

# **SHOULD BANK OF ALBANIA ADOPT THE IT REGIME?**

## **1. ABSTRACT**

Even in light of the problems and restrictions inherited from the past economic events, the monetary policy of the last 10-12 years has been considered relatively successful. Initially using direct control means and later through money market operations, the monetary policy has been able to control money supply most of the time.

Attempts have been made to develop further the monetary policy framework, especially with regards to its operational aspect, which at the current state can be considered relatively advanced. Nevertheless, it cannot be acknowledged that Bank of Albania's monetary policy has either been or is perfect. It still exhibits some weak areas, which substantially diminish the transmission of policy decisions onto economy. At the same time, the sample of empirical analyses available is very small and the conclusions drawn from that are, for many reasons, of little use.

Therefore, it has been some time that the debate on reviewing the overall monetary policy frame has initiated, trying to answer the question: which monetary policy regime is most suitable for Albania, the current one or the Inflation Targeting regime (IT)? This question still remains open to discussions although, lately, the official stance of Bank of Albania is showing support to the idea that the future policy regime over the medium term will be that of IT.

The following paper, which is divided in two parts, will first try to present a brief overview of the monetary policy over the last years, pointing out the political and operational framework attended by the Bank of Albania. The second part will try to present different views and arguments related to policy regimes of the future, or stated differently, it will answer the question: Should Bank of Albania adopt the IT regime?

## **2. AN OVERVIEW ON THE LAST DECADE**

### **2.1. FINAL OBJECTIVE OF THE MONETARY POLICY**

The actual law on “Bank of Albania” clearly states that the final objective of Bank of Albania is to achieve and maintain price stability, while all other objectives take a secondary role backing the final objective. Such an unambiguous expression of the objectives of the central bank has not been offered at the beginnings of modern central banking activity in Albania. According to the first law on Bank of Albania, approved in 1992, the main objective of the central bank was to maintain the value of the domestic currency, Lek.<sup>1</sup>.

Although it was not confirmed publicly, during the first years of transition, the objective of Bank of Albania to maintain the value of domestic currency was associated with attempts to maintain a certain monthly inflation rate. Later, the notion of aiming a monthly rate changed into a quarterly rate and by 1995 into a yearly rate. Given the hyperinflation rates in 1992 and 1993, it did not make sense to set an objective on yearly bases. Due to the implementation of tight monetary policies and budget deficit control, inflation rate came down until it reached a figure of single digit by end 1995. Now, it was reasonable to think of aiming inflation rates over longer time periods.

Yet, positive changes were identified after 1998 and on. During the last years, it has been continuously stated publicly that the objective of Bank of Albania is the annual inflation rate at the end of the year, set as a band between 2-4 per cent.

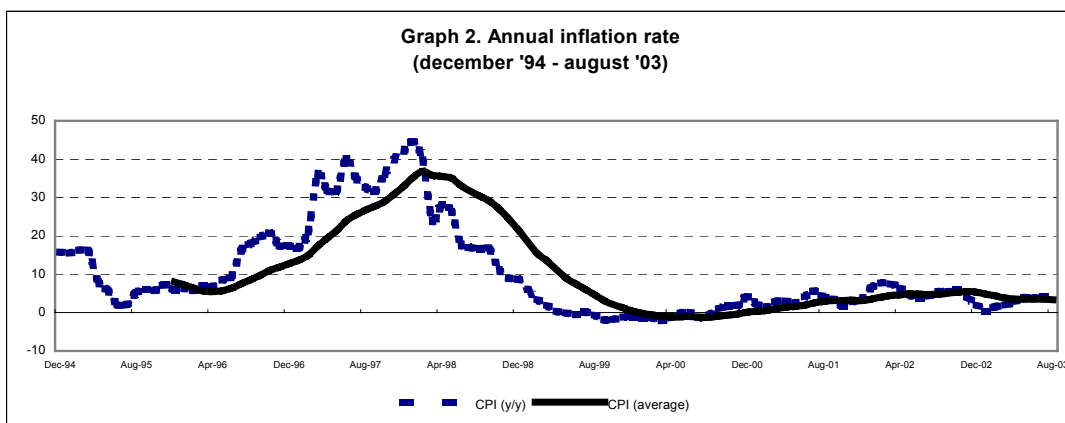
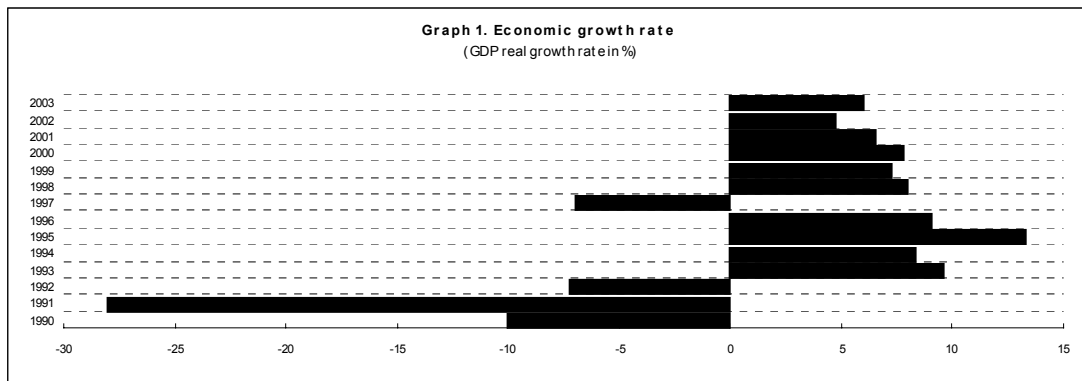
It must be said that Bank of Albania did not doubt when choosing to have price stability as its main objective. This decision is in line with the overall academic theories and the

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<sup>1</sup> However, never has the final objective of the Bank of Albania been the combination of several indicators. Not in any case, have indicators such as domestic production, employment rate, etc. been part of final objectives pursued by Bank of Albania.

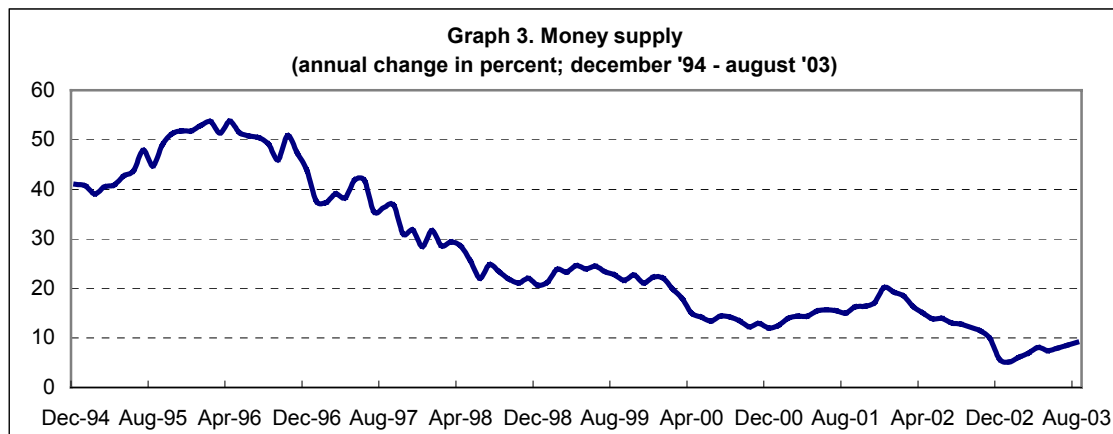
opinions of other central banks, which confirm that keeping inflation under control is the best contribution a central bank can offer.

Nowadays, or maybe even earlier starting since late '80s, the academic and professional beliefs are converging to the point that low inflation means higher economic growth and higher employment rate. Many theoretical arguments in favor or against the presence of inflationary pressures in economy have been brought forth, providing room for different interpretations, such as the one that an expansionary monetary policy can generate higher growth and higher employment. However, it should be noted that this does not hold true over long time periods, since the empirical evidences show that inflation and economic growth are negatively correlated, i.e. the higher the inflation rate, the lower the economic growth (Barro 1995, De Gregorio 1994, Fischer 1994).



Having a look at the case of Albania, one of the most appreciated achievements during the last eleven years has been the control that the monetary authority of the country, i.e. Bank of Albania has exerted on inflation. The process has been a long and continuous one, with ups and downs, but in general it can be assessed as a successful attempt.

The statistical data for the last years indicate low inflation rates which most of the time fluctuate within the aforementioned interval (2-4 per cent). Even though during the last years there have been changes in the basket items as well as important domestic or foreign political events, including armed conflicts in the region, a careful monetary policy combined with a controlled budget deficit have contributed to aggregate demand keeping inflation pressures at reasonable levels.

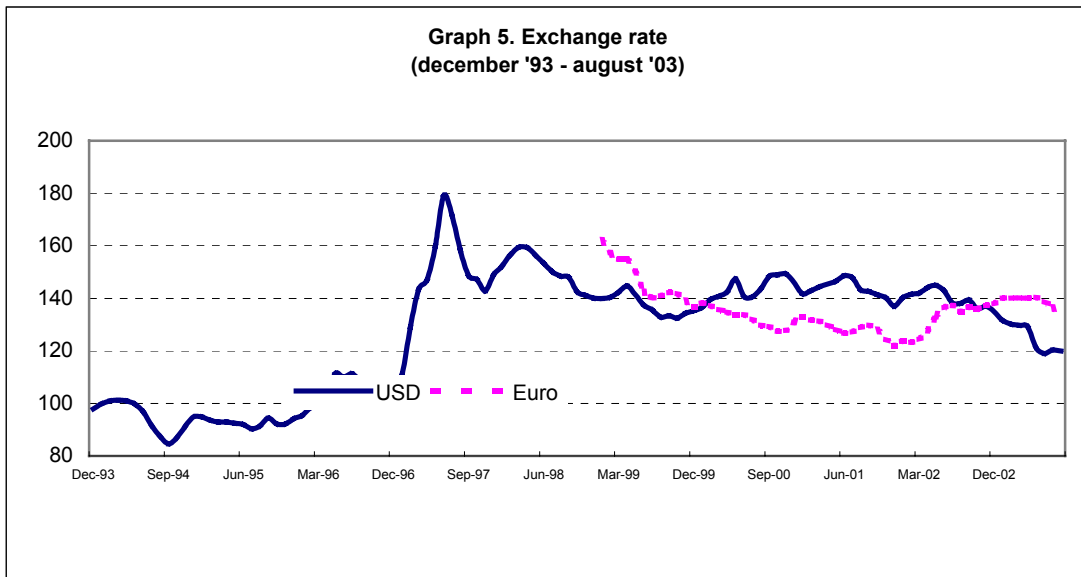
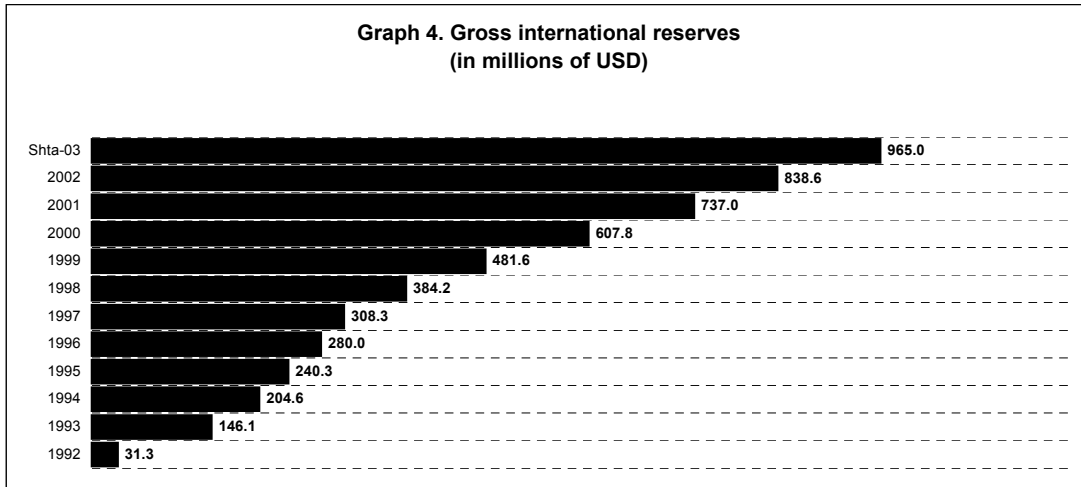


## **2.2. MONETARY POLICY REGIME**

In determining the monetary policy regime, Bank of Albania has been, first of all, confined by the economic environment and the functioning of the transmission mechanism at early '90s.

Although the 1992 law gives Bank of Albania the rights to formulate and implement the foreign exchange policy of the country, the circumstances hinted that priority be given to the monetary policy regime, where the intermediate objective was and still is, the M3 aggregate or money supply.

Choosing between the two alternatives, money supply or exchange rate, in favour of the first one was conditioned by the fact that it was impossible to support a fixed exchange rate regime. Even though the results would have become noted faster in case the fixed exchange rate regime was adopted (in addition this regime was easier to implement), at that time the international reserves of Bank of Albania were at very low levels and moreover, the balance of payments deficit was increasing rapidly.



Now, years after we made this choice, it can be concluded that we took the right decision. Experience pointed out that many countries, including transition countries, at certain moment found themselves unprepared when they had to give up the exchange rate regime for various reasons. As mentioned by Crockett<sup>2</sup> “For as long as exchange rate regime functions, policy makers find no reason to replace it. When the domestic currency is under attack, the authorities do not like to believe that the fixed rate regime has failed already.”

Given a poor inheritance of institutions and market infrastructure in the country, in its initial phases, Bank of Albania could not adopt operational objectives based on free market principles. For this reason, monetary control was carried out through direct operational means. This implied that the assets of the system and those of Bank of Albania should meet some quantitative limits. Hence, the control of the intermediate target, M3 aggregate would be achieved via direct control over foreign assets of Bank of Albania and over domestic assets of banking system, including net credit to government and to economy. In a way, *de facto* these limitations assume the status of intermediate criteria and even today, performance criteria<sup>3</sup> serve to measure the accountability in reporting monetary policy efficiency in the economy.

Briefly, not spending too much time on the definition of these criteria, I would like to explain the logic behind having them:

- **Net foreign assets**<sup>4</sup> of Bank of Albania, relate to the performance of balance of payment and represent the sustainability of international position of the country. These

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<sup>2</sup> Andrew Crockett, “Monetary policy objectives in light of Asian crises”, Monetary Policy Frameworks in a Global Context, pg 224.

<sup>3</sup> Quantitative criteria (performance criteria) are in existence even today, though their definition differs from that of early ‘90s.

<sup>4</sup> The notion of net foreign reserves of Bank of Albania used in the monetary program is a little bit different from the term used very often “foreign reserves of Bank of Albania” or “foreign assets of Bank of Albania”.

reserves serve to hedge the exchange rate of Lek (Albanian domestic currency) from short-time speculations. In these cases, Bank of Albania deems it necessary to intervene in the foreign market. In addition, international reserves are considered as the last resort to finance expenditures or consumption of an economy, in emergency cases, and for this reason they are measured in months of imports. The target set for the international reserves is supported by this line of reasoning.

- **Domestic credit to government** serves as another precautionary measure to control budget expenditures. Hence, Bank of Albania is involved in controlling the credit to government by the banking system, keeping an eye on the domestic debt and furthermore, indirectly trying to control government expenditures that might create inflationary pressures in the economy. Since this objective relates to the behavior of three actors, Ministry of Finance, Bank of Albania and commercial banks, Bank of Albania cannot have full control of it and therefore, it is not responsible if limitations are not met.

- **Net domestic assets of Bank of Albania** represent part of the liquidity generated by Bank of Albania in the system. Changes in net domestic assets come mainly from transactions between Bank of Albania with commercial banks and government. The liquidity generated by these transactions accounts for most of the liquidity in the whole economy and thus has an impact on inflation performance.

### **2.3. OPERATIONAL FRAME OF BANK OF ALBANIA**

As mentioned above, monetary supervision was initially exerted through direct means, applying some administrative measures on banks through some instruments such as the required reserve and credit limitations. Maybe it is not necessary to go back in details, but it is worth emphasizing that controlling the market through the administrative interest rate<sup>5</sup> and the credit limit became more and more difficult. The addition of new private banks, while the Savings Bank was withheld from lending and the level of risk in the

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<sup>5</sup> Floor interest rate for time deposits in Lek placed with second-tier state owned banks.

market was high, was followed by a considerable decrease of the credit to the economy. On the other hand, the impact of the limitation on the rates that state owned banks used to pay on long term deposits in Lek, diminished noticeably, especially after 1999, when the market was not following anymore the continuous reduction of the administrative rate by the Bank of Albania. Under such circumstances, a new conception of the overall operational frame was taken in consideration as well as the decision that the monetary policy of Bank of Albania was to be based only on the implementation of market instruments. More concretely, it was decided that the basis rate of the economy would be the rate of interest of the repurchase agreements (REPO), which would take place in standard weekly auctions<sup>6</sup>, held by the Bank of Albania.

As shown in picture 1, the main instrument of the monetary policy of Bank of Albania is the fix rate of REPO. Depending on the message it wants to give to the market, Bank of Albania organizes two kinds of auctions. In the first one, when the intention is to give signals of neutrality, the amount accepted is unlimited, whereas it is demanded or offered against a fixed priced formerly announced, which is the rate for the repurchase agreements of one week maturity established by the Supervisory Council of Bank of Albania.

In the second case, when Bank of Albania's purpose is to give to the market the signal of more tightened or more expanded monetary conditions, it organizes auctions where the amount accepted is fixed and the announced price is limited (it is still the rate for the repurchase agreements of one week maturity).

Independent on the type of the auction, the only intention is the supervision of the liquidity in the system, aiming to keep it in optimal levels in order to enable the maximum efficiency of the transmission device. It is obvious that the fix rate of REPO

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<sup>6</sup> Depending on the policy of Bank of Albania, auctions could be: (i) repurchase agreements – to draw liquidity, or (ii) inverse repurchase agreements – to inject liquidity in the market.

serves as reference for other rates, not only for crediting facilities that Bank of Albania offers to the banking system, but also for other market rates in general.

Besides interventions in the open money market, at present, Bank of Albania offers other facilities to regulate its relationship with the banking system:

- **Outright transactions**

The outright transactions can be used when trying to obtain a constant sterilization of the market. Practically, the instruments being used now to perform these transactions are treasury bills with one year maturity, whose maturity date does not expire less than 14 days from sale<sup>7</sup>.

- **Interventions in the exchange market**

Even though Bank of Albania has adopted a totally flexible regime of foreign exchange, it has been constantly present in the market, mostly to avoid speculations with Lek. The transactions of foreign exchange can be outright transactions or swaps.

- **Crediting facilities**

**Lombard credit.** The crediting facility of Lombard has been offered relatively early, but it should be mentioned that it has been used very rarely<sup>8</sup>. It is clear its classic goal of assisting banks in their temporary liquidity<sup>9</sup> problems, and it is considered as the last source of credit when all other possibilities have been exploited. Actually, it is the highest rate the Bank of Albania is offering to the system.

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<sup>7</sup> During 2001, only two outright transactions of TB have occurred for the total amount of 8 billion lek. In both cases, the buyer was the Savings Bank.

<sup>8</sup> It was never used during 2000-2001.

<sup>9</sup> It can have a maturity of up to three months and it can be obtained only once in three months.

The price of Lombard<sup>10</sup> is determined adding to the REPO rate a penalty of 6 percent.

**Overnight credit.** This facility was offered to the banking system the last year, and aims at supplying the banks with overnight liquidity. The name suggests that it should be paid back the next day. Its interest rate<sup>11</sup> is based on the REPO rate plus a penalty of 2.5 per cent. Overnight credit has been used very rarely<sup>12</sup>.

- **Required reserves**

The required reserve is one of the few instruments of indirect supervision, which has been used since July 1992, maintaining the same rate of 10 percent. The required reserve is calculated on the total of deposits<sup>13</sup> (liabilities of commercial banks) in Lek as well as in foreign currency. A recent innovation, dating October 2000 relates to the remuneration rate that Bank of Albania offers for these reserves in order to lower the financial intermediation cost in the system. Initially, the remuneration rate was 1/3 of market rate, but starting from the first quarter of 2001, in light of the desire to see the effects sooner, the remuneration rate changed to 1/2 of the market rates.

### **3. POLITICAL VISION OF BANK OF ALBANIA OVER THE MEDIUM TERM**

In view of the overall low inflation rate in the country, the current policy framework of Bank of Albania can be assessed as successful. Yet, many economists are not convinced about the suitability of having monetary objectives when it comes to transition countries. These doubts rise from the fact that the demand for money in this countries is inevitably unstable (Wagner 1998). Also, since transparency, accountability and credibility are the most important conditions for the success of stabilizing policies, targeting money supply

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<sup>10</sup> At present, this rate is 13 per cent.

<sup>11</sup> At present this rate is 9.5 per cent.

<sup>12</sup> Until October 2001.

<sup>13</sup> Except for interbank deposits.

does not offer the best means to reduce inflation. The objectives on domestic assets (credit to government, credit to non financial state and private enterprises) are not very transparent, because even if they were to be published, they do not offer the public a clear message on the expected inflation rate. Furthermore, tight monetary objectives have usually high costs as they cause contractions in economy (although short lasting) and the rise of real interest rates (Sahay dhe Vegh, 1995). These costs might harm credibility, leading to expectations that soon policy will change to being expansionary.

Although there are not many empirical analyses<sup>14</sup>, yet over the years there have been attempts to study what determines inflation rate in Albania. Some authors<sup>15</sup> have reached the conclusion that the correlation between money and inflation is weak.

No matter the differences of opinions, all agree that at a considerable extend, inflation depends from other macro variables, which are beyond the control of Bank of Albania or are not part of policy making issues. One of the most talked about factors is exchange rate, which in view of large imports is an important factor in creating inflationary pressures in the economy. (Hadëri et. al 1999). Also, the fiscal burden, in a way shadows the monetary policy efficiency vis-à-vis inflation.

Based on all the above mentioned reasons, it is logical that measuring all the factors that influence inflation has become a necessity, and maybe it is time that Bank of Albania moves from having money supply as its intermediate objective to targeting inflation. In this context, Bank of Albania has publicly stated that it will change its policy regime to Inflation Targeting in the medium term. In its policy document “The plan for medium

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<sup>14</sup> Mc.Neilly Schiesser (1998); Helbirt & Domac (1998); Karla (1999); Mytkolli & Haderi (1999); (Hadëri et al. 1999); Kolasi (2000); Rother (2000), Kolasi, Çeliku & Hashorva (2001); Sanfey, Muço & Luçi (2001); Hledik (2001) etc..

<sup>15</sup> Hadëri & Mytkolli; Kunst & Luniku (1998); Kolasi, Çeliku & Hashorva, 2001.

term development of Bank of Albania (2003-2005)” it is mentioned<sup>16</sup> that “... a suitable regime for our policy is that of Inflation Targeting....”

In practice, Inflation Targeting has revealed a successful strategy if on one hand it is supported by a sound macroeconomic and institutional environment and on the other hand it addresses an audience (economic agents, individuals, public overall) that understands and welcomes it.

### **3.1. WHAT FAVORS THE FAST IMPLEMENTATION OF INFLATION TARGETING?**

Literature suggests that the successful adoption of IT regime requires a period of at least 2-3 years of **stable inflation** rate. It is not necessary to explain the notion of a stable inflation rate, yet, we would like to stress out the fact that during the last 5-6 years, Albanian economy has recorded inflation rates that can be considered low. On average, annual inflation rate for the period December '98 – August '03 varies around 2.4 per cent, a bit above the lower limit set by the Bank of Albania. However, the most important aspect of this is the public commitment of Bank of Albania to control inflation within a fixed band in the future. Currently, the official stance of the Bank is to keep annual inflation rate at the end of the year not higher than 4 per cent and not lower than 2 per cent. At this point, we would conclude that this fact is a strong point in favor of successful adoption of IT regime.

Another precondition for IT regime is the implementation of **flexible exchange rate** regime. This condition is met by Albania, thus supporting the fast implementation of IT. Since mid '92 and ongoing, Bank of Albania chose a flexible exchange rate regime where price is market determined. Eleven years later, it can be noticed that our domestic currency has been stable in general, except for the “unfair” attack of 1997. At present, the exchange policy of Bank of Albania assumes that interventions will be carried out only to

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<sup>16</sup> The plan for medium term development of Bank of Albania (2003 – 2005), pg 27.

eliminate market speculations and to avoid large deviations from the historic trend of exchange rate of Lek.

Successful implementation of Inflation Targeting regime implies also the **consolidation of budget deficit** and in general the **commitment of fiscal authorities** not to compromise the monetary policy. The last years have marked progress in this respect although the fiscal burden in the economy is still large. Nevertheless, Albania's long term goal to join EU highlights the need for the commitment of institutions *de facto* to reduce the negative effects of fiscal burden in the economy. Two important conditions part of the convergence criteria: central bank is legally prohibited from financing budget deficit; and the budget deficit should be kept lower than 3 per cent of GDP, will be hopefully met during the 3-4 years ahead, coinciding with the Bank of Albania's goal to adopt inflation targeting in the next 2-3 years time.

Another argument favoring Bank of Albania to implement Inflation Targeting relates to the **overall legal and institutional context** of the Bank. Current law on Bank of Albania ensures a high legal, operational and economic independence. According to Albanian scholars, "...if we study the current law on the Bank of Albania, it can be concluded that the institution has a considerable legal independence<sup>17</sup>" (Cani, Baleta 1999). The same conclusion has been drawn with regards to the operational and economic independence. At present, Bank of Albania has managed to build a relatively modern operational setting to control money market, while she enjoys the legal rights to chose those instruments it deems appropriate. However, the authors we are referring to are skeptical when assessing the real independence of the central bank. They bring forth several arguments which create the impression that in everyday life, situation is a bit different and that from this point of view, there are many challenges to face. Stressing the same issue, it would be of

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<sup>17</sup> Shkëlqim Cani, Teuta Baleta, "Central Bank independence. Bank of Albania: How independent is it?", Working Paper 1/99, September 1999, Bank of Albania.

interest to briefly elaborate on other institutional aspects, which have a vast impact in the successful implementation of the Inflation Targeting regime.

During the last years, Bank of Albania has greatly improved the level of transparency in every possible way. Its objective has been that of complying with the Code of Good Practices on Transparency of Monetary Policy of the Central Bank issued by IMF. Even though the number of publications, channels of communications with the public, etc. has increased considerably, Bank of Albania cannot be considered a very transparent institution and that is partly due to the lack of its capacities to fully explain its policy decisions. Nevertheless, the positive developments of the last years create premises to be optimistic for the future.

Increasing transparency has, on one hand, led to improving the image of the Bank of Albania in public and on the other hand it has obliged the central bank to be more accountable for its actions. Different surveys, increasing interest in Bank of Albania's publications, assessments from international institutions, etc. suggest that the credibility of the Bank of Albania has risen continuously, being a positive factor in favor of Inflation Targeting regime. Also, the accountability of the Bank of Albania is based on contemporary principles focusing more on explaining the role of monetary policy and the role of Bank of Albania as a supervising authority by publishing its financial accounts and audit reports. However, there is still room to improve on both aspects especially in terms of explaining more professionally the policy making and administration process of the institution.

### **3.2. WHAT HINDERS THE ADOPTION OF AN INFLATION TARGETING REGIME?**

Albania still constitutes an economy of ongoing reform, with frequent structural changes, which, in a way, have their impact on the main economic indicators. Likewise, its immunity system vis-à-vis domestic and foreign crisis is far from perfect, which increases its fragility. Due to all these reasons and other ones mentioned in previous paragraphs,

the Bank of Albania lacks a clear understanding of the manner how<sup>18</sup> its political decisions are transferred onto economy. Cani in his presentation<sup>19</sup> at the Third Conference of the Bank of Albania has stressed "... that the effect of monetary policy is sensitively decreased due to the presence of certain factors, such as: (i) the monopolistic position of the Savings Bank in the market of lek deposits; (ii) the limited role of crediting in lek; (iii) the relatively large difference between deposit and credit interest rates; (iv) the limited activity of interbank market, which is concentrated in extremely short-term instruments; (v) the remittances; (vi) the large possessions of *cash* in lek and foreign money by the Albanian people, etc."

This statement of the Governor of the Bank of Albania brings out that in the event of a potential implementation of the Inflation Targeting regime, the Bank would necessarily need to address such issues as the low efficiency of the markets, the problems with competition and domination of the Savings Bank, the still low degree of financial intermediation, the lack of clarity that characterizes the mechanism of monetary transmission, the dimensions and impact that originate from shadow economy as well as the scale of dollarization, the familiar problems with macroeconomic statistics, the limited abilities of the Bank of Albania in the techniques of patterning and forecasting, etc.. All these issues, conjoined with the need for an improvement of the real independence of the Bank of Albania, constitute substantial obstacles for an adoption of the Inflation Targeting regime.

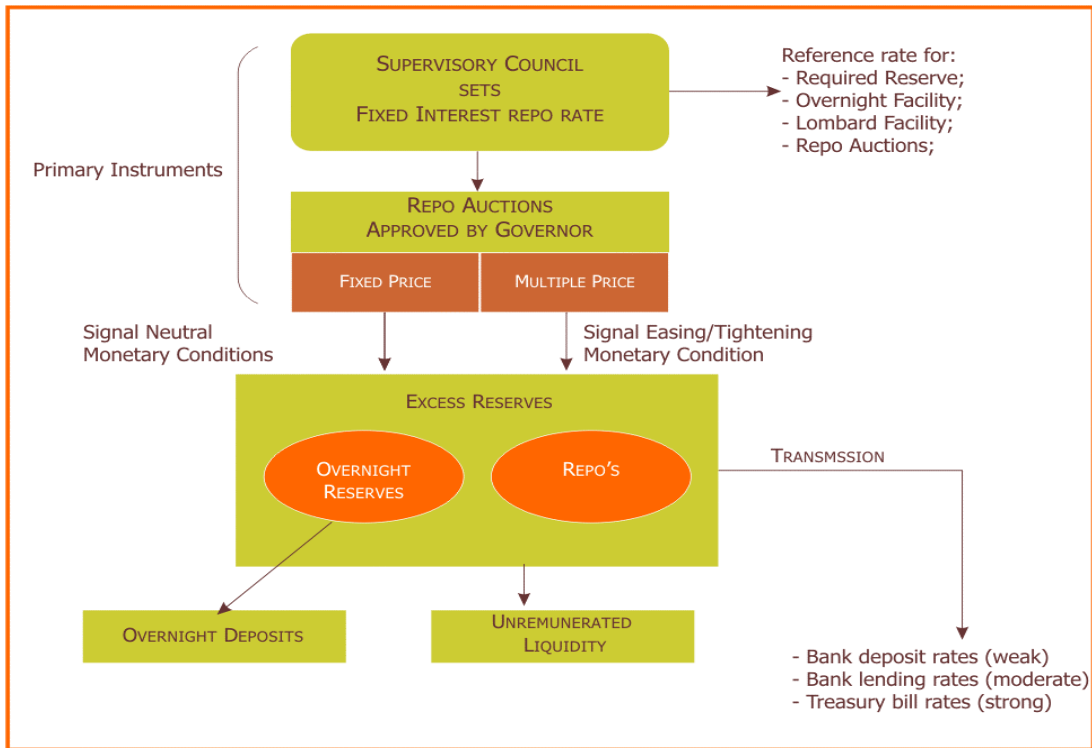
Obviously, it is not the case to draw a balance of the factors that are for and of those that are against the adoption of the Inflation Targeting regime. Of course, there is room for improvement in both directions. More specifically, it cannot be said that inflation in the recent years has been low and this is sufficient. The same way, the fact that there has been a decrease in the market domination by the Savings Bank in the last two years

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<sup>18</sup> Figure 2 reflects a potential scheme of the monetary transmission mechanism in Albania.

<sup>19</sup> Shkëlqim Cani, Monetary Policy: an analytic view on the past and its vision on the future, Presentation in the Third Conference of the Bank of Albania, December 2002.

cannot be denied. The main conclusion that can be drawn out is related to the fact that the institutional engagement of the Bank of Albania to adopt in a medium-term period the Inflation Target regime as a political framework, requests a greater commitment by the Bank itself and by the other institutions in the country. There is no doubt that there is room for more macroeconomic stability, more economic growth, more new work places, greater stability of prices, greater rapidity in the implementation of structural reforms, etc.



**Diagram 1. Current Monetary Policy Framework**



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