

## **Ardian Fullani: Albania's 2013 economic and financial developments and future objectives**

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the Parliamentary Committee on Economy and Finance, presenting Bank of Albania's Annual Report 2013, Tirana, 23 April 2014.

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Honourable Chairman,

Honourable Committee members,

I avail myself of the moment to thank you, on behalf of the Bank of Albania, for this annual opportunity to present the economic and financial developments over the past year, as well as to report on central bank's progress and results conform to its mission and objectives.

As we have mentioned on several occasions, 2013 was a very difficult year for the Albanian economy. It posed serious challenges to both economic agents and policy makers. As one of the key institutions that design macroeconomic policies, as well as the supervisor and regulator of the banking system, the Bank of Albania has been fully committed to addressing these challenges. Overall, I am confident we have been successful in fulfilling our objectives, although the problems facing us may not be considered as overcome, and require even greater attention in the future.

First, I will briefly present the main developments during 2013. Then, I will make a summary of the work of the Bank of Albania. Lastly, I will share some issues I believe should be addressed with priority in the future.

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### **1. Albanian economy during 2013**

Economic activity in Albania slowed down significantly in 2013. According to preliminary data from INSTAT, the Albanian economy grew 0.44% in 2013, from 1.2% in 2012. The economic activity dynamics reflected the contraction in the services sector, especially tourism, whereas the production sector contributed positively, driven by investments in infrastructure, further growth of exports and rise in agricultural produce.

Aggregate demand was weak, reflecting the weak private sector demand for consumption and investments. This component continued to be negatively affected by the low economic agents' confidence, slower income and relatively tight financing conditions. The general elections held last year elevated the uncertainties in economic agents and financial markets, hence decelerating their consumption and investments in the post-election period. Foreign demand and public expenditure contributed positively to economic growth, but they did not manage to fully offset the sluggish private demand.

The external sector was characterised by relative stability of the current account deficit and increase in the country's foreign currency reserve. Exports of goods surged 13.5%, reflecting the improved economic situation in Albania's neighbouring countries and the structural improvements in certain sectors of the economy. Furthermore, imports of goods were 1.8% lower from a year earlier, as a result of the weak domestic demand. These developments materialised in the correction of the trade deficit by 13.5% in annual terms. Moreover, the balance of services deteriorated significantly, due to the fall of net exports in tourism. Main foreign currency inflows during 2013 were in the form of net foreign investments. These foreign inflows were sufficient to cover the current account deficit and provided the premises for a stable exchange rate. During 2013, the gross foreign currency reserve hiked by about EUR 42.5 million, settling at EUR 2,015 million, sufficient to cover 4.6 months of imports and

170% of the short-term foreign debt. In spite of improvements, the balance of the external sector remains fragile. I would like to reiterate our appeal for taking the measures to boost the competitiveness of Albanian products and create a favourable climate to attract foreign investments.

During 2013, the Government pursued an expansionary fiscal policy, providing a positive impulse to economic activity. In annual terms, budget expenditure increased 4.7%, whereas revenues fell 0.5%, from a year earlier. Government's fiscal behaviour increased the budget deficit to ALL 65.4 billion, standing 42.7% higher than a year earlier. Last year's fiscal expansion increased the public debt and public finance's fragility, adding thus concerns over fiscal sustainability in the medium and long run. Considering the public debt as one of the biggest structural weaknesses of the Albanian economy, we have called for measures to be taken for ensuring the long-term soundness of public finances, and eventually welcomed such measures. In this context, we think that there is still much to be done, especially with regard to adopting a transparent and efficient fiscal rule.

Financial markets were characterised by good liquidity conditions and low inflation risk premia. This enabled a fast transmission of monetary policy signals to the interbank and deposit markets. Also, the increase in deficit and public debt was absorbed by the liquidity generated in the domestic financial market. Against the backdrop of a high demand for investment in government securities, their yields dropped significantly for all maturities. All these developments created premises for credit interest rates to decline in 2013.

Monetary indicators were largely in line with the real-economy developments. The annual money supply growth slowed down during the year. This slowdown reflected the weak demand for borrowing by the private sector, especially businesses. Lending to the private sector started to contract in the second half of the year. At the end of the year, the loan portfolio stood 1.4% lower than a year earlier. Similar to developments in the other countries in the region, this performance was influenced by economic agents' reluctance to spend and invest, and banks' more conservative lending policies. I will dwell on lending issues and measures taken by the Bank of Albania to boost lending in the following.

Summing up the performance of the economy for 2013, aggregate demand remained weak and economic growth was low but below potential. This economic slowdown had serious implications for the economy's health and balances. It affected public finances, which saw increase in budget deficit and public debt. Albanian businesses faced financial constraints and banks' balance sheets suffered from worsened non-performing loan portfolios. It also led to a higher unemployment rate and slower rise in wages and prices.

Let me now inform you further on the monetary policy implemented by the Bank of Albania.

## **2. Bank of Albania's monetary policy**

*The primary objective of the Bank of Albania is to achieve and maintain price stability. In quantitative terms, the Bank of Albania aims to keep the CPI inflation at around 3.00%. The inflation target is set to be achieved in the medium-term period, while the actual inflation may be subject to short-term deviations from the target, due to unexpected shocks or shocks independent from the monetary policy. Monetary policy decisions are forward looking and in line with market principles.*

In 2013, the weak inflationary pressures were reflected in lower annual inflation, which averaged 1.9%, ranging close to the lower bound of Bank of Albania's tolerance band. It pursued a downward trend during the year, being more pronounced in the second half of the year. Unprocessed foods inflation accounted for around 90% of the headline inflation, hence determining the direction and fluctuation of the CPI inflation.

From the viewpoint of macroeconomic factors, consumer prices have reflected, first of all, the weak demand for goods and services, a factor that has generated low inflation over the last two years. Increase in demand, which was significantly below Albania's production capacity,

generated weak pressures for rise in the labour and production costs, and in the profit margin. Supply-side factors also influenced inflation on the downside. Imported inflationary pressures fell due to lower inflation in Albania's trading partner countries, low increase or fall in primary commodity prices, and stable exchange rate. On the other hand, economic agents' expectations for inflation have been well anchored, limiting inflation's sharp deviation from the Bank of Albania's target.

Against the backdrop of weak inflationary pressures, the Bank of Albania pursued a stimulating monetary policy in 2013. It cut the key interest rate four times during the year, lowering it from 4.00% to record low 3.00%. In parallel, the Bank of Albania continued to supply the financial market with the necessary liquidity. So, in addition to the standard instrument – the 7-day reverse purchase agreement – longer-term instruments have been used to better adapt to the needs of the banking system for liquidity. The easing monetary policy was further reinforced by unconventional measures. The aggressive key interest rate cut was accompanied by the publication of the future monetary policy direction. This type of communication is considered by central banks as a monetary policy instrument, in the context of interest rates ranging close to minimum values. It aimed and was successful in orienting financial market expectations, and helped reduce the interest rates even further in the financial market. Monetary policy signals were transmitted quickly and interest rates dropped across all market segments.

***Overall, the monetary policy implemented by the Bank of Albania proved successful in containing the downward trend of inflation and in anchoring inflation expectations, hence contributing to maintaining monetary stability. The latter is a prerequisite for the country's economic and financial stability, and the Bank of Albania has accomplished its mission in this regard.***

However, our monetary stimulus was not transmitted in full to the real economy. As we have mentioned before, the monetary policy transmission mechanism faces problems, as a result of uncertainties of both the private sector and the banking system, for the future. In this framework, in March, the Bank of Albania adopted a package of measures to stimulate lending. In broad terms, these measures seek to: i) boost lending by reducing regulatory requirements for capital and liquidity; (ii) encourage intermediation in foreign currency by discouraging foreign currency activity abroad; and, (iii) promote credit restructuring to support businesses in temporary difficulties. Similar to other countries, where such measures have been taken, their success was partial. This fact shows that credit-related problems are very complex and, oftentimes, structural. Dwelling longer on credit-related problems, I would like to underline that its poor performance is a phenomenon that is present in all the European economies, including those of the region. This phenomenon reflects mostly the added prudence of large European banking groups against credit risk and poor economic performance. In this regard, the asset quality evaluation process by the European Central Bank, in June, will serve to give insight into the financial soundness of banking groups and may become a premise for a more positive attitude towards lending. In the domestic context, lending would benefit from the reduction of risk present in the Albanian economy. Therefore, all policymakers should work harder to improve the business climate, develop a new economic growth model, based on producing and exporting activities, and solve legal issues still present in the area of collateral execution.

Once the monetary policy easing reinforces, the external setting improves, and optimism in the economy increases, we expect a fuller transmission of the monetary stimuli to the real economy during the current year. However, as proven by world practice, boosting lending cannot and should not be an issue of concern and scope of work only of the central bank.

I would like now to elaborate on issues pertaining to banking supervision and financial stability.

### 3. Banking supervision and financial stability

The Law on the Bank of Albania sets out a series of rights and obligations, which serve to sustain the country's financial stability. The Bank of Albania is responsible for licencing, regulating and supervising the activity of the banking sector, which dominates the financial system in Albania. By implementing macro-prudential policies, regulating and supervising the banking sector prudentially, playing the role of the "lender of last resort", and regulating and overseeing the payments infrastructure, it aims at sustaining an effective and stable banking system, by providing direct contribution to maintaining the country's financial stability. The legal framework also establishes the responsibility of the Bank of Albania to communicate its assessment on the financial system's stability.

Despite challenges produced by economic realities both at home and abroad, the Albanian banking system is solid, liquid, and well capitalised. At the end of 2013, its financial profit was positive and stood higher than in 2012. The capital adequacy ratio and liquidity indicators were significantly above the minimum regulatory requirements of supervision. Banking sector assets increased, albeit at lower rates from a year earlier, as a result of slower increase in deposits and decrease in crediting.

Overall, the banking system is considered as stable. It is little exposed to direct market risks, but credit risk has been upward and at the focus of Bank of Albania's attention during the past two years. In order to reduce the negative effects of this risk to the financial system and the real economy, the Bank of Albania has intensified banking supervision. Moreover, in March, we adopted some regulatory amendments to address the rising non-performing loans. In constant communication with the banking sector, the Ministry of Finance and the Legislative Authority, the Bank of Albania initiated amendments to the Code of Civil Procedures and Civil Code. These amendments aim to alleviate the banks' balance sheets by improving the collateral execution process. They have started to yield positive results with regard to decelerating the rise in non-performing loans and reducing credit costs. As at end-2013, non-performing loans accounted for 23.5% of the loan portfolio, rising at much lower rates compared to the recent years.

During the past year, the Albanian financial system and its supervisory framework were subject to an appraisal by the International Monetary Fund and the World Bank (FSAP programme). This process consisted in the performance appraisal for all the segments of the financial system, the supervision method, and approximation with international standards. It evidenced, among others, the capacity of public authorities to identify and manage diverse risks and the inter-institutional cooperation to maintain the stability of the country. From this perspective, interconnection of financial system segments that are supervised by different institutions was underlined as very important. Similarly, it was pointed out that the responsibility to safeguard financial stability depends on policy coordination by all relevant authorities.

***The process concluded that the financial system is able to withstand the international financial crisis and that the actions taken by the authorities to identify and manage risks have been on the right direction and extent. Moreover, it found that the supervisory process at the Bank of Albania is highly compliant with Basel's core principles for effective banking supervision.***

Year 2013 was a challenging year for the supervisory process of the banking system. In addition to direct involvement in evaluation processes of the financial stability, the Bank of Albania is involved in other main projects related to: addressing non-performing loans case by case, guidelines on loan restructuring and real estate appraisal, guidelines on recovery and resolution plans, developing credit instrument for development policies, and improving reporting standards. In parallel, it amended the regulatory and supervisory framework to adapt it to the new financial conditions and approximate it with the new international standards. With regard to the latter, we have worked to gradually transfer the supervisory practices from Basel I to Basel II system.

In view of integrating the Albanian banking system with the European one, we have intensified the cooperation with counterparts in other countries. Bank of Albania's membership into Vienna Initiative 2.0 Steering Committee was particularly important in this regard. This initiative is a platform of cooperation, which brings together the European Commission and other institutions of the European Union, international banking groups that operate in Central, Eastern and South-eastern Europe, as well as authorities from home and host countries. Its main objective is to promote coordination between home and host country authorities, to avoid disorderly deleveraging. Given that the Albanian banking system is dominated by cross-border banking groups, decisions from the Vienna Initiative 2.0 have considerable effects on it. Therefore, our participation in the decision-making process is very significant. Albania is the only non-EU member country participating in Vienna 2.0. As such, it also represents the interests of other non-EU countries that are not represented in the Steering Committee. For all these reasons, I believe the involvement of the Bank of Albania in Vienna Initiative 2.0 is an important institutional achievement.

The normal functioning of the banking system relies on a safe and effective payment infrastructure, which, in Albania, is operated by the central bank. Over 2013, the Bank of Albania focused its efforts on improving AIPS and AECH systems. Moreover, in order to render the financial markets infrastructure complete, we are working to establish the Central System for the Settlement and Registration of Securities. This system will provide possibilities for the further development of the secondary market and will guarantee the settlement of transactions in this market, conform to international standards.

In 2013, the approval of the law "On Payment System" was finalised. This law provides a special legal framework for regulating, licencing and overseeing payment systems by the Bank of Albania. It aims at minimising the systemic risk, which is related to the participation in payment and security settlement systems, and risks related to the insolvency of participants in the system. The passing of this Law implies the liberalisation of the payment systems market through the establishment of private payment systems. Furthermore, to encourage the use of electronic payment instruments and reduce the use of cash in the economy, the Bank of Albania has adopted the regulatory framework for using these instruments, by reflecting the principles of the relevant EU directive.

*The successful accomplishment of the main objective for maintaining price stability and the objective for safeguarding the financial system stability required improving all business processes within the institution, both the ones related directly to the legal duties of the Bank and those related to supporting aspects. During 2013, human and financial resources of the Bank of Albania focused on the qualitative development and improvement of these processes and their approximation with European practices.*

*I would like to present them in brief.*

#### **4. Other activities of the Bank of Albania**

The Bank of Albania has started a project to review the collection and processing of statistics according to Eurostat requirements, and has completed the technological infrastructure to automate and process reporting. This process is in a testing phase and is expected to be functional within this year. The Bank of Albania has continued cooperation with the World Bank to improve the reserve portfolio management system. Drawing on the experience of other countries for the administration of the crisis in the euro area, the respective regulation was revised to establish buffering and monitoring mechanisms against the materialisation of investment risks. The regulatory framework for the issue and control of banknotes and coins was amended, setting the standards for banknotes fit for circulation, and strengthening the monitoring of their protection against counterfeiting. In 2013, the laboratory for analysing banknotes suspected as counterfeit was made functional. Its instruments employ state-of-the-art technology, hence fulfilling one of Albania's obligations arising from the SAA.

During 2013, we continued our work to approximate the regulatory framework and working practices with EU directives and ECB standards, in the framework of the European integration process. The last annual report of the European Commission confirms the progress made by the Bank of Albania with regard to achieving European standards in all the fields of its activity. It also commends the contribution of the Bank of Albania to maintaining the country's macroeconomic stability.

Last, but not least, I would like to underline the approach of the Bank of Albania to the public. In our medium-term strategy, we have, among others, set forth two important factors that help achieve our main objective: public education, with the Bank of Albania assuming the role of the financial educator, and enhancing the confidence in our institution. In the framework of financial education, after introducing financial education as an elective subject in the high school curricula, this year we targeted the elementary education, with a new teaching set for both pupils and teachers.

We have also consolidated our position as a scientific research centre. Every year, the Bank of Albania brings together economists and academics from different countries and institutions. During 2013, a part of our resources was invested to enhance research and organise scientific research activities.

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Concluding, I would like to reiterate our long-term commitment to maintaining price stability as the primary objective of the Bank of Albania. The monetary policy has been appropriate and has contributed to maintaining macroeconomic stability. It will continue to be stimulating for the economy in the period ahead, as stated in our public communications. I must underline, however, that not all things can be solved by the monetary policy, and the central bank alone cannot achieve all. Many economies are facing the difficult situation of sluggish economic growth and low inflation rates. These conditions require all authorities at home to coordinate active policies and approach a new economic thought. This approach should aim at establishing a favourable climate for investments, boosting demand, increasing productivity in competitive sectors, supporting technology development, improving education level and implementing reforms in the labour market. In particular, I would like to draw the attention on the implementation of FSAP recommendations, to develop further the Albanian financial system and enhance its stability. I think that 2014 poses new and difficult challenges for sustainable and all-embracing economic growth. These challenges require long-term solutions and the work to face them must continue, without delay.

Thank you.