

Gent Sejko: Monetary policy of the countries of the region - between US Federal Reserves and European Central Bank

Speech by Mr Gent Sejko, Governor of the Bank of Albania, at the Becici Summit of the countries of the region on "Regional financial stability in a new global environment", Becici, Montenegro, 16 June 2017.

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Dear Mr. Chairman,

Dear Colleagues,

I would like to start by thanking the organizers for this invitation. As usual, I find it highly useful to share, among colleagues, opinions on common challenges.

The title of the panel suggests our monetary policy stances are somehow shaped by the ECB and the Fed monetary policy paths. Though far from being the full picture, this is true, at some extent.

The monetary policies of both these central banks are highly relevant to us. They affect external conditions and they could dictate the directions, the speed and the price of financial flows. Furthermore, for countries with a dollarized or euroized financial system, they might also affect domestic credit, financial conditions, balance sheets, as well as exchange rates.

So, this brings us to the following questions. Where does our monetary policy sit at the current situation? What challenges do we face? And, how do we respond to the shifting of these external monetary policies? I am quite confident these issues will be broadly covered during this event.

Now let me make a few remarks, regarding the monetary policy of the Bank of Albania vis-à-vis that of the ECB or the Fed.

The BoA has pursued an expansionary monetary policy, which has been both supported and facilitated by the monetary policy stance of the ECB.

During the past four years, the Bank of Albania has been engaged in an extensive course of monetary accommodation. In the presence of weak cyclical developments and low inflationary pressures, we have decreased our policy rate to a historical minimum of 1.25%. Furthermore:

- ♦ We have increased our liquidity injections in the banking system;
- ♦ We have adopted negative rates for required reserves in euro, in line with the policy of negative deposit interest rates in the euro area;
- ♦ We have been engaged in a clear and transparent forward guidance, announcing our preference for accommodative policy in line with our inflation target;

However, unlike the Fed and the ECB, and similarly to other central banks in the region, we have not activated unconventional monetary policy tools.

This is because the monetary policy accommodation pursued by the ECB has facilitated the implementation of our monetary policy.

- ♦ On one hand, the lower price of euro helped decrease the costs for foreign currency loans;
- ♦ On the other hand, a low policy rate by the ECB has enabled us to decrease our policy rate without having to worry about any exchange rate depreciation or financial stability problems.

This last one is very important, given that around 40% of foreign currency loans are unhedged.

At this point, I would like to take the opportunity and mention that, in order to address the high euro exposure in our financial system, the Bank of Albania, together with other authorities, has drafted a plan to decrease the level of euroization in the country.

Anyway, turning back to our topic, our accommodative monetary policy has been essential in supporting growth and inflation

The accommodative monetary policy has been successful in easing financial conditions and supporting higher consumption and investments:

- ♦ Lending costs have decreased by approximately 400–500 basis points;
- ♦ Liquidity risk premia in the system have been greatly reduced;
- ♦ Government' bonds yield curve has flattened somewhat;
- ♦ Credit growth is recovering mostly supported by lending in domestic currency;

To wrap this up, from a macroeconomic perspective:

- ♦ The economic activity is strengthening and we are on track to meet our inflation target within the relevant time horizon;
- ♦ Our financial system remains liquid and well capitalized, while the profitability ratios are positive;

However, the external background seems about to get more complex.

The Fed and the ECB are following slightly different policy paths.

For the past few years, the Federal Reserve and the European Central Bank have pursued somewhat diverse monetary policy stances.

The Fed appears to be on the tightening side. It raised its policy rate in 2016 and 2017, after two years of gradually reducing its quantitative easing program. At the same time, its forward guidance suggests a tightening path in the near future.

In the meantime, the ECB is facing a different set of economic conditions, including slower growth, lower inflation, and higher economic and political uncertainty. As a result, the ECB is still holding to its accommodative monetary policy for longer. The forward guidance suggests that this path will continue at least for the current year.

These bring us to the conclusion that there are potential international spillovers from these divergent policies, for small open economies.

As a result of financial globalization, monetary policy in major advanced economies has significant spillovers to the global economy. Likewise, changes in market expectations about the future course of their policies have a high impact on financial market volatility.

Furthermore, the region's economies are small and open economies, whose main trading and economic partner is the Euro Area. In addition, the banking systems in our countries are dominated by EU-based banking groups. So, even though the Fed and the ECB's monetary policy decisions affect their domestic economies and financial systems, they might have a delayed, but probably longer lasting effect on our economies.

Depending on their intensity, both the trading and banking channels might affect our monetary policy stance and our monetary policy decisions.

Given our exposure to the dollar and the euro , the ECB monetary policy stance is more relevant to our economy. In other words, it has a stronger and more direct impact on our monetary conditions and our financial systems.

Let me take Albania as an example, whose main trading partners are EU countries:

- ♦ Roughly three quarters of our trade is directed to Eurozone countries.
- ♦ Over 60% of FDIs originate from the EU.
- ♦ The euro is the main foreign currency in our financial system – more than 4/5th of foreign currency assets and liabilities are in the common currency.
- ♦ Furthermore, studies indicate an effective basket of currencies in Albania would comprise roughly 75–80% euro, and the rest would be USD or currencies pegged to it.

All these indicators mean we are much more exposed to the policy stance across the euro area, while the policy stance of the FED affects us only indirectly.

At this point, a presumed tightening of the ECB monetary policy:

- ♦ would increase foreign currency lending costs in our economy, i.e. tightening financial conditions;
- ♦ If not followed by our monetary policy, would cause internal portfolio-shifts and depreciation pressures on the exchange rate;
- ♦ would not result in major capital outflows, as we did not benefit much capital inflows from the extraordinary expansionary policy pursued by the ECB;

On the other hand, a tightening of the FED monetary policy would not affect Albania directly, apart from the usual negative implications it might have on oil and commodity prices.

However, I have to state out that our monetary policy would benefit from a predictable monetary policy stance of the ECB in the near future.

A predictable stance of the monetary policy in the Eurozone enhances the effectiveness of our monetary policy. A wider interest rate differential might lead to appreciation pressures on the exchange rate, and this can, and will be taken in consideration in our policy analysis and actions.

To conclude, let me recap my points:

- ♦ Albania remains much more exposed to the ECB rather than the FED policies;
- ♦ Our expansionary monetary policies have been greatly facilitated by the policy stance of the ECB and the FED;
- ♦ The relative stability of Fed and ECB monetary policy has helped us reduce volatility in our domestic markets;
- ♦ However, any tightening by these banks would represent a tightening of our domestic financial conditions;

- ♦ Our monetary policy would benefit from the FED and the ECB, taking into account they will not present any surprises.