

Ardian Fullani: Monetary policy strategies for small economies

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the VII Annual Conference of the Bank of Albania “Monetary Policy Strategies for Small Economies”, Tirana, 6 December 2007.

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Dear ladies and gentlemen,

It is a great pleasure to open the proceedings of the 7th Conference of the Bank of Albania. On behalf of the institution and myself I take this opportunity to welcome all participants. I am confident that the following two days will instigate debate and discussion on key central bank issues.

This year's main topic will focus on the classical function of a central bank: “monetary policy”. Institutional framework, decision making process, monetary transmission efficiency and other issues related with financial markets, macroeconomic and financial stability, will make interesting topics of discussions from our esteemed speakers.

I am confident that our panellists are well-known senior experts; therefore, on behalf of the institution I would like to thank them heartily for accepting to share with us their views and findings.

Given that the proceedings of the Conference will extensively cover theoretical models and countries experiences as well I would like to briefly present the evolution of our central bank during the last three years.

To our pleasure the enhancement of analytical and modelling capacities of the Albanian institutions has been widely recognized yielding a greater ownership in our medium run economic and financial development programs.

Since the beginning of transition most of these programs have been designed and implemented under the setup of IMF conditional support programs. Even the current policy setup is designed under such program. We currently believe this is the final one which gets IMF financial support, implying that our economy is matured and that Albania is on the right track. After many hardships of transition, the Albanian authorities should have full ownership in the medium-term development programs of our country. This is the reason why the Bank of Albania has quite for long been engaged in a comprehensive process of scrutinizing and choosing the best options.

The year which is coming to an end marked another important chapter in this context. In contrast to the previous two years, the Bank of Albania has further deepened its cautious research of all aspects characterizing the present and future of monetary policy.

It has been quite for a long time that the central bank has publicly announced its efforts in assessing objectively and professionally the future of the Bank of Albania monetary policy. These were not sporadic efforts but part of a process which initiated three years ago with the only objective of finding the answers to the following questions:

Should we move to another monetary policy regime? What regime would be the most appropriate one?

I believe you share the same opinion with me that finding the answers to the aforementioned questions is not an easy thing. This is not a plain mechanical action.

In the last three years the Bank of Albania has been involved in an intensive process of assessment, analysis and conclusions for the future of monetary policy. And we have not been alone throughout this process.

Together with other Albanian institutions – first and foremost with fiscal authorities, different European and regional central banks, other international financial institutions and academia, we have tried to identify the most suitable monetary policy regime to be adopted.

During the last three years, we have been tossing ideas and scrupulously studying the details of a fully fledged inflation targeting regime. Based on the current features and expected developments of the financial markets, we believe the inflation targeting regime provides the best policy choice for the future.

A relatively long history of low inflation, constant soundness of the macroeconomic situation, stable and sound banking system, free floating exchange rate, a suitable institutional framework, fiscal consolidation are important factors that have convinced us on the potential success of inflation targeting regime. However, we are aware that there is still a lot to be done in this context, in particular as far as monetary transmission mechanism and financial market efficiency are concerned.

Furthermore, under a relatively rapid and considerable development of the Albanian economy we are sure that the advantages a complete and independent monetary policy framework provides are larger in size than the disadvantages. Therefore, the currency board has not been considered a possible option for the future.

On the other hand, the current operational targets (quantitative limits on net assets of the Bank of Albania and the banking system), or the so-called performance criteria, which are part of today's decision-making, might not be able to preserve their binding power after the expiration of the conditional agreement with the IMF in 2008. These intermediate objectives may be replaced by a concrete and transparent objective such as the inflation rate, which provides a more direct communication of monetary policy decisions in economy in order to achieve the main target of the Bank of Albania. Consequently, summarizing what has been previously said we have identified the inflation targeting regime as our best choice versus currency board and monetary targeting. Another argument which supports our choice is that various internationally recognized experts have compared the current setup of monetary policy to an implicit inflation targeting framework.

Furthermore, we believe this regime will provide a better platform for harmonizing the monetary policy with the fiscal one, implying that the fiscal authority will seriously commit to support the proposed setup.

To this purpose, we invite the Albanian Government to reach a consensus on the key objectives of both policies, monetary and fiscal, adopting the convergence criteria as a strategic goal.

Success in this endeavour requires Albania, among other things, not only continuity on the path of sound macro policies but even strengthening them further. This means a monetary policy focused on maintaining price stability and a prudent fiscal policy which will ensure that Albania's deficits and debt ratios are sustainable and at low levels to increase the attractiveness to international investors. Put differently pursuing a monetary policy focused on price stability and a prudent fiscal policy, will no doubt reduce Albania's risk premium. The benefit of this achievement will be felt throughout the economy.

To support my idea I have to tell you one fresh news. Yesterday Albania succeeded to sell internationally a seven year fixed rate bond in Lek. This was not a result of a toss of coin, but a reflection of international confidence in the Albanian economy and its macro policies. This confidence should increase in 2008, 2009 and beyond.

Regardless of the monetary policy regime it is to be said that the chances for this setup to be successful are greater under a developed financial market, which understands properly the monetary policy signals and transmits them adequately to the economy. Monetary policy efficiency implies the financial market efficiency.

This issue has been part of my earlier discussions; however I would like to highlight that only recently we have taken concrete steps which will improve certain financial market segments.

We have currently tried to adopt a set of measures which will facilitate the reformation process of the financial market by further deepening it. In more concrete terms, the Government securities market and the interbank market have been most particularly under our special focus.

After several consultations with all actors in place we decided to come up with a package of initiatives and priorities during 2008 whose purpose is to establish incentives and minimize risks in the Albanian financial market:

- **Broadening and deepening the base of participants in the Government securities market**

Starting from January 2008 we will increase the investors' base, eligible to directly invest in the auctions of Government bonds. We believe it will increase the competition while so-far this was a privilege enjoyed by the banking system.

- **Reducing the interbank market risk**

So far, the banking system has applied limits on the amounts it can lend in the interbank market. Therefore, we are working on introducing a new law on repurchase agreements, which will enable the risk-free conduct of repurchase agreements among commercial banks.

- **Establishing the delivery versus payment system**

In order to minimize the payment settlement risk and facilitate the intermediation in all types of transactions involving collateralized loans, repurchase agreements and outright purchase and sale of Government papers, we are working to put into practice the principle of delivery versus payment system.

- **Enhancing the interbank market efficiency**

In collaboration with the Ministry of Finance we have agreed on less frequent Government treasury bills auctions. Moreover the size to be issued in each auction schedule will increase. This less frequent auction schedule will increase the number of transactions in the interbank market for the period in-between the two auctions as banks will try to reduce the costs of liquidity. On the other hand it will limit the opportunity of banks to be liquid based on distributing their treasury bills investment and consequently, they will seek other market options such as the interbank market.

- **Introducing the prime rate**

Being convinced that the monetary policy may be efficient through transparency the Bank of Albania aims to introduce in the first half of 2008 the "prime rate" to the set of orientation rates used by commercial banks.

Regardless of the measures to be adopted I would like to say that other financial market segments need to come along with us in this challenge. I have to say that the financial intermediation role of other financial institutions is weak and it has no substantial influence on the intermediation and reallocation of financial funds in economy. I think today's reality provides a lot of room for making the capital market reactive. According to our estimates, the number of major companies certified by well-known international auditors is ever-increasingly becoming larger.

Further to my speech I would like to focus on another priority of the Bank of Albania, that of financial stability. It holds true that macroeconomic stability is crucial and precedes all other important economic and financial developments. Without macroeconomic stability there is neither growth, nor foreign investment or reallocation; consequently there is no development.

However, macroeconomic stability without financial stability would be a utopia; it would be like a non-standing bridge. This is the reason why we have been paying special attention to

financial stability throughout 2007. The recent developments in the sub-prime mortgage loans must serve as an excellent reminder of the never ending surprises which from time to time cause a lot of turmoil for the financial market stability. Moreover this episode once more highlights the necessity for more harmony between monetary policy and financial stability. I want to make clear that by financial stability I do not assume only the absence of a financial crisis. First and foremost it implies a functional and efficient financial system in its intermediation role.

I personally believe that too tight regulations truly minimize all the risks, but on the other hand they might not always be conducive to sustained growth.

Therefore, the real challenge we are facing is to find an optimal balance between deregulation, which promotes market forces and financial innovations, and negative consequences of possible market failures and financial crises.

Obviously, this optimal balance is hard to be actualized in the daily practice. Therefore more empirical studies need to be made, which I believe is one of the main priorities of the newly established Financial Stability Department.

However, I would like to underline that as a supervisory authority we have been very prudent during the present year, considering among others the rapid growth of credit portfolio in the last 2-3 years. I take this opportunity to inform the banking system and the public at large that starting from January 2008 the Credit Registry will begin to operate.

Special attention has been paid to strengthening banking supervision, in particular to that part which relates to the governance of commercial banks. Moreover, we have required more transparency from the banking system and a more accountable relationship with the public. The continuous improvement of human capacities involved in internal control and risk management has for a long time been a concern for the Bank of Albania. With reference to the latter I would like to underscore that we have already identified three greatest risks whose presence would have severe consequences on the financial stability. I have to say that this group of risks characterizes the whole region; consequently there is a lot of room for cooperation in this context.

1 Credit risk

Credit risk directly relates to the boom of credit to economy in the last years. Although the statistics indicate that the share of non-performing loans is low, prudence is required. We all do know that the rating and re-rating methods may be a tool in the hands of banks to keep the reality away from the truth. The entrance of big international foreign groups puts upward pressure on the other banking operators attempt to compete for borrowers which may often deteriorate the credit portfolio quality. Moreover, let us not forget that the companies' balance sheets lack transparency which makes another issue for this matter. To conclude I would like to say that the current developments in the real estates market may potentially have a negative impact. A considerable rise in prices when real estates account for about 80 per cent of the collateral may have a negative impact in case there is a sudden fall of prices in the fixed assets market.

2 Exchange rate risk

As of November 2007 outstanding credit is shared by 70 per cent of foreign currency credit and 30 per cent in the local currency. It is my impression that the figures are similar to the whole region. Extending credit in foreign currency to borrowers with income in national currency means that a sudden exchange rate depreciation could threaten their capacity to repay.

3 Contagion risk resulting from the presence of big banking groups throughout the region

Currently we are all witnesses of a large-scale penetration of some big international banking groups throughout our region. This development has obviously been welcome as it has provided a better and more efficient allocation of free assets in economy. However, I believe that more prudence is required in this context. A disturbing issue for the parent bank or a concern of one of its branches in the region may cause turbulences for the fact that these banking groups have large market shares. Moreover, host-host supervision-related concerns have not been covered by the Basle standards which makes the whole situation even more complex.

In conclusion, I would like to highlight that our work has been guided by a simple but progressive philosophy which has aimed at:

- Establishing sound and operating structures;
- Concluding and improving the legal and regulatory base; and
- Absorbing qualified and professional human capacities to cope with the future challenges.

I express my belief that the Bank of Albania is fully capable to have the full ownership of designing and implementing the monetary policy.

Dear participants,

I tried to give a short overview of our work in the last years. I am sure than the speakers' presentations and discussions in this conference will help us to better understand certain issues and provide the answer to several questions.

I truly believe all the participants will be active by bringing and focusing on new aspects, different experience and alternative perspectives to our viewpoints.

I wish you good proceedings.