Ardian Fullani: Macrofinancial stability in EU candidate countries and potential candidate countries – lessons to be learned

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the High-level Policy Workshop on Macro-prudential Policy, Frankfurt am Main, 14 December 2010.

*   *   *

Dear colleagues,

It is a pleasure to discuss with you our experience with the crisis and share some thoughts on the relevant lessons for the future. My perspective on this issue will focus on the case of Albania; an emerging market economy which imported the crisis through financial market channels and interconnectedness. The challenges posed to eastern European economies and decision makers were mostly the same in nature, while their policy response differed according to economic structures, institutional differences and degrees of freedom enjoyed by them.

Let me briefly preview the three main messages of my speech.

The first one is that ***there is no conflict between price stability and financial system stability in the long run*** – instead, they do mutually re-enforce each other and the resilience of the economy to external and internal shocks. From a central bank's point of view, a corollary to this is that any macro-prudential measure taken to enhance financial stability is an investment in medium and long term price stability. I believe this conclusion is amply borne from Albania's recent experience.

My second message is that ***global or even regional financial markets require global or at least regional supervision and crisis resolution mechanisms***. Just as problems originating on a particular sector of the economy can escalate into general macroeconomic imbalances, so financial market imbalances in one financial institution or one country can disrupt other financial institutions or countries. Collaboration between home-host supervisors is therefore a must, but I would argue that probably more can be done in this regard.

My third message concerns ***the role of anchors in the design and implementation of macro-prudential policies***. Monetary policy is made credible from the clear focus on a transparent measure of price stability (CPI inflation) which in turn increases the accountability of the central bank pursuing it and ultimately its operational flexibility. Financial stability is inherently a more difficult concept, even on a theoretical level, but I think more should be done to quantify the term and unify its understanding. This would allow for more transparent communication and increased public support for the central bank's action.

I will now expand on these issues.

1. Price stability and macro-prudential measures

A panoramic glance at the experience of central and eastern European economies with the latest crisis would indicate a broad range of outcomes. While this might look normal at first view, it is worth remembering that CEE countries share quite a few commonalities in their economic and financial structures. Furthermore, they were hit by the same type of external shock, at exactly the same time. One has thus a fair approximation of a controlled experiment on the role of macroeconomic policies before and during the crisis.

At the risk of generalizing too much, I would say that CEE economies shared broadly the same development model and problems. We benefited from large capital inflows mainly in the form of FDI, remittances and cross-border loans. Western European banks penetrated our financial system, increasing financial intermediation and facilitating capital inflows. This process resulted in fast credit and economic growth based on a consumption lead model. While inflation has been generally under control financial imbalances and vulnerabilities were increasing, in the form of rapid growth in real estate prices and balance sheet exposures in liquidity and foreign currencies.

Our economies were hit by the crisis since the first week of October 2008. The fear of contagion was enhanced further by a sharp decrease in the market value of the EU banking groups that operate in the region. It affected negatively the public trust in the system, resulting in widespread deposits withdrawals. Later, as the financial crisis progressed and transformed into a global economic recession, the effects extended to real economy and exchange rate depreciation. Most of the countries in the region faced a rapid liquidity shortage caused by the deposits run, lower remittances and FDI outflows. The balance sheets across the region suffered from both liquidity problems and exchange rate depreciation. This was negatively reflected in consumption and investment, which further deteriorated the financial stability outlook with the possibility of a balance sheet deflation and economic contraction mutually supporting each other in a vicious spiral.

The ability of our economies to absorb these shocks was however different. The natural instinct of macroeconomic policies facing such a contraction scenario is to engage in countercyclical measures in the form of expansionary monetary and fiscal policies. However, the very presence of financial stability concerns in the equation significantly changed the equation. We can safely argue that countries which experienced the least macroeconomic and financial imbalances were the ones better placed to pursue countercyclical policies and in fact the ones which emerged the fastest from the effects of the crisis.

I believe Albania is such a country:

- We had no bank failures or public injections of capital;
- We did contain and reverse the confidence crisis in the financial system and its adverse effects. In fact, we did not experience financial disintermediation;
- We did continue to grow, albeit at a slower pace;
- We did manage to keep inflation expectations anchored.

Therefore, I will share with you our thoughts and measures throughout this period. To conclude this topic I will briefly summarize my personal lessons from this crisis.

Before the crisis, Bank of Albania was concerned for the possible financial threats that were being accumulated during the years of fast financial intermediation. To illustrate the point: most of the credit growth went in the non-tradable sector, with services and construction accounting for most of the expansion. At the same time, more than 70 percent of total credit was in foreign currency with EURO making the biggest share of the outstanding stock.

The tune of that period was the same in the entire region. The overall impression that the financial innovations had reduced the risk and the abundant global liquidity created a very optimistic picture. Despite some truth in this, the pace at which financial intermediation grew annually was frenetically high. In particular there were two main aspects of financial intermediation that were particularly troubling in my opinion. *First*, economic agents created financial excesses using mostly the financial system. While meeting their needs, the financial system aligns and matches agents' positions according to length of maturity and liquidity. This holds true under the assumption that all claims and obligation will be fulfilled in timely manner in the same order. Otherwise if they violate this assumption and end up overlapping each other than financial system might become unstable. Our concern was that too many gaps were opening to fast and the Albanian economy seemed to experience some sort of what latter came to be named as risk-taking channel. *Second*, there appeared to be a general mispricing of risks from the banking sector. High concentration in particular sectors or clients indicated undue risk analysis or risk management from banks, while lending to un-hedged borrowers in a flexible exchange rate regime seemed to be a potential moral hazard issue.

We addressed the first issue through increasing information sharing and facilitating the dialogue between the monetary policy and the financial stability and supervision of the Bank. Normally, the foresight of monetary policy is from the trough to the pick of the business cycle because it is mandated with smoothing the fluctuation in economy or prices. However, the duration of financial gaps and excesses might be very different and usually much longer. Therefore monetary policy by design has the potential to forget about financial stability; therefore we were potentially missing important information regarding the effects that decision making on monetary policy could have on the sustainability of agent's budgets. That is why I believe was important to have guardians of financial stability in the monetary policy decision making process. With this reasoning we have brought the director of supervision and the director of financial stability in the monetary policy advisory committee. In this respect our monetary policy did not focus only in the discussion of macro effects but also in the discussion of the micro effects of decision making. This resulted in policy coordination within the central bank. I believe that this is the first line of defense that we had in our philosophy. This helped us to strike the correct balance between all policies.

The second issue was addressed through tightening macro-prudential regulations and policies and strengthening the on-site supervision of banks. ***Through regulatory and supervisory interventions, we aimed to improve the commercial bank's governance and their transparency, to strengthen their risk assessment and risk mitigation strategies, to improve the capital adequacy and liquidity ratios, as well as to reduce the exposure to credit risk stemming from un-hedged borrowers in foreign currency or predatory practices from commercial banks.***

On the same line, our policy response ***during the crisis*** was cautious**,** prioritizing financial stability and the preservation of inflation expectations to outright economic stimulus. By the beginning of the first quarter of 2009, financial panic, liquidity problems especially in foreign currency, slowdown in EU economic area and the financial stress in the EU banking system affected both the real and the financial sectors of Albanian economy. Credit slowed down considerably, exchange rate started to depreciate, and forecasts for economic growth and inflation were down. In the mean time deposit withdrawals continued and liquidity concerns become more prominent.

Bank of Albania provided ample liquidity in domestic currency in the interbank market while tightening its supervision on banks and increasing the collaboration with their home supervisors. A specific feature that needs to be mentioned is the timely increase of the deposit insurance scheme. This move marked a turning point in the confidence crisis of the public to the banking system and the liquidity problems of the system.

From a narrow perspective centered on its main objective of price stability, the focus of monetary policy would be an expansionary action. However, considerations of the external balances of our economy, its financial stability and the need to anchor expectations, constrained our decisions. I will elaborate briefly on these factors. Faced with contained upward pressures in inflation, the central bank focused its attention on determinant factors of financial stability. By refraining from pursuing an expansionary monetary policy, the central bank did not exacerbate the pressures on the exchange rate which would than put additional strain on un-hedged borrowers and the bank's balance sheets. Furthermore, interest rate cuts had the potential to affect deposit withdrawals and cause liquidity problems and further depreciation. At the time these two were the main concerns to financial stability.

The Albanian economy did however receive some macroeconomic stimulus in the form of fiscal expansion. This countercyclical policy was made possible because of the previous work done to consolidate the fiscal position and to anchor macroeconomic policies and public expectations. Albania approached the crisis with sustainable fiscal position in terms of deficit and public debt, creating room for maneuver and fiscal expansion to support economy before monetary policy could intervene. ***Therefore the first lesson from the crisis for authorities would be to follow countercyclical policies, which will permit for bolder action in time of crisis.***

What are the lessons for the future? I think I already mentioned the first one. The second lesson, which relates to the price and financial stability, is equally important. ***Price and financial stability do not conflict each other in the long run.*** Central bankers should never forget that fiat money on which we base our way of life and prosperity, is a social contract, based on the society's trust that every bill will be honored by the creator of that money, which in most of the cases is the central bank. This trust is one of the important pillars that guaranty not only the economic system but the entire society.

In my opinion, even in the short run, the central banks are well equipped to pursue these two goals with the instruments at their disposal: main policy rate on refinancing operation; macro-prudential policies on a systemic level; and, careful and diligent micro supervision of commercial banks. Having two goals and at least two instruments should allow for an optimal mix of policies, at least in theory. In practice, as is indicated from our experience, central banks should not shy to lean against the wing in order to discourage or at least contain financial imbalances. Furthermore, every time we face fundamental economic problems with potentially negative systemic implications, we revert to financial stability. ***I firmly believe that the first and most important job for a central bank is to ensure the integrity of money and the banking system.***

2. Joint supervision and crisis response mechanisms

Building bridges of continuous communication with local bank managers, home supervisors and headquarters of the mother institutions has proved to be critical in dealing with the problems before they get out of hand. While communication is an advice that is frequently used, we made a good use of that beyond mere courtesy. We acknowledged that financial development was following a certain pattern. Financial institutions like all other businesses adopt marketing strategies and stick to such strategies in all markets. What this means for us is that once new product are developed and tested in other markets, they will follow the same pattern of marketing in other markets as well.

In the years that preceded the crisis, financial institutions started the practice of lending in exotic currencies, offering very low interest rates and being without any economic relation with the borrower activity. Being aware of these developments, from previous communication with other central banks in the region, we were alerted to spot the first sign of such behavior in our economy. Therefore at the first signs of such credits, we discussed with the management of our banks and stopped administratively lending in these currencies for all un-hedged borrowers.

On a systemic level, I do believe the recent experience highlighted some issues that need to be looked more carefully in the future. I will highlight here only three of them.

– The policies that facilitated the capital inflows into economies of the region were not followed by actions which could have provided the needed liquidity when these flows reversed or stopped. Countries of the region did not benefit from the swap agreements or similar arrangements that would allow us access to short term liquidity. One can certainly say that in normal times that could be resolved at group level. However, this didn't necessarily prove to be the case in the recent experience. Because our financial systems are inter-connected, I think this issue deserves more attention in the future.

– A crucial step in alleviating the financial crisis in CEE countries was the Vienna initiative, which stabilized both the balance sheets of the big banking groups operating in the region and the trust of our public in them. I think such a facility needs to be permanent, at least in the case of global or European potential financial

– Financial regulation and regulatory arbitrage was a serious issue before and throughout the crisis. Before the crisis, banking groups would play regulatory regime and policies against each other and try to reach some kind of lowest common denominator throughout the region. Countless times we have heard the complaint "Why are you not allowing this, your neighbors do!", and I'm sure others people in this room have heard it too. During the crisis, we experienced several cases of countries trying to seek individual solutions to common problems. While fully respecting the idiosyncrasies and different timing priorities of each country, I think we would all benefit from a more collegial approach to regulation.

– On a national level, I believe the stress should be on supervision of Systemically Important Financial Institutions, with the right care not to create wrong perceptions related with moral hazard. In our region, these institutions are typically banks. In my view, these banks should become subject of a more stringent regulatory framework, in terms of capital and liquidity requirements, business and risk profile, including contingency plans. The supervisory authority should always be prepared for the worse and make sure that crisis management procedures are complete and tested. In this process, valid recommendations of international organizations will be closely followed for adequate implementation over time. It is important to have close coordination with other public authorities in the country, including government.

3. Anchors of macro-prudential policies

The role of anchors in monetary policy is well known. I mentioned before that an important lesson from the crisis for authorities would be to rigorously pursue countercyclical policies. I would like to stop a bit here and focus on this issue. I believe that Albania was prepared for the crisis because IMF programs have played an important role as a credible foreign anchor for economic policies. The IMF programs and similar EU membership process have played a similar role in all CEE and SEE countries. However as the countries have matured out of these programs or joined the EU, the political incentives to continue fiscal consolidation have been fading away. Current events show that the symptoms have spread to other older members of EU, where such policies become the reason behind instability.

Therefore the role of anchors is very important for preserving and safeguarding financial stability. Sound, clear and enforceable fiscal rule would be an important step. Effective supervision based on simple and clear capital adequacy and liquidity rules would be another. The Basel III accord is a first step in the right direction. A unified approach and technical toolkit to stress-testing exercises would be also helpful. The joint stress-test exercise conducted by the ESCB is the right way forward. I would however encourage broadening its scope in candidate and potential candidate countries of CEE, in order to have a unified measurement system throughout Europe. Lastly, other measures of financial imbalances such as excessive asset price increases, under-pricing of risks, search for yields and increased risk taking need to be better incorporated in the standard models used by central banks.

Conclusion

In the light of this discussion, a central bank could not avoid the responsibility of engaging to protect financial stability, even though this is not defined as a particular mandate. Our experience as an emerging country indicates that price and financial stability are preconditions for each other. Our motto is that any investment that we make in financial stability today will return high benefits in price stability in the long run.

Concurrently, I think our collective experience throughout the crisis showed that more can done in order to develop and institutionalize the proper mechanisms that would allow for better FX liquidity management in EE countries. A mechanism such as the Vienna initiative that would encourage the commitment of parent banks to their EE subsidiaries and would discourage their financial disintermediation in these countries can be made permanent with added benefits to all the stakeholders. Furthermore, regulatory harmonization can be improved and regulatory arbitrage can be mitigated.

On macro-prudential policies I argued on the need to develop specific anchors that would make more credible, transparent and therefore achievable the goal of financial stability. Measuring financial stability, or instability, might be difficult but that should not discourage us from trying.

Thank you for your attention.

Box 1

Measures taken in the banking supervision area during the pre-crisis period.

- On June 2007, the new Law on Banks in the Republic of Albania entered into force. This Law stipulates rigorous principles and rules on the risk management, aiming at protecting the depositors, investors and fostering the banking system's stability.
- On January 2008, the Credit Registry started the operation representing a vital infrastructure-related development.
- On March 2008, the Bank of Albania adopted a package of regulatory amendments which were generally oriented to adopting more conservatory policies in several main directions of day-to-day commercial banking running. In more concrete terms, this therapy can be described:
  - In compliance with the new Law On Banks in the Republic of Albania, new quantitative thresholds were set for the calculation, supervision and reporting of banks' large exposures to parent banks and related entities.
  - In order to better diversify the risk arising from the concentration in banks' investments in the international financial markets, lower thresholds were set for banks' large exposures.
  - Internal control is considered an integral part of banks' governance. Hence, special emphasis was put in designing the key principles for an independent, unbiased and accountable internal control. Internal control should cover each section of the bank in order to prevent the origination and development of undesired risks.
  - Accountable governance is a key principle, especially on financial institutions, whose success is, among others, largely dependent on public confidence in them. Accordingly, the Bank of Albania considers the quality of human capacities – implying the hiring of skillful people in the decision-making process and risk management – as fundamental. The decision making process, should always be based on such expert opinions and recommendations.
  - The transparency related to the banking and financial products and services provided, was also paid special attention. The new legal requirements standardize the manner and form of providing information to the clients on the banking products and services banks provide.
  - Part of this new package was also the standardization of the required information that banks and branches of foreign banks should disclose, related to the banks' main activity, their organization and management, their financial performance and position, the risk management and the accounting policies.