Gent Sejko: Region's financial and monetary stability, ten years since the crisis outbreak

Speech by Mr Gent Sejko, Governor of the Bank of Albania, at the regional summit on "Region's Financial and Monetary Stability, Ten Years since the Crisis Outbreak", Governor's Panel "Monetary policy and the stability of the banking systems in the countries of the region – a decade after the Lehman Brothers' bankruptcy", Bečići, Montenegro, 18 June 2018.

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Dear Guests,

Fellow Colleagues,

It is a pleasure to be amongst you today and to be able to share opinions on some of the most pressing challenges we are facing at the moment.

I would like to focus my remarks on the topic of exchange rates. In particular, I would like to focus on how the monetary policy reaction should be based in the exchange rate movements. I take my premise from the rapid appreciation episode we experienced recently in Albania, which forced us to launch an FX purchase program as a last line of defence towards ensuring medium term price stability.

To cover this topic, first I intend to briefly discuss on various monetary policy regimes. I will then discuss on the implications of exchange rate movements for inflation targeting central banks. To conclude, I will give you a short overview of recent exchange rate developments in Albania and our reaction towards them.

1. The choice and implications of exchange rate regimes

A useful starting point on this topic would be to discuss the different options we have. We are fully aware that small open and financially integrated economies have to choose between running an independent monetary policy aiming to preserve macroeconomic stability, usually defined in terms of an inflation target, and fixing the exchange rate. Both these options have their benefits and drawbacks.

The first option – i.e. that of running an independent monetary policy – means central banks can adjust domestic interest rates and domestic liquidity conditions, in order to preserve macroeconomic stability and to accommodate potential shocks to their economies. Furthermore, exchange rate movements and corrections act as a shock absorber to various external shocks. But on the other hand, central banks give up from the option of pursuing exchange rate stability, both as a nominal anchor and as an instrument of promoting international trade.

The choice of the second option – i.e. that of fixing your exchange rate – revolves around two main assumptions. The first is that exchange rate stability promotes external trade. The second is that importing credibility from the anchor foreign central bank, such as the ECB, helps promote overall domestic monetary stability. But on the other hand, this choice means central banks give up from the option of running an independent monetary policy, or at least they accept to lose a large piece of this independence. Consequently, they have to rely more on macro-prudential tools or fiscal policies, in order to accommodate domestic shocks or to mitigate the impact of external ones.

Our region offers a large variety of monetary regime choices. I will not attempt to do any analysis here but I will limit my remarks to saying that the inflation targeting and the flexible exchange rate regime we have chosen in Albania has served us perfectly well.

Our monetary framework has strengthened our successful transition and has increased the resilience of our economy. Over the past two decades Albania has enjoyed: (i) rapid economic growth, – with GDP growth averaging at 5 percent; (ii) price stability, – with inflation rates averaging at 2.4 percent; and, (iii) a rapid monetization, – with financial assets increasing from 52 to 92 percent of GDP.

Furthermore, the flexible exchange rate has proved to be a reliable shock absorber. The Albanian lek depreciated by around 11% in the aftermath of the 2008 crisis. This depreciation occurred in the face of reduced external demand, decreased capital inflows, and higher risk premia in the domestic financial market. This helped us regain some external competitiveness, but it also allowed us to pursue an expansionary monetary policy and to avoid recession.

2. Exchange rate movements under an inflation targeting regime

An exclusive commitment to price stability does not necessarily mean that central banks can afford to ignore exchange rate movements.

In small open economies, such as ours, exchange rates have both, a direct effect on prices through the imported goods, and an indirect one through their impact on cost competitiveness, external balances and aggregate demand. Therefore, our macroeconomic forecasting and monetary policy analysis models prescribe an important role to the exchange rate. Furthermore, in financially euroized economies, such as ours, exchange rate movements tend to have financial stability implications. Rapid depreciation increase NPLs, while prolonged periods of appreciation tend to impose financial risks and encourage further euroization.

In designing the appropriate monetary policy response, we have to distinguish between trend movements driven by fundamentals, and short term volatility driven by sporadic factors or market imperfections.

Inflation targeting central banks should strive to avoid leaning against trend movements in the exchange rate. As long as these movements are in line with fundamentals, these trends represent structural adjustments that do not move the economy away from equilibrium. On the other hand, short term exchange rate volatility is normal in a fully flexible exchange rate regime. The reaction of central banks should depend on their impact on inflation, which in itself depends on the intensity and duration of such volatility. The stronger the duration and the higher the intensity of the shocks, the bigger would be the expected impact on inflation, the greater the risk of rapid shifts in inflation expectations, and the higher the need for a systematic reaction of monetary policy.

3. Exchange rate movements and the Bank of Albania reaction to them

The above mentioned facts have guided our reaction to the recent appreciation of the exchange rate in Albania.

The trend appreciation started around the second half of 2015, but it gathered considerable pace in 2018. Lek appreciated on average by 2.3 percent against the euro in 2016 and 2017, while it appreciated by around 7 percent during the first half of 2018.

Our analyses indicate clearly differing explanations for the pre and post 2018 appreciation.

The 2016–2017 lek appreciation has been largely in line with improving fundamentals in the economy. Some of these structural improvements include:

- Declining current account deficits, on account of improved exports;
- Increased capital inflows, on account of high FDIs;
- Reduced financial market risk premia and increased confidence in our financial institutions.

On the contrary, the rapid appreciation we experienced in 2018 has been largely a FX market driven phenomenon. News of a sudden and sustained influx of foreign currency induced one-sided expectations in the FX market. These expectations were reflected in an accelerated supply of foreign currency and delayed demand for it, generating a vicious cycle of continued appreciation.

The Bank of Albania did not react upon the real appreciation trend of the past two years. While minor miss-alignments were still present, we assessed the trend was largely driven by improving fundaments. Thus, it allowed us to focus our monetary policy on achieving our 3 percent inflation target.

We also did not react upon the recent financial market driven appreciation, in full consistence with our monetary policy and exchange rate regimes. We expected for the market to self-regulate and contain these shocks. However, this did not prove to be the case and the exchange rate appreciation accelerated.

A re-assessment of its implication on price stability indicated this appreciation was not compatible with our price stability target over the medium term. Under these premises, the Bank of Albania was forced to act.

- We lowered the policy rate to a new historical minimum of 1 percent.
- We clearly communicated the Bank of Albania did not assess this appreciation to be in line with fundamentals, anymore.
- Lastly, we announced the initiation of an FX purchase program in the domestic market. This program was aimed at controlling the pace of appreciation, removing the excessive short term FX supply and reversing expectations and one-sided bets in the market.

In regard to this last one, I would like to emphasize the main features of it:

First, it was undertaken as measure of last resort, when the space for further conventional policy rate cuts was limited. Therefore, any additional monetary policy stimulus would need to make use of unconventional instruments.

Second, it was clearly communicated to the market to be of both an exceptional and a temporary nature. Therefore, it does not represent a shift from our commitment to a flexible exchange rate regime, and should not be represented as such.

As a result, these measures proved to be efficient and now the exchange rate movements are going back to normality.

Thank You!