

Ardian Fullani: Bank of Albania's work progress, 2012 results, and challenges for the future

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the Parliamentary Commission on Economy and Finance, Tirana, 9 April 2013.

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Honourable Chairman,

Honourable Deputies, Ladies and Gentlemen,

I would like to start by expressing my great appreciation for this opportunity to present to you, on behalf of the Bank of Albania, the central bank's work progress and results over the past year. Also, this meeting will let us share our opinions about recent economic and monetary developments, and touch upon the challenges, which, in Bank of Albania's opinion, deserve attention in the future.

Right from the start, I would like to emphasize that the Bank of Albania succeeded in fulfilling its legal responsibilities in 2012. Consumer prices remained stable, as depicted by the 2% average inflation rate during the year. The financial system soundness also improved at both macro and micro levels.

The major objectives of the Bank of Albania were achieved, despite adverse internal and external environment, and shocks posed to Albanian economy over this period. Their achievement reflected, to a great extent, the Bank of Albania's cautious monetary policy, regulatory measures and our policy of banking supervision. They were favoured by ongoing improvement of the financial payment infrastructure, prudential and efficient liquidity management operations, and transparent communication with the public. The whole our work was supported by qualitatively improved financial literacy of the public, analytical study of several phenomena, matters of interest for the development of the country, and production of financial statistics conform to international standards. Finally, I would like to emphasize that the Bank of Albania has been a serious and important player in Albania's integration project, completing and updating all its legal responsibilities and institutional commitments.

Honourable Ladies and Gentlemen,

In my speech, I will address the key issues of the Annual Report, focusing on main directions of Bank of Albania's work over the past year. I will start my speech with our work and results in fulfilling the primary objective: achieving and maintaining price stability.

1. Economic developments, price stability and monetary policy in 2012

As I said in the introduction of my speech, the year 2012 was another difficult year for the Albanian economy. Weaknesses in our financial and trading partners were manifested in a low demand for Albanian exports, tight financing conditions for foreign capital, and elevated uncertainty among economic agents. Also, the public and private sector domestic demand remained weak in the Albanian economy.

Besides these factors, two other specific shocks hit the economic activity over the past year. Hence, bad weather in the first quarter was reflected into a sluggish activity in construction and export over the period. The banking system's response to new and tighter regulatory measures provided by the European Banking Authority (EBA) was the other shock of higher importance and influence. Direct impact of this shock on financial markets, and especially on government securities market was about 2% of GDP. However, their indirect impact was even greater. As in other countries of the Central and Eastern Europe, banks originating from

the euro area countries adopted a more conservative behaviour, manifested in further slowdown of lending during the year.

As a result, the Albanian economy slowed further over the past year, leaving spare capacities in the labour and capital markets.

This development was associated with low increase in wages and producer costs and was reflected in slightly increased consumer prices. Supply shocks were few and of low intensity over the past year, inflationary expectations remained anchored and liquidity position was favourable to keep inflation in check. This balance of factors was materialized in low annual inflation rates and the annual consumer price rise eased to 2.4% at end-2012.

Low inflationary pressures and lack of fiscal stimulus made room for further easing of monetary policy in 2012. The Bank of Albania cut the key interest rate three times, to 4.0%, from 4.75%. The monetary conditions were eased to stimulate the domestic demand and create better conditions for meeting the medium-term inflation target.

Also, the Bank of Albania increased significantly the liquidity-providing operations in the banking system to calm down financial agents, control the rising interest rate trends and ensure the smooth functioning of markets. In general, our efforts resulted effective in managing the liquidity problems, however tighter funding conditions faced the Albanian economy in both public and private sectors. This tendency reflects, to a great extent, the risk aversion in financial agents and markets. Addressing it will be our main challenge over the next year.

Back to economic development. Official data show that the economic growth for 2012 remained positive but slower than in the previous year. According to INSTAT data, gross domestic product grew by 1.6% in 2012, supported by boosted activity in services and agriculture sectors.

Meanwhile, the industrial sector remained stagnant, while the construction sector shrank, reflecting the weak domestic demand and specific sector-related problems. Though to a lesser extent, the economic growth was supported mainly by external demand and increased exports. On the other hand, despite the stimulating monetary policy, the domestic demand appeared weak. This weakness reflects the reluctance of consumer and businesses to consume and invest, and the limited space for increasing public spending. In general, the Bank of Albania deems that these determinants of economic growth will continue to be present even over the next quarters. The low degree of existing capacity utilization affected the labour market. The pace of increase in employment slowed down, though the unemployment rate has remained 13.3% over more than one year.

Rising exports and slowing imports brought about 13.8% decline in current account deficit.

Although the capital and financial account inflows fell by 11.3% in annual terms, the overall balance of payments resulted positive and the Bank of Albania's foreign-exchange reserves increased over the past year. The current level of this reserve is in accordance with our operational adequacy rates and could pay for 4.5 months of imports of goods and services. Improvement of the structural current account deficit should be one of our long-term policy objectives; it helps in maintaining the financial stability of our country and increasing the country's resilience to foreign shocks.

Fiscal policy was generally consolidating in 2012. Budget deficit dropped by 1.2% in annual terms, estimated at 3.4% of GDP, or down by 0.3 percentage points from a year earlier. Current account deficit narrowed due to reduced public expenditures, which fell by 0.3% on a year earlier. Similarly, public revenues dropped by 0.2% in annual terms, reflecting the cyclical condition of the economy.

On the other hand, public debt exceeded 60% as a percentage of GDP, reflecting the higher-than-projected rise in budget deficit and the increase in public guarantees. Bank of Albania's attitude to this problem has always been transparent: maintaining public debt at sustainable

and harmless levels for the Albanian economy and preserving financial market confidence regarding the Albanian public debt should remain the primary objective of the fiscal policy.

Monetary indicators performed in line with real-economy ones, slowing down in 2012. Low demand of businesses and households for bank loans and tight lending standards led to poor performance of credit to economy. Its annual growth dropped to 2.4% at year-end. Poor credit performance was present in all its segments, by purpose of use. Meanwhile, foreign-currency loan continues to shift to lek loans. Shifting household savings from bank deposits to public debt securities was a striking financial development over the past year.

This trend led to increase in financing the budget deficit by households and decline in this financing by the banking system.

Financial market liquidity position and risk premium performance conditioned the pass-through of easing monetary policy to financial markets. Key interest rate cuts were immediately reflected in the interbank market and in lek deposit market, but their pass-through to government securities markets and to lek credit was more limited, mainly due to developments I mentioned earlier. However, lek intermediation cost dropped in 2012 and increase in lek intermediation created grounds for better transmission of monetary policy signals to economy during the current year. Finally, the foreign exchange market and the exchange rates were generally calm due to a balanced ratio of the foreign-currency supply and demand.

In operational aspect, the Bank of Albania upgraded the infrastructure of its role as a lender of last resort to commercial banks.

Due to this work, the Regulation “On the liquidity supporting loan” was reviewed and approved, stipulating an appropriate framework to support banks that are temporarily illiquid. Also, the Bank of Albania reviewed its regulation on the required reserves of banks, raising their flexibility in the manner of holding it and creating more opportunities in increasing the banking sector’s exposure to the economy.

Another important aspect of the central bank’s functions is the banking system supervision and regulation, which contributed significantly to strengthening of the financial stability. In the following, I will focus on performance of some key indicators and banking system risks, as well as on the most important developments in supervision, licensing, legal and regulatory framework.

2. Banking supervision and financial stability

Banking sector assets to GDP accounted for 87.9% at end-2012, up by 3.1% on a year earlier. Profit improved, leading to improved indicators of Return on Average Assets (RoAA) and Return on Average Equity (RoAE). At end-2012, the banking system capital adequacy ratio was 16.2%, increased on a year earlier. At system level and for each individual bank, this indicator remained above the 12% minimum requirement.

Supervision has aimed at assessing and monitoring the risks posed to the banking system. Special attention has been paid to monitoring the loan portfolio quality and the systemic risks stemming from lending, as well as to their actual or potential effects on the degree of banking system capitalisation. The banking system exposure to credit risk increased in 2012.

The ratio of non-performing loans to total loans was 22.5% at year-end, from 18.8% a year earlier. However, the share of non-performing loans secured by collateral was larger than a year earlier, accounting for about 81% of the non-performing loan portfolio. Also, the banking system increased the loan loss provisioning by 31%. Liquidity indicators improved in 2012.

The ratio of liquid assets to short-term liabilities was 36.7%, being above the minimum level for both the lek and foreign currencies. Deposits were the main source of financing the

banking activity and the parent-bank lines of credit decreased significantly compared to end-2011. The reduced dependency on parent-bank financing in Albania is a positive development that has increased the domestic banking system's resilience to foreign shocks.

The banking system is hedged against market risks. Our estimates point to a banking system that is slightly exposed to interest rate risk. It is also slightly exposed to direct effects from exchange rate volatility and its foreign-currency open position is obviously below our limits. The banking system continues to be exposed to indirect exchange rate risk due to foreign currency loans granted to borrowers whose income is not in foreign currency.

The control on operational risk improved in 2012, by improving the framework of procedures. The banking system has the necessary technological infrastructure to meet the regulatory requirements, hence ensuring that the activity is carried out even in extreme circumstances. Transparency and publication of information continue to be in focus of the Bank of Albania, as important pillars to protect customer and foster discipline in market competition.

Aiming to enhance transparency and boost competition among banks in the market, on July 2012, the Bank of Albania started publishing on its website the interest rates and banks' commissions on their products. However, we are well aware that there is still room for improvement in reference interest rate used in credit contracts and in the information that banks publish on their websites.

Addressing the prevention of money laundering and of terrorism financing was an important part of the regulatory and supervisory process in 2012. Besides improving the regulatory framework in line with the new Law and EU standards, we have also strengthened our cooperation with the Department of Money Laundering Prevention and have fostered the supervisory process of financial institutions. On-site and off-site examinations revealed that entities have taken appropriate, preventive measures and have established a proper infrastructure to identify and report suspicious cases.

The year 2012 highlighted important developments in the area of financial activity licensing. Hence, two branches of foreign banks turned into their subsidiaries, reducing the risk of their exposure to parent-bank risks, enhancing their independence and the control level exercised over them by the Bank of Albania. An important change was also the transfer of 100% shares of the Emporiki Bank from Emporiki Bank of Greece to IUB Holding France, contributing to long-term and stable development of the banking industry. Finally, in 2012, the number of non-bank financial institutions and the range of financial products and services provided in the market by the financial system increased.

In 2012, the legal and regulatory framework of the banking system underwent important changes. The Bank of Albania and the Deposit Insurance Agency, taking into consideration the European Union regulatory alterations, prepared relevant amendments to the Law "On Deposit Insurance".

In line with EU directives, the base of contributors to insurance scheme expanded, including the savings and loan associations. Also, the formulas for calculating compensation were clarified and simplified. The Assembly of the Republic of Albania approved the related amendments on 26 July 2012. The adoption of the new Regulation "On the establishment, licensing and functioning of the bridge bank" improved significantly the regulatory framework on bank management in the event of bankruptcy. Other important regulatory amendments and improvements took place on bank management, risk management and related structures, supervision decisions, as well as insurance and re-insurance activity.

Besides the main directions of the Bank of Albania's work described above, I would like to dwell on some other activities of our work. These activities not only help us fulfil our legal responsibilities, but also serve the development of the financial system and market economy in Albania.

3. Other activities of the Bank of Albania

Money issuance

The Bank of Albania has the exclusive right to issue and circulate our national currency and to oversee and ensure banknote and coin quality. One of the biggest investments of the Bank of Albania to guarantee our currency's integrity is the construction of the new building of Currency Issue Centre, which started operating in 2012. The closed and automated cycle of controlling processing, packaging and shredding of banknotes takes place in this building. Soon professional expertise on banknotes and coins suspected to be counterfeit will be made, hence fulfilling one of the obligations of the Albanian state in view of the Stabilisation and Association Agreement.

Foreign-exchange reserve management

Holding and managing Albania's foreign-exchange reserve to preserve financial stability of the economy is another constitutional function of the Bank of Albania.

The gross foreign-exchange reserve was up by EUR 65 million in 2012, registering EUR 1.972 million at the end of December 2012.

Payment system

Fulfilling its legal duty, the Bank of Albania promotes smooth functioning of payment systems to support the monetary policy implementation and maintain financial stability. During 2012, Lek interbank transactions were cleared and settled timely, efficiently and safely, conform to rules and procedures of both systems (ARCH and AIPS). Also, several regulations and manuals were reviewed and drafted, consisting in strengthening the supervision and further developing the Albanian payment system.

Improvement of statistics

The year 2012 pointed to improved statistics as a legal responsibility of the Bank of Albania.

During this year, a model was drafted to improve the balance of payments statistics and the international investment position, aiming to approximate the national statistics system with the ECB and ESCB standards. Also, the objectives under the IPA-2009 project on "Regional statistical cooperation programme for the Balkans countries" were successfully completed and project coordinators have commended the Bank of Albania.

Other (research, human resources, communication and transparency, integration process)

In addition to fulfilment of legal duties, the Bank of Albania is committed to attaining other objectives that help in completing a modern central bank's role in economy. Bank of Albania intensified its research and academic activities in international arena during 2012. Worth of note is the 10th International Conference on "Monetary Policy: From the past to the present", which was coordinated with other activities in the framework of the 100th anniversary of Albania's Independence.

Also, through the Institute of Economic Studies, we have promoted the broad interest of Albanian and foreign researchers, and have organised two regional workshops.

Since some years ago, the Bank of Albania has put on focus of its development plan, the improvement of bridges of communication with the public and enhancement of transparency. During 2012, we continued to complete the published information and diversify it according to target audience. We built up contacts with the media and intensified our efforts in financial education, aiming to increase financial literacy and clearly transmit the Bank of Albania's messages.

The Bank of Albania was an active participant in fulfilment of obligations arising from the SAA, Central European Free Trade Agreement, and other national commitments.

International authorities have assessed the Bank of Albania's work progress as positive. Regarding institutional issues, the European Commission, International Monetary Fund and World Bank have given the Bank a maximum score.

Dear Members, Ladies and Gentlemen,

Completing my speech, allow me to highlight some problems which have conditioned and will condition the functioning of Albanian economy and financial markets. We deem that these problems require prior attention and cautious solution.

First, the integration of the Albanian economy with the European financial systems and markets implies that shocks and swings to our financial and trading partners are soon transmitted to the Albanian economy. The medium and long-term outlook of the Albanian economy is related to that of our trading partners. Global market ups and downs increase or decrease the economic activity in the country. Overall, the integration process remains beneficial to the Albanian economy, but it poses challenges as well.

Therefore, I would like to emphasise that the Albanian economy and financial system should pay more attention to global market developments; our structural reforms should aim at increasing resistance to their swings, while our economic policies should be cautiously oriented toward long-term global trends.

Secondly, the country's financial stability should be seen as a duty of all and not as an issue of one or some institutions. The financial stability is a public good that serves the long-term development of a country. Recent global developments have proven that the financial system is a highly integrated mosaic; its stability has many dimensions and it is determined by the interplay of many segments and stakeholders. Therefore, I would like to reiterate my appeal for finding a political consensus that would enable the establishment of a fiscal rule, which serves the maintaining of long-term sustainability of public finances and investors' confidence in the Albanian economy.

Third, the reform of social and health insurance systems is another important aspect that remains problematic for the long-term stability of the country. Deficits resulting from them are upward and may substantially affect fiscal parameters in the future. This reform should open the way to development of relatively backward segments of the financial system, those of private pension and insurance funds. This would really contribute to expanding and deepening the financial market in Albania.

Fourth, sticking to financial stability, I would like to bring to your attention the changes in the code of civil procedure relating to easing of collateral execution. Further to the package launched recently by the Bank of Albania and the letter I sent a few days ago to the major parties in the Assembly, I would appeal once more for their approval at an earlier time possible.

It is a set of proposals that we and international experts regard indispensable for the stability of the banking system, guarantee of deposits and recovery of credit to economy.

Finally, the long-term development of Albania and the policies and strategies supporting it deserve greater attention. The Bank of Albania remains confident in the long-term development prospects of the country. These prospects are favoured by natural resources and low labour costs, but above all, they must rely on our opportunities and abilities to be integrated into the value-added chain of the European economies. The road ahead is long and arduous. In short and medium term, it needs political will and wisdom to carry out reforms, and increased attention to issues of Albania's macroeconomic and financial soundness.

In the long term, the structure of the Albanian economy should be more aligned with those of the European countries; economic growth should be based more on production factors

productivity, and Albanian businesses should pay more attention to finding and exploring new markets.

Being heedful and aware of the challenges ahead, the Bank of Albania has started to analyse new tools and techniques to fulfil its mission. Pinpointing the economic slowdown as the main risk facing the Albanian economy and financial system, and assessing the role of bank credit to economy, on March 2013, the Bank of Albania adopted a set of macro-prudential measures oriented toward promoting lending and lowering banking system risk. Briefly, these measures consist in easing capital requirements to boost credit, easing liquidity requirements, reducing provisions for restructured loans, and increasing capital requirements for assets abroad above the rates required by the Bank of Albania.

These temporary measures are another sign of our willingness to accomplish the mission and our legal duties.

Concluding, I would like to point out that the Bank of Albania's 2012 Annual Report and Financial Statements are presented to you. I remain open to any questions or remarks.

Thank you for your attention.