

Gent Sejko: Albania's economic and financial developments in 2017

Address by Mr Gent Sejko, Governor of the Bank of Albania, presenting the Annual Report 2017 to the Parliamentary Committee on Economy and Finance, Tirana, 10 April 2018.

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Honourable Chair,

Honourable Members of the Committee,

Thank you for your invitation!

I have the pleasure of presenting today the work and the achievements of the Bank of Albania over 2017.

I would like to start my presentation emphasising that 2017 was marked by progress in the Albanian economy and the financial system. According to Instat data: the Albanian economy grew by 3.8% in annual terms and created around 79 thousand jobs in the private non-agricultural sector, the unemployment rate and the current account deficit decreased, whereas inflation has been trending up. In parallel to developments in the real sector, interest rates in the financial markets remained low and soundness indicators of the banking system have been improving. In particular, the ratio of non-performing loans fell to 13.2% at the end of the year, down by around 5 percentage points from a year earlier. All these indicators show the cyclical position has improved and provide encouraging signals regarding the outlook on economic growth.

The Bank of Albania provided its contribution to the improvement of the economic and financial landscape. This contribution was materialised through:

- ♦ Implementing an accommodative monetary policy stance, which supported economic growth, increase in employment and wages, and rise in inflation;
- ♦ Prudential supervision and proactive approach to banking regulation, contributing to the improvement of banking sector indicators;
- ♦ Enhancing the banking system security, by establishing specialised structures to administer the necessary interventions and restructuring in banks facing solvency difficulties;
- ♦ Promoting the development and efficient functioning of the payment system;
- ♦ Promoting financial education;
- ♦ Further fostering the institutional capacities of the central bank, through constant investment in enhancing professional skills, independence, accountability and transparency, as well as through cooperation and exchanging information and opinions with Albanian and international partners.

Our activity in 2017 was guided by the Medium-term Development Strategy 2016–2018. In addition, the Bank of Albania has paid particular attention to the implementation of the recommendations left by this Committee in the Resolution “On the assessment of the activity of the Bank of Albania for 2016”.

Let me first present an overview of the activity of the Supervisory Council, the highest decision-making body of the Bank of Albania.

1. Activity of the Supervisory Council and strengthening institutional governance

The Supervisory Council has conducted its activity in line with the provisions of the organic law and the procedures established in the internal regulation on its organisation and functioning.

In 2017, the Supervisory Council held 15 meetings and took 82 decisions. In addition, it approved 29 regulations and 1 guideline for general application.

The highest body responsible for the Bank of Albania, the Supervisory Council has paid attention not only to complying with the legal obligations of the Bank, but also to strengthening the institutional governance, as an essential precondition for enhancing its credibility. In 2017, the Medium-term Development Strategy of the Bank of Albania, together with the medium-term budget, was updated.

The Medium-term Development Strategy of the Bank of Albania sets out the main objectives for the 2018–2020 period. It establishes the priorities in the main functions of the Bank of Albania and development of auxiliary services. Thus, the Bank of Albania has adopted the model of a number of banks of the European System of Central Banks, which have a twofold strategic planning system: (i) a major planning process, once in 3-5 years; and (ii) a yearly update. The span of the application ensures adequate planning support for the guiding medium-term budget of the Bank of Albania for 2019 and 2020. For the first time, this year the capital expenditures and the projects included in the budget were preliminary approved by the Capital Expenditure Committee, a body established as a control measure over major expenditure and investments.

With a view to strengthening the internal audit process, the Audit Committee was established in 2015 and is composed of three members of the Supervisory Council. In 2017, this Committee exercised its duties with a view to support the strengthening of internal and external control lines. It met regularly, without the presence of the administrators, with the Inspector General. These meetings enabled the members of the Committee to learn about the internal control systems and risk management procedures. Upon the proposal of the Inspector General, and following consultations at the Audit Committee, the Supervisory Council approved, for the first time, the level of tolerance to the operational risk at the Bank of Albania.

The activity of the Supervisory Council has been faithfully published in our periodic press releases.

2. Monetary Policy of the Bank of Albania

The monetary policy decision making is based on a comprehensive, consistent and transparent set of macroeconomic analyses and forecasts. They are supported by the whole range of information available at the time of decision making, and the expertise and judgement of the Bank's experts on the trends of economic development and the monetary policy pass-through mechanism.

I will elaborate on the underlying reasons of our decision making to maintain the accommodative monetary policy stance in 2017 and the assessment of its effects on the economy in the following.

2.1 Economic developments and monetary policy in 2017

The Albanian economy performed positively throughout 2017. The volume of economic activity trended upward, spare capacities in the labour market reduced, while the main indicators of economic and financial stability improved. Following are presented a few figures to illustrate it.

- ♦ According to Instat statistics, the volume of economic activity grew 3.8% in 2017, registering a positive dynamics compared to 2.2% and 3.4% growth in 2015 and 2016. The economic activity expanded on a broad base. From the aggregate demand, it was driven by the growth in consumption, investments and exports. The services, industry and construction sectors mainly benefited from this expansion of aggregate demand. A notable development in 2017 was the positive performance in tourism, which provided a positive impetus to economic growth. Together with the high levels of foreign direct investments, it contributed also to the

increase in foreign currency inflows in the Albanian economy.

- ♦ Employment increased by 3.3% in 2017, driven largely by the increase in the services sector. In parallel to the increase in employment, the unemployment rate fell, from 14.2% at the end of 2016, to 13.4% at the end of 2017.
- ♦ The decrease in the current account deficit averaged 6.9% of the GDP in 2017, against the 7.6% registered in the previous year. Its improvement reflected the increase in tourism and other services of the business.
- ♦ Fiscal indicators marked consolidation, reflecting a low level of budget deficit and the maintained control over the public debt.
- ♦ From the financial aspect, the Albanian banking system maintained good indicators of liquidity, profitability and capitalisation. The financial situation of enterprises has been improving, as illustrated by their high liquidity levels and the progressive decline in the non-performing loans ratio.
- ♦ Lastly, inflation has been upward, averaging 2.0% from 1.3% in the previous year. The upward inflation reflected the improvement of economic activity, but its undershooting continues to reflect the operation of the economy below the potential, the low level of inflation in trading partner countries, as well as the strong exchange rate.

I would like to focus on the last item – the exchange rate. The appreciation of the Albanian lek over the last two years has been at the focus of the Bank of Albania, as a result of a comprehensive impact of this factor on the overall economic and financial indicators, including inflation. Our analyses show that the appreciation trend of the exchange rate reflects the improvement of fundamental factors, such as narrowing of the trade deficit and of the current account deficit, high levels of foreign currency inflows in the form of foreign direct investments, and the improved confidence in the national currency in the domestic financial market. For as long as such appreciation reflects the effect of stable economic and financial factors, it does not lead to harmful consequences for the Albanian economy. However, its effects appear in the form of reduced inflationary pressures in the domestic market. The appreciation of the Albanian lek is estimated to have reduced the inflation rate for 2017 by 0.2-0.3 percentage point.

In the context of the not-yet-complete utilisation of production capacities and of low inflationary pressures, the Bank of Albania maintained the direction and intensity of the monetary stimulus unchanged over 2017. The policy rate maintained the low historical level at 1.25%, creating thus the conditions for the reduction of the costs of financing for the real sector. Liquidity injection in the interbank market increased in terms of average volume and duration, enabling thus a normal functioning of the financial markets.

The accommodative monetary policy was successful in boosting domestic demand, which was the main driver of economic growth. The effects of the monetary policy on the economy were present in several aspects:

- ♦ First, lower costs for financing consumption and investments. The cumulative reduction of the policy rate by 5.0 percentage points since the beginning of 2009, has been accompanied by the cumulative drop in interest rates on loans, 12-month Treasury bills, and deposits in lek, by 6.9, 4.5 and 6.6 percentage points, respectively. Low interest rates have increased demand for new loans, and decreased the cost of servicing the existing loans. In response to them:
- ♦ The volume of lek credit to the private sector increased by 7.2% in 2017, being the main contributor to total credit growth. The growth rate of the latter was only 3.3%, in response to the still sluggish credit demand and still conservative lending policies applied by banks.
- ♦ The cost of servicing the existing loans was reduced. This financial saving creates scope for increasing consumption and investments, through the use of own funds.

- ♦ Second, reduction of uncertainties among economic agents. The forward guidance on the monetary policy stance has guaranteed the private sector that the monetary stimulus will remain present in the quarters ahead, promoting their orientation toward consumption and investments.
- ♦ Third, mitigation of appreciation pressures of the exchange rate, contributing to the improvement of the balance of trade exchanges and further growth of economic activity.
- ♦ Fourth, strengthening of financial stability. The financial environment with low interest has improved the financial balances of borrowers, through bolstering the aggregate demand, easing the cost of debt servicing, as well as encouraging the restructuring of businesses and of existing loans.

Our assessments on the monetary policy impact show that its contribution to economic growth for 2015, 2016 and 2017 is around 0.2, 0.4 and 0.7 percentage point, respectively. In addition to the impact on growth rates, the positive contribution of the monetary policy has a cumulative impact on the level of economic activity. For 2017, the effect of the accommodative monetary policy on the level of economic activity in Albania is estimated at around 1.3 percentage points.

Growth in aggregate demand has led to higher employment and improved capacity utilization rates, boosting medium-term inflationary pressures; however, inflation remains below our target. The persistence of low inflation has been at the focus of our analyses. The consensus of these analyses is that the monetary policy has been and remains effective for boosting aggregate demand and guaranteeing price stability in the medium and long term.

Against this backdrop, the Bank of Albania remains confident that the return of the economy to its potential and the fuller utilisation of production capacities will be accompanied by faster increase in wages and productions costs. Inflation is, therefore, expected to return to the target within 2019.

This forecast is conditional to maintaining an accommodative monetary policy stance in the quarters ahead, and takes into account the continuation of the fiscal consolidation process. The continuation of fiscal consolidation has enabled a better transmission of the monetary stimulus to the economy and has helped reducing fiscal weaknesses and increasing the resilience of the public sector against future challenges.

The coordination of the monetary policy with the fiscal policy is vital for strengthening the macroeconomic stability and ensuring sustainable growth. We deem that the current macroeconomic policy mix is adequate. On one hand, it maintains a stimulating resultant trend of main economic policies and, on the other hand, it addresses the weaknesses deriving from the relatively high level of public debt.

Honourable Committee members,

In response to your recommendation for on-going improvement of the monetary policy transmission mechanism, let me share with you some obstacles we have identified as well as our matrix with actions for addressing them.

2.2. Monetary policy and its transmission mechanism

In our judgment, the pass-through of the monetary policy effect to financial markets and the economy, in other words the transmission mechanism, continues to suffer from three structural obstacles.

The first obstacle is the relatively high level of the euroization in the Albanian financial

markets and economy. The high euroization renders the monetary policy pass-through more difficult, as it reduces its scope and exposes the private agents and the financial system to exchange rate volatility. Aware of this fact, the Bank of Albania, the Ministry of Finance and Economy and the Albanian Financial Supervision Authority signed a Memorandum of Cooperation on increasing the use of the national currency (ALL) in the Albanian financial system and economy. In this (published) document, in the framework of the de-euroization objective, all the signatory institutions commit to identifying and undertaking actions within their area of competence.

In this framework, the Bank of Albania identified a package of measures that envisage the implementation of differentiated rates for keeping the required reserve for banks' liabilities in foreign currency and in the national currency. This measure is aimed at encouraging financial intermediation in lek through a relative reduction of its cost. Furthermore, banks will be required to comply with higher liquidity requirements for liabilities held in foreign currency. To raise the awareness of borrowers in foreign currency about the potential risks of this form of borrowing, banks will be required to explain by concrete examples foreign currency credit risks and provide borrowers with an alternative and comparable credit in lek.

The proposals for these measures are discussed with the banking industry and the necessary amendments to the regulatory acts have been prepared.

The second obstacle is the still-low appetite of banks to expand lending. This behaviour continues to reflect the effect of two factors: (i) deleveraging policies for reducing exposure in the countries of the region, including Albania, implemented by parent banks from the euro area; and, (ii) perception of credit risk at home. While banks' balance sheets have improved and the credit risk has diminished, the policies for reducing their exposure in countries outside the EU remain conservative. Such policies reflect also EBA's new supervisory rules on reducing the exposure of European-based banking groups in South East Europe.

In the context of addressing this issue, the Bank of Albania has signed a memorandum of cooperation with the European Banking Authority College in 2015, on exchanging information and harmonising supervisory policies.

Regarding non-performing loans, the Bank of Albania continues to be committed to implementing the measures set out in the national plan for reducing them. The reduction of the credit risk, in parallel with the improvement of the banks' balance sheets and economic growth, should be accompanied by more realistic lending policies by the banking system. This is a recurring appeal I have made in my public appearances. The implementation of such policies would create the conditions for fulfilling the needs of the economy for financing, which are expected to be upward in the future.

The third obstacle is the development level of financial markets and the narrow range of financial instruments. In 2017, the Bank of Albania, in cooperation with the Ministry of Finance and Economy and the World Bank explored options for developing the secondary market of Government securities and improving the functioning of the primary market. This project will help in the Government securities trading, increasing the investors' base, and forming a yield curve that is a representative one for the economy. Such a curve enables a better management of liquidity for all the financial agents, as well as a better monetary policy transmission to financial markets. I would like, however, to underline that the development of markets is a long process, which requires cooperation by all economic and financial agents in the economy.

Turning to the contribution of the Bank of Albania in the overall improvement of the financial and economic context, I would like to present now our work with regard to safeguarding and promoting financial stability. The main aspects of our work consisted in strengthening the stability

of the banking system, enhancing its resilience to shocks and adoption of international standards.

3. Financial stability and banking system performance

In 2017, the activity of the banking system was stable and supported the safeguarding of the financial stability. As at the end of 2017, the share of its assets stood at 92.5% of the Gross Domestic Product (GDP). The main financial indicators of the banking sector activity improved, and the net financial result of the banking sector grew considerably in 2017. The return on assets (RoA) of the system increased at 1.54%, in December 2017, from 0.7% a year earlier, whereas the return on equity (RoE) increased at 15.7%, from 7.2%. The capital adequacy ratio was 16.6% at the end of 2017, up by around 0.2 percentage point from a year earlier.

The monitored indicators show a mitigation of risks to financial stability. In particular, credit risk fell considerably during 2017, as shown by the fall in non-performing loans. The liquidity risk continues to be low, while the banking system's exposure to market risks remains significant.

Notwithstanding the positive developments, the Bank of Albania has continued to work for improving its supervisory capacities and further strengthening the regulatory framework.

The macro-prudential policy strategy was compiled and approved in 2017. The implementation of the macro-prudential policy was coordinated with a prudential and pro-active supervision. The supervisory practice improved regarding the methodology for banks control, the approximation of standards with Basel principles and the efforts to adopt the best international practices.

Let me now focus on the preparation of the regulatory framework on the Internal Capital Adequacy Assessment Process. This framework was prepared in the light of Basel principles and EU directives. The Internal Capital Adequacy Assessment Process is particularly important, as it complements the supervisory perspective with the self-assessment dimension of banks.

Significant changes have been made regarding the prevention process of money laundering, through the revision of the relevant regulatory framework.

The revision of the supervisory methodology on the qualitative assessment of the corporate governance in banks, of the functioning and independence of their committees, of the internal audit structure in assessing the risks and their functioning continued during 2017. In this project, we partnered with the European Bank for Reconstruction and Development.

Notwithstanding the progress made in reducing the non-performing loans, attention has been paid to the achievement of banks' annual objectives regarding the situation of non-performing loans and the compilation of the Recovery and Resolution Plans for larger borrowers. Banks report regularly to the Bank of Albania on the level of their relationships with every borrower, as well as the expectations and plans on future developments, in compliance with our requirements. With assistance from the World Bank and the International Monetary Fund, a regulatory framework, aiming to encourage the collaboration and coordination of banks for addressing common borrowers, is being compiled.

Special attention is being paid to the consolidating processes with the expected merger of two banks in Albania and the strategic plans on the re-positioning in the market depending on the dominant short and long-term factors.

In parallel with the work to improve the regulatory framework and the adoption of the best international standards, high priority has been given to on-site examinations. During 2017, fourteen full-scope and partial examinations were performed in banks, non-bank financial institutions, and savings and loan associations. The examinations showed that the performance of the banking sector improved in terms of: the quality of internal policies and their

implementation; the establishment of adequate risk management processes; and, the implementation of the supervisory regulatory framework. Moreover, the non-bank financial institutions are assessed to have still space to ensure proper effectiveness, independence and authority. Some of the savings and loan associations were examined for the first time after the conclusion of the consolidation process and the separation from the respective unions.

The Law “On the recovery and resolution of banks in the Republic of Albania” entered into force in 2017. This Law designates the Bank of Albania as the Resolution Authority for banks and branches of foreign banks that conduct their activity in Albania. This Law is another step in adopting the European standards in the regulatory framework of the Bank of Albania. In its role as the Resolution Authority, the Bank of Albania increases the security of the banking system.

In compliance with the legal requirements, the Resolution Fund was established to provide for the implementation of resolution tools. The Bank of Albania compiled the methodology for the calculation of contributions that each bank should pay and the procedure of the payment. The calculation methodology and fund management was the topic of informative meetings organised with banks and the Albanian Association of Banks.

We deem that the implemented policies and the undertaken measures have served to promoting monetary and financial stability, by contributing to safeguarding the economic and financial balances, necessary for sustainable economic growth.

Following, I will briefly summarise the work of the Bank of Albania regarding the promotion and development of the payment system.

4. Functioning of safe and efficient payment systems

In the framework of strengthening the payment systems and payment instruments oversight, the Bank of Albania has worked to align the regulatory base to the international standards that guarantee the security and promote the efficiency of payment systems.

A huge amount of work has been done to compile the draft-law on Payment Services, which approximates the EU’s Payment Services Directive. The implementation of this directive is expected to considerably contribute to improving the security and efficiency of payment services through promoting competitiveness, strengthening transparency and clearly defining the rights and obligations of these services’ providers and consumers. Also, it addresses the risks arising from technological novelties (Fin-Tech) in payment services. Currently, the Bank of Albania is in the consulting and finalising process of the draft-law. The approval of this draft-law is an important step towards the implementation of the European Commission recommendations for the free movement of capital and for the adherence to the Single Euro Payment Area (SEPA).

The Bank of Albania also has the role of payment systems’ reformer. In this framework, the Bank of Albania continued to work on the consolidation of inter-institutional collaboration, through the National Payment System Committee (NPSC), which it chairs. The Committee has initiated several projects, most importantly the projects on the compilation and implementation of the draft-strategy for the reformation of the small value payments market, the increase of financial inclusion and the assessment of remittances market.

The successful accomplishment of the main legal obligations is supported by a range of other functions of the Bank of Albania. I will now briefly mention some of the improvements in these activities.

5. Other activities of the Bank of Albania

In the field of **statistics**, the Bank of Albania has intensified its work to align the methodology on statistics with the international standards and their harmonization with the *acquis communautaire*. In concrete terms, the methodologies on the preparation of financial soundness, interest rates, financial accounts and international reserve indicators are revised. The Statistics Code of Practice at the Bank of Albania was adopted for the first time. This code ensures integrity, quality, access and confidentiality in using and reporting the statistics, according to the international standards. Also, the Bank of Albania, for the first time, published the policy and calendar of statistics review, which ensures full transparency related with the review of released statistics. Since June, Albania implements the IMF's Enhanced General Data Dissemination e-GDDS). Some of the statistics are compiled by the Bank of Albania.

Regarding **the international reserve management**, regulatory amendments have been made to clarify the function of international reserve management and the responsibilities of decision-making structures, as well as to broaden the range of investment instruments in compliance with the adopted policies. As at end-2017, the international reserve was around EUR 3 billion, sufficient to cover 6.7 months of imports of goods and services, and 178% of the short-term external debt. The yield on its investment was slightly negative, due to the low interest rates of euro in international markets.

The economic and financial analyses and the decisions of the Bank of Albania are based on a broad **research** work within the institution. The Bank of Albania deems that the investment in human resources and in research techniques is always rewarding, taking into account the rapid structural changes in the economy and in the financial markets. The monetary policy transmission, the safeguarding of financial stability, the banking supervision and the coordination among these objectives were the main focus of working papers during 2017. The results are shared with national and international experts in scientific panels and are published in working papers. Also, the international experts have continued to assist to improve the macro-economic and statistical models, which support Bank of Albania projections.

Public communication is an important pillar in Bank of Albania's activity for enhancing the transparency and public confidence in the institution. The classic channels of communication are supplemented with digital platforms, such as Twitter (information), YouTube (video) and Flickr (photos). The Bank of Albania has continued the practice of organising scientific conferences and national and international forums to share opinions with national and international partners and groups of interest.

The Bank of Albania is committed in **expanding financial literacy**, for an informed public understands better and responds more adequately to the decisions of the central bank. Also, a financially literate public manages better its personal finances. This commitment is further concretised with the establishment of the Museum of the Bank of Albania. During 2017, a range of informing and educational activities were organised at the Museum of the Bank of Albania with the participation of academics from various fields to share their knowledge with the public at large.

The Bank of Albania has strengthened the **cooperation with the national and international institutions**, through information sharing, and consultation and joint projects. During 2017, a number of memoranda of cooperation were signed with national and international partners.

Good governance in terms of the performance of the work processes, the efficiency in using the resources and risk management, is an element of the Bank of Albania's accountability. In this light, I would like to mention the main improvements that have taken place in terms of internal audit systems.

The internal audit at the Bank of Albania is an independent activity from the management, ensured through the Inspector General, appointed by the Parliament.

6. Internal audit

The Operational Risk Management function was consolidated over 2017. The purpose of the Operational Risk Management is to manage properly the uncertainties, and to inform the decision-makers on the risks that may hamper the accomplishment of the Bank's objectives, or to have adverse financial and/or reputational effects. The maturity level of operational risk management activity assessed by the international experts, increased at 'managed', thus crossing the 'basic' level. This maturity level shows that the operational risk management policy is guided by a risk matrix and a definite governing structure.

The application on the automated management of audits and operational risk management process was implemented over 2017. During 2018, the major part of internal audit activity is expected to be realised and documented in the new system. The risk assessment automation for audit purposes provides the planning of audits fully based on risks, in line with the international practice.

Honourable Chairman,

Honourable Members of the Committee,

At the end of my presentation, I want to assure you that the Bank of Albania will continue to be committed to following its legal objectives, and to implementing the institutional tasks and commitments.

I am confident that the Albanian economy and financial system will continue to see in the Bank of Albania a reliable, professional and transparent partner.

Thank you for your attention!