

Gent Sejko: Safeguarding Albania's monetary and financial stability – challenges and objectives

Address by Mr Gent Sejko, Governor of the Bank of Albania, presenting the Annual Report 2014 to the Parliamentary Committee on Economy and Finance, Tirana, 29 April 2015.

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Honourable Chair of the Committee,

Honourable Members of the Committee,

In my first presentation as the Governor of the Bank of Albania, I avail myself of this opportunity to assure You of my highest consideration for the work of this Committee. The Bank of Albania and I are fully committed to creating and maintaining a climate of cooperation for sustainable and long-term development.

Allow me now to present a general overview of our work. The Bank of Albania has successfully fulfilled its legal duties and institutional commitments during 2014, and has been a decisive actor in safeguarding the country's monetary and financial stability. Moreover, it has contributed to further develop and consolidate financial markets, amid a challenging economic and financial markets environment.

At the beginning of my address, I would like to focus on Bank of Albania's main objectives and the economic and financial situation in Albania.

During 2014, the Bank of Albania focused on two main aspects:

- i. addressing low inflationary pressures;
- ii. safeguarding financial stability, especially with regard to credit risk management.

With regard to these two main objectives, the results have been positive, as noted in the reports of our international partners.

Positive assessments on the work of the Bank of Albania were also confirmed during the IMF and World Bank Group Spring Meetings with governors and ministers of finance, in Washington D.C.

In parallel, during 2014, the Bank of Albania successfully fulfilled its legal duties related to maintaining and improving the payment system, managing the foreign exchange reserve, and compiling and publishing monetary and balance of payment statistics. Moreover, the Bank of Albania worked to support the European integration process and the legal and regulatory approximation with the *acquis communautaire*, enhance communication, improve financial literacy, and strengthen research, analyses and forecasting capacities.

A detailed description of the activities is provided in the Annual Report that has been submitted to the Assembly of the Republic of Albania conform to the determined timeframe. I will therefore focus first on some aspects of our work and achievements for 2014, and will then continue with the challenges facing the Albanian economy and highlights of Bank of Albania's work in the period ahead.

1. Monetary policy and price stability

Bank of Albania's legal objective is to achieve and maintain price stability. Achieving this objective implies keeping inflation at 3.0%. Our monetary policy employs the inflation targeting strategy, whereas the exchange rate employs a free floating regime. The monetary policy of the Bank of Albania is forward looking; it aims to be a flexible, balanced and transparent policy.

The Albanian economy has been facing, for some time, a sluggish economic environment. During 2014, our monetary policy was drafted and implemented amid low inflationary pressures and below-potential economic growth. Annual inflation, in 2014, averaged 1.6%, standing lower than the 1.9% average rate recorded a year earlier. The low inflation rates were dictated mainly by low pressures generated in the domestic economy, as well as by the low inflation rates in our trading partners and low inflation expectations by economic agents.

According to the Albanian Institute of Statistics (INSTAT) data, the Albanian economy grew 1.9% in 2014, against the 1.5% growth in the previous year. Economic growth was driven mainly by the domestic demand and – excluding construction – it was reflected in activity expansion across all the sectors of the economy. Economic activity grew, benefitting from the eased financing conditions as well as the improved confidence and balance sheets of the real and financial sectors of the economy. These factors contributed to the increase in private consumption and investments.

Excluding the payment of arrears, the fiscal policy has been consolidating during 2014. On the other hand, trade exchanges with abroad did not generate positive impulses for economic growth. Regardless of the higher growth rate, the Albanian economy continued to operate below its potential. As a result, production capacities were not fully utilised and the situation has dictated unemployment rates, which go beyond the equilibrium level. As we have mentioned earlier, the spare capacities in the labour market lead to low increase in wages, production costs and final prices in the economy. These phenomena have been present in Albania during 2014.

In Bank of Albania's opinion, aggregate demand is the main problem facing the Albanian economy; thus, addressing it requires the increase of macroeconomic stimulus. Reflecting the above, our monetary policy has been increasingly accommodative. The Bank of Albania lowered the key interest rate three times in 2014, bringing it down from 3.0% to 2.25%, and further down to 2.0% in the first quarter of 2015.

Our monetary operations consisted in continuous liquidity injection in the banking system, up to the three-month maximum legal timeframe. On average, in 2014, the Bank of Albania injected ALL 24.52 billion (in liquidity) against ALL 17.31 billion in 2013. In addition to lowering the key rate, the Bank of Albania has constantly signalled that the monetary policy will remain accommodative in the period ahead. This verbal communication is a non-traditional instrument of the monetary policy. It has aimed at enhancing the certainty of economic agents on the expected direction of the monetary policy and enabling them to extend the time horizon of their decisions for loans and investments.

The transmission mechanism of the monetary policy has continued to show signs of weakness, especially with regard to the growth of lending. For this reason, the Bank of Albania has combined its monetary stimulus with macroprudential easing policies. In parallel with the above-listed monetary policy instruments, the Bank of Albania has continued to apply eased regulatory requirements during 2014. These measures widened the space in banks' balance sheets for loans, reduced intermediation costs, and encouraged credit restructuring.

The accommodative policies of the Bank of Albania have been relatively successful. They have been reflected in the overall lowering of interest rates, downward risk premiums in the markets, improved liquidity indicators both in the banking system and the private sector, as well as in improved lending in the national currency. The interest rate on lek loans fell to the historic minimum levels and favoured the growth of credit denominated in lek. The Bank of Albania deems that these developments have contributed to stimulating domestic demand and have been reflected in the upward trend of core inflation during the year.

However, the transmission of the monetary stimulus in the economy continues to suffer from low risk-appetite, structural weaknesses in the Albanian economy and unfavourable developments in the external economy. I will dwell on these factors, which are beyond the impact of the monetary policy, in more detail in the third point of my address.

2. Financial stability and banking supervision

The law on the Bank of Albania tasks the Bank of Albania with duties to support the country's financial stability. To fulfil them, the Bank of Albania regulates and supervises the activity of the banking system, oversees and stimulates the development of the payments infrastructure, and functions as the lender of last resort.

The banking system showed ample liquidity and well-capitalised levels, during the past year, and improved profitability. The volume of assets in the banking system was up, due to the slight expansion of the loan portfolio and the investment portfolio in government debt securities. The Bank of Albania deems that the system has low liquidity and market risk exposure, and our analyses and stress tests show that the financial system is overall resilient.

On the other hand, credit risk is the main risk to which the banks are exposed. As at December 2014, the non-performing loans stood at 22.8% of the loan portfolio. While improved from the previous year, it remains high. As a result, our macroprudential measures have sustained and encouraged constantly the credit growth and recovery, urging banks, however, to keep prudentiality high, with the aim to decelerate non-performing loans.

In 2014, the work of the Bank of Albania towards safeguarding financial stability and strengthening banking supervision focused on four main aspects:

- Addressing credit risk

Credit risk was monitored through rigorous examinations of individual banks' credit portfolios, aimed at identifying factors contributing to the deterioration of credit quality and taking respective measures.

In May 2013, some countercyclical/macroprudential measures entered into force, which provide regulatory stimuli to orient the use of banks' financial resources in the economy and encourage credit restructuring at an early stage of its cycle. Moreover, the Bank of Albania has been actively identifying proposals for amendments to the Civil Procedure Code, as necessary, with a view to improving the collateral execution process. Such amendments entered into force in September 2013.

In addition, in cooperation with the Ministry of Finance, the tax treatment in the case of loan loss write offs was clarified through the approval of the respective legal amendments. Following the clarification, the Bank of Albania approved regulatory amendments, which encourage and support the procedure for cleaning banks' balance sheets from non-performing loans.

In cooperation with the World Bank, particular attention has been paid to the solution of large exposures of clients, in cases when they are to more than one bank. With the support of the International Monetary Fund, we are working to establish a common strategy for fully addressing non-performing loans.

Lastly, with a view to upholding factors that boost lending, the Bank of Albania decided to extend the effect of macroprudential stimulating measures in 2015. Our analyses show that, overall, these measures, which have addressed both the stock and the flow of non-performing loans, have yielded positive effects both on reducing non-performing loans and on lending levels.

- Improvement of the regulatory framework and approximation to Basel II regulatory standards

Improvements to the supervision and regulatory framework are set out in detail in the Annual Report. However, in this presentation I would like to highlight two important amendments:

- i. approval of the Regulation "On the capital adequacy ratio", which marks the transition from Basel I to the new Capital Accord, known as Basel II;

- ii. drafting of the new Supervision Policy document, which ensures a more efficient monitoring and management of risks facing the banking system.

- Fulfilment of FSAP recommendations

Financial Sector Assessment Program (FSAP) recommendations served as guidelines for improving the regulatory and supervisory framework of the banking system. Their implementation focused on the improvement of monitoring the risks facing the banking system and their treatment. Some of the recommendations have been incorporated in institutional obligations in the framework of the implementation of the development policy loans (DPL) of the World Bank. In the first quarter of 2014, the Bank of Albania fulfilled all the obligations for which it was responsible.

- Cooperation with other institutions

Considering the safeguarding of financial stability as a shared responsibility among several supervisory institutions, the Bank of Albania has closely cooperated with the Ministry of Finance, Financial Supervisory Authority (FSA) and Deposit Insurance Agency to prevent and manage extraordinary situations in the financial system. This cooperation is institutionalised in the framework of the Financial Stability Advisory Group. Cooperation with the FSA consisted also in joint inspections in banks or associations managing common funds.

We have been and remain committed to adopt best international practices and standards, in close cooperation with both local and strategic international partners such as the IMF, ECB, EU central banks, WB, FSVC and other renowned organisations.

3. Economic development perspective and problems

The Bank of Albania deems that the cycle of economic growth marked a turning point during 2014. In the next years, the Albanian economy is expected to pursue an upward trajectory, which may enable the return of the economy to equilibrium and of inflation to target in the medium term. Some fundamental factors that will drive this growth, such as eased lending conditions and monetary and financial stability in the country, are present.

Economic stability and downward financing costs should be supported through maintaining the actual framework of macroeconomic policies. Other factors, such as economic activity in the euro area and businesses and financial system's risk appetite are expected to improve.

The last group of factors underlying growth, such as business climate across all its dimensions and structural reforms that broaden development horizons and approximate labour productivity to that of advanced economies, should be further improved through our common endeavours.

I would like to emphasise that this landscape describes the expected direction of the country's development in the next two-three year period. In the meantime, under the current situation, the Bank of Albania is following developments attentively and is assessing the effects arising from the components of this scenario:

Lending highlights in Albania. At present, lending suffers from both the weak and low-quality demand and the conservative lending policy applied by banks. In our judgment, lending will grow at modest rates in 2015. Concerning the above, I would like to share the two considerations with you as follows.

First, a part of the banking system's conservative approach arises from developments in the European financial market and, eliminating it, will take its time. However, another part of this conservative approach arises from the real or perceived risk of lending, at home. The Bank of Albania alone may not offer solutions to all the issues that hinder lending. For that reason, we deem that the systematic reduction of credit risk should be treated as an issue of national

interest, which should become the scope of coordinated work between public authorities in Albania.

Second, the European experience, along with our experience, has shown that the country's economic growth is not conditioned by the performance of lending in short-term horizons. However, in longer-term horizons, the sustainability of economic growth will undoubtedly depend on the performance of lending. For this reason, we should primarily focus on maintaining and strengthening the soundness of our banking system, for it to be able to respond to future needs of the economy for financing.

The Bank of Albania is undertaking a comprehensive review of lending-related problems. Issues that, in our opinion, are yet to be solved and require cooperation from all policymakers include the treatment of non-performing loans and conceptualisation of stimulating factors in banks for healthy lending. The Bank of Albania will organise two work platforms for each of them, trying to draw in the cooperation of all stakeholders and interested parties.

Structural developments in parent bank groups. As I mentioned earlier, these arise from both new regulatory requirements of the Single Supervisory Mechanism at European level, an economic/financial developments in the countries where parent bank groups operate.

Requirements for more qualitative and higher capital levels, which underlie the new European directives on banking activity, have triggered European banks to revise the model and expansion of their activity. In more practical terms, it implies that the presence of foreign bank subsidiaries in the countries of our region is subject to a careful assessment, to determine their effectiveness and business continuation. This process is not necessarily restrictive for the economies of our region, as it may generate processes related to banking consolidation or lead to new investors entering the market.

The Bank of Albania is closely monitoring economic and financial developments in the countries where parent bank groups operate. We have undertaken over time measures that ensure the strengthening of capital and liquidity indicators and improve the resilience of both individual banks and the whole sector. At a more operational level, periodic analyses and other processes are under way, with a view to realising:

- i. a professional assessment of the financial situation and operational risks for individual banks and the whole sector
- ii. a comprehensive framework for addressing and mitigating risks facing the financial system stability.

4. Main objectives for 2015

This was an overview of Bank of Albania's activity in 2014 and of the first months under my governance. In conclusion, I would like to focus briefly on our main objectives for 2015 that stem from both legal obligations and the medium-term development of the Bank of Albania.

First, monetary policy decisions will aim at anchoring inflation expectations close to the 3.0% inflation target. Our projections suggest that the monetary policy will remain accommodative side in the period ahead. In our judgement, the current monetary conditions are adequate for the return of the economy to equilibrium and of inflation to target. However, within the legal framework that regulates the work of our institution, we are ready to undertake all the necessary measures for compliance with our inflation target.

Second, supervisory policies aimed at strengthening the banking system stability. Main challenges facing the Albanian banking sector are as follows:

- i. ensuring the return of a steady growth of lending;
- ii. improving indicators of bank asset quality, in the framework of measures taken for cleaning their balance sheets, which are expected to have a positive effect on the operational efficiency and intermediation capacity of banks;

- iii. mitigating effects arising from structural regulations imposed to EU-based banking groups in the context of reducing their exposure to subsidiaries outside the EU;

To safeguard the financial stability, the aim will be to further strengthen the inter-institutional cooperation with other financial supervisory institutions and international financial institutions.

Third, strengthening the system of management and internal audit, and institutional capacities, in accordance with EU standards will be among other objectives of the Bank of Albania. In parallel, the Bank of Albania aims at enhancing transparency with groups of interest and the general public, as regards communication about its activities. In the light of the independence provided in the organic law of the institution, enhanced transparency implies more accountability and responsibility.

I would like to conclude reiterating that the Bank of Albania is confident that the unconditional reliance on these principles, and the effectiveness of its policies on the economy will boost the public confidence in the institutional integrity of the central bank and will contribute positively to achieving successfully all the objectives of the institution.