

Ardian Fullani: Pushing the boundaries - the challenges facing Albania

Discussion by Mr Ardian Fullani, Governor of the Bank of Albania, at the 11th Euromoney Central and Eastern European Forum - Pushing the boundaries: ensuring competitiveness in the CEE, Vienna, 18 January 2006.

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The march onward to new markets has pushed the boundaries of industry ever farther east in the CEE. CIS countries are currently experiencing an economic boom while much of 'Old Europe' stagnates. There has been a recent boom in domestic markets, FDI, real estate, commercial development, among others.

Will this high level of investment continue, and under what circumstances? What can the Central Bank Governors do to continue to encourage this new growth? Are there any downsides? How do Governors keep the balance between growth and stability?

Will this high level of investment continue, and under what circumstances?

The Albanian economy has continued its good performance also during 2005 with the exception of the end year when we encountered some electricity shortages. The positive performance concerns both the economic activity and the macroeconomic stability. Our opinion on the robust economic performance is based on an increased volume of sales, improvement of revenues from tax and VAT, a rise in the volume of lending to the economy, as well as a reduction in the unemployment rate.

The creation of 13400 new jobs in the private sector during the last 4 quarters indicates robust growth and it is another indicator of the increased capacities of domestic production this year. Except for the service sector, BoA's survey on business confidence shows an increase in the number of employees in manufacturing and construction sectors in the second quarter, where the actual index for the latter surpassed expectations. The preliminary data of the latest survey indicate that employment level has also increased in the third quarter contrary to an expected fall from the previous quarter.

While it is true that there has been a recent boom in domestic markets, the picture is more mixed if we look at individual segments. Thus, FDI are still not there in Albania. Although it is well positioned to attract foreign direct investments, with its favourable geographical location, competitive salaries, and natural resources, foreign investors have been reluctant to commit their resources given the actual state of business environment.

Domestic investment seems to lag behind too, based on some surveys of Bank of Albania. An important source of domestic investment has been remittances. The Bank of Albania estimations indicate that total workers' remittances have reached around 1,028 million (one billion) of USD or 13.5 percent of GDP. This is twice as high as revenues from export of goods, which makes "work force" our main country export. Furthermore, remittances are estimated to be three times higher than foreign direct investments (FDI) inflow and its value exceeds by far official aid from abroad. During the first stage of transition in Albania policies for optimising the administration and utilisation of workers' remittances for developing purposes have been completely lacking. A few sporadic measures have aimed at driving workers' remittances into official channels and improving savings and investments incentives of emigrants in the country but have been by and large inadequate. More recently, we have taken a more attentive approach toward remittances and their potential contributions in financing the growth and development of the country. More specifically we are working in three main areas (1) improvement of statistic (2) bringing workers remittances into formal channels (3) directing workers remittances toward country's development needs.

There has been a boom in other areas of economy like real estate and commercial loans. Credit to the economy grew by 60-70 percent on annual terms. On GDP terms, credit to the economy has grown by 3 percentage points during 2005, approaching the level of 11 percent of GDP. It has been the main source of the monetary expansion during this period has been the increase in the volume of lending to the economy, which is a shift from government borrowing and from foreign assets. Foreign-currency loans continue to be preferred due to lower interest rates, hence accounting for nearly 75 percent of total loans at end-July. The rapid credit growth has so far had no effect on overall credit quality. The

ratio of non-performing loans fell to 3.5 percent of total loans in March, down from 4.2 percent in December last year.

Nowadays foreign banks in Albania hold around 95% of the total assets. Most of the assets is owned by banks coming from the European Union area. This ample participation of foreign banks has certainly had positive implication on both banks' governance and the quality of services. This latter has improved considerably in the recent years with the privatisation of the ex-Savings Bank, still the biggest bank in the country. As a result, we have experienced an increase in the banking network throughout the country's territory, a gradual restructuring of the banking system balance sheet including a quick increase in the lending to the economy, introduction of ATM and other new banking products etc.. Banks with private Albanian capital, that have been licensed in the last three years, have been active in trying to position themselves in these changing market. They offer a full range of banking services, having the advantage of better understanding the local environment.

Despite the above achievements, the economy is still fragile and considerable progress is needed to establish an attractive framework favourable to investment and sustainable growth, driven by private sector development. Customs procedures, tax administration, land and construction permits, sector licensing, and the judiciary system are the major obstacles to investment in Albania.

What can the Central bank Governors do to continue to encourage this new growth? Are there any downsides?

Governance and institution building reforms remain critical for developing a rules-based business climate and attract increasing levels of investment. Under this framework the Bank of Albania is committed to go ahead with additional structural reforms to enhance banking sector intermediation and financial services provision. In close consultation with commercial banks, governmental institutions, and the private sector, the Bank of Albania developed an action plan for increasing the use of the banking system in the regular conduct of business.

Regarding an important aspect of our central bank, the banking system stability, a lot of work has been done to encourage the development and consolidation of a sound banking and financial system for the country economic progress. Measures supported by the Bank include the privatization of the Savings Bank, the development of a deposit insurance system, improvement of the bankruptcy framework and collateral enforcement, and strengthening of bank regulation and supervision, which will also assist the Government's anti-money laundering efforts. The IMF has provided technical assistance to the Bank of Albania. The IMF has also funded a resident adviser to support the implementation of the institutional development program for banking supervision developed by the Bank of Albania. In the wake of the large Savings Bank privatization, the financial sector is showing welcome dynamism and the BoA is stepping up prudential vigilance. The recent FSAP exercise will certainly help to advance reforms in the financial sector.

Bank of Albania is also committed to increase the mutual relationships with all international partners. We are trying to be a real partner in the discussing table, arguing on the economical-financial policies, through presenting its solution alternatives, being elaborated not only on the economic logic base but also on the Albanian reality. I am satisfied that, in the end, Albania is on the way to get a new PRGF/EFF arrangement with IMF which suits its actual needs very well. Given Albania's difficult legacy, together with the setback of the 1997 events, the country needs to accelerate its reform agenda, not least to for it to be grouped together with countries like Macedonia for EU accession purposes. This requires significant investments, improvements in public institutions, and technical assistance in all sorts of fields. The PRGF element allows Albania not only to access many of these resources from the IMF and WB organizations but also have the support of the Albanian government in absorbing more effectively available EU funds.

We are also working for the institutionalisation of the cooperation between the central banks of the region. Judging from the meetings we have recently organised with some of the regional banking authorities, the initiative on regional cooperation has been welcomed. Nevertheless, I believe that it is the right time to carry out concrete measures in this direction through the establishment of a club of regional banks, which would enable the exchange of experiences and the consolidation of cooperation, mainly in the field of further financial/banking sector development in Southeastern Europe. Bank of Albania will continue to actively support and promote the establishment of this club in the future. I want also mention here the "Convergence" program which is a novel financial development program sponsored by the World Bank to promote public-private policy dialogue in

South-East Europe. It could serve as an effective instrument to catalyse our efforts in bridging the gap with banking association and the other counterparts in the region.

How do governors keep the balance between growth and stability?

Theoretically, the answer would be to apply some kind of a 'Taylor Rule' by putting even weights on both output gap and inflation. However, for a small, open and developing economy the empirical experience may not be that simple. One issue would be how able are countries like ours to pursue independent monetary policies.

An argument that I do advocate is that the Albanian economy is a relatively flexible economy, as it manages to bring inflation to normal levels in quite a short period of time. Rigidities, observed in some other economies, seem not to apply in the case of Albania. Here, I have in mind the long hiring and lay off procedures or the variety of rules related to the goods and services markets. Most importantly, the adoption of a flexible exchange rate regime has been and still is one of the main contributors to economic flexibility, which has a direct impact over the high mobility rate of the Albanian economy.

Due to this flexibility Albania has shown impressive results in terms of price stability. Inflation has been distinguished generally by lower rates relative to other transition economies. In the last five years, inflation has stabilized at moderate levels as measured both at the end and average period figures, though it sometimes diverges from the target due to unforeseen shocks and speculative factors that are mainly beyond the central bank's control. We will continue to aim inflation rates around the 3 percent level.

However, several threats may prevent the bank from reaching the target while preserving growth. To begin with, the signalling power of monetary aggregates targeted by BoA may start to deteriorate. This might involve changes in the administrative prices and structural reforms in general, fiscal uncertainty issues, the impact of dollarisation on the effectiveness of monetary policy, the potential decrease in foreign remittances and its implication on exchange rate volatility, financial system development and stability etc. *Also, what's more important, as the economy gets more and more formal we may start losing some of the flexibility seen so far, making it more and more difficult our task of keeping inflation down with little real costs.*

In face of this forthcoming developments, we are considering alternative regimes such as IT that could both transmit central bank signals better and are more suitable to keep a better balance between economic shocks and inflation. On top of theoretical benefits of an IT regime compared to the other regimes, (summarised in a series of paper by Mishkin et al. (1997, 2000, 2002)) such as broader information base it utilises, its relatively higher flexibility with regard to supply shocks, the fact that it is easily understood by the public, there is also the successful reference to regime shifts in other European transitioning and developing economies can be made, such as the Czech Republic, Hungary, Iceland, Poland and Turkey.

Bearing the above issues in mind the BoA retains that a switch to inflation targeting over the medium term will put us in a better position to strike the right balance between growth and stability. Accordingly, it has initiated steps to improve its governance structure and strengthen its analytical capacities, with technical assistance from the Fund. To this end an open forum took place at the end of last year where most of the issue regarding the implementation of inflation target were discussed by top experts all around the world. The main motivation for moving to the IT regime is the anchoring of inflation expectations in the medium to longer term while allowing some room to respond to shocks.

I'm conscious that going to fully fledged Inflation Targeting is a process that requires hard work with several preconditions in place. Our forum clearly showed that it is not a one-off decision. It should be more a smooth process. This holds in particular for a transitioning country like Albania. Our country faces different challenges and virtues compared with developed countries.