

## 4<sup>TH</sup> NATIONAL CONFERENCE OF BANK OF ALBANIA

### "ALBANIAN ECONOMY: PERFORMANCE AND POLICY CHALLENGES"

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#### SOME COMMENTS ON THE PAPER:

#### "INFLATION, EXCHANGE RATES AND THE ROLE OF MONETARY POLICY IN ALBANIA"

by Marta Muco, Peter Sanfey and Anita Taci.

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At first, we would like to thank the authors of the paper for their clear insights on the interactions between real economic indicators as well as the dynamic role of monetary policy in this process.

In our discussion, we would like to bring forward three points:

- The relationship between economic growth and economic stability;
- Monetary policy in Albania;
- The challenges of establishing an IT regime in Albania.

#### (I) THE RELATIONSHIP BETWEEN ECONOMIC GROWTH AND ECONOMIC STABILITY.

Albanian economy has been expanding rapidly during the last decade, averaging 6.3% in real terms during the 1993-2002<sup>1</sup> period. *We would like to argue that macroeconomic stability, while being a key contributor to GDP growth, has not been the driving factor of growth in Albania. On the other side, our experience shows that the lack of macroeconomic stability has a negative effect on GDP growth, as 1997 and, to some extent, 2002 events have shown.*

Before assessing the factors behind Albania's high economic growth, we need to put it into perspective: it is worth noting that the Albanian economy started the transition period from a very low base. National income was estimated to be around 800 USD per capita in 1989. It is obvious that you can expect high growth rates starting from a low base. Nevertheless, average income almost doubled during the transition period. National income is estimated to be around 1600 USD per capita in 2002.

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<sup>1</sup> Excluding the contraction of the Albanian economy during 1997, which was a result of a general socio-economic crisis, Albanian GDP growth during this period averaged 7.9 per cent.

The main engine of economic growth has been private sector development. It is estimated that the private sector contributes 75% of GDP in 2001<sup>2</sup>. Public economy and public contribution in the wealth-creating process has been decreasing steadily, reflecting the shift towards a market economy. Therefore, the main factors behind this growth appear to have been:

- Domestic demand. A "hidden" demand, unfulfilled during the centralized economy, served as a catalyst for the economic development. It started with consumer goods and continued with housing later. This contributed to the development of trade at the beginning and to the development of the construction and transport industries later;
- Private remittances from migration, which have been a steady source of income, have fueled domestic demand. Official estimates put them close to 13% of GDP in 2002. They have helped to sustain the aggregate demand and to finance private infrastructure investments. The role of this remittances in driving domestic demand can be better assessed if we note that FDI-s have averaged at round 3.8% of GDP<sup>2</sup> during 1999-2001, lower than most EU accession countries.
- Informal economy and illegal activities on a regional basis have contributed to the national income. Different estimates put the "gray economy" close to 30% of GDP.

*Macroeconomic stability has been a key contributor but not the driving force in these developments. The development of the economy is financed mainly through remittances or by their own means, as in the case of enterprises. Private sector credit of the banking system, though growing at very high rates (around 25 annually during the last two years) is just 6.6% of GDP<sup>3</sup>. The credits of the banking sector or international capital inflows have had a limited role. Nevertheless, the role of macroeconomic stability, and the inherent place monetary policy has within it, is due to increase in the future. It will provide the basis for a normal functioning of the economy, of its financing from the banking sector and in helping to attract FDI.*

## **(II) MONETARY POLICY IN ALBANIA.**

### *A. Evaluating effectiveness.*

There are several indicators to judge the effectiveness of monetary policy. We would like to keep it simple: *monetary policy has been successful in Albania in so far it has made possible relatively rapid disinflations (1991-1995 and 1997-1998) of the economy and a satisfactory price stability in the last 5 years.* Of course, there are other factors contributing to price stability, but you can't negate the primary role of monetary policy.

### *B. The development of the transmission mechanism.*

The development of the transmission mechanism is a process that concerns many factors in the country. Broadly speaking, the transmission mechanism can be split in two parts: The first part starts with BoA and ends in the financial system, the second one comprises the links and dynamics between the financial system and the real sector of the economy. *The first part of the transmission mechanism in Albania can be defined as functional, or, at least, acceptable for the stage of development of our financial market. BoA interest rate decisions are being timely transmitted to financial market interest rates. The second part of the transmission mechanism is largely unknown. The ties between*

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<sup>2</sup> Source: EBRD, Transition Report 2002.

<sup>3</sup> The data are for end August 2003.

*the financial sector and the real sector are hampered by informal economy, the degree of competitiveness of the financial sector, etc.*

**C. Monetary policy framework in Albania.**

BoA has a monetary targeting framework. As a theoretical background, it looks at money supply as the prime determinant of price level in the economy. There are several comments we would like to make:

- *The role of monetary aggregates in the economy is important for the price level. Regression analysis done at BoA suggests that broad money influences prices with a lag of 5 to 6 months. The withdrawal of the deposits in 2002 is a good indicator of the effects liquidity has on prices in Albania.*
- *Targeting broad money (M3) implicitly covers exchange rate developments, as exchange rate level is included in Fx deposits.*

**D. Transmission channels of monetary policy.**

We would like to focus on the two main channels:

– **Interest rate channel.**

Interest rates affect economic activity in three directions in Albania:

- The effect it has on credits to the economy;  
*This seems to be limited in Albania because lending in domestic currency is relatively small, SB is not allowed to lend to the economy.*
- The impact it has on the savings-consumption ratio, as well as in deciding the asset portfolio of savings (cash vs. deposits).  
*The increase in interest rates has had an important role in bringing back the liquidity withdrawn from the banking system in 2002.*

– **Exchange rate channel.**

BoA has a free-floating exchange rate. *We agree and support the conclusion of the paper that exchange rate is very important for price stability. Exchange rate effects prices through the imported inflation. On the other hand, it is an important input in the price-setting mechanism in Albania.*

**(III) NEXT STEP. IMPLEMENTING THE IT REGIME IN ALBANIA.**

BoA has made it clear that it intends to adopt the IT regime in the medium term, as its monetary policy regime.

According to McNees, *monetary policy framework comprises "the institutional arrangements under which monetary policy decisions are made and executed"*.

Therefore, the choice of a monetary policy regime requires an analysis that extends beyond the central bank. BoA fulfills several preconditions necessary for the implementation of IT framework. It has:

- a clear mandate to achieve and maintain price stability, as its overriding objective;
- legal independence in two aspects, both goal independence and instrument independence;
- made a rapid progress in its analytical capabilities during the past 2 years.

The implementation of the IT regime in Albania needs to address several issues:

**1. The development of financial markets;**

There is no clear theoretical consensus of what represents the necessary degree of development of financial markets. *Nevertheless, we can identify to areas where Albanian financial markets are inappropriate at the moment for supporting an IT regime:*

- the deepness of financial markets - (Albanian financial market is practically equivalent to the banking sector, there are no long term financial assets to support IT, as a forward-looking policy arrangement)
- the transmission of BoA interest rates decisions in the financial markets is subject to some time and size uncertainties (a more competitive financial market would address this issue).

**2. The identification and refinement of the transmission mechanism;**

*This issue is highly correlated to the first issue. It also requires the development of the real sector of the economy: the improvement of its ties with the financial sector and the correction of some structural weaknesses such informal markets, cash transactions and the monopolies.*

**3. The development of the necessary analytical capabilities requires quality data on all sectors of the economy;**

*The dissemination of SNA is a first step in this process. Furthermore, the data needs to be timely and reliable.*

**4. The clear support of all relevant economic policy-making actors in adopting and implementing an IT regime.**

The theoretical benefits of IT regime are well known. As Mr. Hossein has rightly pointed in his paper, BoA has used discretion in its monetary policy decisions, though they appear to be close to the predictions of a Taylor rule. This has had a positive effect on the credibility of the BoA. The adoption of IT as a monetary policy regime does not affect the flexibility of BoA. Theoretical work suggests there is no trade-off between credibility and flexibility (Fry. M. Key issues in the choice of a monetary framework. 2000). "By imposing a conceptual structure and its inherent discipline on the central bank, but without eliminating all flexibility, IT combines some of the advantages traditionally ascribed to rules with those to discretion". (Bernanke, Laubach, Mishkin and Posen, 1999).