

## **Ardian Fullani: Challenges facing the Albanian economy and financial sector**

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the Regional Summit of Governors and Bankers, Becici, Montenegro, 20 June 2009.

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Distinguished Governors,

Dear participants,

I want to start by thanking the organizers of this meeting, for promoting 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 USA, has transformed itself into an economic crisis, that is having dire consequences in real sectors of the world economy. I will start by describing the main macroeconomic developments of our economy and the characteristics of our financial system, which is similar to other countries in our region. Then I will proceed with some of the measures taken by Bank of Albania, to alleviate the impact of the international financial crisis on our banking sector and the economy. I will finish by mentioning some thoughts on future policies, which I consider important to strengthen the economic environment and the financial stability in our region and in Albania.

### **The Albanian economy has been growing steadily over the last decade**

Our economy has been in a solid path of growth for the last decade, with an average annual growth rate of around 6 percent. It has benefited from economic reforms that have provided development opportunities for our private business sector, have sustained markets development, have promoted competition, have stimulated flexible labor markets and have increased social revenues. Supported by an IMF assistance program, 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. 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.

### **As in other countries in our region, the banking sector dominates the financial system in Albania**

The assets of the banking sector make around 95 percent of the total financial assets in Albania, or around 80 percent of GDP. Nowadays, the banking sector counts 16 banks with around 500 branches, all in private hands, where the foreign capital dominates. Over time, the sector has increased the number of branches, has improved its products to the public and has increased its intermediating role. At the same time, the entrance of well-known European banking groups from Greece, Austria Italy and France, has been associated with episodes of consolidation in the banking industry. Financial performance indicators have been very good. 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. Undoubtedly, the banking sector has been a very important contributor in the economic growth, while preserving solid business development and financial soundness indicators.

Despite the solid performance in the last years, the Bank of Albania, in its role of the monetary authority and the exclusive supervisor of the banking sector, was vigilant to point out areas of the banking activity that required increasing attention from the industry.

We have continuously expressed our concern regarding the rapid increase in lending, which at some time reached up to 8-9 percentage points in terms of annual growth to GDP. We were aware of the risk it would bring to the credit quality, even though this was not expected to be relevant. The composition of the loan portfolio, which is dominated by the euro-denominated loans, has always been a point of concern. Despite the fact that this position is supported by a strong presence of retail foreign currency denominated liabilities in banks balance sheets, a generally supportive environment of exchange rates and interest rates over time and very close economic links to Euro-area countries like Italy and Greece, Bank of Albania has been consistent in its approach to introduce gradually 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.

### **Impact of the crisis in our economy and in the financial sector, has been increasing and ...**

In the last quarter of 2008, the financial sector in Albania started to feel the impact of the international financial crisis. The main development was an increasing sensitivity of the public for their savings in the banking sector.

People started to withdraw their deposits regardless of the currency of denomination. At the beginning, there was no pressure on the exchange rate but it started to mount at the beginning of this year, when it was noticed a contraction in the inflow of foreign currency, due to a decline in exports and remittances. The quality of the loan portfolio started to deteriorate, and the nonperforming loans reached 8 percent of the entire outstanding loan portfolio at the end of April 2009. We expect this figure to edge higher, as data from the economy and surveys of business expectations and a marked slowdown in the credit availability, suggest that the economic growth is going to be much lower than the previous year. Due to a decline in interest income margins and an increasing amount of provisions, some of the banks have started to accumulate negative financial results.

On a brighter note, almost all the banks have increasingly supported loans in domestic currency. At the same time, the banking sector remains well capitalized and liquid. The capital adequacy ratio was 17.1 percent in March 2009, compared to the required minimum level of 12 percent. Liquid assets to total assets, is at around 42 percent.

The capital adequacy of the banking sector is sufficient to cover for a worst scenario that combines no economic growth, a higher level of depreciation for the exchange rate, and a higher level of non-performing loans. I want to mention also that banks shareholders have quickly and sufficiently responded to our calls for capital injection. Obviously, we remain in very close contacts with bank representatives, to identify further needs in this direction.

### **... measures have been taken to cope with the changing environment**

Since the last quarter of 2008, the Bank of Albania has intensified its work on various directions to carefully monitor the developments and preempt them where possible. For this reason we have:

- strengthened bilateral and multilateral contacts with bank representatives, asking them for increased vigilance due to current international market conditions;
- increased contacts with other domestic institutions that regulate and monitor the financial markets, in particular with the Authority of Financial Market Supervision that supervises the insurance sector;

- increased the number of publications, including the Financial Stability Report 2007 (Sept.) and the Statement on Financial Stability (Oct. 2008, April 2009), which try to analyze the elements of the crisis and its potential effects on Albanian Banking Sector and the economy;
- increased 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;
- changed and improved the reporting framework of banks, in terms of timeliness and quality of data, in particular regarding their exposure to international markets (and the mother-banks), their liabilities (deposits and exposure to credit lines) from mother-banks, and their loan portfolio developments. These data are being closely monitored;
- intensified the on-site supervision of banks, to closely monitor their process of risk management and the way they have been reacting to the new developments;
- improved our stress-test analysis, in terms of introducing more conservative assumptions, and technicalities that allow for a combination of adverse scenarios;
- started to execute fixed-price (unlimited amount) weekly reverse repo transactions and longer term reverse-repo transactions, and extended the list of eligible collateral for these transactions, to better suit the liquidity needs of the banks;
- doubled the usage rate of the required reserves in order for banks to use more of their reserves with the central banks, should they need it during the maintenance period;
- prepared and forwarded to Parliament changes in the deposit insurance legislation. The approval of these changes has provided our depositors with a significant and permanent increase in the maximum amount of their deposits that is fully insured;
- lowered in January 2009 our policy interest rate by 50 basis points, to 5.75 percent, on the back of declining inflationary pressures. Since then, concern about the exchange rate developments and potential impact on inflationary expectations and financial stability have been dominating the discussions;

In addition, in an improved framework of the internal discussions and decision-making, we are reviewing our “back-up” plans, to assess the possibility of new actions, should we encounter a worsening scenario.

### **Now is the time to introduce policies that will strengthen the economic environment and the financial stability in our region...**

In a global level, it has now become clear that the recent crisis was a consequence of wrong incentives that supported unbalanced financial activity development and misconception of risk assessment, pricing and management. The supervisory institutions, trapped sometimes in situations of complicated structures, insufficiency of resources, inability to follow and understand market financial innovations and risk location, were not able to correct the situation in due time. The need to restore and maintain financial stability during this unprecedented crisis, has called for swift, coordinated and extraordinary measures by the public authorities, both in the area of monetary and fiscal policies. Central banks have abandoned almost any restriction and have even adopted unconventional measures in providing liquidity to the financial markets. Governments have shown a very strong commitment to reduce systemic risk by saving important financial institutions, provide guarantees for inter-bank lending, raise the level of deposit guarantees for the public etc.

This crisis is providing the public authorities and markets wherever in the world, with the best opportunity to identify deficiencies and correct those for preventing a similar crisis in the

future. Such task requires strong and visionary measures, which in the medium term will enable the strengthening of the supervisory architecture in different levels, but also will create conditions, including macroeconomic and fiscal ones, to avoid excesses in the financial activity, not only in the financial industry but also in the balance sheet of households and businesses. Such measures will require strong coordination and responsibility by the public authorities in the national level, and a commitment to push ahead with the necessary steps to reform and improve the supervisory superstructure in the regional, European and global level. In the European level, such measures will be supported by the findings and recommendations of the “De Larosière Report”, but of course their implementation will not be easy. As it is expected to be a more centralized model for globally systemic banks and, to an extent, a more decentralized one for smaller financial institutions, we hope that supervisory authorities in small countries will have a better determined position that would allow for clearer responsibilities and stronger voice in communication with the supervisors in the home countries.

More or less, all the countries in our region have resisted the initial direct impact of the international crisis, by enjoying some natural protection from less developed and integrated financial markets and a much lower level of indebtedness from the households and businesses, compared to developed countries. However, it is now clear that at the time of continuing financial integration and economic globalization, this may not be enough to compensate for potential risks coming from less diversified economic growth, overreliance in remittances, insufficient culture of risk management in financial institutions and other economic agents – in particular for the exchange rate and liquidity risk, and very limited space from the public authorities to introduce financial measures similar to those in the developed countries. Hence, policy measures should address these and other deficiencies to find a proper solution in the medium-term. Such measures should reflect the preference for preventive approaches.

### **... and in Albania**

The Bank of Albania has been vocal in its concern regarding the impact of the international financial crises, in particular regarding the performance of the Albanian economy.

Risks to economic growth have increased and they are related in particular with a further 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 believe that at these times, there is a much stronger need for a careful monetary policy and responsible fiscal policy.

Regarding the financial sector, we believe that there is also a need to establish certain rules, that would support a more balanced and safe development of the financial industry in general and of the banking sector in particular in the future. Firstly, on general measures, I would support any such one that will contribute to: the establishment of a strong legal framework for property title and property rights in Albania, which in return will be instrumental in developing a non-financial asset market and increase price transparency and ultimately, strengthen the process of risk assessment. Secondly, efforts should be made to develop the non-bank financial market as well the capital market in general.

This will help to better support the economic development of the country and of various economic agents, increase their opportunities to finance their needs in a more diversified and competitive way (thus improve their skills in managing risks) and release some pressure from the banking sector. Thirdly, the public authorities in the country (the supervisory authorities and the Government) must have sound contingency plans for possible financial crisis management. Recent events in other countries, have shown the importance of having a well-coordinated plan of actions, which is discussed, agreed and tested in advance. Fourthly, when it comes to the regulatory and supervisory framework of the banking sector, I am in favor of introducing the necessary changes to make it less pro-cyclical. In the case of Albania

– where the minimum required capital levels are already high, I would be more in favor of introducing the model of dynamic provisioning adapted to the business structure and to the level of technical sophistication of the banking sector. In addition and in a more general position, I would support a revision of the regulatory framework toward clearance and simplicity, even though it might be interpreted like I am supporting more a rule-based approach in supervision.

I think that a regulatory framework is really effective and successful when it combines both the simplicity and transparency of a rule-based approach with the flexibility and forward looking characteristics of a principle-based approach. In any case, I believe it is necessary to make banks responsible for convincing the supervisor on the risk and return characteristics of various new products, before they exceed a certain threshold in size and exposure. This is achievable if the supervisory framework is always built with the main focus on assessing and managing the risk in different directions of the banking activity. Fifthly, when it comes to choose between lending in domestic currency or foreign currency, one should have various considerations in mind related with the nature of currency flows in the country, the concerns of the transmission mechanism of the monetary policy, the nature of the exchange rate regime, the currency composition of the asset-liabilities of the banking sector etc.. In this regard, we shall support a stronger role of the domestic currency in the lending activity of banks, and will make lending in foreign currency more costly for banks if it is not supported by retail savings in foreign currency. Thus, the over-reliance of banks in wholesale financial resources in foreign currency to support rapid lending should be addressed and managed in due time.

I find this meeting as very useful to discuss these issues and others that you have identified. I believe that the ultimate goal should be to establish a genuine and effective cooperation and to support a coordinated approach where possible.

Thank you very much for your attention.