

Ardian Fullani: Economic and financial developments in Albania

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the presentation of the Bank of Albania's Annual Report 2009 to the Albanian Parliament on 29 April 2010, published on 30 April 2010.

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***Honourable Ms. Chairwoman,
Dear deputies,***

It is a privilege to present to you today the Bank of Albania's Annual Report for 2009. This Report, the key conclusions of which will be briefly reviewed in my speech today, makes a thorough and transparent analysis of economic and financial developments in Albania, and provides an overview of the Bank of Albania's work to meet its legal obligations and institutional commitments.

The year 2009 was a challenging year for the Albanian economy in all its dimensions. In response to the global economic and financial crisis, the following were put to the test during this year:

- The country's macroeconomic balances;
- Our financial system's stability;
- The business models and the private sector's financial sustainability; and
- The analytical and responsive capacities of macroeconomic policies.

In a broader setting, the shock that hit the Albanian economy in 2009 put the flexibility of Albania's economic development model and its capacity to respond to a thoroughly transformed global environment to test.

The global crisis provided a quick impact on the economic activity at home. It was soon followed by the reduction of current and capital account foreign inflows, an abrupt fall of foreign demand and slowdown of domestic demand for goods and services. In response to these developments, the economic growth rate marked a progressive slowdown during the last year, but still remained positive. Albania's balance of payments was characterized by imbalances in foreign currency inflows and outflows. The imbalances were reflected in the swinging of demand and supply ratios of foreign currency, yielding the depreciation of the exchange rate in response to new balances that dominated the foreign exchange market. Fiscal policy became more expansionary in 2009, supporting economic activity in the country but also increasing the pressures on the financial markets.

The shock that hit the financial system gave rise to the establishment of a challenging environment for the monetary policy to be transmitted completely and timely. Against this challenging background, the Bank of Albania accomplished its legal mandate to maintain price stability in economy successfully: CPI annual inflation remained within our 3 ± 1 percent target in 2009.

The Bank of Albania's easing monetary policy established the proper monetary conditions required to maintain price stability. In addition, the supply of the economy with the necessary liquidity and at a declining cost stabilized the financial markets and created the proper conditions for the support of economic activity during 2009.

The performance of the Albanian financial system was affected by the wavering of confidence in our financial system during the first half of the year and the withdrawal of a portion of deposits. This performance, coupled with another group of factors, yielded less support, and at higher cost, to the Albanian economy with banking loans.

Among the factors worth noting are:

- Higher economic agents' uncertainty and liquidity premiums;
- The correction of the business model in particular financial market segments;
- Increased exchange rate volatility; and
- Contracted demand for loans in the second half of 2009.

The wavering of public confidence underscored the prime importance of financial stability in Albania's economic life. Within its area of responsibility, the Bank of Albania undertook a number of comprehensive and co-ordinated measures, which aimed at maintaining financial stability at a systemic and institutional level.

These measures, *inter alia*, consisted in:

- Reviewing the regulatory base in terms of increasing the supervisory prudence;
- Strengthening on-site supervision;
- Increasing the analysis of banks' balance sheets at an individual and systemic level; and
- Enhancing the co-operation with the national and foreign counterpart institutions.

Our endeavours to preserve financial stability were also coordinated with other public, executive and legislative authorities. Worth noting is the improvement of the public deposit insurance scheme and the increase of the deposit insurance level by the Deposit Insurance Agency. These measures proved successful in curtailing the negative consequences and in fully restoring confidence in the banking system.

Subsequently, the Albanian banking system maintained sound balance sheets and was in full capacity to carry out its function as a financial intermediary and supplier of the economy with payment instruments. *The developments of the first quarter of 2010 attest to the full restoring of public confidence in the banking system. Currently, the level of deposits has exceeded that of end September 2008, prior to the beginning of the withdrawal of deposits.*

In what follows, I would like to dwell on the aforementioned topics.

1. Monetary policy and price stability

In accordance with its legal mandate, the Bank of Albania's monetary policy has been designed and implemented in order to achieve and maintain price stability. During 2009, the main risks to price stability have arisen from the slowdown of economic activity, wavering of economic agents' confidence, imbalanced external position of the Albanian economy and the exchange rate depreciation. Despite these challenges, the Bank of Albania managed to keep the CPI inflation within the target. Let us dwell on these elements further.

1.1 Economic growth

The global context that accompanied Albania's economic and financial performance over the past year was not at all favourable. The year 2009 featured contracted global economic activity as a result of the economic downturn in advanced economies and considerable economic slowdown in emerging countries. Global economy posted the first negative growth rate of the last 50 years.

The increasing integration of the Albanian economy and the financial system in particular caused the global crisis to be reflected early in our country. The main channels the Albanian economy was exposed to were:

- Decline of exports;

- Decline of remittances and other foreign currency inflows;
- Increased uncertainty in the financial institutions; and, in response to the latter
- Review of almost all economic agents' business plans.

This impact was reflected in low growth rates and shaking of some macroeconomic balances in 2009. According to the Statistics Institute, GDP grew 3.1 percent in annual terms in 2009. The slowdown of GDP growth reflected the contraction of activity in industry and construction, while the services sector's value added remained the key contributor to economic growth.

Given the difficult circumstances in which economic activity took place and compared with other regional countries' experiences, the preservation of the economic growth rate at positive levels is an encouraging development. However, its slowdown and the new macroeconomic balances need due attention by all economic agents in their projections for the future. Albania's economic development outlook also requires greater support from the private sector, while the contribution of the public sector to economic growth is expected to decline. The data on aggregate demand show that the contraction of private consumption and the fall in investment were determining factors in the slower growth of demand at home.

Net exports continued to provide a negative contribution to aggregate demand in 2009, however at more moderate rates than in 2008. In addition to easing monetary conditions, the fiscal stimulus supported the economy in generating positive growth rates during 2009.

Private consumption is the key component of aggregate demand accounting for about 80 percent of GDP. The slow growth rate in wages, the decline of remittances and the contraction of consumer loans contributed to the slowdown of consumption in 2009.

Private investments are assessed to have been affected more by the global financial and economic crisis than the other components of aggregate demand. The contracted domestic and foreign demand and the tight lending conditions triggered the contraction of private investment in 2009.

1.2 Fiscal policy and fiscal indicators

The slowdown of the Albanian economy affected the performance of fiscal policy and fiscal indicators. Fiscal policy was expansionary being reflected in the deepening of budget deficit. Budget deficit for 2009 is estimated at 7.1 percent of GDP. The main sources of deficit financing were privatization receipts and syndicated loan, which reduced the need to borrow in the domestic market.

Budget revenues posted an annual increase of 2.7 percent, largely due to the slow increase in tax revenue. On the other hand, public spending grew by about 8 percent, led by the high rate of current expenditure. The expansionary fiscal policy provided the economic activity with the necessary impulse over the course of the year; however it was also accompanied by higher public debt and upward pressures on Government T-bill yields.

The deepening of budget deficit resulted in substantial public debt increase, which as at year-end 2009 accounted for about 59.5 percent of GDP.

The Bank of Albania encourages measures to reduce the budget deficit and public debt in the medium run. Lower budget deficit and public debt levels will provide more room in accessing of funds from the private sector and boost confidence in Albania's macroeconomic stability. In addition, these measures will help to create appropriate conditions for attracting foreign capital in the form of private loans or foreign direct investment.

1.3 Monetary developments and financial markets

Financial intermediation in economy was conditioned by the contraction of financial resources, wavering of confidence in financial institutions and the decline of demand for banking loans in 2009. At the end of March, deposits fell to 55 percent of GDP compared to 63 percent in September 2008. The withdrawal of deposits during the first quarter of the year brought about the slowdown of money growth in economy.

Banking activity recovered slowly during the following three quarters. Money supply grew by an average of 6 percent this year or about twice less than the previous year. The growth of money supply mainly attributes to the growth of its ALL component, while foreign currency loans and deposits contracted in 2009. The creation of money in ALL has been based on the fiscal sector's domestic borrowing and the preservation of the private sector's ALL credit rates.

In addition to the higher banks' sensitivity to their liquidity indicators, private sector credit activity was carried out under the conditions of a more conservative behaviour of banks' lending in 2009. This conservative behaviour owes also to an increased caution of banks to certain banking products, such as:

- foreign currency loans to certain segments of the economy exposed to exchange rate fluctuations, and
- consumer loans.

In the second half of the year, demand for loans declined as a result of the tight lending standards and the slowdown of economic activity. Despite the easy monetary policy of the Bank of Albania, private sector credit maintained a uniform slowdown trend during 2009.

As at year-end 2009, credit annual growth rate marked 12 percent versus 33 percent in 2008. The growth of credit has been triggered by the business demand to finance the liquidity needs, while the households' loan portfolio contracted over the same year.

1.4 Balance of payments and the exchange rate

In the presence of slow domestic demand and reflecting the difficult situation of the global economy, current account deficit narrowed by about 3 percent in 2009, standing at 15.3 percent of GDP.

Despite the slight correction during the year, current account deficit remains high and one of the weaknesses of the Albanian economy. The Bank of Albania considers that the prioritized handling of the current account deficit requires the formulation of policies supportive to the long-term growth of savings in Albania, as well as measures to encourage production in those branches or industries that result competitive in the international markets.

Trade balance narrowing was affected by the concurrent annual decline of exports and imports by 18 and 9 percent, respectively. The difficult situation in our neighbouring countries has been also reflected in the decline of remittances, which contracted 6.5 percent in annual terms, while their share to GDP was 9 percent. Capital and financial account surplus reduced substantially over the course of 2009, dropping by 35.6 percent compared to 2008. This performance owes to a large extent to the low increase in foreign direct investment and the reduction of private foreign borrowing.

Unlike the previous two years when capital and financial account covered over 100 percent of the current deficit, in 2009 it financed only 77 percent. Total foreign inflows, albeit downward, were almost sufficient to cover this deficit in 2009. The country's foreign reserve remained at similar levels as in 2008, sufficient to cover 4.2 months of imports of goods and services.

The contraction of foreign inflows exerted depreciating pressure on the exchange rate, particularly in the first half of 2009. In the domestic foreign exchange market, average annual depreciation of ALL against the EUR and the USD was 7.6 and 13.2 percent, respectively.

1.5 Inflation and monetary policy

1.5.1 CPI inflation

Consumer prices rose 2.2 percent on average in 2009, which is in line with the Bank of Albania's target for inflation. As a result of the reduced inflationary pressures worldwide, annual inflation marked low rates – 1.8 percent on average – during the first quarter of 2009. In the following two quarters, inflation rates stabilized close to the lower limit of the Bank of Albania's target, 2.0 percent. Annual inflation displayed an upward tendency in the last quarter, when it marked 2.9 per cent in average terms and converging to the inflation target. The highest inflation rate of 3.5 percent was marked in December. The increase of inflation in the last part of the year was mainly triggered by the more complete exchange rate devaluation pass-through to consumer prices, in the presence of upward primary commodity prices in the global markets.

The slowdown of economic activity at home and the low inflationary pressures from the global economy created an environment of relatively low inflationary pressures. Core and non-traded inflation marked average rates of 1.3 and 1.6 percent, respectively, in 2009 attesting to the low inflationary pressures of the domestic economy. These factors offset the devaluation effect of the national currency, which led to higher prices of imported goods and a part of products that are still indexed to the exchange rate. Traded goods' inflation – a portion of which are imported and the rest are directly affected by global prices – increased substantially compared to the previous two years. Its contribution to headline inflation was about 73 percent in 2009.

1.5.2 Bank of Albania's monetary policy

The weakening of economic activity and domestic inflationary pressures, our forecasts for a contained inflation in the future and the anchored expectations of economic agents provided room for pursuing an easing monetary policy in 2009. This policy was materialized in two interest rate cuts by 0.5 percentage points each in January and October 2009 to 5.25 percent, and in the continuous injection of liquidity required by the market and the economy. By means of this prudent monetary policy, the Bank of Albania aimed at creating appropriate monetary conditions for a balanced and long-term development of the country.

The key interest rate cuts were instantly passed through to the short-term interest rates in the interbank market, which declined and were less volatile than in 2008. On the other hand, these movements were not fully and instantly transmitted to the interest rates on banking loans and deposits. As in all other countries, the increase of the liquidity premium, the higher uncertainty and the deterioration of the banking system's financial results were amortizing factors for the easy monetary authorities' measures. However, our monetary policy and our interbank market operations managed to successfully avoid a detrimental contraction of banks' balance sheets, something that many emerging countries had to go through.

The 1.00 percentage point cut in 2009 relaxed the financial burden of the banking system's intermediation activity. The Bank of Albania has consistently supported the banking system with the required liquidity. In addition to cutting the key interest rate, the Bank of Albania has helped Albania's banking system activity through:

- the change of the refinancing auction form from fixed-amount auction to unlimited-amount auction;
- up to 3-month extension of the maturity term of injected liquidity;
- expansion of the range of collateral in our refinancing operations;

- increase of the use of required reserve; and the reduction of the overnight loan interest rate.

We have employed almost all of our range of instruments for implementing monetary policy. The amount of liquidity injected by the Bank of Albania peaked in summer with ALL 40 billion. As a result of the deposits entering the banking system, this amount reduced gradually to about ALL 28 billion at the end of 2009.

2. Banking supervision and financial stability

The banking system performance was significantly conditioned by the economic slowdown and wavering of confidence, aspects that were elaborated at length in my speech. Consequently, there was higher uncertainty, higher bank sensitivity to liquidity, a more cautious lending behaviour, and an increase in non-performing loans. These are the main highlights of the banking system performance during 2009.

Despite the downward profitability, capitalization indicators remain at satisfactory levels. The banking system remains sound, a fact that also attributes to the effective carrying out of the regulatory and supervisory function of the Bank of Albania. In what follows I would like to elaborate more on these aspects.

2.1 Banking system performance

The Albanian banking system's total assets increased in 2009, but at a rate about twice lower than in 2008. This decrease reflects fully the lower expansion of lending. Our banking system continues to be mainly financed by public deposits and be concentrated on business lending.

The banking system's deposits and loans grew but at a lower rate than in the previous years. Loans to total deposits increased by nearly 3 percentage points, from 62 to 65 percent. On the other hand, the increase of deposits as a result of the restored public confidence has improved the liquidity situation in the banking system.

Non-performing loans increased in 2009 owing to the economic slowdown and the exchange rate depreciation. Loan portfolio quality index expressed as "non-performing loans to total outstanding loans" rose to 10.48 percent as at end 2009 from 6.64 percent at the end of 2008. On net basis, that is deducting total provision fund, the same figure is only 6.3 percent.

The Bank of Albania has monitored the situation closely being aware of the pro-cyclical effects that these developments may have on the loan portfolio. Despite the loan portfolio deterioration, capital adequacy and quality, to carry out the banking operations, to extend and expand lending, have remained almost intact. Although the loan portfolio growth is below the previous years' levels, it is satisfactory and at higher levels than in the region.

Based on the periodical stress-tests, the Bank of Albania has identified all banks' needs for capital, thereby enabling a rapid increase of the capital when necessary. Banks' responses were instantaneous bringing in new capital.

Total regulatory capital of the banking system increased 37.7 percent, being dominated by the core capital providing evidence for a qualitatively good and sustainable regulatory capital. The banking system's capitalization level was significantly above the regulatory minimum required by our regulations and international practices.

Efficiency indicator shows almost the same level as at year-end 2008, attesting to a prudential and stable growth of banking activity in general. On the other hand, shareholder's equity is estimated to have increased 18.7 percent in 2009 versus 2008. Financial leverage reduced gradually during 2009. The decline of the financial leverage from 11.7 to 10.4 percent over a year implies that the system has relied less on debt to finance assets. Compared with the European Union countries, the Albanian banking system's financial

leverage remains low attesting to a low degree of the system's borrowing practice. This indicator provides further evidence for the sound situation of the banking system.

The network expansion of banking branches and agencies in the territory of Albania persisted in 2009 however at lower rates compared to the previous years. As at year-end 2009, the total number of branches and agencies amounted to 530 from 517 at the year-end 2008. 17 new bank branches were opened while 4 existing branches were closed.

2.2 Banking system supervision

The medium-term strategy for banking supervision approved in 2009. The main pillar of this strategy is the adoption of a new philosophy: risk-oriented supervision.

The main highlights of this new supervisory policy are:

- further interaction and harmonization among monetary policy, financial stability and supervision;
- harmonization of our supervisory framework with the *acquis communautaire*;
- interaction between the domestic and foreign supervisory authorities and the Financial Supervisory Authority;
- harmonization with the third pillar of Basel II, encouraging the process of self-regulation and consumer protection.

The Bank of Albania has been constantly engaged in a process of deep analysis and supervision of the legal and regulatory framework compliance and enforcement from the licensed entities. This process has been achieved through on-site inspections, which in 2009 were more frequent and rigorous. Besides the observance of the supervisory cycle, banks were constantly contacted for phenomena that have represented a concern during the year, taking appropriate measures to address potential problems in due time. Overall, the banking system has acted with caution in conducting the operational processes of their activities and in compliance with the regulatory framework of the Bank of Albania.

2.3 Strengthening of regulatory and supervisory framework

The design of strong and appropriate rules and their rigorous monitoring constitutes a guarantee for the preservation of financial stability.

The Bank of Albania has been active in improving the regulatory framework, consolidating it further in compliance with the legal provisions and the Basel Committee principles, the European Council directives and the best practices in the area of regulation and supervision of financial institutions licensed by the Bank of Albania.

The main objective was the harmonization of the best practices in:

- strengthening internal control;
- improving banking institutions' governance;
- strengthening the risk management capacities; and
- increasing the level of banks' transparency to the public.

With respect to the latter, the Bank of Albania has required higher and improved communication of the banking system with the public about the products and services being provided, the promotional campaigns for new products and the provision of information on their real financial situation and risk profile.

3. Other Bank of Albania activities

After the analysis of the two key functions of the Bank of Albania, I would like to elaborate on some other aspects of the central bank's work.

3.1 Payments' system

The payments' system reflected security and efficiency in 2009. On average, 225 transactions a day were processed and settled in the AIPS system, with an average daily value of ALL 19 billion. Total liquidities settled in the AIPS system during 2009 is about 4.3 times higher than the GDP.

3.2 European integration

The Bank of Albania plays a key role in the European integration process. The Bank of Albania has been active in revising the National Plan for the Implementation of the SAA for the period 2009–2014.

The Bank of Albania has prepared monthly progress reports that reflect the achievements in terms of the accomplishment of the legal measures and implementing activities, and a description of the level of compliance of judicial acts approved by the Bank of Albania with the *acquis communautaire*.

3.3 Communication and transparency

Public communication was one of the major priorities of the Bank of Albania in 2009. We have aimed at transmitting the Bank of Albania's decision-making to the financial market, other decision-making institutions, media, other economic agents and the public at large, timely and efficiently.

The Bank of Albania's communication has been materialized through added transparency in:

- our analyses of economic and financial developments at home,
- the risk balance and potential implications for the economy,
- the entire regulatory and supervisory activity of the banking system.

With the belief that added transparency is translated into higher integrity and transparency, the Bank of Albania has been paying an increasing attention to public education as well.

The Bank of Albania acknowledges and appreciates the importance of having a well-informed and well-educated public in the transmission of monetary policy to the economy, by taking timely, right and rational decisions.

In this context, our activities in the area of public's financial education intensified further in 2009 through the expansion of age groups and greater geographical coverage.

In figures, for the period 2008–2009:

- were distributed a total of 21 000 educational leaflets;
- were held training seminars for around 170 teachers teaching Economics in Tirana, Vlora, Korça, Shkodra, Gjirokastra and Elbasan;
- were held 20 meetings with different stakeholders in Tirana, Vlora, Korça, Gjirokastra and Shkodra;
- the competition "The Real Value of Money" was organized in Tirana, Vlora, Shkodra, Korça and Gjirokastra, with a total of 100 high schools taking part;
- were held seminars for 60 social workers in Tirana;

- were held full cycles of training seminars and lectures for the journalists;
- the Governor held 7 lectures for students in Albania and abroad;
- Bank of Albania Day was organized in four universities.

Lastly, the redesign of the Bank of Albania website in the beginning of 2009 provides a more efficient portal for the provision of information, making it efficient, re-arranged and user-friendly.

3.4 Monetary and financial statistics

The Bank of Albania plays a key role in the national statistical system, as an institution responsible for the production and dissemination of monetary statistics and external sector statistics.

In 2009, the Bank of Albania continued to develop and disseminate monetary statistics and external sector statistics, aiming at:

- the further approximation of the methodology with the recommendations and best international practices,
- enhancing the quality of data through the improvement and automation of control processes, and
- increasing the number of released indicators and detailing of aggregate indicators.

3.5 Strengthening of research capacities

Based on the tradition of the best international models, the Bank of Albania has been ever-increasingly paying special attention to enhancing the research capacities in the field of economy and finance.

Our guiding philosophy has been the improvement of the Bank of Albania decision-making, basing it on scientific conclusions and empirical results. The study of different economic phenomena is now based on complete or partial econometric models that allow the drawing of conclusions and reliable forecasts. Our future challenge will be the further refining of these models and their growing use in the Bank of Albania decision-making.

4. Bank of Albania's financial statements

The financial statements of 2009 were audited by an Independent Auditor and they give a true and fair view of the Bank of Albania's financial position for 2009.

Bank of Albania's financial position has improved further. Total assets have amounted to ALL 353,6 billion, whilst liabilities have amounted to ALL 321 billion. Realized profit totalled about ALL 10 (9,993) billion, the highest in the last three years. This result has increased the Bank of Albania's capital.

Pursuant to the obligations of Law No. 8269, dated 23 December 1997, Article 9, 25 percent, about ALL 2,5 (2,479) billion, of the net profit was capitalized, causing the general reserve to amount to ALL 10 (9.994) billion.

Similarly, the Bank of Albania has observed the obligation of transferring the net profit to the State Budget pursuant to Article 10 of the same Law, and paid to the State Budget about ALL 6,74 billion for the year 2009.

Pursuant to Article 10, in March 2010 the balance of 2009 net profit amounting to ALL 2,4 (2,436) billion was paid to the State Budget.

**Honourable Ms. Chairwoman,
Dear deputies,**

Thanking you for your attention, on behalf of the Supervisory Council of the Bank of Albania, I want to guarantee the Parliament of the Republic of Albania that the central bank will remain a responsible decision-making institution in 2010.

Our decision-making will:

- remain transparent both for the financial market and the public at large;
- consider all possible information in and out of Albania;
- rely on qualified human resources, and
- improve its policy and operational framework, considering the best contemporary and international practices.

The focus of monetary policy will remain oriented to consumer price stability, whilst endeavouring to accomplish successfully all the other legal objectives.

Albania's financial stability remains another major priority for the period to follow. To this purpose, the Bank of Albania is fully committed to monitoring the situation and designing and implementing proper measures timely and at the right intensity.

Lastly, in the capacity of the Governor of the Bank of Albania, I guarantee that the central bank will continue to provide a responsible, accountable and transparent reporting to the Albanian Parliament without hesitancy to meet the constitutional and legal obligations.

In addition, in full observance of the legal obligation to preserve the autonomy of the institution I preside, I assure you that I will make any ethical, legal and constitutional endeavours to ensure that our accountability before you and the public at large is unbiased and true.

Expressing my highest considerations on my behalf, on the behalf of the Supervisory Council and the Bank of Albania staff, I avail myself of this opportunity to thank the Albanian Parliament for the contribution and continuous support provided to our institution.

Thank you.