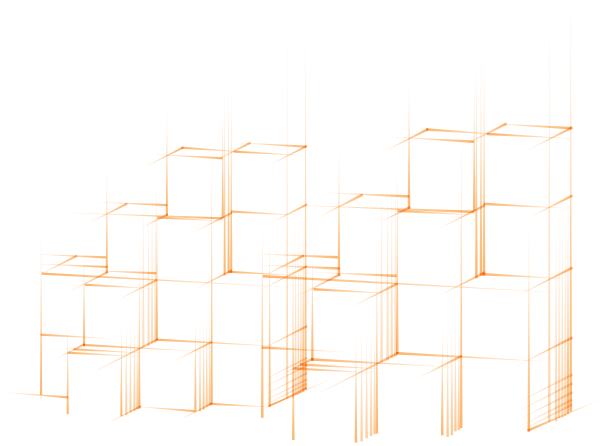




seesox
South East European Studies at Oxford



Aligning Monetary Policy with Financial Stability

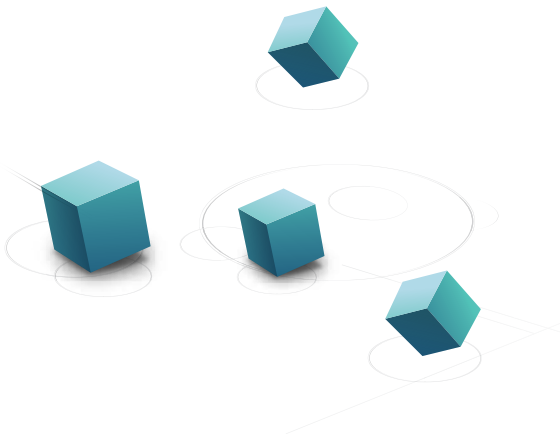
**Their Objectives, Responses and
Interaction in Times of Uncertainty**

Conference of the Bank of Albania
and the South East European
Studies at Oxford (SEESOX)
speeches & papers
Tirana, October 27, 2016

ISBN 978-9928-4453-3-9



9 789928 445339 >



Published by:

© *Bank of Albania*

Adress: Sheshi "Skënderbej", Nr.1, Tirana, Albania

Tel.: + 355 4 2419301/2/3; + 355 4 2419401/2/3

Fax: + 355 4 2419408

E-mail: public@bankofalbania.org

Reproduction is permitted provided that the source is acknowledged.

Printed in: 300 copies

Printed by: Botimet IDEA sh.p.k.

ISBN 978-9928-4453-3-9

CONTENTS

WELCOME AND OPENING ADDRESSES	7
WELCOME ADDRESS <i>Gent Sejko, Governor of the Bank of Albania</i>	9
OPENING ADDRESS <i>Edi Rama, Prime Minister</i>	17
WELCOME ADDRESS <i>Othon Anastasakis, Director, South East European Studies at Oxford, St Antony's College, University of Oxford</i>	23
FIRST SESSION:	
EUROPE'S POLITICAL ECONOMY AFTER BREXIT <i>Chair: Adam BENNETT, Deputy Director of Programme on Political Economy of Financial Markets (PEFM) & Associate of SEESOX, St Antony's College, University of Oxford</i>	25
EUROPE'S EXISTENTIAL CRISIS IN THE WAKE OF THE BREXIT REFERENDUM <i>Othon Anastasakis, Director, South East European Studies at Oxford, St Antony's College, University of Oxford</i>	27
WESTERN BALKANS IN POST-BREXIT EUROPE <i>Bas B. Bakker, Senior Regional Resident Representative, IMF Regional Office for Central and Eastern Europe</i>	35
WHAT DOES BREXIT REALLY MEAN? <i>Robin McConnachie, Associate of PEFM and Member of the International Advisory Board of Oxford Analytica</i>	47
THE LONG-TERM CHALLENGES OF THE BREXIT VOTE FOR EUROPE: A CENTRAL BANKER'S POINT OF VIEW <i>Valeria Rolli, Senior Economist International Relations Directorate, Bank of Italy</i>	57
BREXIT AND ALBANIA: AN ASSESSMENT OF POTENTIAL IMPLICATIONS <i>Erald Themeli, Head of Monetary Policy, Bank of Albania</i>	69

SECOND SESSION: MONETARY POLICY AND FINANCIAL STABILITY AND THEIR COORDINATION IN THE WAKE OF CURRENT DEVELOPMENTS	81
<i>Chair: Robin MCCONNACHIE, Associate of PEFM and Member of the International Advisory Board of Oxford Analytica</i>	
BREXIT: IMPLICATIONS FOR MONETARY MANAGEMENT IN SOUTH EAST EUROPE	83
<i>Charles Enoch, Director PEFM and Associate SEESOX, University of Oxford</i>	
MONETARY POLICY AND FINANCIAL STABILITY INTERACTION: CURRENT AND FUTURE CHALLENGES	97
<i>Gilles Noblet, Deputy Director General of International & European Relations, European Central Bank</i>	
STRENGTHENING MONETARY POLICY FRAMEWORKS	103
<i>Andrew Filardo, Head of Monetary Policy, Monetary Policy and Economic Department, Bank of International Settlements</i>	
ALBANIA MONETARY POLICY AND FISCAL STABILITY	111
<i>Anita Tuladbar, Mission Chief for Albania, International Monetary Fund</i>	
INTERACTION BETWEEN MONETARY POLICY AND FINANCIAL STABILITY: THE BANK OF ALBANIA APPROACH	119
<i>Klodion Shehu, Head of Financial Stability, Bank of Albania</i>	
GOVERNORS' PANEL: PROVIDING THE CENTRAL BANKS' POINT OF VIEW AND EXPERIENCE	127
<i>Chair: Charles ENOCH, PEFM and SEESOX, University of Oxford</i>	
<i>Panellists (in alphabetical order):</i>	
<i>Johannes BEERMANN, Member of the Executive Board, Deutsche Bundesbank</i>	
<i>Dimitar BOGOV, Governor, National Bank of the Republic of Macedonia</i>	
<i>Nikola FABRIS, Vice Governor, Central Bank of Montenegro</i>	
<i>Michael FAULEND, Vice Governor, Croatian National Bank</i>	
<i>Bedri HAMZA, Governor, Central Bank of the Republic of Kosovo</i>	
<i>John (Iannis) MOURMOURAS, Deputy Governor, Bank of Greece</i>	
<i>Gent SEJKO, Governor, Bank of Albania</i>	

EDITORS

(in alphabetical order)

Othon ANASTASAKIS

*Director of South East European Studies at Oxford
(SEESOX), St Antony's College, University of Oxford*

Adam BENNETT

*PEFM Deputy Director & Associate of SEESOX,
St Antony's College, University of Oxford*

Charles ENOCH

*PEFM Director and Associate of SEESOX,
St Antony's College, University of Oxford*

Gent SEJKO

Governor, Bank of Albania

WELCOME AND OPENING
ADDRESSES

WELCOME ADDRESS

*Gent Sejko**

*Your Excellency Prime Minister,
Your Excellencies Ambassadors,
Honourable Members of the Government,
Ladies and Gentlemen,
Dear Mr Anastasakis,
Dear guests,*

It's my great pleasure to welcome you to the Annual Conference of the Bank of Albania 2016. The conference is organised in cooperation with the European Studies Centre of St Antony's College, University of Oxford.

This year's conference will focus on two main topics that prevail in the analyses and debates among policymakers, academia and professionals circles:

- First, possible implications from the Brexit; and
- Second, determining the modalities for coordinating the monetary policy with the macroprudential policy and measures, in the new reality we are facing.

* *Gent Sejko, Governor of the Bank of Albania.*

Together with guests from European and regional central banks, international institutions and academia, we will be discussing about the current challenges, and appropriate policies and instruments central banks need to employ.

I am confident the proceedings of this Conference will produce more clarity for all participants, policy makers and private sector representatives alike.

Let me elaborate in greater details the perspective of the Bank of Albania on these two topics.

- Initially, I would like to present the backdrop of the current economic and financial situation.
- Next, I would like to share the Albanian and regional perspective on the possible implications from Brexit.
- Concluding, I would like to present an overview of challenges facing the two main central bank policies: the monetary policy and the macroprudential policy.

1. ALBANIA AND WESTERN BALKANS IN THE POST-CRISIS PERIOD

The last global crisis affected the economic, financial and social dimensions of the human activity. By size of shock, complexity of challenges and interdependence of transmission channels, the crisis was unprecedented, for decades. It started as turbulence in certain segments of the financial system to later transform into a fully-fledged crisis of the system; before long, it was transferred to the real sector. This shock caused immense loss in production and employment levels, reduced the welfare and put to test the stability of growth and development models in many countries.

Western Balkan countries were not at the eye of the cyclone of the global crisis. Yet, while at the periphery, the effects of the crisis became increasingly stronger on the region, as well. The decline in foreign demand, increased uncertainties, tightening of financing conditions and deleveraging in the region decelerated the economic activity and evidenced a series of structural problems.

I would rather not list all the channels and consequences of the global crisis, but I would like to say that withstanding the crisis required revising many conventional policies and practices.

First, central banks were obliged to explore untrodden paths. The intensity of the accommodative monetary policy was unimaginable a few years ago. Oftentimes, this policy relied on employing non-conventional instruments, which had not been tested before, but now have a legitimate claim to be enlisted in the arsenal of central banks.

Second, to guarantee the sustainable and long-term development of the economy, special attention was paid to the financial stability aspect, both at system and institutional level. In this regard, a series of supervisory and regulatory policies were adopted.

Third, interaction between fiscal soundness and economic and financial stability became necessary, thus conditioning the space for action and reaction by public finances.

Lastly, many development models - relying more on debt and consumption, rather than on investments and productivity - proved to be short lived. These models have required and still require the continuation of radical structural reforms to reconceptualise business models in many countries and guarantee sustainable and long-term growth.

While debates continue on the suitability and efficiency of the instruments used to withstand the crisis, it is unquestionable that - overall - these instruments managed to prevent the worst and gradually create premises for further growth of the global economy.

The situation described above is true for the Western Balkans as well. The stimulating economic policies, structural reforms and adjustment of internal and external imbalances have yielded their effects. The economies in the region seem to be set on the growth path, and are now based on a better understanding of the determining factors for the long-term development, and a more comprehensive framework of endorsing policies. The experience gained and the

lessons learnt are undoubtedly elements that will help us steer safely, as we navigate our way into the future.

As a typical Western Balkan country, Albania is in a similar development stage to its peers.

Our analyses and forecasts confirm that the Albanian economy is on a positive track. Economic growth is expected to improve progressively over the next three years. Such growth continues to be fuelled by the recovery of the domestic private demand.

The accommodative monetary policy of the Bank of Albania, the improved financing conditions and strengthening of private agents' confidence are considered as the main elements underlying the recovery. The gradual return of the economy to equilibrium will help improve economic indicators across the board, more specifically:

- increase in employment;
- return of inflation to target;
- reduction of public debt; and
- further strengthening of private sector balance sheets.

The acceleration of economic growth in Albania attests the private sector dynamism. This is an encouraging development given that the fiscal policy implemented over this period focused on showing prudence and rendering public finance healthy, while the macroprudential policy and measures of the Bank of Albania have sought to further strengthen financial stability. As a result of our measures, the Albanian banking sector is sound, with high degree of capitalisation and liquidity, and positive levels of profitability.

The conditions for lending in Albania have improved and are on the course of constantly improving. In the light of its mission, the banking sector should translate these positive premises in more lending:

- showing far-sighted decisions;
- assessing properly the development perspective of the Albanian reality; and
- utilising the potential from various sectors of the economy.

On the other hand, the phenomenon of non-performing loans - which reflects to a large extent the retroactive effect from the crisis shocks - is being addressed, although a lot remains to be done until its eventual solution.

Dear guests,

When we discuss about the development perspectives, as policy makers, we may not ignore the risks and challenges we face. Relations with our economic and financial partners in the euro area have been and continue to be a source of progress as well as an open channel of shocks.

As a region, we have generated and consumed crisis, but recently the balance has been notably on the consumption side.

Beyond economic and financial problems, the global crisis was also reflected in notable social problems. These problems have materialised in different forms in different countries, but the anti-globalisation movement is a common thread of tension in global economic developments. This movement has produced various results: in some places it has been reflected in increased protectionist barriers, in other places in isolationist policies, in others in repatriation of capital and refocusing of activity in home countries. The result of the 23 June referendum on the relationship between the UK and the European Union is one of them.

The anti-globalist movement and barriers to the free movement of goods, people and capital appear as harmful to the overall global economy. However, their negative effects fall disproportionately on emerging countries, such as Albania, and the Western Balkans in a broader sense.

Let me know outline our assessment on the potential negative implications resulting from Brexit and the relevant effects on the central banks in the region.

2. POTENTIAL IMPLICATIONS RESULTING FROM BREXIT FOR ALBANIA AND THE REGION

Brexit is certainly a determinant factor for the European Union and the euro area. As such, it has left its mark in Albania and the region. It may be accompanied by direct or indirect, short-term or long-term negative effects in the labour, goods and services markets.

Overall, the direct implications for Albania and the region are assessed as minor ones, given that trade exchange with the United Kingdom is low. To illustrate my point, the export of Albanian goods to the UK accounts for only 0.2% to the total over the past ten years, whereas the share of imports amounted to around 1.1%.

The stock of British foreign investments in Albania shows low rates, whereas the impact of emigration and remittances indicators is somewhat higher, but still a non-determinant factor.

On the other hand, indirect effects would depend on Brexit's impact on the European economy and banking system. Brexit may also translate into institutional developments that will affect the rules of European economic and financial market development, as well as European integration processes. In other words, implications for Albania and the region potentially exist, but still remain difficult to identify. I would rather not dwell very long on this topic; however, I do believe that today's discussions will help us understand these processes and assess in advance the potential political and economic implications and consequences for our countries.

I would like to stress that all of us in the Western Balkans remain hopeful that Brexit will not generate centrifugal forces, which harm our European integration processes, initiate setting barriers to free trade and movement of people, and encourage further fragmentation of the European financial system.

3. MONETARY POLICY AND FINANCIAL STABILITY IN THE POST-BREXIT PERIOD

The coordination of the monetary policy with the necessary measures for safeguarding financial stability remains a challenging issue for policy makers even in better days. The challenges to this coordination may only strengthen, if Brexit implications assume the negative dimensions listed above.

Let me emphasise that, in Bank of Albania's vision, the monetary policy oriented toward price stability, and the supervisory and regulatory policy oriented toward financial stability contribute to the sustainable and long-term development, and are complementary to each other. This creed is fully tested by experience, both in the world and in Albania.

In the long-term horizon, the Bank of Albania is confident that the investment we have made in promoting financial stability will bear its fruit with regard to sustainable development, and will increase the space for monetary policy manoeuvring. In addition, accomplishing our price stability objective would enhance the confidence in the national currency, reduce volatility and foster transparency in financial markets, thus contributing to the sustainable development of the financial system.

Meanwhile, in the short-term, the coordination of monetary policy and financial stability often present challenges and compromises. In this context, setting clear priorities, using the right instruments, and communicating transparently central bank actions and objectives are key elements for the success of our work.

Concluding, I would like to reiterate that I am fully confident that in the course of the day, all the issues I posed above will be elaborated in greater detail. I do believe that the contribution of the eminent panellists and active input from all participants will be an added value in this regard.

I wish the best of success and look forward with the greatest interest to the outcome of your deliberations.

Thank you for your attention!

OPENING ADDRESS

*Edi Rama**

We live in a troubled world, and undoubtedly from the financial point of view, amid economic cycles which continue to be unclear, fluctuating, and insecure, standing as a daily challenge to all policy-makers or market stakeholders. However, I believe that it could be strongly asserted that during these years, the Bank of Albania, has not only played a key role, but also enacted a completely affirmative approach to this challenge by guaranteeing full coordination with the policies of the Government. This response enabled the overcoming of a dramatic moment of crisis, when in reality, our economy and finances were threatened by collapse in 2013.

Overall, governments are assessed on what they do, but economists and financial experts provide a specialised assessment of governments on what they prevent from occurring. I believe this auditor is the right instance to highlight what we stopped from happening at the end of 2013, when we went through an unusual challenge and were threatened by the impossibility of paying wages and pensions at the end of that year.

In fact, the coordination of all forces and all stakeholders provided us with the possibility of entering into an ambitious and difficult

**Edi Rama, Prime Minister of Albania*

programme of fiscal consolidation, and facing an unusual debt level given the conditions in Albania.

I would like to recall here that in addition to official debt, we faced a large level of hidden debts or not officially included in the public debt of USD 720 million, in the form of arrears to third parties for services and works performed throughout the activities of the Government, from street infrastructure to services for education and health. This debt was situated in a context where the economy was growing between 0% and 1%, and was threatened by an asphyxiant stagnation for all its stakeholders.

As it stands now, the Albanian economy grew by 3.2% in the second quarter, and based on solid data on revenues, next year our economy may grow at rates as high as 4%. Although this figure says a lot, I believe that it is necessary to point to the fact that this figure is insufficient to successfully meet the needs of the society and of individuals. I am optimistic not for the positive projections, but for the fact that a set of projects prepared during this time in tourism, energy, infrastructure, etc., are close to finalisation and I believe they will have an additional impact on economic growth in the next five years. After three years of difficult operations, many years of delayed reforms and arduous measures, the public finances are consolidated. Overall, public debt is set on a downward path, while revenues are up.

I believe that nobody here will misunderstand if I proudly say that the revenues for this year are closer than ever to the projection of the beginning of the year. Meanwhile, thanks to this newly established situation, we have been able to raise wages and pensions to the total amount of USD 100 million, without having to increase public debt. On the contrary, we are reducing public debt by at least 1% during the next year.

I think that maintaining the primary budget at + 0.3% minimally is also rather indicative of the economy's soundness in the light of macroeconomic stability.

It has been a difficult period; in some aspects, it has been rather challenging, but at the same time I would like to emphasise some data that I believe speaks a lot for the progress made, as a comparison.

We have paid all hidden debts.

Now the Albanian Government owes no debt to third parties on contracted works and services.

We have set forth a solid red line not to create such new debts. We have entered into a process of reducing the public debt. At the same time we have contributed from the state budget to the household budget, by lowering personal income tax, not insignificantly, by USD 440 million in four years, which in addition to USD 100 million designated for the raise in wages and pensions, totals a contribution of USD 540 million. It is very simple to understand that these actions have had and continue to have a direct contribution to boosting consumption.

To make a comparison and place this figure in context, in the eight years of the previous government, only USD 124 million from the state budget was allocated to household budgets, while income tax was significantly higher, in particular for minimum and average wages, than the current rate.

Thanks to these actions - lowering the income tax and raising wages and pensions - we are no longer the country with the lowest average wage in the region; we are now the country with the lowest income tax rate in the region.

Nevertheless, the quality of the credit portfolio has been and remains a significant challenge. In 2015, it improved considerably. The level of non-performing loans fell by 4.6 percentage points compared to the end of the previous year; however, further reduction remains a common challenge for the Bank of Albania, the Albanian Government and other stakeholders. I believe that it must be noted that exports and stable growth were among the hot topics of discussion at last year's conference, in view of Albania's large exposure due to the fall of remittances and the increase of loan costs.

I think it is significant that one year on, the value of exports, excluding the sectors of minerals, energy and fuels, has increased by 8.5%, showing a diversification of exports, unlike in previous years. This diversification is and will remain the main focus of our work in the field of exports, as we focus on further diversification of the economy as a precondition to mitigate as much as possible our modest size, and the effects of the external crisis.

Finally, I would like to emphasise that relative to last year, in this conference special emphasis has been put on the indispensability of intensifying efforts to collaborate with other regional stakeholders. We are making difficult but stable progress. We have made further advancement over this year. In parallel with common projects in infrastructure or energy in the framework of the Berlin process, with the support of the World Bank networks in our region, crucial steps have been made towards regional collaboration, to facilitate trade and economic exchanges. We have undertaken joint actions to remove non-taxable barriers and unify procedures to facilitate trade and interaction among the entrepreneurs across all regional countries where boundaries are still a considerable obstacle in the form of bureaucracy and non-taxable barriers.

I would like to bring to your attention to a saying by Joseph Stiglitz, to meet the special request of the Governor, who wanted me to speak on Brexit. According to Stiglitz, Europe faces a decision: to reform or divorce. Undoubtedly, reforms to avoid divorce, or a chain reaction of divorces, would affect fiscal and monetary issues. Reforms would address the large-scale stagnancy facing all European Union member countries, and those aspiring to become part of the EU, regarding the Shakespearean-like dilemma of austerity versus growth. In this regard, central banks, undoubtedly, have a key role to play. I think that some experts will agree with me when I say that central banks have been at the core of European activity and creativity throughout this period. By implementing an unprecedented arsenal of unconventional monetary instruments, their reactions have helped to mitigate crisis effects and bolster economic growth. These instruments seem to be coming to an end, and their impact is becoming

limited over time due to the rather narrowed framework of the European marriage, for which Stiglitz refers to that solution that I cited above.

I thank you for your kindness in listening to my address and I hope that my address will be a contribution, albeit a minor one, to this Conference. I extend once more my gratitude and respect to the Governor and the Bank of Albania for their praiseworthy work, and I thank you for your attention.

WELCOME ADDRESS

*Othon Anastasakis**

*Prime Minister,
Governor,
thank you very much for hosting us here!*

It is a great honour and privilege to be the co-convenor of today's high-level Conference, which has become our established high profile annual event and is the flagship and culmination of our cooperation between SEESOX and the Bank of Albania.

I would like also to thank, on behalf of Oxford University, all the speakers that have come today to present their work and all those attending today's proceedings.

The aim of the conference is to engage with some very topical questions that have to do with political economy developments in Europe. It is also about monitoring what is happening in our environment in South East Europe, and how the region is affected by developments in Europe.

Our cooperation has so far produced an impressive output reflected in numerous panel discussions, annual conferences, brainstorming

** Othon Anastasakis, Director of South East European Studies at Oxford (SEESOX), St Antony's College, University of Oxford*

meetings, books, reports and other publications, including our most recent joint book from the proceedings of last year's conference in Tirana on "Do crisis change economic fundamentals in Southeast Europe?"

Albania is an important country and an integral part of our work at SEESOX and its study is strengthened by this partnership as well as the presence of Albanian students and scholars in Oxford. We have been privileged to host high profile speakers at SEESOX, like the Prime Minister of Albania or the Governor of the Bank of Albania, as well as others from the world of academia and policy making community.

In our view, Albania plays a key role in how the region of South East Europe progresses. In addition, its commitment and orientation towards the European Union, sends a clear message to the eurosceptic voices across Europe that the European Union still matters and can indeed make a difference in the lives of its citizens.

We certainly do "live in interesting times", as the Chinese proverb has it, full of challenges and uncertain prospects. Cooperation of our type, between one of the most respected central institutions in Albania and our University, does matter for the output and the ideas that it produces.

And I do believe that today's discussion is going to be a very fruitful debate.

Thank you very much for hosting us here and I wish us an exciting Conference!

FIRST SESSION:
EUROPE'S POLITICAL ECONOMY
AFTER BREXIT

What are the potential political and economic challenges and implications resulting from Brexit in the European integration process? Is Brexit an isolated phenomenon, or could the EU disintegrate further? What are the implications for the relationship between the EC and member states, and for the cohesion of the Eurozone? What does all this mean for the Balkans? How can Balkan economies co-ordinate better with more advanced EU economies to sustain growth and stability after Brexit?

*Chair: Adam BENNETT,
Deputy Director of Programme on Political Economy of
Financial Markets (PEFM) & Associate of SEESOX, St
Antony's College, University of Oxford*

EUROPE'S EXISTENTIAL CRISIS IN THE WAKE OF THE BREXIT REFERENDUM

*Othón Anastasakis**

Europe was shocked by the outcome of the Brexit referendum, a decision that had not been anticipated but which would have massive implications for the future of both Britain, as well as the EU. In the wake of the UK referendum, the President of the European Commission, Jean Claude Juncker, expressed his concerns over the EU's existential threats, linked to multiple challenges and exacerbated by the British referendum.

In the following presentation, I am discussing three themes:

- First, the immediate impact of the Brexit vote on Britain and the EU.
- Second, Britain as exceptional case in Europe.
- Third, Britain as a typical reflection of a wider EU pathology.

1. THE IMMEDIATE IMPACT ON BRITAIN AND THE EU

On the 23rd of June 2016, the British public voted for exit from the EU by a margin of four percentage points (51.89%-48.11%), in a turnout of over 72.21%. The outcome was a surprise not

* *Othón Anastasakis, Director, South East European Studies at Oxford, St Antony's College, University of Oxford*

just for those who voted to remain within the EU - the so-called “remainers” – but also those who wanted out – the so-called “Brexiters”.

The impact of this unexpected vote was immediately felt in the UK political environment within a day, when the Conservative Prime Minister, David Cameron, resigned, the leader of the Labour Party, Jeremy Corbyn, was challenged by the resignation of over 20 of his shadow ministers, and even Nigel Farage, the leader of UK Independence Party, which had been fanatically advocating for exit from the EU, announced that he was no longer needed and resigned too. On the economic front, the pound dropped sharply and economic uncertainty reigned supreme.

The government had a colossal administrative task ahead of it, that of initiating a process of return to the status quo ante, the period before 1973 when Britain became a member of the European Communities, and of changing a massive body of law that will give back to Britain national control over domestic legislation.

The Brexit vote triggered a new bitter division within the British political class over the question of whether there should be “soft” or a “hard” Brexit, the former meaning that Britain would continue to have access to the single market and the customs union, the latter that it would break with both and settle for a completely new trade regime with the EU, before negotiating bilateral trade agreements with third countries of the world.

The Brexit vote instigated a climate of uncertainty for the economic elites of the UK as well as foreign investors. While exports and tourism were expected to benefit from a weaker pound, FDIs, the property market, and the rise of inflation were expected to hurt in the short to medium term.

The outcome of the referendum reflected deep geographical divisions between metropolitan centres versus countryside, England versus Scotland, Northern Ireland versus the Republic of Ireland, as well as social divisions between economically privileged versus underprivileged, educated versus less educated,

young versus old. Because the issue of immigration was a determining factor in the anti-EU outcome of the referendum, this subsequently fuelled further divisions between the UK and EU nationals living in Britain, leading to unpleasant nationalism, populism and exclusionary social attitudes. The future of the 3.1 million EU citizens living in the UK was bound to become one of the most sensitive issues in the negotiations with the EU, and would be directly connected with the 1 million British citizens living in the EU.

As for Europe, Brexit came at a time when the EU was juggling with multiple crises and important challenges in the economic, migration and security domains.

Having been tormented during the past seven years by the worst economic crisis in its history, the EU economy was still struggling with income inequalities, high unemployment, unsustainable low growth rates and economic divisions between the northern and the southern economies. The migration crisis, which had reached a peak in 2015, had become one of the most divisive issues among EU member states, some of which were rushing to control their borders for fear of new migratory waves. In the near abroad, following Ukraine's conflict, the competition with Russia was worsening followed by military build-up in Eastern Europe and toxic Cold War language.

In such a volatile environment, the British referendum came as a blow to the EU, adding more worries as to what kind of impact Britain's exit would have for Europe's economy, foreign policy, security and military capability.

Britain's departure was bound to upset the EU at such a critical moment and would affect its internal market, by shrinking its size by 60 million people, its budget as a financial contributor and its military capabilities as one of the two largest military powers in Europe. As this was the first time that the EU would negotiate a member state contraction, the exit of a member state, it was in uncharted territory.

2. BRITAIN AS EXCEPTIONAL CASE IN EUROPE

When trying to explain why Brexit came about, the most obvious answer is that Britain had been historically a deviant case, an awkward EU partner, and a reluctant member state, which never fully committed to the European project and narrative.

To begin with, Britain was absent from the founding 6 countries in 1958, and when it later applied to join it was rebuffed twice by France on the grounds that it was too close to US interests. When it finally joined in the 1973, it did this in the midst of its own economic crisis at home and was not able to see the benefits from its European integration immediately. When Margaret Thatcher took over as Britain's Prime Minister in the 1980s, she fought for a British rebate, asking for the return of part of the UK financial contributions to the EC budget, on the grounds that it was paying far too much compared to what it was receiving, not benefiting as other countries did from EC agricultural funds. Although Margaret Thatcher was among the protagonists of the single market, which had been one of the main reasons why Britain wanted to join the EEC in the first place, she always resisted the idea of a federal Union, the expansion of majority voting in the EU decision making process, and the transfer of more powers to Brussels.

Britain always felt that Brussels was taking over its national sovereignty and decision making, and chose subsequently to opt out from various sub-projects such as the Social Charter, the Schengen area, the Eurozone. Of all the countries of the European Union, Britain was the one with the most opt-outs, being in the outermost circle of integration, more so than any other member state.

Yet, despite the opt outs, Britain's party system, and the Conservative Party in particular, was bitterly divided between europhiles and eurosceptics, a trend which culminated during David Cameron's premiership and led him to hold the referendum.

As it happened, the 2016 Brexit referendum was an acrimonious moment in British history. On the one side, a populist eurosceptic political class cultivated a climate of aversion towards the Brussels

bureaucracy and immigration coming from Europe; on the other side, a complacent pro-European political class led a campaign of post-Brexit gloom and economic disaster.

In sum, according to one view, Britain has always been an exceptional case in Europe, while Brexit was an unavoidable outcome for a reluctant and awkward partner, an incident waiting to happen.

3. BRITAIN AS A REFLECTION OF A WIDER EU PATHOLOGY

Contrary to the exceptionalist argument, the Brexit outcome can also be read as a reflection of a wider pathology of the EU system, and there are important messages for Europe that could be taken into consideration. The Brexit vote exposed some wider weakness well beyond the British national boundaries, which have been common with many other European societies.

To begin with, the alienation of the EU from its citizens and the rise of euroscepticism is not just a British phenomenon, but a broader reality which had been festering during the eurozone crisis, as shown by the declining citizens' trust towards the EU in almost all member states. Britain was not alone in mistrusting the EU institutions and complaining about Commission centralisation and EU directives. There were other countries, notably in the European south, which fiercely reacted to EU-led austerity. Traditionally pro-EU countries like Greece, Italy, Spain and Portugal witnessed a remarkable rise of euroscepticism. Similarly, in the east of the EU, all Central European political elites showed signs of euro-reaction and populist illiberalism, and a stern reaction to the EU freedom of movement and migratory (refugee) burden sharing. Even in the founding members of the EU, mainstream politics were challenged by the openly anti-European and racist discourses of extreme right political forces. Euroscepticism was therefore not just a feature of the British discourse but a wider European phenomenon shared by increasing parts of the European citizenry.

Seen from another perspective, the UK vote against the EU was also understood as a vote coming from the more disadvantaged people in

England or Wales. Yet, this is not an exclusively British phenomenon either. Inequality and unemployment were also rising across the EU and more and more people were complaining about the neoliberal economic dogmatism of fiscal austerity and tight budgets, or against big business interests and banking bailouts. The quest for social Europe resonated, especially in member states, which were experiencing the negative impact of Europe's dominant neoliberal economic policy.

In addition, the negative outcome of a referendum on Europe is not an exclusively British phenomenon either. The EU has a history of national referenda over EU issues, and lately most of them have led to outcomes which were a reaction to the EU in one way or another. Greece's referendum over the EU memoranda in 2015 reflected the aversion of the Greek people towards externally imposed austerity and the EU's harsh conditionality; the negative outcome of the 2015 referendum in the Netherlands over Ukraine's association agreement with the EU showed that the country was becoming more and more sceptical towards further EU enlargements; in Hungary, the 2016 migrant quota referendum was one more negative expression against the burden sharing of refugees; in Italy the rejection by referendum of a pro-European constitutional reform in 2016 led to the resignation of the centre-left Prime Minister Matteo Renzi, and gave a boost to the eurocritical voices within the country's political class. Internal politics in most countries of Europe showed that the EU was past the period of liberal consensus, and heading towards an era of divided societies and polarised politics.

Finally, the dominant issue of immigration was hardly a British phenomenon considering the rise of anti-immigration politics in most countries of the EU, from East to West. The rise of anti-immigration parties was a phenomenon across Europe, and the control of borders had become one of the most contentious matters, going against the principles of the four freedoms.

In sum, seen beyond British historical exceptionalism, the Brexit vote also reflected some of the structural problems in the contemporary EU.

CONCLUSION

Having said that, the EU approach to Brexit has been to view the referendum result as a specifically national phenomenon, an exceptional case which has to be addressed in its own right and as quickly as possible, as a bilateral issue between one member state wanting to leave, and the EU as a united front of 27 member states. The future holds a major dilemma on either side:

For Britain, it is what kind of Brexit; a fight between the supporters of hard versus the supporters of soft Brexit.

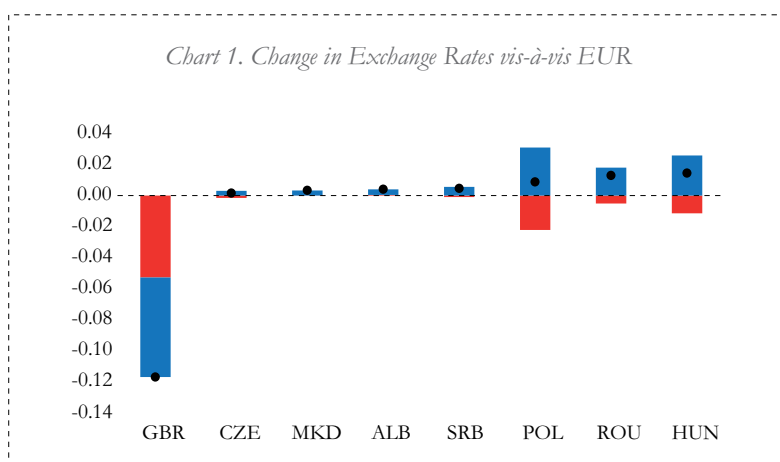
For the EU, it is what kind of Europe; a fight between those who advocate more federal integration, versus those who advocate more focused integration and more inter-governmentalism.

WESTERN BALKANS IN POST-BREXIT EUROPE

*Bas B. Bakker**

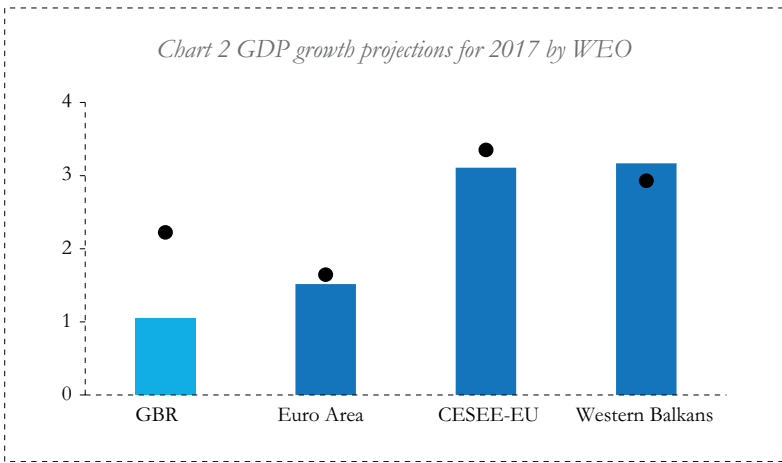
Today I will talk about the Western Balkans in Post-Brexit Europe.

When I went to bed on June 23 at 11.30, I had just seen the exit polls that suggested that the UK had voted to remain in the EU. When I woke up next morning at 6.30, I read that the UK had voted to leave. It was a 9% decline overnight.

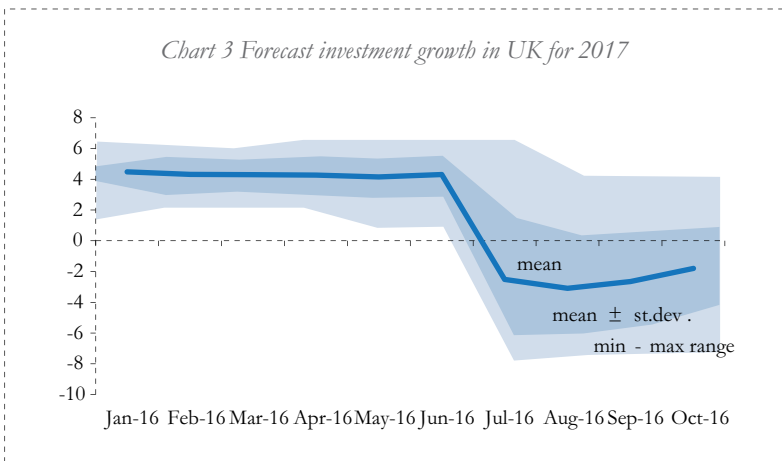


* *Bas B. Bakker, Senior Regional Resident Representative, IMF Regional Office for Central and Eastern Europe*

Fortunately, much of the financial market impact of Brexit was short lived. Chart 1 shows the exchange rates changed vis-a-vis the euro, both on June 24 and after June 24. The dot is the cumulative change. What you can see is that for most countries the change is fairly minor, with a notable exception of the British pound, which is still far below the level it was before the referendum.

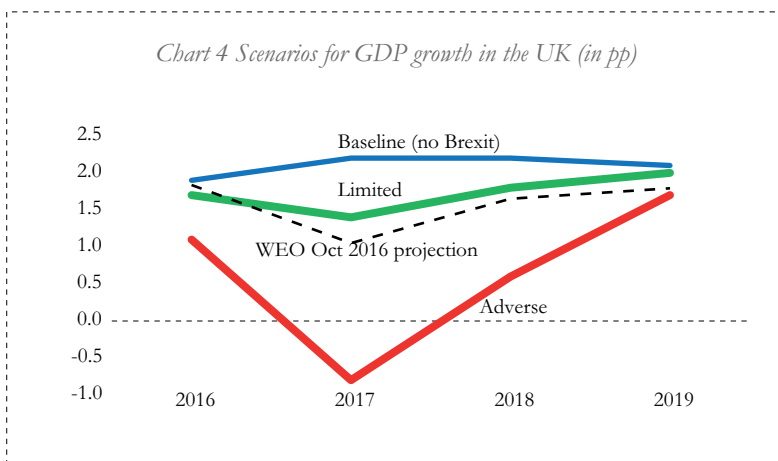


The near-term economic fallout so far has also been less than initially feared. In chart 2, the dots represent the April WEO forecast for growth in 2017; and the bars show the October forecast. With the exception again of Great Britain, there is not much difference, and for the Western Balkans growth has actually been revised up.



Uncertainty about future relationships with the EU may lead to a postponement of investments. That does not mean, of course, that all is fine. In particular, the longer-term impact on Great Britain remains uncertain.

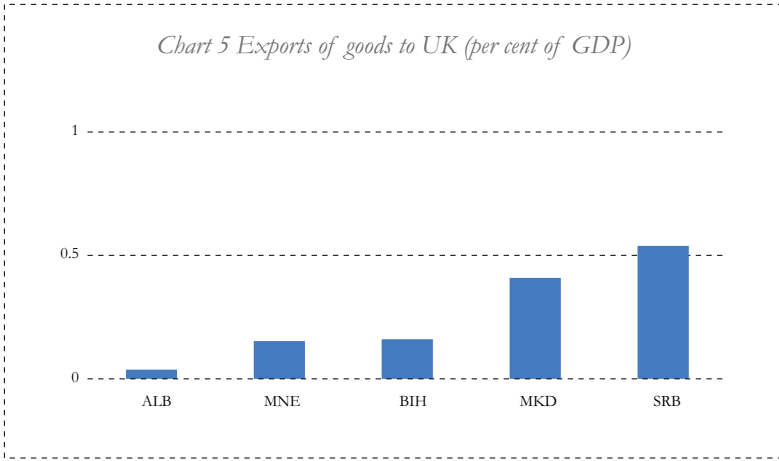
This chart represents the consensus forecast for investments in Britain in 2017, which are published monthly. The investment forecasts were fairly constant in June, and after that month they plunged; however, they did not just plunge, the range of estimates then increased sharply. So, there is a lot of uncertainty: What is going to happen to investments in Britain? How will they be affected by uncertainty?



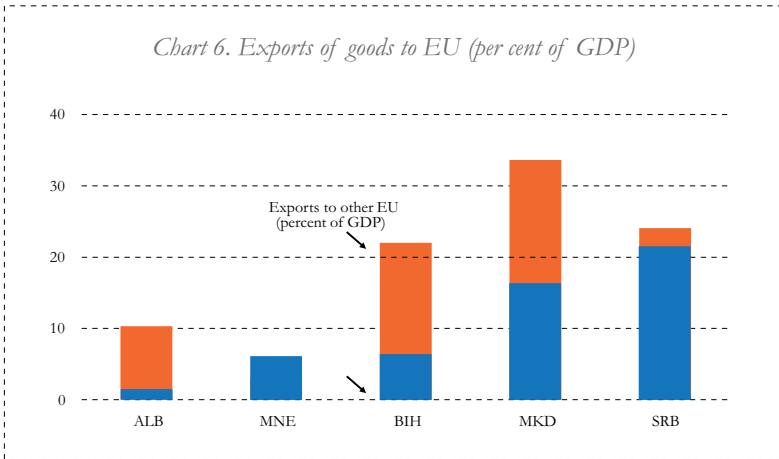
A related question is: How hard will Brexit be, and what will happen with the economy if there is a hard Brexit? The chart shows three scenarios from the IMF staff report for Great Britain that came out before Brexit.

1. The adverse scenario with a hard Brexit - the red line
2. The baseline scenario with no Brexit - the blue line at the top; and
3. In-between scenario - a Brexit but with limited uncertainty.

Our current projections are close to the limited uncertainty scenario. But there is the risk of course that a more adverse scenario will develop.

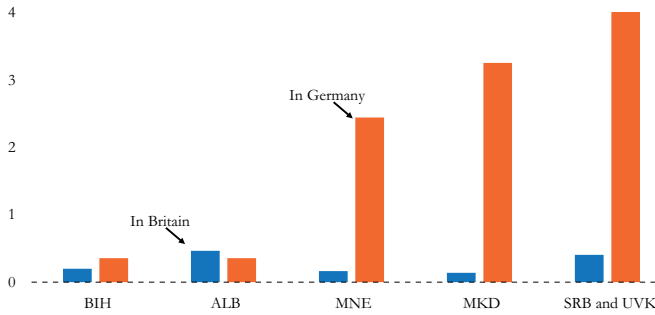


So, what will be the impact on South East Europe? Direct economic and financial links with Britain are not very strong. Chart 5 shows exports to Great Britain of goods as a percentage of GDP. They are typically 0-0.5. So, not very high.



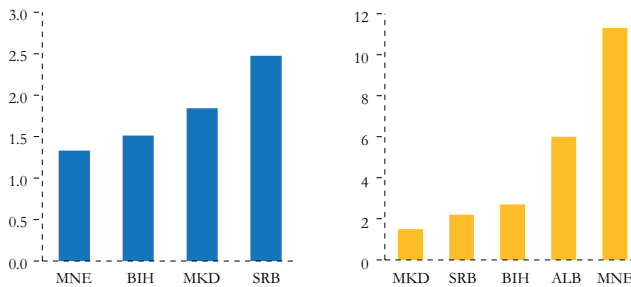
The indirect trade links may be larger. Western Europe exports a lot to Britain. If Western Europe is hit by recession in Britain, then South East Europe may be hit, because it may export less to Western Europe. Chart 6 shows that exports to the rest of the EU are more sizable than those to the UK.

*Chart 7 Residents of Britain and Germany born in Western Balkans
(per cent of population in countries of origin, latest census)*



In terms of emigration, the UK is not the main destination for South East Europe. Chart 7 shows individuals from the Western Balkans living in Britain as a percentage of the population of Western Balkan countries. The blue bar represents Britain. We can see that it is typically very small, below 0.5 per cent. Germany, represented by the red bar, is much more significant.

*Chart 8 Share of UK residents in total foreign visitors in 2015.
Overnight stays, per cent (left), and contribution to GDP In 2015, per cent (right)*



In terms of tourism, the impact of Brexit is also unlikely to be substantial. The share of UK residents in tourism in the Western Balkans is below 3%. Tourism for most countries is not of great importance. If you look at Montenegro, the share of tourism in GDP is about 11%. And we see share of British tourism less than 1.5%. If all tourism from Britain disappeared, the impact on GDP would be 0.1%. Therefore, the economic impact of Brexit on the Western Balkans may not be that big. What would be more important is the impact that Brexit may have on the EU.

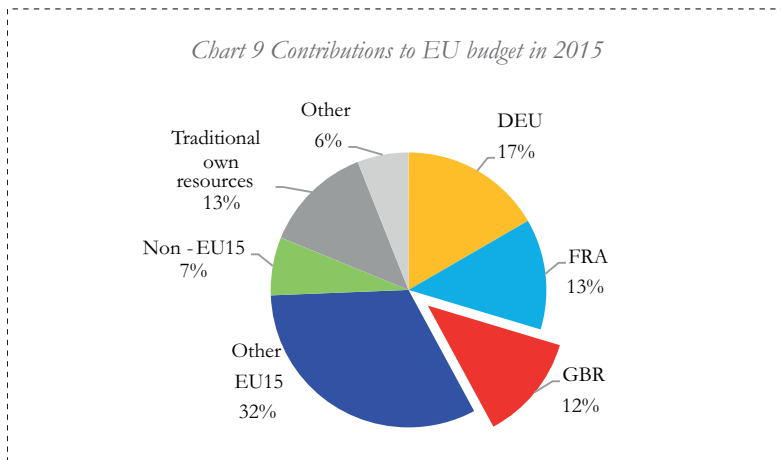
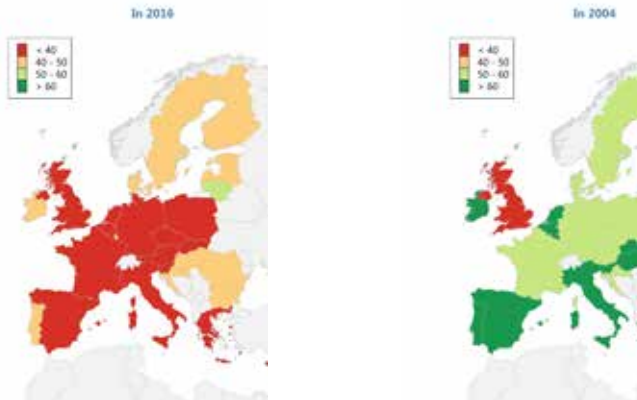


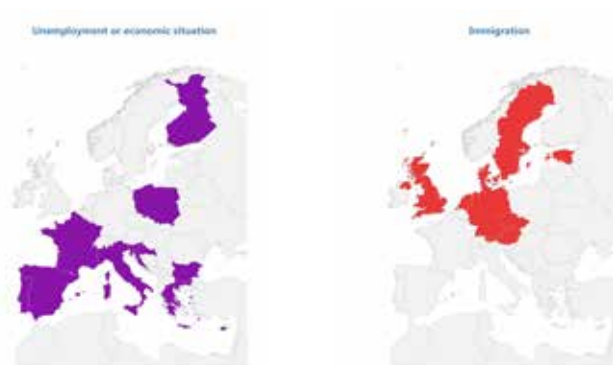
Chart 9 demonstrates that Britain pays a sizable portion to the EU budget. There may not be much appetite from other countries to pick up the tap. This may have a significant impact on the future of the EU. As charts 10-13 demonstrate, the confidence of EU citizens in the EU has fallen sharply in the past decade. The appetite for further integration has dropped. The question is whether this has also impacted the appetite for further expansion. If this is the case, and EU prospects for South East Europe were to diminish, what would be the impact on reforms and on future growth in the region? Let's discuss these issues in further detail.

*Chart 10. Level of confidence in the European Union
(percent of population as surveyed by Eurobarometer)*



In the past decade, there has been a sharp decline in confidence in the EU. Chart 10 shows confidence in the EU in the various countries. This poll is conducted frequently by the EU. The left chart shows the confidence level in 2004, and the right one in 2016. Confidence levels above 50 are green, whereas levels below 40 are in red, and between 40 and 50 is marked in orange. In 2004, confidence was below 50% only in Great Britain and Latvia. By 2016, it was above 50% only in Lithuania, and in most other countries it was below 40%, the level in Great Britain a decade before. Why has confidence in the EU fallen?

*Chart 11. Most important issues facing EU countries in 2016
(according to Eurobarometer)*



Confidence has most likely fallen because Europe has been hit by several crises: the global financial crises in 2008 and 2009; the sovereign debt crisis a few years later; and most recently large scale immigration and refugee flows. Chart 11 demonstrates the issues of greatest concern. In the North, immigration is the most pressing concern, as shown on the left. In the South, the economic situation is of the most pressing concern.

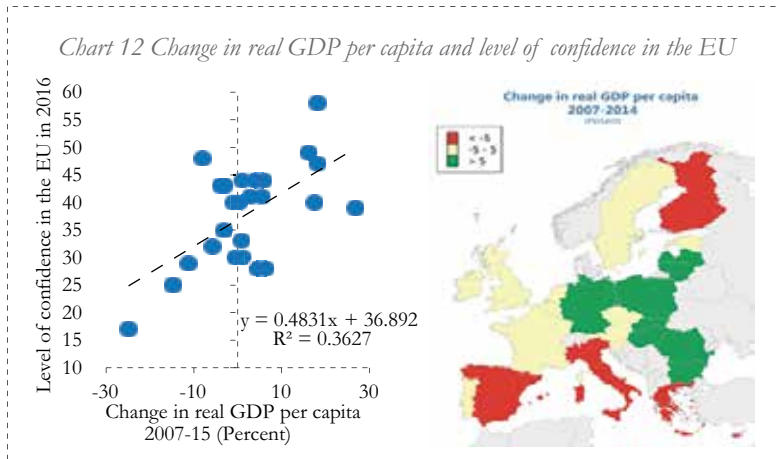
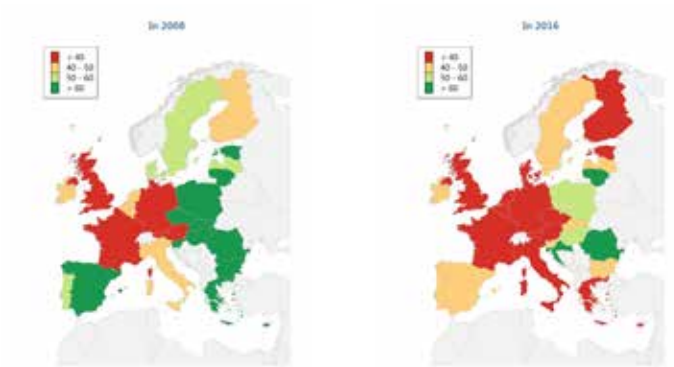


Chart 12 shows that there is a clear link between how economies have performed since the crises and the level of confidence in the EU. The chart on the right shows the change in the real GDP per capita since 2007. You see that Eastern Europe has performed well, but Southern Europe (Spain, Italy and Greece) have fared poorly, and Western Europe sits somewhere in between. Not great, but not as bad as Southern Europe. The chart on the left shows that there is a clear link between the change in the real GDP per capita and the level of confidence in the EU. The more GDP has declined, the lower the current level of confidence in the EU. In this environment, political support for further integration has fallen. The results: there are increased political uncertainties; there is less support for free trade than in the past; and there are more calls for protectionism.

*Chart 13. Support for EU enlargement
(Per cent of population surveyed by Eurobarometer)*

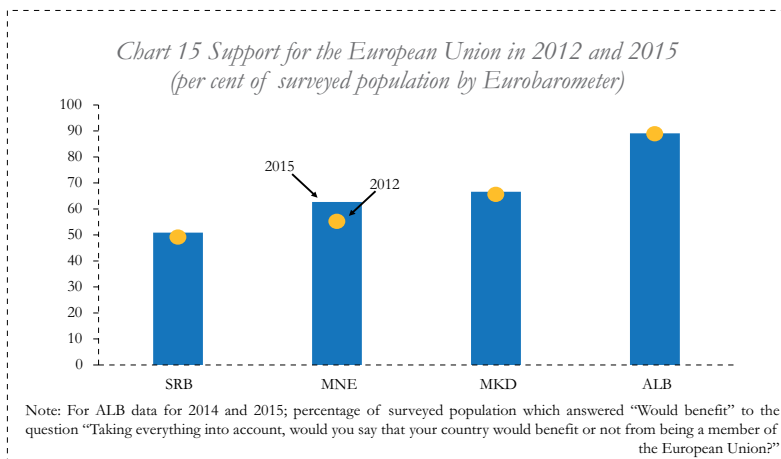


Support for EU enlargement has also fallen. Chart 13 shows support in various countries for further enlargement. The chart on the left represents 2008, and on the right 2016. There has been a clear drop over time in support for further expansion. Interestingly, this has occurred not only in Western Europe, but also in the new member states. The question is: How will this affect further expansion of the EU to the Western Balkans?

Chart 14. EU member states by year of accession



Chart 14 shows the various expansion waves of the EU. The Western Balkans remains the only part of Europe, outside the Former Soviet Union, that is not yet a part of the EU.



Contrary to the rest of Europe, enthusiasm in South East Europe for the EU remains very high. Chart 15 shows the support for the EU in both 2012 and 2015. There has not been much change; in some cases it has even increased. Particularly striking is the very high level of support in Albania, over 90%. Albania is clearly the most pro EU-country in Europe.

If further EU expansion stopped, what would be the impact?

Well, the EU has been very important for the former European transition countries as an export market, a source of technology, a source of private capital, and also as source of EU funds. Chart 16 shows the annual net flows from the European Commission to countries in Eastern Europe. This has been very sizable, particularly for the member states. But it is not just as a source of financial support that the EU has been important.

*Chart 16 Average annual net flows from the European Commission
(per cent of GDP, 2010-2015)*

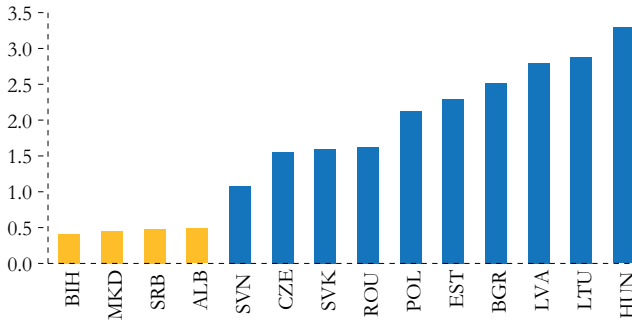
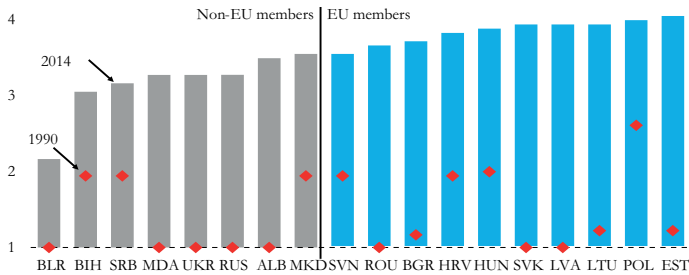
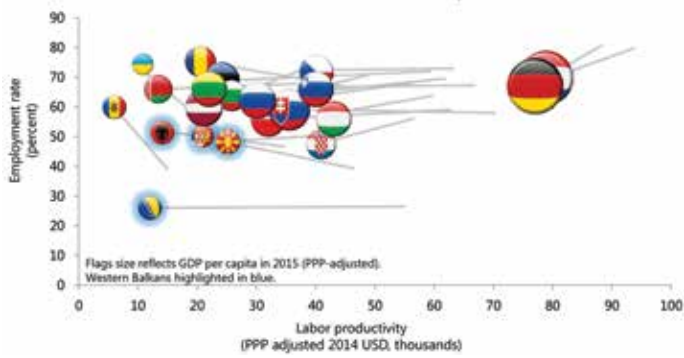


Chart 17 Average of Six EBRD Transition Indicators



Prospective EU membership has also been a key trigger for reforms. Chart 17 represents the EBRD transition indicators, which indicate how far a country has progressed from a communist economy to a market economy. The higher the score, the more progress has been made. The red scores show scores in 1990. Here there is not much difference between EU members and non-EU members. The bars represent the main three scores in 2014. Here there is a very clear distinction. All EU member countries have much higher scores than non-EU members. So the EU really is important in reforming the economy.

Chart 18. Labour utilisation and productivity



Finally, South East Europe is still relatively poor. Progress has been made. Chart 18 shows labour productivity and employment in 2015. The size of the bubble shows GDP per capita. Countries have become richer as labour productivity in particular has increased, but employment rates have often not increased. However, there is still a long way to go. Labour productivity is still much lower in South East Europe than in Western Europe. The circles highlighted in blue represent the Western Balkans. South East Europe is still relatively poor, and will benefit greatly from a strong EU and EU membership.

WHAT DOES BREXIT REALLY MEAN?

*Robin McConnachie**

I am very pleased to be back in Albania after a lapse of too many years. I used to work at the Bank of England and after the collapse of the Berlin Wall I came as the very first person to resume international contacts in the financial sector. From there developed a very happy cooperation, with seminars and technical advice in Tirana and London, not just for the Bank of Albania, but also for the Ministry of Finance, the Albanian Stock Exchange, and so on. That close cooperation with the Bank of England continues to this day. I have already seen signs of progress as a result, and I hope that despite the British exit from the EU this contact will develop even further.

As most of my first slide has been covered by various speakers, I will run through it briefly because I know you want to hear in more detail about some of the economic consequences of Brexit.

What has been said already, but I will say again, is that the Article 50 negotiation process has not started yet. It will not start until March 2017. The European authorities have said that they are not willing to discuss anything - this is their public position - unless and until Britain applies to exit. The process will certainly be long and difficult, and it will certainly last longer than two years.

* *Robin McConnachie, Associate of PEFM and Member of the International Advisory Board of Oxford Analytica*

Brexit: whither now?

- **Article 50 negotiation process**
 - Will this be triggered in March 2017?
 - Two year timetable
- **Phoney War**
 - Initial market overreaction
 - Economy still doing well
 - Stock Market buoyant
- **Worries on the horizon**
 - Exchange rate very weak
 - Inflation set to rise
 - Growth forecast to slow in 2017
 - labour and skill shortages if EU immigration restricted

Bas Bakker talked about the initial market reaction, which was overdone, but that is what markets tend to do: they tend to oscillate and only later settle down at a level. The initial reaction was “Oh dear, this is a disaster! It will have significant economic effects.” However since then the British economy has not declined. There will in due course be net adverse effects from the exchange rate, despite the recent optimism of the Governor of the Bank of England. The worry is not about what happens now, but in 2017 and beyond. The UK equity market index has continued to increase, it is now over 7,000. However this is not difficult to explain because the fall in the value of the pound, 18% at its maximum, has meant that the immediate effect has been to benefit UK exporting companies considerably.

However, as the UK imports more than 50% of its food, prices of raw materials will increase. Therefore the adverse effects on imports from a low exchange rate of the pound will begin to feed through, leaving the Governor of the Bank of England to express worries about inflation. Currently “only 1%”, I quote, but destined to rise. This is all relatively benign, though it reminds me of the phrase in 1940 about “the phoney war”. Two things are worrying: one is that

surveys by respected opinion-takers indicate that the real worries are about investment intentions, and not just for 2017 – I will come back to that with a particular example – but the other worry, which has not been mentioned so far, is that Britain relies very heavily on, and welcomes, foreign workers. Not just skilled workers, but unskilled workers as well. So there will be skill shortages and not just at the higher end. The National Health Service depends not only on foreign workers, EU but also non-EU staff. Also, if there is a construction boom, which seems to be the current UK government's sole economic policy, from where are we going to get the people to implement these massive public-sector investment schemes?

What about some more specific examples? Well, the big thing for the UK - but I will not talk about it first - is the invisible earnings from all forms of financial services, sometimes called the City of London, which depending on how you define them, account for 25 to 30% of our GDP.

Brexit: Risks to the UK

- UK car industry could suffer from tariff wars : e.g., BMW in Oxford
- CITY of LONDON big potential loser : up to 30% of UK GDP
- French and German ambition to recover business from the UK, e.g., euro clearing from London
- London still an HQ for international companies?
- UK still has advantages AND could offer favourable regime e.g., a predatory 10% corporation tax rate

The particular example I want to start with is a trading one regarding the UK car industry, because this is a very direct illustration of the problems there will be in negotiating our exit from an inclusive tariff

community, which has benefited us hugely. You only have to see the difficulties that have already arisen in relation to the EU Trade Agreement with Canada.

In the town we come from, Oxford, there is a big and successful car assembly plant owned by BMW, which makes Minis that are exported from the UK all over the world. . Now, if in the future BMW (UK) is going to face a tariff of let's say 10%, what is BMW going to do when a proposal comes to the main Board to expand operations, which could be in the UK, but which could equally be in several countries in Europe? It is going to require quite a brave Board Member to say "I am confident that because of the importance of the German car industry to Germany overall – remaining as it will the central part of the EU - I am confident that we should expand in the UK even though all our exports from there will face a 10% tariff wall."

Now, it may be that an independent Scotland, which I will come to, would offer BMW an incentive to offset the tariff barrier, but this is highly speculative, and at a conference in Oxford I recently had a long discussion with the main policy advisor to another big German competitor, without a UK subsidiary, which of course is following this debate closely. This is only one example, but cars are an important area for the UK. There are other plants, e.g. Honda has a big operation in Swindon, and is selling cars out of the UK to other parts of Europe.

The big danger, of course, as shown in the second example in the slide above, is to the City of London. It is no secret that some countries, our former partners in the EU, have long had ambitions to repatriate all types of financial services, in particular transactions denominated in euros. Despite Britain being in the EU, their individual national interests have produced several attempts to require all euro denominated transactions to be cleared through a clearing house, or federation of clearing houses, physically situated in the Eurozone.

Now in another life I worked as the senior UK adviser to the Bank of England on financial markets, and I can tell you that there is no technological reason whatsoever why that should be necessary. It is

simply an attempt to snatch business out of London and locate it in, hopefully, Paris or Frankfurt. After Brexit, this predatory attitude of former partners will remain a threat to the City of London. Of course there are other countries who could take advantage of this situation, the US for example, which has a very sophisticated clearing system, or emerging financial market players in South East Asia. So, it is not just an argument within the EU, and as result the UK could lose business, not necessarily to the benefit of the remaining EU.

All this is speculative. My own view tends towards a cautious optimism that the City of London will largely retain its present position, but it will be a hard fight against vested interests masquerading as EU policy.

The last example in the slide concerns the extent to which the UK has been, and in my view, will continue to be, a headquarters for international companies, particularly in the financial sector. There are many advantages: there is the language, English, there is the convenience of the time zone, there is a significant availability of skilled labour, rather than having to bring it in, and there are many locational and cultural advantages. Most of these will remain. Some advantages may weaken, because of tariff barriers, but I suspect the UK government will back off from a hard-line stance on restricting work permits for EU citizens. There may be new modest restrictions on the conditions under which foreign workers come to and remain to the UK, and this gets down to quite technical detail, if you talk to the human resources director of any reasonably sized company. There is a lot of bureaucracy associated with existing EU rules on this, some of which would be reduced if the UK were to be independent. That again, is a battle to be fought and won.

Recently, the EU has tried to tackle what it calls “international tax avoidance”, by attacking under anti-competition rules the special taxation deal that Ireland reached with big companies, such as Apple and Google - there is a long list - in order to attract inward investment. If Britain leaves the EU we would no longer be bound by these rules and if we wished we could attract companies by reducing the rate of corporation taxes, much along the Irish lines. The argument that this is effectively a state subsidy and therefore conflicts with the rules of

competition in the EU would disappear because we would no longer be subject to these rules. We could do what we like, as we would be no longer a member of the EU, but all of this is to play for and here too I am afraid the outcome is uncertain.

Jumping ahead to my conclusion, a compromise will have to be reached. After the sabre rattling is over there will be a series of concessions on both sides, plus bargains on a whole raft of important details. But markets hate uncertainty and it is precisely because the current outcome is so uncertain, and even preliminary discussions are not taking place, that companies are having trouble and holding back on investment.

I will push on now to a brief word on the banking sector, which is so important in the UK.

Brexit – debt, finance and banking

- UK banks sounder than European banks including France, Germany and Italy
- Euro woes and bail-out arguments will continue for Eurozone with consequences for public debt – a growing problem for ALL countries
- Single passport bank regime and home/host supervision under threat
- ECB regime will increasingly be in conflict with US/UK policy stance

The UK has learned serious lessons from the banking crisis and has reformed its banks, at some cost to them, much more extensively than banks in France, Germany – see the recent troubles of Deutsche Bank - and Italy - we all know about several of the Italian banks. So overall, I would expect the UK banking system to continue to thrive

in Europe despite the obstacles that will be put in its way. However, one particular problem is that the EU has threatened to withdraw what is called the “single passport arrangements” under which a bank headquartered in one European country can be supervised by that country and the ECB overall, but has a passport to do business in any country in the EU without having to negotiate and get type approval for each individual line of business with the national authorities in every country where it does business. That position is under threat and the negotiations will pose a significant problem, but since UK banks are stronger in capital and better regulated now than most European banks, again I am relatively optimistic that logic and economic efficiency will in the end prevail over national self-interest.

Brexit: the Scottish Question

- Scot Nat independence movement could be unstoppable
- Scottish economy is relatively poor and this will get worse - borrowing premium of 150bp
- Scotland wants to stay in EU for the subsidies
- Scotland currently supported (bribed) by rest of UK on Barnett formula. How safe is this?

Now, I have a slide on Scotland, the details of which I am going to pass over. I mention it because we have a dichotomy, a *décalage* in French, between the Scottish position and the UK position. Scotland has rejected - for the moment - independence. So, it wants to stay part of the United Kingdom and of Europe along with Wales and Northern Ireland, but the UK as a whole has voted to get out of the bigger Union, the European Union. The situation in Scotland is not unique; we all know about Catalonia, there is a significant danger

there. If a newly independent Scotland were successful in remaining a member of the EU, and therefore getting a subsidy not only from the rest of the UK (as a result of the Barnett formula), but also access to European funds through membership of, or an association with, the remaining EU countries, then for sure this would encourage other countries to follow suit.

I have covered some of the European reactions here. One thing not to underestimate – and we have seen it already - is that there is prestige, pride, and even arrogance involved. We are the first country that has dared to question how many clothes the European Emperor currently has, thus “Your wonderful Project Euro is good in theory, but it has such significant adverse consequences for individual Members of the Union, that this has led us in the end to vote no.”

Like Othon, I think that others will try to follow and that is why the central European bureaucracy and France and Germany combined, who basically started this huge experiment, which has had enormous success, will take a hard line at least initially. The public stance of the EU will be, as they say, for a “hard Brexit”. But I would expect that after some flaming rows the hardliners will be replaced and years of detailed pragmatic discussion will follow. It is in the overall

Brexit: European reactions

- Negotiations will be tough, even vindictive, to discourage other potential leavers
- Offended pride/prestige - someone has dared to question the flagship Europroject
- French/German axis - worried about break up of euro and even of EU
 - Will be medium term adverse consequences for UK of Brexit
 - But ultimately a sensible balance will (have to be) be reached by both sides in negotiations
 - Recovery of British entrepreneurial spirit and export success

economic interest of many European economies that they retain a trading partnership with the UK on commercial lines.

Summing up briefly, there will, in my view, be medium term adverse consequences in the UK from Brexit. But in the end, there will be a messy compromise, though the legal cases will run on for several years. Unfortunately, therefore, the outcome for the EU and, ultimately, for Albania cannot at the moment be predicted, but I do think, on the whole, that we should be optimistic. As far as Britain is concerned we might even see a revival of the entrepreneurial spirit that animated our people in the XIX century, and indeed my own ancestors, to go out and do business abroad. I see Albania as a small but essential part of that future alliance.

THE LONG TERM CHALLENGES OF THE BREXIT VOTE FOR EUROPE: A CENTRAL BANKER'S POINT OF VIEW

*Valeria Rolli**

OUTLINE AND CONCLUSIONS

The UK referendum decision marks the beginning of a complex and unchartered process with an uncertain long-term outcome, which would affect the dense web of interrelationships between the UK and the EU.

Recent developments in the UK economy have been quite reassuring so far, and financial markets have calmed down. However, we should not be too complacent: a number of (neutral) policy makers, international and private analysts, in the UK and elsewhere, have warned that the medium-term costs from Brexit could be far from negligible.¹

This would be so in the case of a messy process with a “hard Brexit” outcome, which seems the most likely scenario right now. For instance, if you consider the financial sector and take into account the joint regulatory framework in Europe, British providers of financial services would be seriously penalized as they could lose the right of full access to the Single market.

* Valeria Rolli, Senior Economist International Relations Directorate, Bank of Italy.

¹ According to some authoritative viewers, Brexit would be economically manageable for the UK. See Daniel Gros, Director of the Brussels-based Center for European Policy Studies, contribution: “The Not-So-High Costs of Brexit”, posted on Project Syndicate, September 8, 2016.

Prolonged policy uncertainty linked to Brexit represents a significant negative risk not only for the UK and the euro area, but possibly also for the global economy. In the medium-term, negative risks for the eurozone economic outlook could come from the spread of unfavorable market expectations.

Moreover, the political situation in Europe does not look favorable, due to the rising influence of populist parties and the possible spread of national inward-looking policy stances. As the main challenges for Europe are nowadays of global nature (think of those in the realm of migration, security and defense) we argue however that the best solutions are to be found with more, not with less, joint European action.

In the economic and financial realm, this means creating a common fiscal backstop, and completing the Banking Union and the capital market Union. In particular, by enhancing the role of risk-sharing mechanisms within Europe, this would provide European policy makers with more effective policy tools to prevent the risk of fragmentation of markets along national lines in times of financial and economic stress.

RECENT ECONOMIC AND FINANCIAL DEVELOPMENTS

UK real developments. A well-known UK Treasury paper (released before the referendum by the previous government) foresaw dire consequences from Brexit for the UK economy.² Even if these effects may not materialize, still the extraordinary measures adopted by the Bank of England's Monetary Policy Committee (MPC) last August signal that there are serious economic concerns.³

² See HM Government, "HM Treasury analysis: the long-term economic impact of EU membership and the alternatives", April 2016.

³ On 3 August, the MPC voted to introduce a package of measures to support the economy: (i) a 25 basis point cut in Bank Rate to 0.25%; (ii) a Term Funding Scheme to reinforce the pass-through of the cut in Bank Rate, financed by the issuance of central bank reserves; (iii) purchases of a stock of sterling non-financial investment-grade corporate bonds, financed by the issuance of central bank reserves, up to £10 billion; (iv) an increase in the stock of purchased UK government bonds, financed by the issuance of central bank reserves, by £60 billion, to £435 billion. On 15 September the MPC kept monetary policy unchanged. Next meeting will be in November. In mid October, Bank of England Deputy Governor Ben Broadbent said that Sterling's fall after the Brexit vote has acted as an important "shock absorber" for the economy and that it was "likely" that inflation would overshoot the BoE's target on the back of the weaker currency

In recent months economic activity in the UK has held better than expected - prompting the BoE in September to revise upwards its Q3 GDP growth projections.⁴

However, post referendum growth forecasts for UK have been revised down significantly, particularly for 2017.⁵ Moreover, we have to take into account that some “shock mitigating” factors may have supported the economy only temporarily – such as the anticipation of looser monetary policy, the pound depreciation and the announcement of a likely reset of the fiscal policy stance.⁶ Finally, policy and macroeconomic uncertainty in the UK remains high (though partially retrenched from its early summer spike).⁷

Financial market developments. The outcome of the Brexit referendum was largely unexpected by financial market participants and triggered turbulences across all asset classes. More than three months later those tensions have faded away but two developments persist: (i) the exchange rate of the British pound versus the euro and the US dollar (which keeps hovering around 15-20 per cent below pre-referendum levels); and (ii) the euro-area banking sector, which is again 9 per cent below pre-Brexit levels.

The fall in the international value of sterling may partly reflect fundamental factors, helping the UK economy to adjust to a structural shock which may include a slow-down in domestic demand (due to postponement of investment plans) and external terms of trade deterioration (due to a reduction in the access to European markets).

⁴ For quarterly annualized growth in 2016Q3 to 1.2% (from 0.4 in August). But this rate is still half of 2016Q2 growth.

⁵ In the confidential draft of the *World Economic Outlook*, the IMF has revised down the GDP growth in the UK by 0.1 percentage points in 2016 (to 1.8%) and 1 point in 2017 (to 1.1%), while in the *September Interim Economic Outlook* the OECD revised GDP growth upwards in 2016 (by 0.1 percentage points to 1.8%) and downwards in 2017 (by 1 point to 1%). Forecasts for 2017 provided by private analysts are more pessimistic than those of international organizations: the analysts surveyed by *Consensus* in September lowered expected growth in 2017 by 1.4 percentage points, to 0.7%; also the main international banks revised their forecasts downwards by 1.4 points, to 0.8% (median value; Table 1).

⁶ While an Emergency Budget has been ruled out, the Chancellor announced an overall reassessment of fiscal policy.

⁷ As it is shown for instance by the Goldman Sachs composite uncertainty index for UK.

The fall in European banking valuations may reflect the relatively high direct and indirect exposures of this sector towards Brexit (taking into account the large international banking presence in London, the natural exposition to regulatory and institutional developments in Europe, and the present juncture, characterized by weak profitability and fragile balance sheets on the European banking systems which make them relatively exposed to an economic slowdown in UK and the euro area).

QUESTION MARKS ABOUT THE BREXIT PROCESS AND MEDIUM-TERM OUTCOME

The UK referendum decision marks the beginning of a complex and unchartered process with an uncertain long-term outcome, which would affect the dense web of interrelationships between the UK and the EU. As Draghi said: “the event is very significant and we don’t know frankly what’s going to happen over the medium term”.⁸

While the commitment by the new UK Government to Brexit is quite evident, and the Prime Minister Ms. May has signaled the intention to deliver a notification of Article 50 of the Treaty on the European Union by the end of March 2017, unwanted uncertainty remains as regards:

- i. the direction of the process, that is what is the final model sought for the future UK – EU relations → a “soft” versus a “hard” Brexit
- ii. the transition to the final outcome (that is, the negotiating process necessary to get to the final model) → a “smooth” versus a “messy” transition

THE FINAL OBJECTIVE OF THE BREXIT VOTE. Before the referendum the Foreign and Commonwealth Office (FCO) published a paper on the alternatives to the EU membership.⁹ Based on existent relationships, the possible options considered were: a) membership

⁸ *Speaking at the IMF, October 2016.*

⁹ *See HM Government, Foreign and Commonwealth Office “Alternatives to membership: possible models for the United Kingdom outside the European Union”, March 2016.*

of the European Economic Area (as the case of Norway), b) bilateral free trade agreement (as for Switzerland, Turkey, Korea, and Canada) c) no agreement at all (World Trade Organization membership). This implies a tradeoff between enjoying the benefits of the Single Market versus maintaining national sovereignty, at the price of a more limited (third country) access to the European market.

In her party conference speech on 5th October 2016, , the UK Prime Minister delivered a stance oriented towards regaining national authority over borders and law, while maintaining close trade links with Europe. This would rule out the EEA Membership option,¹⁰ unless the UK would get “special treatment” from the European Union. On the other hand, the stance on maintaining close trade links with Europe would imply a preference for bilateral FTA over no bilateral agreement at all.

THE TRANSITION PATH TO BREXIT. If the UK Government delivers a notification of Article 50 of the Treaty on the European Union by the end of March 2017, this would trigger a two-year deadline by which Britain should leave the Union (early 2019). However, several technical and political constraints on both sides may jeopardize a smooth transition.

The Brexit negotiation process could be messy, taking into account that the technical negotiations must be completed and approved by a qualified majority of EU members. In addition to that, and unless option a) is chosen (European Economic Area), past experience with free trade agreements shows that negotiations may take several years.¹¹ In order to create the temporal room necessary to carve out the final agreement, an “interim” UK- EU agreement would be struck to regulate the bilateral relations during the transition, which would probably envisage a “temporary freezing” of the current relations (however, this solution is not granted). This would require unanimous approval by the EU member States and ratification by

¹⁰ *The European Economic Area (EEA) is an international agreement under which countries participating in the European Free Trade Agreement (EFTA) may also participate in the European single market. Currently the EEA comprises the EU, Iceland, Liechtenstein and Norway; Switzerland has not joined the EEA, albeit member of the EFTA.*

¹¹ *The EU-Canada Free Trade Agreement, with a more limited scope than the one under discussion, required seven years and is not yet ratified.*

national and regional parliaments. More complications are likely to arise as it will be also necessary to regulate the UK relations with “third countries” (including “renewed accession” to the WTO).

In order to reduce policy uncertainty, it is paramount to ask the UK authorities for more clarity on Brexit. However, as the situation is unprecedented, long-term political and economic implications are indeed not entirely foreseeable.

The UK government seems to have an uncompromising stance and is ready to accept limited access to the Single Market as a price to pay in order to retain control over its borders - indeed, curbing migration flows from other EU Member States was at the core of the pro-Brexit campaign. However, its position may change as the economic costs of Brexit become more apparent.

The UK government may hope to get “special treatment” from Europe, carving out an agreement granting full national sovereignty over its borders and law without compromising its access to the Single market. However, the likelihood of this outcome is probably overestimated. In recent months, and again during the recent October European Council, while refusing to officially start any exit negotiations with the UK before the intention to leave is formally notified, the EU has made it clear that access to the Single Market would require acceptance of all four freedoms (free movement of goods, services, capital, and people). That message has been reinforced by declarations by the Heads of State of the major European countries.

A complication for British exporters: financial regulation in Europe. Being a EU Member State, the UK currently enjoys the benefits of being within the internal market, including free movement of capital and financial services. Maintaining the latter will depend on the actual form of the new EU-UK relationship.

EU membership versus EEA versus FTA. Should the UK opt for EEA, it could still enjoy all four (EU Treaty) fundamental freedoms, including movement of capital and financial services. However it would be bound to apply all the relevant EU legislation (acquis

communautaire). In order for British providers of financial services to continue to exploit the benefits of the single passport, the UK should also apply all EU provisions concerning financial activities, including the single rulebook.¹² However, no longer being an EU Member State, the UK would not participate in decision-making processes within the EU bodies.

Should the UK opt for a bilateral FTA with the EU, the above benefits would be reduced. FTAs are used by the EU to regulate economic relationships with third countries. However current FTAs between the EU and third countries (e.g. the FTA with Canada and Switzerland) do not provide mechanisms comparable to the mutual recognition and the single passport. Thus, even in the case of a FTA, the UK would be likely treated as other third countries.

Third country treatment. For third countries, cross-border banking services are regulated at a national level by each single EU Member State (since this matter is not harmonized by EU legislation).¹³

Some EU financial directives/regulations provide simplified regimes in respect to the provision of financial services from third countries which are acknowledged as applying an ‘equivalent’ regulatory (banking supervision) framework.¹⁴ It is improbable that the EU will grant the UK special rights if it fails the adequacy or the equivalence tests.¹⁵

Moreover, maintaining this simplified regime for British providers of financial services would not be granted, as UK would have to

¹² *The Single Rulebook is the single set of harmonised prudential rules which institutions throughout the EU must respect. The term Single Rulebook was coined in 2009 by the European Council in order to refer to the aim of a unified regulatory framework for the EU financial sector. The European System of Financial Supervision is composed of the European Systemic Risk Board and the three European Supervisory Authorities: the European Banking Authority, the European Securities and Markets Authority, the European Insurance and Occupational Pensions Authority.*

¹³ *For instance, according to the Italian law, the provision of banking services from or to third countries, with or without the establishment of branches, is subject to authorization, which includes an assessment of the adequacy of the third country's banking supervision framework.*

¹⁴ *In the event UK becomes a third country, the adequacy or the equivalence assessments would be probably facilitated. The Bank of England already confirmed its commitment to apply the EU financial regulation until Brexit is completed.*

¹⁵ *This depends, on the one hand, on the possible opposition of some national governments and, on the other hand, on the concern that a more complaisant stance could offer incentives to other EU Member States to consider withdrawing from the Union.*

pass these equivalence tests in a “dynamic manner”. The moment British regulation deviates from EU regulation (due to a change in the latter), the UK would risk one again failing the EU’s equivalence tests.

Thus, in the event of Brexit, British providers of financial services would indeed lose the right of full access to the Single market.¹⁶ The EU authorities cannot compromise on this, not only as a matter of principle – being part of the Single Market requires acceptance of all four freedoms - but also for more pragmatic and vital reasons.

Otherwise, the integrity of the Single Market would be jeopardized. Homogeneity of rules and their enforcement is key to preserving a level playing field in the European financial market: failing these conditions, EU banks and financial firms could be subject to unfair competition from British counterparts.

Moreover, a more complaisant stance by EU authorities towards the UK could offer negative incentives to other EU Member States to consider withdrawing from the Union.

POLICY UNCERTAINTY: A SIGNIFICANT NEGATIVE RISK FOR THE EUROPEAN ECONOMIC OUTLOOK

Prolonged policy uncertainty linked to Brexit represents a significant negative risk not only for the UK and the euro area, but possibly also for the global economy. This has been stated for instance by the IMF in its July World Economic Outlook Update: “The outcome of the U.K. vote (...) implies the materialization of an important downside risk for the world economy (...) the global outlook for 2016-17 has worsened, despite the better-than-expected performance in early 2016. This deterioration reflects the expected macroeconomic consequences of a sizable increase in uncertainty, including on the political front”.

The Brexit vote has had so far no clear spill-over effects on the euro area’s economy. Eurozone GDP growth in Q3 continued at a rate similar to the previous period. As there has not been a decline

¹⁶ *In fact, such right could be granted only in case of UK “dynamic compliance” to all (present and future) relevant EU provisions.*

in confidence, the ECB macroeconomic projections released in September 2016 point to very marginal lower growth in 2017, partly due to lower exports towards the UK.

However, in the medium-term more negative risks for the economic outlook could come from the spread of unfavorable market expectations, with a tightening of financial conditions due to investors' flight to safety, strains on bank securities, business confidence decline, and the reining in of investment.

If a negative economic outlook should materialize, policy makers (at European and national levels) will use all the tools at their disposal to contain possible tensions in financial markets, strengthen the banking systems, and sustain business and consumer confidence.

The monetary policy toolbox is well stocked and has proved effective. However, banks' profitability is still weak, and a number of intermediaries must strengthen their balance sheets against the background of poor economic prospects and the ongoing process of regulatory reform.¹⁷ And the policy mix is clearly sub-optimal, with no common European fiscal budget to be used and many countries having exhausted their fiscal room to maneuver.¹⁸

THE EUROPEAN UNION CONSTRUCTION: STILL AN UNFINISHED JOB

Taking a broader perspective, the long-term risk of a deeper-than-expected economic slowdown in Europe may derive from the possible spread of political instability and inward-looking policy stances in a number of countries. Populist parties, sharing nationalist ideologies, have gained influence over wide parts of the European electorate. Eurosceptic campaigns have fomented distrust in European Union institutions.

¹⁷ *In Italy and other euro area countries a significant drag is represented by the large stock of non-performing loans, a legacy of the economic recession. The issue is being addressed by the Italian authorities via a comprehensive strategy. See Bank of Italy Governor Visco speech (available on the web): "Italy's economy and banking sector in the aftermath of Brexit". Address at the 56th Italian Banking Association Annual Meeting, Rome, 8 July 2016.*

¹⁸ *See Bank of Italy Governor Visco speech (available on the web): "The euro area: uncertainty and growth", OMFIF – 7th Main Meeting in Europe, Rome, 22-23 September 2016.*

An exceptional list of dramatic phenomena has hit Europe in the past few years.¹⁹ In combination with economic hardships - due to high domestic unemployment or growing inequality - this has reinforced fears in populations and widened the electorate of populist and Eurosceptic parties.

However, as the main new challenges for Europe happen to be of global nature – think of those in the realm of migration, security and defense²⁰ - they should be tackled with joint European action and solutions, not with sparse national intervention.²¹ Instead, as nationalisms and domestic myopias are blocking effective supranational coordination, people’s frustration may cause dissatisfaction with the European Union’s political and economic construction.

To prevent eventual progressive political paralysis and the disintegration of Europe, the unfinished pieces of the European Project should be taken forward. Turning back to the realm of central banking, completing the Banking Union and the Capital Markets Union, which implies introducing effective “risk-sharing” mechanisms within Europe (as those applied for instance in the United States), would improve long-term economic growth (as firms would improve their access to finance). This completion would also provide policy makers, both at the national and European levels, with more effective policy tools to prevent the risk of fragmentation of markets along national lines in times of financial and economic stress.²²

¹⁹ *Pressures from international migration flows, terrorist attacks, geopolitical threats in the close neighborhood have given rise to fears for personal safety.*

²⁰ *Others are older ones, for which national sovereignty has already been (partly) transferred to the European Union. Consider for instance engaging in international trade negotiations with third countries. In the last two decades the global economic center has shifted inexorably towards the Far East, and Europe has no choice but to counterbalance this development with regional political cohesion and a large internal market, if it intends to retain any leverage in international economic relationships.*

²¹ *See Mr. Draghi, President of the ECB, Introductory statement to the Hearing of the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 26 September 2016.*

²² *See the speech by Peter Praet, Member of the Executive Board of the ECB “Beyond monetary policy: on the importance of a proper alignment of economic policies in EMU”, at the conference “Beyond Monetary Policy”, organized by the US-Korea Institute at SAIS and Reinventing Bretton Woods Committee, 7 October 2016.*

Let me conclude by saying that reinforcing institutional communication about the benefits of the European Union and also enhancing the democratic legitimacy of the European institutions is paramount. People are sometimes not fully aware of where political responsibility for policy failures actually stands; they tend to blame non-elected European bureaucrats and policy makers for decisions which lie, instead, still mostly in the realm of national governments.²³ People could be convinced again that what we need in fact is more Europe, not less Europe.

²³ See Mr. Cœuré, Member of the Executive Board of the ECB, speech “Having confidence in Europe”, at a conference organised by the Istituto Affari Internazionali, Rome, 26 September 2016.

BREXIT AND ALBANIA: AN ASSESSMENT OF POTENTIAL IMPLICATIONS

*Erald Themeli**

1. INTRODUCTION

As for the rest of the SEE region, a seemingly irreversible feature of Albania's path to EU convergence has been its ever-closer integration with the EU economy and its financial system. Such integration has undoubtedly been beneficial. The free movement of goods and services facilitated domestic consumption by alleviating domestic shortfalls in production capacity. It also opened up export markets, thus increasing investment incentives and allowing for some degree of specialization in our economy. Such increased investment and specialization was aided by capital and financial inflows, and greatly benefited from imported managerial expertise. Last but not least, the outflow of labour generated remittances and allowed for higher wages in the domestic economy.

As a counterpoint to all the benefits, a higher degree of economic and financial integration also has potential drawbacks. These drawbacks take usually the form of spillovers from external crises, adverse unintended impacts of changes in external policies and regulations, as well as a larger degree of financial market volatility, given the inherently mobile nature of international financial flows.

* *Erald Themeli, Head of Monetary Policy, Bank of Albania*

These drawbacks do not outweigh the advantages, though at certain times they tend to come to the forefront of policy-makers attention. One such case has probably been the aftermath of the recent economic and financial crisis. Starting with the great economic and financial crisis of 2008, Albania has been faced with a prolonged series of shocks from the external environment. The Albanian economy has had to deal with negative spill-overs from the global economy: the initial financial turbulence mutated into an EU sovereign-debt crisis around 2010-2012; together they caused a deleveraging trend across the SEE region, which impinged negatively on our economic performance. In 2015, the SEE region had to deal with potential possible Grexit and the adverse effects from the Greek crises. Now in 2016 we are facing potential negative impacts from Brexit.

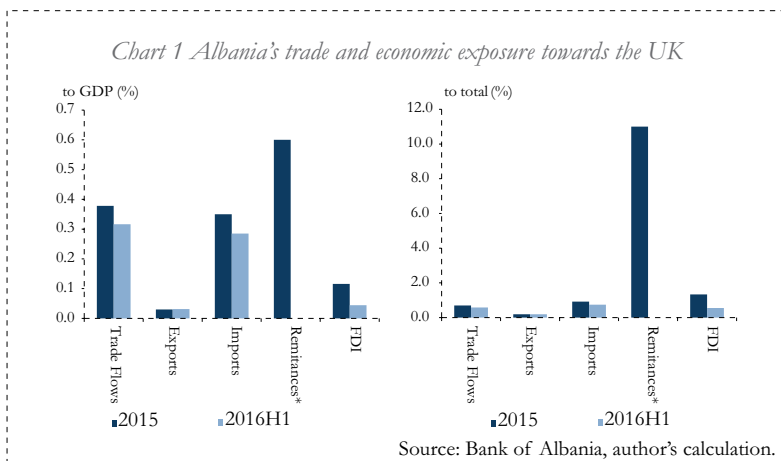
The standard operating procedures across central banks in the region require us to assess the potential spill overs from such a crisis. Following on, I will present the conclusions of our crisis-impact exercise for Albania. To pre-empt our conclusions very briefly, our initial assessment follows largely along the same lines as those presented by previous speakers.

The content of my presentation will focus on three subjects. First, we are going to look at the implications Brexit might have for the EU, then its consequences in Albania, and, lastly, my conclusions.

2. ALBANIA'S DIRECT EXPOSURE OF THE UK: THE KNOWN KNOWNNS OF BREXIT

It is of course easier to start an assessment with what you know best, and what we know best is the direct exposure we have vis-à-vis the UK. As previous speakers pointed out, Albania's – and the SEE region's– direct exposure to Brexit seems to be pretty minor, in all dimensions one might care to look at.

Let's have a look – initially – at Albania's trade and economic exposure towards the UK. Chart 1 summarises different dimensions of this exposure, both in absolute terms (i.e. Albania's direct exposure to the UK), and in relative terms (i.e. Albania's exposure to the UK as a share of the total economy).

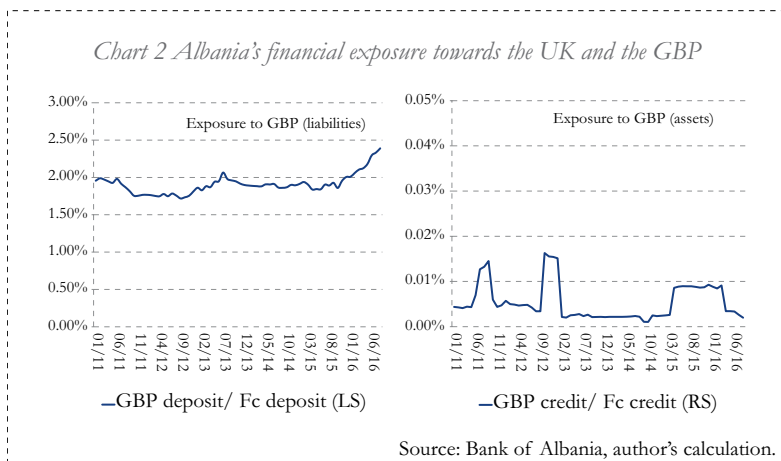


From a perusal of chart 1, we can draw some brief conclusions:

- First, our trade integration with the UK – and, consequently, our potential negative exposure to Brexit – is low. This is true in terms of exports and imports: at a few GDP basis points both these figures are pretty minimal, though we suffer a negative – and pretty marginal – trade balance with the UK.
- Second, at around 0.6 GDP percentage points, remittances sent home from Albanian migrants in the UK might represent a potentially larger source of contagion. However, our experience with remittances from crisis-hit countries has been one of unexpected resilience. We do not see any reason why they would behave differently in the case of Brexit.
- Third, FDIs from the UK to Albania are pretty minor, and – as such – any cutback on FDI inflows or outright withdrawal of them would not – in itself – represent a noticeable crisis.

What was true for our trade and economic exposure to Brexit holds also true for our financial exposure to British financial institutions and the British pound.

The left-sided panel of Chart 2 shows the exposure on the asset side of the economy (or, alternatively, the liabilities of the banking system). Overall, GBP deposits stand at less than 1% of GDP and at roughly 2% of total foreign currency deposits. The exposure is



even less on the assets side of the banking system, where – looking at the right-side panel of Chart 2 – credits in the British pound are negligible. Furthermore, there is an absence of UK-headquartered financial institutions in Albania and little evidence of direct cross-border financial flows originating from the UK.

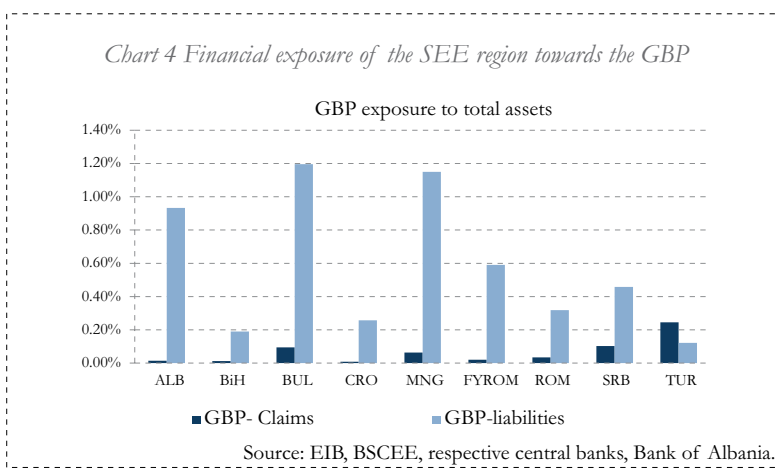
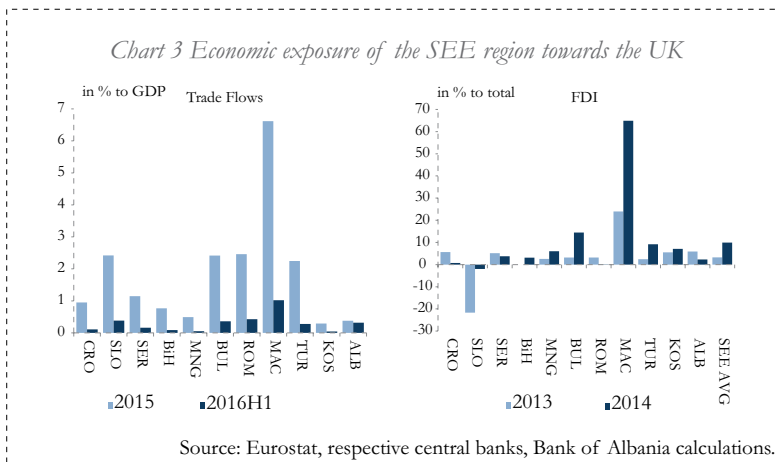
All in all, it seems Albania is relatively sheltered from any direct negative impact Brexit might have on the value of GBP and on the health of its financial institutions. Given the minor exposures involved, this conclusion holds true for both the real and the financial systems of our economy.

Based on this cursory analysis of economic and financial linkages, we feel safe to conclude that any direct exposure Albania has vis-à-vis the UK is pretty minor. Therefore, regardless of the different scenarios Brexit might play in the future, direct negative spillovers in Albania are expected to be low.

The same conclusion holds true also from an SEE perspective.

The real economy exposure of the Western Balkan countries towards the UK, with the possible exception of Macedonia, is pretty minor. Trade flows and FDIs, again with a notable exception of Macedonia, are rather low, as depicted in Chart 3.

Concurrently, the SEE countries' financial sector exposure vis-à-vis the UK is also low. Countries in the region have predominantly subsidiaries of the EU-based banks, but not a presence of any UK bank (Chart 4). At the same time, GDP exposure to the British pound across the region is pretty minor, at less than one and a half percentage points; so, whatever direct exposure we have is pretty limited and containable (right-side panel, Chart 4).



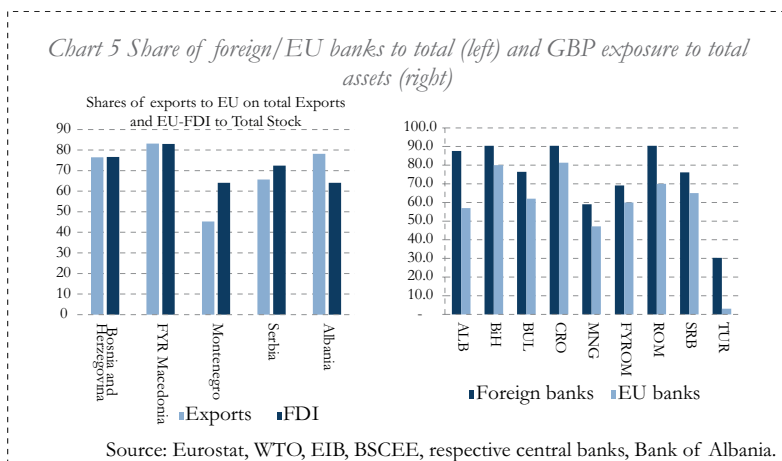
3. ALBANIA'S INDIRECT EXPOSURE TO THE UK: THE KNOWN UNKNOWNNS OF BREXIT

An analysis that limits itself at the direct exposure which a country has towards Brexit would only be looking at the tip of the iceberg. Given the central role the United Kingdom has had in the EU, both in terms of economic and financial contributions and in terms of steering EU policies and regulations, Brexit is bound to have wide-reaching consequences in the EU. Because the EU represents the overwhelming economic and financial partner for Albania and the SEE, Brexit would have indirect – but potentially larger – consequences for us.

We can have a reasonable degree of certainty in assessing the direct exposure and direct impact of Brexit – hence why I classify them as known knowns, but our assessment of indirect impacts is harder and more fraught with uncertainties. To some extent, we know what to look for, i.e. we know the contagion channels, but we don't know with any degree of accuracy the severity of the impact. This represents the known unknowns of Brexit.

Without pretending to be exhaustive, this section will try to shed some light on the issue. I will first try to briefly assess the exposure of the SEE region towards the EU. I will then try to expand on three possible indirect contagion channels: the indirect economic channel, the indirect financial markets channel, and the political economy channel.

Chart 5 summarizes the exposure of SEE countries vis-à-vis the EU. As can be clearly seen, large EU economies represent – by and far – the biggest trading and financial partners of the region. The share of both exports towards the EU and the EU-originated FDI's averages at around 70% of the total. Similarly, foreign banks dominate the banking landscape across the region and the EU-headquartered banks represent the large majority of them. It's understandable then, that the indirect impacts we might have from Brexit by far outweigh the direct ones.



The discussion here turns to what kind of impact Brexit might have upon the EU. At the moment there is a great degree of uncertainty regarding concrete or hard estimates about the implications that Brexit could have for the EU, and in turn on Albania.

The following table reproduces an initial assessment – carried out in July 2016 by the European Commission – on the potential effects that Brexit might have on EU 27, the euro area and the UK itself.

Table 1 Cumulative GDP growth effects as a % from baseline

	Mild Scenario		Severe Scenario	
	2016	2017	2016	2017
UK	-0.3	-0.9	-0.6	-2.6
EA	-0.1	-0.2	-0.2	-0.5
EU27	0.0	-0.2	-0.2	-0.5

Source: European Commission. "The Economic Outlook after the UK Referendum", Institutional Paper 032, July 2016.

The EC assessment distinguishes between two scenarios: a mild or soft exit scenario and a hard or severe exit scenario. The prevailing mood seems to favour the possibility of a hard rather than a soft Brexit. However, even in this case, the European Commission seems rather relaxed about the size of the impact on the EU's GDP. The impact would be understandably negative, but its expected magnitude appears to be centred at around half of a percentage point. At these

projected magnitudes, the direct economic impact on the EU would probably be too small to have any meaningful negative implications for the SEE region and Albania. However, should such an economic impact be felt, it would pass through three potential channels:

- Erosion of external demand;
- Loss of foreign direct investments;
- Heightened uncertainty and postponed domestic investment.

On the other hand, Albania might be more exposed to indirect Brexit effects stemming from the EU financial system. This expectation corroborates the strongest observed impact channel propagating the 2008 global economic crisis into the SEE region.

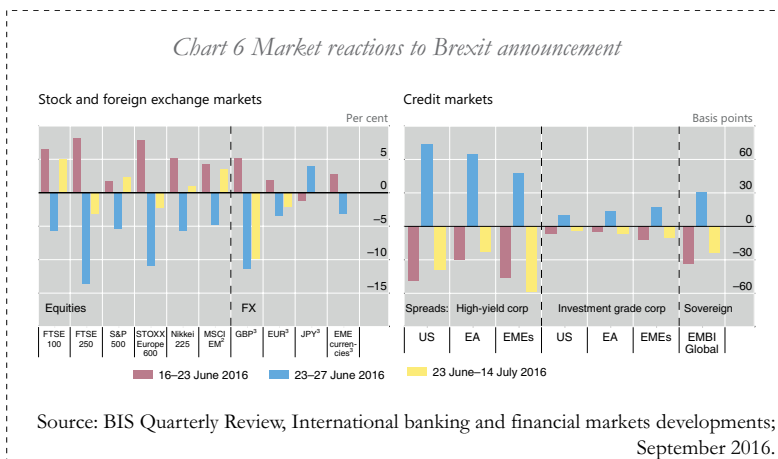


Chart 6, taken from the BIS, shows that financial markets reacted abruptly in the week after Brexit: there was a wide-spread increase in spreads, decrease in asset prices, and increase in bond yields. However, the market recovered afterwards and some of the losses were completely reversed.

A notable exception from this pattern is the foreign exchange market. In the foreign exchange market the initial depreciation of the GBP stuck and for the foreseeable future there is a clear depreciating trend of the British pound. On the other hand, what Brexit induced in terms of monetary policy was the fact that, as

long as it relates to the US economy or the Federal Reserve, they were forced to revise down the expected normalization of monetary policy. To some extent, the previously expected divergence of ECB and Fed Monetary Policy was bounded on the upper side. That, in turn, would be expected to limit the probable expected appreciation of the US dollar vis-à-vis the euro and the negative terms of trade shocks that this phenomenon represents for the region.¹

To conclude the discussion on financial markets, the immediate aftermath of the Brexit impact on financial markets appears to be rather benign. However, this does not represent the whole story. Further contagion channels – which are not examined in depth here – might come into play later. Potential spill overs to the SEE region might include:

- Increase in financial market's risk aversion, higher financing costs / insurance premia
- Further deleverage possible

In addition to the indirect impact via trade, investment and financial market channels, the legacy of Brexit might affect the region through a final group of factors, which altogether might be referred to as the political economy of Brexit.

The impact of Brexit on the EU is still unclear, though widely discussed. The impact it could have on the EU enlargement, its governing structures, and its philosophy of economic management, could reverberate across the region.

I would like to focus very briefly on three points:

First, the potential loss of momentum for EU integration would be quite dangerous for the region. The prospect of EU integration has served as a policy anchor for countries across the region. It has served as a basis for a social consensus for hard structural reforms. One would understand that in the short term, the attention of the EU will be concentrated mostly on Brexit. However, over the

¹ *The vast majority of the SEE region exports are flowing to EU, and thus are euro-denominated, whereas a large chunk of imports, such as oil and commodities, remains denominated in US dollars.*

medium to long term, countries in the region would expect for the promise of EU integration to hold true and for integrating forces to prevail over the disintegrating ones.

The convergence process has both guided our structural reforms and helped to shape our domestic institutions. Furthermore, our domestic policies have converged with the stability oriented consensus, propagated by the EU. If this anchor is lost, the SEE might diverge from this path and engage in sub-optimal, if not outright dangerous, economic policies.

Secondly, the loss of UK might instigate a change in terms of the political philosophy and economic governance of the EU. By and large, the UK has tended to vote on the liberal side of economic policies and, to some extent, it counterweighed more public intervention driven policies. Without the UK, the EU might drift towards less market and growth friendly policies, thus hampering its competitiveness and long-term growth prospects. Furthermore, this change in the governance approach would go against what countries in the region have strived to achieve over their transition and convergence period, resulting in policy uncertainty and policy volatility across the SEE.

Finally, there is the remote risk that the precedent of Brexit could be followed by other countries, putting in jeopardy the EU project itself.

4. CONCLUSIONS

This assessment of the potential impact of Brexit on Albania and the region is still preliminary. It indicates that the direct exposure of the Albanian economy and the region to Brexit is rather limited, given the relatively modest direct economic and financial ties we have. On the other hand, Albania and the region might be proportionally more exposed to indirect Brexit impacts. The economic and financial impacts Brexit might have on the EU, as well as its potential implications for the political economy of the EU, could be far more serious for the SEE region. However, given the indirect nature of these channels and the complex dynamics of this process, more theoretical and empirical work needs to be done in the future.

LITERATURE:

BIS Quarterly Review, International banking and financial markets developments; September 2016.

European Commission. "The Economic Outlook after the UK Referendum", Institutional Paper 032, July 2016.

SECOND SESSION:

MONETARY POLICY AND
FINANCIAL STABILITY AND
THEIR COORDINATION IN
THE WAKE OF CURRENT
DEVELOPMENTS

How will current developments affect aggregate demand conditions and concerns for financial stability in Eurozone and the region? What does all this mean for central banks objectives (price vs. financial stability) and policy coordination (monetary policy vs. financial stability)? What is to gain and lose from coordination?

*Chair: Robin MCCONNACHIE
Associate of PEFM and Member of the International
Advisory Board of Oxford Analytica*

BREXIT: IMPLICATIONS FOR MONETARY MANAGEMENT IN SOUTH EAST EUROPE

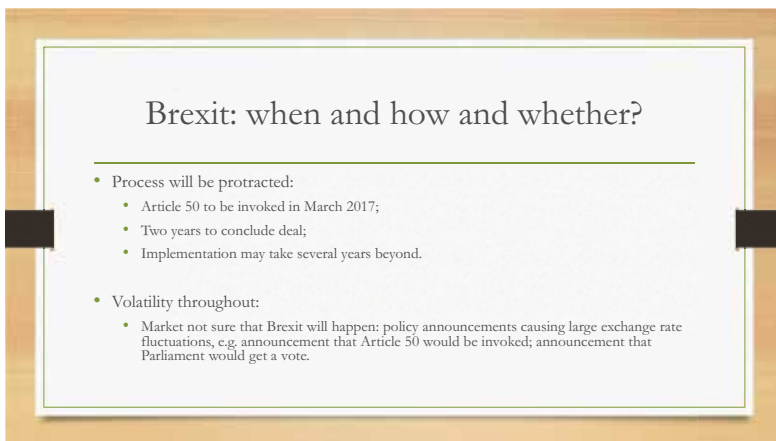
*Charles Enoch**

We move on now from looking at what has happened as regards to Brexit, to looking forward, to the policy-makers and their reactions: for central bankers this means financial stability as well as monetary stability. One of the lessons we have learned from the global financial crisis, and events since then, is that one does not just look at the central forecast, but also at the tails: what could be a lot better than what one expects, and what could be a lot worse. We also know from the crisis that there are fat tails, meaning that the probability of a crisis being a lot better or a lot worse may be substantially greater than we expect. So, from policy-makers' points of view the overall conclusion is uncertainty, and that one does not just need to know what is the most likely outcome, but what could be better, and what could be worse.

I will make two initial points. First, there was a general consensus in our first session that things are going to be slightly worse but manageable. Indeed, that may be right, but policy-makers have to make sure that the situation will be manageable, not just if things turn out in line with the central forecast, but also if the outcome is rather different from the central forecast.

* *Charles Enoch, Director PEFM and Associate SEESOX, University of Oxford.*

The other point I will make is that the title of the conference as “post-Brexit” is a misnomer as regards where we are at now: we are post the referendum on Brexit. Brexit itself cannot take place, if indeed it does take place, before 2019. So, when we look at what policy-makers are doing now, we are really looking at what policy-makers are doing in the transition through to Brexit, and during the time before Brexit would actually take place. And indeed, managing the economy in the time through to Brexit may be the most complicated task, and maybe one needs to get through the pre-Brexit period before one even can manage the actual Brexit.



Brexit: when and how and whether?

- Process will be protracted:
 - Article 50 to be invoked in March 2017;
 - Two years to conclude deal;
 - Implementation may take several years beyond.
- Volatility throughout:
 - Market not sure that Brexit will happen: policy announcements causing large exchange rate fluctuations, e.g. announcement that Article 50 would be invoked; announcement that Parliament would get a vote.

So, anyway, here we have ‘What Brexit, when and how and whether?’. In any case the process would be protracted; as I said, the actual process of Brexit has not even started yet. The UK is still in the EU, it still is in theory on every committee, and it still participates. All EU rules apply to it. The process of disengaging starts when the UK invokes Article 50. It has a unilateral right to invoke Article 50. It is when it invokes the Article that the withdrawing starts, and the Prime Minister has declared she will do it in March 2017. At that point there will be two years to conclude the negotiations unless there is unanimity to extend it. As we heard, there is an enormous amount of work to do in those two years, so maybe there will be an extension. In any case, even if it concluded within two years, it will take many years to implement. For instance, we heard the EU-Canada treaty

is seven years in the making, and still it is not done. And thereafter the UK has to negotiate with 180 countries as to trade deals, from a starting position where there are no trade negotiators in the UK because we haven't had to do it for 43 years. So this will all take time, and the ultimate outcome is uncertain.

I would also stress that there is likely to be volatility throughout any transition period. Markets are not sure what will happen, and they are not even sure there will be a Brexit. Looking at individual announcements, if there is an announcement of a possibility of no Brexit, markets would bounce back. At every announcement, there is extreme volatility in sterling, and this can be expected to continue as more or less important decisions are taken. The announcement of the date of invoking Article 50 being led to a big fall in sterling, while at the announcement that the Parliament will have a vote on Article 50 the pound bounced back again. This is likely to continue, so policy-makers must realize that they are living in a world of more volatility.

Another point I would make is that some things move very rapidly and some things at a slower pace. As we heard this morning, exchange rates move instantly. The markets see something, and they move: you go to sleep one night, and the next morning rates could have moved by 20%. Other things take years to move: if you have a car industry, the vintage model of capital shows that the company will go on building the same model until that model's time runs out, and then the next investment will be somewhere else. The car company will move very rapidly at that point, but not instantly.

There are two further points in this regard. The moves in activity can be very dramatic. I have been working on the Western Hemisphere countries recently, and we found, for instance, that 98% of the Mexican derivatives market has moved out of Mexico to Chicago, due to regulatory quirks. In this case, the move was a collateral effect, it was not even intended, but 98% of the market is gone. And it went very quickly. This can happen. We may have a stable market, and suddenly there is a steep jump; something unexpected happens, there is a critical decision day for the markets, and every market decides "Hey, we are going to do this in Frankfurt, we are going to

do it in New York, rather than in London”. Maybe not, but this may be, and this is the sort of thing that policy-makers need to be aware of, and no doubt they are watching this very closely.

Also, totally extraneous events can have big impacts. If you watch the news closely you may have seen that Ms May has just made an announcement on Heathrow Airport. Now, the relevance of Heathrow Airport expansion is that there is one Member of Parliament who said he would resign if there was a decision to announce the expansion of the Airport. This Member has resigned, and there is therefore a by-election coming up in London, which will therefore be a vote on Brexit. This may have broader implications, maybe not. But again, there could be market volatility regarding the prospective by-election, so that one decision actually leads to another; all is interconnected. What one should really do as a policy-maker is to ensure resilience in the face of all this volatility.



Brexit: impact on the economy

- IMF WEO amongst consensus forecasts for significant fall in UK activity and lesser negative impact more widely.
- UK Treasury study shows 5.4% to 9.5% fall in GDP after 15 years, depending on type of Brexit.
- Loss of revenue 38 billion to 66 billion Pounds pa after 15 years because of smaller economy.

- Challenge to these numbers:
 - Pound has already fallen over 16% since referendum; if Brexit occurs significant further fall in prospect, will improve exports and import-substitutes;
 - Very hard to quantify.

So, anyway, we go now into this Brexit. Firstly, what happens to the UK economy? I will start with the UK, then the EU, and then come to South-East Europe. The IMF WEO is amongst the consensus to forecast a significant fall in UK activity, but a lesser impact more widely. The fall in activity was not quite as quick as expected; it may come later, or there may be less of a fall, and much less fall in activity so far seen elsewhere. Again, it may be a timing question, but it may not. The study authored by the UK Treasury shows a significant fall

in GDP after 15 years, depending on the type of Brexit. We have seen differences between hard Brexit and soft Brexit, and there are great uncertainties as to what is in Brexit, but the general consensus is that the harder the Brexit, the deeper the fall. According to the Treasury study there would be a big loss of revenue, of between 38 billion Pounds and 66 billion Pounds. Again, it depends on whether there is a soft Brexit or a hard Brexit after 15 years. These results seem to be borne out in more recent Treasury figures, which show the fall in revenue and that the UK's fiscal targets are likely to have to be moved.

These pessimistic numbers have been challenged. However, the Pound has already fallen 16% from the referendum. This is quicker than expected. It will lead to a boost in exports *ceteris paribus*, and therefore dampen any fall in activity, conceivably dampening this fall substantially. Again, this is very hard to quantify. We have the central estimates, but given the outcome uncertainty and the uncertainty of timing it is very hard to be precise on the longer term economic outcome.



The slide features a light beige background with a white rectangular area in the center. The title 'Background: a weak European economy' is centered at the top of the white area. Below the title is a horizontal line, followed by a bulleted list of three items. The slide is framed by a dark orange border with black rectangular accents on the left and right sides.

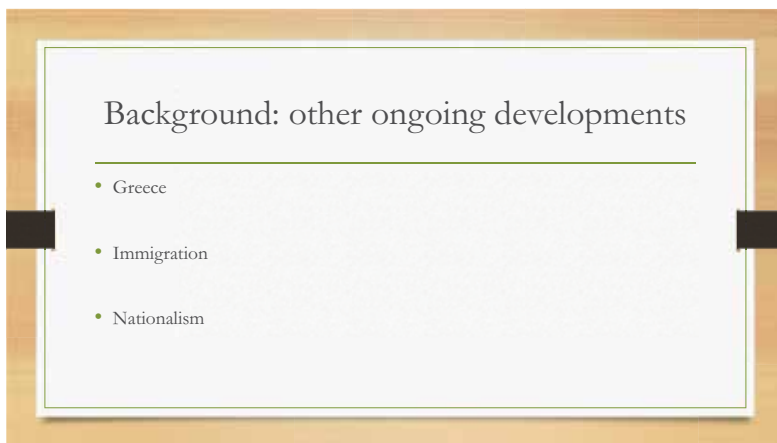
Background: a weak European economy

- Growth barely positive in the EU, inflation at lower bound of band.
- Plans for further quantitative easing: continuing policy actions to stimulate activity.
- Unfinished business: bank restructuring in the EU ongoing: Italian banks; German banks.

So, what is the overall impact on Europe? If Europe were growing strongly, Brexit might be just a blip; but if the European economy is really weak, as we have heard, with growth barely positive and inflation at the lower bound of the band, a further adverse impact on Europe could have an effect, possibly disproportionate. The ECB

has already been working on plans for further quantitative easing. In that regard, policy-makers responded immediately: they have already said there is likely to be more quantitative easing, and policy action, to stimulate activity. They have a policy toolbox to hand, a stronger toolbox than before, and this toolbox will be used, but some of it has already been used. There have already been rounds of quantitative easing, and there is a general feeling that further quantitative easing has less impact. There will be attempts at monetary stimulation, but again there may be some weakening in its effects.

There is also, one should say, a lot of unfinished business in Europe. Europe has not yet totally resolved the global financial crisis, or the sovereign debt crisis. A great deal of attention has already been given, particularly towards the on-going work on restructuring in the EU banks. For instance the Italian banks weakened, and the Italian government is attempting to take the bad loans out of the banks in order to strengthen them, while there is continuing bad news about Deutsche Bank. So, there is unfinished business there, and one is not starting from a position of strength in the global real economy, or indeed in the financial sector.



Of course, Brexit is only one of the factors impacting the rest of Europe; it may not even be the biggest ongoing crisis. There are several on-going issues, which we do not have time to go into, including the on-going Greek programmes, and immigration, which

is a big issue in the UK and elsewhere in the EU, raising concerns amongst some about the desirability to regain control of borders. Rising nationalism is also another factor in a number of European countries, well beyond the UK.



The slide features a light-colored background with a thin border and is set within a larger orange-bordered frame. A horizontal line is positioned above the list of bullet points.

UK: managing the economy through Brexit

- Expectation of lower activity prompting Bank of England to reduce interest rates. Contentious: Prime Minister challenges this on grounds it hits pensioners and other debt holders.
- Higher inflation already seen in the figures: price level likely to adjust by up to 10 pct points in response to exchange rate fall of 16%. (“Marmite” coming off the shelves). Not clear how Bank responds.
- Debt stock likely to rise: lower activity plus more accommodative fiscal policy.

Returning to the UK: how does one manage the economy through the Brexit process? The expectation of lower activity has prompted the Bank of England to reduce interest rates, and this has already become contentious: the Prime Minister has challenged the Bank of England because low interest rates mean a redistribution away from those who would earn income through interest rates, particularly pensioners. Therefore there is an on-going debate as to what extent these low interest rates can be maintained. Higher inflation is already seen in the figures: with the pound down over 16%, and over 60% of food for instance being imported, there is bound to be a substantial increase in domestic inflation.

There have been news stories about “Marmite” coming off shelves. The British press focuses on individual goods, and one can see shortages in some goods where there is a tension between rising prices and the retailers not wishing to show the full impact of inflation at this stage. Despite such actions, there will be a significant increase in inflation and an increase in the UK’s debt stock. Already there are Treasury figures which show a substantial increase in the expected debt in the UK. The Chancellor of the Exchequer has abandoned

the previous Chancellors' objective of a surplus in the coming five years; this surplus will not be happening.



UK: macroprudential implications

- Brexit likely to lead to departure of major banks plus their services from UK. “Hard” Brexit means loss of “passporting” rights. Ancillary loss of markets, e.g. euro clearing.
- Loss of high paid staff (estimates over 50,000 over several years) leads to fall in property prices, at a time when high-end prices already weak.
- Leads to downward pressure on interest rates.
- Situation would be much worse if this led to financial sector instability: not anywhere near the central forecast at this stage.

As far as macro-prudential implications are concerned, as I said earlier, linkages and costs may come through the financial side rather than the real side. Brexit may well lead to the departure of major banks and their services from the UK. There is only a very narrow path through which one can get to a Brexit and nevertheless maintain the UK financial sector in its present role in the UK. The financial sector is a major export industry. Hard Brexit would mean the loss of “passporting” rights into the EU, and the loss of a range of ancillary markets. There is a whole line of products and activities involved; it is not just the highly paid investment bankers, whom one hears about, but also “euro clearing”, and a whole line of ancillary activities.

So, loss of high paid staff, for which estimates are difficult to quantify, but possibly 50,000 people; falling property prices when high-end prices are already weak; and downward pressure on interest rates. The situation could be worse if this leads to financial sector instability. This is not in any of the forecasts, or even within the tails, because British banks are reckoned to have been more successfully recapitalized than others. Conceivably, there could be some other banks that have unhedged exposures, and for whom a 16% change in the exchange rate could cause losses, and there could be financial instability. This will be watched closely by policy-makers.

Economic implications for EU

- Direct effects manageable: UK a relatively small share of EU economy.
- If Brexit proceeds, Sterling depreciation will be reflected in Euro appreciation, downward pressure on prices at a time when sub-target inflation is already a concern.
- Interest rates already at minima. May be pressure for further types of QE.
- Unlikely this leads to financial crisis, although some European banks already weak. If there were crisis in UK, could spill over through most exposed countries e.g. Ireland, Malta.
- Scope for other countries to gain as industries move from UK, e.g. banking to Germany, cars to Slovak Republic. May provide substantial offset to initial losses.

As for the impact on the EU, direct effects are manageable; the UK is a relatively small share of the EU economy. So that, again, is not a major crisis. Sterling depreciation will be reflected in euro appreciation, downward pressure on euro prices when sub-target inflation is already a concern. Already the euro area is below the target, so this could push it further, and there is more pressure on the euro area to get inflation within its target range. However, it is unlikely that this effect would be very significant: the UK economy is not dominant in Europe. It is unlikely that the changes envisaged would lead to financial crisis, although some European banks are already weak.

As noted earlier, this all adds somewhat to economic weakness, and clearly will need to be watched by policy-makers. Regarding weakness in the UK, there are a few countries that are more heavily exposed than the generality, such as Malta and Ireland; these may have more significant effects, but not the EU as a whole. Also, other countries may experience gains as a result of redistribution of activity. Insofar as the UK loses competitiveness, because of loss of passporting, several countries are lobbying to try to attract the business. It seems from some observers, however, that the main gainer may be the United States, in that some of the big banks have said that they will relocate their activity to New York rather than to Europe. However there may be a re-thining as other EU countries offer incentives for the banks to stay. Motor vehicle companies may

eye the Slovak Republic, for it has been very successful in producing cars from companies which are headquartered elsewhere in Europe, so Europe as a whole may not be much affected.



The slide features a light beige background with a white rectangular area in the center. The title 'Implications for EU policy makers' is centered at the top of the white area. Below the title is a horizontal line, followed by a bulleted list of five points. The slide is framed by a dark orange border with black rectangular accents on the left and right sides.

Implications for EU policy makers

- Uncertain.
- Brexit would change perceptions of the EU; main objective of policy-makers to avoid an unravelling of the EU: challenge to the very basics of the European project.
- Concern to avoid spillovers from volatility during the two plus years of negotiations.
- May seek modification of policies e.g. labour markets.
- Much hinges on French and German elections in 2017.

Resulting implications from Brexit for EU policy-makers are uncertain. Brexit threatens to change the popular perception of the EU as an ever-closer union of European nations. The main objective of EU policy-makers would be to avoid the unravelling of the European project, as Brexit could be a challenge to the very basics of the European project. The major concern on the policy side, as regards the European Central Bank and other central banks, is to avoid spill-overs from volatility during the two plus years of negotiation, as the transition period will be a particularly dangerous period. There may be some modification of EU policies, such as those regarding the labour markets. The UK's concerns about free movement of peoples are shared elsewhere in Europe. Nicolas Sarkozy, for instance, has said that if he wins the French election, he may also introduce some sort of restrictive policies on labour markets. Denmark has some sort of frictional labour market policy, so possibly there something in there too, not to impede labour market mobility, but to throw some sand in the wheels. Much will hinge on the French and German elections in 2017; if any of the anti-EU parties do well, this will be quite significant. However, if their threat is seen off, then the European project will be much more self-confident.

Economic implications for South East Europe

- Direct real implications likely limited unless situation deteriorates through the financial side.
- May be more competitive against UK companies as they lose passporting rights, although Sterling depreciation makes UK competitive.
- Likely increased caution amongst remaining EU countries to make sure that new members are fully aligned with the objectives of the EU (this from Hungary etc as much as from UK).
- Brexit negotiations likely to be labour-intensive, delays focus on other issues.
- Pressure from populist parties may lead to modifications of single market practices.

What are the economic implications for South-East Europe? The direct real implications are likely very limited - the UK has a very small share of the goods and services markets. The situation may deteriorate through the financial side, in which case there is the possibility of spill-over, but again, this has to be very indirect. If there is an EU company which is very badly exposed because of its sterling position and has been affected by the European weakness and that spills over, that may have an impact, but this is not a high probability.

South-East European countries may be more competitive against UK companies as they lose passporting rights, but sterling depreciation makes the UK competitive. More broadly, there is likely to be increased caution amongst the EU countries as regards to accepting new members, to make sure that any new members are fully aligned with the objectives of the EU. It is not just the UK, but also for instance Hungary, that has stepped back from the overall vision of the EU, and the EU will be particularly careful to minimize any further possible backsliding in this regard.

Brexit negotiations are likely to be labour-intensive, so just purely in bureaucratic terms, there will be fewer resources able to negotiate accession. There is also pressure from populist parties throughout Europe which may lead to modification of single market practices.

As regards overall implications, EU accession remains attractive, for a whole range of reasons that are well known, but the economy of the EU may be more volatile, and policy-making may be more complicated. There is likely to be a higher entry bar, partly because of accession fatigue in Europe, but on the other hand also acceptance of “variable geometry” through which countries integrate at different speeds. Overall, there is likely to be greater scrutiny of applicant countries.

Policy implications for South East Europe

- EU accession remains attractive, although economy may be more volatile.
- Higher entry bar likely, but also maybe acceptance of “variable geometry” through which countries integrate at differing speeds.
- Greater scrutiny of applicant countries: Implies mitigating effects of higher volatility: monetary policy close to that of EU; fiscal prudence; macroprudential caution; ensuring banking soundness; institutional reform (ECB study showing countries with strong institutions are better able to manage debt and grow strongly).

This all provides challenges for the policy-makers in this region to seek to mitigate these effects. The EU does not want further problems, but it would like further opportunities. Insofar as the Western Balkans are seen as an opportunity, the attraction to the EU is the reassurance that they see there are still six countries here in Europe that want to enter, and that could do more than balance the one country, which may want to leave. In order to be attractive to the EU, however, a country would need to maintain the monetary policy close to the EU, fiscal prudence, macro-prudential caution, and to show there are no financial problems that might risk being imported; this in turn implies a high degree of transparency as regards the country’s fiscal and financial positions.

On the financial side, all this implies pre-emptively aligning with the EU rulebook. This does not just mean that one has to adopt the rules, but also the regulations, and their implementation - all

these things would come from EU accession, but can be done pre-emptively; one can move in that direction. Also, institutional reform: there is a very recent ECB study showing that countries with strong institutions are better able to manage debt and grow strongly, and that again would be an attraction for the EU to expedite accession negotiations. So, strengthening institutions is really part of the preparatory work, which would therefore foster growth towards the EU and also strengthen growth in the South East European region.

MONETARY POLICY AND FINANCIAL STABILITY INTERACTION: CURRENT AND FUTURE CHALLENGES

*Gilles Noblet**

1. INTRODUCTION

Today I shall discuss the interplay between monetary policy and financial stability. This interplay is a highly topical issue widely debated among central bankers and academics. The topic also echoes in this region. To a different extent countries in the Western Balkans also experienced financial boom-bust cycles prior to and in the aftermath of the global financial crisis. The legacy of the crisis still poses challenges to policy makers, for example through a high stock of non-performing loans and subdued credit growth in many countries. It is thus very timely to reflect on the interplay of monetary policy and financial stability also here in the Western Balkans. I will, however, not talk about this region, but focus on the ECB perspective.

2. GENERAL REMARKS

Financial cycles are characterized by recurrent ebbs and flows in financial asset prices and credit creation.¹ Such movements may not always be supported by the fundamentals of the economy. In

* *Gilles Noblet, Deputy Director General of International & European Relations, European Central Bank*

¹ See *Claessens, S., M. Ayhan Kose and M. E. Terrones, "Financial cycles: What? How? When?", IMF Working Paper, April 2011.*

such instances, typically two related factors underlie these cycles. First are waves of ‘irrational exuberance’ as investors increase their expectations of future income in response, for example, to promising technological improvements. Second, financial intermediaries then have the capacity to transfer these expectations into the present through credit creation – resulting in a financial upswing. Yet, the cycle will eventually reverse, when some of the expected benefits do not come to pass.

Such cycles can be harmful to the economy as a whole. There is potential for negative externalities. Some asset price bubbles may be associated with a misallocation of resources and lower productivity growth. Moreover, financial upswings driven by irrational exuberance come with the risk of harmful and possibly abrupt reversals.² At the same time however, credit-financed investments in risky ventures are an essential part of sustainable economic growth.³

It must be acknowledged that monetary policy interacts with financial cycles.⁴ Monetary policy affects the risk-taking incentives of market participants, and as a consequence asset prices and credit creation.⁵ Moreover, as financial cycles are propagated via global financial markets, domestic monetary policy actions will result in international spillovers.⁶

² See Akerlof, G. A. and R. J. Shiller, *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism*, 2009.

³ See Ranciere, R., A. Tornell and F. Westermann, “Systemic Crisis and Growth”, *The Quarterly Journal of Economics*, Volume 123, Issue 1, 2008, pp. 359-406.

⁴ See Rey, H., “Dilemma not Trilemma: The global Financial Cycle and Monetary Policy Independence”, NBER Working Paper, No. 21162, May 2015; Adrian, T., A. Estrella and H. S. Shin, “Monetary Cycles, Financial Cycles, and the Business Cycle”, Federal Reserve Bank of New York Staff Reports, no. 421, January 2010; Juselius, M., C. Borio, P. Disyatat and M. Drehmann “Monetary policy, the financial cycle and ultra-low interest rates”, BIS Working Papers, No. 569, July 2016; Schularick, M. and A. M. Taylor, “Credit Booms Gone Bust: Monetary Policy, Leverage Cycles, and Financial Crises, 1870-2008.”, *American Economic Review*, Volume 102, No. 2, April 2012, pp.1029-61; Bruno, V. and H. S. Shin, “Capital flows and the risk-taking channel of monetary policy”, *Journal of Monetary Economics*, Volume 71, 2015, pp. 119-132; Hiebert, P., “Characterising the financial cycle: A multivariate and time-varying approach”, ECB-IMF 1st annual macroprudential policy and research conference, 26 April 2016.

⁵ See Black, I. K. and R. J. Rosen, “Monetary Policy, Loan Maturity, and Credit Availability”, *International Journal of Central Banking*, Volume 12, No. 1, March 2016, pp. 199-230; Borio, C., L. Gambacorta and B. Hofmann, “The influence of monetary policy on bank profitability”, BIS Working Papers, No. 514, October 2015; De Groot, O., “The Risk Channel of Monetary Policy”, *International Journal of Central Banking*, Volume 10, No. 2, June 2014, pp. 115-159.

⁶ See for example Koepke, R., “Determinants of Emerging Market Crises: The Role of U.S. Monetary Policy”, IIF Working Paper.

Monetary policy pursuing price stability tends to support financial stability. For instance, ECB easing to raise low levels of inflation also supports disposable income and balance sheet repair. Similarly, the contribution of the ECB policy measures to the economic recovery supports the creditworthiness of borrowers by improving their earnings prospects.

3. POSSIBLE CONFLICTS BETWEEN PRICE STABILITY AND FINANCIAL STABILITY OBJECTIVES

Yet, monetary policy and financial stability considerations may not always coincide. Business and financial cycles tend to have different frequencies. When pursuing price stability, the business cycle typically determines the horizon for monetary policy. This is often a shorter time horizon than appropriate for interpreting slower-moving financial cycles.

Pursuing a financial stability objective with the same weight as the price stability objective, however, does not represent a solution as it could present policy makers with a lasting trade-off. It could lead to conflicts of interest and eventually expose monetary policy to the risk of financial dominance. Policy may also simply become overburdened, leading to sub-optimal outcomes in terms of both financial stability and price stability. Indeed, as ECB Executive Board Member Peter Praet recently emphasized: “the lesson from the 1970s is that if a central bank downgrades its inflation mandate to a point where inflation expectations become seriously de-anchored, sooner or later it will be called upon to assume full responsibility for bringing inflation back under control. At that point, inflation stabilisation and a re-anchoring of expectations may have to come at a very high cost in terms of output losses and financial stability risks.”⁷

It can also happen that an inflation targeting regime unintentionally creates or reinforces financial vulnerabilities at a global level. Take for instance an inflation-targeting central bank which aims at bringing inflation back to target within a rather rigid horizon. Such a central

⁷ See Praet, P., “Financial cycles and monetary policy”, speech in the context of a panel on “International Monetary Policy”, Beijing, 31 August 2016

bank would act swiftly to correct any deviations from its price stability target. But assume expectations of future productivity enhancements trigger a financial upswing. This will resemble a positive cost-push shock that reduces price pressures. If the central bank responds to these reduced pressures with monetary easing, it would risk fuelling the financial cycle. This is for instance what happened in the run-up to the dot-com bubble in the late 1990s.⁸ Indeed, empirical evidence suggests that it has been the rule for stock market booms to coincide with atypically low inflation.

The ECB monetary policy strategy was designed having in mind that credit developments deserve special attention. The ECB policy strategy features a flexible and shock-dependent medium-term horizon, with the implication that policy does not automatically respond to supply-type shocks, unless there is a risk of these shocks becoming embedded in inflation expectations. And it also features a monetary pillar. Under this pillar, trends in credit markets are monitored, and factored in policy decisions even when inflation is still unmoved.⁹

Despite this monitoring of credit developments, it is no reason for complacency. Major imbalances in the financial system have accumulated also in the euro area prior to the global financial crisis.

4. MONETARY POLICY AND OTHER POLICIES

The crisis has highlighted that monetary policy has to be supported by additional policies in order to ensure financial stability. One reason for this new consensus is that monetary policy may lack the granular or targeted tools to address specific developments affecting the financial system. For instance, in the euro area only if negative spillovers become so strong that their effects are felt across the entire currency area would monetary policy intervene. Another reason is that otherwise monetary policy may risk becoming overburdened.

⁸ L. Christiano, C. Ilut, R. Motto and M. Rostagno, "Monetary Policy and Stock Market Booms", paper prepared for *Macroeconomic Challenges: the Decade Ahead, A Symposium Sponsored by the Federal Reserve Bank of Kansas City Jackson Hole, Wyoming August 26 - 28, 2010*.

⁹ See Issing, O., "Monetary and financial stability - is there a trade-off?", *Speech at Conference on "Monetary Stability and the Business Cycle", Bank for International Settlements, Basel, 28-29 March 2003*.

The first line of defence against financial imbalances must be a strong institutional and legal framework that directly targets the sources of market failure. Such a framework would include: financial regulation and macro prudential policy tools that limit excessive risk taking in the boom and make banks more resilient to losses in the bust, a strong resolution framework for banks and insolvency regimes to accelerate deleveraging and balance sheet repair after a crash, and effective regulatory frameworks in other non-financial policy domains – especially in the housing market, which has often acted as a key amplifier of financial boom and bust cycles.

And as shown by a large body of empirical work, fiscal, macro-prudential, regulatory and supervisory policies can also help mitigate the adverse effects of foreign monetary policy on domestic financial stability.

Since the start of the crisis, significant progress has been made in strengthening the macroeconomic framework. Basel III has addressed weaknesses in banking regulation. This is complemented by the euro area's moves towards a banking union. Moreover, the individual euro countries have made important strides in terms of operationalising new macro-prudential instruments.

Yet, challenges remain. One such challenge in some euro area jurisdictions is the reduction of non-performing loans on bank balance sheets.

Of course, while macro prudential policy should be the first line of defence, it should not be the only one. The perimeter of financial institutions directly covered by such policy may be limited as a result of shadow banking. Therefore, while more granular and targeted, the macro prudential policy's international reach may be more contained. Implementation also has the potential to be time-consuming. The impact of monetary policy, by contrast, is more immediate and more comprehensive.

5. CONCLUDING REMARKS

To summarize, rather than to establish a lasting trade-off between financial stability and price stability in central banks' objective functions, the way forward for central banks should focus on reinforcing institutional and legal frameworks.

The ECB strategy has a built-in monitoring framework of credit developments that contributes to prevent financial imbalances.

While more needs to be done to reinforce the euro area's incomplete macroeconomic framework, the adjustments currently being made will further support financial stability.

STRENGTHENING MONETARY POLICY FRAMEWORKS

*Andrew Filardo**

The surprising outcome of the Brexit referendum is just one of the latest among several geopolitical developments with far-reaching implications. I agree with others at the conference that the direct effects of Brexit on Albania and South-Eastern Europe (SEE) are likely to be fairly limited given their modest bilateral trade and financial links with the United Kingdom. But the indirect effects may prove significant. If, for example, Western Europe were to suffer from Brexit, so would the SEE region. The extent of the spillovers will depend on, amongst other factors, the vulnerabilities in the global economy and the resilience of monetary policy frameworks.

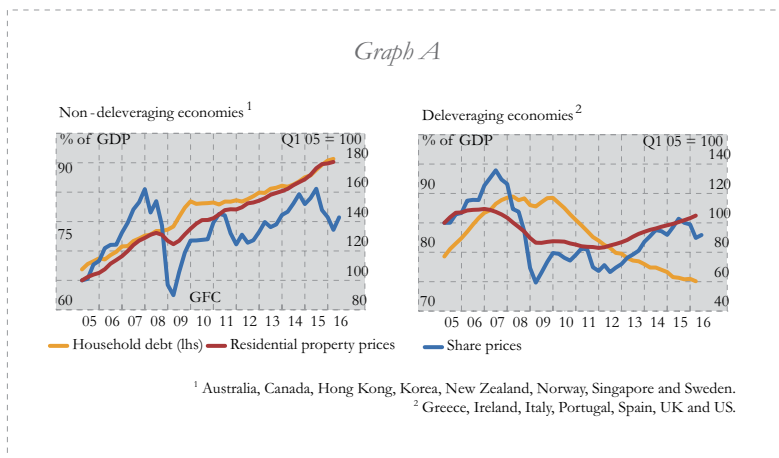
GEOPOLITICAL UNCERTAINTIES AND THE GLOBAL ECONOMY

Before turning to the monetary policy implications, a few points from the extensive Brexit discussion in the early sessions are worth re-iterating to set the stage. First, central bankers are facing considerable uncertainties. When will Article 50 be invoked? What

* *Andrew Filardo, Head of Monetary Policy, Monetary Policy and Economic Department, Bank of International Settlements.
The views expressed are those of the author and do not necessarily reflect those of the Bank for International Settlements.*

will be the negotiating objectives of the various stakeholders? How smooth will the negotiations be? What are the economic and financial consequences? These are just some of the big issues that need to be addressed before turning to the many legal and political details. In many respects, we are at the start of a very complex set of negotiations. The potential for a smooth process is certainly there. But as in any negotiation, setbacks, impasses and conflicts cannot be ruled out. Second, the size and scope of the negotiating agenda suggest a long process. It may go on for many years, with all the inevitable ups and downs associated with negotiations. And it will not come as a surprise if the press tries to accentuate differences. As a result, financial markets may experience wide swings in sentiment, with periods of quiescence followed by periods of turbulence.

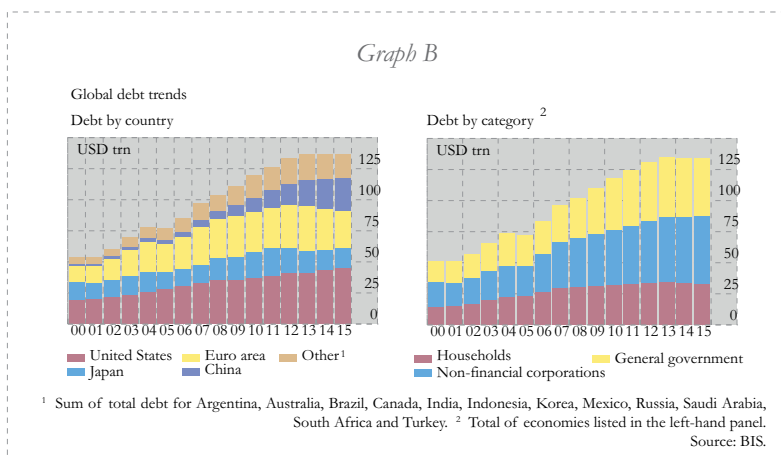
At the same time, the Brexit negotiations are occurring at critical period for the global economy. The global economy remains fragile even amid signs of a recovery that is starting to gather some momentum. Consumption has been leading the way, but consumer-led expansions have historically been associated with less durable recoveries. The flip side of this has been lagging investment demand. The disconnection between improvements in financial markets and disappointments in real investment growth continues to linger. On prices, global disinflationary pressures have been waning as inflation has finally begun to turn upward in some parts of the world. Diminishing global slack has improved the prospects of a shrinking



gap between inflation and central bank targets, which may open up room for manoeuvre to address other central bank concerns.

Notably, the state of the financial cycle, for example house price and credit trends, is particularly worrisome in various countries. Graph A emphasises cross-country differences in the trends. For those countries that have not deleveraged after the Great Financial Crisis (GFC), credit has grown significantly, as have housing prices. For those that experienced deleveraging during the GFC, such as the United States and Europe, housing prices initially fell but are now rising in the persistently low interest rate environment. Global equity prices also appear richly valued given economic fundamentals.

All this is happening against the backdrop of elevated levels of total debt around the globe. International indebtedness has reached new heights in recent years. Graph B shows the debt trends by country and by category of debt. What we can see is that debt levels are about 25–30% higher than levels in 2007. This graph also hints at a possible turning point in debt trends. The low interest rate environment has encouraged borrowing. But questions have been raised about the ability of persistently low interest rates to bring forward consumer spending. Once consumers take on debt to bring consumption plans forward, there would naturally be reluctance to do more in the same low interest rate environment. If the graph truly reflects a turning point in debt trends, the maturing of the financial cycle may suggest



a tempering of or even an end to the consumption-led recovery. Adding to the risk of this situation is the likely normalisation of monetary policy. Rising debt service ratios could further sap consumption spending. Uncertainties abound.

In this economic and financial environment, considerable global financial market bumpiness cannot be ruled out. Geopolitical developments could conceivably be a trigger in a high debt environment. As in the past, a ‘risk-off’ environment can have important cross-border financial flow and exchange rate implications, even if the geopolitical events occur outside one’s own neighbourhood. The 2013 ‘taper tantrum’-type of dynamic cannot be ruled out. Small, open economies would be particularly vulnerable to such shifts in sentiment.

IMPLICATIONS FOR MONETARY POLICY

The current conjuncture has various implications for monetary policy. First, what should be done in the near term? Second, how might monetary policy frameworks evolve to best confront the increasing globalisation?

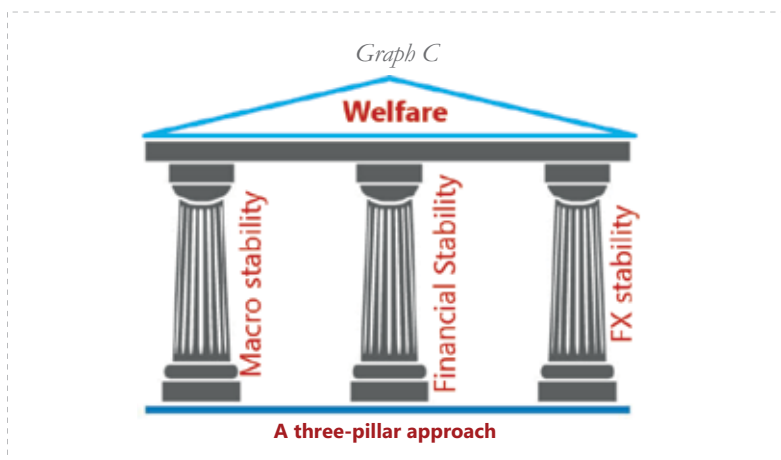
On the question about the near term, normalisation of monetary policy includes reducing implicit burdens on central banks. At the start of the GFC, central banks were relied on to restore financial market liquidity and intermediation. Now that financial markets are on the mend and the financial regulatory regime has been shored up, financial markets are ready to resume their more traditional roles in allocating capital. One by-product of normalisation is a reduced role for central banks as the market makers of last resort. Why? If financial markets come to expect the central bank to always step in as downside risks materialise, market incentives will become significantly distorted. Such distortions can lead to financial dominance, i.e. where markets become too reliant on central banks, and a tendency for the private sector to overleverage. Practically, this means that central banks step back from reacting too sensitively to transitory bumpiness in financial markets and stay the normalisation course. Naturally, central banks have to be ready just in case financial markets find themselves on the verge of melting down, as was the

case in the GFC. Striking the right balance may not always be easy, especially if the triggers are of a geopolitical nature.

With respect to monetary policy frameworks, central banks have been asking whether they should give greater prominence to financial stability and exchange rate stability. In addressing this question, it is important to emphasise a global perspective and highlight the related monetary policy challenges from a medium-term perspective.

While there is wide agreement on the stability-oriented goals of monetary policy, there is less consensus on the monetary policy frameworks most likely to achieve it. Certainly, price stability plays a central role. The adoption of inflation targeting regimes in the region is a testament to this perspective. However, views on the appropriate roles of financial stability and exchange rate stability vary from central bank to central bank.

In part, the post-GFC period has witnessed a sea change in thinking about monetary policy frameworks. Central banks, especially those in small open economies, see that strict inflation targeting is not a panacea. Some central banks have embraced a more flexible version of inflation targeting, which includes the possibility of extending the policy horizon when financial stability concerns are at odds with near-term price stability concerns. Other central banks have become more open to trading off price stability, financial stability



and exchange rate stability, which leads to questions about the appropriate weights to assign to each aspect of stability.

What might a stability-oriented monetary policy framework look like for a globalised 21st century? When reflecting on the last 50 years of central banking history, and especially on the last 10 years since the start of the GFC, it is instructive to consider a three-pillar approach to monetary policy.

The first pillar emphasises macrostability; we often talk about that in terms of price stability, focusing on inflation and growth. But, this is not the only pillar we need to worry about. Other things affect inflation, such as financial stability and the exchange rate. Financial stability and the exchange rate, however, have implications above and beyond those for inflation and the business cycle.

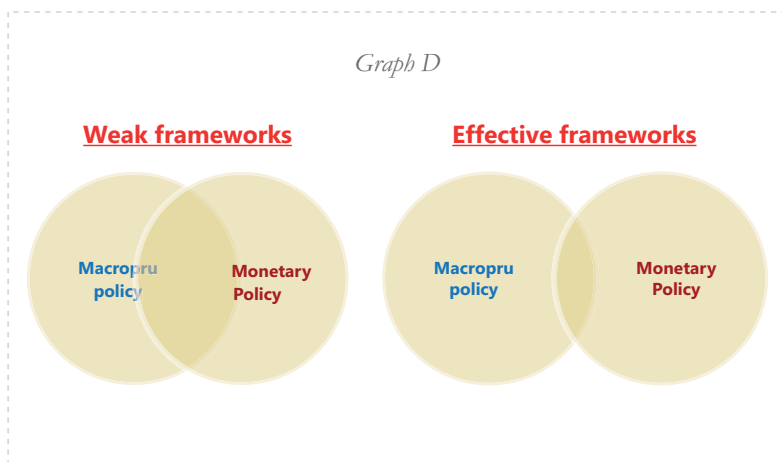
The second pillar focuses on financial stability, including financial stability concerns associated with tail risks. In other words, financial stability-oriented monetary policy is more than leaning against booms. Geopolitical events such as Brexit can have far-reaching implications. When the financial stability pillar is sound, the financial system and the real economy will be more resilient to shocks, whatever their origin. A strong financial stability orientation is particularly important in a world of high debt levels.

In terms of the leaning debate, experiences over the past 20 years have arguably demonstrated the importance of leaning against the financial cycle during booms and of easing during busts. But as the limitations of monetary policy become more visible, especially in the aftermath of a crisis, central banks must be mindful of the distortions and misallocations that can accompany very accommodative policies. In other words, it is important to act symmetrically over the financial cycle to prevent a vicious cycle in which central banks become overburdened and financial markets become too reliant on central banks as the ‘only game in town’. In such an environment, low rates may beget even lower rates.

The third pillar addresses exchange rate stability. Increasingly, exchange rates have become the main monetary policy transmission

channel in a persistently low interest rate environment around the world. This reflects the consequences of economic and financial globalisation. The more open an economy, the more exchange rates will influence economic developments at various policy horizons. However, experience shows that exchange rates do not always act as shock absorbers. Swings in exchange rates may be sources of shocks in some cases and amplifiers of shocks in other cases. Exchange rates do not appear to always work in the way they are supposed to work in theory. This seems particularly to be the situation in small, open, emerging market economies. Using monetary policy, in addition to capital flow management tools and exchange rate intervention, may therefore be appropriate. I will leave a discussion of this aspect of the framework for the future.

Of course, the size of the monetary policy trade-offs often depends on the actions of other policymakers (Graph D). In the case of leaning-against-the-wind monetary policies, the role of macroprudential policies is critical. If macroprudential policies are ineffective, monetary policy would be left with a greater role. With strong and effective macroprudential policies, the role of monetary policy can be much more limited with respect to financial stability mandates. Additionally, with less overlap of responsibilities, monetary authorities and macroprudential authorities are less likely to face political economy challenges. Strengthening both macroprudential and monetary policy frameworks is an important challenge for central banks.



How effective are macroprudential tools? The record of their effectiveness so far is mixed. The evidence suggests that macroprudential tools are good for building financial sector resilience. These tools include loan-to-value (LTV) ratios, debt-to-income ratios and countercyclical capital buffers. The evidence is less conclusive with respect to the effectiveness of these tools in managing the financial cycle. For example, Hong Kong has used LTVs extensively to deal with the financial cycle; however, housing prices have continued to grow to exceptionally high values. Another example is the use of countercyclical capital buffers in Switzerland. The use of the countercyclical capital buffers in 2013 and then in 2014 did not fundamentally alter the trajectory of housing prices or credit.

The insufficient effectiveness of macroprudential tools in managing the financial cycle keeps open the case for using monetary policy for price stability and financial stability. Why the monetary policy rate? Well, the policy rate in theory and in practice plays not only the role of the margin rate substitution in order to influence aggregate demand but also the role of the universal price of leverage affecting the financial cycle. Moreover, while macroprudential regulations can be circumvented over time, the influence of the policy rate is harder to elude. As some say, the policy rate ‘gets inside all the cracks’. Experience also points to the value-added of monetary policy and macroprudential policies when they are pulling in the same direction, suggesting that these policies are best when they are complements, not substitutes.

In sum, effective monetary, financial and exchange rate frameworks are of key importance when dealing with various types of risks that may affect stability. It is therefore essential that we learn from the past and take opportunities to strengthen the frameworks especially during good times – that is, when the economy is less vulnerable to shocks – in order to decrease the likelihood that risks will materialise in a destabilising way in the future. The lessons learnt from the GFC and its aftermath suggest that elevating the prominence of financial stability and exchange rate concerns in the conduct of monetary policy can have significant benefits both domestically and internationally.

ALBANIA MONETARY POLICY AND FISCAL STABILITY

*Anita Tuladhar**

I'd like to focus my remarks today on the perspective of the IMF program in Albania and the challenges it faces with regard to the monetary policy and financial stability to deal with external shocks.

Figure 1.



As many of you know, the IMF program was started in early 2014, at a time when growth had slowed down significantly, fiscal vulnerabilities had risen quite high, and the banking system was suffering from a high degree of NPLs. The program objectives were

* *Anita Tuladhar, Mission Chief for Albania, International Monetary Fund*

thus focused on reducing fiscal vulnerabilities, stimulating growth and maintaining financial stability – these are the main pillars of the program. The macro-economic policy mix therefore was focused on a tight fiscal policy, while maintaining an accommodative, easing, monetary policy stance.

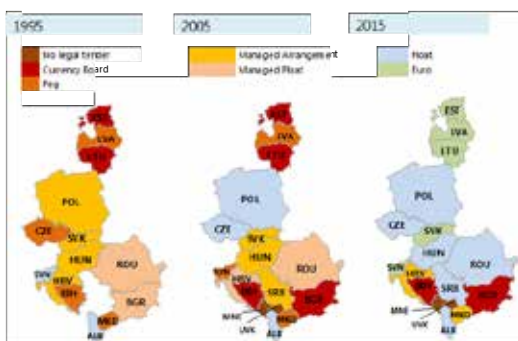
Now, in the present context, with the monetary policy near the lower bound and the financial system still weighed down by post-crisis legacies, I think it is very topical to be examining the challenges of monetary policy and financial stability, especially in the context of the potential for further pressures coming from external shocks such as Brexit.

Figure 2.

Background: Albania's monetary framework

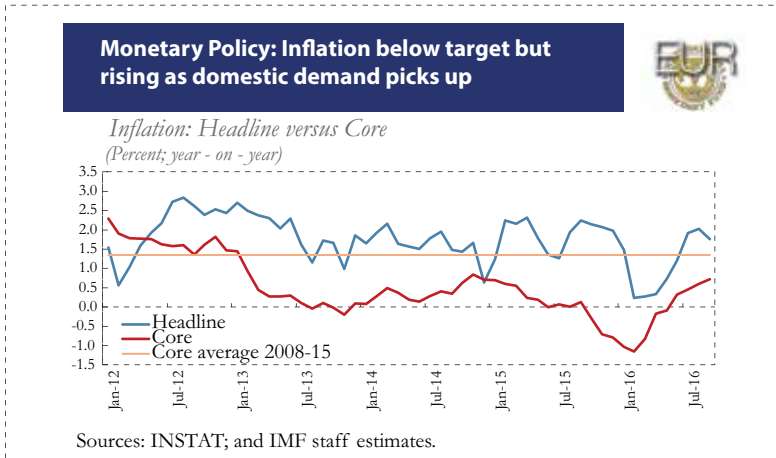


→ One of the few Western Balkan nations with an independent monetary policy (inflation targeting) framework



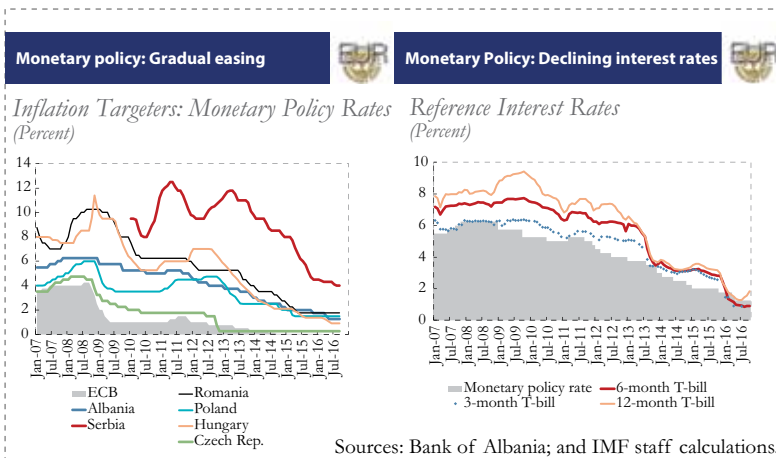
If you look at the monetary framework for Albania you will see that it is actually pretty unique, in the sense that it is one of the few Western Balkan countries with an independent monetary policy framework of inflation targeting. If you look at the far right of figure 1, in 2015, the blue countries are the ones that have an independent monetary policy, whereas the others are mostly somehow linked to the exchange rate. This framework gives some more flexibility to Albania in terms of the policy space.

Figure 3.



In terms of inflation performance, we see that Albania has been able to maintain a low and stable inflation rate, although it has been below target for a number of years reflecting the weak domestic demand. More recently, we have seen a slight pickup in the core inflation rate, a sign of a pickup in domestic demand which is also supported by a number of other high frequency indicators.

Figure 4.

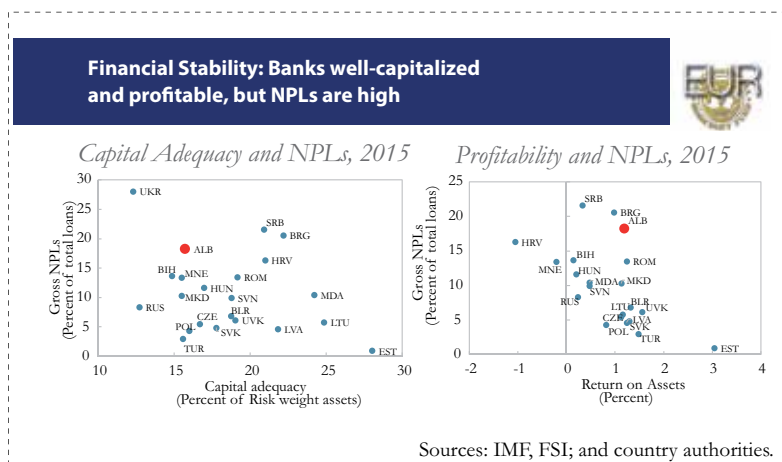


So, in line with global trends, the policy rate has been eased significantly and it has come to a historical low of 1.25% - as shown

by the blue colour on the left of figure 3. We can see that the accommodative stance implies a negative real policy rate of about -0.7% using the expected inflation rate. So, in line with this decline in the policy rate, we also see a decline in the reference interest rates—in this case the treasury bills. So, given the historically low interest rates, there are important questions on the implications of this easing monetary policy on the financial sector. A related question is to what extent should monetary policy consider financial stability objectives in it's pursue of price stability?

Turning now to the financial sector, let me discuss some factors in the financial system in Albania that pose a challenge for monetary policy, in terms of the effectiveness of the monetary policy due to limitations on its transmission, as well as constraints on policy space given its adverse impact on the financial sector. Let me highlight just a few of these factors.

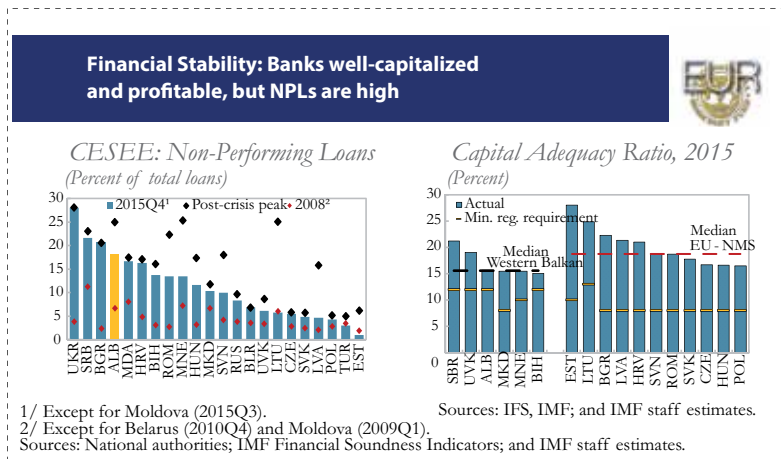
Figure 5.



The banking sector in Albania is generally well capitalized. The capital adequacy ratio is slightly below the regional average, but it is well above the regulatory limit, and it currently stands at a comfortable level. The banks are liquid. Also, in terms of profitability, it is at a level that is slightly above the regional average. However, we find that the NPLs are still quite high, above 20%. This data is as of

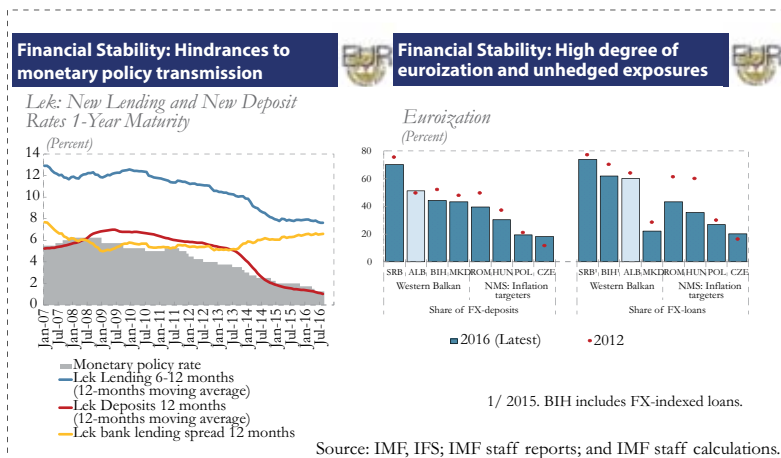
the end of 2015 and since then the NPL levels have increased even further.

Figure 6.



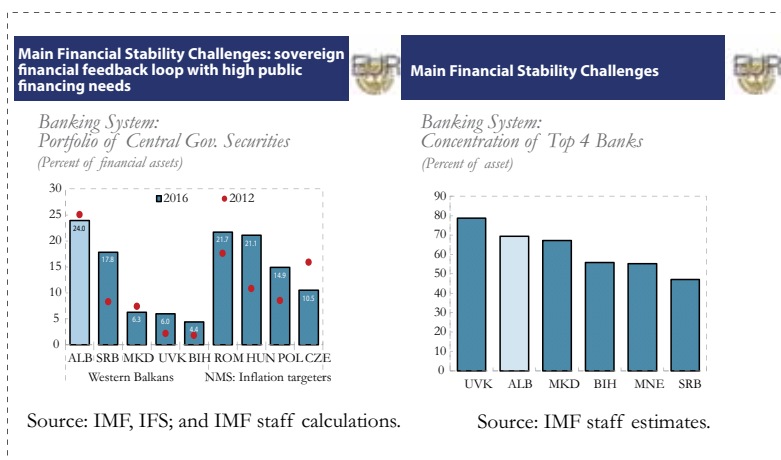
So, this clearly has an impact on the transmission of the monetary policy rate. We find that while deposits rates, shown here in figure 6 by the red line, have been declining over time, the lending rates have not declined as much. In other words, the spread has been increasing, hindering the credit channel of monetary policy.

Figure 7.



Another key challenge is the degree of euroization. If you look on the side of deposits, almost half of deposits are denominated in foreign currency. On the side of the liabilities, euroization is even higher with about 2/3 of lending denominated in foreign currency. More concerning perhaps is that about half of that lending represents potential unhedged exposures which creates concerns about indirect credit risk from an exchange rate depreciation, limiting the room for monetary policy rate cuts.

Figure 8.



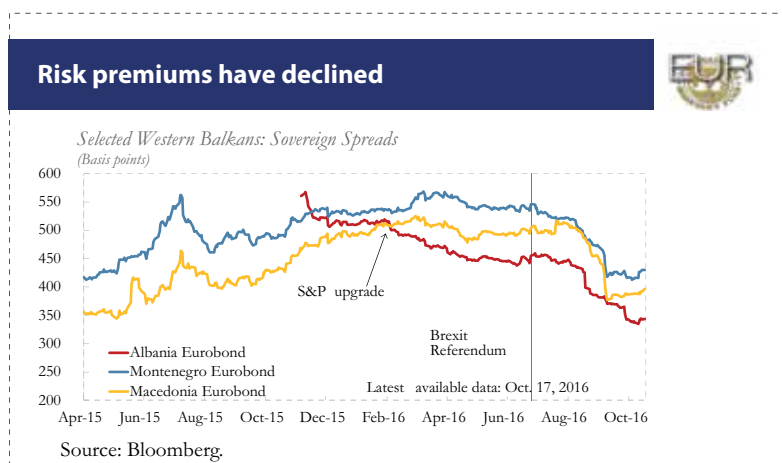
Another key feature in Albania is that banks are heavily exposed to sovereign debt. About 24% of assets are invested in sovereign debt. As a result, if there are any portfolio shifts arising from interest rate changes this could have implications for fiscal financing as well as the reverse: if there are any problems in the debt sustainability, this will also spill over to the financial sector. So this interlinkage exacerbates systemic economic vulnerabilities through the feedback loop between the financial and the fiscal sector.

Finally another feature of the Albanian system is the high degree of concentration of the largest banks, with the top 4 banks accounting for about 70% of the financial system.

So, what are the implications? These features of the financial sector can challenge monetary policy because excessive monetary easing can lead to a depreciation, which adversely affects financial stability through unhedged exposures. Narrowing of the lek euro spreads can lead to an abrupt shift in foreign currency deposits, or even disintermediation. So, monetary policy action needs to be wary of implications of the exchange rate and the indirect effect on banking stability, as well as the impact on large and sudden portfolio shifts. Also, strengthening monetary policy effectiveness will require dealing with euroization as well.

Fortunately, Albania has benefited from a sharp decline in the risk premium and that has allowed interest rates to fall without having large implications on the exchange rate.

Figure 9.



So how do we address the challenges? The conventional wisdom has been that the policy tools have clear objectives. Our view has been that while monetary policy should be guided by the price stability objective, the main objective for macro-prudential policies should be focused on financial stability. There needs to be a close coordination between monetary policy and macro-prudential policy. Monetary policy should proceed gradually with due consideration of the financial risk. The coordination will depend on the type of shocks and the state of the economy.

More specifically, our view is that the current monetary policy stance of “wait and see” approach remains appropriate. There is room under the monetary policy framework to lower rates further if needed. There is no need for unconventional policies to address the price stability objective. At the same time, macro-prudential policy should be used to address euroization challenges. Some of these policies are already in place - policies could be introduced to address in particular the unhedged exposures if needed. However, there are also additional measures that can be taken to strengthen, for example, public debt management in order to reduce the high exposure of sovereign debt and develop the market for government securities. Similarly other macro-prudential policies could also be used to address the risk arising from the concentration of large systemic banks. But, in implementing these policies, one has to take into consideration that complex tools can overload the banking supervision resources and policy circumvention could limit the effectiveness of these prudential measures.

Figure 10.

To what extent should monetary policy focus on financial stability objectives?



Main Message:

- Monetary policy should primarily focus on price stability as the main goal, and leave financial stability to macro-prudential policy.
- Coordination is key to enhance the transmission of monetary policy as well as preserve financial stability.
- Macroprudential policy should consider supervision capacity limits and bank circumvention risk.

So, to summarize, our message is that the monetary policy should focus primarily on price stability as the main goal, and leave financial stability to macro-prudential policies. Coordination is key to enhancing the transmission of monetary policy as well as to preserving financial stability. Policies should consider supervision capacity limits and circumvention risk.

INTERACTION BETWEEN MONETARY POLICY AND FINANCIAL STABILITY: THE BANK OF ALBANIA APPROACH

*Klodion Shehu**

This is the content of my presentation for today. The first two points were already covered by the distinguished previous speakers, in particular from the ECB and BIS.

Figure 1.



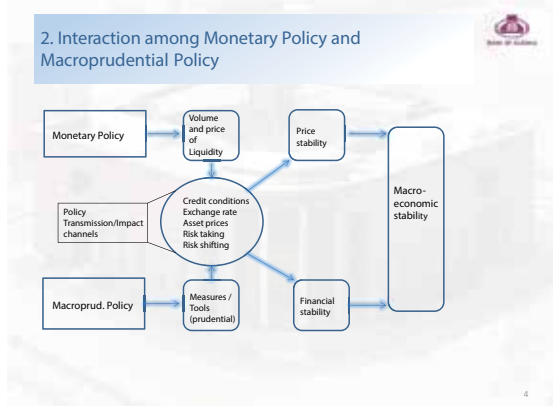
However, let me show you figure 1, which tries to define the scope of each policy. Since we are talking about monetary policy and macro prudential policy, overall the scope or the goal of each economic

* *Klodion Shehu, Head of Financial Stability Department, Bank of Albania*

policy is to increase or to achieve social welfare. However, we all know there are some distortions of financial imbalances that exist in the economic environment and, because of these, such economic policies usually have the so-called interim objectives. For monetary policy, it is very well known that this objective is price stability and for the macro prudential policy the objective is now financial stability. It has already been already mentioned that monetary policy is quite a blunt instrument, so it has a very wide effect on aggregate demand. Hence it was noted that during the crises, to target specific problems in specific sectors of the economy, for example in the financial sector, it was better to use the so-called macro prudential policies, in particular with an exact counter-effect in order to prevent systemic risks from arising.

It has already been mentioned that there is scope for interaction between monetary policy and macro prudential policy, and I believe one additional reason why is that the transmission channel or the impact channels of these two policies are very similar.

Figure 2.



Both policies operate mostly through the financial system. In countries like Albania, where the financial system is dominated by the banking sector, they operate mostly through the banking channels. Obviously, this interaction depends on the phases of the financial cycle, on the characteristics of the economy, and certainly also on the features of the exchange rate. But, for example, if monetary policy

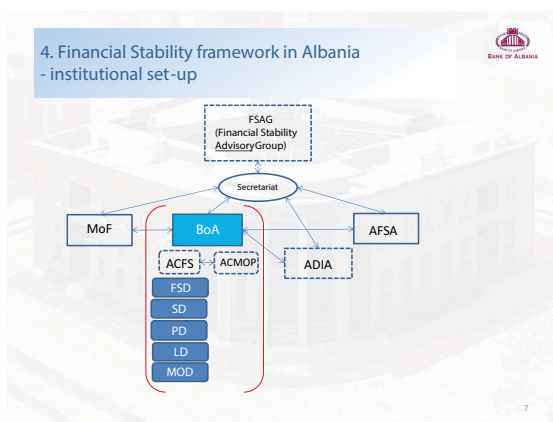
changes can affect credit conditions, they can affect the ability of the borrower to repay the loans and so they can affect the probability of default for the borrowers. In addition, the raising or tightening the policy rate in an open economy can be associated with foreign currency inflows and it can create some pressure on the exchange rate. Monetary policy can also be very influential on asset prices, both financial asset prices and non-financial asset prices. Moreover it can impact the risk appetite of financial intermediaries. It is then exactly because of these reasons that the macro prudential policy can come in. In cases where there are some so-called external effects or side effects from the monetary policy, macro prudential policy can step in and try to mitigate these types of risks. For example, if we see that there is a rise in asset prices or non-financial asset prices, then the introduction of a mean to value prudential measures can try to cool down the trend in the asset prices and impede this vicious circle of when asset prices and credit go up together.

So overall, I think that the similar transmission channels between monetary policy and macro prudential policy make the case for policy coordination and complementarity in order to achieve respective objectives while mitigating possible distortions. One can also say that, as I think was already mentioned by Gilles, there are cases when there might be some confusion about the target and the use of monetary policy and macro prudential policies. The authorities have to make sure that this confusion is avoided and that any use of these policies is very well transmitted to the public and in compliance with the specific policies. So the level and direction of interaction certainly will vary and will depend on the structure of the financial system; obviously the case for interaction may be a bit stronger in cases when we have a financial system which is dominated by the banking sector. As previously mentioned, the case for interaction can also be impacted by the phase of the financial cycle, and obviously by the openness of the economy, because there might be foreign currency flows that may have an adverse impact on the exchange rate and there might be scope for intervention by both policies. It can be determined by the experience with macro prudential policy – which as we all know this is very young almost in every country - the institutional set up, and whether these powers have remained within the central bank or are put in different institutions. On the other

hand, the design of the effective tools is quite a difficult job. Often, quantifying the instability in the economy is quite difficult.

This is the financial stability framework in Albania. In our institutional setup we have the financial stability advisory group which is made up of three institutions: the Ministry of Finance, the Bank of Albania, and the Albanian Financial Supervision Authority.

Figure 3.



Although it is not written in law, the Albanian Deposit Insurance Agency is also regularly invited into these meetings. The focus of this financial stability advisory group is to talk about financial stability issues in Albania, and in particular the way we are dealing with the identification, assessment and monitoring of systemic risks.

This is an advisory group, and while it does not have the capacity to direct decisions, it is quite important because things are discussed in an open way and also an abstract is published in a press release after each meeting trying to point out what we assess as risks at particular times.

At the Bank of Albania, we have two internal committees. The advisory committee on financial stability, whose members are from the departments listed in figure 3, and the advisory committee on monetary policy. These are two separate committees, but their composition is very similar and the idea is to share information in

due time and informing through these the decision-making in the Bank of Albania.

Figure 4.

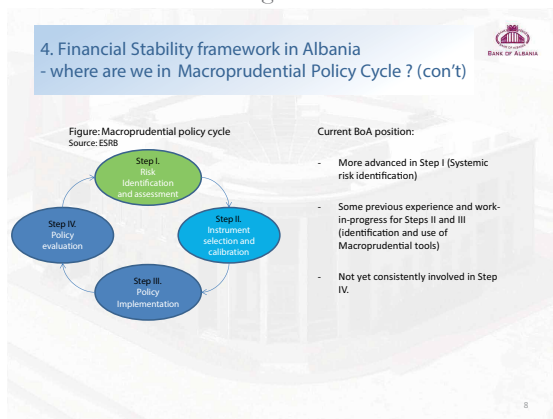


Figure 4 shows where we stand with the macro prudential policy cycle at the Bank of Albania; this figure is presented by the European systemic risk board.

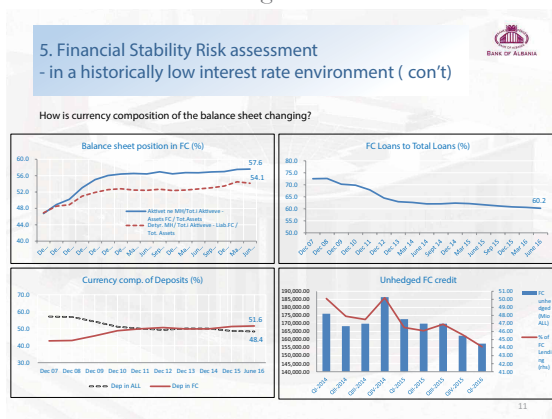
Judging from this cycle, we think that at the Bank of Albania we are more advanced in step 1; that is, for the systemic risk identification we have developed several methodologies in order to assess systemic risks and certain indexes which are also aimed at this issue. We have developed a methodology for assessing systemic banks and also probably in the future for assessing systemic additional capital for these systemic institutions. We also have been involved in instrument selection and calibration, for example for capital requirements on systemic banks. But nonetheless, we have some work to do there as well.

We had had experiences with policy implementation before we took certain measures of a macro prudential nature in order to affect the credit and financial cycle. For example, in 2006, and later in 2008 and 2009, when we were still experiencing rapid credit growth, we introduced high capital requirements for banks' changed risk weights for foreign currency lending, and introduced liquidity requirements both for foreign currency and domestic currency. Somewhere in

2011, this declining monetary policy cycle started to quicken. We also introduced certain measures to provide more incentives for banks to lend domestically, because at the time we were also facing a marked slowdown in credit expansion.

This is the financial stability risk assessment. Obviously we are now operating in a historically low interest rate environment, not as low as in other countries, particularly in the EU, but judging from our history certainly we are at historically low levels. Figure 5 shows how the currency composition of the balance sheet position has been changing recently.

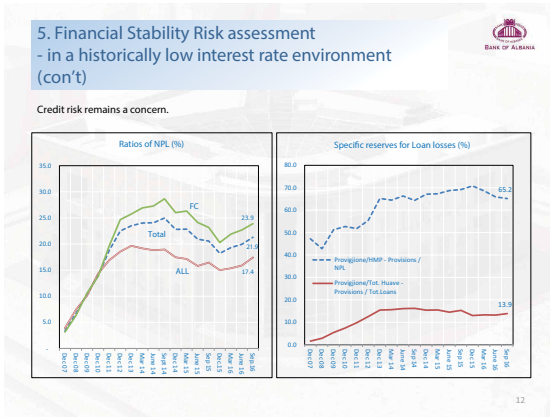
Figure 5.



We can see for example that there is a gradual increase in the activity of the banking sector in foreign currency. The upper left graph shows assets and liabilities in foreign currency in relation to total assets. The upper right graph shows the share of foreign currency loans to total loans has come down, but still remains a concern because almost 2/3 are denominated in foreign currency. The lower left graph shows the currency composition of deposits and, as was also mentioned by Anita, we have seen a gradual but steady rise in foreign currency deposits of the banking sector. The lower right graph shows the unhedged foreign currency credit. It has gone down recently but it still remains at around 26% of the total portfolio or around 44% of the foreign currency loan portfolio. This is the NPL issue, which remains a concern for the central bank, and a number

of measures have already been taken. We are also part of an inter-institutional plan to deal with the NPLs but again you can see here that the figure has been rising in the first half of this year, and the NPL ratio is higher for the foreign currency loans compared to loans denominated in the domestic currency.

Figure 6.



When it comes to the provisioning of NPLs, the graph on the right shows that it stands at around 65%, which is in our view appropriate because we also have a very good collateral coverage of the NPLs and, we do not take collateral into consideration when judging for the NPL figure. So, the total outstanding amount is shown as NPL.

Figure 7.

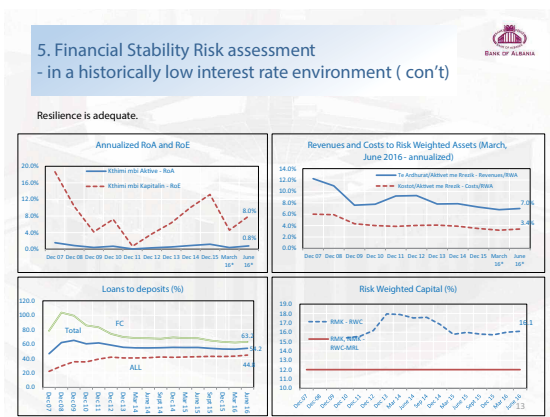


Figure 7 shows the resilience of the financial system. We have a profitable banking sector; the return on equity and return on assets are in positive terms. The upper right graph shows the revenues and costs of the banking sector in relation to the risk weighted assets of the banking sector. It shows that banks have so far been able to adjust their costs in order to face a gradual decline in revenues. When it comes to loans to deposits ratio, this is at very low levels, which also shows the ample level of liquidity that the banking sector has now. The risk-weighted capital, as shown in the lower right graph, is at 16.1%, against 12% the minimum, so again we think these are at appropriate levels.

To conclude, I think that it has already been mentioned that no economic policy alone can achieve financial stability and, at least in our case, having regular communication between monetary policy and financial stability has been necessary. Of course, when allowed by specific objectives and not endangering the credibility of the central bank, clearly monetary policy and macro prudential policy can work very well indeed.

In our case, institutional and inter-institutional setups have been useful in dealing with issues and problems that we have had for both monetary policy and financial stability so far. And we are working to strengthen our analytical work in terms of macro prudential policy. In spite of historically low levels of interest rates, the banking sector has refrained so far from undertaking high risks. Actually, this was one of the figures that was missing there. Moreover the foreign currency weight in banks' benefits is a concern for policy implementation, as already mentioned by Anita, and in our view it also remains high and a concern, along with the NPL; however, the banking sector's resilience in terms of profitability, liquidity and capital position, in our view, is adequate.

GOVERNORS' PANEL:

PROVIDING THE CENTRAL BANKS' POINT OF VIEW AND EXPERIENCE

What are the most pressing current problems in Governors' opinion? How have things changed since Brexit? Do these changes affect monetary policy and the financial stability situation? What policy instruments are best suited to address current problems? Is there any trade off in using monetary policy and financial stability tools and instruments interchangeably?

*Chair: Charles ENOCH,
PEFM and SEESOX, University of Oxford*

*Panellists (in alphabetical order):
Johannes BEERMANN, Member of the Executive Board, Deutsche Bundesbank
Dimitar BOGOV, Governor, National Bank of the Republic of Macedonia
Nikola FABRIS, Vice Governor, Central Bank of Montenegro
Michael FAULEND, Vice Governor, Croatian National Bank
Bedri HAMZA, Governor, Central Bank of the Republic of Kosovo
John (Iannis) MOURMOURAS, Deputy Governor, Bank of Greece
Gent SEJKO, Governor, Bank of Albania*

GOVERNORS' PANEL

Charles ENOCH: This panel aims to bring together the discussions from the earlier sessions of the conference, and to focus specifically on the views of the central bank governors. Seven countries are represented on the panel: three are in the European Union, four outside; two are in the euro area, and the others are not. Each member of panel is likely therefore to have a separate perspective, but all are faced with similar issues.

I suggest three rounds of questions amongst the panelists.

The first round would look at the biggest issues facing your countries. Fifteen years ago, for all the countries in the region, the main concerns were internal; in contrast the external environment, the European Union in particular, was a zone of stability. With the onset of the Global Financial Crisis the situation was suddenly the other way around, in that the shocks were coming from the European Union. And now, as we heard in the earlier sessions, there are shocks and challenges both internally and externally. These clearly are the external challenges: there is weak growth in the European Union, there is Brexit, there is weakness in the European banks. On the domestic side, there are high levels of non-performing loans, there is euroization and there are other issues. So, what is the balance? What are the biggest challenges?

In the second round the panel could look at the instruments discussed in the earlier sessions. There is nowadays a bigger toolkit available than before: there is monetary policy, which has however expanded through the bringing-on-board of a variety of non-conventional instruments; and there is macro-prudential policy, which is new. To what extent can these instruments serve to address the challenges?

And third, it could be helpful to think beyond individual country policies and instruments. With the diversity of panelists here, it would be good to consider what the benefits are that one can get from coordination. Can one coordinate across policies, across institutions, and across countries? What would be the mechanism for coordination? For instance, could it mean that the euro area should coordinate with the individual countries here?

On the first question above:

Gent SEJKO: Thank you for the question. It is quite general, but a very good question. Actually, regarding current concerns and policy instruments to address them, there are many issues that we face as central bankers. I will discuss mainly the issues that the central bank is facing in Albania, but I believe that many of these issues are probably very similar to those experienced by my colleagues from the neighboring countries.

First of all, we would like to speed up economic growth. The biggest issue is to have the necessary economic growth, in order to close the output gap. Growth before the crisis was satisfactory, but after 2008 it dropped sharply, down to around 1%. We are trying to play our role as a central bank, through our monetary policy, to stimulate growth. For this reason, we have been pursuing an accommodative monetary policy by lowering the interest rates in order to incentivize consumption, investment and lending in the economy.

The Bank of Albania has actually cut the policy rate to its lowest historical level. Currently, the policy rate stands at 1.25%; versus 6.25% in the period before the crisis. This expansionary monetary policy has had a positive effect on prices and economic activity, but, on the other hand, as it was discussed here during the morning

sessions, and I hope our colleagues will give their opinion on this topic, we are also concerned about potential negative side effects that these policy rate reductions might have on financial stability. In terms of financial stability there have been some controversies, some discussion and debates. Are there also negative implications and effects?

In this regard, the public must understand that in addition to our macro-prudential policies and our monetary policy, we (the central banks) are also the regulator of the financial sector. We have, therefore, been monitoring carefully to ensure that our accommodative monetary policy will not go beyond the acceptable limits of risk and will not harm the stability of the system, banking groups or any single institution (bank) in the near or long-term future. However, the biggest issue is growth, and through our monetary policy we have been first and foremost trying to contribute to growth. Of course, as we have always been saying, growth cannot be provided without adequate lending.

Up to now we have had credit-less growth: we have been having moderate, progressive growth ranging during the last 3 years, from 1% to 2% of GDP. Now we are going to 3%, and we forecast higher growth rates in the short-term future. This was also mentioned by the Prime Minister in his speech earlier today. This too is the forecast of our central bank, as well as the IMF and other international institutions, but faster growth cannot be achieved without the necessary financial support. Banks account for 95% of our financial sector, and they are mostly part of international financial groups, with European banks constituting the largest and most significant group, among them: Société Générale, Intesa Sanpaolo, Raiffeisen and a few others. Among them, there are also the three largest Greek banks. So, basically they are all banks from the euro area, which are therefore under the monitoring and risk restrictions of the ECB, SSM and EBA and they basically reflect the difficult situation of the euro area. We are aware that these banks no longer have the same operational objectives in the SEE region as they used to have before the crisis, and this definitely influences the financial stability of our economies.

Despite that, we have a very healthy banking sector. The banking sector is well capitalized, and over-liquid. The problem is that there is no longer the same risk appetite, which is somehow understandable. The high level of non-performing loans (NPLs) is another concern. Following the depreciation and slowdown of economic growth in the aftermath of the 2008 crisis, the NPLs went up to 25% by the end of 2015. The Bank of Albania managed to decrease it to 18% in the course of 2016 as a result of an integrated plan. The recent increase in NPLs is a temporary phenomenon as the persistent implementation of our strategy will contribute to further decreasing NPLs in the near future.

To facilitate addressing the NPLs issue, the Bank of Albania, in coordination with the Ministry of Finance, are attempting to streamline the tax treatment of collateral recovered in judicial procedures, after it being written off from bank balance sheets. In addition, the Albanian government and the Bank of Albania have implemented an all-inclusive strategy to address the NPLs issue by involving all the key institutional stakeholders in Albania. This strategy integrates reforms in the areas of supervision, collateral/contract enforcement, debt restructuring, and insolvency. Furthermore, we are working on a new Bank Resolution Law, to align our legislation with the EU's Bank Recovery and Resolution Directive and clarify supervision and resolution responsibilities. Some key objectives of this law include: ensuring healthy capitalization in the banking system, discouraging bank outflows to non-resident entities, and strengthening the monitoring mechanisms of loans to unhedged borrowers.

The Bank of Albania has worked hard to involve all the domestic institutional actors in this process, including the Government, private banks and the Deposit Insurance Agency, as well as international actors such as the World Bank, and the International Monetary Fund. Such a broad-based institutional involvement has been necessary for creating a suitable environment to implement and to resolve the NPL problem.

As for any trade-off in using monetary policy and financial stability tools and instruments interchangeably, from a central banking perspective, monetary policy and financial stability need to

complement each other, and trade-offs between them have to be kept at a minimum. Of course, this complementarity condition is not fixed permanently, and the fine-tuning among policies is the most important aspect of the work of policy-makers.

In our case, the economic and financial cycles that define the course of policy have moved together. At the start of 2000s, increased financial intermediation led to faster growth, until the global crisis of 2008. After that, the slowdown in the global economy led to lower growth rates, starting from 2011. For the first part of the cycle, the contractionary monetary policy helped lower inflationary pressures and calm the economy. In parallel, monetary policy was supplemented and supported by a range of micro and macro-prudential measures, targeting financial stability risks related to un-hedged foreign exchange loans. The accommodative monetary policy we implemented after 2011 responded to the cyclical weakness of the economy and the low inflationary pressures. In addition, we introduced macro-prudential measures to promote credit growth and ensure adequate capitalization of the banks. In both cyclical economic positions, policy coordination proved effective and timely. We designed the optimal policy mix carefully, in order to obtain the best results. Empirical analyses at the Bank of Albania provided supportive evidence that a faster and more drastic policy rate cut would have placed more stress on the financial markets. We acted in line with this evidence.

Our experience shows also that policy coordination within the central bank is necessary, but not enough. Particular problems require policy and institutional coordination between the central bank and the banking system on the one side, and the government, legislative and international institutions, on the other side. This experience has guided our approach for an all-inclusive solution for the structural issues that undermine meeting both our objectives.

BEERMANN: Central banks have to be alert to fiscal policies; they have to strengthen the economic performance of the country; they have to ensure that competition works. On the other hand, what central banks have to do is to look at the monetary sector. For us, due to the part that Germany has in the euro system, the issue is to work within the euro system too. Since Greece and Germany

are in the system, we have to talk with each other, and of course be supportive of the policies of the European Central Bank.

MOURMOURAS: Continuing from the previous speakers, and I fully agree with both of them, and leaving aside the chronic problems of the Eurozone, namely anaemic growth, high and persistent unemployment and lately the risk of deflation, which is linked of course with unconventional monetary policies, which hopefully we will have the chance to comment on later, I would like to restrict my remarks to the following two points:

The first point relates to an issue that has already been with us over the past year, and continues today. I am referring to the on-going migrant crisis. We have all seen emotional images on our TV screens from boat crossings in Gibraltar, in Lampedusa and in the Greek islands of the northern Aegean, and felt the heat of the problem in our Balkan neighbourhood. This problem has potential long-term damage for the future of Europe. The second point I want to make is about Brexit, which perhaps will materialize two years after the UK triggers Article 50 in March 2017, and which represents the biggest - according to my humble opinion - medium to long-term challenge with regard to the dynamics of European integration, because, for a start, it has already heightened political risk.

Let me say a few words about the migrant crisis, and then spend more time elaborating on the issue of Brexit. Migration and the linked labour mobility issue need to be recognised as an urgent policy issue since, if they escalate further in the months to come, they will play a critical role in the shaping of the European Union's future. As we all know, last month the United Nations adopted a declaration which calls for more equitable sharing of the burden of hosting the world's migrants and refugees. For Europe in particular, this would depend upon an efficient and speedy implementation of the EU deal with Turkey.

Moving to the Brexit question, Euroscepticism is now a strong sentiment in Europe. Populist, authoritarian parties are in government or in the ruling coalition in nine countries of the European Union. Nine countries - this is an alarming figure. The upcoming referendum

in Italy and the national elections next year in the Netherlands, the Czech Republic, France and Germany are expected to reinforce this Eurosceptic mood. Eurocrats should take note of this reality. For continental Europe, Brexit represents a shock to the institutions and norms that underpin markets, albeit in a different form from the Euro breakdown fears of 2012, the Global Financial Crisis of 2008 or the bursting of the high-tech bubble of 2001. Today's risk is not financial contagion; instead it represents contagious political development. No matter whether we have a full-blown Brexit or a light Brexit, the political risk for the rest of the continent is that referenda may mushroom across Europe in a tug-of-war between populist forces and the political establishment and elites. Brexit has the potential to unleash centrifugal forces, and may well lead to a breakup of the Euro. I am talking as a very pro-European professor, but would be concerned if at this time such a referendum were to be held in a member country of the Eurozone.

In such a gloomy scenario, it is crucial how the core Eurozone countries will move ahead, and how they are going to react. Hopefully, they will move to a full-blown fiscal and banking union. However, for my own country, Greece, and perhaps other countries in the periphery, the hard question then would be, in this hypothetical scenario, whether we would be part of this new architecture, or we would be left behind. I don't want to speculate further on this.

FAULEND: With low interest rates and very accommodative monetary policies, central banks are trying to do two things. First, to revive credit growth, because this is the avenue to support the economic activity of a country. The second is to enable refinancing of all the sectors. Low interest rates, in particular, help the larger debts to be more sustainable. We all are aware however that with low interest rates alone we cannot revive credit just like that. Why? Because there is also the demand side, and if there is no confidence in the economy, there will be no demand for loans. And in this particular moment we are still, to a certain extent, facing this problem. From the economic literature, what we know is that credit growth is a lagging indicator of economic recovery. So, first comes economic recovery, and only then credit growth follows, exactly because of this demand side.

The second point I wanted to mention is that, given the fact that central banks have been helping to make the refinancing of existing debts, so to say, easier, central banks are physically, and technically, buying time for ministers of finance to carry out needed fiscal consolidation and also necessary structural reforms. When I talk about fiscal consolidation in this low interest rate environment, I consider that there are many negative effects from the low interest rates—for instance for the pension funds, and for the banks, but also for efforts to consolidate fiscal positions, because in such an environment there is no pressure on the fiscal authorities to undertake decisive fiscal consolidation.

I did a little homework before I came here. I looked at a couple of numbers at a very aggregate level. For the EU-28 I looked at the public debt values for two years: 2005 and 2015. During this period public debt increased. In 2005 public debt was 42% of GDP on average. It was 68% in 2015. At the same time, fiscal deficits declined from -2.3% of GDP on average to -1.8% of GDP on average. As regards growth, which declined from approximately 5% to under 3%, the difference is even larger. A fiscal deficit of -1.8% is not enough over the long term to make the public debt come down to the level of 42%, where it used to be ten years ago. Fiscal consolidation on average should have been twice as strong than it actually was.

Having said that, I want to mention that some countries have fiscal space to use in this kind of recession, but some don't, and those who do have fiscal space can use it, but on average fiscal consolidation should be twice as strong as it is in reality.

Obviously, central bankers are buying time for the fiscal authorities to deliver, both on the fiscal consolidation and on the structural reform. I will stop here, and will continue later.

BOGOV: I fully agree with what was said so far - and yes, these are issues, but I would say these are issues that depend fully on us. They are our internal issues, and we have to do our homework. We as central bankers should provide price stability and financial sector stability. So far, if we judge by the results, we can say that

all the countries that are here at the table have these objectives in place. And what should politicians provide? Structural reforms, and improving the quality of institutions. This is a never-ending process; it is something that should continue.

What I am more disturbed about, when I think about the most pressing current challenges, is what is coming from outside and could disturb us in doing our homework. When I think about this I think about two issues. One is related to the banking sector. We have a banking sector dominated by EU banks. These banks entered our countries in the previous decade; they have played an extremely positive role in our countries. They brought competition, they improved corporate governance, they improved risk management processes, they brought capital, and they brought new products, so the banking sector was flourishing. However, after the Global Financial Crisis, and especially after 2010-11, other processes have been in place that make EU banks in our countries not an asset, but, I'm sorry to say, a liability, because we have been facing deleveraging. With the help of the Vienna Initiative, this process became smoother for a while, so the pressure eased, and this was a great achievement. However, after that we have also faced pressure from some home country supervisors. There were cases where a home country supervisor, to protect the country's credit rating - because exposure to Eastern Europe was taken as a negative by the credit rating institutions - acted without caring about the impact on their banks' subsidiaries in the region, despite the fact that some of these subsidiaries are systemically important banks in our countries.

Then pressure from EU regulation: first, increased demands on EU banks, which made them focus entirely on the issues they were facing at home and neglect the situation in their subsidiaries; and second, regulation was introduced that in part was discriminatory vis-a-vis the non-EU countries. If we are on the way to be one day part of the EU, there is no logic in this.

Someone earlier in this conference suggested that we are aiming for an equivalence of supervision. However, some of our countries were left to be the last to be assessed as to whether they have equivalence of supervision. In the meantime, we are discriminated against

as regards treatment of sovereign exposures. For EU countries, sovereign exposure has zero risk weight; for our countries, it is 100 percent. When this is included in the consolidated base in the home countries, this non-EU sovereign exposure is a burden for the EU banks, especially when they are also facing increased capital demands and, they claim, reduced accessibility of domestic credit instruments. All these are issues that we are facing now in the banking sector, and this can be a threat to our financial sector stability.

We have seen recently the possibility that some of the European banking groups will exit from the region. They are already talking about this possibility. Are there buyers on the horizon for banks in our countries? Some of them are really systemically important banks, locally. So, in the current circumstances, we will be facing the issue of finding a buyer for these banks who is fit and proper.

The second issue that will pose a challenge for us in the future is connected to Brexit, but it is not the direct impact of Brexit. The direct impact, as noted earlier, will be practically non-existent. The indirect impact too, in the short term, will be very little. Any impact will come through its impact on EU growth, because the EU is our major trading partner. If there is some deterioration of prospects in the EU, it will affect us indirectly, but still it will not be a very heavy impact.

What I am worried about is the indirect long-term impact, and about the implications which come from a shift of focus of the EU. Now the EU will not be focused on enlargement. Also, populists in the EU are getting stronger and, under the pressure of these populist parties, enlargement will be put on stand-by. When this happens, it will be very dangerous for us, because then it means that our domestic political elites will not have the driver for convergence. In the case of my country, in the last two years we have had a political crisis, because our progress towards EU integration has been stuck. Since 2009, for six years in a row, we have been getting positive recommendations from the European Commission about starting accession talks. However, accession talks did not begin, because of the well-known “name issue”; so, without having the EU perspective, there was a deviation in our domestic politics, and this deviation created a political crisis that has had an economic impact. Our economic growth in the last

two years has not been as it could be, and as the trend was before, just because of this political crisis. So, if enlargement is stopped or is put on stand-by, there is risk of a reversal in democracy, in the rule of law, and in institutions in the Western Balkan region.

HAMZA: Economic developments in Kosovo have been positive in recent years. Average economic growth has been about 4%. This is not bad, but bearing in mind the country's economic level, Kosovo needs to increase its economic growth further. Kosovo has macro-fiscal stability. The budget deficit is less than 2%. Inflows continue to be positive, and revenues in the two major agencies for the collection of revenues, Kosovo Customs and Tax Administration, are understood for the past year to have exceeded expectations. Public debt remains at an acceptable level—indeed, at a low level, currently around 15% of GDP. We have also an improved business environment, as pointed out by the World Bank's reports. Kosovo's banking sector is well-capitalized, liquid and profitable. Referring to the latest data, from September 2016, there is an increase in lending of 9.8% over the same period in the previous year. Deposit growth is over 6%. All banks are profitable and above all healthy, and their loan portfolio is sound, which differentiates Kosovo from the other countries of the region; non-performing loans are only 5.1% and well covered by 122% provisions.

Kosovo adopted the euro unilaterally, and we have very limited monetary policy instruments. Our main objective is to maintain financial stability. We need our banking system to be solid and profitable, not just for itself, but to also be a strong supporter of the real sector. Without macro-fiscal stability, it would be difficult to claim that we would have financial stability over the medium and long term. Therefore, our focus is on the banking sector, to support the real sector, to support business through improving credit conditions, and to increase the variety of the products offered to those productive sectors that so far have had less access to credit.

However, Kosovo's economy is small and new, and has its own challenges and problems. Amongst its problems are the large trade deficit, the high unemployment rate, particularly of the younger generation, and the heavy dependence on remittances, which are

currently around 13% of GDP. We need to strengthen law and order, we need structural reforms, and we need an enhancement of the processes leading us toward integration, so that we can address these challenges in order to have stable economic growth resting on investment supporting the growth of the private sector, especially that of medium-sized enterprises, as well as investments in tourism, energy and quarrying.

Regarding Brexit, the impact was beautifully put into words in the previous sections. This is an event of great importance for the future of the European Union. Taking into account that we all aspire to be part of the European Union, it is of great importance for the countries of this region as well. Direct effects on the economy of Kosovo are limited, due to our geographical distance, and because Kosovo does not have much commercial exchange with the UK and we do not have a high dependence on remittances from it. Foreign direct investment is also low, although it will have an effect on EU countries and, since EU countries are our main partners, our economy might be indirectly affected by it too.

Brexit will be a long process, with many unknowns. It is difficult to determine when it will be completed. But, looking at the economic structure of the EU countries, I believe that the economy of EU will bear this challenge successfully. Kosovo, as part of the region, needs to stimulate the processes that accelerate European integration, since that is our perspective as a small economy. And as part of the EU we will be able to easily address our challenges.

FABRIS: Montenegro has some specific problems, but most of our problems are shared with other countries from the region. Currently, our big source of concern is the level of public debt, around 63% of GDP. This itself is not too high, but we have in mind that Montenegro has started building the highway, and it is expected that by the end of 2018 the level of public debt could therefore reach 80% of GDP. Before the Global Crisis, Montenegro was very low indebted country, with the level of public debt at around 27% of GDP. Therefore we have had a strong trend increase in public debt, which will continue in the near future, in particular due to the building of the highway.

After our new government is appointed in the near future, we are expecting that it will start to prepare a programme of fiscal consolidation, which will be the crucial condition for sustaining economic development in the coming years. GDP growth is at quite an acceptable level. In the last year it was 3.4%, and a rate of GDP growth of around 3% is expected for the next two to three years. The building of the highway, for a very small country like Montenegro, will significantly increase aggregate demand and will support economic growth.

Regarding inflation, we expect that it will be around zero, as Montenegro is a euroized economy like Kosovo. Our instruments of monetary policy are very limited, and we are not able to influence the level of inflation, so we are just importing the level of inflation from the euro area. The average rate of inflation in Montenegro over some longer period of time will be the same as the average rate of inflation in the euro area. In some specific years, inflation is higher or lower, but in general it is the same as the inflation in the euro area.

Regarding the banking system, until recently our biggest source of concern was the level of NPLs. Before the global financial crisis, the level of NPLs was extremely low, 2 to 3% of total credit, but since the crisis there has been a strong trend increase in the level of NPLs. The peak of NPLs was in the third quarter of 2011, when it reached 25% of total credit. Since then, the level has gradually fallen, and is currently around 10%. We are not treating NPLs as a systematic issue any more; we are treating it more as the problem of some individual banks that have higher levels of NPL than the average in the banking system.

We are a little concerned because the appetite of the banks to accept risk has completely disappeared. The banks are extremely liquid. Currently the amount of liquidity in Montenegrin banks is around 1 billion euro, which is extremely high for a small economy like Montenegro; on the other side, credit growth has stagnated, and it is expected that this year again the rate of credit growth will be zero. Meanwhile, there is a strong trend increase in deposits. It is expected that this year deposits will grow at 7%.

Our source of concern, as in Macedonia, is the fact that our banking system is dominated by EU banks. The share of EU banks in the total capital of the banking system is more than 80%. But some of these EU banks want simply to leave the market; their strategy now is to concentrate on their domestic market, and on the EU market. We have recently heard that Hypo Alpe Adria Bank will sell. Also, the Slovenian NLB Bank will be sold, and some other EU banks are looking for potential partners to whom they can sell their business. Regarding external sources of concern, we are in the same situation as Macedonia when talking about Brexit. Direct effects almost do not exist. Earlier, we had an excellent presentation that clearly showed that all countries in this region have a very low level of economic connection with Great Britain. On the other side, there is the potential for indirect effects through the effects of Brexit on the EU, because all countries of the region are significantly dependent on the situation in the EU. That said, all estimates show that the indirect effects also will be relatively limited. The biggest source of concern is how Brexit will influence the process of accession. Montenegro is the most advanced country in the process of accession to the EU, and we are worried about what will happen with the accession process. It is obvious that in a lot of EU countries there is a strengthening of populist parties, and of Euroscepticism, and we fear that this could have a negative impact on our prospects for EU accession.

ENOCH: Thank you for your interesting impressions. We heard that internally the main issues are non-performing loans, rising debt and fiscal prospects.

On the external side, the main concern is the attitude of the EU. There is concern that the accession process is going to become more difficult. Moreover, for those countries outside the EU, there is concern that the EU banks will retrench from the region, from what they see as the periphery.

Moving on to the instruments, four of the seven countries represented here have no exchange rate policy, either because they are part of the currency union, or peg to it unilaterally. They therefore have no monetary policy. To some extent, they have macro-prudential policy. It would be interesting to hear from

everyone how, given their challenges as central bankers, they can operate in this environment. Macedonia is one of those less constrained in this regard?

BOGOV: Theoretically yes, but in fact small, open economies have very little freedom in conducting monetary policy. Nominally, we can play with the exchange rate, but we in Macedonia chose 20 years ago to peg the Macedonian currency to the German mark, and later to the euro, and in the last 19 years the exchange rate has been stable, so our domestic economic agents are already well used to a stable exchange rate.

The exchange rate is no longer a source for losing competitiveness. Our inflation nowadays is at the same level as in the Eurozone, so competitiveness is not declining against the Eurozone. We saw today, in an earlier presentation, that even in large economies, such as that of the UK, when there is depreciation of the currency there is immediately a huge pass-through to inflation; in the end there is not much freedom for monetary policy, since one would have to restore price stability and this would come through higher interest rates. As a result, what has been talked about as a freedom of the exchange rate would very soon be lost.

Therefore, we are pushed to use a combination of macro-prudential and monetary policy measures. Regarding the monetary policy measures, despite all these limitations, we have some very limited freedom to play with the policy rate. We are using macro-prudential measures extensively, because we think that only by combining the two sets of policy instruments can we achieve our goals. These goals are given to us in the law: to achieve price stability and financial sector stability through the banking sector.

So, even in the previous decade, when the whole region was experiencing a credit boom, many countries were experimenting with macro-prudential measures, although nobody was then calling these measures macro-prudential. Some of the countries in the region are pioneers in this: Croatia, for instance, was quite active in this area. We are trying to use a range of measures, including capital buffers, LTV ratios, and reserve requirements. We try also to reduce

the level of euroization, which is present throughout our region. We are playing with the reserve requirement: we can use this ratio to influence the level of euroization, not fully but to some extent, and through this ratio to achieve a stronger transmission of our monetary policy. So, we have to be inventive; we have to not just stick to the text books, because text books are written on the basis of the US economy, and we know that in small economies the market is not functioning so well.

HAMZA: As far as monetary policies are concerned, as we use the euro we are very limited in that regard. Our main objective remains financial stability, and for that reason we have been careful to use a very vigilant bank licencing process. We are aware that safeguarding financial stability means starting with the licensing of the legal entities, and then performing attentive supervision with the allocation of the necessary resources. We are very careful with big exposures because they are risky in themselves.

As an advisor to the government, the central bank has especially cautioned it in two areas: public debt – even though we have very low public debt we are not proponents of the view that it should grow rapidly, especially not through projects that have no productivity and do not have returns – and the structure of the budget, especially as regards current expenses: if there is macro-fiscal stability, and the government finds it impossible to pay companies for the work they have done, then this automatically will raise the level of non-performing loans as well. We are developing macro-prudential policies; in this regard, we have the support of the International Monetary Fund. Their expertise in this field is extraordinarily positive; for instance, they have been able to demonstrate that past events have shown that macro-prudential policies alone are insufficient. Thus, within our constraints, we focused on financial stability as our main objective, since we have limited scope for using the instruments of monetary policy.

FABRIS: Montenegro is in the same position as Kosovo. We are a euroized economy, and we have very little scope for using monetary policy. Our only real instrument of monetary policy is the reserve requirement. In the past, we have experimented with

reserve requirements. We tried to influence credit activity and the term deposits of the banking system, but in the end we concluded that reserve requirements in a euroized economy are a very weak instrument. Now we are using reserve requirements only as part of the instruments for supporting financial stability. As in Kosovo, our main goal is not price stability as is the case for many other central banks; our main goal is financial stability, because with our available instruments we cannot influence the level of prices.

Theoretically we have the possibility to conduct open market operations, but up to now we have not done so, because only the resources of the central bank can be used for conducting open market operations and we are not issuing central bank bills. We are mostly focused on strengthening the banking system, including through prudential supervision, starting from the issuance of bank licenses up to surveillance of all phases of bank operations. This is our main means for preserving financial stability. We are also in the process of developing our macro prudential framework, and are in the process of trying to use monetary instruments, but basically our instruments are not efficient in a situation of euroization.

SEJKO: We have more autonomy, in terms of having our local currency, so our monetary policy definitely has some limited influence despite the euroization of the economy. In this context, I repeat what my colleague, Governor Bogov has said: we too have plans for de-euroization. Through the monetary policy we have been able to fight euroization through increasing lending in local currency. We have seen a positive response since the start of the monetary policy easing, but it has become more pronounced during the last 2-3 years in particular. The transmission of this expansionary policy in the economy has contributed to increased lending in the domestic currency, resulting in an increasing share of local currency lending portfolios in the total outstanding debt to private sector. This trend is continuing, and shows us that the monetary policy is having a positive impact not only on aggregate demand and prices, but also on financial stability. This expansion of domestic currency lending is substituting potential foreign currency lending to unhedged borrowers, who could otherwise be at risk of future prospects of currency depreciation. In this respect, the expansionary

monetary policy is contributing to reducing a potential direct impact of foreign exchange developments on the current loan portfolio and future NPLs. In terms of monetary policy, we are implementing, as I mentioned, an accommodative policy. The central bank is increasing liquidity injections into the market, and we have been increasing them year by year in order to meet market needs for liquidity. Between the Bank of Albania and the commercial banks, we are following a policy of forward guidance through monetary policy declarations and through our communications with the public and the media. We do this by giving a clear signal to the financial markets about our forecasts, our prospects, where are we going, for how much time approximately we expect to pursue an accommodative monetary policy, and so on. Through these basic means we have been able to manage our monetary policy successfully in terms of the Albanian lek. I could mention that, today, as regards the total loan portfolios of the banking system, 45% is in local currency and 55% in foreign currency. But 3-4 years ago, it was 75%, even more than 75%, in euro. So, step by step we are having some influence with our monetary policy in de-euroizing our economy.

At the same time, as my colleagues have said, we are also operating macro prudential tools and policy. The Bank of Albania has introduced to the market a set of macro prudential tools to encourage faster credit growth. They are mainly linked to the capital requirements for different business models. These macro and micro prudential tools are formulae and schema that oblige the commercial banks to raise more capital if they are having more placements and deposits with non-resident institutions and less capital if they are lending more to the economy. This is indirectly linked with the capital adequacy ratio. We still have these types of macro prudential tool in place.

During the last year, however, we have been more focused on addressing the problem of NPLs. I mentioned before that this was becoming an issue; indeed, NPLs are an issue everywhere. We do not have to exaggerate the fact though. We have to be aware that we may be mentioning NPLs too much. NPLs are an issue: they are lost money, which is a problematic and a headache. This is an obstacle, but not an absolutely blocking obstacle. First, we can continue to lend; banks can continue to lend despite having NPLs.

Sometimes if you make a mistake you learn the lesson, and if you have enough capital and enough liquidity you can continue lending if you know the market well enough. Second, you have to address the NPLs problem and engage to resolve it, and in terms of NPLs, we have been developing a plan with the Albanian government. The plan has been partly successful. The plan has many points, but most importantly, it includes writing off loans from banks' balance sheets, as part of the restructuring of NPLs portfolios, and in addition taking legal and regulatory measurements for the recovery of the non-performing loans. We are keen on this, but there has not been too much progress in the selling packages of non-performing loan portfolios from the banks to other asset management companies.

As an adviser to the government, we have made it clear that despite our use of monetary policy and of macro prudential rules and policies, central banks alone will not be able to overcome the crisis without the support of a full package of structural reforms by the government. Albania has a list of structural reforms; every country has its own structural reforms, but we have been advising the government on the priority of reforms for Albania. Albania is still under an IMF-supported arrangement. The mission chief of IMF earlier in the day made her own presentation; this shows that basically we are interacting a lot with the IMF, and we are discussing many constructive plans with them. In this context, the Bank of Albania is advising the government for conducting the necessary structural reforms. As I have mentioned, we are applying measures of monetary policy and for financial stability, but the recovery will come only through structural reforms, because as we have seen, the tools of the central bank--especially for monetary policy--are already exhausted. We might use them more, but we are not sure without seeing good progress in structural reforms. We do want to see increased lending but, on the other hand, while there is very low aggregate demand, whatever we do, still there will be no lending, even when interest rates are zero or minus. It is a matter of risk, perception, and long-term prospects, not a matter of price, and the risk, perception, and long-term prospects will be addressed only through these structural steps.

BEERMANN: As part of the euro system, we have limited macroeconomic instruments. Of course, we are advisers of the government as well; we raise our voice in public, so almost everything is said. It might be interesting to consider, on the other hand, what the ECB does at the moment, and how it works for Germany. Maybe that is interesting because Germany's economy probably will not be quite as vibrant as it was in the first six months of this year, although we do expect to see continued sound growth in the second half of this year. In 2017, we are talking about a 1.6- 1.7 percent increase in GDP. Upbeat labour markets and brisk income growth will keep consumer demand robust. That is important for us, and will help external demand to a degree.

Since German enterprises are now running at full capacity, there is a strong case that investment activity, which has been somewhat delayed, might pick up as well. We had just today some announcements that private companies are going to lend more money, and that this would start now, but I would not be a good central banker if I did not see a fly in the ointment.

Germany too is facing major challenges. For us, the most important thing is the aging population: dragging on the economy is the demographic factor. This is very important for our future, and maybe there could be a connection to the country's investment needs, and why people are going to invest or not to invest.

At the end of the day there will be no getting around raising the retirement age again. We made several decisions to raise the retirement age for certain just a couple of years ago. If we are to prevent a big increase in pension contributions, or a huge drop in the level of pension benefits, we have to act forcefully.

Also, we are talking about the integration of refugees. In the short-term, the influx was like an economic stimulus package, because the expenditure on accommodating and providing for the refugees last year in Germany was as high as half a percent of gross domestic product. This spending will taper off as the influx of refugees dwindles, but then more will need to be spent on education and creating residential space. And for what it is worth, the influx of

refugees has shown just how sensible it is to run small fiscal surpluses. If budgetary policy was not always bumping into the deficit limit, fiscal policy makers would have the resources to fund unforeseen events without immediately crashing through the budget ceiling.

We have seen in Germany, at the federal level, the level of the states, and the municipal level, in the past two to two and a half years, that reducing the public debt has stopped completely. Public treasurers always try to make more money. What they are going to do is to try to make a bigger breakfast than they had before; so, what we see is that it is still necessary to go into the structures of the private sector, as well as the public sector, as competitiveness is no longer guided by a single monetary policy, as we have a common market in the Eurozone. What we have to do is stick to the rules, strengthen the economy, and look at the various sectors: that more or less covers the framework that we have to adopt as a political task.

MOURMOURAS: Before offering my remarks on the policy instruments, I would like to comment on the so-called unconventional monetary policies. I refer to quantitative easing, negative rates, and so on. And I would like to agree on this with my German colleague.

Unconventional monetary policies are, by definition, non-permanent. We all agree on this. They can be only a one off, at least in the Eurozone, so I propose we agree that they are temporary. So, the question, the hard question is: how temporary is such a temporary situation? This is just to reflect on this.

I will now move on to the policy instruments. Taking as given the fact that we will move to a more accommodative monetary policy in the months ahead, a more open question in the Eurozone is the following: which policy instrument will be used: more quantitative easing or further negative rates, or a combination of the two perhaps? This is the essence of the monetary policy debate today in the Eurozone. Clearly, there are limits in persisting with negative rates. Namely, the live question is again, how far and for how long can they actually go? Another concern, looking at banks' profitability: how negative rates may act as a sort of anaesthetic effect to Euro area governments, especially in the southern periphery.

And another concern: that fiscal space, gained from lower debt service cost, may result in low implementation of necessary fiscal structural reforms. In addition, there are concerns about the political and institutional feasibility of negative rates, since their long-term effects are still unknown. Most importantly, their effectiveness is put under question during a recession. Thus, if this dilemma were to emerge in the near future, I would personally, both with my professorial hat and as a central banker, prefer to see more QE, rather than further negative rates. If this is the case, of course the next question is: where could more QE in the Eurozone come from? There are supply constraints on this.

In other words, does the European Central Bank have the tools for more QE stimulus? The answer of course to that is: Yes. There are several options, from changing the parameters of the current QE programme, like for instance buying bonds below the deposit rate, increasing the issue share limit, or more controversially dropping the capital allocation, or perhaps adding new securities to the pool of eligible assets such as bank bonds or equity.

FAULEND: I will move back to the issue of monetary policy in the EU countries from the perspective of the Eurozone. I will limit my remarks to 3 or 4 points. First, I want to say that I agree with what Governor Bogov was saying at the very beginning of this round, and in addition I would point out that, if you have accommodative monetary policy in a small open economy, in the EU or close to it, but you are very integrated into their financial flows, then I personally do not see a clear line making a distinction between monetary policy and macro prudential policy. This is number one. Number two: monetary policy in a Eurozone economy. I do not have to mention it but, just for those who do not know: Croatia is a heavily euroized economy, with approximately 75 per cent euroization. So, monetary policy in a Eurozone economy is a very specific one.

Why? Because the critical point in such circumstances is to have exchange rate stability, for two reasons: first, with exchange rate stability, you have macroeconomic stability, because of the huge pass-through which exists in such an economy because of the real euroization band, and also because of expectations due to past

hyperinflation, and so on. And the second thing: exchange rate stability is also kind of proxy for financial stability because of the balance sheet effects. But what we also want to understand is why monetary policy in such an economy is special. Because in a crisis, if there is a crisis, what people demand from the banking system is not local currency, it is foreign currency. And you know that the central bank in a currency union cannot print foreign currency, *ex nihilo*, because we are not the Eurozone central bank, although we do have an otherwise full-fledged crisis management role. So, the critical point of the monetary authority in such circumstances is in good times to create enough liquidity buffers in foreign currency that can be released in times of need.

In this connection, there is another thing: you need to create better or stronger capital buffers in the banking system in order to make banks more resilient. I do not believe that, even with monetary and macro prudential policy, you can avoid bust cycles. Neither can you prevent boom cycles, but what you can do is that you can really make your financial system more resilient if something bad happens.

Croatia has demonstrated that. We were really pioneers, as Governor Bogov mentioned, in applying macro prudential policies, well before the crises, not in 2006 or 2007, but we had started already in the early 2000s. We created these buffers for both liquidity and capital protection, and we used them when the crises occurred. That was the second point I wanted to make, and the third one regards the prevention of booms and also dealing with busts. The fourth point I want to mention is that I think there is a kind of misperception. Usually people say that if you have a fixed exchange rate, or are close to it, there is no monetary policy. This is not true. There is monetary policy. Why? Because perfect capital mobility in reality does not exist. If there is no perfect capital mobility then you do have a certain room for manoeuvre. It is not a large one, but you can do something. And remember one other thing: You can also work in a sense to create obstacles to perfect capital mobility. This is also very important.

Charles ENOCH: Maybe we can have a third round now on the possibility of coordination, and governors may wish to respond to each other, and then we will turn to questions.

We have heard what the governors have said as to what they as central bankers can do for themselves. Use the instruments, use the limits. But to what extent could they be helped, if there is further coordination? For instance, as regards non-performing loans, it is not central bankers alone but governments also have a role. We heard also that maybe low interest rates, accommodative interest rates, represent central bankers buying time for others, such as the government, to implement necessary structural policies. Is this happening or is there continuing frustration? Do we go on having accommodative policies because there is no debt consolidation by the government, and there is no structural change? To what extent could there be such reforms? To what extent could they be helped by international coordination? If banks are pulling out of some of the countries, should there be Vienna 3? The Vienna initiative was considered successful to begin with but Vienna 2 was not so good. And now banks are just moving unilaterally. Is there scope of further central bank government coordination and is there a role for international coordination, either amongst the central bankers, or with regulators and others?

SEJKO: There is always scope for coordination, but it depends very much on how economic developments unfold; there are many questions as to the future, despite the fact that the central bank's forecasts foresee growth in the next three years. This is demonstrated in the monetary policy models and all other forecasting models. Higher growth prospects are not only a wish, but also a result of the models; and this is not only true for Albania, but basically for the entire region and for the euro area as well. These are the monetary policies and analytical forecasts. We have to see how this will materialize in the short term, and how it will impact the financial sectors specifically.

In terms of lending, Albania has had three per cent growth and we expect a higher rate of growth, yet this remains to be seen. I believe that the forecasted lending and economic growth are in line with fundamental equilibriums in the economy. If we achieve certain parameters in terms of growth and prices, we do not need to stretch more. We do not need to use unconventional monetary policy tools because basically we might already be going in the right direction.

We might be on the right path; despite having moderated growth relative to the pre-crisis period, it is still good enough to close the negative output gap. Albania did not fall into recession in the crisis, growth reduced to just 1 per cent in 2011, but started to recover in the following years leading to a closing output gap, and now we just want to consolidate, and to sustain this growth trend. We foresee progressive developments, but we will have to wait, and then we will have to see if we need to use other instruments, or to do more with the plans and actions we already have designed. The Bank of Albania has studied and analysed alternative expansionary policy actions, but we have not taken the decision to implement these measures. Their implementation is constrained by economic developments. If things progress according to our expectations, meaning that we will achieve above 3 per cent growth this year, and probably 4 next year; as predicted by the Bank of Albania, which is desirable but needs to be seen, because there are many uncertainties; if indeed this comes about, then we will not need to take additional policy actions and engage in further policy coordination.

In terms of monetary policy, as my colleagues mentioned, we all agree that central banks have almost exhausted our tools, and we are looking forward to seeing action through fiscal policy, to stimulate the economy, and also to speed up the structural reforms. Without such economic reform implementation, we cannot provide anything more as a central bank. However, this does not mean that the Bank of Albania is staying and doing nothing. We will definitely continue to exert our role.

This is a wait and see approach, and also involves coordination among all actors. Internally, we continue to coordinate with the Albanian Government. The action plan for the handling of the NPLs was a clear proof of this. We are the regulators by law, but on the other side the role involves continuous communication, including very important coordination with the financial sector. The financial sector is the one that will support the lending and financing of the economy, and this is what we are looking forward to improve in the short-term future. It is not only in the interest of ourselves as the regulators for the improvement of the financial stability parameters and macroeconomic outcome, but for their own interest. The

interest of the commercial sector is key because higher profitability will come only through this lending and thereby will impact the economy and so on.

In the regional perspective, central banks are cooperating through exchanging experiences with neighbouring countries. The SEE region needs more FDIs. Albania receives most of its FDIs from EU, mainly Greece and Italy. Also, Macedonia, and all the neighbouring countries, receive FDIs from the same sources. We have the same trade partners as our trade activity is dominated by the euro area countries; however, as regards central banking tools and activity, I don't see any clear cooperation with the region apart from on FDIs. If the general macro-economic situation is supportive, definitely the synergy within the region is very, very important. If we have a good coordination and combined plans as a region, we could have much more success. We could have very good cooperation in terms of financial stability, for example, through banking supervision, exchange of information through the banks, and discussing the situation of certain banks, because these are banks which are operating in all our countries, as well as in our neighbour countries, and they are subsidiaries of the same EU groups; so, as a region we could share and exchange information and could have a positive impact.

Overall, I would say that we have already played our role: we will continue to play our role but, if future developments meet our expectations, we do not need to move on to any additional unconventional monetary policy tools. In addition, financial stability and, therefore, monetary policy efficiency can benefit more from further cooperation among central banks of the region in terms of banking supervision.

BEERMANN: Coordination always helps; it makes a lot of sense, especially in the financial markets, and we coordinate at a lot of levels. You see it for instance in the regulatory systems, Basel 3, Basel 4. We have a lot of conferences, like this one for example.

But let me come back to the Eurozone, because we are completely coordinated in the Eurozone by the ECB, and the organs of the ECB.

As noted before, we always have to think about, if we are acting in a coordinated fashion, how do we come out again? How are the different interests between the Southeast and the North coordinated? As we pointed out during the earlier talk, the same instruments have completely different results. How are we able to keep this together? That is what we have to do. And there is one big point: we have a regulatory framework that is for the masses of people in the euro system, for the consumers. It is very, very important that they have the feeling that we work within this framework, that we stick to the regulatory rules, and that we are able to give them confidence that we are not doing something behind the curtain, if I can describe it that way. So, coming back to the overall results, just let me take the ECB programmes. The Euro System asset purchase programme has now made the ECB the biggest creditor of the Euro area countries. And this harvests the risk that the Euro System might come under pressure further down the line. Pressure to hold back on tightening rates in spite of monetary policy evidence that action is warranted.

Fiscal dominance might then take its toll on price stability, and that would run counter to the Euro System's mandate. I imagine that would not exactly bolster confidence in the currency, and that is what we have to maintain in our Euro System. So, if we are working on a coordinated system, and if we are taking common action, it is easy to come in, but how then do we get out? And when do we get out of this system? And there we are again, with responsibilities for the monetary policy and the politics. If we the central banks are the biggest creditors of our countries, and our activities are all based on public laws that are provided by the governments or the parliaments of our countries, then we are off the market. If we see our public debts, that is, the fiscal policy, it is easier for us to be the creditors of our governments, than for individual banks or insurance companies: when they give the money to the government, they are part of the market and we are off.

Coordination is important, to talk to each other, and to see the differences, and work them out. I think that the most important thing is that when we have a framework of rules, we have to stick to it.

MOURMOURAS: Coordination versus non-coordination delivers better results. So, I will try to offer my insights on the following three issues.

First of all, should there be any coordination between central banks and governments - independent central banks and governments? Should there be any coordination among the G4 major central banks? And finally, I have to say something on financial stability. What is the coordination at the European Monetary Union level about?

So, about independent central banks and governments. Is there any role for governments, for instance, in delivering our mandate at the Euro Zone level? In other countries, independent central banks, like the Fed, have dual objectives: price stability and employment. But, clearly their first primary objective is price stability. So, in this era of unconventional monetary policies and non-standard measures, somebody is entitled to ask: Is there any role for government?

Clearly there are limits to central bank actions. On the question that I just raised, on whether there is any role to be played by governments, to be on the safe side I would quote President Mario Draghi on this. He said recently: Low interest rates are not the problem. They are the symptom of an underlying problem, which is insufficient investment demand, across the world, to absorb all the savings available in the economy.

So, elaborating a little bit on this, on the quote by President Draghi, one for instance could add that in countries with fiscal space and/or at a Eurozone wide level, some extra spending, for instance in infrastructure, especially in today's environment of extremely low long-term rates, even negative rates, would perhaps increase low levels of nominal demand in the Eurozone; enhance by definition its potential growth rate, its trend growth rate; make the task of monetary policy much easier--for months in a row they are ignoring their target; and finally, contribute to public debt sustainability in many countries, especially in South Europe.

My second comment, on whether there should be some coordination among major G4 central banks. I have listened to that question for

the last 20 years. It reminds me of something that a distinguished Professor of Macroeconomics and good friend of mine, MIT Professor Olivier Blanchard, former Chief Economist of IMF, once said: This coordination is like Nessie, the lovely monster in Loch Ness. Everybody is talking about it, but we never see it, or at least rarely.

So, it is good to have in this era of low rates, of risk of deflation, expansion of balance sheets, some coordination with tangible results, not only the meetings in the United States, or in Basel. But I am not very optimistic about this.

Now, about coordination and what we do in the Eurozone in terms of financial stability. At the institutional level, the proposal for a full-blown banking union is very important. We have got the first pillar: the single supervisory mechanism; and we have got the second pillar, the Bank Recovery and Resolution Directive. This came into effect in January 2016, aiming to ensure that banks will have sufficient loss absorbing and recapitalization capacity to implement orderly resolution, if and when it is needed, while minimizing the impact of bank failures on financial stability and avoiding the use of public money.

The third pillar of a full-blow banking union is the so called the European Deposit Insurance Scheme, which will complete the European Banking Union architecture. It is of paramount importance for preserving financial stability. Of course, there is the issue of burden sharing that, according to my opinion, would make the process rather slow.

Finally, we have to praise the European Commission's initiative to establish a capital markets union. This is a significant initiative to establish a less bank-based system in Europe, as compared to the United States, that would increase the shock absorbing capacity of the European economy and strengthen cross-border risk sharing, thereby contributing to financial stability.

FAULEND: I will support Johannes in what he said, in particular that he pointed to the need for the central bank in Europe, the ECB,

to exit the existing over-accommodative mode. This exit will be only possible if there would be enough coordination, between fiscal and monetary policy. I, personally, do not believe in this coordination. I mentioned to you some real numbers in my first intervention. I noted that fiscal consolidation so far should have been twice as strong on average as it has been in reality. We really have the central bank independence issue at the stake here. There is a big question mark, whether the central banks will be able to behave independently in the face of public pressure if something happens, given the level of debts and the risks to sustainability in the system.

BOGOV: Coordination is very important, and should not be taken as meaning that central banks should do what the other party is not doing, to compensate for it, but rather to coordinate both parties to do what each can do. I will also refer to the issue that you mentioned - coordination in the field of NPLs - which we think is very important. Here we have the internal component, which is coordination internally in the country, because the central bank is not the institution that can solve these issues alone. There are other stakeholders, because it is important what the regulation is, what is the bankruptcy law, what is the VAT law, and what is the judicial system. So, all these stakeholders have to work together in order to improve the environment for solving the NPLs faster and to convert them into a performing part of the banks' portfolios.

Then, there is coordination on the external front, which means that we need to exchange information, and share experiences. I would mention here the Vienna 2 Initiative, which recently took the decision to establish an NPL monitor, which means that they collect information from all countries included in this Initiative and make the information available for everybody, in order to consider measures that might be implementable in their own country. I would add that the IFIs are also very important in the issue of NPLs, in the sense that those IFIs that are market-oriented, such as the IFC and EBRD, can help to bring funds into the region, funds that are dealing with distressed assets. They are entering now into some parts of the region, in Croatia, in Serbia a little bit, but not yet in other countries, and we need more of them, because without such funds the problem of NPLs cannot be realistically solved.

HAMZA: Coordination at the local level is indispensable. At the regional level it is welcome and desirable; at the global level it is also welcome.

Regarding the local level, it is difficult to ensure sustainable economic development and financial stability without adequate coordination among institutions. It is almost impossible to imagine how to inject the excess banking liquidity into the economy, at favourable conditions, to boost credit demand, without impacting credit risk. To reduce credit risk, several factors are relevant, such as: private bailiffs; an efficient judicial system; timely and proper loan procedures; banks that can use the courts; and many other factors that are within this system.

Regarding regional collaboration and coordination, we have had contacts and bilateral meetings and regional-level meetings in the context of conferences. In addition, we have benefited from the technical assistance of important international financial institutions such as the European Central Bank and the International Monetary Fund, contributing to drafting good laws and regulations, and most importantly to the increase of resilience in the financial sector. I believe that this is more than necessary for sustainable economic growth, financial stability and good development of the banking sector.

FABRIS: We can talk about the two dimensions of coordination: first, coordination of the economic policies within the country; and secondly coordination of the economic policies on the global or regional level.

Talking about Montenegro, we have very good coordination of economic policies; for example the Central Bank of Montenegro is preparing recommendations for the whole economic policy for the Government; the Central Bank of Montenegro also advises the Government about managing the public debt. We have also a formal body, the Financial Stability Council, that is a good body for coordination. The Financial Stability Council includes the Central Bank of Montenegro, the Ministry of Finance, the Insurance Agency, the Securities Commission and the Deposit Protection Fund, and it

is a good place for discussions, sharing experiences and coordinating all our policies.

Talking about the regional level, I think we have very good regional cooperation. We have a lot of conferences, seminars, workshops, and bilateral - formal or informal - meetings at a very high level. Also, I have mentioned that in Montenegro we traditionally organise in June the Summit of the Governors and of the Ministers of Finance, which is a good forum for exchanging ideas.

Another aspect is the coordination through information sharing about the policies on the EU and Euro Area. It is something that can significantly influence the situations of the countries of the region. Unfortunately, we do not have such high-level coordination, but it unfortunately is not up to us. We hope that the EU in the coming years, as it advances the process of accession to the EU, will improve also that aspect of the coordination.

ENOCH: Do any of the panellists want to comment on anything that their colleagues have said?

MOURMOURAS: I would like to talk about my own country. As you know, Greece right now is under its third program. After last year's set back, now things have stabilised. I remain optimistic, and still see the glass half-full: let me try to explain to you why. We expect to complete the second review by the end of this year. After this, the requirements of the second review, it paves the way for a road map which includes the following positive steps.

In this field it is perhaps time to deliver on public debt restructuring, It is time for our lenders to help us with public debt restructuring. It was promised in November 2012. We expect after this quite a few, at least two, credit rating upgrades by the rating agencies. And finally we expect to get the country into President Draghi's Quantitative Program, which will be a catalyst towards a lower cost to funding the sovereign, and the gradual return of the country to the international capital market.

ENOCH: Any question from the floor?

Question 1: First, thanks a lot to the Bank of Albania and to the University of Oxford for the invitation here. We had the pleasure and opportunity to hear very interesting presentations today. Some presentations sound pessimistic. I liked the presentation of Mr. Beermann, who said that we need to be optimistic and that, despite the negative impact of Brexit, the SEE states continue to believe in the EU. I have a question for Mr Beermann. Which is the best way for Balkan countries in this moment to deal with the consequences of Brexit?

BEERMAN: Thank you very much for the question. It is not easy; it is the most difficult question I could answer, because neither the UK knows how to organise Brexit, nor the European Union how to react to it. But I am very thankful that we both have an optimistic attitude, and let me say why. If we concentrate on our role as central banks, or advisers at the economic level, I think that we may agree that the best for the economy in Europe and in the world is an open market. It means that, if we are able anywhere in Europe, and that means also the UK after the Brexit, to organise a free market, that is the best for the economy. And I think if we concentrate on this, this would be a common rule for the EU countries as well as for the countries in the Balkans. That is much easier for us, because, if you look on the political side, we cannot address these, and we cannot go too much into the UK's feelings after Brexit. The UK will no longer be a member of the European community, so there will need to be some political measures. That's none of our business. But if you concentrate on the economy, it is the best to say: well let us talk. Let us try to make the markets as free as possible.

Question 2: Andrew FILARDO, BIS: I have a question about the low, very low interest rates in the Euro Area, indeed the negative interest rates, and how that affects financial stability and net interest margin in the banks in EU countries. If they remain low for a very long time, will there be serious imbalances in the banks' accounts, and how is that influencing decisions on the monetary policy stance?

MOURMOURAS: It is a good question. If you know that the Euro Zone has to move further down the road of accommodative policy, this would be done through more QE or further negative rates. Really, there is a threat to financial stability, if we go with more negative rates, for the obvious reasons: banks' profitability, mutual funds, pension funds. Perhaps the most important risk is that this will change the behaviour of savers, for instance in Germany. As a result of this, people may want to save more. Then we are going to witness growth effects quite soon. That is why I present to you a kind of insight to see if there is any role for governments to act. We have to realise that, President Draghi and the Governing Council, all that they can try to do is to reach their mandate, which is there in the Treaty, to achieve close to a two per cent inflation rate. I am sure that he is quite right when he says after every Governing Council meeting that he will do whatever is in his power to reach this objective.

Now the question is, as I said in the beginning, how temporary is this temporary situation hitting perhaps all of us, including the governments?

BEERMAN: the longer it lasts, the more dangerous it is for financial stability and the markets.

Question 3: Gerond Ziu, Bank of Albania: It seems that small countries are facing similar problems. My question is: What are the chances of a creating a common financial market, with that I mean harmonising regulations, bringing in similar terms and making it easier for the banks to shift between countries and borrowers, having regulatory treatment across countries?

SEJKO: This is an idealistic wish. This would be very desirable ideally, but practically it would be, I cannot say impossible, but very difficult to have a common regional market. We see the need of having a region that is organised or coordinated, as we mentioned before, mostly towards the foreign direct investment. If we like to have serious foreign direct investments, by having a good coordination of the region, we can really win. Spontaneously, many large businesses - multinational corporations, large international banks - when they

came, they came to the region. They did not come only to one country, but they came also to all the neighbouring countries. This proves that the large foreign direct investors, when they come they see the region as a whole, because separately our markets are very small. In this context, it makes a lot of sense for our common region. Beyond that, we are all aspiring- as was stressed in the presentations and discussions of our colleagues- and looking forward to being members of the European Union one day. We are all in the process of integration to this end. As regards regional integration, what our colleague raised as a question, it would be very interesting. It sounds very good, but in practice we will have to see how it may be implemented.

ENDING COMMENTS

Charles ENOCH: Thank you governor. I think this is a nice ending, optimistic and idealistic. We also heard an optimistic line throughout the conference, cautiously optimistic, with no grounds for complacency. But we have heard a common aspiration, which is the aspiration to all meet in the European Union, ultimately, maybe in the Euro Area, arriving at different speeds, and we have identified here the management tasks of central bankers to move in that direction. The central bank is not the only player, but certainly a big and important player. This was a really interesting panel, with participation from the whole West Balkan region as well as other nearby countries. I think it was a very useful panel and I would like to thank all the panellists for their contributions.

CONCLUDING REMARKS

Gent SEJKO: As we come to the end, I would like very briefly to make a recap of the main points. We have had very interesting discussions from our colleagues, governors, deputy governors and the member of the Deutsche Bundesbank Executive Board. The main topics of our discussions and presentations consisted in the following:

1. First, the financial crisis, sovereign debt and large scale immigration have been some of the main factors in the current situation.
2. Second, as we have mentioned, a strong Europe is what we need; however, the completion of the Banking Union and the capital market are also needed.
3. Third, it was a point presented and discussed not only now, but during the whole day, and in the panel: Brexit has increased uncertainty on the global scale. For the South East European countries, EU integration is the main aim. For our countries, Brexit has an indirect impact, but it is at most an indirect impact. For the time being we have many headaches, but Brexit is not our major headache. For the time being, there are other things. For the future, we will see what the implications will be, especially on the financial side.

At this point, monetary policy and financial stability have two different objectives, but they are really interconnected with each other. The most important channels are interest rates, exchange rates, asset prices and the correlation between the business and financial cycles.

Central banks have to pay attention to monetary policy, financial policy and exchange rate policy. There was another point raised in the discussions. Having a good framework for analysing financial stability risk and uncertainty are necessary for the coordination between monetary and financial stability.

Another point raised was to emphasise the importance of fiscal consolidation and structural reforms. Central banks have to be very inventive with the new tools and policy coordination.

Economic recovery and growth is what everyone is looking for, but this cannot come without sustainable lending. We need both economic growth and lending growth.

And last, to conclude: future European integration, the future EU, is the main concern for European countries and for our region as well.