.

2. Bank of Albania's activity during 2008

As the monetary authority of the country, the Bank of Albania's mission is to ensure price stability in the economy. In order to fulfil its mission, it drafts and implements independently the monetary policy and monitors and regulates the financial market activity in general and that of the banking system in particular. Also, the Bank of Albania is an important and active actor in the country's efforts for European integration. Let me further make a brief presentation of Bank of Albania's work throughout 2008.

Bank of Albania's monetary policy and operations

The Bank of Albania's monetary policy is drafted and implemented exclusively in view of fulfilling its primary objective, i.e., achieving and maintaining price stability.

Inflationary pressures present during the first half of the year and the shaking of agents' confidence dictated the pursuit of a prudent monetary policy during 2008. The key interest rate was held unchanged throughout the period, aiming at a better balancing of the demand and supply ratio, and contributing to subduing of inflation expectations in the economy. Along with the strengthening of some banking supervision prudential measures for credit risk management, this policy has brought about a more balanced credit growth and has transmitted proper encouragement for consumption and savings.

The international confidence crisis in early fourth quarter of 2008 encouraged deposit withdrawals from commercial banks in Albania, highlighting lack of liquidity in the banking system. It was reflected in raised interest rates, slowed banking activity in the money market. The Bank of Albania intervened in the monetary market by injecting liquidity, in order to cover the banking system needs for liquidity.

The dynamics of 2008 events required the usage of all open market instruments and modification of some of them. The Bank of Albania has injected liquidity of a weekly, monthly and quarterly term. It has increased securities basis that may be used as collateral and has reduced the upper limit of interest rate corridor of its operations. Also, in order to better satisfy the banks' needs for liquidity, the Bank of Albania changed the main auction type, from fixed-amount auctions into fixed-price auctions. Also, the Bank of Albania has induced more flexibility to banks for short-term liquidity management, by raising the quantity of the daily required reserve usage. All these operations have served for settling down the liquidity situation and attenuating its impact on interest rate rise. They have also prevented balance sheets of commercial banks from contraction and have been reflected in enlargement of Bank of Albania's balance sheet.

Banking regulation and supervision

Year 2008 coincided with an upward prudence of supervisory policies of the Bank of Albania. The passing of the new banking Law gave way to adoption of a new package of measures, highlighting:

- In compliance with the new Law, new criteria were adopted for calculating and reporting large exposures of banks to parent banks and connected entities, aiming at management of the risk deriving from concentrated exposure to them.
- In order to achieve a more effective management, a new Regulation was drafted, strengthening the internal audit in banks and branches of foreign banks.
- Taking into consideration previous problems, a special importance was given to transparency of banking and financial products and services. This is another aspect where we intervened during 2008. The new requirements standardise the way and form of providing information about banking products and services to clients.
- Part of the new package was also the standardization of the required information that banks and branches of foreign banks should make public, related to the banks' main activity, their organisation and management, their financial performance and position, the risk management and the accounting policies.
- Aiming at a better diversification of risk deriving from the concentration of bank investments in international financial markets, the Bank of Albania's Supervisory Council made some other amendments to the Regulation on Risk Management, consisting mainly in putting more prudential benchmarks on large exposure indicators and on the techniques of collateral calculation and recognition.
- The Bank of Albania has prohibited lending to the economy with "exotic money", implying funds of a very low cost, ready to penetrate even into our economy. Let me remind you that many developing economies have fallen into the trap of those funds, currently suffering gravely from their flight.

In view of enhancing the transparency, these measures were discussed in advance with the banking system, through an open forum held with representatives of the system. Financial market developments during 2008 highlighted the appropriateness of measures taken by the Bank of Albania. Its actions for absorbing the spill-over effects of the international crisis at the lowest cost possible, have continued to take place even during the first months of 2009.

Legal and regulatory initiatives

During 2008, upon the passing of the Law "title repurchase contract", the Bank of Albania's efforts to create a proper legal infrastructure for the development of the repurchase agreements market among commercial banks were finalised, creating the possibility for the usage of these agreements as flexible instruments to ensure and invest interbank market liquidities, in view also of enhancing the efficiency of the monetary policy transmission.

Also, another important highlight of the effective legal framework during 2008 was the approval of some amendments to the Civil Code Procedure of the Republic of Albania, which are expected to provide positive effects in terms of easing and shortening the time frames of collateral execution procedures for loans extended by banks and branches of foreign bank.

Also, in view of improving the existing regulatory framework in banking supervision area, intending its adjustment to the requirements of the new Law "On Banks in the Republic of Albania" (which entered into force on 01.06.2007) and to the *Acquis Communautaire* in this area, and in accordance with the commitments under the Stabilization and Association Agreement, the Bank of Albania adopted some regulations on internal audit system and transparency of banks to the public, which are expected to positively impact the overall management and administration of banks.

European integration

In the framework of European Integration, the Bank of Albania has paid special attention to the meeting of Bank of Albania's obligations stemming from the SAA related to meeting the Copenhagen economic criteria for EU membership, guaranteeing the right of decision-making and the freedom to provide financial services to EC banks and other financial institutions, liberalization of capital flows and of payments between Albania and the EU, as well as approximating the Albanian legislation with that of the European Community (*acquis communautaire*) in these areas.

During 2008 the Bank of Albania kept regular contacts with the Ministry of European Integration and posted there monthly progress reports, which reflect the progress achieved in terms of implementation of legal and applicable measures, in accordance with the terms specified under the National Plan for the implementation of the SAA, as well as a description of the degree of compliance of the legal acts adopted by the Bank of Albania with the *acquis*.

In the framework of the National Plan for the Implementation of the SAA (2007-2012), the Bank of Albania continued working for legal issues and applicable measures it should adopt. Hence, pursuant to the Law "Banks in the Republic of Albania" which entered into force on June 2007, the banking supervision regulatory framework was reviewed, particularly in terms of management, transparency and internal auditing of banks.

Transparency of the Bank of Albania and its communication with the public

A special importance in the everyday activity of the Bank of Albania is given to public relations and communication, since an open and transparent communication with the public helps to raise confidence in and efficiency of its decision-making. The Bank of Albania has carried out a number of activities and meetings with banking and financial system stakeholders, with different representatives of the media and academics, lectures at high schools and universities, regional meetings with representatives of the banking system, local government, business and the public.

The Bank of Albania has carried out its work in two main directions: first, enhancing the transparency and communication with the public on its decision-making; and second, enhancing the banking system's transparency. During 2008 the Bank of Albania tried to enhance the transparency about decision-making and its effects on the economy, adding not only physical contacts and the number of publications, but also investing in public education, in order to raise the economic culture in general and the financial one in particular. It has aimed at ensuring a compliance of the rational decision-making at micro level with Bank of Albania's decisions.

Only during 2008:

- There were published more than 4500 pages in Albanian and above 2100 pages in English;
- There were distributed about 80.000 educational brochures;
- There were carried out training workshops for about 100 teachers of economics in Tirana and Vlora;
- There was organised a competition on "Real value of money" in Tirana and Vlora;
- There were organised 44 conferences, workshops, seminars, forums and round tables;
- There were organised 5 training workshops with journalists from visual and written medias in the field of economics.

Also, “Transparency on Decision-making” was enhanced by providing signals on future tendencies of monetary policy decision, thus creating a standard form of communication that enables the public to perceive the direction of future monetary policy decisions.

“Transparency on Economic Developments” was enhanced through the publication of inflationary expectations tendencies generated from forecasts and analyses based on empirical models of the Bank of Albania and from the extension of the forecasting period from 12 to 24 coming months. Also, it is worth noting that in the framework of the banking system transparency, a set of regulatory measures were prepared, aiming to enhance transparency to clients, and protect them in consequence.

The financial result

The Bank of Albania has carried out its economic and financial activity pursuant to effective laws. Its balance sheets have been constantly monitored and have been audited by the KPMG, which has certified their truth in compliance with the accounting policies adopted by the Bank of Albania’s Supervisory Council.

During 2008 Bank of Albania’s balance sheet assets increased by ALL 60.1 billion, or about 23 percent. This growth is attributed mainly to increased foreign reserve of the Bank of Albania and its transactions for injecting liquidity in ALL. During 2008 the Bank of Albania had a net profit of about All 9.3 billion.

3 Current and future challenges

As I emphasized many times earlier in my speech, the Albanian economy is being affected more and more by the global crisis impact. The uncertainty induced from the global financial system shock was reflected in the withdrawal of a part of deposits from the banking system, thus generating liquidity problems in the system and upward interest rate tendencies. This situation has naturally decreased the possibilities and willingness of the system to credit the economy.

On the other hand, global economy developments suggest that during 2009 the Albanian economy may be faced with a decreased level of remittances and capital inflows. These developments, in turn, would further decrease the possibilities for financing the economic activity and would damage the foreign currency demand and supply balances. They give rise to depreciating pressures on exchange rate, likewise in many economies of Eastern Europe. This depreciation is in itself a corrective behaviour, under the conditions of a flexible exchange rate regime applied in Albania.

From Bank of Albania’s viewpoint, the main problem the Albanian economy will encounter during the current year is lack of liquidity, and related to it, the tightening of conditions for financing activities. As we have emphasised even in our public presentations, this restriction should be recognised and factorised in business plans of all economic agents. The Albanian economy will access less credit during 2009. Lack of liquidity would also reduce the possibilities of the fiscal and monetary policy for reaction. Under these circumstances, a broader efficiency is required in making use of banking system funds, via a priority ranking of expenditures in view of their impact on the economic growth.

Furthermore, the Bank of Albania deems that current account deficit behaviour should be constantly monitored. Equalization of this deficit to reduced capital account inflows should be another priority of development of economic policies. As I emphasised earlier, this moment significantly conditions the financial and macroeconomic balances at home. Therefore, it will be constantly held in focus of Bank of Albania’s monetary policy.

Honourable Mr. Chairman of the Commission,

Honourable Ladies and Gentlemen,

The current problems the Albanian economy is faced with have not originated in Albania; therefore, their solution will mostly depend on global economic activity improvement.

The country's macroeconomic stability has absorbed the economic and financial global crisis impact on the country's economic activity. This stability, reflected in low consumer price inflation, stability of the balance of payments and public debt, sound balance sheets of economic agents, low financial market volatility, and public confidence in financial institutions, is a great capital of the Albanian economy. It is achieved through work and sacrifice throughout the past years, therefore the Bank of Albania deems that even during these challenging moments for all of us, we should pay full attention to its further safeguarding and consolidation. The private sector's dynamism of the Albanian economy needs long-term favourable economic and financial conditions, and transparent competitive market structures to fully release its potential.

Only countries knowing how to rise and respond to these shocks have managed to grow and prosper in the long run. Learning this lesson requires an explicit ranking of development priorities, separation of long-term interest of the country's development from short-term intentions and the political willpower for their accomplishment