2. ACTIVITY OF THE BANK OF ALBANIA DURING 2016

2.1 MONETARY POLICY

The primary objective of the monetary policy is to achieve and maintain price stability. An economic environment with stable prices: (i) allows households and enterprises to make well-informed decisions on consumption, savings and investments; (ii) prevents unexpected income distribution; (iii) facilitates the efficient allocation of resources in the economy; and, (iv) promotes financial stability at home. Thus, the monetary policy promotes the stable and long-term growth, and fosters economic and social welfare.

The objective of Bank of Albania's monetary policy is to keep inflation around 3% in the medium term. To achieve this objective, the Bank of Albania applies an inflation targeting regime, while the exchange rate is freely determined by the demand and supply for foreign currency in the market. The monetary policy is implemented by intervention with indirect instruments in financial markets.

ALBANIAN ECONOMY PERFORMED POSITIVELY THROUGHOUT 2016

The volume of economic activity has been growing, the spare capacities in the labour and capital markets reduced, while the main indicators of the economic and financial stability of Albania improved.

INSTAT data show that the Albanian economy grew by 3.3% over the first nine months of the year. Indirect data suggest a similar growth rate for the fourth quarter, as well. The economic activity expanded driven by the increase in consumption and private investments, while external environment remains unfavourable; the external demand was volatile and fiscal policy continues to be oriented toward consolidation.

The growth of aggregate demand drove to the increase of employment and full utilisation of production capacities by enterprises. Thus, the domestic inflationary pressures strengthened and inflation showed clear signs of convergence toward the target. The annual inflation averaged 1.3% in 2016, and hit 2.2% at the end of the year.

Fiscal consolidation drove to the reduction of deficit and public debt. Although this consolidation implies the presence of a low fiscal stimulus, it helps the accommodative policy pass through to the financial markets and contributes to lower the financing costs for the private sector.

The expansion of the current account deficit reflected mainly the high imports related to big energy projects. Nevertheless, this deficit continues to be highly
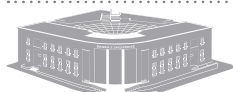
financed by non-debt creating flows, in the form of foreign direct investments.

In the financial aspect, the available data show that the financial situation of enterprises improved. Also, the Albanian banking system maintained good level of liquidity, profitability, and capitalisation indicators.

The accommodative monetary policy provided the main contribution to the improvement of economic indicators.

The interest rate cut and the establishment of good financing conditions, among others, supported economic developments in 2016. With a stronger simulating nature over 2016, the Bank of Albania's monetary policy played a key role in this regard. This policy was transmitted via the following instruments:

- **Bank of Albania cut the policy rate twice during 2016 H1, for a cumulative effect of 0.5 percentage point, down at 1.25% in May.** The policy rate remained at this level throughout the remainder of the year. Disinflationary pressures from foreign markets drove to the increase of monetary stimulus. It aimed at further reducing financing costs in the economy and signalling the Bank of Albania's willingness and capability to respect its price stability objective.
- **Also, the Bank of Albania narrowed the interest rates corridor in the interbank market, determined by the overnight credit and deposits' interest rates.** This movement aimed at reducing the fluctuations of interest rates, and a better pass through of the monetary policy in the financial markets.
- **In addition, the Bank of Albania continued to inform the public on maintaining the monetary policy accommodative stance.** The use of the forward guidance was strengthened over 2016, orienting the public on the time frame and intensity of the monetary stimulus. These terms were related and consistent with the forecasts on the achievement of the objective. Thus, they served to increase transparency and credibility of the monetary policy, which are important objectives of the Bank of Albania's development strategy.
- **Finally, the Bank of Albania, for the purpose of its monetary policy implementation, continued to supply the banking sector with the required liquidity.** The Bank of Albania has constantly adopted the terms and instruments to inject liquidity to the market's needs. The injected liquidity in the banking system averaged ALL 24 billion over 2016.

The monetary policy implemented by the Bank of Albania was effective. The policy rate cut, the limitation of the volatilities in the short term and the forward guidance in the medium term drove to the reduction of interest rates across all segments of the financial market. The average interest rates on credit, deposits and 12-month T-bills in ALL were 0.8, 0.5, and 1.5 percentage points lower than in the previous year.
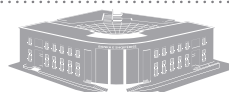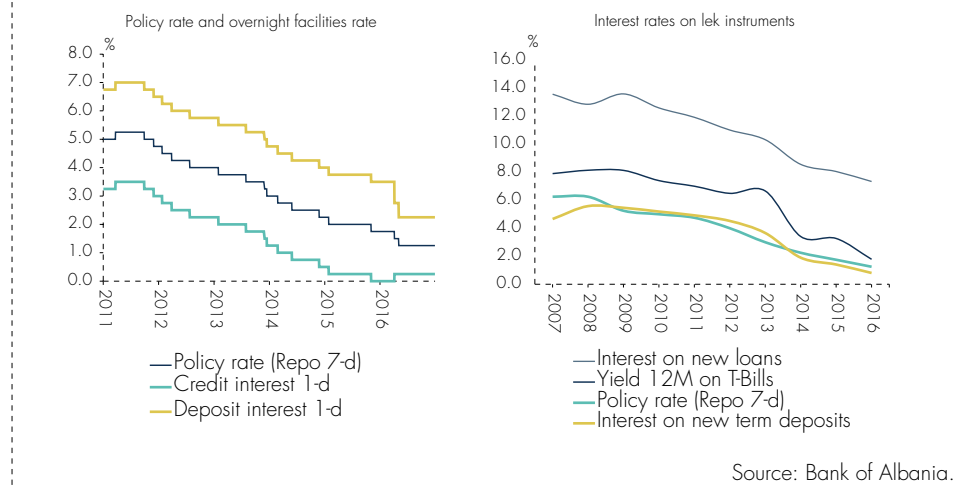
Chart 1 Policy rate and overnight facilities (left), interest rates on some lek instruments (right)

Policy rate and overnight facilities rate

Interest rates on lek instruments

— Policy rate (Repo 7-d)
— Credit interest 1-d
— Deposit interest 1-d

— Interest on new loans
— Yield 12M on T-Bills
— Policy rate (Repo 7-d)
— Interest on new term deposits

Source: Bank of Albania.

The effects of the monetary policy on the economy were felt in several aspects.

– **First, although banks' lending policies remain conservative, the reduction of financing costs helped the expansion of credit in ALL.** The ALL credit portfolio to the private sector grew by 10.2%, over 2016, while total credit grew by 3.2%.
– **Second, the low interest rates helped to reduce the service costs of the existing credits and to lower their re-financing costs.** The fall of interest rates over 2016, helped borrowing enterprises and households save ALL 1.7-3.4 billion[2].
– **Third, the low interest rates supported the increase of private consumption in the economy, encouraging a propensity toward consumption, rather than savings.**

The three aspects mentioned above drove to the growth of aggregate demand and to the acceleration of economic growth over 2016. The recovery of the latter was reflected in the upward trend of inflation during the second half of the year, providing the preconditions for achieving our target within the medium term.

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[2]   *This assessment is based on an optimistic scenario and a conservative one of the transmission of financial market's reference rates fall in the credit service cost.*
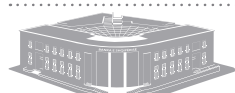
BOX 1. FORMULATION, IMPLEMENTATION AND COMMUNICATION OF THE MONETARY POLICY

Monetary policy mission and functions

The Bank of Albania is vested with the legal right and responsibility to formulate and implement the monetary policy. The objective of the monetary policy is to achieve and maintain price stability. The Monetary Policy Document defines and determines in quantitative terms the price stability, as: achieving and maintaining the average inflation at 3% in the medium term. For countries that apply a free-floating exchange rate regime, like Albania, the monetary policy implies the management of the policy rate,[3] through which the Bank of Albania conducts short-term lending and borrowing transactions with commercial banks. The level of the policy rate serves to determine the short-term liquidity price in the interbank market and all the other prices of financial products, with the purpose of achieving the target. In parallel with maintaining price stability, but always conditioned by the primary objective, the Bank of Albania's monetary policy aims at reducing the short-term fluctuations of the business cycle. The accomplishment of these objectives implies an important contribution of the monetary policy in fostering stable economic and welfare growth.

Monetary policy decision-making process

Given that changes in the policy rate need time to be materialised in the economy, the formulation of the monetary policy should be forward-looking. It should be based on a structured analysis and forecast process, which is consistent, efficient and transparent, and takes account of all the available information at the decision making time, as well as the expertise and opinion of the Bank's experts. The outcome of this process is the assessment of the current situation of the economy, expectations of its performance in the medium term and the identification of potential risks. At the end of this process, different alternatives of the monetary policy are studied to select the response, which is consistent with achieving the inflation target in the medium term.

The analysis, forecast and formulation of the monetary policy takes place in eight dedicated meetings of the Supervisory Council of the Bank of Albania. The process begins with the analysis of the new economic, monetary and financial information, aiming at assessing the current economic situation and identifying the deviations from expectations. The process moves toward the preparation of the economic and financial forecasts, which serve to determine the expected development, identify the potential risks, and assess the various options of the monetary policy. This phase coordinates the generation of short-term forecasts, which model the behaviour of economic indicators for four quarters, with the medium-term ones, for a three-year period. In this time horizon the effects of the monetary policy provide the maximum effect in the economy. A portfolio of various econometric models, which vary in structure, aim and use, are employed to generate the forecasts.

Main improvements of the process over 2016

The continuous improvement of the forecast analysis of the monetary policy is at the focus of our work and part of our strategic objectives.

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[3] This rate is the interest applied in 7-day repurchase agreements, in the regular weekly auctions of the Bank of Albania.

Throughout this year, additional attention was paid to:

(i)   the expansion of analysing capacities of macroeconomic models, enriching them with contemporary diagnosing and assessing techniques;

(ii)   the updating and enrichment of econometric infrastructure in use , through including new sectors and constructing new models, increasing thus the coverage of the Albanian economy;

(iii)   the better coordination of stages in the forecasting process and better integration of their results. The results of this work are materialised in a more complete and advanced platform for constructing analytical and forecasting information and have helped to better support the formulation and implementation of the monetary policy.

The research work of the Bank's staff, the technical assistance in the framework of collaboration with the International Monetary Fund (IMF) and with the Graduate Institute Geneva and the Swiss State Secretariat for Economic Affairs (SECO), as well as the synergy created from the close collaboration within the Bank have contributed to the improvement of this process.

At the same time, the Bank has worked to increase the knowledge on the monetary policy transmission channels, to enrich the range of indicators and instruments that are used in the process of analysis and forecasts, and to increase the understanding of policy decision-making.

The economic and monetary analysis and the arguments on the monetary policy decision-making are transmitted to the public through the quarterly Monetary Policy Reports and the public statements of the Governor on inflation and economic growth outlook. The work to improve their quality, structure and clarity has aimed at increasing our transparency and accountability, ultimately aiming at strengthening public confidence in the monetary policy and price stability.

To serve transparency and optimisation of operational decisions, the methodology for assessing the foreign exchange reserve was reviewed. In compliance with our monetary policy, and to support the financial stability, the Bank of Albania aims to maintain an adequate foreign exchange reserve. Pursuant to the best international practices, the methodology to assess this level is completed, by considering the criteria to withstand shocks in the external sector of economy and the opportune cost of maintaining the foreign exchange reserve level.

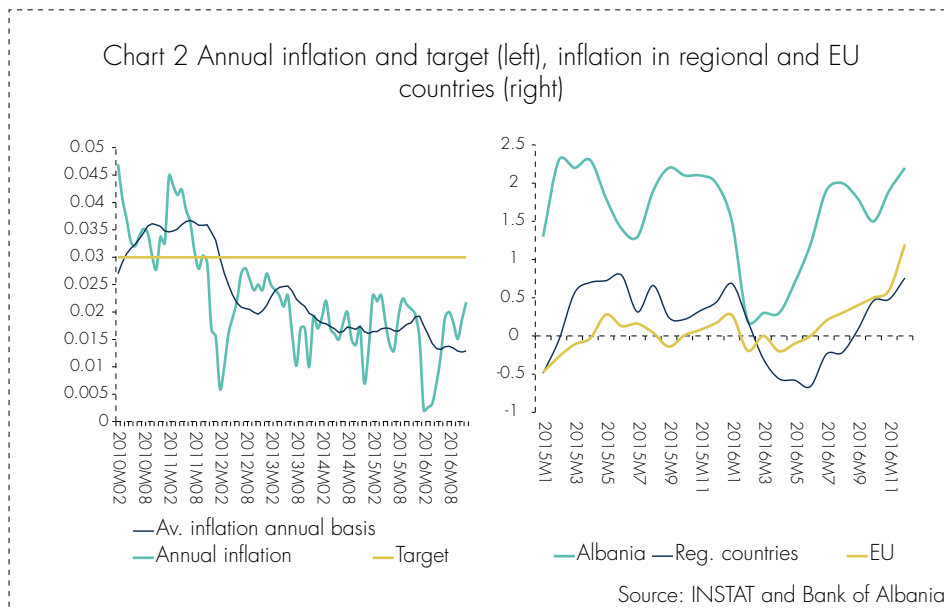## INFLATION AND MAIN ECONOMIC DEVELOPMENTS

Inflation and underlying factors

Overall, inflationary pressures increased over 2016. Supply-side shocks were reflected in a temporary fall of inflation over the first half of the year; further, as they weakened and economic activity improved, this indicator increased.

In 2016, the annual inflation rate averaged 1.3%. Its profile was characterised by a fast fall in the first quarter, stabilisation at low values over the second quarter and progressive increase in the third and fourth quarters. The inflation rate averaged 0.7% over the first half of year, and stood at 1.9% in the second half of year.
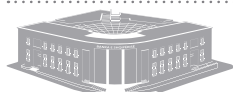
The fall in inflation in the first months was mainly attributable to supply-side shocks, materialised in the fall in the inflation of unprocessed foods, oil and related services. The rapid fall of inflation, at the beginning of the year, was not an isolated phenomenon of the Albanian economy: in the euro area and regional countries it fluctuated also at rather low values, even negative ones, in these months. On the other hand, inflation's increase in the second half of the year reflected the weak supply-side shocks and the strengthening of internal inflationary pressures, due to the narrowing of the negative output gap.

Chart 2 Annual inflation and target (left), inflation in regional and EU countries (right)

Source: INSTAT and Bank of Albania.

Inflation increased across almost all main items of goods and services.

Inflation of food prices continues to provide the largest contribution to the performance of inflation. Inflation of processed and unprocessed foods fell in 2016 H1, reflecting the overall fall of food prices in global markets. Further, their inflation showed recovery signs during 2016 H2, in response to the fall of disinflationary pressures from foreign prices and high production costs in the food processing industry for the domestic market.

Table 1 Contribution of key items to annual inflation

|	Q4:14	Q1:15	Q2:15	Q3:15	Q4:15	Q1:16	Q2:16	Q3:16	Q4:16
Processed foods (p.p.)	0.2	0.3	0.2	0.1	0.0	-0.4	0.1	0.4	0.6
Bread and grains (pp)*	-0.1	0.0	0.0	0.0	-0.1	-0.2	-0.1	0.0	0.1
Alcohol and tobacco (p.p.)	0.3	0.3	0.3	0.3	0.2	0.1	0.1	0.1	0.1
Unprocessed foods (p.p.)	0.8	1.7	1.8	1.8	2.6	1.5	0.9	1.2	0.9
Fruit (p.p.)	0.4	0.5	0.8	0.8	0.9	0.7	0.6	0.4	0.2
Vegetables (p.p.)	0.2	1.1	0.9	0.9	1.7	0.8	0.3	0.8	0.6
Services (p.p.)	0.2	0.1	0.0	0.0	0.0	-0.1	0.0	0.2	0.0
Regulated prices (p.p.)	0.1	0.1	0.1	0.1	0.0	0.1	0.1	0.1	0.0
Fuels and energy (p.p.)	0.0	0.0	0.0	0.0	-0.1	0.0	0.1	0.1	0.1
Housing (p.p.)	0.1	0.1	-0.1	0.0	-0.2	-0.2	0.0	0.0	0.0
Non-food consumer goods	0.0	-0.4	-0.2	-0.2	-0.3	-0.3	-0.3	-0.1	0.3
Durable consumer goods (p.p.)	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1
Consumer Price Index (y-o-y, %)	1.3	1.9	1.8	1.8	2.1	0.7	0.7	1.9	1.9

Source: INSTAT and Bank of Albania.
*The table presents some of the main items.

Inflation of "non-food consumption goods" trended up, mainly driven by the performance of oil prices in Albania. This category shifted the direction toward increasing positive values, after a long period of negative contribution to the headline inflation (December 2014 - August 2016). The increase in prices of other items in this category, also, provided a positive contribution in the last two months of the year[4]. "Housing" prices returned to the slight positive contributions to headline inflation since 2016 Q2. Also, "services" provided upward inflation and contribution in the summer months, mainly driven by the increase of prices in transport services[5].

Chart 3 Output gap (%), unemployment gap (pp)*, and core inflation (%)**
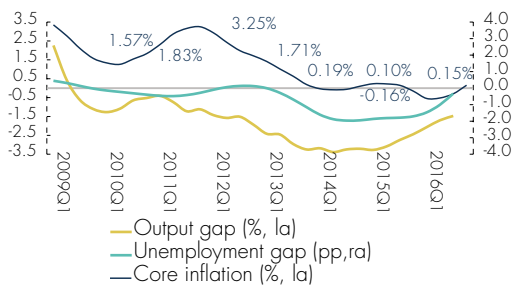
Source: INSTAT and Bank of Albania's calculations.
Note: All indicators are flattened by the four-term moving average.
* Unemployment rate gap is calculated as the difference between the natural rates of unemployment with the actual unemployment rate published by INSTAT, to simplify the interpretation of the equal or unequal direction with the output gap, which is calculated in per cent of the potential output. **Proxy indicators of labour productivity and labour costs per unit of output are calculated by the Bank of Albania using the total series Short-Term Statistics (SHTS, INSTAT, 2016 Q3). Their calculation includes the index of the number of paid employees, of the turnover volume and wage fund for the total activities covered by the survey of SHTS.

Chart 4 Contribution of imported and domestic inflation to annual headline inflation

Source: INSTAT and Bank of Albania's calculations.

The improved cyclical position of the economy was reflected in a gradual narrowing of the negative output gap, by strengthening the inflationary pressures from the domestic demand side over 2016.
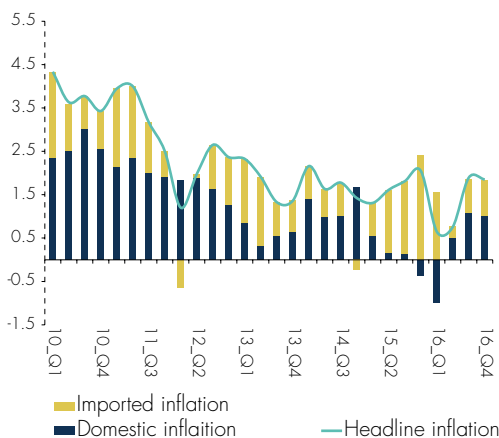
The improved aggregate demand and better utilisation of production capacities conditioned an increasing trajectory of core inflation over 2016. This indicator moved from negative values during the first half of year to positive ones in the second half of year, reflecting the strengthening of mid-term inflationary pressures.

Imported inflation was moderated, against the increase of domestic inflationary impulses.

Imported inflation contributed by around 66.5% to the formation of the average annual inflation. This indicator fluctuated considerably during the first half of the year, while it reflected a more stable behaviour over the second half of 2016. On the other hand, domestic inflation is assessed to have determined around 59% of headline inflation, during April - December 2016, supported by the cyclical improvement of economy.

Inflation expectations continued to generate weak inflationary pressures.

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[4] The increase of mandatory insurance price of motor vehicles or the high fluctuations of fuel prices contributed, in particular periods, to the increase of "non-food consumption goods" category.
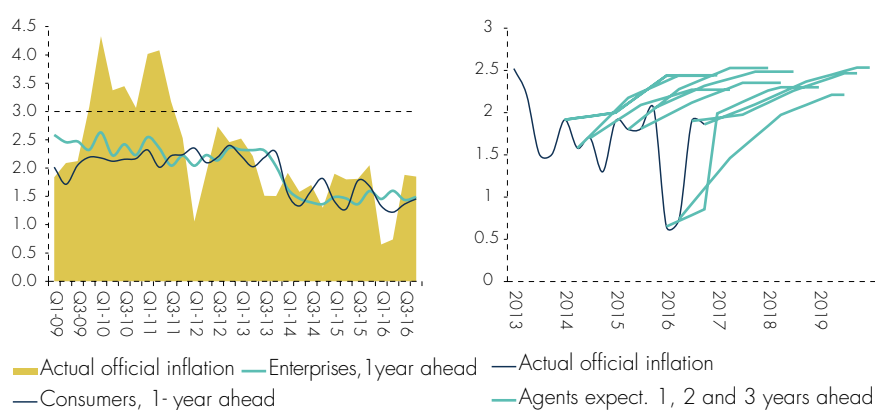
[5] In particular, the increase of air transport prices, with an annual inflation higher than 30% during August, which after that was stabilised at lower values.

Inflation expectations by agents and time horizons[6] reflected an uneven behaviour over 2016. Consumers and financial agents' short-term expectations reacted more against the low values of the actual inflation at the beginning of year, while enterprises' expectations, overall, remain unchanged. Financial agents' short-term expectations were around 1.9%, remaining higher compared to the expectations of enterprises and consumers, 1.5% and 1.3%, respectively. In the medium term, after two and three years, inflation expectations surveyed with financial agents were 2.2% and 2.4%, respectively. The good anchoring of medium-term expectations, close to the target, and the low reaction against the short-term fluctuations of the actual inflation, reflects the credibility of the monetary policy.

Chart 5 Inflation expectations: enterprises and consumers' (left), financial agents' (right)

Actual official inflation — Enterprises,1year ahead — Actual official inflation
— Consumers, 1- year ahead — Agents expect. 1, 2 and 3 years ahead

Source: Bank of Albania.

BOX 2. SUPPLY-SIDE SHOCKS AND MONETARY POLICY RESPONSE

The rapid fall of inflation in Albania, over 2016 Q1, seems to reflect largely supply-side shocks. The lower inflation rates especially in February and March were mainly due to the decline of food and fuel prices in international markets. The changed prices of these items provided a negative direct and indirect effect on the domestic headline inflation. In response to this development, the Bank of Albania intensified the monetary stimulus, by cutting the policy rate by 0.5 percentage point. This response was assessed to be sufficient to guarantee the achievement of inflation target in the medium term. This Box aims to shed light

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[6]   *Inflation expectations are not measured by official statistics. Bank of Albania receives qualitative and quantitative information on inflation expectations through periodic surveys conducted with enterprises, consumers and financial agents. The quantitative information on inflation expectations is taken from three groups of agents for short-term horizons (one year ahead) and only from financial agents is received for medium-term horizons (two and three years ahead). Short-term expectations are used to better capture the credibility in the ability of the monetary policy to bring inflation to target within the medium-term horizon. They were more rational than short-term expectations, which are characterised by the domination of the adaptive factor (high adaptability to the previous published inflation).*

on theoretical considerations that are taken into account in formulating the monetary policy response.

Supply-side inflation (also known as cost inflation) is experienced in case of the increase and decrease of costs. There are several factors that may drive to shocks in production costs, such as: increase/decrease of raw materials cost; increase/decrease in labour costs per unit (due to the increase/decrease of wages or increase/decrease of labour productivity); increase/decrease of taxes; and increase/decrease in transport costs. In small and open economies, where imported products have a relatively large share in the structure of final consumer goods, supply-side shocks can also take the form of consumer price increase in trading partners or the form of exchange rate shocks.

While the monetary policy response to demand-side shocks is relatively clear - a positive or negative shock on aggregate demand tends to produce respectively a tightening or easing of monetary policy - the response to supply-related shocks is conditioned from a wider range of circumstances and objectives.

In a first analysis, the monetary policy tends to ignore the supply-side shocks. This (non) response is associated with at least three reasons. First, supply shocks are generally temporary. So, they leave no medium and long-term trace in the trajectories of economic growth and inflation, and may not be addressed by the monetary policy because of its transmission mechanism time-lags. Second, unlike demand shocks, supply shocks contain a self-correcting mechanism. Thus, a supply shock would lower production costs (and inflation), but it would, on the other hand, increase consumers' purchasing power and aggregate demand, compensating thus a part of its direct effect. The above mechanism operates in the opposite direction in case of increasing shocks in production costs and inflation. Third, the opposing effect of these shocks on inflation and economic growth poses dilemmas on the functioning of the monetary policy response, which typically considers the divergence of both inflation from target and of the economy from equilibrium

Despite these considerations, supply shocks can generate long-term inflationary pressures and be legitimately subject to the monetary policy response, on at least two occasions. First, these shocks can damage (decrease or increase) inflation expectations. This may occur in case of a prolonged, as well as of adaptive nature (oriented retroactively) inflation expectations (Albania case). The damage (decrease or increase) of inflation expectations is equivalent to a change in monetary conditions in the economy (their tightening or easing). Second, the presence of indexing mechanisms in the economy (mutual indexing of consumer prices and wages) can generate a spill-over effect in prices and costs in the economy. Both these channels can drive to the creation of the so-called "second round" phenomena, which tend to make supply shocks last longer.

Thus, the analysis and the proper understanding of the extent, intensity and secondary effects of supply shocks are of primary importance to the monetary policy. The stronger these elements are, the stronger the monetary policy reaction is. In Albania, second-round effects are not expected to be significant: supply shock prolongation is not expected to last and indexing mechanisms are not present. In such circumstances, the control of inflation expectations is of high importance for the control of supply shocks' secondary effects. Thus, the Bank of Albania increased the monetary stimulus, while communicating clearly and transparently their expected effects.
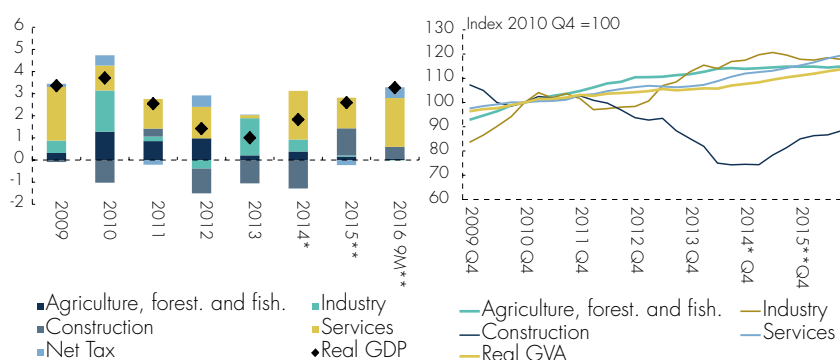
ECONOMIC ACTIVITY

Economic activity grew over 2016. The economic growth mainly reflected the expansion of consumption and private investments. It was reflected in the expansion of services and construction sectors.

Gross Domestic Product grew by 3.3% during the first nine months of 2016.[7] Economic growth was largely driven by the expansion in services[8], whose contribution to growth accounted for around 2.2 percentage points in the period under review. All main branches of services supported the performance of the sector. Services related to "Trade, hotels and restaurants, and transport" provided the highest contribution, 0.8 percentage point. Construction, although slowing down the growth pace, continued to provide the main contribution, by 0.5 percentage point, among the producing activities.[9] This contribution remains above the average value for the period 2009 – 2015 supported by the investments in new constructions.[10] Meanwhile, industrial and agricultural activities provided a low contribution to economic growth, around 0.1 percentage point.[11]

Chart 6 Annual growth of real GDP (in %) and contribution of production-side components (pp). Trend of real GVA in economy and sectors°

Legend (left): Agriculture, forest. and fish.; Industry; Construction; Services; Net Tax; Real GDP

Legend (right): Agriculture, forest. and fish.; Industry; Construction; Services; Real GVA

Source: INSTAT and Bank of Albania. * Preliminary data. ** A preliminary assessment.
°Indices of the real GVA for the economy and its sectors reflect the trend of the relevant value added, calculated as the moving sum of quarterly values for four quarters, based on 2010 Q4.

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[7] The latest GDP data by output and expenses method for 2016 Q3, published by INSTAT. The annual economic growth in 2016 Q1, Q2 and Q3 was 3.3%, 3.4% and 3.1%, respectively.

[8] Main branches of services are: "Trade, hotels and restaurants, transport", "Information and communication", "Financial and insurance activities", "Real estate activities", "Professional activities and administrative services", "Public administration, education and health", "Arts, entertainment, recreation, goods production activities of families for own use and other services".

[9] It reflects at a considerable degree also the effect of comparison at a higher base from the previous year. In more concrete terms, in the first nine months of 2015, the added value of construction expanded by 14.0%, providing a contribution of around 1.1 percentage points in the economic growth of the period.

[10] Referred to the volume index in construction which is categorised in: new constructions, restructuring and engineering works.

[11] Positive performance of production branch "Electricity, gas, steam and air-conditioning supply" was insufficient to offset the shrinking trend of extracting industry and the slowdown trend of mining and quarrying. Thus, the industry contribution in the annual growth of GDP is estimated around -0.02%. Meanwhile, agriculture, forestry and fishing contributed by 0.08 percentage point in the growth of GDP over the nine months of 2016, after the contribution of 0.26 percentage point in the same period a year earlier.

In line with the growth of economic activity, labour market improved over the first nine months of 2016.[12] Employment increased averagely by 6.8%, against 5.2% in the same period in the previous year.[13] This performance was largely attributable to the expansion of employment in services. The fast growth dynamic of employment determined the continuous reduction of unemployment over the year. The unemployment rate stood at 14.7%, at the end of September, around 2.5 percentage points lower from the same period in the previous year.[14]

The recovery in investments and private consumption was the determinant factor in the economic growth.

Domestic demand expanded by 3.4% in the first nine months of 2016.[15] The growth of investments, following the behaviour of the previous year, generated the main support. The respective contribution to the increase of demand is assessed at 1.7 percentage points. Also, the expansion of private consumption contributed to the increase of domestic demand, by expanding the range of underlying factors of economic growth and by strengthening its stability. Public consumption provided a slight positive contribution to the increase of

Chart 7 Domestic demand, contribution by components and ESI
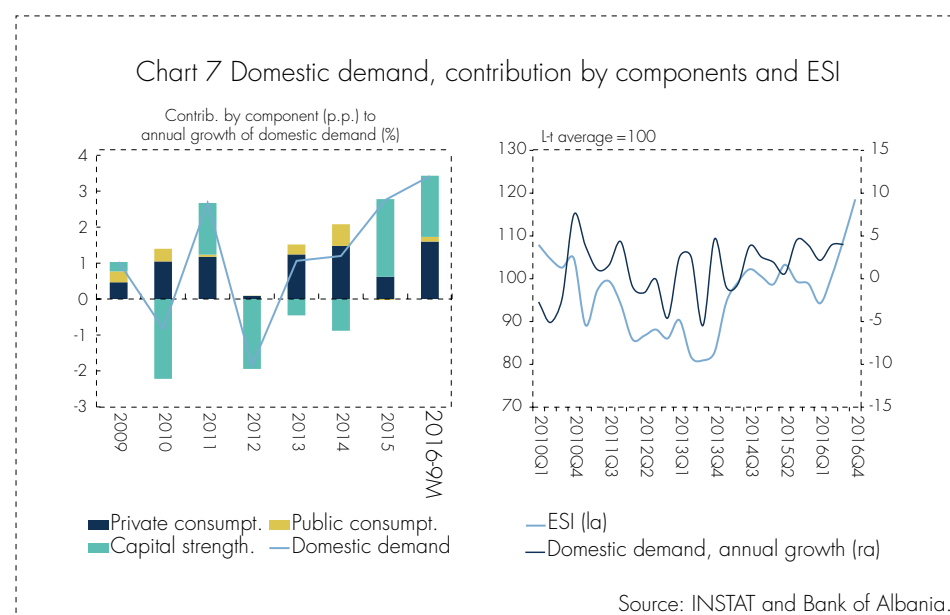
Source: INSTAT and Bank of Albania.

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[12] Analysis of employment and unemployment is based on the data of the Labour Force Quarterly Survey, and it refers to the indicators for those 15 of years and older.

[13] Also, the administrative data reflects an increasing employment trend, considerably affected by the formalisation process implemented by the Government, started since 2015 Q3 (particularly reflected in the strong increase of employment in the non-agricultural private sector till 2016 Q2).

[14] The administrative data also show a fall of unemployment level, at more rapid pace, by considerably reflecting the entered into force legal amendments, which aim at the identification of that part of population which is interested and ready to be employed. 146/2015 "For job seekers", dated 12/17/2015 and procedures for its implementation (Decree of the Minister of Social Welfare and Youth no. 4, dated 15.02.2016, published in the Official Journal on 22 February 2016).
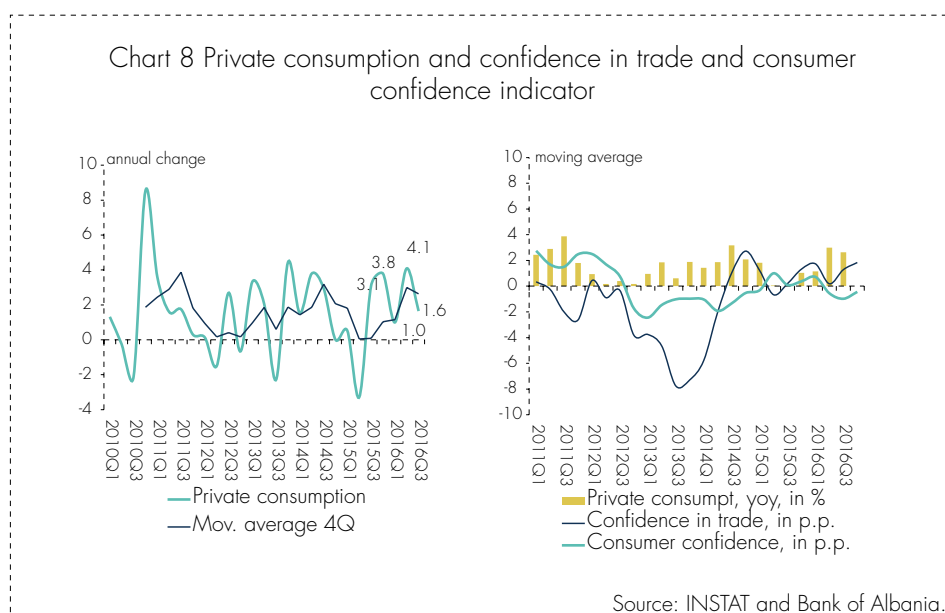
[15] Domestic demand components are final consumption (including final consumption of the population, of the public administration and of not-for-profit institutions) and gross fixed capital formation. In terms of national accounts, private consumption in this report refers to final consumption of the population, whereas investments are equivalent to gross fixed capital formation.
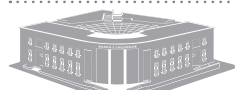
domestic demand. Information from indirect indicators suggests a positive performance of domestic demand, driven by the growth in private investments and consumption, even in the fourth quarter.

Private consumption provided positive contribution to economic growth in the first nine months.

Private consumption grew 2.2% over the first nine months of 2016. The acceleration of the consumption growth rate, over 2016, [16] was favoured by the increase of disposable income and downward uncertainties. The positive performance of employment and wages fund mainly affected the increase of disposable income. In parallel, the eased financing standards and credit growth supported the financing sources of private consumption. Preliminary indicators suggest positive growth rates of consumption during the fourth quarter as well.

Chart 8 Private consumption and confidence in trade and consumer confidence indicator

Source: INSTAT and Bank of Albania.

Like in the previous year, investments continued to provide the main contribution to the expansion of aggregate demand over the first nine months of 2016.

Investments recorded an annual growth of 8% over the first nine months of 2016, from 11% in the previous year. By structure of investments, indirect data show that the two main categories, construction and investments in machinery and equipment, provided positive contribution. The growth of investments was supported by the eased financing standards, the improved capacity utilisation rate, and the increase of enterprises' confidence, their improved financial situation and the increase of foreign direct investments.

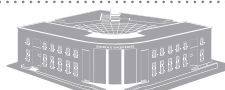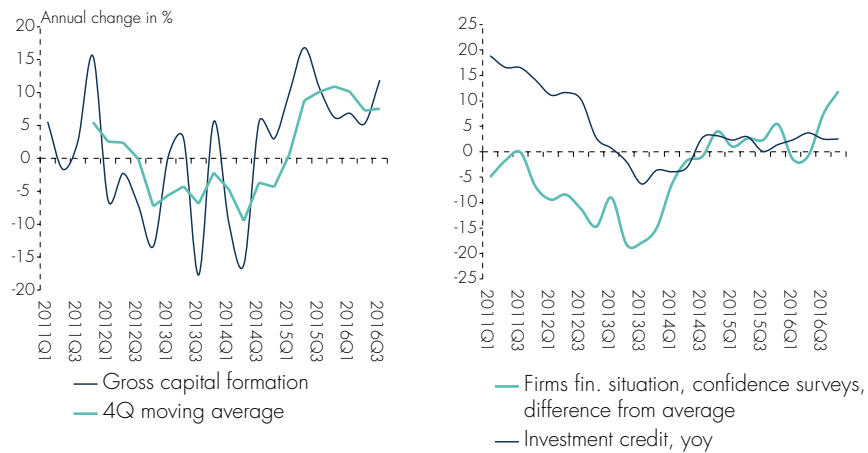
[16]   *The growth of private consumption was 1% over 2015.*

Chart 9 Annual performances of investments in the economy

Gross capital formation
4Q moving average

Firms fin. situation, confidence surveys, difference from average
Investment credit, yoy

Source: INSTAT and Bank of Albania.

Fiscal policy maintained a consolidating stance during 2016.

Fiscal policy showed a correcting trend over 2016, being materialised in a primary surplus of 0.7 percentage point to GDP, against the primary deficit of 0.2 percentage point to GDP in 2015[17]. Fiscal consolidation was supported by the increase in revenues, while public expenditure maintained similar levels with the previous year.

Chart 10 Fiscal policy and position, 2003 - 2016*


Domestic financing
Foreign financing
Budget deficit/GDP
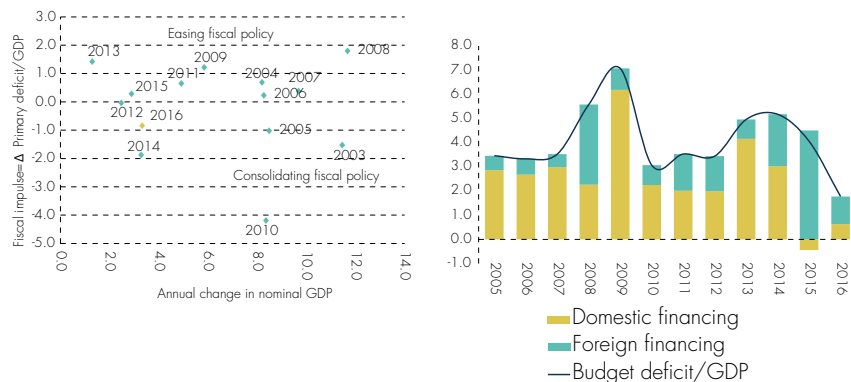
Source: Ministry of Finance, INSTAT and Monetary Policy Department (BoA) calculations.
*The left-hand chart shows changes in the primary deficit (general deficit − interest payments - effect of one-off measures) depending on changes in nominal GDP. The changes in the primary deficit on a year earlier positioned on the horizontal axis imply the deterioration of the fiscal position, or positive fiscal impulse, and vice versa.

After the positive values of the budget balance in the first eleven months, budget deficit amounted to around ALL 26.2 billion at the end of 2016, shrinking

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[17] *Fiscal data refer to the publication of the Ministry of Finance, 23 February 2017.*
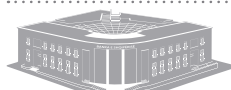
by 54.9% in annual terms. This level of deficit accounted for around 1.8% of GDP, from the planned 2.4% according to the normative act of December. The lowest level of deficit was mainly attributable to the under the programmed realisation of programed current expenditure. Borrowing in the domestic market financed around 40% of the deficit. The increase in long-term instruments offset the reduction of the short-term domestic debt. The rest was financed by the borrowing in the external market.

Public expenditure stood at 29.1% of GDP, from 29.3% in the previous year.[18] Budget expenditure was unevenly allocated over 2016 as well. The highest concentration was noted in the last quarter.[19] Primary current expenditure resulted around ALL 330.6 billion, or around 5.9% higher in annual terms. Capital expenditure amounted to ALL 57 billion, from the plan of ALL 58.7 billion, annually down by 9.6%. They were estimated at 3.8% of GDP, from 4.4% in the previous year.

Chart 11 Annual changes in main fiscal items (expenditure, left and revenues, right) by contribution of relevant items, 2005-2016*
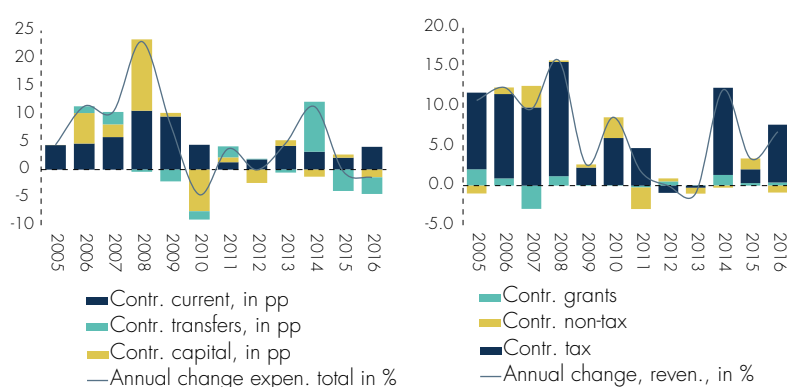
Source: Ministry of Finance.
*"Transfers" for budget expenditure includes all the other expenditure items, excluding current and capital expenditures. In 2014 and 2015, this category is formed mainly by the payment of arrears.

In 2016, budget revenues amounted to ALL 404.8 billion, or 27.3% of GDP, with the ratio improving by 0.9 percentage point from the previous year. In annual terms, revenues grew by 6.8%. Revenues from social insurance, VAT, profit tax and local taxes provided the main contribution to this growth. The factors that drove to the improved dynamic of revenues compared to the previous year are: the legal amendments on determining the reference wage on the calculation methodology of social contributions for free professions; the increase in local taxes; the formalisation process, and the more favourable

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[18] Excluding the effect of the payment of arrears in 2015, by around 1.2 percentage points.
[19] The last quarter accounted for around 33.5% of total expenditure.

economic environment[20]. The last factor is manifested in both, forms, the increased domestic demand and higher profits of public and private companies.

BOX 3. LEGAL AMENDMENTS ON ENHANCING FISCAL STABILITY

The global crisis effects drove fiscal authorities to face the dilemma on the use of fiscal spaces, for the recovery of the economy in the short run, and the recreation of these spaces in the long term, through fiscal consolidation. Depending on the financial soundness of the private sector, debt level and access to the financial markets, many countries chose fiscal consolidation, as an instrument to reduce risk premia, to boost confidence in their financial system and to establish the needed space to withstand with possible shocks in the future.

In Albania, fiscal policy pursued a consolidation trend over the last three years. Since 2016, the commitment to maintain the soundness of the public finances is stipulated in the respective Law. Hence, the Law No.57/2016, dated 02.06.2016, amends Law No.9936, dated 26.06.2008 "On the Management of the Budget System", aiming at strengthening the fiscal stability.

These amendments stipulate:

i)   Targeting a downward trajectory of public debt in terms of GDP in every budget year; until this ratio reaches the level of 45%[i].

ii)   Prudential forecast of nominal GDP, by not exceeding the latest projections of IMF at the moment of compiling the budget plan.

iii) Planning a contingency of 0.7% of total expenditure in every annual budget law to offset the shocks' effect on debt, on the exchange rate or on the interest rates.

iv)   A golden fiscal rule; according to it the planned budget deficit should not exceed the programmed capital spending.

v)   Control on the allocation of budget deficit during the electoral years: budget deficit at the end of first quarter, at the end of the six months and at the end of nine months, may not exceed 30%, 55% and 80%, respectively, of the annual planned level.

The above legal stipulations are a positive step in guaranteeing the stability of public finances, to improve fiscal discipline and increase fiscal policy credibility. In order for fiscal consolidation to be stable and reliable, it should be supported by the adoption of fiscal rules. Fiscal rules are institutional mechanisms that improve the fiscal discipline and contribute to the increase of fiscal policy credibility. On the other hand, the strengthening of fiscal discipline as perceived

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[20] *At the beginning of 2016, the Law on the calculation of health and social insurance contributions entered into force. According to this Law, the sum of contributions for free professions, depending on the city where it is conducted this profession. This amendment of the Law, in addition to the effect of economy formalisation, generated a contribution of 2 percentage points to the growth of total revenues for 2016, from 0.5 percentage points in the previous year.*
VAT revenues, an indirect indicator of the consumption and investments' performance at home, contributed by around 1.5 percentage points in the total growth of revenues, from 0.5 in 2015.
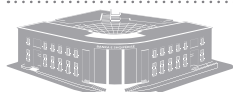
by market stakeholders helps to reduce the risk premia in the economy. On the other hand, the new legal specifications pave the way to implement a counter-cyclical fiscal policy in periods when the economy is expected to grow considerably,[II] thus serving to strike a balance between the strengthening of fiscal policy and the stabilising role of fiscal policy.

[I] *Exception to this rule are only the natural disasters, the financial crises which require the intervention from state budget, the declaration of the war, or the cases when the economic growth as foreseen from IMF <1%, when the public debt against GDP is lower than 60%.*

[II] *In more concrete terms, it is foreseen that in years when real economy growth as foreseen by IMF is higher than 5%, the budget deficit is planned at 2% of GDP.*

The worsened balance of trade exchange with abroad provided a negative contribution to economic growth in the first nine months of 2016.

The expansion of net exports' deficit provided a negative contribution to the growth of aggregate demand during the first nine months of 2016, determined by the recovery of imports driven by a higher domestic demand. Total exports expanded by around 11.5% in annual terms, mainly driven by the growth in services exports by around 22.4%. General imports expanded by around 10.4% in annual terms, with the main contribution from the growth in the import of goods by around 11.4%. Financial flows from tourism continued to expand, similarly to the previous year. On the other hand, the unfavourable conditions of the foreign demand and international prices drove to a reduction of goods export by around 15.4% in annual terms. Nevertheless, goods trade statistics show a recovery of exports during 2016 Q4, affected by the increase of commodity prices in international markets.

Chart 12 Contribution of net real exports (in p.p. to GDP)*

Imports, pp
Exports, pp
Net real exports to aggregate demand, pp
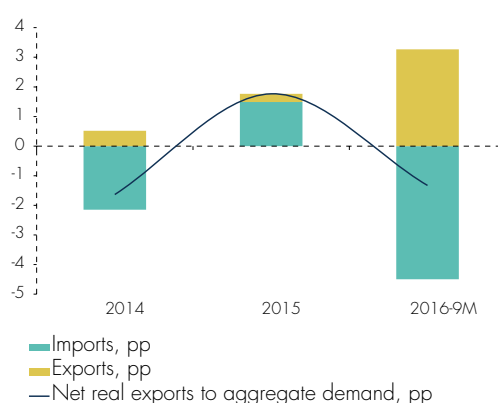
Source: Bank of Albania.
*For 2016, data belong to the first three quarters.

The higher deficit of net exports has provided the primary contribution to the expansion of the current account deficit in the first nine months of the year. The positive developments in the services account were insufficient to offset the high expansion of goods' deficit. On the other hand, secondary income account [21] did not provide any contribution, due to the relative weak performance of remittances[22]. Related to primary income account[23], the respective deficit

[21] *The secondary income account includes current transfers of the central government, of households and of not-for-profit institutions serving households. Remittances are the main item in this account.*

[22] *Remittances recovered considerably in the third quarter and the trend is considered positive for the last quarter of 2016, as well.*

[23] *Primary income account includes all the flows of the profit from the stock of assets invested abroad by residents or in Albania by non-residents. The main item in this account is FDI income.*
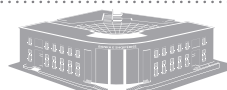
narrowed, attributable to the higher inflows and lower outflows from direct investments.

The current account deficit was financed based on non-debt creating foreign currency flows.

The profile of financing the current account deficit continues to be based on non-debt creating foreign currency flows, in the form of foreign direct investments and capital account inflows. The financing by debt-creating flows resulted somewhat lower compared to the previous year. At the end of 2016, the stock of foreign exchange reserve assets was sufficient to cover 7.2 months of imports of goods and services and 170% of the short-term external debt.

Table 2 Main balance of payment items (in EUR million, unless otherwise stated)

	Q2 '15	Q3'15	Q4 '15	Q1 '16	Q2 '16	Q3'16
Current account (in mln euro)	-163.2	-312.7	-397.7	-224.2	-353.8	-207.6
/GDP (%)	-6.0	-12.1	-14.7	-9.4	-12.6	-7.7
Goods and services	-360.6	-476.3	-564.5	-403.3	-555.2	-410.9
Exports, f.o.b.	705.9	785.0	714.7	608.5	716.8	926.9
Imports, f.o.b.	1066.5	1261.4	1279.1	1011.9	1272.0	1337.8
Net Trips	76.4	64.5	51.6	67.3	72.8	153.1
Primary income	-12.9	-12.8	-34.2	10.0	-15.1	-6.5
Loan	34.5	40.0	43.9	50.8	44.9	42.7
Debit	47.4	52.8	78.1	40.7	60.1	49.2
Net FDI income	-26.4	-27.7	-31.7	-3.8	-23.9	-21.7
Secondary income	210.2	176.4	201.0	169.1	216.6	209.8
Loan	243.3	219.1	247.2	205.0	249.7	250.3
Debit	33.0	42.6	46.2	35.9	33.2	40.5
Remittances - net	161.7	139.7	153.9	135.7	153.6	159.1
Capital account	21.3	45.6	32.8	6.6	7.2	3.1
Net borrowing/net lending	-141.9	-267.1	-364.8	-217.7	-346.6	-204.5
Financial account (in EUR million)	-177.1	-126.6	-243.3	-163.7	-253.6	-71.9
/GDP (%)	-6.5	-4.9	-9.0	-6.8	-9.1	-2.7
Direct investments	-196.5	-248.1	-120.0	-143.6	-240.1	-276.4
Portfolio investments	-66.8	-11.2	-172.1	107.5	-8.7	-2.1
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0
Other investments	70.0	-179.7	-120.3	-77.9	-4.8	262.7
Reserve assets	16.2	312.5	169.1	-49.6	0.0	-56.1
Errors and omissions	-35.2	140.5	121.5	54.0	93.0	132.7

Source: Bank of Albania.

FINANCIAL MARKETS AND MONETARY INDICATORS

Developments in financial markets, over 2016, reflected the strengthening of accommodative monetary policy stance, in the presence of high liquidity and low risk premia. The accommodative monetary policy has been transmitted to all financial market segments, and interest rates continued to trend down. In the foreign exchange market, the domestic currency continued to appreciate against the euro, driven by both supply and demand factors.
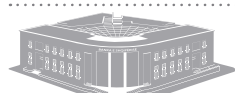
The reduction of financing cost in the financial market was followed by the growth of credit in the Albanian lek. Nevertheless, the overall portfolio dynamic continues to be limited by a slow recovery of credit demand and tight supply for certain segments.

The monetary policy was reflected in lower interest rates in the money market.

The interest rates in the interbank market were down over 2016, in line with the monetary policy stance. They ranged close to the policy rate, in accordance with the operational objective of the Bank of Albania[24]. The average overnight interest rate in this market fell to 1.37% in 2016, from 1.92% in 2015, while the one-week rate fell to 1.37%, from 1.93%. Volatility indicators for interbank market interest rates were similar to those in the previous year.[25]

Chart 13 Yields curb in the primary market (left) and interbank rates (right)

Source: Bank of Albania.
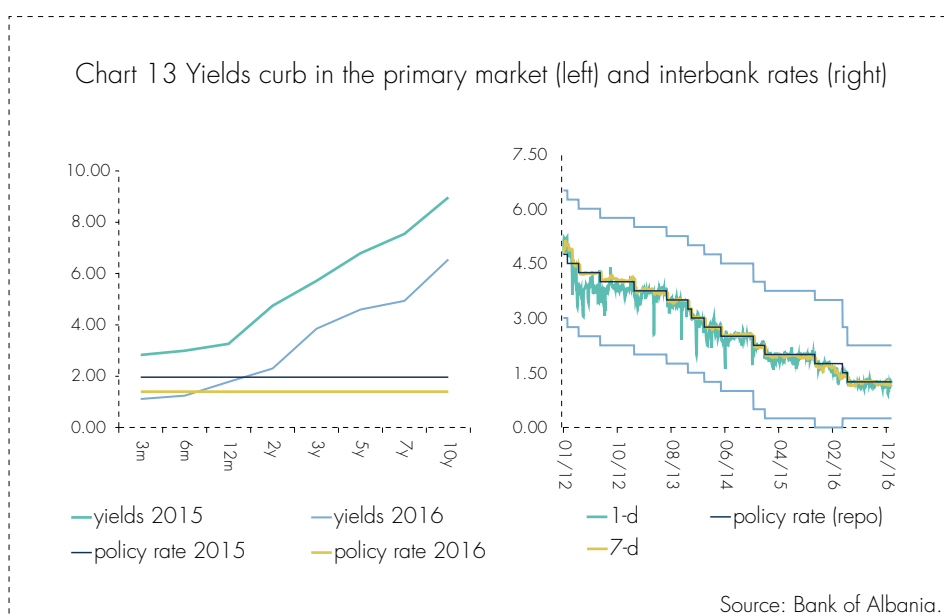
In the primary market of Government' debt securities, yields on bills and bonds in average terms are below the level of the previous year. They had an uneven performance over the year, pursuing a strong downward trend in the first half of the year, and an upward trend in the second half. In addition to the accommodative monetary policy, this performance reflected the dynamics in the demand and supply for funds in the primary market. A similar panorama was reflected in the yields on bonds. The average yield on 12-month T-Bills fell by 1.5 percentage points from the previous year, while the yields on long-term debt instruments fell by 2.3 percentage points. This dynamic is reflected in the downward shift of the yields curve and its flattening compared to the previous year.

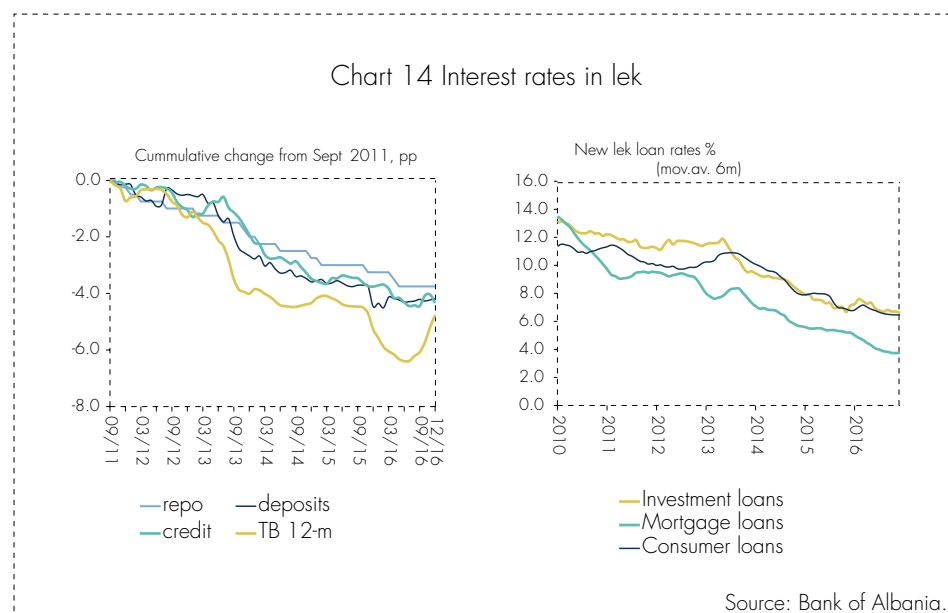## The interest rates on lek credit to enterprises and households continued to fall.

The interest rates on new lek credit and deposits fell further over 2016, seeing a full pass through of the monetary stimulus of the Bank of Albania. The good

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[24] *The operational objective of the Bank of Albania is addressed in more detail in the chapter on "Financial market operations and foreign exchange reserve management".*
[25] *The standard deviation of the overnight interbank rate for this year was 0.18, from 0.15 in 2015.*

liquidity situation, low risk premia and heightened of competition among banks, provided the favourable conditions for the transmission of the policy rate cut to the interest rates on deposits and loans. The interest rate on new time deposits averaged 0.81% in 2016, from 1.35% in 2015. The interest rates applied on lek credit to non-financial private sector averaged 7.52%, from 8.07% in 2015.

Chart 14 Interest rates in lek

Cummulative change from Sept 2011, pp

New lek loan rates %
(mov.av. 6m)

repo — deposits
credit — TB 12-m

Investment loans
Mortgage loans
Consumer loans

Source: Bank of Albania.

Reduction of interest rates on loans fell accross all main segments. Households benefited lower interest rates on mortgage loans, by around 1.37 percentage points, and on consumer loans, by around 0.73 percentage points. Interest rate on loans to enterprises for investments fell by 0.45 percentage points compared to the previous year. The unusual dynamic of yields in the primary market, noted over 2016, did not drive to increased fluctuation of interest rates on loans.

The Albanian lek pursued an appreciating trend over 2016.

The domestic currency showed an appreciating trend against the currencies of partner countries over 2016. The EUR/ALL exchange rate averaged 137.4 during this year, with an annual appreciation of 1.7%. The increase of foreign currency supply drove to this appreciation. In addition, the EUR/ALL exchange rate in the domestic market also reflected a part of EUR/USD exchange rate dynamic in the international markets. Thus, the appreciation of the US dollar in the international markets was only partially reflected in the USD/ALL exchange rate, by affecting the depreciation of the European currency against the Albanian lek[26]. The USD/ALL exchange rate averaged 124.1 over 2016, appreciating 1.4% in annual terms. In the international market, the US currency appreciated by 0.3% on average against the European currency.

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[26] *Overall, USD/EUR exchange rate in the international markets is mainly reflected in the USD/ALL exchange rate at home - the annual changes of USD value in ALL in the domestic market are close to those of the USD value in EUR in the international market. In 2013-2015, their spread is 0.1 percentage points. In 2016, this spread increased at 1.7 percentage points.*
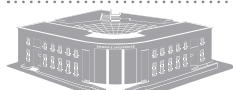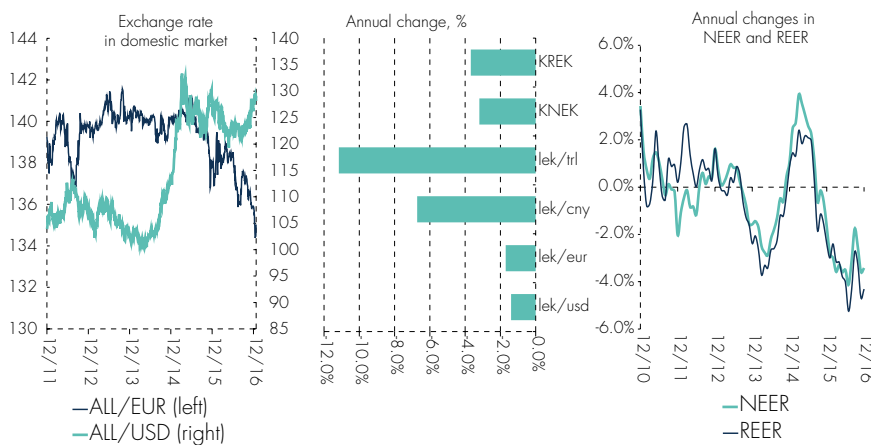
Chart 15 Effective exchange rate and EUR/ALL and USD/ALL exchange rates

Source: Bank of Albania.

Also, the lek appreciated against the currencies of two other trading partners, Chinese renminbi and Turkish lira. This performance mainly reflected the strong depreciation of these two currencies against the US dollar. According to the effective measurements,[27] the lek recorded an average annual appreciation of 3.2% in nominal terms, and 3.7% in real terms.

The lending activity improved somewhat, in line with our expectations and the expansion of economic activity over 2016, although it remains still slugish.

Credit to private sector expanded at a contained pace[28]. This portfolio, adjusted for written off loans, recorded an annual increase of 3.2%, faster than a year earlier. At the end of the year, credit to private sector was estimated around 37.3% of GDP, at the same level with the previous year. The expansion of credit reflects the increase of credit in ALL (10.2%) supported by the fall of interest rates, the propensity of banks policies towards crediting in the domestic currency, and the awareness of the economic agents on the exchange rate risk. Credit in foreign currency performed negatively (-1.6%), affected by ALL appreciation against EUR. Excluding this effect, credit portfolio to private sector recorded an annual growth by around 3.9%.

Credit expansion to private sector shows the good performance of credit to households (5.1%), driven by the continuous easing of lending standards, the increase of confidence and the improvements in the labour market. Credit

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[27] The nominal effective exchange rate (NEER/REER) is calculated against the currencies of the five major trading partners (Italy, Greece, Germany, Turkey and China), using the relevant market weights. For the purpose of calculating the lira/lek and the renminbi/lek rates, the official reference rates remain those of the Turkish lira and the Chinese renminbi against the US dollar. The real effective exchange rate (REER) is calculated similarly to the nominal, but it considers the domestic inflation and those in the trading partners, as well.

[28] Credit data refer to the monetary data and include the credit granted to residents. The written off loans from balance sheet, over 2016, amounted to ALL 14.6 billion.

portfolio to enterprises recovered at a contained pace (2.4%), reflecting the still tight supply and the fragile demand for financing from this segment. By purpose of use, credit to households for consumption and house purchase increased faster, also the credit to enterprises for investment purposes.

Chart 16 Lending to the economy
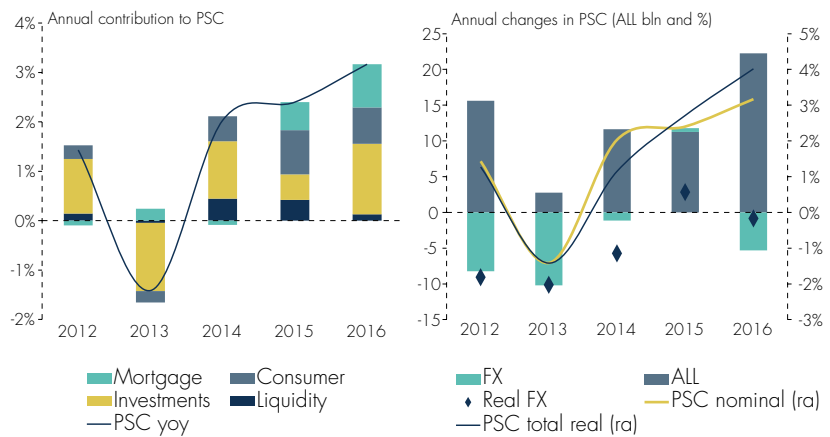

Source: Bank of Albania.

BOX 4. LENDING - AN ASSESSMENT OF THE IMPACT OF CREDIT DEMAND AND SUPPLY

Credit growth to private sector in Albania slowed down considerably after the financial crises in 2008, and further after 2011, by showing only signs of sluggish recovery. Similar situation is also noted in other Balkan and Central European countries. This performance simultaneously reflects the tight standards of the supply, driven by the conservative behaviour of the European banks that operatein the regional markets, and the weak demand of the private sector for financing.

Chart 17 Change of credit growth as change in demand and supply's contributions
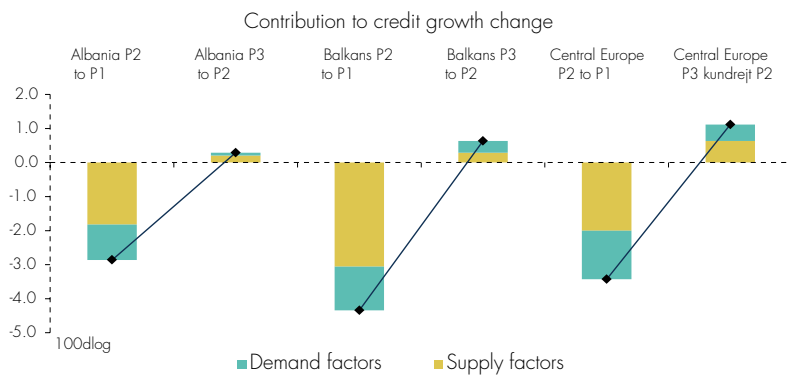
Source: Central banks and respective institutions of statistics, authors' estimates.
Note: The Balkan region includes Serbia, FYROM, Croatia, Bulgaria and Romania. Central Europe includes Czech Republic, Poland and Hungary.
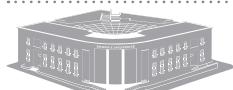
To better understand the reasons behind this sluggish lending performance, a model on the determinants of real credit growth in the Balkan and Central European countries[I] was updated, by adding the assessment for the period 2013 - 2016. From the model results, we may filter the contribution provided by the demand factors (economic growth and intermediation level[II]) and the supply factors (growth of deposits, increase of foreign liabilities of the banking system, interest rate and non-performing loans) on the credit growth[III]. Chart 17 shows these contributions in the change of credit growth in the period 2009-2012 (P2) against the period 2005-2008 (P1), and in the period 2013-2016 (P3) against the period 2009-2012 (P2).

Econometric results show that the strong deceleration of credit growth pace in Albania immediately after the crisis of 2008 (2009-2012) was due to the simultaneous tightening of both demand and supply's factors, at a higher degree of the latter ones. Related to the demand factors, both, the slowdown of economic growth and the need to reduce the financial leverage (positive intermediation gap) affected almost at the same degree the reduction of credit growth. In terms of supply-side factors, financing sources provided the highest impact, in particular, deposits, followed by the increase of non-performing loans. The reduction of the real interest rate of credit provided a positive impact, by reflecting the easing of the Bank of Albania's monetary policy. Similar situation is also noted in other Balkan and Central European countries.

In 2013-2016, demand and supply recovered, compared to 2009-2012. Nevertheless, it should be noted that compared to the tightening of these factors in the period after the crisis, their recovery in the recent years is low for Albania, like in the other Balkan countries. In terms of demand factors, the low level of financial intermediation (negative intermediation gap), mainly explains the growth of credit demand. In terms of supply-side factors, the slower increase and then the reduction of non-performing loans provided positive contribution to lending, while the increase of external financing is balanced by the slowdown of the domestic deposits. The real interest rate provided a positive contribution, similar to the previous period.

The results show that the slow recovery of credit depends on both credit supply and demand, both remaining considerably below the levels of the pre-crisis years. In addition to the expected growth of credit demand, following the further improvement of the economic activity, the recovery of lending pace will be conditioned by the risk appetite of banks and the speed to ease the banking supply.

[I] *This model, initially assessed for the periods 2005-2008 and 2009-2012, explains the credit growth to private sector through the economic growth, credit interest rate, deposits, foreign borrowing of banks, non-performing loans ratio, intermediation degree of the banking system and the exchange rate. The model is described in the working paper " Credit growth determinants in the South Eastern Europe countries", prepared by Erjona Suljoti and Sofika Note. A short version of this material is published in the Summary of the Conference "Financial Sector Development: Policies to promote and strengthen local capital markets'" page 107.*

[II] *Credit to GDP ratio represents the intermediation level.*

[III] *Demand and supply factors, according to the applied model, do not explain the complete performance of credit. In addition, a set of factors have their impact (specific risk of the country, institutional development, banking system development, etc.), whose effect is summarised into the specific factor of each country.*
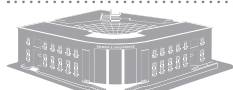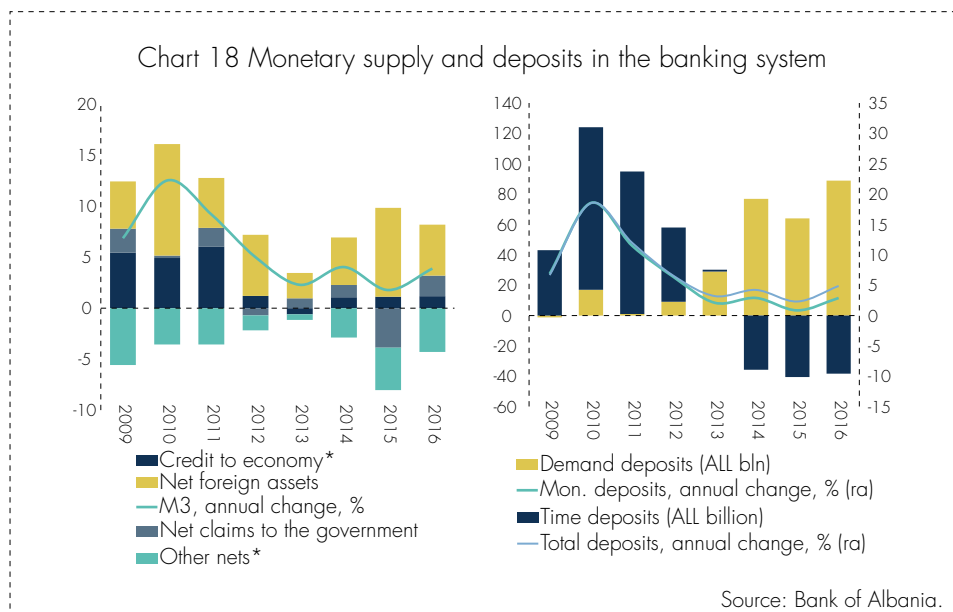
The performance of monetary assets reflected the moderate demand for financing from the private sector, and the consolidated nature of the fiscal policy.

The monetary supply expanded moderately, at a similar pace with the previous year. The growth of monetary supply was driven by the increase of net foreign currency assets of the banking system, but it was conditioned by the slow increase of the internal demand for funds. The broad money indicator, M3 aggregate, accelerated its growth over the year, from an average growth rate of 0.9% in the first half of year, to an annual growth rate of 3.9% at the end of the year. Money structure shifted toward the liquid component, mainly driven by the fast growth of demand deposits.

Expansion of deposits in the banking system continues to reflect the rapid growth of liquid deposits.

Banking system continued to withdraw the deposits of economic agents, particularly in foreign currency. Deposits stock, as at end of December, was around 4.9% higher in annual terms, accounting for around 73.7% of GDP, or around 1.1 percentage points higher from the previous year. Developments by time structure show a shift toward demand deposits. Such shifts were also noticed in deposits of over two-year maturity, but at a lesser extent. This year was characterised by a good performance of both households and enterprises' deposits, with an average annual growth of 1.9% and 7.6%, respectively.

Chart 18 Monetary supply and deposits in the banking system

Credit to economy*
Net foreign assets
M3, annual change, %
Net claims to the government
Other nets*

Demand deposits (ALL bln)
Mon. deposits, annual change, % (ra)
Time deposits (ALL billion)
Total deposits, annual change, % (ra)

Source: Bank of Albania.

2.2. MONETARY OPERATIONS IS THE MONEY MARKET

The Bank of Albania implements its monetary policy by using indirect market instruments. They include open market operations, standing facilities and the required reserve. The main market operations are the repurchase and the reverse repurchase agreement of seven-day maturity, whose interest rate represents the policy rate.

OPEN MARKET OPERATIONS

Open market operations consist in three sub-items: the main operations; fine-tuning operations; and structural operations. They are used for the short-term management of liquidity in the money market, aiming at accomplishing Bank of Albania's operational objective – orienting short-term interbank interest rates close to Bank of Albania's policy rate and limiting their fluctuations.

During 2016, as well as in the previous two years, the overnight interbank rate floated very close to the key rate, deviating by 0.07 percentage point. The one-week interbank rate stood on average around 6 percentage points below the policy rate, but with a higher fluctuation than the previous year. For the second successive year, structural surplus of liquidity in a part of the banking system have driven liquidity trading in the interbank market below the policy rate of the Bank of Albania. Also, interbank trading for maturities longer than one week was very rare over 2016.

During 2016, the average injected liquidity by the Bank of Albania through open market operations amounted to ALL 24 billion, from ALL 29.50 billion in 2015, and ALL 24.50 billion in 2014. The need for liquidity by commercial banks has been increasing throughout the year, from the average level of ALL 10 billion in the first quarter, to ALL 30 billion in the last quarter.

Table 3 The structure of the liquidity injecting operations by the Bank of Albania

	2009	2010	2011	2012	2013	2014	2015	2016
Main instrument	55%	58%	74%	55%	60%	64%	55%	80.7%
Long-term injections	45%	42%	26%	45%	40%	36%	45%	19.3%

Source: Bank of Albania.

During 2016, the Bank of Albania has carried out structural operations, by purchasing and selling Treasury bills of the Ministry of Finance, in order to reduce the ownership in some 3- and 6-month issues where the concentration was over 60%. The total amount of T-bills owned by the Bank of Albania has not changed since the end of 2015, when the portfolio decreased.

STANDING FACILITIES

Standing facilities – overnight deposits and overnight loans at the Bank of Albania are instruments available to commercial banks to manage liquidity on

a daily basis and to define a corridor in which interest rates fluctuate in the interbank market. This corridor narrowed in April 2016, from 3.50 percentage points to 2.50 percentage points and, since the last cut of Bank of Albania's policy rate in May, the overnight deposit stands at 0.25%, and the overnight loan at 2.25%. During 2016, the overnight deposit was used more frequently by banks, but at lower daily average levels than in the previous year (110 cases with an average level at ALL 2.9 billion). The same trend is observed for the use of the overnight loan, which is rarely used by the banks (25 cases with an average level of ALL 1.7 billion over 2016).

REQUIRED RESERVE

The level of the required reserve is applied to the amount corresponding to 10% on deposits up to two years of the commercial banks, denominated in lek, euro and US dollar. The required reserve in lek is a monetary policy instrument that aims to adjust liquidity in the banking system and stabilize interest rates. The Bank of Albania allows banks to use up to 40% of the required reserve in lek on a daily basis, while observing the obligation to keep the monthly average level of the required reserve not lower than the level specified for it.

The performance of the required reserve has been in line with the performance of the deposits that are subject to this instrument. The remuneration ratio on the lek required reserve reflected the performance of the Bank of Albania's policy rate (70% of the policy rate). Starting from September 2016 the banks pay for the required reserve in euro an interest rate equal to the deposits rate of the European Central Bank.

The remuneration rate on the surplus reserves in lek and US dollars has remained 0% during 2016, whereas the remuneration rate on the surplus reserves in euro has changed: it was determined 0.25 percentage points lower than the deposits' interest rate of the European Central Bank.

2.3 FINANCIAL STABILITY AND BANKING SYSTEM PERFORMANCE

Financial stability is considered fulfilled when the financial system is able to realize an efficient distribution of resources, by assessing and controlling the financial risks. The role of the Bank of Albania for securing and safeguarding financial stability is defined in the Law "On the Bank of Albania". This Law, in addition to the primary objective of achieving and maintaining price stability, lays down as one of the main objective of the Bank of Albania the promoting of the normal functioning of the banking system based on market principles, as well as duties related with the achievement of this objective like, the supervision of the banking activity in order to secure the stability of the banking system, promotion of developments of payment systems, as well as issuing acts that aim to secure the sustainability of the banking system. Also, in compliance with the obligations deriving from this Law, the Bank
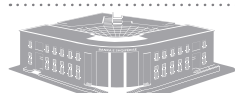
of Albania publishes twice a year the Financial Stability Report and the relevant financial system statement that prefaces the report. This document contains an analysis of the situation and the performance of the banking sector and the financial system, identifies risks that may affect financial stability, as well as measures and initiatives that may be undertaken to mitigate or prevent these risks and safeguard financial stability.

## BANK OF ALBANIA'S ACTIVITY FOR SAFEGUARDING THE FINANCIAL STABILITY

In exercising its critical role to secure and safeguard financial stability, the Bank of Albania identifies the risks, assesses their size and their potential spill over, analyses their causes and the determining factors, and assesses the necessary corrective actions to avoid or mitigate the impact of risks on financial stability. In fulfilling its legal obligation toward financial stability, the Bank of Albania communicates regularly with all public authorities, the financial industry and the public, as important stakeholders in achieving financial stability.

During 2016, in line with the medium-term strategic objectives, the Bank of Albania has been working to enhance and improve the existing indicators, methodologies, analyses and models related with the:

- macro-prudential policy and its instruments, as well as the adaptation from the operational standpoint of these instruments;
- methods that are used for the assessment of the systemic risk and the identification of the regulatory requirements for systemically important banks;
- modelling capacities for the assessment of the impact of various risks on the banking and financial system.

The work on addressing the objectives, the identification of the instruments and indicators related with the macro-prudential policy is based on the recommendations of the European Systemic Risk Board (ESRB) and the standards of the Financial Stability Board. These policies generally focus on identifying warning systems and instruments for the treatment of: preservation of stable/optimal levels of crediting and financial leverage; mitigation and prevention of significant mismatch between assets and liabilities maturities in the balance sheet of the financial institutions and the preservation of liquidity in the market; limitation of direct and indirect exposures concentrations of the financial activities to risk sources; limitation of the systemic impact of negative stimulating factors and the strengthening of the sustainability of the financial system.

In terms of identifying the macro-prudential policy, the Bank of Albania has been working during this year in drafting a general framework of this policy, which in view of possible legal improvements as well, will define the principles and the
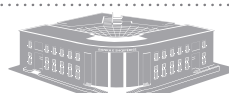
methods of its use. In parallel, for the development of macro-prudential policy instruments and the construction of the indicators used in the implementation of the macro-prudential policy, the Bank of Albania has been working in determining the signalling indicators of stress situations in the financial system and the assessment of the financial cycle, in order to develop methodologies that show the operationalization manner of the relevant instruments. Amongst these instruments, which may be used in the future to deal with risks in relevant segments of the financial, are: the implementation of the quantitative limits of the indicators 'credit to collateral value', 'credit (debt) to income value' – this mainly in the case of mortgages[29] and 'debt service ratio'[30].

During 2016, the Bank of Albania has been working toward enhancing the methods and the indicators used for the identification, assessment and prevention of systemic risks. Specifically, the existing methodology to identify systematically important banks has been improved by adopting the approach of the European Banking Authority (EBA) for the quantitative determination of the critical limit mark of systemic importance, based on which these banks are identified. Also, based on the EBA methodology, the Risk Map is prepared, which is part of the internal analyses on financial stability issues. Bank of Albania has worked to consolidate, strengthen and integrate in periodic analyses the results of surveys or assessments of different indicators, i.e. "Systemic risk by the banking sector perception" or the "systemic financial stress" index.

Regarding the objective of strengthening the modelling capacities within the framework of assessing the financial stability risks, the Bank of Albania has been working toward the determination of the financial cycle, the improvement of the methodologies associated with the exercise of top-down and bottom-up stress test, more effective use of financial modelling that assess the interaction between macro-economic developments and the banking sector activity, as well as the method of determining the capital requirement for the systemically important financial institutions. These models and methodologies are improved continuously by reflecting the improvement of the international standards in this regard.

The communication of the Bank of Albania with the public and other actors is realized through the periodic publication of documents like the Financial Stability Report and the Financial Stability Statement , various research papers that deal with the methodology, analyses and assessments for particular aspects or issues related with the banking sector and the financial system activity, as well as other publications of the Bank of Albania, including press releases and the speeches of the administrators. An important forum for decision-making, collaboration and public communication of the analyses and the relevant decisions related with the financial stability is the Financial Stability Advisory Group (FSAG). The FSAG during its meetings in 2016 has analysed regularly

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[29] *Quarterly survey with commercial banks.*
[30] *The indicator is based on the data collected from the survey on "The financial situation and the borrowing of households".*
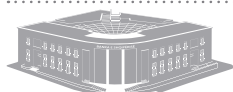
the situation of the banking sector and of the financial system, as well as it has assessed the different risks about sustainability of the system and the progress of its activity. Meeting press releases are published in the internet websites of the participating institutions.
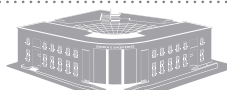
Banking sector performance

The banking sector remains the main segment of financial intermediation in Albania. As at end of 2016, the share of its assets stood at 95.8% of the Gross Domestic Product (GDP), up by 4.5 percentage points compared with the previous year. The expansion in the securities portfolio provided the main impact in the increase of the sector's assets. Loans and deposits grew by 2.5% and 5.2%, respectively. The banking sector consists of 16 banks. Four large banks share about 70% of the deposits and manage about 65% of loans given by the sector. The banking sector activity during 2016 was stable and supportive to financial stability safeguarding. The main financial indicators of the banking sector activity: capitalisation, liquidity and profitability indicators show that the banking system has the ability to withstand internal and external shocks. These assessments are supported by the results of the stress test exercises on solvency and liquidity risk, which the Bank of Albania performs periodically several times a year.

Financial result and profitability indicators

The average indicators of profitability decreased during 2016. The net financial result of the banking sector was positive, around ALL 9.3 billion, compared to ALL 15.7 billion in 2015. The average trend of banking sector profitability indicators confirm that RoA decreased at 0.7% (from 1.2% in the previous year) while RoE decreased at 7.2% (from 13.2% in the previous year). The main factor that affected the contraction of profitability of the banking system was the increase by around ALL 6 billion of the provisioning expenses on credit risk. On the other hand, despite the re-pricing (declining) of the deposits interest rates and the decrease of the share of time deposits (costlier), net interest income have decreased their contribution in the financial results. The net interest margin decreased at 4.2%, from 4.4% in the previous year.

Banking business capitalisation

During 2016, risk-bearing assets registered a relatively higher increase compared with regulatory capital. Hence, the capital adequacy ratio fell by around 0.3 percentage point, standing at 15.7%, compared with the previous year. However, the capital adequacy ratio remains notably higher than the 12% required minimum, laid down in the regulatory framework. Good capitalisation remains a feature of the banking system and it has been maintained due to the continued positive values in the net financial result. The structure of the regulatory capital appears favourable in terms of the banking system's capacity to cover potential losses, as the core capital continues to account for 87.9% of it.

Bank of Albania

RISK ASSESSMENT AND THEIR MANAGEMENT

Credit risk

During 2016, the Bank of Albania continued to closely monitor the lost loans write off from balance sheets, as part of implementing the regulatory obligations[31]. Throughout the period, the Bank of Albania has gathered data on the execution process of the obligation, as part of the banking sector's effort to collect non-performing loans. Also, the Bank of Albania continued to implement the countercyclical measures undertaken since May 2013, which contain incentives to channel banking surplus sector liquidity toward lending to economy, and support the early restructuring of loans. The impact of these measures, throughout their implementation period, was assessed as positive. In December 2016, the non-performing loans accounted for 18.3% of the loan portfolio, maintaining almost the same ratio of the previous year. The increase of this ratio in the first nine months of the year was offset by the last quarter of the year, where the decrease of non-performing loans brought the decrease of the ratio. At the same time the coverage ratio of non-performing loans loss provisions, registered 70.5%, tightening slightly by 0.3 percentage point against the last level of 2015.

During 2016, banks have been less active the in the process of write off of lost loans from their balance sheets, removing from the balance sheets a portfolio of ALL 14.6 billion. There was a significant progress in 2016 toward the implementation of the Action Plan for the reduction of non-performing loans. In addition to the amendments in some regulatory acts of the Bank of Albania, at the end of the year, the Parliament approved some significant legal amendments, in particular the Law "On bankruptcy" and the amendments in the Law "On bailiffs". The Bank of Albania deems that these legal amendments will give banks and other actors involved in the process of problematic borrowing resolution significant instruments to improve the efficiency of the process and accelerate the decrease of non-performing loans in the banking sector.

Market risk

The Bank of Albania monitors carefully the developments related to the market risk and the direct and indirect impact from possible fluctuations in the exchange rate and the interest rate on the banking sector's activity. Owing to the mismatch between interest rate-sensitive assets and liabilities, the sector is exposed to a fast increase in the interest rate. Although the probability of the fast increase of the rate is actually low, the Bank of Albania recommended banks to include the assessment of this risk in their analyses, and to act to minimise this risk in case it is deemed as important. The level of net open position in foreign currency appears down compared with the previous year, suggesting a limited exposure

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[31] Starting from January 2015, banks are forced by regulatory requirements to undertake the process of cleaning the balance sheets – the write off from balance sheets of the loans that are found in the "lost" category for more than 3 years.
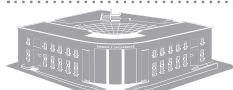
to the exchange rate risk (volatility). In December 2016, at sector level, the open position of foreign currency was "long", at 7.0% of the regulatory capital, from 7.7% in December 2015.

The indirect impact of potential exchange rate volatility on the banking activity indicators is important. In the event of unfavourable exchange rate fluctuations, the most probable impacting channel is the credit quality in foreign currency, when the borrowers' income is in lek. Although, this credit portfolio has been downward during the period, exchange rate volatilities may affect considerably the solvency of borrowers. The unhedged foreign currency credit accounts for 26.6% of credit outstanding, down by 1 percentage point form the end of 2015. The trend noted in recent years, for the expansion of crediting mainly in the Albanian lek, has contributed to the reduction of the above-mentioned exposure; therefore, both, banking industry and economic agents, should provide more support in this regard.

Liquidity risk

Liquidity position of the banking sector stands at good levels. Bank of Albania assesses that banking system exposure to liquidity risk is low. Stress test exercise on liquidity risk shows that banking sector in Albania owns sufficient regulatory capital and liquidity reserves to withstand strong shocks caused by adverse economic and financial developments, domestically or abroad. In December 2016, liquidity indicators, stated as the ratio of liquid assets to total assets and the ratio of liquidity assets to short-term liabilities, were 31.3% and 40.6%, respectively. All banks have maintained liquidity ratios significantly above the required minimum levels laid down in the applicable regulatory framework. The ratio of credit to deposit value was around 52%. Deposits remain the main source of funding the banking sector activity. Overall, deposits have a low concentration, which has been downward since the end of 2014. During the year, commitments undertaken by parent banks in the form of lines of financing expanded. In December 2016, credit lines accounted for 0.9% of total assets of the sector, compared with 0.42% in December 2015.Only 30% of the total credit line was used.

Monitoring systemic risk

The construction of adequate indicators for the identification of systemic risk in the financial system is a significant and persistent challenge for regulators. The Bank of Albania, in the framework of developing macro-prudential policies, monitors the developments in the systemic risk through some indicators and methodologies, which assess its various aspects. For 2016, the accumulation of the systemic risk increased compared to the previous year, reflecting the developments in real estate prices and external debt in foreign currency. In contrast, the materialisation of the systemic risk has declined due to improved credit quality to enterprises and households, the decrease of the unemployment rate and the lower exposure of banks to the exchange rate risk.
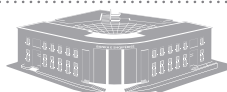
2.4 BANKING SUPERVISION

Bank of Albania's supervision is based on three pillars: licencing, regulation and supervision. The latter is carried out through off-site surveillance and on-site inspections. The constant supervision and regulation of financial activities in Albania, mainly of banking activities, are at the focus of this function and represent its main activities[32].

The focus of the Bank of Albania in the supervision function has been the meeting of targets for ongoing monitoring, through on-site inspections and off-site analyses of banks' risk level and their management performance. Particular attention has been given to the monitoring of risks to which the financial institutions are more exposed, as well as to financial institutions that constitute a special importance for the proper functioning of the financial system in Albania. There has been enhanced supervision attention not only to particularly important financial institutions, but also to other financial institutions with problems, which have the potential to materialize risks, and therefore losses. Bank of Albania's actions aimed at the prevention of adverse events through an approach aimed at their early identification and the assessment of risks and their impact in view of the future. The work to fulfil these functions is performed in parallel with the development of domestic capacity, review and improvement of the supervision structure, the roles and responsibilities, as well as through the cooperation and coordination with other regulatory authorities, domestically and abroad.

In addition to the regular activity for the supervision of the licenced subjects, resources are focused on the implementation of the medium-term strategy objectives of the Bank of Albania. In this context, actions have been undertaken towards:

Consolidation of risk-based supervision

In this regard, the final document of the Internal Capital Adequacy Assessment Process (ICAAP) was prepared. This document is drafted in compliance with Pillar II of Basel II and sets out the criteria on internal assessment by banks of the needs for capital based on their perceived risk levels. It is being discussed with banks and is expected to be approved during 2017. Likewise, Recovery and Resolution Plans of systemic banks were also revised, by reassessing the internal processes in place to prevent adverse events as well as to assess the readiness to react.

Also, the supervision organizational structure was revised, allowing its regrouping in function of work processes. Thus, it was provided the possibility for off-site analyses harmonization with on-site control of banks, work-flow processes were revised, an equal approach for entities with similar activities was ensured. New processes were established. These developments also dictated the need for increasing the supervision structure capacities of human resources.

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[32] *The Bank of Albania publishes detailed data on the developments in the banking sector and the banking process in the Supervision Annual Reports.*
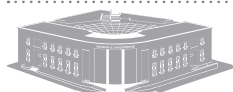
Alignment of supervision practices with the European standards

The Bank of Albania, within its objectives for aligning the supervision practices with the applicable practices in the countries of the European Union as well as for drafting the methodologies that reflect the latest developments is this regard, has collaborated with the European Bank for Reconstruction and Development on a project to review risk direction and management issues for the banks. The aim is to revise the structures of governance, Steering Council and established committees structures; their composition, responsibilities and role in promoting an efficient and transparent control environment; governance focused on risk management; assessment and regulation of remuneration policies; assessment and regulation of compatibility and internal control. To analyse the adequacy and the potential needs for review and reassessment of the above mentioned elements, the European Bank for Reconstruction and Development will focus on assessing their implementation in the legal and regulatory framework, as well as internal documents that support this process. The project started in 2016 and is expected to end in 2017.

Reconceptualization and development of the Early Warning System methodology and policy

This system consists in the periodical analysis of several key indicators of financial performance assessment of banks and it early warns about developments that need increased supervisory attention. This methodology serves as a rather good support of off-site analyses, by drawing attention toward risks that should be considered. In this regard, the aim is to increase risk control quality, through staff specialization, indicators' extension and combination of off-site analyses with on-site inspections.

ADDRESSING NON-PERFORMING LOANS

During 2016, the reinforced horizontal review of non-performing loans trend and the efforts undertaken by the banks to address the phenomenon were fulfilled. The Bank of Albania has communicated with the banks of the system, addressing the issue of portfolio quality in terms of dealing with non-performing borrowers as well as writing off loans categorized as lost in compliance with the relevant regulatory obligation. At the same time, the Bank of Albania has requested each bank to draft and present the Recovery and Resolution Plans on large borrowers, as defined in the relevant regulatory framework on major risk management as well. At the end of 2016, banks were also required to formalize the strategies for the reduction of non-performing loans, their implementation, the forecast of the impact in the budget accompanied by requirements for their periodic monitoring. The progress of these requirements will continue to be monitored more frequently during 2017.

The development of the implementation of the national plan of measures on addressing the non-performing loans also received special attention. Two of the
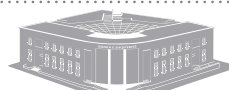
most important issues of this plan, which constitutes a direct commitment of the Bank of Albania, are the solution for the 35 largest borrowers as well as out-of-court debt restructuring. In collaboration with the World Bank, following the international experience in addressing these problems, it is expected to finalize in the near future two important products: the guideline on loan restructuring, which will completely revise the current guidelines according to the best international principles; and the creation of a formal framework for banks' cooperation on addressing the problematic of common borrowers.

As part of the implementation of the national plan, in 2016, several changes were undertaken on the clarification of the concept of loan writing off from the balance sheet, the review of the supervision treatment of real estate taken into ownership as a consequence of the legal proceedings for the execution of the non-performing loans' collaterals, the review of the regulatory framework to facilitate the sale of non-performing loans, as well as some needed improvements in the credit registry.

ENHANCING SUPERVISORY CAPACITIES

With the support of the TAIEX programme of the European Union, in 2016, a cooperation project started with the Bank of Italy, which aims at providing technical assistance for the supervision on several dimensions, such as:

- Starting the work on the implementation of the supervision requirements under Basel III, by reviewing the regulatory framework on liquidity risk.
- Reviewing the Regulation "On capital adequacy ratio" and identifying the needs to amend it, in order to further align it with the requirements of Basel II & III, as well as drafting an action plan for their addressing.
- Capacity building of internal supervision, to ensure a better assessment of the criteria used by banks for lending, by defining the criteria for the financial analysis assessment that banks perform for their borrowers as well as assessing the possibility of defining the limits of the main financial indicators for various sectors of the economy.
- Reviewing the Early Warning System with a view to improving off-site analyses.
- Reviewing the regulatory framework in force for electronic money institutions.

REVIEW OF THE LEGAL AND REGULATORY FRAMEWORK

The drafting and the review of the supervision regulatory framework was aimed at supplementing and improving it continuously by the supervision authority, in order to ensure compliance with the requirements of the Law on banks and the alignment with the directives and the regulations of the European Union (EU), the standards of the Basel Committee on an effective banking supervision,
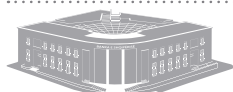
the better practices in this area, by also considering the developments and problems of the banking system. The main regulatory changes are provided in the following.

- In response to the encountered problems, the Regulation "On minimum safety requirements on premises where banking and financial activities are carried out and on the transport of monetary values", by redefining the minimum safety requirements in premises where banking and/or financial activities are carried out, as well as the transport of monetary values. This Regulation took also into account the various problems faced by the inspections carried out in banks' branches and agencies, in non-bank financial institutions as well as in foreign exchange bureaus. During the year, this Regulation was revised to include in the criteria of physical safety the activities of savings and loan associations as well, after the legal and regulatory amendments mentioned above.

- The Bank of Albania led the process for the thorough review of the legal and regulatory framework on the functioning and the supervision of the savings and loan associations. In collaboration with the World Bank and with the stakeholders the Law on the functioning of the savings and loan association was drafted and then approved by the Parliament of Albania in May 2016. In compliance with this Law, the entire regulatory framework on the supervision of the savings and loan association was revised, which consists in the regulation of the licencing process, the regulation on the risk management criteria in the activity of these institutions, as well as the reporting system for the periodic information on their financial activity. These amendments brought also profound structural changes in the number and size, as well as in the restructuring of these institutions' activity.

- The Regulation "On licensing and activity of banks and branches of foreign banks in the Republic of Albania" was revised in part, in order to ensure compliance and consistency with the concepts used in the Supervision Policy document.

- The Regulation "On licensing and activity of non-bank financial entities" and the Regulation "On licensing, organization, activity and supervision of foreign exchange bureaus" were revised simultaneously and interdependently. The amendments aimed at ensuring a more effective supervision approach to electronic money and non-bank financial institutions, by increasing the responsibility of the institutions themselves associated with their agents, in accordance with the requirements of EU directives in the payment area. Likewise, in the context of implementing measures to reduce non-performing loans, some easing requirements were stipulated on the capital level of institutions that purchase non-performing loans (non-performing loans managing companies).

- The Regulation "On capital adequacy ratio" and the Regulation "On the management of credit risk by banks and branches of foreign banks" were amended at the same time, in light of the commitments of the Bank
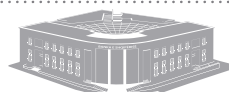
of Albania in the plan of measures to reduce non-performing loans.

- The Regulation "On licensing and activity of non- bank financial institutions" and the Regulation "On electronic payment instruments", were reviewed at the same time, based largely on the provisions of EU directives on the activity of electronic money institutions, as well as taking into account the development of these institutions in the Albanian market.

- The draft-law "On recovery and resolution of banks in the Republic of Albania" was finalized, and was approved by the Parliament of Albania in December 2016. It was drafted with regard to the respective EU directive and aims to provide the Bank of Albania (the Resolution Authority) with a set of legal instruments for a rather early and rapid intervention in the case of a bank in unfavourable positions.

BOX 5 THE LAW ON "BANK RECOVERY AND RESOLUTION"

The Law on the recovery and resolution in banks in the Republic of Albania sets out a clear legal framework for the recovery and the resolution of banks, when they face financial crises, and it aims to align partially the Albanian legislation with the Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 (Banking Recovery and Resolution Directive).

The provisions laid down in this Law provide the Bank of Albania, as the Resolution Authority, with a set of legal instruments to intervene early and rapidly enough in the case a bank is in an unfavourable position, in order to ensure the continuity of the critically important financial and economic functions of the bank, always by minimizing the effect in the economy and in the financial system.

The Law applies on banks licenced by the Bank of Albania that conduct their activity in the territory of the Republic of Albania.

The Law provides four main resolution tools: the bridge bank, the sale of business, the asset separation and the bail-in. While the bridge bank is already known in the banking legislation, the other tools are provided for the first time in a particular legislation on recovery and resolution of problematic banks.

The implementation of the tools provided in the Law takes into account the principle of proportionality based on the nature of the activity, shareholding structure, legal format, risk profile, size and legal status, relationship with other institutions and the financial system in Albania, scope and complexity of banks' activity, their participation in the shielding schemes or any other common system.

In order to implement the instruments laid down in the Law, specific provisions are in place related to the creation, use and management of the resolution fund. This fund is financed mainly by the annual contribution and the extraordinary contributions by the banks, and are managed by the Deposit Insurance Agency. The target level of the fund is projected to be fulfilled within a 10-year transitory period from the entering into force of this Law.

ON-SITE EXAMINATIONS

Following the risk-based supervision model, the importance of off-site analyses has grown. However, on-site examinations have a primary role in terms of on-site examination of the quality of the internal policies and their implementation, establishment of adequate processes of risk management, implementation of the regulatory supervision framework, of the best international standards, as well as the verification of the accuracy of the reported information. During 2016, ten full-scope and partial examinations were performed in banks and non-bank financial institutions, 14 examinations in savings and loan associations, and 5 examinations in foreign exchange bureaus. Of them, 13 examinations were realized with the collaboration of the Deposit Insurance Agency, 3 examinations were realised in collaboration with the General Directorate for the Prevention of Money Laundering, and 1 examination in collaboration with the Albanian Financial Supevisory Authority.

The main objective of the examinations is to determine a thoroughly comprehensive risk profile for the licenced entities. Banks' examinations have identified the activities' areas which need improvements, while relevant recommendations are provided, as follows:

- Governance and supervision role of the steering bodies. The accountability of these bodies has been intensified by defining their direct responsibility for addressing the problems identified in the bank's management to ensure at all times compliance with the regulatory requirements, maintaining a steady activity and the anticipation of certain situations.
- Strategic planning and setting of objectives. The need was identified and a recommendation was made for a clear definition of the activity objectives, accompanied with the planning and providing of the necessary human, financial, and technological resources, for their realisation.
- Control systems efficiency. It was identified the need for a more adequate separation of responsibilities, delegation, providing independence, increasing professionalism in order to increase the performance of the control systems in the banks.
- Capital adequacy. An assessment was made of the indicator's calculation accuracy by identifying regulatory implementation deficiencies and the material impact in the indicators as well as the responsibilities of the relevant structures.
- Credit risk assessment and the creation of adequate reserves. The need was identified to revise loans classification and the creation of the relevant reserve funds to match the assessed level of risk. A policy review was recommended for a more careful approach to credit risk, ensuring appropriate guarantees, the early identification of deterioration signs to adapt continuously to the conditions of the economic environment.
- The non-performing loans recovery and the treatment of properties
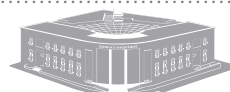
acquired by legal proceedings have attracted the supervision's attention due to the increased share in the recent years, albeit at a modest size against banks' main activity. Based on the conclusion of the audit, it was recommended to maximize the efforts to increase the income from the recovery in order to increase available funds, by fulfilling the primary goal of banking activity, financial intermediation.

- Transparency with customers. Efforts were made and spaces were found to improve the quality of the information provided to customers, in terms of expansion of products and services, technology progress and the combination of financial activities with each other.

The focus on safety and physical protection of banks was expanded during the examinations carried out in 2016. In parallel with regulatory amendments and on-site examinations, the Bank of Albania has also collaborated with the Albanian Association of Banks and other stakeholders to address the issues of funds safety management.

During the examination of other licenced financial institutions, the following main areas were identified that should be addressed further:

- Compliance with regulatory indicators, mainly the capitalization level.
- Completion of the management bodies.
- Regular reporting of financial information to the Bank of Albania.
- Improvement of the identification and analysis processes for the prevention of money laundering and terrorism financing.

At the conclusion of the examinations, the Bank of Albania recommended the necessary improvements and followed rigorously their implementation. Supervisory measures were implemented as well on some entities, for which repeated violations of the regulatory requirements were identified.

COLLABORATION WITH FOREIGN AUTHORITIES

With the creation of a Single Supervisory Mechanism (SSM) at the European Central Bank in November 2014 and considering the active presence in Albania of branches of large groups of European banks, the Bank of Albania and the European Central Bank are in the process of drafting a complete agreement that will regulate all the cooperation areas and aspects, which is in the approval phase at the European Central Bank. After the prior approval of this document's format, which will be used as a benchmark standard to formalize the cooperation with the regional countries, the agreement will be signed and the method of implementation will be negotiated.
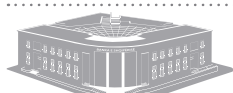
LICENCING AND APPROVALS

The Albanian banking sector continues to be dominated by EU-based banking group subsidiaries. Currently, there are 16 banks exercising their activity in the Republic of Albania.

Table 4 Banks' ownership structure (number of banks at period-end)

	2011	2012	2013	2014	2015	2016
Banks in Albania, of which:	16	16	16	16	16	16
Branches of foreign banks	2	0	0	0	0	0
Banks' ownership structure, by capital origin, of which:						
Majority foreign owned[1]	14	14	14	14	13	13
- EU[2]	10	10	10	10	9	9
- Turkey[3]	1	1	1	1	1	1
- Owned by IFIs (Saudi Arabia)[4]	1	1	1	1	1	1
- Kuwait[5]	1	1	1	1	1	1
- Swiss Confederation[6]	1	1	1	1	1	1
Majority Albanian owned[7]	2	2	2	2	3	3

[1] *"Majority" is in any case the simple majority of 50 per cent plus 1 vote.*
[2] *Banks with capital origin from EU countries are from: Italy (Intesa Sanpaolo Albania, Veneto Banka), Austria (Raiffeisen), Germany (Procredit), France (Societe Generale Albania), Greece (Banka Tirana, Alpha Bank Albania, NBG Albania), Bulgaria (First Investments Bank Albania).*
[3] *National Commercial Bank.*
[4] *United Bank of Albania.*
[5] *Credit Bank of Albania.*
[6] *International Commercial Bank.*
[7] *Majority Albanian owned banks at the end of 2016 are: Union Bank, Credins Bank and American Bank of Investments.*

During 2016, the Bank of Albania approved the transfer of the (indirect) qualifying holding of the shareholders' capital of a bank, as well as assessed and approved three applications submitted by banks to increase the financial activities permitted in the licencing annex: exercising the transferable securities trading, factoring and trading transactions financing, insurance and reinsurance intermediation, etc.

Banks submitted applications for their bank network regarding both expansion and reduction (closure, merger/transfer) of branches/agencies in the country. Following these changes, the number of branches/agencies within the country at the end of 2016 was 493, from 500 at the end of 2015.

In this year, the Bank of Albania granted new licences and its approval for financial institutions, subject to its licencing and supervisory framework. In 2016, four non-bank financial institutions were licenced, to conduct lending, factoring, financial leasing, payment services and money transfer activities, and 3 existing licences were revoked. The number of licenced non-bank financial institutions was 28 at the end of year. Also, 3 approvals were granted to conduct additional financial activities, and 3 approvals for the
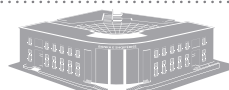
transfer of qualifying holdings of capital quotes/shares of non-bank financial institutions.

Table 5. Number of banks and financial institutions licenced by the Bank of Albania (end of period)

	2011	2012	2013	2014	2015	2016
Banks and branches of foreign banks	16	16	16	16	16	16
Non-bank financial institutions	19	21	21	22	27	28
Foreign exchange bureaus	301	322	333	356	397	428
Unions of savings and loan associations	2	2	2	2	2	2
Savings and loan associations	126	126	121	113	111	13

Source: Bank of Albania.

The licencing of foreign exchange bureaus continued the upward trend during 2016 as well. Thirty-nine new foreign exchange bureaus were licensed. Eight licenced entities that exercised the foreign exchange activity returned their licenses to the Bank of Albania for termination of activities. As a result, the number of foreign exchange bureaus was 428. This year recorded the finalisation of the reorganising process of savings and loan associations, through the merger by absorption of 98 savings and loan associations on the base of the existing savings and loan associations. As at the end of 2016, there were 13 savings and loan associations and 2 unions of savings and loan associations.

2.5 CURRENCY ISSUE

The Bank of Albania has the exclusive right for the issue and circulation of the national currency – the Albanian lek. It determines the form, dimensions, weight, model, and other features of Albanian banknotes and coins of legal tender in Albania, as well as coins and banknotes for numismatic purposes.

BANKNOTES IN CIRCULATION[33]

At the end of 2016, there were 131,202,354 banknotes in circulation, worth around ALL 254.722 billion. Compared with 2015, the number of banknotes in circulation increased by around 5.9 million banknotes, while their value increased by 8.2%. The change in these indicators is attributable to the continuing change in the structure in favour of 5000 Lekë and 2000 Lekë banknotes. Also the volume of payment requests by commercial banks increased by 25.9%. The average value of a banknote in circulation at the end of 2016 was ALL 1941, from ALL 1878 at the end of 2015.

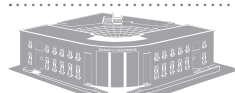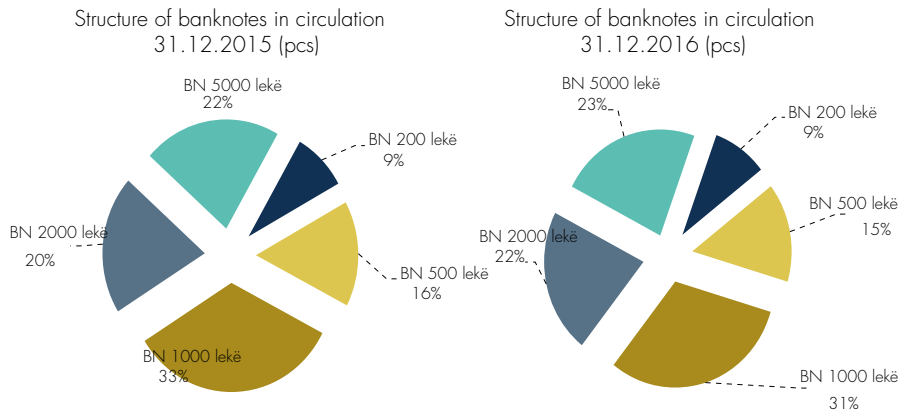[33] *It is the number and value of banknotes put in circulation by the Bank of Albania.*

Chart 19 Structure of banknotes in circulation

Structure of banknotes in circulation
31.12.2015 (pcs)

BN 5000 lekë
22%

BN 200 lekë
9%

BN 2000 lekë
20%

BN 500 lekë
16%

BN 1000 lekë
33%

Structure of banknotes in circulation
31.12.2016 (pcs)

BN 5000 lekë
23%

BN 200 lekë
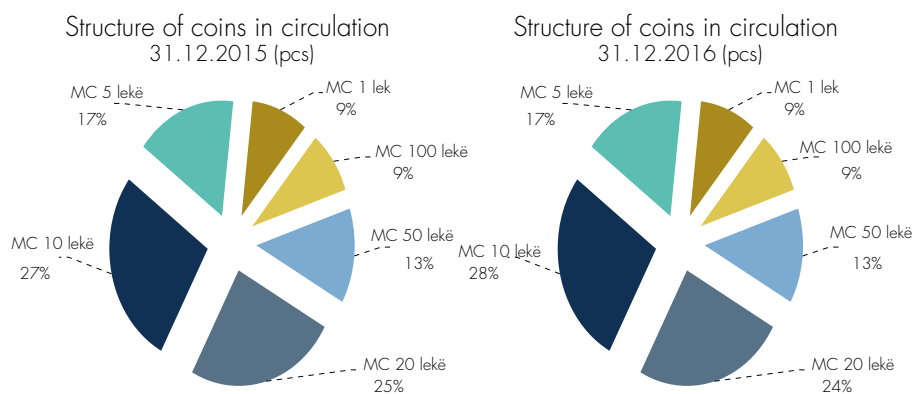9%

BN 500 lekë
15%

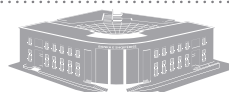BN 2000 lekë
22%

BN 1000 lekë
31%

Source: Bank of Albania.

COINS IN CIRCULATION

At the end of 2016, there were 170,494,419 coins in circulation, worth ALL 4.098 billion. Compared with 2015, the number of coins in circulation increased by 7.6% and their value by 7.9%. At the end of 2016, the overall coin to banknotes ratio was almost unchanged from the previous year.

Chart 20 Structure of coins in circulation

Structure of coins in circulation
31.12.2015 (pcs)

MC 5 lekë
17%

MC 1 lek
9%

MC 100 lekë
9%

MC 10 lekë
27%

MC 50 lekë
13%

MC 20 lekë
25%

Structure of coins in circulation
31.12.2016 (pcs)

MC 5 lekë
17%

MC 1 lek
9%

MC 100 lekë
9%

MC 10 lekë
28%

MC 50 lekë
13%

MC 20 lekë
24%

Source: Bank of Albania.
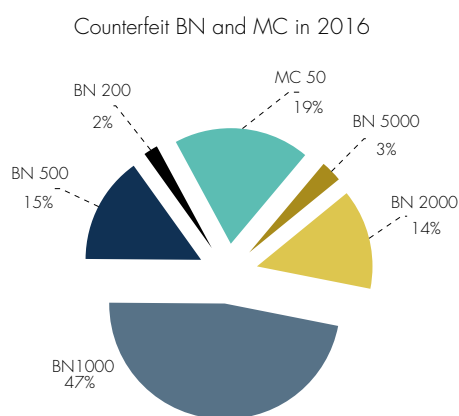
INDICATORS OF CURRENCY IN CIRCULATION

At the end of 2016, the ratio of currency in circulation to the M2 aggregate was 35.13%[34], from 31.3% of the end of 2015. Meanwhile, the coefficient of currency circulation[35] in the Bank of Albania was 0.412, from 0.409 in 2015.

RECYCLING OF CASH AND QUALITY OF BANKNOTES IN CIRCULATION

During 2016, around 114 million banknotes were processed, which were checked for authenticity and fitness for recirculation. From the process, around 25.9 million banknotes resulted unfit for use, which were withdrawn from circulation. The sorting rate[36] was 22.6%, from 25% in 2015. Unfit banknotes were replaced case by case with new banknotes fit for circulation. The banknote circulation coefficient[37] for 2016 was 0.95, implying that a banknote is returned at the cash desks of the Bank of Albania, on average around once a year. This rate is higher for 500 Lekë and 1000 Lekë banknotes (around 1.7 and 1.2, respectively) and lower for 5000 Lekë and 2000 Lekë banknotes (around 0.22 and 0.78, respectively), which shows that the latter are returned more rarely at the cash desks of the Bank of Albania.

PROTECTING BANKNOTES AND COINS AGAINST COUNTERFEITING

Chart 21 Banknotes and coins, counterfeit, by denomination 2016

Counterfeit BN and MC in 2016

BN 200 2%
MC 50 19%
BN 5000 3%
BN 500 15%
BN 2000 14%
BN1000 47%

Source: Bank of Albania.

During 2016 work continued for monitoring and full expertise on the counterfeiting of the currency in circulation. In this context, the Bank of Albania conducted on-site inspections and examination of the banking system, for the verification and the necessary help for the implementation and decision of the measures for an effective and real functioning to ensure the integrity of the currency in circulation, in accordance with the regulations approved by the Bank of Albania. Also, in order to increase capacities and expertise in this area, prevention-related activities were organised, such as training in the field of protection of the currency against counterfeiting mainly with groups of cashiers in and outside the banking system, as well as testing and monitoring machines used by staff.

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[34] Note: it is the value for aggregate M2 based on preliminary data for 2016.
[35] Ratio of the number of banknotes and coins cashiered at the Bank of Albania cash desks to the average annual number of banknotes and coins in circulation.
[36] Ratio of unfit banknotes and coins to the total number of banknotes and coins sorted in a year.
[37] Ratio of the number of banknotes received at the Bank of Albania cash desks to the average annual number of banknotes in circulation.

Compared with the previous year, the quantity of counterfeited banknotes and coins discovered in circulation decreased by 13.4% during 2016. Overall, compared with the number of banknotes and coins in circulation, they remain insignificant. We observe that the counterfeited banknotes of the 1000 Lekë denomination constitute around 47% of the total counterfeited banknote and coins, followed by the 50 Lekë coin at 19% of the total as well as the denomination 500 Lekë and 2000 Lekë at 15% and 14 % of the total, respectively.

The monitoring of the phenomenon of counterfeit national banknotes shows that it continues to be dominated by the digital colour reproduction, combined with the application of additive methods for the imitation of the security features. Meanwhile, in terms of techniques of banknote falsification, we note that there is no tendency toward professional printing. Mostly, the tendency is to imitate first level - visual and tactile - security features, and less frequently those readable through authentication devises.
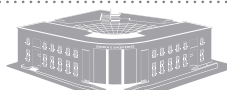
2.6 PAYMENT SYSTEM

To accomplish its legal responsibilities, the Bank of Albania promotes and supports the smooth functioning of the domestic payment systems in Albania. The Bank of Albania has taken steps to achieve this objective, by promoting developments, in its role as the systems' operator and overseer. These measures have consisted in the completion and improvement of the regulatory framework of the payment system, the promotion of the inter-institutional cooperation, the expansion of research work and the increase of transparency.

PAYMENT SYSTEM OVERSIGHT

The Bank of Albania fulfils its legal obligation on the normal functioning of the payment systems through three approaches: operator, overseer and promoter. In this framework, the Bank of Albania has continued to take concrete steps, by promoting developments in its role as both the operator and the overseer of these systems. More specifically, in addition to the completion of the regulatory framework on payment systems oversight, particular attention has been dedicated to the promotion of the inter-institutional collaboration, the expansion of the research activity, and the increase of transparency.

The payment instruments, as components of the payment systems, have also been in the focus of the payment system oversight. Thus, during 2016, in order to promote the efficiency of electronic money and in accordance with the EU directives, the regulatory framework "On electronic payment instruments" approved by decision of the Supervisory Council No. 11, on 09.11.2016, was revised.

In view of fulfiling the strategic duties of the Bank of Albania in the framework of the European integration, throughout 2016, the Bank of Albania has started the work for the transposition in the Albanian legislation of the Directive 2015/2366 "On payment services in the internal market". For this purpose, the Bank of Albania started a cooperation project with the Bank of Italy, which will contribute to strengthening the rules related to internet payments as well as the implementation of the European practices and regulations on payment system supervision.

PERFORMANCE OF AIPS AND AECH SYSTEMS

Albanian Interbank Payment System for large-value payments (AIPS)

Chart 22 Transactions in AIPS by number and value
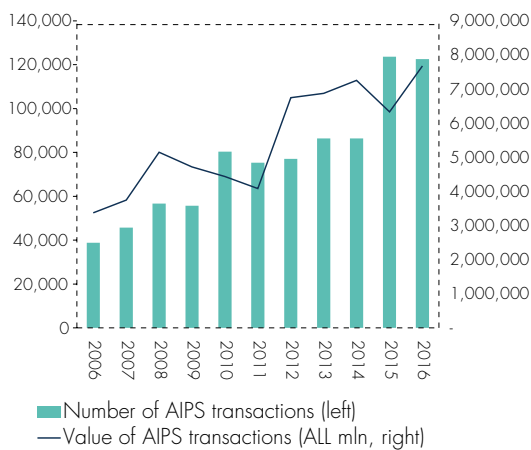
Number of AIPS transactions (left)
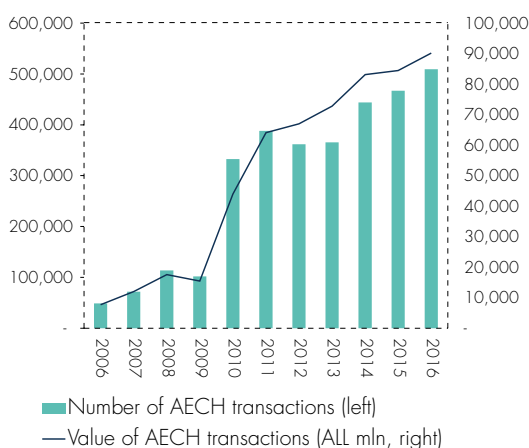—Value of AIPS transactions (ALL mln, right)

Source: Bank of Albania.

During 2016, the Bank of Albania and 16 commercial banks participated directly and the Ministry of Finance indirectly in the AIPS system. The volume of transactions processed during the year was 122,550 with a total value of ALL 7,676 billion. Compared with the previous year, the volume of processed transactions decreased by around 0.83%, while the value of the processed transaction increased by 21.29%.

The Intraday Loan Facility (ILF) has decreased in terms of both number and value (13.25% and 28.64%, respectively), reflecting the decrease of the exposure of the system to liquidity risk.

Albanian Electronic Clearing House for small-value payments (AECH)

Chart 23 AECH transactions, by number and value

Number of AECH transactions (left)
—Value of AECH transactions (ALL mln, right)

Source: Bank of Albania.

During 2016, the Bank of Albania and 16 commercial banks participated directly and the Ministry of Finance indirectly in the AECH system. The volume of cleared payments during the year was 508,935 with a total value of around ALL 90 billion and an average value of around ALL 180,000. Compared with the previous year, the activity of the AECH system, increased in both volume and value of cleared payments, by 9.05% and 6.79%, respectively.

PAYMENT INSTRUMENTS

Banks' reporting on payment instruments show that around 11.9 million payment transactions were
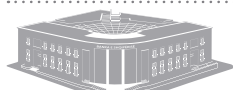
made, totalling ALL 4.512 billion, registering an increase by 8.54% in volume, and a decrease by 1.85% in value, during 2016.

From the total number of clients' payments, we observe for this period a high use of credit transfer (at 65.08%), of which, around 76.94% were payment instructed in paper form. However, it is worth highlighting that, in the last years, we have noted a contraction of paper credit transfers, meanwhile non-paper credit transfers (home banking) and card payments increased.

In terms of use of electronic payment instruments, it is worth highlighting the use of electronic money by both bank and non-bank financial institutions. The increase in the use of such instrument is considered to have a positive impact on the financial inclusion of the population in financial services.

Chart 24 Performance of payment instruments during years

Paper-based credit transfers
Non-paper credit transfers
Card payments
Direct debit
Cheques
E-money payments
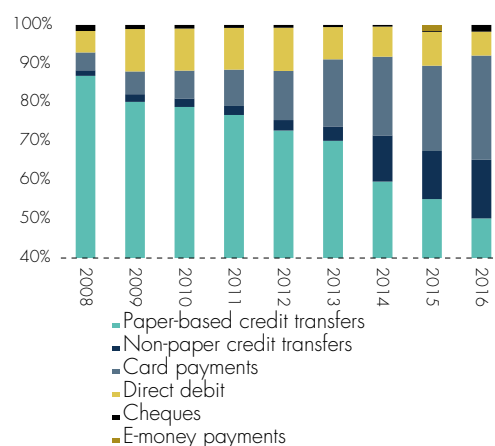
Source: Bank of Albania.

Bank cards

As at the end of 2016, fourteen banks were licenced as card issuers in the Republic of Albania, 9 of which were also licenced as card accepters, up 1 bank compared with 2015. Also, during 2016, two electronic payment institutions exercised their activities in the market as well. During the year, the issuing of debit cards increased by 5.5% and the issuing of credit cards increased by 5.9%. On the other hand, the introduction of cards with electronic money functions has showed a rapid upward trend during the year.

From the use of bank cards in ATM and POS terminals, we see that the major share of processed transactions with cards has been cash withdrawals from ATMs, an indicator of a largely cash-based economy. However, during 2016, we observe a significant increase in the number and value of card payments in physical and virtual POSs, 28.9% and 21.2%, respectively, continuing the positive trend registered in the last years. In relative terms, payments carried out with prepaid cards reached up to 6.51% of the payments with debit and credit cards.

As at the end of 2016, the number of POS terminals increased by 6.31%, while the number of ATMs slightly decreased by 3.15% compared with the last year. Notwithstanding the positive upward trend in the number of POS terminals, their concentration continues to be high in the region of Tirana,[38] at

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[38] Regions are divided according to the branches of the Bank of Albania.

81.76%, while terminals for the use of electronic money cards registered an upward trend of 13.9% compared with the end of 2015[39].

Home Banking

Recently, home banking has been increasingly expanding in the Albanian market. Thus, 14 of the 16 banks were offering different home banking products, as at the end of 2016. These products provide remote access to the bank account, via on-line, telephone or software that the bank makes available to its clients. From banks' reports, we observe a significant increase of 27.63% of the volume of home banking payments and of 21.51% of the value of the transactions, compared with the previous year. The increase of home banking transaction also dictates to a large extent market's developments in this aspect.

The increasingly upward trend of home banking is closely connected to the presence of infrastructure and the expansion of possibilities to access internet through a smartphone.

Regarding cash transactions conducted by customers at banks' cash desks, during 2016, we observe a decrease of the number and an increase of the value compared with the previous year. This year has registered a slight decrease of cash desk transactions by 0.4% in numbers, and an increase by 10.27% in value, compared with the previous year.

Chart 25 Trend of online accessible accounts against total accounts and trend of online accessible accounts utilisation ratio*

— % of online accessible accounts to total
— Utilisation ratio
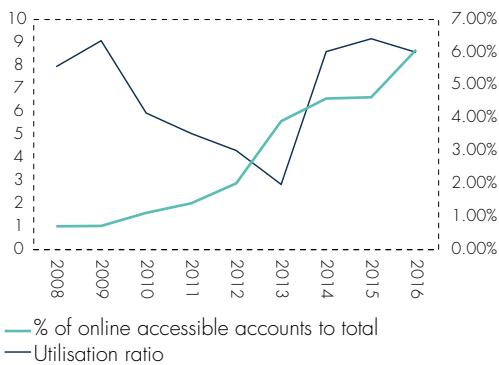
Source: Bank of Albania.
*The utilisation ratio shows how much on average an account is used on-line to carry out transactions.

NATIONAL PAYMENT SYSTEM COMMITTEE

The National Payment System Committee (NPSC) continued its proceedings in this year, in light of fulfilling its operational strategy. Particular attention was paid to fulfilling the NPSC recommendations as well as to the cooperation and collaboration with the institutions participating in it.

In November 2016, the first standardisation process of the payment order format was successfully completed, which is based on SEPA's standards[40]. Another project initiated by the Albanian Association of Banks that requires the collaboration of the Bank of Albania is that of the implementation of the Interbank Direct Debit. Its goal is to increase the use of this instrument by the

[39] Electronic money is a payment instrument, different from the remote payment instruments. E-money is an electronic store of monetary value and provides to the holder the possibility to make payments electronically. This instrument may be reloaded with monetary value whenever necessary, within the limits set out by the Bank of Albania. Electronic money may be stored on a card or a system (i.e. PAYPAL) and is not conditioned by the need to own a bank account.

[40] Single Euro Payments Area – initiative of the European Union for the integration of payment systems through the development of harmonized electronic payments schemes and systems.

clients of all the banks, regardless of the location of the utility companies' bank account thus contributing to reducing the use of cash in the economy.

In view of promoting innovation in banking services, the Albanian Association of Banks, in cooperation with the Bank of Albania and the NPSC, organized a conference on "Digital Banking". In this conference, international experiences were presented not only from the perspective of regulator and overseer of the market, but also from the perspective of the institutions that offer these services. Special attention was also paid to the initiatives of banks and other financial institutions in the Albanian market.

BOX 6 PROJECTS WITH THE WORLD BANK IN THE PAYMENT AREA

Throughout 2016, the Bank of Albania continued to cooperate with the World Bank in the framework of implementing a project on measuring payment instruments costs. This project is based on the methodology created by the World Bank and aims to identify and measure all costs carried by the different payment instruments, in order to create a strategy for the efficient reform and development of the payment market.

Preliminary results succinctly identify physical currency as the most expensive payment instrument and credit transfers in electronic form as the cheaper. The project will be completed within 2017.

Following this cooperation, two other projects started during 2016, which also aim at promoting payment services from the perspective of remittances as well as promoting financial inclusion of the public with in these services. The following is the summarized information on these two projects:

1) Financial inclusion

The purpose of this project is to assess and draft a strategy of financial inclusion from the point of view of payments, which fundamentally will aim to provide to individuals a broader access of the payment offer in the Albanian market. To achieve the goals abovementioned, experts of the World Bank and representatives of the Bank of Albania have analysed the Albanian context from the point of view of infrastructural and institutional developments, as well as the legal and regulatory framework related with the area.

2) Remittances

This project is divided in two activities. The first activity aims to carry out an assessment of remittances in the international market, based on a methodology of the Bank for International Settlements (BIS). The second activity, named Greenback, is an instrument, which, through financial education, is expected to help building a closer relationship between individuals that send remittances and financial institutions.

At the current stage, the two projects are in the process of finalisation of the market analysis report, the identification of gaps and need for improvement and the drafting of a programme/strategy to achieve the abovementioned goals.

LIST OF LICENCED ENTITIES ACTIVE IN THE PAYMENT AREA

Institution	Licence number and date	Area of activity
Paylink sh.a.	Nr. 1 dt. 04.10.2013	Operator national scheme card payments
Unioni financiar i Tiranës sh.a.	Nr. 1 dt. 08.12.1999	Payment and money transfer services
Posta Shqiptare sh.a.	Nr. 3 dt. 18.04.2001	Payment and money transfer services
Ak - Invest sh.a.	Nr. 7 dt. 03.12.2003	Payment and money transfer services
NOA sh.a.	Nr. 9 dt. 06.06.2007	Payment and money transfer services
M-Pay sh.p.k.	Nr. 22 dt. 31.05.2011	Payment and money transfer services
Vodafone M-Pesa sh.p.k.	Nr. 31 dt. 25.03.2015	E-money institution
EasyPay sh.p.k.	Nr. 35 dt. 16.11.2015	E-money institution
Kastrati sh.p.k.	Nr. 36 dt. 10.03.2016	Payment and money transfer services
Pay and Go sh.p.k.	Nr. 37 dt. 18.03.2016	Payment and money transfer services

2.7 FOREIGN-EXCHANGE RESERVE MANAGEMENT

The Bank of Albania is the national authority responsible for maintaining and managing the foreign exchange reserve of the Republic of Albania. It uses its best opportunities to achieve and maintain a certain level of foreign exchange reserve, which support Albania's financial stability, and is in accordance with the monetary policy.

The Supervisory Council is responsible for approving the objectives of the foreign exchange reserve management. The primary objectives of this process are liquidity and security, whereas ensuring returns from reserve funds management represents the third objective, as long as it does not infringe the objective for liquidity and security. The Investment Committee approves the names of entities where foreign reserves may be invested. These names include the governments of USA, Japan, Great Britain and those in the euro area , as well as government-related agencies or institutions that are generally rated at least AA- (for euro area governments the accepted minimum rate is BBB-).[41] The names of entities allowed for investment also include multilateral institutions or other institutions rated at least AA-.

FOREIGN-EXCHANGE RESERVE PORTFOLIO

At the end of December 2016, the stock of foreign exchange reserve was around EUR 2.944 million. The composition of foreign exchange reserves by currency was: USD 22.2%; EUR 62.7%; GBP 2.8%; JPY 2.4%; AUD 1.4%; SDR 6.1%; gold 1.9%; CNY 0.5%.

At the end of 2016, foreign exchange reserve is invested in liquid assets, mainly with maturities of 0-3 years. The share of time debt instruments with maturity over 5 years does not exceed 2.5% of the reserve portfolio. The portfolio managed by the external manager (World Bank), is invested against a reference portfolio of 0-3 years, mainly in debt instruments issued by the government.

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[41] *Entities/ instruments listed up to BBB- are included in "Investment" category (investment grade).*
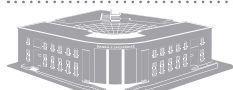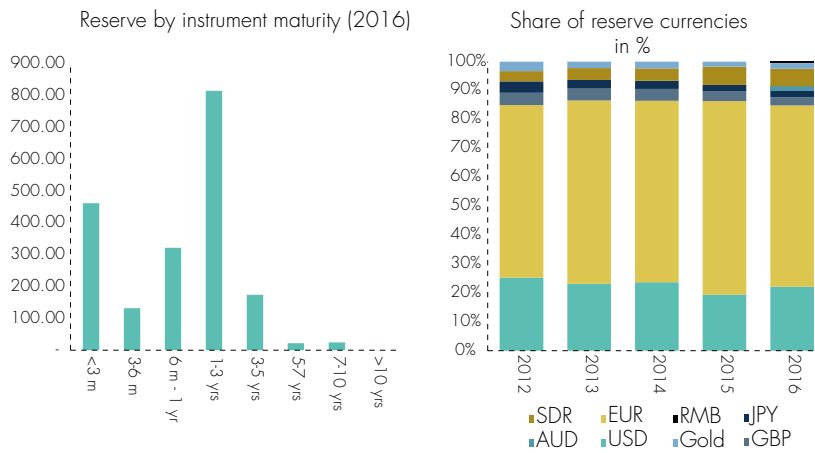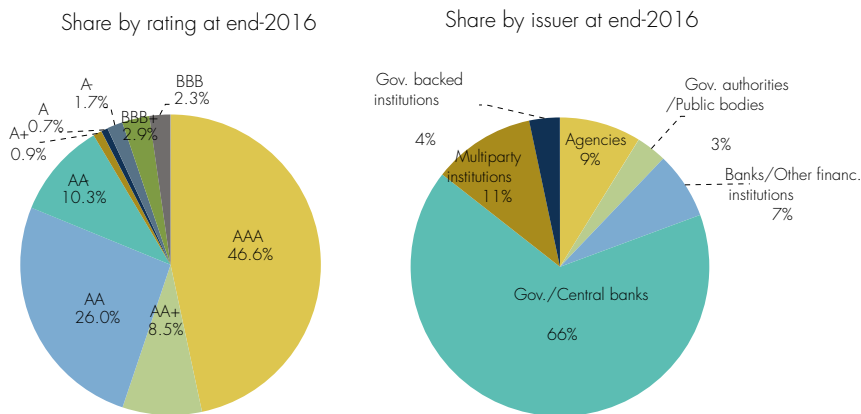
Chart 26 FX reserve indicators by maturity (left) and currency (right)

Reserve by instrument maturity (2016)

Share of reserve currencies in %

SDR EUR RMB JPY
AUD USD Gold GBP

Source: Bank of Albania.

Chart 27 Composition of the reserve portfolio by rating and issuer

Share by rating at end-2016

A+ 1.7%
A 0.7%
A+ 0.9%
BBB 2.3%
BBB+ 2.9%
AA 10.3%
AA 26.0%
AA+ 8.5%
AAA 46.6%

Share by issuer at end-2016

Gov. backed institutions 4%
Multiparty institutions 11%
Agencies 9%
Gov. authorities /Public bodies 3%
Banks/Other financ. institutions 7%
Gov./Central banks 66%

Source: Bank of Albania.

More than 90% of the foreign reserves portfolio is invested in institutions of high quality ratings (classes AAA and AA). The reserve is mostly invested in debt instruments issued by governments / central banks (66%), followed by multiparty institutions (11%), agencies (9%), banks / other financial institutions (7%), government-guaranteed institutions (4%) and government authorities / public bodies (3%).

## OTHER DEVELOPMENTS IN VIEW OF THE FOREIGN RESERVE MANAGEMENT

In the framework of the agreement with the World Bank (IBRD), in 2016, this institution provided technical assistance in several significant aspects. First, in

cooperation with World Bank experts, the methodology and criteria applied by the Bank of Albania for the size and composition by currency of foreign exchange tranches were re-evaluated. The World Bank also provided assistance in improving the selection of the strategic portfolio, with a view to enhancing the efficiency during the management of the reserve fund. Furthermore, in an effort to improve the infrastructure of information technology to support foreign exchange reserves management, last year, the Bank of Albania engaged and successfully finalized the project for the implementation of the new version of the Portfolio Management System. This version enabled adjustments to problems encountered in the previous version as well as improvement in the processing and maintenance of static data, automation in processing operations, and reduction of the operational risk level.

Regarding the regulatory framework on foreign exchange reserve management, in September the investment policy for foreign exchange reserve management was amended, driven by the decision of the IMF to include the Chinese currency (CNY) in the SDR basket. This amendment confirmed that the existing criteria will continue to be applied, as the composition of investment tranche is largely determined by the composition of the SDR basket. In particular, the proposal to distribute the weight of the CNY, as part of the SDR basket, onto two currencies, the Chinese currency (CNY) and Australian dollar (AUD), was approved. The new composition of the investment tranche represents a diversified movement towards investment in a new currency of a G10 country, as well as getting an exposure in emerging markets.

Further on, after the consultation with World Bank, and IMF experts, the new project of the regulation "On policy and management of foreign exchange reserve" was finalized. The main amendments in the new draft regulation are related to: a clear definition of the objectives for which the foreign exchange reserve is held; a full formulation of the objectives of the foreign exchange reserve management, taking into consideration a wider framework of several risk sources, reflecting these aspects in the review of the criteria of the size and composition by currency of reserve tranches. The new project proposed the adoption of the criteria for risk budget in the case when, due to the necessity of respecting the primary criteria, a significant part of the reserve fund needs to be invested in an environment with negative interest rates. Content of the proposed project by the new regulation was approved by the Supervisory Council in February 2017.
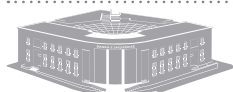
BOX 7 HIGHLIGHTS IN FOREIGN EXCHANGE RESERVE FLOWS IN 2016

During 2016, the gross foreign-exchange reserve, estimated and reported in euro, increased by about EUR 62.85 million, registering EUR 2,944.13 million as at end-December. The stock of gross reserves increased significantly, at the end of December, as a result of shifting of liquidity to foreign currency by commercial banks from non-residents in the form of surplus reserves at the Bank of Albania.

A.   *Transactions with the Ministry of Finance provided a negative impact, estimated at EUR 139.51 million, according to the following items:*
•   *Net inflows from disbursement of various loans, at EUR 249.18 million;*
     o   *International Monetary Fund (IMF), at EUR 144.75 million;*
     o   *International Development Agency (IDA) etc., at EUR 104.43 million.*
•   *Inflows from the issue of foreign currency debt, in the domestic market, at EUR 35 million;*
•   *Outflows (including debt service), at EUR 423.69 million.*

B.   *Commercial banks and other entities' transactions provided a positive impact, estimated at EUR 135.54 million, according to the following items:*
•   *Commercial banks' deposits at the Bank of Albania to comply with the required reserve and transactions related to their capital, etc., at EUR 615.39 million;*
•   *Outflows, at EUR 478.56 million;*
•   *Net outflows for the account of other entities (IDA, etc.) at EUR 1.29 million.*

C.   *Bank of Albania's transactions provided a positive impact, estimated at EUR 85.27 million, according to the following items:*
•   *Buying foreign currency from the Ministry of Finance and other institutions, at EUR 58 million:*
     o   *Ministry of Finance EUR 56.76 million;*
     o   *other institutions EUR 1.24 million;*
•   *Profit generated from foreign-exchange reserve investments, estimated at about EUR 41.83 million. These receipts represent mostly interests and coupons and are calculated on cash basis;*
•   *Settlement of Bank of Albania's dues to the IMF and the Government of Greece estimated at EUR 12.45 million;*
•   *Transfers at around EUR 2.11 million.*

D.   *Market factors provided a positive impact, estimated at EUR 18.45 million, according to the following items:*
•   *Foreign-exchange rate volatility of currencies composing the foreign-exchange reserve contributed positively to the gross reserve reported in EUR, registering an effect of about EUR 14.56 million.*
•   *The portfolio revaluation effect, as a result of interest rate volatility, is estimated at a negative value of EUR 33.01 million[1].*

[1]   *This value includes the effect from the securities coupons.*

2.8 STATISTICS

Undertaking good monetary and supervision policies requires regular monitoring, in-depth analysis and an extensive set of granular, frequent and high quality statistics. In this context, the development of monetary and financial statistics and external sector statistics is a fundamental responsibility of the Bank of Albania and is the basis for monetary policy decision-making and financial stability.

The Bank of Albania meets also the reporting obligations to international institutions - the IMF, World Bank and Eurostat and ECB - within the framework of Albania's European integration process. The Bank of Albania is a member of the 'GDDS'[42] and of different reporting systems guided by the IMF.

During 2016, the activity in the field of statistics was oriented towards the strict implementation of projects serving the realization of medium-term objectives of the Bank of Albania (2016-2018), the National Plan for European Integration (NPEI), the recommendations of the Eurostat mission and IMF missions, and in consideration of the requirements of Eurostat and other international institutions.

The main obligations were: (i) production of timely and qualitative of external sector, monetary and financial, and banking statistics, (ii) production of new statistical indicators, (iii) alignment of methodologies with international standards, and (iv) statistical and methodological reporting to national and international institutions (INSTAT, IMF, Eurostat, WB).

### ALIGNMENT OF METHODOLOGIES WITH INTERNATIONAL STANDARDS

The Bank of Albania has intensified its work on approximating its statistics methodologies to the international standards and aligning them with the acquis communautaire. Concrete efforts have been undertaken to collect and build new data and to improve the data processing system. This progress is supported by the cooperation / assistance with the IMF, Eurostat, and included the completion of the reporting obligations to international institutions.

In the area of monetary and financial statistics, in the framework of approximation to international standards of compilation (ECB, IMF) and pursuant to the recommendations of the ECB experts report, the Bank of Albania has worked on implementing ESA 2010 standards for the classification of instruments by institutional sectors (referred to this standard) for reporting by commercial banks and the alignment of drafting interest rate statistics with the standard and reporting requirements by the European Central Bank[43]. This new set of statistics on interest rates further increases the expertise in the analysis and the monetary pass-through mechanism.

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[42] *General Data Dissemination System - The general data dissemination system.*
[43] *Approximation of the ECB Directive No. 34/2013*
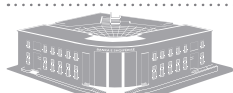
In addition to periodic reporting of existing indicators, new indicators are reported to financial institutions over the year. The Coordinated Portfolio Investment Survey (CPIS) and the relevant methodology through the Integrated Correspondence System (ICS) was reported for the first time to the IMF; four new questionnaires were reported to Eurostat (in accordance with Regulation (EC) 555/2012 on the transmission of data), through SDMX platform (Balance of Payments-Quarterly, Quarterly International Investment Position, Direct Investment by flow-country and Direct Investment by stock-country). For the very first time, in a quarterly frequency the public is provided data on: (i) International Investment Position; (ii) investment flow by country and economic activity; and (iii) direct investment stock by country and economic activity. Also, the time series 2008-2012 of the external sector statistics (balance of payments, international investment position, and gross external debt) is reviewed and published in accordance with the new methodology of the IMF, BMP6, as well as the time series of Direct Investment by nomenclature of economic activities, Nace. Rev. 2.

Following the consolidation of data sources, the drafting of financial accounts by sector was enabled for the first time, based on the methodological standard ESA 2010, for the end of 2015 - at the same time approximating to the time frame that the standard provides.

The methodology of compiling external sector statistics is drafted pursuant to the objective provided in the National Plan for European Integration (Regulation (EC) 184/2005).

ENHANCING THE QUALITY AND INTEGRITY OF STATISTICS

Pursuant to the strategic vision, the Bank of Albania is working towards further increasing the effectiveness and efficiency of the statistical product. In this context, intensive cooperation not only with INSTAT (the official statistics producer and coordinator of the national statistical system in Albania), but also with third parties is addressed. The Memorandum of Understanding between the Bank of Albania, INSTAT and MF was finalized in September 2016. According to this memorandum, technical working groups were set up for the adequate sharing of statistical data collected/compiled by the respective institutions as well as for better methodological harmonization between the three statistical agencies.

The Bank of Albania continues to cooperate with institutions such as the Albanian Financial Supervision Authority (AFSA) and the Albanian Association of Banks (AAB). Cooperation with the AFSA is expected to further strengthen in several areas for the timely and qualitative exchange of information.

The Bank of Albania was represented and has actively participated in the Interinstitutional Working Group for Chapter 18 (statistics) of the Acquis, and in

the Interinstitutional Working Group for the preparation and reporting to Eurostat the Excessive Deficit Procedure (EDP)[44]. EDP reporting involves a harmonized set of tables where important data of the government sector are reported, such as government deficit, debt level, financial accounts and other additional information. Such tables serve for monitoring public finances soundness in member states and candidate countries, and respecting the two criteria set out in the Maastricht Treaty.

Modern statistics cannot be perceived without the powerful support of the IT, regarding their collection, compilation and dissemination. In terms of achieving international standards in the infrastructure of reporting, storage and control of data, during 2016, the automated system of regulatory reporting by the commercial banks was put into operation. Since 2016, the Bank of Albania is connected online with commercial banks for regulatory reporting- through the Electronic Regulatory Reporting system (ERRS). Also, starting from 2017, it has been working on including also non-bank financial institutions in this system. Processes are automated through the new platform of reporting. Before, they were carried out manually by operators and specialists. Automation has contributed to the reporting, control, processing and dissemination of data for the users within the Bank of Albania, aiming to increase the efficiency of reporting, reducing the reporting load and increasing the statistics quality.

During the year, we have been working for developing the International Transactions Reporting System (ITRS). This reporting is a necessity in order to meet the criteria (reporting requirements for the integration), by geographical location, institutional sectors, compilation frequency and publication and dissemination of statistics.

Further on, in the framework of the legal obligation of the Bank of Albania as a statistical agency for reporting to the international institutions, some compendium modules were prepared for the statistics produced by the Bank of Albania in 2016.

- Balance of Payments
- Direct investments
- FATS
- International trade in services
- Monetary and financial statistics
- Financial accounts- data production

Internationally, the Bank of Albania continues to maintain reporting relations with the IMF, Eurostat, ECB; such relationship is expected to be strengthened through collaborations in various projects, such as that of the government finances, e-GDDS and statistics development of other financial corporations, planned for this year.

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[44] Groups are headed by the Institute of Statistics (INSTAT).
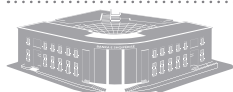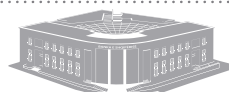
2.9. RESEARCH

The Bank of Albania aims to base its decision-making process on the sound foundation of a body of tested knowledge on the Albanian economy. Investment in creating solid research capacities contributes to improving Bank of Albania's reputation and credibility as an institution with advanced methodologies and the required knowledge for guaranteeing the country's macroeconomic equilibriums. Therefore, the active development of research assumes a primary role in Bank of Albania's development strategy.

The Bank of Albania's research is oriented toward empirical studies and analyses, often offering practical applications in support of its objectives for controlling inflation and maintaining financial stability. Research papers in 2016 aimed to assess the ability of the tools used for generating economic projections, as well as understand the functioning of monetary transmission facing the current challenges in the financial system.

Analyses on the modelling suggest that the forecasting capacities of the used models in the central bank are at satisfactory levels. However, research should continue to improve them with new methodologies and modern techniques. Analyses on evaluating the used structural models show that medium-term projections generated for the economic activity, inflation and exchange rate are at satisfactory levels. This is proven by several indicators on their forecasting capacity. However, the analysis pays attention to the need to complete the model portfolio with new techniques based on the microeconomic methodology, which are widely being used for the preparation of analyses and projections for formulating the monetary policy.

New evaluations on the parallel market (informal) of credit in the economy and national accounts indicators are in line with the conclusions of the past analyses. It should be emphasized that the results obtained from sources of information, wherefrom this activity is thought to originate, show that non-formal funding plays a significant role. On the other hand, information from the users shows that this phenomenon, measured at economy level, is not widespread or disturbing. Given the importance of this phenomenon in terms of financial stability, effectiveness of the transmission and the mechanism on which the policy rate operates, the study will continue during the up-coming period.

Econometric estimates have dispelled the fears that the banking stability may be threatened by sovereign risk. Relevant research highlights that the banking stability is more affected by the financial leverage and operational efficiency, followed by macroeconomic factors and situations. Thus, it is necessary that banking supervisors carefully monitor the credit performance of both individual banks and the entire system. Studies show that rapid lending rates are significantly correlated with exposure to higher risk, causing the expansion of non-performing loans, after four years.

The findings of research are presented in the activities and conferences organized by the Bank of Albania and other activities. The presented papers and comments and remarks have served to further improve studies and comparative analyses, before they are offered for decision-making purposes at the Bank of Albania. One of the most important activities was the 10th SEE Economic Research Workshop "Including monetary policy and financial shocks and trends in modelling and policy analysis ", held at the Bank of Albania on 1-2 December 2016. The topics discussed related to assessments of various aspects of the monetary policy, fiscal policy and central banking, financial stability, various aspects of international trade and analysis of macroeconomic models. Twenty five papers were presented this year by various central banks such as Italy, Greece, Turkey, Estonia, Hungary, Bulgaria and Macedonia, as well as by academic institutions such as Paris School of Business and Ouest Nanterre – La Defense in France, Artvin Coruh in Turkey, Johannes Gutenberg , University Mainz in Germany, etc.

A more complete and detailed information on the research works of the Bank of Albania is found at the web page of the Bank of Albania: "Publications/ Researches and Working papers". Other research works are published as articles in the "Economic Review" of the Bank of Albania. A semi-annual brochure "Research Newsletter at the Bank of Albania" informs about the newly completed research or in progress, materials presented in the "Friday Seminars", or in other activities organized by the Bank of Albania throughout the year.

2.10 EUROPEAN INTEGRATION AND INTERNATIONAL COLLABORATION

European integration is a priority objective for Albania. On 24 June 2014, Albania received the EU candidate status. On 9 November 2016, the European Commission recommended the conditional opening of accession negotiations. EC periodical reports have commended the contribution of the Bank of Albania towards maintaining macroeconomic stability, financial stability, improving supervisory practices and promoting market development and payment systems in Albania.

EUROPEAN INTEGRATION ISSUES

The Bank of Albania has continued to contribute to fulfilling the obligations arising from the Progress Report and National Plan for European Integration. It coordinates and prepares the reports related to Chapter 4, "Free movement of Capital" and Chapter 17, "Economic and Monetary Policy". On the other hand, in contributes to six other chapters of the Acquis.

On 9 November 2016, the European Commission published the "Progress Report 2016" for Albania. The report highlights the achievements and
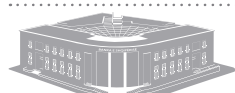
obligations that arise in relation to EU integration processes. In its general conclusions, the Report highlights that Albania engaged in EU-related reforms and continued to make progress in meeting the objectives set out in the five key priorities for the opening of accession negotiations. The approval of constitutional amendments which sanctioned the adoption of comprehensive and deep justice system reform while its implementations is a key priority for further success in the negotiations with the EU was mentioned as one of the most prominent achievements.

The contribution of the Bank of Albania on maintaining and further consolidating the macroeconomic balances, is positively assessed in the report. The European Commission considers the monetary policy of the Bank of Albania adequate to ensure inflation's return to target and support economic recovery. The report assesses the banking sector as stable and banks maintained adequate capitalization and liquidity ratios. Non-performing loans continue to be the main risk for the banking system; such risk is being addressed by local authorities.

The Bank of Albania continues to regularly monitor the implementation of the SAA, and the National Plan for European Integration. It participated in the Stabilisation and Association Committee meetings, as well as the meetings of the respective subcommittees.

The Bank of Albania has benefited from the EU's short-term assistance instrument TAIEX (Technical Assistance and Information Exchange) to help candidate and potential candidate countries, in terms of familiarisation and enforcement of EU legislation. The TAIEX assistance for 2016 focused on the approximation of legislation of the supervision of the payment systems, human resources management, cash processing and management as well as management of documents and security electronic systems.

INTERNATIONAL COOPERATION

Relations with the International Monetary Fund

The Republic of Albania has been a member of the International Monetary Fund (IMF) since October 1991. In the framework of the resolution to revise the overall 14th quota and Executive Board reform of 2010, the quota of Albania rose to SDR 139.3 million, after the payment made for its increase in February 2016. Albania has 2857 votes (or 0.06% of the total amount of all IMF members). It is in the same constituency with Italy, Greece, Portugal, Malta, and San Marino and is represented by the Italian representative, Mr Carlo Cottarelli, the Executive Director of constituency. This constituency has a total of 207.942 votes (or about 4.13% of total votes of all IMF members).

On 28 February 2014, the Executive Board of the IMF approved the three-year arrangement for SDR 295.42 million (about EUR 330.9 million) under
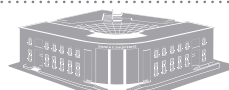
the Extended-Fund Facility for Albania, supporting the programme of the Government reforms. In a report published at the end of the relevant review, the IMF experts highlighted that monetary policy has been appropriate and that the central bank has contributed to maintaining financial stability in Albania. The arrangement with the IMF is projected to be concluded at the beginning of 2017.

During the year, several IMF missions visited the Bank of Albania, providing technical assistance and consultation. This assistance has targeted some improvement in the performance of the main functions of the Bank of Albania, such as the implementation of monetary policy, the compilation of statistics, banking supervision and safeguarding financial stability. Cooperation with the IMF has been extended beyond the provision of technical assistance. Sharing the same concern with the Bank of Albania, and to emphasize the importance of credit to the economy, in cooperation with the IMF, a forum was organized to discuss measures for credit recovery. This was the fourth financial forum organized in cooperation with the IMF, which aims to address sensitive issues related to the sustainable economic growth of the country.

## Relations with the World Bank Group

The World Bank Group (WB) supports Albania through the Partnership Framework, which covers the period 2015-2019, and aims to support Albania's aspirations for an equal growth and integration with the European Union. Since 1991, when the Republic of Albania became a member, the WB has provided over USD 2.2 billion assistance for Albania. Currently, there are nine projects amounting to USD 544 million, credited by IDA and IBRD[45].

Cooperation with the WB in the framework of the Reserves Advisory Management Program (RAMP) continued in 2016. The WB continued to offer trainings to Bank of Albania staff according to their needs, aiming to maintain, consolidate and further increase the professionalism of the staff engaged in foreign exchange reserve management. The issue of financial inclusion of population received great attention and the WB is working with the Bank of Albania to assess the use of payments systems and remittances behaviour. The WB has provided full support for drafting the law on banks recovery and resolution in the Republic of Albania, which was finalized and approved at the end of 2016.

In accordance with the concerns of the Bank of Albania, a workshop was organised on: "Corporate Governance in the Financial Sector", in cooperation with the IFC (International Finance Cooperation" and the Swiss State Secretariat for Economic Affairs (SECO). The workshop discussed the challenges of corporate governance and identified needs for further development of governance practices in the Albanian financial sector aiming to approximate them with international standards.

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[45] For reference, see this link: http://www.worldbank.org/sq/country/albania/overview#2.
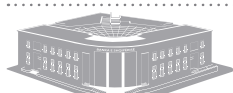
## *Relations with other international institutions*

The Bank of Albania continued to cooperate with the **FSVC** particularly on the issue of recovery and resolution of banks and topics related to the budgeting process. The Bank of Albania continued to keep regular contacts with the **European Bank for Reconstruction and Development** (EBRD), with regard to providing information and statistics on the development of the Albanian economy in general, and the financial sector in particular.

Throughout the year, the Bank of Albania has cooperated with the **central banks** of Kosovo, Italy, etc., to exchange experiences and provide assistance exchange for some departments of the Bank.

The implementation of the agreement with the **Graduate Institute Geneva** continued in 2016, in the framework of the cooperation with the Swiss State Secretariat for Economic Affairs. In this framework, various activities were organised, such as the 10th SEE economic research workshop, a workshop on corporate governance in the financial sector, training on further improving the forecasting models, improving research communication in the decision-making process, implementation of macro-prudential policies, etc.

Also, under the **European Commission's** Pericles programme, on 5-7 October 2016, with the support of the Bank of Albania was held the conference of the Mediterranean countries aiming to draft a holistic strategy for the protection of the Euro in the Mediterranean area.

On 27 October 2016, the Bank of Albania in cooperation with the **South East European Studies at Oxford** organised its annual conference on "Aligning monetary policy with financial stability – their objectives, responses and interaction in times of uncertainty." This conference was organised in the framework of the co-operation Agreement signed between the Bank of Albania and the University of Oxford.
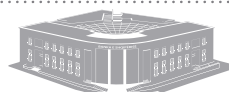
PARTICIPATION IN INTERNATIONAL CONFERENCES, FORUMS AND REGIONAL SEMINARS

During 2016, senior officials of Bank of Albania participated in several international events, such as conferences, forums and regional seminars. Following are some of them:

- **21ˢᵗ Central and Eastern European Forum,** organized on 19-20 January 2016 in Vienna (Austria), by Euromoney. This is an annual Forum and brings together prominent international personalities in the fields of politics and economy.

- On 24 February 2016, Governor Sejko paid an official visit to the **Central Bank of the Republic of Kosovo**. Discussions focused on economic and financial developments in both countries as well as on fostering the cooperation between the two central banks.

- **The annual meeting of the EBRD** was held on 11-12 May 2016 in London on "Influencing change - the next 25 years." The Governor of the Bank of Albania informed the interlocutors on the latest developments in the Albanian economy, focusing on the outlook of economic growth, as well as on banking sector developments in Albania.

- On 19-20 May 2017, the Governor of the Bank of Albania participated in the High Level Seminar on "Rethinking Monetary-Fiscal Policy Coordination", jointly organised by the **Bank of Slovenia and the International Monetary Fund**. The seminar served as a discussion platform for exchanging ideas on the co-ordination of monetary and fiscal policies.

- On 26-27 May 2016, the Governor of the Bank of Albania was on a two-day working visit at the **Bank of France**, where he discussed bilateral economic relations, on the performance of the Albanian banking system, promoting the potential of Albania as well as the latest developments in the euro area.

- **Meetings of the Governors' Club of Central Asia, the Black Sea region and Balkan countries**, in the meeting in June in Almaty (Kazakhstan), where the discussions focused on the role of central banks in ensuring the countries' macroeconomic and financial stability. In the meeting in Jerusalem (Israel) on 30 October- 1 November discussions focused on various challenges that central banks face in fulfilling their objective to maintain price stability and macroeconomic stability as well as the security of information and the latest technological developments.

- **Annual and Spring Meetings of the International Monetary Fund (IMF) and World Bank Group (WB)**, held in Washington D.C. on April and October 2016, in which Albania was represented by a joint delegation presided by the Governor of the Bank of Albania, Mr Gent Sejko and the Minister of Finance, Mr Arben Ahmetaj. Governor Sejko held several important meetings with renowned personalities in international finance and senior representatives of these institutions, and informed the participants about the latest developments in the Albanian economy, problems and prospects of economic growth, and developments in the banking sector.

2.11 TRANSPARENCY AND PUBLIC COMMUNICATION

Public communication is an important pillar in Bank of Albania's activity. It contributes to fulfilling the responsibility for maximum transparency about decision-making and its effects, and to enhancing public confidence in the central bank. Therefore, the Bank of Albania views interactive communication with the public as a primary issue of strategic importance, to transmit its monetary policy directly and comprehensively to the public.

An open and transparent central bank

Beyond legal obligations, the Bank of Albania communicates a wide range of information to the public regarding its role and activity, from the decision-making of the Supervisory Council to its daily operational activity. This transparent communication helps increase the effectiveness of policies pursued by the Bank of Albania, prompting the public to understand its decisions in a timely and clearly manner, and be able to properly evaluate them.

In this regard, the Bank of Albania uses a variety of communication channels, to explain more clearly its role and main objective: maintaining price stability, as well as the way to achieve it.

The Monetary Policy Strategy is based on a decision-making cycle, consisting in eight meetings of the Supervisory Council. After each meeting, the Governor holds a press conference, to explain the decision taken by the Supervisory Council and the underlying analysis to the public. Relevant press conferences were organized in accordance with this cycle, in 2016. In these conferences, the Governor also answered to the media on various issues related to the Bank of Albania. Following the press conferences, the Governor's speeches and the related Q&A were published in Albanian and English.

Each meeting was followed by a publication of a brief summary of the main decisions taken by the Supervisory Council of the Bank of Albania. All public decisions of the Supervisory Council were fully published in the Official Bulletin of the Bank of Albania, on 11 issues.

Besides the monetary policy decision, the Bank of Albania publishes extensive information in the field of banking supervision and financial stability, notably the Annual Supervision Report and the Financial Stability Report. The latter analyses important developments in the financial system during a six-month period and identifies factors that represent systemic risk.

The Bank of Albania's communication is complemented with a number of surveys, analyses, data, evaluations and opinions on the macroeconomic situation of Albania and its role in supporting financial stability. In 2016, its activity was presented primarily through 65 statements, press releases, 20 speeches, and 20 interviews and participation in TV programmes.

Communication with the public is tailored according to the interest, academic level and professional know how of targeted groups of the Bank of Albania, among which, the media has an important role. In this framework, the media is continuously informed and sensitized on issues related to the Bank of Albania and on the performance of the Albanian economy and financial system. In 2016, communication with the media continued with press conferences, speeches, presentations and press releases for activities organized by the Bank of Albania or other national and foreign institutions. There were also interviews or participation in dedicated TV programmes, views on specific issues of interest to the Bank of Albania or other public activities of the Governor and other representatives. Six of its periodic reports were presented "off the records" to the media during this year. These meetings aim to guide the media for a correct understanding of the decision-making of the Bank of Albania and are seen as effective means of communication with the public.

The forums and round tables held with representatives of the banking system, business and academia were part of the communication with the public. During 2016, we highlight the two forums: the meeting "Business Banking Relationship: The prospect of lending 2016 "(March 2016) and the Albania Financial Forum IV organized in cooperation with the IMF (June 2016). The discussions focused on credit recovery, reducing non-performing loans and treatment of problems associated with this phenomenon, as a concern of particular importance for the Albanian economy.

A novelty in 2016 was the increased communication with the ambassadors of foreign countries accredited in Albania. Besides bilateral meetings, in May, the Bank of Albania organized a round table with representatives of all the diplomatic corps accredited in Albania. Through the economic diplomacy, the Bank of Albania has contributed to promoting Albania and foreign investments in the Albanian financial system and beyond.

A responsible and accountable central bank

As an independent institution, the Bank of Albania aims to inform citizens, and in particular the Parliament of the Republic of Albania, on all its activities.

Institutional relations with the Parliament take place in several forms. Governor's hearing sessions in the Parliamentary Committee on Economy and Finance are the most significant ones. In March 2016, the Governor introduced the Annual Report of the Bank of Albania to this Committee, responding to its members' interest on specific issues. In November, in a dedicated hearing session, the Governor expressed the opinion of the Bank of Albania regarding key elements of the states' draft-budget for the upcoming year, 2017. During 2016, two separate hearing sessions were also held on the operational activity of the Bank of Albania and the banking system.
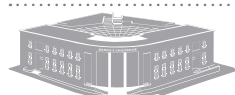
The official website *www.bankofalbania.org* is another tool where the public may find complete and updated information on the economic and financial situation and the general macroeconomic developments in Albania, as well as the role and contribution of the Bank of Albania in this aspect. During 2016, the website had about 720 000 visitors who viewed our page around 2.100.000 times and browsed in total about 4.310.000 rubrics.

Our website is constantly enriched with a broad set of statistics for many sectors of the Albanian economy, such as: banking sector, fiscal sector, real sector and external sector, published according to a defined schedule that is updated semi-annually. Bank of Albania's statistics are also found in the monthly statistical reports and in quarterly monetary policy reports.

Bank of Albania publications provide detailed and updated information on Albanian and global economy, developments in the banking and financial system, currency and financial stability, amendments and improvement of the banking legislation and its regulatory framework, as well as other relevant issues. Periodic and non-periodic publications, in 2016, consisted of about 2252 pages of analyses, statistics and research, published in both Albanian and English. The set of periodic reports was the same as in the previous year: Annual Report, Quarterly Monetary Policy Report, Financial Stability Report (semi-annual) and Annual Supervision Report. In addition to periodic reports, the following were published: the Official Bulletin, the semi-annual Economic Review of the Bank of Albania, and the semi-annual "Research newsletter".

During 2016, the Bank of Albania continued to freely distribute all its publications, taking into account the social responsibility regarding reducing paper publication. The Bank of Albania informs the public in writing or in electronic form, depending on their preference.

2.12 FINANCIAL EDUCATION AND THE MUSEUM OF THE BANK OF ALBANIA

The financial education of the public is not a legal obligation of the Bank of Albania. However, for over a decade now, the Bank of Albania has been committed to expanding and deepening financial literacy, focusing on the younger generation. Two are the main goals of the programmes, activities and special educational publications prepared by the Bank of Albania: presenting the central bank, its functions and role to the public; and cultivating and strengthening financial literacy in the society. In our view, financial literacy is a necessity, taking into consideration not only the pace of economic, banking and technological development, but also the importance and significance of information in today's global world.
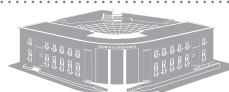
In view of the objective of enhancing financial literacy in Albania during 2016, the Bank of Albania continued to its work on public education in several aspects:

Museum of the Bank of Albania - The Museum of the Bank of Albania has functioned as a space to provide not only numismatic and historical information, but also financial knowledge to its visitors, through educational publications, audio-visual materials prepared and displayed, as well as through presentations for the visiting pupils and students.

Educational publications - the distribution of educational textbooks: "Personal finance in your hands" continued during 2016 for 8 high schools (in total 1180 textbooks). On the other hand, a brochure was prepared to celebrate the "100th anniversary of the declaration of the Autonomous Province of Korça"; 2 leaflets for 2 commemorative coin series, the brochure "The symbolism of Albanian banknotes" was published in English, and educational leaflets and brochures prepared in previous years were distributed as well.

Global Money Week - started on 14 March 2016. It is a global celebration, which aims to sensitize the youth to be responsible and financially capable citizens in the future. It was the third time that Bank of Albania participated in this money celebration week. In cooperation with the Albanian Association of Banks, Ministry of Education and Sport and Ministry of Social Welfare and Youth, several educational and awareness-raising activities for children and youth were organized. The round table discussion on: "The need of a National Strategy for Financial Education" was of particular importance. The discussion aimed at raising the awareness of key public institutions in the country on the importance of financial education and considering the possibility of setting up a Joint Working Group to develop a national strategy for financial education.

BoA's facebook page - was created in 2014 to promote and foster financial education. During the last quarter of 2016, the presence of the Bank of Albania was reactivated on social networks, as another way to be closer to the public, mainly the youth. The posts on this web page intend to inform the public through educational materials, numismatic curiosities, activities and publications of the Bank of Albania, reaching a total of about 5000 followers.

Museum of the Bank of Albania

Inaugurated on 30 October 2015, the Museum of the Bank of Albania officially started to welcome its visitors in April 2016. As it was its first year of operation, it was highly important to provide the regulatory acts for the functioning of the Museum, as well as to standardize the visitors' guide and adapt the information to the interests and knowledge of different age groups of visitors. Initially, the Museum was open to the public for only one day a week; but, given the increasing requests to visit, from December, it is now open to the public for three days a week. in 2016, the Museum of the Bank of Albania was visited by over 2,100 visitors, of whom 1,300 were schoolchildren and students.
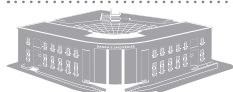
An activity that was welcomed by the public was the exhibition marking the "100th anniversary of the declaration of the Autonomous Province of Korça", on 9-10 December in Korça. This historic event was reflected through the exposure of the collection of Korça Province banknotes. The Museum Bank of Albania exhibited them at the National Museum of Education in Korça, aiming to unfold the historical and cultural values of the Albanian banknotes, issued over the years. The exhibition presented the full collection of local banknotes issued by the Autonomous Province of Korça during 1917 and 1918, accompanied by photographic and graphic illustrations, which reflect the historical, economic and numismatic context of that period. In addition to banknotes, visitors had the opportunity to access several educational materials of the Bank of Albania, such as brochures, information panels, etc.

In the up-coming two years, in accordance with the medium-term development strategy, the Bank of Albania will continue to enrich the Museum with new numismatic objects, materials and new programmes regarding financial education, by better adapting them with the visitors' interest. In 2017, we plan to introduce a series of lectures at the Museum of the Bank of Albania, with renowned personalities from various fields, to present their lectures and views and stir the public's interest and add to the list of educational activities organised at the Museum of the Bank of Albania.