

## **Ardian Fullani: Past and future banking reforms in Albania and the region**

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at The Fifth International Banking Forum, Athens, Greece, 6 December 2006.

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Honorable Dr. Margret Doyle,  
Dear Mr. Chairman,  
Distinguished participants,

Before starting my speech I would like to briefly address the perennial question that stands at the heart of our quest: "Are the prosperous times ahead of us?" It comes to my assistance an old saying of one of your ancient philosophers, Eupides: "Prosperity is full of friends". As we are gathered here as friends, I believe we have a positive answer to this question.

I would like to thank "The Economist Conferences" for inviting the Bank of Albania in this very important forum. It is a great pleasure to be here today. The topic of my speech will be economic reforms. I will take this opportunity to express my views on past and future banking and financial reforms in Albania and the region. The topic is not new of course. However, reforms and their implementation are a dynamic process that must reflect changes and expectations for future developments in both domestic and global markets. Therefore, it will always be an open discussion in need for new ideas and solutions.

Central banks are important contributors to the economic reforms and their implementation. They not only welcome and support but also generate reforms in the capital, labor, and product markets. Such reforms have ripple effects that go beyond economic benefit of a long run stable growth and financial stability. I believe that positive spillovers will be materialized in the South East European region's prosperity and its economic and political integration in European Union.

The Bank of Albania has been a constant generator and supporter of reforms both institutionally and as the provider of stable prices, sound macroeconomic conditions and financial stability. It makes an undeniable fact that financial integration which we are experiencing will be to the forefront of European Union integration process. It will ease the challenges and speed up the process of European integration which Albanians have embraced by wide popular consent.

Like in many other transition economies banking reforms in Albania were implemented as an integral part of the structural reforms undertaken to transform the Albanian economy in a market oriented economy. Continuous improvement, along with approval and implementation of new banking legislation and supervisory regulation; liquidation and privatization process of the state owned banks; and foreign ownership; have change banking and financial markets.

Foreign banks have been an important push factor toward increasing efficiency, number, quality, and coverage of financial intermediation. New entries, mergers and acquisitions are recently altering the market structure in both asset and liabilities. Reforms that brought big European players and their capital in the market, have further increased confidence in our economy and in the region as whole.

However, the presence of foreign banks does not replace the need for legal and institutional framework. Moreover, latest developments in banking and financial markets might foster additional risk factors related to asymmetric exposure, issues of home host supervision and financial safety net with foreign banks dominance. These challenges and the expected financial developments in the region will outline the scope and the structure of reforms in the future. So, please allow me to briefly present my view on the future trends of regional financial markets.

Financial markets in the region are becoming part of broader global developments which fuels financial integration, liberalization, and financial innovation. The lucrative regional market and the consolidation process have imposed a vertical financial integration in the region. Less than ten European banks with headquarters in Vienna, Athens or Milan dominate the regional banking markets. The process of financial integration will continue, making the region more and more integrated to the European Countries. Financial systems are leading the road to financial integration and the positive spillovers of such process will spread over.

Financial markets are and will continue to be bank dominated. Non banking financial sector will grow very rapidly, but banks will continue to be the major players. They will help to further build the needed

financial infrastructure for nonbanking financial activities, and support growth in our economies. Not long ago I asked a friend of mine who had recently returned from migration after 15 years: "Why did you come back"? His answer was simple but true: "It is not important for me where I like to live – he said – it is important where the opportunities are". As the gap in living standards closes and Albanians see opportunities flourishing in Albania, they will come back. They will bring important human capital and managerial skills, which they have gained in the countries where they work. Many Albanian emigrants are at this stage of the migration cycle and we see potential benefits from such a process. It is the role of banks to match this human capital with necessary financial capital and provide financial services to develop their entrepreneur skills.

This role comes very naturally to Greek commercial banks that operate in Albania, which I take the opportunity to thank for their early confidence in Albania. They are natural partners for these new entrepreneurs who are familiar with the culture, and probably have a long history operating with respective Greek offices. The fact that such ventures could also involve Greek capital in the case of pure joint investments makes one more argument in support of my observation. According to the Bank of Albania surveys, Greek companies are ranked first by the size of capital invested in the Albanian economy, while holding the second place for the number of Foreign Direct Investments.

The involvement of these banks in financing such activities will play a positive role in shifting the balance of the loans portfolio from retail and consumer crediting toward production activities in industry and agriculture. At the same time, it might also fuel the growth rate of credit to economy, which has already experienced very rapid growth during the last two years, raising concerns for macroeconomic and financial stability.

The results of reforms were not limited only to the openness and development of domestic financial market. They generated price and financial stability, sustained economic growth, assisted institutional building and increased confidence. These developments attracted interest of, and brought big financial groups in the region in general and Albania in particular. As I mentioned above entry of big financial groups, and the consolidation process that has followed since will continue to grow. What we are observing right now in the market is that the big fish is eating the small fish; the very big fish is eating the big fish in the European market with implications for the host countries. However, the process is far from over, gigantic fish (global player) might enter the region by eating the very big fish. Last but not the least, there will be mergers among domestic banks as well.

Despite the increase in the concentration ratio that comes with these mergers and acquisitions, we have started to observe increased competition in our market. This competition increases efficiency, introduces new services and products, lowers spreads and generates positive spillovers for economic activity. While this makes a good precondition to foster financial stability, it is not a sufficient condition to increase financial discipline.

Currently, the activities of financial institutions and commercial banks have a limited scope; however, we are starting to see the signs of financial conglomeration. We have no doubt that this trend will grow and continue in the future. It will bring innovation, new financial instruments and products in the market. Along with this, rapid growth of credit and debit cards as well as other systems of payments will continue to grow. While these instruments might not subside or even reduce the use of cash, this trend must be taken into account.

Transition economies of the region are lucrative markets. They are growing substantially faster than traditional European markets and offer impressive prospects for high profits and significant growth. To give you an example, return on banking activity in Albania during the last two years has been around 20 percent. These positive prospects and the eagerness to compete quickly and beyond rational limits for profits and market share may create potential risks. If managers were to lose sight of the entire picture, and financial constraints, such competition might result in mismanagement, nonperforming loans, and other banking problems. Therefore, there is no room for sloppy managerial attitude. It is very important that managerial staff must be up to the challenges which, if materialized, could be more complex than in the self-regulated developed markets. It is important to act en bloc and engage in regional projects of infrastructure including here the financial ones.

We have great confidence in the ability of the banking system to promote the best banking and cautionary practices; however, I believe that preemptive action is needed to ensure that latest observed trends do not hamper financial stability. Therefore, we cannot neglect improving our legislative, regulatory and prudential measures as a major element of financial sector reforms in Albania.

In this regard, a new Draft Banking Law is prepared by Bank of Albania; likewise, a new Law on Securities will be introduced shortly. In addition, efforts are underway to revise legislation on Pension and Investment Funds, and draft a Law on the Payments Systems, which will substitute several sub-legal acts issued by the Bank of Albania until now. This process aims at gradual harmonization of the banking legislation with that of the Acquis Communautaire.

To address issues of increased competition, poor managerial practices and safeguard stability, the Bank of Albania is working toward establishing a Credit Registry, revising regulatory framework on capital adequacy ratio and credit risk management, increasing on-site supervision, and improving its stress-testing models. Following Financial Stability and Assessment Program (FSAP) recommendations, a separate entity "The Authority of Financial Supervision", has been established recently to supervise the securities, insurance and pension funds markets.

Last but not the least, I would like to address the implementation of the Basel II accord. While it will shape the financial market, I believe it will pose challenges to our banking system and to us at the moment. We have initiated the implementation of the new accord, but we are currently being pragmatic to approve only the adoption of well understood elements of Basel II that can be implemented in a safe way.

Now, I would like to shift your attention to the other important pillar of banking reforms: the role of the central bank itself and its monetary policy. The contribution of the Bank of Albania to the economic reforms comes also through maintaining stable prices and helping to ensure financial stability. Over the last five years the Bank of Albania stability oriented monetary policy has generated low and stable inflation; it has also ensured that medium and long run inflation expectations have been well contained. The economic growth has been robust at around 5-6 percent of GDP, while enjoying a high degree of financial stability. Reflecting broadly on the nature of the monetary policy I would say that it has always been focused on maintaining price stability and using the control of monetary aggregates as an intermediate target. Current account and foreign exchange transactions were liberalized at the early stages of transition along with the adoption of the free floating exchange rate regime.

Indirect instruments are been used to transmit interest rate and liquidity signals to the market. Repo rate has become the signaling tool for short term interest rates while repo and reverse-repo operations are used to manage liquidity. Reforms in the conduct of the monetary policy have granted greater flexibility to banks to determine both the volume and terms of lending and deposits.

The Bank of Albania has provided all necessary conditions to ensure sustainable economic growth and stable prices; however it alone can not guarantee that the objectives will be fulfilled. All these positive developments have taken place in the presence of a well contained fiscal expansion, as element of sound fiscal policy and bold structural reforms.

Banking system has become an important provider of domestic financing for the government. Commercial banks have played a major role in it, while direct financing from the Bank of Albania was limited to address issues of independence and deficit monetization. Recently Government introduced to market papers of five years maturity. In addition, with the consent of the IMF, government will shortly issue euro denominated government securities. Bank of Albania welcomes such development as a certification of cautious and responsible fiscal policy. At the same time we call for more prudence and proper addressing additional risks.

It is undeniable however, that these latest developments have been achieved under the watchful eye of International Monetary Fund. IMF has been an important element of the reforms in Albania. Its presence and the memorandum of understanding signed under the framework of ESAF and current blend of PRGF and EEF Programs, enhanced credibility of our economic reforms and served as external anchors. However, as our economy grows and current agreement ends at 2009, we will soon get full ownership of our economic policies with a reduced role of IMF under article 4 of the Agreement.

The Bank of Albania has a proven track record of competence, credibility and professionalism in the service of our economy. These three elements provide necessary conditions to support and guarantee achievement of economic goal of stable prices and boost credibility in Albanian economy; but, we can not be hold responsible for the behavior of the other players. I am convinced that we need to find and implement clear domestic and foreign anchors to preserve the credibility of our reforms in the future.

For the way ahead we are focusing our efforts in the identification and utilization of key elements of the state, politics, markets, institutions and general public that could efficiently play the role of domestic anchors. As part of this preemptive action, the Bank of Albania is carefully considering the possibility

to launch a fully fledged inflation targeting regime of monetary policy in the midterm. This will be a conditional decision based upon results of current ongoing research, evaluation of the preconditions and building up of capacities. Other possible anchors such as a memorandum of understanding with ministry of finance and public education are considered as well.

On the foreign side we see numerous prestigious partners which understand our concerns and appreciate the value of fiscal discipline. They enjoy the power and the virtues of an influential voice. Some of them have already been partners in reforms and will be shaping the future ones. European integration process and the Association and Stabilization Agreement that we just signed in provides nominal anchors. In addition, sovereign ratings and other independent country reports could also play this role. The Bank of Albania intends to establish open lines of communication and adopts instruments that will automatically start building up pressures before it is too late.

My personal conviction is that European Accession lies out as a natural process, where central banks have a vital role to play. This approach would be of mutual benefit and it will speed up the convergence toward European standards, making the political decision a natural outcome of our efforts. To make this process more effective the central banks and the European institutions should continue the dialogue, why not even by surveillance, supporting, assisting and guiding us in fundamentals and economic financial and legal, infrastructure. This process would increase our responsibility and accountability to make Albania an eligible partner.

Let me conclude my discussion quoting Euripides who says: "Much effort, much prosperity".

Thank you again.