

BANK OF ALBANIA

MONETARY POLICY  
DOCUMENT FOR 2007



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## INTRODUCTION

The Bank of Albania, the monetary authority of the Republic of Albania, has the exclusive right to design, approve and implement the monetary policy. The monetary policy is designed and implemented in view of achieving the primary objective: achieving and maintaining price stability.

Each year, the Bank of Albania publicly explains its mandate, giving as such evidence for its institutional accountability, in compliance with the stipulation requiring a transparent attitude with regard to the monetary policy issues. The explanation of its mandate implies the definition of price stability in quantitative terms. Along with it, the Bank of Albania also provides information related to the approach and instruments it will use in achieving its primary objective. This process serves to the orientation of public expectations towards inflation targeting.

Monetary Policy Document for 2007 was designed as a follow-up of the medium-term strategy "Bank of Albania Development Plan over 2006-2008" and of the Monetary Policy for 2004-2006. The basic strategy of the monetary policy for 2007 and its operational framework will maintain the key principles and forms pursued over the previous year. In this document, the Bank of Albania details all the concrete elements of the monetary policy for 2007, in particular in the field of monetary policy objectives and its operational framework. This document serves as a basis for orienting the coordination of monetary policy with other Government's economic policies. The publication of this document explores in concrete terms the commitment of the Bank of Albania to be a transparent institution.

Over 2007, the Bank of Albania will aim at improving the analyzing forecasting function of the economic and monetary developments, as well as enhancing the transmission mechanism efficiency of the monetary policy decisions to the financial markets and to the economy at large. These changes are dictated by both domestic and foreign experience in the field of monetary administration, as well as by the structural changes in the Albanian economy. Another objective of the Bank of Albania for 2007 is the enhancement of transparency in designing and communicating the monetary policy. To this aim, over 2007, the Bank of Albania will rationalize and enhance public communication for all monetary policy-related issues.

## I LEGAL GROUNDS

Pursuant to Article 161 of the Constitution of the Republic of Albania, the Bank of Albania "... is granted the exclusive right to independently implement the monetary policy".

Pursuant to Article 3, paragraph 4a<sup>1</sup> of the Law No. 8269, dated 23 December 1997 "On the Bank of Albania", the main task of this institution is "to independently design, approve and implement the monetary policy of the Republic of Albania, in accord with its primary objective".

Pursuant to Article 3 of the Law No. 8269, dated 23 December 1997 "On the Bank of Albania", the primary objective of the Bank of Albania is "to achieve and maintain price stability".

Pursuant to Article 43, paragraph a of the Law No. 8269, dated 23 December 1997 "On the Bank of Albania", the Supervisory Council of the Bank of Albania has the following competences: "To approve the monetary policy of the Republic of Albania, defining the limits of the Bank of Albania operations in the open market, the interest rates for deposits held with the Bank of Albania and for the discounts and loans or credits of the Bank of Albania, and the reserves and level of reserves banks are required to maintain with the Bank of Albania".

## II ECONOMIC DEVELOPMENT AND THE ROLE OF MONETARY POLICY

Both world and Albanian experience have clearly indicated that the macroeconomic stability is an indispensable precondition for ensuring a sustained and long-term economic growth. This stability implies a balanced development of various sectors of economy, the smoothing of business cycles and minor fluctuations of economic growth, employment, inflation and interest rates indicators. The creation of such conditions affects the reduction of risk in economy and the more efficient distribution of production factors. The achievement and maintenance of macroeconomic stability is carried out through the two main economic policies of a country: monetary policy and fiscal policy.

In the context of stabilizing policies, the monetary policy is oriented towards the achievement and maintenance of price stability. Fluctuations in the level of prices, inflationary or deflationary situations are harmful to the economy. The most genuine contribution that the central bank may provide to the economy is the maintenance of price stability. This is the main principle guiding the Bank of Albania monetary policy. Moreover, the Bank of Albania believes this principle is shared by the public at large, as well.

The monetary policy aims at influencing on the economic variables through

the change of short-term interest rates. It aims at administering the monetary conditions of economy – money supply, interest rates and the exchange rate – in view to accomplish the objective of price stability in the medium and long-run. The implementation of monetary policy is carried out through the Bank of Albania intervention in the financial markets. In generic terms, the monetary policy includes: the theoretical part used for its design; the objectives framework; and the instruments used in its implementation.

The central bank is in a position to influence on the short-term interest rates through the recognized monopoly of making money: physical money and reserves of commercial banks. In the short-run, a change in money supply or interest rates in the money market affects the overall economic activity: production, employment and the level of prices. Meanwhile, in the long-run, that is after all the possible adjustments in the performance of economic agents would have taken place in economy, the change in the quantity of money would be only reflected in the change of the level of prices, without infringing the real variables of economy. This conclusion currently enjoys a great support by the theoretical thought and its implementation in practice, including our own country's experience. For these reasons, the Bank of Albania believes that the monetary policy cannot be used as a tool for boosting the economic activity.

## RECONCILIATION WITH OTHER MACROECONOMIC POLICIES

The Bank of Albania reconciles its monetary policy with the needs of the country's economic development and with the designed strategies. In particular, special emphasis is placed on the reconciliation with the fiscal policy, as another essential determinant of the economic developments in the country.

At the same time, and without infringing the principle of reconciling the country's economic policies, the Bank of Albania independently determines the approval of the monetary policy by the Supervisory Council of the Bank of Albania and its implementation through the monetary instruments. Monetary policy decisions shall not be contrary to the need of accomplishing the objective mandated by law, which is to achieve and maintain price stability.

## III INFLATION TARGET FOR 2007

To achieve price stability implies achieving low positive inflation rates or consumer prices changes. To maintain price stability implies ensuring low positive inflation rates for relatively long periods of time.

In concrete terms, the Bank of Albania is committed to maintain the inflation rate at 3 per cent, with a fluctuation band of  $\pm 1$  percentage points. The annual growth of consumer price index, measured and published by the INSTAT, will continue to be considered as the inflation target.

The abovementioned quantitative rate of inflation target reflects the reality of the Albanian economy as a developing economy. These economies are characterized by large fluctuations of relative prices towards finding the proper balances of market economy. The target to have lower inflation rates might impose high cost to the Albanian economy. On the other hand, the maintenance of inflation target at the same rate as the six preceding years will provide a positive contribution to the consolidation of inflationary expectations around the pronounced target of the Bank of Albania.

The Bank of Albania will continue to maintain a free floating exchange rate. The lek value against foreign currencies will be freely determined in the foreign exchange market, in response to the laws of demand and supply. The Bank of Albania will be present through special interventions in the foreign exchange market, aiming at smoothing the short-term risky fluctuations of the lek exchange rate and/or the observance of the net international reserve objective of the Bank of Albania (see item IV).

#### TARGET LEVEL

The maintenance of inflation in low levels will provide a positive contribution to the development of the Albanian economy. First, since it is a positive inflation rate, it takes into account the technological evolution of products and their qualitative improvement. Moreover, many studies have proved that the inflation performance has an internal statistical tendency to record positive rates. In fact, an inflation rate close to 0 may correspond to a deflationary situation. Second, the low inflation rate helps in keeping positive real interest rates. Positive real interest rates help in absorbing the public savings in the banking system, contributing to the stability of the latter and to maintaining its ability to meet the economy's and the Government's demand for monetary assets. Third, such an inflation rate corresponds to the needs of the Albanian economy development, as a transition economy. It facilitates the relative prices mobility, providing a positive contribution to the instructive role this mechanism has on the allocation of funds in economy. Most developed countries define price stability as an inflation level of about 2 per cent. Since Albania is a transition country, a higher inflation level reflects a higher structural risk in the Albanian economy, and a larger mobility of relative prices in it. Fourth, being at the same level with the inflation target of the last five years, it will positively impact the stabilization of inflationary expectations in economy, as well as the enhancement of confidence in taking economic decisions. On the other hand, such an inflation level and the monetary policy designed for its achievement will provide a positive contribution to the economic growth rates, as it has been proved over the recent years.

Moreover, the inflation target of 3 per cent is also consistent with Albania's objective to join the European Union in the early future. The objective of controlling the price rise to a close level, but higher than the European Central Bank target<sup>2</sup>, allows the Albanian economy for a real convergence, providing at the same time, the required extent to carry out the appropriate structural changes.

## TARGET FORM

The inflation target for 2007 will be the level of 3 per cent.

Since inflation is frequently subject to the influence of supply factors or of the rise in the administered prices, consumer prices fluctuation may not always be a consequence of monetary conditions and subject to the monetary policy influence. The monetary policy is prudent even with regard to these factors, but, as a rule, does not react against them. This principle relates to the transitory nature of these shocks over inflation and to the need of maintaining a stable monetary and financial market.

Taking into account the risk of possible shocks over inflation and the need of establishing medium-term monetary policy stability, the Bank of Albania will allow the inflation rate fluctuations within a fluctuation band of  $\pm 1$  percentage points around the central rate, considering them to be in line with the objective of price stability.

## OTHER INFLATION MEASUREMENTS

With a view to enhance the decision-making process, the Bank of Albania will employ other inflation measurements. These measurements provide a more comprehensive basis for taking more realistic decisions. Other inflation categories include:

- Core inflation. The Bank of Albania will constantly work over 2007 to set up the core inflation series and refine the methodology of its measurement. Core inflation will provide a great contribution to the monetary policy decision-making.
- Average annual inflation rate. This category represents the average annual inflation rate for the last twelve months, providing useful information on the tendencies of consumer prices developments. As such, the average annual inflation rate will be a key point in the monetary policy decision-making process.

In line with its commitment to adopt in the near future the inflation targeting regime, the Bank of Albania will work on enhancing its analytical abilities; on extending the information range used in the decision-making process; on increasing the efficiency of transmission channels; and on raising the extent and quality of its communication with the public.

More concretely, over 2007 the Bank of Albania will pay a great attention to the set up of time series and to the better use of information generated by the following indices:

- Business confidence index.
- Consumer confidence index.
- Real estate market index.

#### IV INTERMEDIATE AND OPERATIONAL OBJECTIVES

The control of inflation is based on the control of other indicators, which, on one hand, are strongly related to the inflation target and on the other, are under a more direct control of the Bank of Albania. These are the intermediate and operational (quantitative) objectives. Intermediate objectives are orienting (indicators), whereas the operational objectives are strictly attended. Along with the primary objective of the Bank of Albania, these objectives make up the framework of its objectives.

The annual growth of money supply (M3) is the intermediate objective for 2007. The defining of M3 annual growth as an intermediate objective is based on the argument that inflation, being a monetary phenomenon, is influenced by the money supply growth. For this reason, the Bank of Albania aims at controlling the increase of monetary assets in economy, so that the money supply corresponds to the need of economy for real monetary assets. Based on the economic growth forecast for 2007, on the Bank of Albania objective for the inflation rate, and on the monetary developments trends, the Bank of Albania will aim at maintaining the money supply growth at the level of 11.9 for 2007<sup>3</sup>.

The framework of monetary policy objectives is completed by the identification of the monetary policy operational objectives. They establish a closer relation between the monetary policy operations, its intermediate and primary objective, which is to achieve and maintain price stability. Net domestic assets and the net international reserves of the Bank of Albania constitute the operational objectives for 2007. A quantitative level is set for each objective, so as to control the efforts for their achievement. Moreover, the Bank of Albania pursues and monitors the net domestic credit to the Government, although this is not part of its operational objective.

- Net domestic assets of the Bank of Albania represent the amount of the Bank of Albania claims, excluding its foreign currency claims on non-residents. More concretely, here are included the Bank of Albania (net) claims on the Government, and its claims on commercial banks. An upper limit is set on these claims, which implies that the Bank of Albania cannot increase the position of net domestic assets beyond the set limit.
- Net international reserves of the Bank of Albania represent the Bank of Albania net foreign assets, minus all foreign currency assets of commercial banks held with the Bank of Albania (required reserve in foreign currency plus excess reserve in foreign currency). A lower limit is set on them, and the accruals are based on the exchange rate as of end December 2003.
- Net domestic credit to the Government represents total claims of the banking system on the Government, minus the deposits of the latter held with the Bank of Albania and the commercial banks. The setting of an upper limit level aims at putting under control the crediting of budget deficit by the banking system, within the pre-defined levels. The upper limit of budget deficit domestic financing is ALL 25.0 billion for 2007.

These quantitative levels are reviewed over the year, based on the performance of monetary developments and on the corrective measures proposed by the Bank of Albania in the monetary programme.

In line with the expansion and the enhancement of competition in the Albanian banking market, the Bank of Albania will pay an increasing attention to the control of interest rates in the interbank market. Although they do not serve as an operational objective of the Bank of Albania, the interbank market interest rates are an important indicator of the monetary situation in economy and a key indication of the economy development.

## V MONETARY POLICY INSTRUMENTS

With a view to achieving its objectives, the Bank of Albania employs indirect monetary policy instruments. Monetary policy instruments will be oriented towards the accomplishment of the Bank of Albania operational objectives. In compliance with the monetary policy principles for 2007, as defined above in the present document, the Bank of Albania does not have any definite commitments related to the foreign exchange market interventions.

### OPEN MARKET OPERATIONS<sup>4</sup>

Open market operations aim to manage the interest rates in economy, to administer the liquidity situation in the market and to signal the monetary policy.

Open market operations include:

- Repurchase agreements and reverse repurchase agreements;
- Outright transactions;
- Foreign exchange market operations.

The main instrument used to transmit the monetary policy signals is the interest rate applied in the repurchase agreements and reverse repurchase agreements of one-week maturity<sup>5</sup>. The interest rate applied by the Bank of Albania in these operations plays the role of the core interest rate in economy. The core interest rate is set by the Supervisory Council of the Bank of Albania and it is employed by the Bank of Albania in the weekly auctions of repurchase agreements (repos). This rate also sets the overnight deposits and loans interest rate of the Bank of Albania. It also influences on the interbank market interest rate, on the lek deposits rate held with commercial banks and on the Treasury bills rate and credit in lek extended to the economy.

### STANDING FACILITIES

Standing facilities influence on the situation of liquidity in the banking system and impede large fluctuations in the interest rates. They are always and

exclusively initiated by commercial banks. The latter are the sole counterparty of the Bank of Albania in these operations.

Standing facilities provided by the Bank of Albania include:

- Overnight deposits;
- Overnight loans;
- Lombard loan.

#### REQUIRED RESERVE

Through the required reserve instrument, the Bank of Albania obliges commercial banks to keep a minimum reserve in lek or in foreign currency with the Bank. The minimum reserve system pursues the aim of stabilizing money supply, liquidities and the interest rate in the banking system, and to foster the banking system security.

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Dependent on the Albanian financial market conditions and on the needs of the monetary policy, the Bank of Albania will continue to review its monetary policy instruments. These reviews will aim at enhancing the efficiency of their use.

## VI COMMUNICATION OF MONETARY POLICY DECISIONS

The monetary policy and its decisions are communicated to the public through the following documents:

- Monetary policy document, which describes the main principles of the monetary policy adopted for a year.
- Quarterly assessment of the economy, which describes the quarterly economic and monetary developments.
- Publication of the Bank of Albania Supervisory Council's decisions on the interest rates, within 48 hours after the decision has been made.
- Press conferences of the Governor of the Bank of Albania for the communication and explanation of the monetary policy decisions.

The communication of monetary policy will be also carried out through the publication of all regulations and other acts, which regulate the instruments applied in the implementation of the monetary policy.

## GLOSSARY

- Repurchase agreements/reverse repurchase agreements

The Bank of Albania employs these agreements to temporarily withdraw or inject liquidity in the banking system. Repurchase agreements are used to temporarily reduce the liquidity in the banking system. Reverse repurchase agreements are used to temporarily increase the liquidity in the banking system or the banks' ability to increase lending or currency in circulation. Repurchase agreements and reverse repurchase agreements of one-week maturity are executed through standard auctions. While agreements of one-day, one-month and three-month maturity are executed through quick auctions.

- Outright transactions

The Bank of Albania reduces the liquidity in the market through outright sale transactions and increases it through outright purchase transactions. These transactions are executed through the purchase or sale of Treasury bills of up to one year maturity or of debt securities with high credibility.

- Foreign exchange market operations

Foreign exchange market operations are carried out by the Bank of Albania through the purchase or sale of foreign currency in the market. These operations are executed in order to pursue the policy defined in the present Document.

- Overnight deposit

Overnight deposit assists commercial banks in operating with the excess liquidity, by depositing it for one day with the Bank of Albania. Overnight deposit also helps to withdraw the excess liquidity from the banking system and to mitigate large short-term interest rate fluctuations. The overnight deposit interest rate represents the lowest interest rate in the market provided by the Bank of Albania.

- Overnight loan

Overnight loan is a fully collateralized loan provided to commercial banks to satisfy their overnight liquidity needs. It also helps in mitigating short-term interest rates fluctuations. Overnight loan interest rate is higher than the core interest rate.

- Lombard loan

Lombard loan is used to help commercial banks satisfy their temporary liquidity needs. It is a fully collateralized loan of up to three-month maturity. Lombard loan interest rate represents the highest interest rate set by the Bank of Albania.

## NOTES

<sup>1</sup> According to the ammendment made upon the Law No. 8893, dated 25 July 2002.

<sup>2</sup> The European Central Bank aims to maintain inflation close to, but not higher than 2 per cent in the medium-term.

<sup>3</sup> This objective may alter over the year, in response to the new economic and monetary conditions.

<sup>4</sup> The attached glossary provides a detailed description of the functioning of monetary instruments.

<sup>5</sup> Operations of repurchase agreements and of reverse repurchase agreements are known as repo and reverse repo.