

## **Ardian Fullani: Economic and monetary developments in Albania in 2010**

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the Parliament presenting the Annual Report of the Bank of Albania, Tirana, 9 June 2011.

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*Dear Madam Speaker,*

*Dear Members of Parliament,*

It is a pleasure for me to be here today to present the Bank of Albania's opinion on economic and monetary developments of the past year.

Pursuant to legal requirements and our institutional commitments to enhancing the central bank's transparency and responsibility, in this presentation I will share with you the main highlights on Bank of Albania's activity over 2010. This activity, in its entire spectrum, aimed to fulfil our mission and legal obligations, and reflect the Parliament's recommendations for 2010.

Let me begin my presentation with a brief overview of our conclusions.

*During 2010, the Albanian economy experienced an overall positive performance. The economic activity posted growth, while the macroeconomic stability and financial health indicators improved.*

Economic growth reflected mainly the foreign demand for Albanian products and services, affirming, above all, the dynamism of our private sector. It was also supported by a sustained macroeconomic environment, with downward risk premia and improved liquidity indicators.

*In particular, reflecting developments in the financial and real sector of the economy, as well as our monetary policy, consumer price inflation remained in line with our 2010 target.*

Also, during this year:

- The economy's external position improved;
- The ratio of budget deficit and public debt to GDP dropped;
- Financial stability consolidated;
- Financial intermediation expanded further; and
- Interest rates and risk premiums in financial markets decreased.

On the other hand, 2010's developments underlined the need to continue and intensify structural reforms, which are pre-requisites for a sustainable and long-term economic growth.

***First***, the new agenda of structural reforms should aim at establishing the requisites for a more balanced and sustainable growth in the long run.

Greater orientation of Albania's economy to export and overall higher competitiveness of our products in international and domestic markets dictate the need for continued structural reforms at macro- and microeconomic levels.

***Second***, macroeconomic stability consolidation requires more work in the future. The greatest lesson that the recent global financial crisis taught us is that prevention is better than cure.

Maintaining the country's internal and external balances requires further development of decision-making architecture and macroeconomic coordination, as well as economy and market supervisory and regulatory mechanisms. Analytical forecasting and decision-making skills of public and private economic agents should also be further improved.

**Third**, ensuring the country's financial stability requires coordinated action by all supervisory and regulatory institutions, and a greater attention by private agents of the market.

A sustainable financial system, oriented to new long-term horizons and prudential to risks, serves to channel savings into the most competitive sectors of the economy.

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In the following, I would like to address the above-listed topics in more details, focusing on key points of the Bank of Albania's work.

## 1. Economic and financial developments in 2010

According to INSTAT data, the Albanian economy is estimated to have grown by 3.9 % this year. Compared to 2009, economic growth is more balanced in terms of sectorial distribution and demand components.

During 2010, the Albanian economy was characterised by gradual improvement of the aggregate demand and further consolidation of the macroeconomic stability. Economic development was followed by price stability, while the public debt and current account deficit narrowed.

**Economic growth relied mainly on foreign demand and increased Albanian exports, while domestic demand was sluggish.** The latter decelerated due to public finances consolidation and budget deficit reduction in 2010, while consumer spending and private investments were affected by insecurity about the future and presence of spare capacities.

**Fiscal policy** was oriented towards fiscal consolidation in 2010, following the stimulating nature in 2009. Fiscal consolidation accelerated especially in 2010 H2, following the approval of the revised budget. This consolidation was present on both, income and expenditure sides. Budget revenues increased by 8.4% y-o-y, reflecting the economic growth, expansion of taxpayers' base, and privatisation receipts. On the other hand, budget expenditures decreased by 4.5%, attributable to reduction of government capital expenditures.

**Budget deficit** for 2010 settled to around 3.0% of GDP, reduced by 52% compared to a year earlier. This deficit was funded mainly through the issue of domestic debt instruments. However, deficit financing was a novelty in 2010, with the issue of the first Albanian **Eurobond**. Its issue, at EUR 300 million, met a part of the public sector's need for foreign currency and was accompanied by reduction in domestic borrowing.

**Current account deficit** narrowed by 21.5% in 2010, to 11.9% of GDP. This was reflected in augmented private and public sectors savings. Increased exports as a result of invigorated foreign demand, depreciated exchange rate and improvement of trade terms over this period also contributed to it. Notwithstanding the improvement recorded in 2010, current account deficit remains high. As we have continuously stated, the Bank of Albania deems that compilation of structural policies to dampen the external economy misbalance should be a priority.

Net flows in the capital and financial account recorded a decline by 11.2% in 2010, leading to current account deficit financing to 87.5%. Excluding privatisations, foreign direct investments were estimated at 9.3% of GDP and constituted the main source of foreign financing of the Albanian economy. Foreign reserve increased by about EUR 178.8 million and its stock of EUR 1.9 billion may cover 4.8 months of goods and services import.

Positive developments in the external sector of the economy, primarily owing to expansion of exports and foreign currency inflows from the Eurobond, contributed to the generation of contained pressures in the foreign exchange market. From the macroeconomic viewpoint,

relative exchange rate stability during the year reflected a new equilibrium in foreign currency demand and supply.

***In sectorial terms***, the Albanian economy development relied chiefly on growth of industry and services sectors, while construction sector continued to contract in 2010. Industry and services sectors benefited, to a great extent, respectively, from foreign demand and structural shift of the domestic demand to short-term consumption goods.

In the short- and mid-term horizon, both sectors are expected to remain the main supporting pillars of the Albanian economy. Agriculture, the other important sector of the Albanian economy, marked a positive performance in 2010. Even so, based on the broader concentration of the country's population and the great potential for development, the increase in this sector's productivity remains a long-term priority.

### ***Money and financial markets***

Monetary developments in the past year were in line with the performance of the real sector of the economy, reflecting simultaneously the fully restored confidence in the financial system, improved supply and demand ratios in the financial markets and prudent liquidity management policy of the Bank of Albania.

Expansion of monetary stock by 10.6% on average complied with the economy's demand for money and did not trigger any inflationary tendencies in the economy. Deposit to GDP ratio was 64.2% at end-year, higher than its level prior to deposits withdrawal. In addition, the profile of deposit time structure reflected a higher preference for saving, characterised by a shift to longer maturity-term deposits.

Easing lending terms during 2010 H2, stimulating measures taken by the Bank of Albania, and decreasing uncertainty and risk premiums were followed by a gradual credit growth. Private sector loan portfolio expanded by 10% in 2010, principally influenced by foreign-currency credit growth. This performance reflects prudential bank policies on loan portfolio quality and economic agents' moderate demand for loan.

In general, lending continues to suffer from lack of demand and realistic, qualitative and valuable business plans for crediting.

Restoration of confidence in the financial system, macroeconomic stabilisation, and regulatory and supervisory measures taken by the Bank of Albania led to stabilisation and improvement of banking system capitalisation, liquidity and profitability indicators.

## **2. Inflation and monetary policy**

***Annual consumer price inflation*** was on average 3.6% in 2010, remaining within the Bank of Albania's targeted band. Inflationary pressures were more concentrated in 2010 H1, mostly triggered by a rise in some administered prices. Average annual inflation in 2010 H1 was 3.9%. In the following two quarters, relative stabilisation of the exchange rate and low inflationary pressures from the domestic demand contributed to the average inflation rate convergence around the Bank of Albania's target.

Negative output gap generated contained inflationary pressures throughout 2010, thus balancing the national currency depreciation effect and the international market price rise. The prospects for the future show that the Albanian economy is expected to operate below its potential even in the medium-term, putting downward pressures on inflation.

As I highlighted earlier, in 2010, the Bank of Albania's ***monetary policy*** was implemented in a macroeconomic environment with positive growth rates, contained inflationary pressures and anchored inflation expectations. *This environment led to retaining the stimulating monetary policy stance that has been conducted since 2009. It triggered downward interest rates and completed even further the stimulating effects from the exchange rate depreciation.*

Low interest rates favoured rise in domestic consumption and investments, whereas the depreciated exchange rate supported growth in Albanian exports.

Reduction of the fiscal stimulus in 2010 H2 expanded the space for monetary policy conduct. *In July 2010, the Bank of Albania lowered the key interest rate by 0.25 percentage points, to its historic low of 5.0%.* Improvement of banking system liquidity condition and weak public sector demand for money supported the transmission of an easing policy to all segments of the financial markets in the last months of 2010.

*In parallel, the Bank of Albania supplied the financial market with the required liquidity to support financial intermediation.* Aiming at adopting the most advanced models of central banking, and particularly, convergence with Euro-system practices, the Bank of Albania changed the form of its operational objective.

***Since June 2010, our liquidity management operations are oriented to targeting short-term interbank interest rates and minimizing their volatility.***

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The banking system supervision function is another important aspect of central bank duties.

### **3. Banking supervision and financial stability**

Year 2010 was characterised by increases banking system activity, improved banking soundness and profitability indicators, as well as a good capitalisation of the system. On the other hand, the banking system was characterised by increase in non-performing loan portfolio, reflecting also the active policy of the Bank of Albania in terms of enhancing the transparency of bank balance sheets.

#### ***Banking system development***

The banking sector continues to remain the main actor of financial intermediation in Albania. At end-2010, banking system assets doubled compared to a year earlier, accounting for about 81% of GDP. The banking system continued to be financed mainly by public deposits and focused on lending to the private sector.

On the other hand, the economy's below-potential growth and the depreciated exchange rate contributed to increasing non-performing loans, to 14% of total loans. However, this indicator's growth rates decelerated in 2010.

Capital adequacy ratio remained at satisfactory levels, to 15.4%, obviously higher than the 12% benchmark set forth under the regulatory framework. The system's shareholder equity increased by 10% in 2010.

Credit risk remains the main risk to the banking sector. In response to this risk, the banking sector has created adequate provisions to weather big shocks to borrowers' solvency and market equilibria.

#### ***Banking system supervision***

In early 2010, the Bank of Albania changed its banking supervision organisational framework, orienting and relating it directly to risks associated with the financial activity. In parallel, the Bank of Albania re-conceptualised its supervision focus and strategy in accordance with risks posed to Albania's banking and financial system.

Transparency and publication of information on banking and financial products and services were in focus of supervision in 2010. Encouraging enhancement of private financial agents' transparency is also reflected in amendments made to regulatory framework during the year.

High commission fees on banking products and services were a sensitive issue that was addressed over the past year and will constitute a priority in the upcoming period. The Bank of Albania, through its analyses, played a key role in discussions about this matter, aiming to tackle it timely and duly.

Also, issues related to anti-money laundering, transparency and compliance with prudential regulations were an important part of the supervisory process in 2010.

In view of strengthening the supervisory process on banking institutions, the Bank of Albania has signed a number of cooperation agreements with central banks in the region and with European ones, where parent banks have their headquarters.

### ***Strengthening the supervisory regulatory framework***

In 2010, the Bank of Albania finalised drafting of several new regulations and amended some other regulations on banking supervision. This process aimed at compliance with Basel Committee standards and EU Directives, taking into account international best practices and Albanian banking system developments.

New regulatory acts and key amendments to actual acts on banking supervision approved during 2010 are:

- Regulation “On management of risk from open foreign exchange positions”;
- Regulation “On risk management in the activity of non-bank institutions”;
- Guideline “On conservatorship and liquidation of banks”.

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Besides the main aspects of the Bank of Albania’s work, such as monetary policy and banking supervision and regulation, the Bank of Albania’s activity was also focused on fulfilment of its other legal obligations and institutional commitments.

Sparing the details, I would like to emphasize that the Bank of Albania has done a great job in 2010 for:

- Developing and sophisticating the payment system;
- Supporting the integration processes of the country, in accordance with our scope of activity;
- Enhancing our communication with the public, as an essential instrument to foster transparency and central bank independence;
- Further developing the monetary statistics and those of the external sector of the economy;
- Strengthening research capacity, in support of analysis and decision-making.

All these activities serve the financial system development and support the free market economy in Albania. A detailed analysis on them can be found in our Annual Report

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*Dear Madam Speaker,*

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Turning back to our analysis on economic and financial developments in the country, during and after the crisis, I would like to highlight a structural weakness of the Albanian economy

that has accompanied it throughout the transition: high current account deficit and still low degree of our economy's competitiveness in global markets.

Today we live in a global world, with integrated capital, product and labour markets. As a developing country, Albania is facing (and will continue to face) a rising competition, not only in the region but also beyond it.

In our opinion, the long-term sustained development of the country and reduction of our structural weaknesses, imply necessarily increase of competitiveness of the Albanian economy. Ongoing structural reforms should be driven by ambitious goals and a realistic time horizon.

Structural reforms should aim at creating a more attractive climate for foreign and domestic investments, encouraging employment and further growth of welfare, providing:

- A sustainable macroeconomic environment;
- An efficient and reliable financial system;
- A legal, complete and transparent functional framework;
- A modern infrastructure;
- A qualified and competitive workforce in terms of cost; and
- A clear perspective for a faster integration into the European Union, which will open the way to convergence funds.

Fulfilment of all these criteria requires a joint commitment, and the Bank of Albania will play its role. Personally, I remain convinced that increasing effectiveness of these reforms in light of this, would enable Albania to make a qualitative step towards its integration.

In conclusion, allow me to remind you that, besides the Bank of Albania's Annual Report, the Bank of Albania's financial statements and balance sheet, as certified by auditors, are submitted.

***Thank you for your attention***