

MONETARY AND FISCAL POLICY IN A DIFFERENT ENVIRONMENT

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ABSTRACT

During the last years the banking system in Albania has been fully managed, transformed from state-owned banking system to a privately owned banking system. Privatization of the banking system in Albania is a part of a package of policy measures intended to strengthen the financial system, to reduce the likelihood of future crises and to increase the efficiency of the economy. In the same time, because of its agenda and economic development, Albania is preparing itself to integrate more widely into the world economy and the international financial markets. Shifting from a state-owned banking system to a privately one, naturally raises some questions about the functioning of this system and the relationships about fiscal policy and monetary policy. In this paper we will try to analyze these issues and we will further focus on some concerns that policymakers should take in consideration about the future relationships of monetary and fiscal policies.

INTRODUCTION

Albania in the start of its transformation to a market economy, inherited a single-bank system that performed central bank functions and limited commercial transactions. The policy that Albania

implemented in the start of transition period can be classified to “Washington consensus” philosophy. In fact, not all structural reforms implemented in Albania can be classified as Bing Bag policies. The policies implemented to the banking sector during the ten years of transition can be classified as slow policies.

The banking reform in Albania started in July 1992 by creating the Bank of Albania as a new central bank, and all commercial operations were transferred to the newly created National Bank of Albania. The Central Bank was awarded a degree of independence, which was essential for implementing the comprehensive stabilization program and in 1992, for the first time in Albania, the Central Bank imposed a hard budget constraint to control money and credit growth. There was not given a high degree of independence to the Central Bank at that time. Referring to the Law of Central Bank, members of the Board were appointed by the President with proposal of the Central Bank Board and not more than 5 years; and there was no provision to ensure that direct credit facility was at the market interest rate.

Till 1996, there were a very few reforms on banking sector, and after the 1997 crises, a new banking law was passed which further strengthened the independence of the Bank of Albania and a privatization strategy started. According to Maliszewski (2000)¹ the independence of the Bank of Albania is considered with high legal independence with 12 points, nearly to the Bundensbank with its 13 points in the original GMT index and one additional point for non-political provisions for governor’s dismissal. The index for the older law (1992) found from Maliszewski (2000) was 10. Hence, it is clear that there is done a good progress in terms of the Bank of Albania independence. Also, the quantitative ceiling on central bank credit (direct loans) to the government has declined from 10 per cent of the average budget revenue for three preceding years in 1996 to 6 per cent in 1997 and 5 per cent in 2002, all under condition that interest rate be not lower than the market rate on Treasury bills.

Creating an independent central bank is a part of reforms in banking sector. It is generally accepted that a market functions well if the legal infrastructure is in place. In our analysis the Albania did a good step in creating the institution of Central Bank before privatizing

commercial banks. The privatization strategy of the banking system started in 1998 has been successfully finalized at the end of 2004, when 95 per cent of the banking sector belongs to private sector. Beyond the structural reforms in banking sector, during these years the economy of Albania has changed dramatically. Now, the private sector generates more than 75 per cent of GDP, the economy is fully opened, and the macroeconomic stability seems to be sustainable. Of course, those progresses in the economy have resulted that the GDP per capita in 2004 accounted for about 2,500 US\$. In the context of banking sector the privatization of this sector and the leave from soft loans will raise some concerns for discussion. In this paper will try to analyze the potential effects of banking privatization in the economy. The next section will analyze the path of Albania for its financing budget deficit. We will end with some conclusions and recommendations.

Why a privately owned Banking System?

It is generally accepted that in the market economy a private-owned banking system is superior to a state-owned banking system. This theoretical conclusion has found successful implementation during the end of last century around the world. The number of bank privatizations around the world since the mid 1970s is evidence of how state ownership of banks has fallen into disfavor with many policymakers, it includes over 235 privatizations in more than 65 countries (Andrews, 2005). The system that Albania inherited from the previous system was completely different from what is required in the market economy system.

As we mentioned above, the privatization of the banking system in Albania after the strengthening of Central Bank can be classified as a wise policy. We think that the picture of the 1997 crises would be worse if the banking system was owned by private sector. This thought is based on the idea that banks would be involved in the transactions of the pyramid firms in order to survive. Taken in consideration that the role of the supervision of Central Bank was weak, banks would be part of that financial mess. Fortunately, the banking sector was free from the pyramid firms and this was a good

start in creating a strong financial sector in Albania. Of course, the privatization of these commercial banks is the first movement.

In its excellent studies in over 65 countries about the linkages between state-owned banks, privatizations, and banking sector, Andrews (2005) stated that privatization is frequently part of the package of policy measures intended to strengthen the financial system, reducing the likelihood of future crises and the associated output losses. In its paper Andrews (2005) has tried to answer to the question if the privatization can cause banking crisis. Only few examples show that the resources of banking crisis have been privatization, especially in Mexico and Chile. According to Andrews (2005) the fundamental problems of the privatized banking sector are: (i) failure to establish preconditions for effective banking supervision; (ii) deficiencies in the regulatory framework and its enforcement; and (iii) lack of capital and inadequate managerial capacity. Regardless of these problems, one of the main conclusion of the paper was that privatization of banks is only rarely associated with banking crisis.

It is relevant that the same concerns should apply to the Albanian banking sector. The privatisation of the banking sector during those years has changed completely the structure of the ownership. In 1998, the private sector accounted for less than 10 per cent of the commercial banks, and now it accounts for more than 95 per cent. This change has been associated with the new commercial banks entering in the market. Despite the evident progresses made in the banking sector, there still are some concerns in this sector.

The financial sector in Albania has experienced the pyramid scheme and deposit panic (2000). This is a feature that requires further efforts to educate the public about the commercial banks functioning. The central bank should be alert about the wrong signals on commercial banks, especially from politics. Still, the banking sector does not reveal a high competition, which is another fragility of the Albanian banking sector. Not all commercial banks are involved in credit market, a feature that requires more analyses. The central bank should be involved in the reasons of this behaviour for both those with high level of credit (loans) and those that are not

part of this market. It will be helpful for the financial market that this kind of behaviour of commercial banks does not bring concerns in the future.

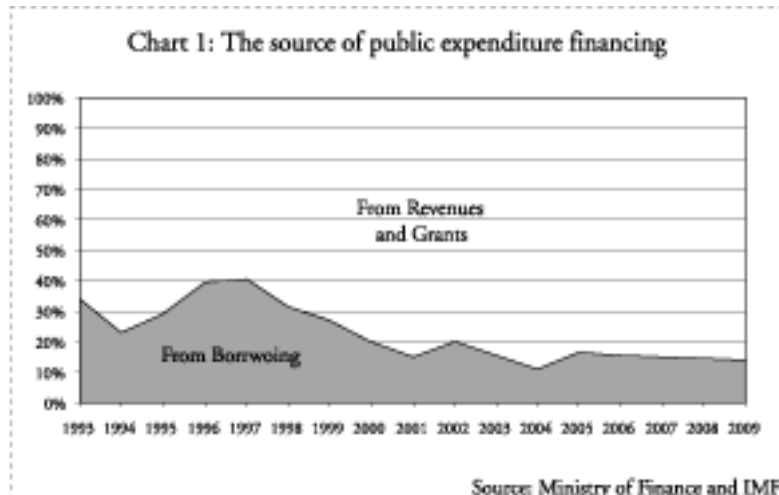
Another feature of the Albanian banking sector is that the commercial banks are not involved in economic transactions (very few). It is difficult to say in which directions is the casualty, from the banking sector or from the other sectors. This feature of Albanian banking sector has a “good” implication that during the economic crisis the impact on banking sector is small – like the 1997 crises. Besides this “good” impact, the banking sector must be involved in economic transactions, and the pressure should come from all actors (central bank, government, private sector, etc.). The involvement of the banking sector in economic transactions will have an important impact on the perception of financial sector from the public.

Despite the further steps that should be taken in banking sector, the progress is obvious. The level of credit to economy increased significantly from 4.3 per cent of GDP in 1998 in 8.4 per cent of GDP during 2004. It is worth to note that the privatisation of the largest bank in Albania - the Saving Bank - is done recently. This privatisation will influence positively the financial market, through its competition. The experience shows that the banking system will be more effective in the future, now it is almost privately owned. Albania’s experience and the experience of other countries show that the central banks should increase the capacity of the part of the supervisory authority.

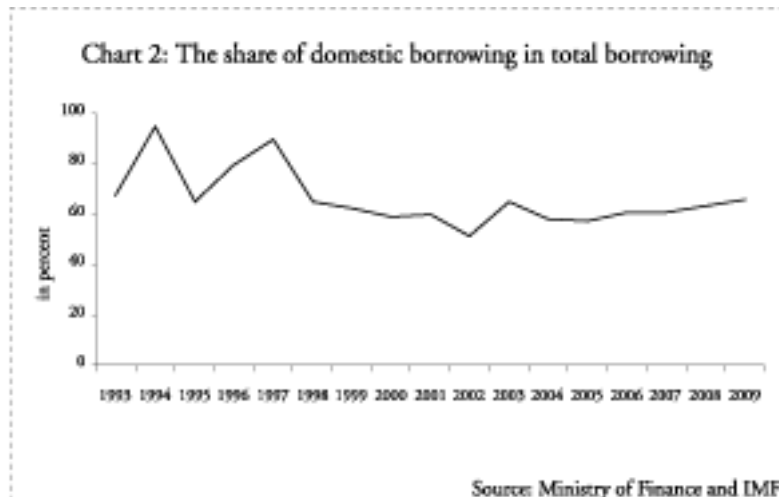
Bank privatization: Budget Deficit Financing

In a market economy it is generally accepted that the government functions with budget deficit – it spends more than it collects. The rest of the money that government spends is coming from borrowing. The government is free to borrow in financial sector. In this economic philosophy is operating the Albanian government too. From 1993 to 2000, the share of borrowing in financing of the public expenditure in average has been around 20 per cent, for the period of 2000 –2004, around 16 per cent and based in the IMF

estimation for the period of 2005-2009 it is around 15 per cent (see Chart 1).



The government has borrowed in both, domestic market and international market. The international market for the government of Albania during these years means borrowing from international institutions like World Bank – with soft loans. The government of Albania mostly relied on the domestic market. In most of the years the share of domestic borrowing to total borrowing has been greater than 60 per cent (see Chart 2). According to the Medium Term Budget Program 2005-2007 and IMF estimation, the structure of



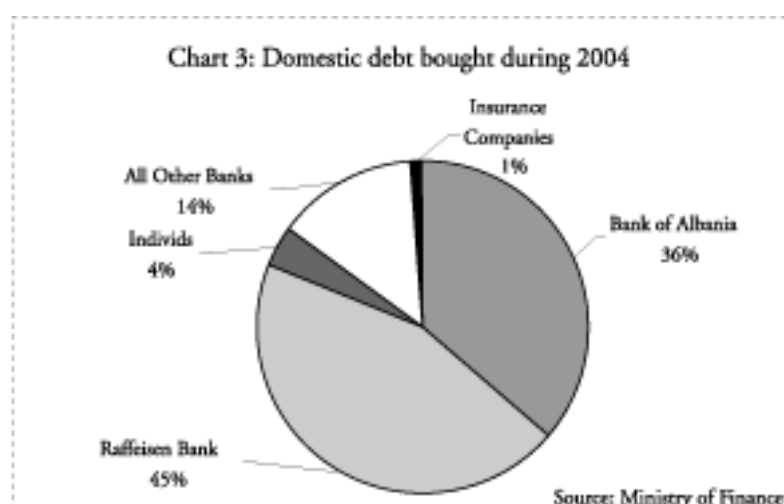
government borrowing will be in the favour of domestic borrowing, reaching 65 per cent in 2009.

According to standard neoclassical economic theory, capital-scarce countries should be involved in borrowing large amounts to finance domestic investment. Albania as a country that inherited high level of poverty and bad infrastructure is obliged to rely for a long period of time on borrowing in order to finance the huge demand for public investment. The need for borrowing and the change of the environment where Albania government has been operating till now raise concerns about the future budget deficit financing. We say different environment because now the banking sector is entirely privately owned, and the economy of Albania is not classified as a low country in order to benefit from soft loans from international institutions. Under these circumstances the options of government of Albania is to be prepared to borrow in international market and to be careful in domestic market.

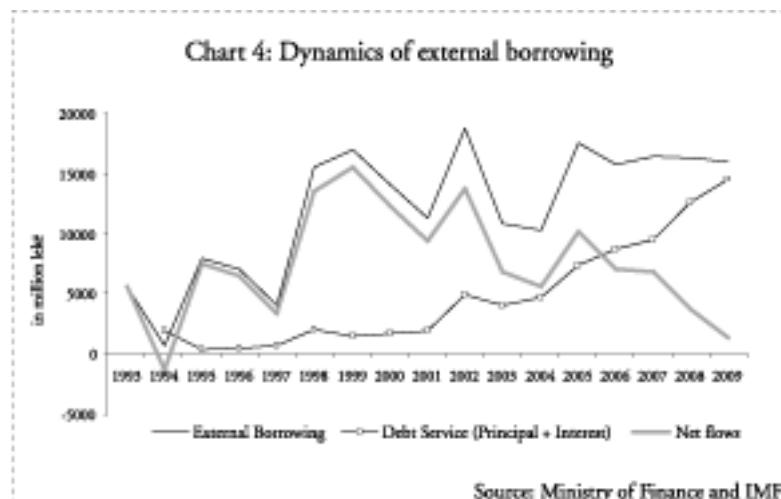
Despite this different environment in which government will operate, the macroeconomic situation is favourable. During the recent years, the Albanian economy has experienced a considerable high economic growth and this ratio is expected to continue for a considerable path time in the future. This economic growth is expected to be associated with a macroeconomic stabilised situation, with low inflation and stable exchange rate. During these years measures are taken with considerable improvement on public finance that will influence in strengthening public expenditure management. Also, for a considerable path time in the future the flow of remittances from emigration will stay at high level, and also the official reserves are expected to stay at high level. As always there are signs of uncertainty, it is difficult to forecast the path of budget deficit – in fact it is supposed (estimates by the IMF also) to stay at low levels. The behaviour of interest rate is also an important factor that should be taken into consideration. Nevertheless, the cases that should be taken into consideration will depend on macroeconomic situation – that seems to be stabilised. According to the experience of Albanian economy, it is difficult to forecast the impact of political instability and external shock on fiscal sustainability. Anyway, these factors should be a concern for policymakers in Albania.

Another feature of the Albanian economy is that the level of debt can be considered as strong position. The rate of public debt in 2004 accounted for less than 55 per cent of GDP, while in the 15 EU countries it accounted for an average of 63.2 per cent of GDP. Most of the public debt in Albania belongs to domestic debt, at 35 per cent of GDP in 2004, and 20 per cent of GDP belongs to external debt. The aim of public borrowing, domestic or external, is for the same reason - to deliver public service, but different factors influence the behaviour of the domestic and external borrowing in different way and with different implication. The privatisation of commercial banks is mostly related to domestic borrowing and the leave from soft loans is related to external borrowing.

The level of domestic debt at the end of 2004 reached ALL 295 billion or 35 per cent of GDP, and according to IMF estimation (December 2004), in 2008 it will reach ALL 427 billion. It seems that domestic financial market will face a considerable government borrowing demand during the coming four years. It is important that the government should take at the same time some actions in order to fix some problems that domestic market faces. The maturity of domestic market is short, which will hamper the harmonisation of fiscal and monetary policy. Also, the domestic debt is highly concentrated (see Chart 3), as 45 per cent of the domestic debt belongs to Raiffeisen Bank.



According to the external debt, the economy of Albania again reveals strong position; the level of external public debt is around 20 per cent of GDP, and this ratio has been decreasing over last years. Besides the public sector, the statistics show that the private sector does not borrow in international market or it is very small. This is another good sign of external position. The structure of public external debt in Albania has a long run and mostly multilateral donors own it. Benefiting from soft loans from international organisations, the level of service of external debt has been small, because most of the debt has a ten-year grace period (the period that the borrower is free to pay back debt).



Another feature of the external debt that the Albanian government will face in the near future is that it loses the right to benefit from soft loans. This means that the government should find other resources in order to finance public service. The government of Albania should cooperate with multinational commercial banks or should borrow in financial market. Both financing resources will be more expensive than the ones by which government has operated till now. Apart from the cost of the loans, the government of Albania should fulfil some other obligations in order to participate in financial market. The first conditionality to go in financial market is the evaluation of credit rating of Albania. Credit rating evaluation is an important step that Albania should take, and the decision for the rating should

be very careful. It will be good for Albania if the time of evaluation corresponds with a favourable domestic and regional economic environment. In its statement of 18 January 2005 the Filipino Presidential Spokesperson “This rating [RP credit rating downgrade by Standard & Poor’s] caught us in the midstream of urgent reforms and we are confident it will be reversed in full recognition of our comprehensive fiscal program. ... We are confident that S & P will revisit our rating and consider reversing the downward action once they have a complete understanding of the government’s significant achievements...”. It is clear that the first evaluation of credit rating will influence the future cost of public external debt. Until Albania has a credit rating, the multinational commercial banks should be a source of borrowing.

According to the MTBP 2005-2007 and IMF estimation, the level of external debt service in 2009 will be almost the same as the one of new external borrowing (see Chart 4). This means that the net cash flow in the economy from the public finance will be nearly zero. It will be the interest of the government of Albania to be involved in more research on this topic and to evaluate the impact on fiscal sustainability. Of course, the various scenarios with different levels of interest, levels of inflation and different economic growth regarding the fiscal sustainability should be established in order to precede each event.

CONCLUSIONS AND RECOMMENDATIONS

The main conclusion that we can draw from this paper is that further and in-depth research is needed over this issue in order to give proper advice to policymakers. Nevertheless, we indeed conclude that the banking system in Albania is on the right track. The time of privatisation of the banking system can be classified as a wise policy. It is carried out after the creation of the regulatory and monetary body – central bank.

Apart from the good performance of banking sector in Albania, the strengthening of the capacity of supervisory authority of banking system needs to be taken seriously into account from the central bank.

The level of public debt of Albania is in the right position, but some actions to regulate its structure are to be taken. It will be necessary that the government should take measures to improve the management of the domestic borrowing. Short maturity and concentration of the domestic debt can raise the liquidity problem. Thus, the structure of domestic debt should be extended and policies that involve households in buying domestic debt should be implemented. Also, according to the increase of competitiveness in the domestic financial market (bank privatisation), the Ministry of Finance should improve the treasury operations and debt management.

It is obvious that Albania has lost the right to benefit from soft loans, and it should be prepared to be involved in international financial market. Of course, till now Albania presents a favourable external debt level, but the future borrowing should be more prudential and needs important cost-benefit analyses. Also, the Albanian government together with Central Bank should initiate the preparation for a credit rating evaluation. This should be done on the basis of transparency in order to decide for a favorable time. Because of lack of experience, another step that is necessary to be taken is the staff training on international financial markets.

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ENDNOTES

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¹ He has employed the similar indices with some changes, for measuring the degree of Central Bank independence, to those proposed by Grilli, Masciandaro and Tabellini (GMT) (1991).

