Ardian Fullani: The financial future of the region

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the summit of finance ministers and governors "The financial future of the region", Becici, Montenegro, 14 June 2013.

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Dear Ministers of Finance,

Dear Governors,

The crisis we are going through, being so profound and lasting, will leave its mark on economics in general, and central banking in particular. Up until the Great Recession, monetary policy was living in a world that we may call "the inflation targeting era". To anyone that has followed the discussions regarding the optimal central bank policy ever since the onset of the crisis, it is clear that the validity of the previous approach has been heavily questioned.

In many ways inflation targeting made the central bank's job simple, as long as it followed the policy correctly. The Central Bank, seen by the public as an independent institution, had to credibly commit to an explicit inflation target, in order to anchor mid-term inflation expectations. Self-fulfilling expectations from economic agents and price setters would, in turn, help deliver the objectives of monetary policy.

Unfortunately, as shown recently, this strict approach to monetary policy has some shortcomings. What this approach missed, due to its focus in consumer prices, was the drift in prices of assets in general. Escalating asset prices and their sudden burst affected significantly the behaviour and balance sheets of the economic agents and challenged the stability of the financial system. In this respect, the concept of financial stability was seen as a by product of monetary stability.

Economists believed that by stabilizing consumer prices, financial assets would also behave in a stable and predictable way. The crisis painfully reminds us that: this is not necessarily true. Behaviour in financial markets is not always rational and lack of confidence in the markets can spiral out of control, sending shockwaves throughout the economy.

Fortunately, the Bank of Albania adopted a more conservative approach considering monetary policy and financial stability issues simultaneously, conditioning either decision-making process by the other one. Due to this behaviour, the crisis had a direct but trivial impact on the financial system.

Despite this, the banking system faced immediate difficulties in the form of deposit withdrawals, emerging as indirect effects of fear contagion and irrational expectations. The liquidity problems that emerged spilled over to the credit market and later to the real economy and foreign sector.

The Bank of Albania reacted quickly to this changing economic climate. Liquidity was abundantly injected to our banks and more stringent regulations were applied in regard to the transfer of funds. However, unlike in most other countries where monetary policy was used initially to boost aggregate demand, in Albania, monetary policy stayed in its course giving way to expansionary fiscal policy.

Due to a relatively long period of consolidation, fiscal policy at the outburst of crises had abundant room for manoeuvre and has a more direct impact on the economy. Our policy response was conditioned by the concerns of financial stability, assuming that interest rate cuts would speed up deposit withdrawals from the banking system.

Bank of Albania took bold and decisive steps to control these problems and restore the credibility in banking system. As the effects of the fiscal stimulus began to phase out and confidence was restored in the banking system, we reduced our policy rate to its historic low in order to provide further stimulus for the economy. More importantly, our supervision of the banking system has been enhanced by establishing a thoroughly new Department of Financial Stability and by bringing financial stability issues in the decision-making process of monetary policy.

As a result, the set of tools available to the Bank of Albania has extended to include several macro-prudential measures, which aim to address simultaneously both economic growth and financial stability concerns.

I believe that similar steps have been taken by most central banks around the world. Willingly or not, the objective of financial stability is now seen as the central duty of our institutions. It does not matter whether the legal mandate of the central bank is amended to include this new objective or not. What matters is that financial stability is a prerequisite to overall macroeconomic stability and monetary stability. ***The challenge that lies ahead of us is how to include this new objective in our policy making; whether inflation targeting and financial stability can be combined or whether a new regime altogether is needed.***

Various new radical approaches have been mentioned so far. However, I believe that we should not discard all the hard-learned lessons and the successes of the past. Stabilizing inflation should be something that central bankers may be proud of, something that we should cherish and continue to strive for.

Incorporating financial stability objectives with the inflation targeting regime should be seen as an opportunity to understand economic developments and potential macro-financial risks, to achieve both these objectives and preserve long-run economic stability. I believe the course of the monetary policy will continue to be extensively discussed in the future, including our improved understanding of the role of asset prices and financial frictions.

Under the current conditions, the largest central banks in developed countries have stretched central banking theory and practice beyond traditional activities.

Their balance sheets have increased beyond imagination and, in some cases, include private assets; they have accepted a much broader role and have assumed more responsibility. This all new and untested type of central banking will have a strong impact not only on the nature of monetary policy and its interaction with other central bank objectives but also on the independence and credibility of the central bank itself. The nature of future monetary policy will largely depend on the success of the largest central banks to get out of this situation in a controlled and timely manner, without causing excess inflation and damaging central banks hard-earned credibility.

These developments will affect monetary policy in the emerging markets through interest and exchange rates, but most importantly in the way central banks conduct their monetary policy.

Influenced by current practices of leading central banks, some other central banks have reoriented their objectives and engaged in activities which are traditional for development banks and governments. We have been careful to stay away from adopting and targeting such objectives not only in monetary policy but also in our macro-prudential policy.

The Bank of Albania has traditionally based its policy on two important pillars. Our first focus has been to achieve our inflation target and manage inflation expectations to preserve the purchasing power of our currency. This policy has simultaneously provided necessary stimulus to economic activity. Second, our focus on banking supervision and financial stability has enhanced the confidence on our financial system and therefore increased the efficiency and credibility of our monetary policy.

As I have said in April of 2008, during the annual conference with the banking system in Albania, “every investment we make today in financial stability yields increased efficiency in our monetary policy”.

Recently, the Bank of Albania has introduced financial literacy as a third pillar of our policy and independence. This objective is founded on my belief that the first two pillars gain sustainability only if the public understand the role of the central bank, its independence and its policy.

Last but equally important, I would like to emphasise the need of cooperation and coordination with the fiscal policy. Fiscal policy and its impact are facts of life which can't be ignored. Therefore, monetary and macro-prudential policies have to be designed and implemented in full awareness of its existence.

A Central Bank does not live in an isolated island; its success will, among others, depend on its ability to act in coordination and cooperation with the fiscal policy, without losing its independence.

Incorporating this understanding in the central bank theory and practice requires some adjustments and flexibility but, at the same time, requires that central banks preserve their focus and independence and acknowledge their limitations.

Altogether these changes will allow the central bank and its inflation targeting regime to become a useful tool at the hand of the monetary authorities to preserve economic and financial stability in the post-Global Financial Crisis period.

Thank you very much for your attention!