

Ardian Fullani: Albania's economic and financial developments in 2011

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the presentation of the Bank of Albania's Annual Report 2011 to the Parliamentary Committee on Economy and Finance, Tirana, 30 April 2012.

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Honourable Chair,

Distinguished Members of the Committee, Ladies and Gentlemen,

Before starting my speech, I would appreciate your kind understanding about the fact that the period after the submission of the Report has enriched the 2011's economic data inventory with new information. It is understandable why this information is not incorporated into the submitted material. In the following, I will address overall economic developments based on the latest information, trying to also identify the differences between the latest data and the version available to you.

Our annual meeting on introducing Bank of Albania's Annual Report remains a special pleasure for me. More than a legal obligation, the Bank of Albania considers this Report as an important step to enhance institutional transparency, foster accountability and intensify the dialogue with all economic policy-makers and stakeholders. Let me now start with an overview of main conclusions of the Report.

The economic activity recorded positive growth rates, while the macroeconomic balances remained stable or were further strengthened. It should be emphasized that this activity was conducted against the backdrop of deteriorating global economic and financial situation in 2011.

INSTAT's data reveal that Albania's economy grew 3.1% in 2011, supported mainly by the increased external demand for goods and services, whilst the domestic demand performed sluggishly.

The economic growth was materialised into a better performance of services sector and individual branches of industry, while construction continues to suffer from sluggish demand and high inventory, especially of residential buildings.

These developments reflect the internal restructuring of the economy and Albanian business, in response to changed aggregate demand composition and the need for enhancing the economic competitiveness in the region and world-wide.

Consumer price inflation appeared volatile in 2011, due to upward prices in international markets and other supply-side shocks. However, the past year's average annual inflation was 3.5%, i.e., in line with Bank of Albania's target. The meeting of inflation target was driven by low inflationary pressures from the domestic economy, controlled monetary expansion and anchored inflationary expectations. Meeting inflation target amidst a challenging environment, full of unexpected developments, reflects the effectiveness and credibility of Bank of Albania's monetary policy. Our unwavering commitment to maintaining price stability has led to anchoring inflationary expectations.

Inflation anchoring has brought about direct benefits to the economy, in the form of mitigating economic fluctuations and reducing the intermediation cost of macroeconomic policies.

Year 2011 was featured by an increasing harmonization of macroeconomic policies. These policies stimulated the Albanian economy, but were prudent in terms of maintaining macroeconomic and financial stability in the country.

In particular, the tightening fiscal policy made room for increasing monetary stimulus in the economy over the second half of the year. Along with continuous liquidity injection, key interest rate cuts were soon passed on to the short-term financial market segment, while the easing monetary policy direction was followed by long-term interest rates.

Fiscal policy indicated an upward orientation towards consolidation over the past year. This commitment was reflected in maintaining the budget deficit at about 3.5% of GDP and the public debt at about 58.1% of GDP.

Although the prudent fiscal policy has a short-term cost in the form of absent fiscal stimulus, the Bank of Albania deems that the long-term benefits deriving from reduced risk premia make the pursuit of this policy necessary in the short and medium run.

Albania's trade and financial relations with foreign partner countries increased in 2011, reflecting mainly the satisfactory growth of Albanian exports and the increased import bill as a consequence of upward prices in international markets. Current account deficit accounted for 12.1% of GDP, continuing to illustrate a structural vulnerability in the economy.

The handling of this issue requires ongoing and speeded-up structural-reforms, in order to promote competitiveness of the Albanian economy and establish appropriate balances among consumption, savings and investments in the economy.

The banking system supported the economic development in 2011 with loans, liquidity, financial products and payment instruments. Unlike the experience of many other countries, loan portfolio of the economy increased over the past year; banking supervision framework was improved and financial stability was further strengthened. Although non-performing loans increased, the Albanian banking system, responding to strengthened prudential regulations of the Bank of Albania and our initiatives to enhance the transparency of its balance, remains solid, with adequate capital and liquidity to support the economic development.

I will proceed with a more detailed analysis of the foregoing issues, focusing on Bank of Albania's main directions.

1. Economic and financial highlights for 2011

GDP expanded by 3.1% in 2011. Likewise in 2010, external demand was the main driver to economic growth, though its impact pursued a moderating trend due to the slowdown in partner countries' economies. On the other hand, domestic demand remained relatively sluggish.

Consumption and private investments remained under the impact of consumers and private businesses. These significant aggregate demand components did not reveal any strong signs of recovery over the past year, despite the improving financial conditions. The sluggish **consumer spending** reflected the continuation of consumers' high propensity to save and the heightened uncertainty surrounding the future.

On the other hand, the presence of spare production capacities and tight lending conditions gave rise to a slow performance of **private investments**. Judging from the distribution of

credit flows, these investments were mainly allocated to industry and services sectors, which benefited the most from the external demand performance.

In 2011, **fiscal policy** was oriented towards further consolidation of fiscal indicators in order to preserve the public debt thresholds. This approach established a mild fiscal stimulus in the economy, concentrated mainly in the first and fourth quarters of the year. Budget deficit was 3.5% of GDP, up by 0.5 percentage points, y-o-y. The budget deficit was determined by the slow increase in fiscal revenues and expenditures. Revenues increased by 1.8% y-o-y, due to decelerated economic activity. Their performance also determined the prudent approach in carrying out expenditures, which rose by 7% from the previous year.

The budget deficit was financed by domestic borrowing with an increasing orientation towards longer maturities, thereby improving the public debt maturity structure and lowering the refinancing risk. The low public sector demand for financing was reflected in the decreased yields on government securities and also made more room for higher private sector financing.

Adverse developments in external economy were also reflected in the **balance of payments**. The curbed economic growth in Albania's trade partner countries was reflected in decelerated exports, which reduced their annual growth rate to 20.0%. On the other hand, high global market prices materialized into 12.4% increase in import expenditures, in 2011. These developments reversed the adjustment trend of the current account deficit pursued over the past two years. Current account deficit reached 12.1% of GDP, up by 12.5% from 2010. Net flows in capital and financial account increased by 5.6% and contributed to financing 80.4% of the current account.

Bank of Albania's international reserve remained almost unchanged at EUR 1.9 billion, sufficient to cover 4.4 months of imports of goods and services.

In line with the economic activity performance, employment figures showed gradual signs of recovery in 2011. According to INSTAT's data, the average number of employed people increased by 1.7%, mainly as a result of higher employment in the private non-agricultural sector, while the number of people employed in the public sector maintained the downtrend that had begun in the last quarter of 2010. The number of unemployed people remained almost unchanged from the previous year. Despite the higher employment in the economy, unemployment rate dropped slightly by only 0.2 percentage points to 13.3% at end-2011. The presence of the negative output gap and the incomplete utilization of capacities kept the unemployment rate above 13% over 2011, thereby conditioning the dynamics of nominal wage increase in economy.

Monetary indicators in 2011 were in line with the real-economy developments, featured by a moderate monetary supply growth, low demand of the economy for funding and steadily high propensity of consumers to save. The broad money increased by 9.2%, y-o-y. Stimulating measures taken by the Bank of Albania, along with good liquidity condition and well capitalisation of the banking system, supported the increase of lending to the economy in 2011.

Private sector credit was up by 11.7% on average, improving from a year earlier. Nonetheless, the increase in bank lending remains contained due to supply and demand factors. The sluggish consumption and investments were reflected in a low demand for loans and mainly oriented towards shorter-term maturities. On the other hand, higher prudence by banks in crediting was reflected in tighter terms of credit supply.

Financial markets were generally stable and evidenced improved liquidity conditions and controlled risk premia. Money market interest rates pursued a downward trajectory, due to easing policy of the Bank of Albania and satisfactory liquidity levels.

While costs for the private sector credit were lower than a year earlier, the sluggish performance of the economy and uncertainties about its outlook made the trend appear more moderate in interest rates applied on lending to this sector.

Pressures on foreign exchange market were low and the exchange rate of the national currency against the major foreign currencies was stable, being a supporting factor to controlling inflationary pressures at home and increasing the certainty in foreign trade relations.

2. Inflation and monetary policy

In 2011, average annual consumer price *inflation* was 3.5%, remaining close to the previous year's average inflation rate. The performance of inflation was featured by a high volatility in the past year. Over the first and second quarters, annual inflation rate approached the upper limit of the targeted band, mainly driven by rapid and sharp price rise for food and primary commodities in international markets. These pressures were short-term and soon moderated; over the second half of the year, inflation started to fall gradually, marking 1.7% in December. Besides the mitigation of imported inflation, the cancelling out of the effect of regulated price increases in the previous year and the lack of any further increase in them are factors impacting on the downward trend of the annual inflation rate.

From the viewpoint of macroeconomic factors, the annual inflation volatility was induced by supply-side factors, while the demand-side inflationary pressures remained low.

Anchored inflation expectations prevented transmission of supply shocks to the cost structure of the Albanian economy, dwarfing the effect of the supply shocks only on the first round effects. On the other hand, below-potential growth of the Albanian economy led to an incomplete utilization of production capacities, generating moderate pressures on wages and production costs in the economy. Also, the sluggish aggregate demand reduced businesses' ability to dictate prices in the economy and hence their profit margins remained at historically low levels.

These developments were also reflected in the performance of core inflation, which fluctuated around the lower half of the Bank of Albania's target band. Finally, the Bank of Albania prudentially supplied the economy with liquidity and monetary expansion was in line with the economy's needs for monetary assets, thus preventing the generation of inflationary monetary impulses.

Bank of Albania's *monetary policy* maintained its expansionary nature in 2011, responding to the performance of inflationary pressures balance and taking into account the contained fiscal stimulus. The sharp price increase in international markets and its rapid pass-through to domestic consumer prices in early 2011, led to key interest rate rise by 0.25 percentage points in March. Such a move aimed at anchoring inflationary expectations and preventing second-round effects on inflation, against the setting of projections for further international price increases. Over the second half of the year, upon moderation of inflationary pressures and inflation's falling back within the target, as well as upon the shifting of expected inflationary pressures balance downward, the monetary policy became strongly stimulating. The Bank of Albania carried out two consecutive key interest rate cuts, taking the key interest rate in the economy to the lowest historical level (to 4.75%).

The stimulating policy through the key interest rate was accompanied by continuous liquidity injections into the financial market. Overall, the monetary policy pursued in 2011 and the sluggish demand for public sector financing helped in controlling the risk premia, leading to lower financing costs and increased financial intermediation in the national currency. The latter was also helped by a change to the required reserve instrument, by means of which the foreign required reserve remuneration was abrogated. It aimed to discourage foreign-currency intermediation and improve the monetary policy transmission mechanism.

The issue of financial euroization in Albania will continue to be on the focus of the Bank of Albania's monetary policy in the future.

3. Banking system and supervision

The Albanian banking system has faced numerous challenges over the recent years and has succeeded in overcoming them, always maintaining sound parameters of liquidity and capitalisation. Even in 2011, banking system activity was conducted in an unfavourable context of international financial markets and the sluggish demand for loans and economic growth at home. Regardless of these factors, banks in Albania remained well capitalised and healthy. Economic growth slowdown was reflected in moderate performance of crediting and increase in non-performing loans, whereas bank liquidity condition improved. During 2011, prudence for monitoring the banking system was heightened for early identification of potential risks, and the regulatory framework was consolidated.

Stress-test results show that the banking system remained stable and resilient to large shocks on macroeconomic indicators and parameters.

Following, I would like to focus on several main indicators of the banking system in 2011, as this system remains the main actor of financial intermediation in Albania.

Banking system highlights

At end-2011, the banking system assets accounted for about 85% of GDP, from about 81% at end-2010. Financial profit of the banking system was downward, with a significant increase in provisioning expenses playing a determinant role. In the framework of absorbing any potential losses from credit risk, the banking sector increased the provisioning by about 52.4% from a year earlier. By contrast, net operating profit was up by about 7.7%, which shows that the banks have generally achieved a stable net profit and volume from their core activities.

The banking system profitability, which is estimated through return on assets and return on equity, is positive but lower than a year earlier, whereas the effectiveness indicator is higher.

As at end-2011, the capital adequacy ratio of the banking system was about 15.6%, being higher than in 2010 and significantly higher than the 12 % minimum regulatory requirement.

Supervision

During 2011, the supervision of banks and non-bank financial institutions was strengthened in accordance with international standards and dynamic requirements that the financial situation in European market has brought about. On-site examinations aimed at a complete evaluation of institutions' risk profile, followed by examinations initiated from appearance of specific issues at licensed institutions. Overall, the system operated in accordance with the requirements of the legal and regulatory framework. Year 2011 recorded the finalisation of a number of new regulations and amendments to some other banking supervision regulations, aiming at alignment with Basel Committee standards, European Union directives and best practices on banking regulation and supervision.

I would highlight here, regulations on: credit risk, liquidity and operational risk management; enhancement of financial institutions' transparency to their clients; and, expansion, diversification and well functioning of business processes of financial institutions. In order to address the liquidity risk, at end-2011, some regulatory amendments were made, including re-definition of liquid assets, increase in the minimum regulatory threshold liquid assets to short-term liabilities ratio to 25%, and the start of implementation of two separate limits for the indicator in the national currency and in foreign currency at the minimum level of 20%. Banks responded swiftly to this decision of the Bank of Albania by increasing their liquidity.

The supervision of the banking system and assessment of the financial system stability show that exposure to credit risk has increased, as a consequence of increased non-performing loans to outstanding loans in 2011.

As a result, loan portfolio quality indicator – non-performing loans to total outstanding loans of the banking system – increased by 4.8 percentage points, settling at 18.8%. Nonetheless, stress-tests have revealed that the banking system is resilient to shocks that may come from extreme deterioration of this indicator.

Concerning the foreign-exchange risk, the indicator of open foreign-exchange position of the banking system shows a long position at 3.94% to the regulatory capital. Compared with the maximum regulatory threshold of 30%, this figure depicts a low level of exposure of the Albanian banking system to the foreign exchange risk.

As regards exposure to interest rate risk, the spread between assets and liabilities repriced up to three months, accounted for 5.1% of earning assets, which shows a low exposure to interest rate fluctuations at system level.

Moreover, during 2011, the banking system performed positively in terms of compliance with new standards and regulations on operational risk management approved over the year.

Issues related to transparency and money laundering prevention were an important part of supervision in 2011. To monitor them, a number of examinations on banks and non-bank financial institutions, including bureaux de change, have been conducted. They have revealed that the entities have generally taken preventive measures.

Transparency and publication of information were subject to reforms in 2011 and aimed at establishing a more appropriate business climate for banks and providing higher protection to the public. Banks, on their side, have responded positively by adapting their internal regulatory framework in line with these changes.

Further improvement is needed to enhance the transparency with regard to credit agreements, which have been a source of customer complaint and on focus of examinations on transparency and corrective measures taken by the Bank of Albania. The practices for deposit and account estimation, as well as disclosure and addressing of customer complaints are generally regarded as less problematic.

Supervision of non-bank financial institutions is also a functional part of the Bank of Albania. Their number amounted to 19, from 17 a year earlier; their specific share remained unchanged, accounting for 3.1% of banking system assets. During 2011, their activity posted moderate growth with regard to total assets, loan portfolio and financial profit.

Overall, non-bank financial institutions have adhered to regulatory framework and supervision standards. However, on-site examinations have identified several problems, thereby making appropriate recommendations related to them.

Among them, we would highlight the need to: improve lending process; revise internal regulatory framework; enhance transparency to clients, etc.

The expansion dynamics of the financial sector activity is reflected in the licensing process. During 2011, additional activities requested by banks and non-bank financial institutions were approved, consisting in introducing new market products and diversifying the existing products of financial institutions. Moreover, a preliminary approval was granted to new bank branches and agencies (10), but at low paces, whereas the activity of some bank branches and agencies was closed (11). As at year-end, there were 528 bank branches and agencies operating in the country and 1 branch operating abroad.

Regarding supervision of the financial activity under the jurisdiction of the Bank of Albania, allow me to reiterate that it remains within the security parameters and is resilient to unexpected shocks.

The Bank of Albania remains committed to monitoring the Albanian financial system rigorously and vigilantly, aiming at identifying early the potential risks and taking corrective measures to prevent them.

Besides the foregoing directions of Bank of Albania's work, I would proceed with some other activities of our work, which contribute not only to fulfilment of our legal tasks, but also to development of the financial system and market economy in Albania.

4. Other Bank of Albania activities

- Bank of Albania's role in the European integration

In the light of the objective for Albania's integration in the European Union, the Bank of Albania has strived for aligning its activities and regulations with the European Union directives and standards.

Conform to institutional commitments, the Bank of Albania has regularly contributed to reporting according to respective chapters of the *acquis communautaire*, reflecting the progress achieved on the approximation of Albanian regulatory framework to EU legislation and attainment of European standards. With regard to Bank of Albania's activity, the EC in its Progress Report of October for Albania, *inter alia*, commented positively that the monetary policy has successfully helped in keeping inflation stable and the banking sector remains well-capitalised and liquid.

Implementation of the EU-funded Twinning Project of the Bank of Albania with the Bank of Italy in partnership with the Bank of France started in 2011. This project, which covers the major part of Bank of Albania's activities, will help in enhancing institutional capacities, approximating the regulatory framework and work practices of the Bank of Albania to those of the EU and ECB, as well as promoting the development of financial market and instruments at home.

- Promoting payment system

Fulfilling its legal responsibility for a smooth functioning of payment systems, in 2011, the Bank of Albania actively worked to strengthen the payment systems oversight, improve the technology infrastructure and develop new payment products in Albania. Both main payment systems, AIPS (for settling large-value payments) and AECH (for settling and clearing small-value payments) operated with full efficiency, reflecting the stability of the systems.

In March, the Bank of Albania made several amendments to regulations on the operation of both payment systems, aiming to promote the use of payment service and reduce the use of cash. Also, in fall 2011, the Bank of Albania submitted to the Ministry of Finance a draft-law "On Payment Systems", which is in line with the basic principles of EU directives. Also, the Bank of Albania is preparing draft-regulations necessary for implementing the provisions provided under this draft-law.

- Improving statistics

In 2011, the Bank of Albania worked intensively to identify new requirements on statistical production structure, in line with EU requirements for candidate and member countries. Constructing a reporting model, reviewing and improving the reporting forms, and applying best practices for publication of statistics were on the focus of our work.

Also, the Bank of Albania has started the project for "Regulatory Reporting Automation", which aims to establish an electronic reporting system for institutions that report data to the Bank of Albania. This electronic reporting system would alleviate the reporting burden of institutions, shorten the reporting time, automate process control, generate statistical tables and significantly improve the quantity and quality of statistics produced by the Bank of Albania.

- Improving research capacity

In recent years, the Bank of Albania has paid special attention to increasing the level of study and research in the institution by investing significantly in human and technical resources. During 2011, seminars and round-tables were organised, aiming at training and sharing scientific novelties among economists at local and international level, thus making the Bank of Albania a point of reference for researchers of economics and finance.

The main focus of Bank of Albania's research papers was on issues pertaining to: financial stability, monetary policy, fiscal policy, regional integration and trade relations, study of uncertainties arising from estimation of econometric models, etc. At the same time, with the assistance of foreign experts, we worked for constructing and improving macroeconomic and statistical models, on the basis of which the Bank of Albania builds its projections for macroeconomic and financial indicators.

- Improving communication with the public

Establishment of transparent and productive relations with the public is an integral part of Bank of Albania's development strategy. The conduct of activities for financial education of the public was a priority of the communication strategy in 2011.

In order to achieve Bank of Albania's objectives in this area, we carried out a number of educational activities in 2011. Among them, we would highlight the project for integrating the financial education into high-school curricula in Albania.

A working group with Bank of Albania's experts, assisted by experts of curricula from the Institute for Educational Development, worked for compiling the curricula and preparing the text in the form of a free-choice module, which was incorporated into the high-school curricula for the first time in the 2011/2012 academic year.

Also, the Bank of Albania's Annual International Conference on "Building our Future through Financial Literacy", attended by senior representatives of public and private authorities at home and abroad, contributed to enhancing the awareness of financial education importance and drawing the attention of respective authorities and institutions.

Honourable Members of the Committee,

Both current and previous year were filled with challenges posed from the external environment and the internal structure of the economy. I listed above only some of the main accomplishments of the Bank of Albania and issues the Bank was faced with in 2011, while the Annual Report contains more detailed information.

The Bank of Albania will continue to work to rigorously fulfil its legal mandate and render maximum contribution to growth of welfare in Albania.

Concluding my introduction on the Report, I would like to share with you some reflections on Albania's economic outlook. Recent years, have brought to the fore certain fragilities of the Albanian economy. Against this backdrop, economic policies should intensify their efforts to ensure a stable economic growth.

In particular, increased productivity, ongoing restructuring and strong economic growth require the compilation and implementation of structural reforms to support domestic production and enhance its competitiveness in the national and international markets.

Also, economic policies should aim at further improving the free-market terms and conditions, in order to strengthen the structure of the market economy and enhance efficiency in our economy.

Lastly, the world experience, and ours as well, gained during these development decades, have shown that the coordination of policies of various institutional actors with market operations is an indispensable requirement to ensure ongoing progress of a country's society and economy.

In light of this, only continuing cooperation and coordination of efforts among all players would guarantee sustainable economic growth and welfare in Albania.

Concluding my speech, I would like to remind you that in addition to Bank of Albania's Annual Report 2011, the financial statements, certified by auditors, are also submitted.

Thanking you for your attention, I remain available to your questions and comments.