MONETARY POLICY REGIMES AND BANK OF ALBANIA'S ATTITUDE

*Gramoz Kolasi**

Keywords
- Monetary Policy - Inflation targeting - Inflation-targeting regime - Dynamic programming -

A monetary policy is able to perform everything and this could evenly happen either to a sound or a fragile economy, otherwise called "economy in transition".

Irrespective of the growth rate of economy, the macroeconomic stability should be doubted evenly, if the monetary policy will constantly be expansive or whether the obtained macroeconomic indicators will be far from the established targets. The results will be obvious in the growing prices, which tend to make the monetary policy even more expansive, by establishing a vicious circle between monetary policy and inflation.

The inefficiency of monetary policy may be as a consequence of two factors:

i) Taking wrong decisions: if the policy makers provide a wrong interpretation about the achieved figures and if they are not characterized by the capability to anticipate future developments, it is only but understandable that the received decisions will lead to erroneous results, generating disfigurement of macroeconomic offset.
ii) The deficiency of an efficient monetary instrument: on the other hand, having a highly developed skill of analyst is not

> enough. You may be equipped with a fair assessing skill over a certain phenomenon and the exact programming for the future; however, if you do not possess at least a single efficient monetary instrument, the uselessness of monetary policy will be happening for sure. We made mention of these two phenomena only, because other factors related to the legal and institutional framework, the economic growth and individual features of each country have been taken for granted.

Which is the principal target of monetary policy? Actually, the consumer price stability is ever more regarded as the only target that monetary policy should comply to the strictest mode possible, notwithstanding the fact that many conjecturers are of the opinion that the economic growth, the foreign position of the country, employment and so on should be a bound part of monetary policy.

The debate remains hot even nowadays and the idea that the monetary policy should tend to a single direction, that of controlling inflation, is more dominant. The first part of this article intends to provide an answer for the above question based on the contemporary ideas on the function of monetary policy[1].

I. WHAT CAN NOT MONETARY POLICY MAKE?

Before drafting a logic framework for conducting monetary policy, it is essential to know what it can or can not make. The monetary policy on its own is the integrity of central bank operations undertaken to realize its targets.

In most of the developed countries, the most important element of monetary policy is the short-term rate fixed by the central bank to affect financial factors of economy which, on their side, have effects on the aggregate supply, consequently.

In other countries, especially where financial markets are undeveloped, the central bank effect is achieved through the

obligatory reserves and the managing control on interest rates supplied by commercial banks even on lending activity.

From a performing survey[2] on 77 countries, it has been noticed that the monetary policy is mostly practiced through the application of indirect instruments. More precisely, 60 per cent of the countries under survey use the required reserves, 48 per cent use Repo agreements and 45 per cent operate on securities transactions. Only 3 per cent, including our country use direct instruments of control[3].

The standard monetary model is based on the principle of the interest rate effect on the aggregate demand of economy. A lower interest rate elevates the required money, while the use of the excessive reserves, which hoists the aggregate demand, is more advantageous for banks; otherwise the growing interest rate reduces the money claim because the fund costs exceed the potential rate of return for banks.

Alan Blinder (1998, page 14) underlines that a rational monetary policy should begin with a target function and with a macroeconomic model at least, whose minimum requirement should be a single monetary instrument to affect the economy. Furthermore, Blinder adds that the macroeconomic model should be based on the concept of dynamic programming, which consists in the idea "think before for the decisions you are making today". This must be understood that the decision-maker should be able to find out the appropriate way that will be successfully leading him from the present to the desired future. It is precisely the compatibility of a dynamic programming, based on the tardy effect of one variable over the other that eliminates any potential failure in meeting future targets. The alternative compatibility, i.e., the static programming, the tightening or mitigating of monetary policy depending on the current inflation rate, would enforce the monetary policy be stagnant for a long time in the sense of its tightening or mitigating.

Making a summary of both approaches, Blinder concludes, "Pondering on a dynamic program is not sufficiently ingrained

in the custom of the policy makers who, frequently view outside the window and take the occasional decisions based only on the assessment of the instant situation." This basic mistake is another reason why central banks frequently maintain a stagnant policy for a long period of time.

According to Blinder, a typical example of dynamic programming is the case of the premonitory measures of the Federal Reserve in 1994, where the monetary policy was tightened before inflation was increased. However, the apparent bewilders in the case of dynamic programming is connected with the fact that in certain occasions, the tight measures of monetary policy seem to be unnecessary.

In the case when premonitory measures turn out to be successfully, inflation will remain at low levels. This would furnish the critiques with the argument that the tightening of monetary policy was unnecessary. Naturally, a perfect premonitory policy obscures some relations of monetary policy decisions with macroeconomics variables. More precisely, if inflation is maintained at 2.5 per cent rate for a long period of time, it would be impossible to discover the monetary policy effect on it (the secondary variable will be constant).

It is already known that the monetary policy control is a mechanic process of controlling money through the interest rates. The money supply may have several shocks, which enforce the emergency for interest rate changes within a rational interval. This means that the central bank is always compelled to regulate the money supply through acceptable interest rates. Even through this will initially require time, in market-oriented economies, if the control on the quantity of money is not achieved immediately, sure enough it will be achieved with the passing of time.

The debate on what monetary policy can and can not make is still going on even currently. On one side is the opinion that in addition to consumer price stability, the monetary policy should be also targeting employment and economic growth.

On the reverse side, the alternative opinion is focused only on the consumer price stability. Per irony, both opinions converge in the idea that the monetary policy serves employment and the economic growth only in the case of the consumer price stability.

Thus, the consumer price stability is a necessary prerequisite for a stable economic growth and consequently the only appropriate objective of monetary policy. The argument between both alternatives has a long history.

Actually, the balance is weighing in favour of the second viewpoint: an ever-growing number of central banks insist on the consumer price stability. The opinions on what the monetary policy can do, have been in constant change during the XX century. While, Irving Fischer (1992- the quantitative theory) concluded that the primary effect of the monetary policy was in that changes in the money amount affected changes in price rates, Keynes (1959- Radcliffe Report) found out that money role in macroeconomics was less feeble. Milton Friedman and other monetary conjecturers challenged Keynes' findings when they concluded that there is a casual relation between the money and inflation growth.

Two very important facts of this literature are related to the empirical job of Bill Philips (1958), on the relation between unemployment and change of money wage rate in the Great Britain and on the successive article of Robert Solow (1960) about the reduction of inflation cost in terms of slowing economic growth rates.

In 1958, Bill Philips demonstrated the existence of a stable relation between employment and the rate of change in money wage rates in the United Kingdom, throughout the previous century.

He used this relation to estimate the maximum of aggregate demand and the minimum unemployment rate in consistency with the consumer price stability.

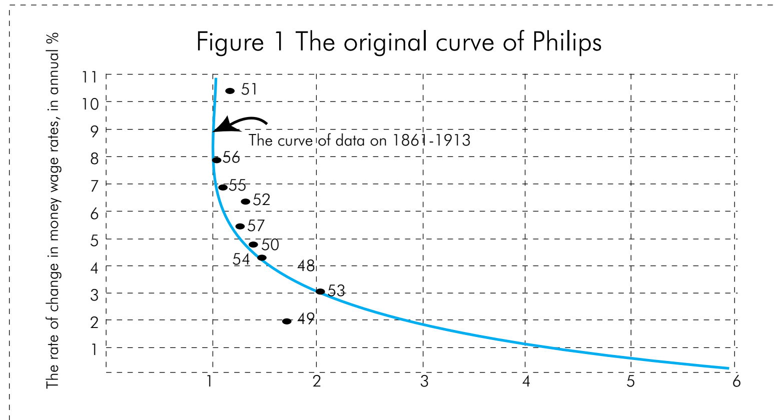
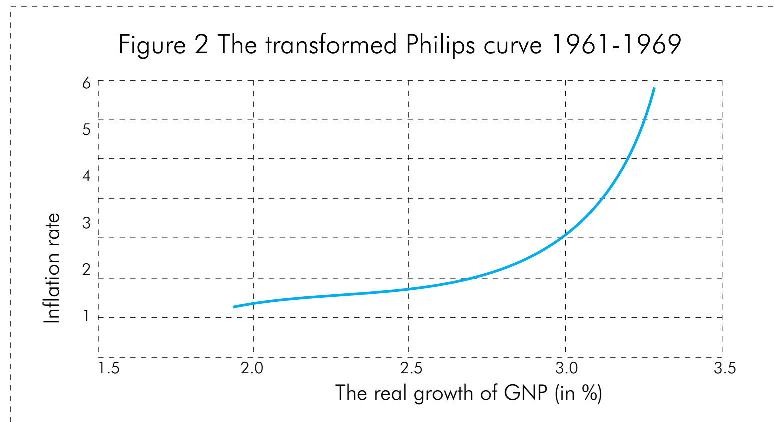


Figure 1 The original curve of Philips

He discovered that some combinations of low unemployment rates associated with positive inflation constitute a disallowed area for macroeconomic concepts and as such they should be avoided, consequently.

Within the four years of this discovery, Samuelson and Solow (1960) capsized Philips analysis and concluded that an inflation rate of 3-4 per cent was necessary to reduce the unemployment rate at 3 per cent in USA. Samuelson and Solow introduced the Philips curve more as a relation between inflation and unemployment than as a relation between the change in wages and unemployment. This transformation was in line with Philips claim that low growth of productivity in Britain, in order to maintain the consumer price stability, allowed 2 per cent growth on the nominal wage. In other words, it was deemed reasonable to assume 2 per cent growth of productivity. Therefore, the Y-axis of the Philips diagram was repositioned on inflation rate 2 percentage points lower than the corresponding change in wages.

The combination of assumptions for a constant growth of productivity and labour force enabled Arthur Okun (1960) to deviate with a monotonous relation between growth and employment. In this way, the Philips curve was transformed from a falling into an upward curve through inflation and the



economic growth rates: a higher growth rate could be ensured by a higher inflation price. Chart 2 presents the transformed Philips curve for USA during the first post-war years, beginning with 1 per cent inflation rate and less than 2 per cent economic growth rate in 1961. For all developing countries, the Philips curve may be practically introduced in the transformed shape due to the lack of employment data.

In 60's the economic theory accepted the proportional reality of a certain type of relation between inflation and growth: a higher growth rate could be attained on a higher inflation cost. In fact, Philips (1958) evidenced that due to the insufficient action of the policy-makers to use the Philips curve relation, the original curve relation began to disappear. Therefore 10 years after discovery, the Philips curve was found under the pressure of several attacks. In fact, Philips curve disappeared within the two successive decades. From an upward curve, expressing the relation between inflation and growth, it was transformed into vertical curve, which means that the long term relation between the economic growth and inflation could no longer be confirmed, particularly, with the data collected after year 1970.

In the two recent decades, Philips curve has been twisted again, discovering a negative relation between growth and inflation for a large number of countries on no time distinction. The currently accepted idea is that in long-term periods, the relation

between production and inflation is negative: the increasing inflation is accompanied by a falling production. (Barro 1995, Fischer 1994). The negative effects of high inflation are easily noticeable in the disturbances they cause to savings, monetary mechanisms and the price structure.

There is a multitude of potential channels through which inflation exerts its positive or negative effect on the economic growth and vice-versa. In developing countries, fixed nominal interest and exchange rates might have been destabilization factors. (Fry 1995). While inflation arises, the real decreasing interest rates (a fixed nominal rate result) dampen the willingness to extend credits and skew the new credit accordance. In the meantime the export prices remain outside international markets due to the fixed exchange rate. Both effects discourage the economic growth rates.

The negative relation between economic growth and inflation in the recent years could be due to the money demand shocks on the whole world during the 70's and 80's: A left side displacement of the money supply curve reduces the quantity and elevates the price. The following years (1988-1995) were not characterized by supply shocks and in consequence, the demand vacillations affected the prices and quantity in the same direction. Moreover, this negative relation seems to be more powerful in the recent years.

Notwithstanding what above mentioned, based on what was evidenced from the developing countries and those in transition, the idea that the monetary policy could accelerate the economic growth and reduce the number of unemployed persons is not supported at any case.

II. RULES VERSUS DISCRETION

An important issue is related to the fact whether the central bank is obliged to use fixed rules or is free to use its own discretion throughout the application of its monetary policy.

Milton Friedman (1960, page 87) underlines that monetary policy decisions provide expected effects at a latter period than that of decision-making.

"There are many cases when monetary policy decisions provide their effects only after a considerable delay or a long period of time, this lag of time is, moreover variable by itself".

Since these are unexpected delays in view of time, it is impossible to achieve the desirable results through an arbitrary application of monetary policy, simply, through discretion.

Given the incomplete knowledge on the functioning mode of economy and the inappropriate measures for fighting risks on the side of decision-making authorities, it would be better for any specialist to apply one rule of monetary policy (for example: that of money growth by a certain rate), than simply base on own intuition or discretion. Only in this way, it will be enabled to avoid a pro-cyclic expansionary monetary policy.

Although imperfect, this rule could bring more stability than a simple action based on discretion.

The modern argument on this issue is more focused on the problem of time discrepancy. This argument could be illustrated by the licence case. A licence promotes development, contributing to the growth of the social welfare. Although the innovation might have happened, the social welfare would be raised only if the licensing right is trespassed, enabling the production of unlicensed products under a competitive situation. Per analogy, in the case of monetary policy, there is a thrilling motive (the growth of production) to trespass, though temporally, on the rule of consumer prices stability and to generate unexpected inflation.

The unexpected rise of consumer price rates due to the presence of the Philips curve raise the economic activity in real terms, the expansion of which, although providing utility, still needs to be doubted since the cost caused by it is still high.

On the other hand, individuals of one economy understand the motives stimulating the decision-makers and the functioning mode of economy by their rationality. So they understand that inflation rise serves the growth of production and in terms of full balance, the current inflation is correctly accelerated only on average terms. Therefore to maximize the national wealth, the decision-makers create unexpected inflation to the point when the margin cost of inflation equals the margin advantage of sudden inflation. (Barro 1986, page 16-19).

Under these conditions, the balance rate of inflation is relatively high; since it is the inflation cost on its own.

However the decision-maker can improve the social welfare, by the commitment for a low inflation rate. If this commitment is reliable, individuals will accelerate the decrease of inflation and the balance will correspond to a low and stable inflation, although on the same unexpected amount of inflation on average terms (zero), as previously.

The ability to enforce commitment is very important to ensure credibility. Under the conditions of a low reputation of decision-makers, individuals will realize that the authority's efforts to maintain a low inflation rate will result pointlessly and the maximizing policies of equity will turn the economy to the balance of flared up inflation.

Due to the difficulty to undertake serious and reliable commitments, various alternatives have been put forward to operate against inflationary deviations in the standard monetary frame.

i) A free and competitive bank activity. Only competition would ensure the public to accept commercial banks only in bidding a real competitive rate of return on deposits.
ii) Monetary Constitution, "a constitutional regime which could be changed only in main line with constitutional amendments" Yeager (1992, page 731).
iii) The safety that central bank advantages, perhaps financially

be connected with the setting and maintaining of consumer price stability.

iv) Recruiting conservative central bankers.

v) The motivation of central bankers not only based on small financial stimulus but also on inflation utility as the only scope to be achieved.

vi) Linking the central bank operation with inflation performance. Many scholars have concluded that inflation targeting[4] is the best medicine to successfully advance in the above-mentioned duality as a rule or discretion. "Enforcing a conceptual structure and internal discipline on the central bank, surely not eliminating the whole flexibility, inflation targeting combines some fixed priorities from rules with some of those attributed to discretion" - Bernmarke Laubach, Miskin and Posen (1999, page 6).

III. MONETARY POLICY REGIMES

Actually, monetary policy regimes are practiced through the application of a certain appointed regime of market effect.

Normally, central banks have only one direct macroeconomic indicator, i.e., money.

However, we must not forget that central banks, in many cases, also have the exclusivity of selecting monetary policy, thus having another opportunity to control the economy.

Nowadays, it is getting ever more stylish for central banks to be more straightforward with respect to expected inflation and this is enabled by announcing the inflation target for the future and the strategy that the central bank will follow to make the expected inflation comply with the target.

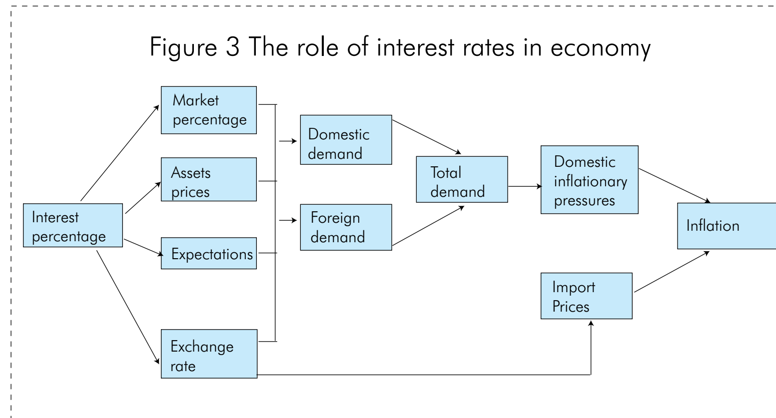
Notwithstanding the fact that the final target of monetary policy will be the consumer price stability or other targets like the economic growth, employment or the external balance, what's more important to underline is that the final success of

monetary policy will be achieved thanks to the selected regime for maintaining monetary policy.

This regime implies the selection of an intermediate objective after all, which is assessed to be the main factor in achieving the final targets.

Differently from final objectives, intermediate targets are macroeconomic variables, which in one way or another are under the direct control of central banks, such as the monetary base, the exchange rate, etc.

Figure 3 The role of interest rates in economy



The classic manner of controlling these variables is simply through active participation in the market (the money and foreign exchange market), where the central bank price becomes the main determinant in establishing all other market prices as those of lending and foreign exchange transactions.

The above scheme simply illustrates the way how the central bank manages to control inflationary pressures in the economy through interest rate manipulation.

Actually, inflation control is getting an even more difficult process to attain. Nowadays, inflation is not simply a phenomenon related to whether the money demand is increased or not.

There are many casual shocks, which from the anticipation incapacity turn into phenomena that tend to break the established balances of the economy.

The success of establishing control on inflation is mostly dependent on fiscal consolidation, which still comprises a serious challenge for transition and developing country authorities. It must not be forgotten that an open market economy means free exchange of goods, services and capital which in one way or another mean imported inflation at a certain extends.

Moreover, nowadays, the globalization of finical markets, besides ousting the geographical distinctions, is absorbing more and more capitals, and on the other hand is making the central bank commitment more difficult. The large subordination amongst markets has made their contagious effect be higher in the form of "domino effect", imposing the big economic powers pay more time to the enforcement of rules and their supervision. The crisis events in Asia and Russia are clear evidence of the latter. Under a new focus, the monetary policy should be more prudent especially when it has to assess future inflation.

This is one of the reasons, which together with the need for more transparency have made very trendy the inflation-targeting regime or more simply inflation-a target to be achieved.

In conclusion, it must be asserted that there are three monetary policy regimes, monetary targeting, exchange rate targeting and inflation targeting. The economic environment and the nature of transmission mechanism, particularly typical for any specific country, condition the selection of the monetary policy regime.

Based on the fact that different countries face different economic, financial structures or environments, it is but understandable that even the monetary policy anchors will be variable in different countries.

As Andrew Crocketts writes, "a measure must not indispensably correspond to all dimensions" (1999 page 222).

IV. MONETARY TARGETING

Monetary targeting is considered as the most appropriate regime for the so-called economies in transition or emergency. In these countries, where financial channels are not developed (our country is a typical case of it), a better control on credit expansion is followed by fixing monetary targets, generally.

In these countries, credit transmission conduits are practically amongst the most important channels, in view of monetary policy.

On the other hand, the intermediate targets of monetary policy help the settlement and household of budget discipline. This is one more reason why the International Monetary Fund, through its assistance programs, imposes preliminaries on the growing rate of money and lending.

Other favourable factors to the application of this regime have to do with the immense difficulties acquainted in the adoption of the other two regimes by those economies.

Foreign exchange targeting bears the risk of breaking the external balance under the conditions when the domestic affected inflation remains out of control. In the meantime, inflation targeting may suffer from the slight confidence in a macroeconomic environment of unstable inflation. This would hamper the achieving of a core objective for inflation targeting, i.e., the orienting of consumer price expectations, domestically.

V. EXCHANGE RATE TARGETING

Although in several cases, the exchange rate regime has led into foreign exchange crises, it can not be denied that the foreign exchange regime where the exchange rate has been pegged to another currency has managed to restrain inflation outbursts in the economy. It may be asserted that a pegged exchange rate, carefully managed, could constitute a very useful political

framework for a developing market at a certain extent of its development.

Some observers suggest that this might be a useful instrument of monetary policy in the first steps of anti- inflation packet, which with the passing of time should be replaced by a monetary policy regime based on the domestic instruments of monetary policy.

Frequently, the exchange rate might have effects on the economy. This may happen when a large part of domestic production is influenced by the international prices or when inflationary pressures are conditioned by the exchange rate (Albania included herewith). Under the conditions when the consumer price sensitivity against political and economic changes is high, especially, in a low and medium income society, the decision-makers' efforts to mitigate imported price vacillations will become more difficult. Unfortunately, they will be incapable of managing the exchange rate only through decreasing or increasing the interest rate domestically. This is a changing point between these countries and the developing countries where the domestic interest rate reflects an unexpected effect on capital movements and exchange rate.

Another and the last point has to with the rate of confidence. If the level of confidence is low and authorities fail to establish it, than the selection of this regime could be of negative consequences, which may lead to smashing of external balance, as well as may be prey of speculations.

In conclusion, it is hard to make an accurate assessment on the use of this anchor of monetary policy. "The difficulty lies in a very practical issue: very few countries have succeeded in preparing a successful "emergence strategy" from the application of a fixed exchange rate. As long as the banking system is functioning appropriately, the monetary authorities do not find the reasons to replace it. While the domestic currency is under pressure, authorities, abandoning its secondary exchange rate, do not want to affirm their willingness to accept even this failure of monetary policy"- Andrew Crockett, (1999, page 224).

VI. INFLATION TARGETING

Inflation targeting is a mode for maintaining monetary policy, under which the political decisions are conceived from the ratio of future expected inflation with its previously announced target. Under the inflation targeting regime, the authorities declare a single figure or an interval (the second is more typical) as an inflation target for future inflation (J. H. Green), 1996). If the expected interval falls out of the announced interval in the following period (one or two years later), this implies that something is not working with the monetary policy; Hence something must be changed to increase its efficiency. From this point of view, the expected inflation is nothing else but "an intermediate target" of monetary policy.

Under a certain regime of inflation targeting, the monetary authority (usually, the central bank) announces the targeted band of inflation in compliance with the final objective of monetary policy, that of consumer price stability. In practice, it is aimed at maintaining the forthcoming inflation within the limits of the announced interval. It may happen that for a certain group of casual phenomena, whose effect on the band has been studied and announced previously, the expected inflation be someway outside the announced interval, but anyway within some additional spaces which have been already admitted. So, the previously announced deviations reveal the necessity to measure the core inflation, an indicator that overlooks the inflationary pressures which are out of the monetary policy control.

As already assessed, another important element of inflation targeting is its transparency in weight, simply because the success of this monetary policy regime is largely dependent on whether the private agents, individuals or the public at large, will accept this officially announced target or not. This important principle of inflation targeting is closely linked with the institutional credibility and the applied policy. Inflation targeting on its own provides free spaces for politics, which may tempt the monetary policy to adopt expansive policies to support the increase of production in the short run.

In other words, the distinct discrepancies between inflation targeting and the preference to increase production beyond the potential capacities could reduce either its credibility or its role in the economy. In this context, most of the countries adopting this regime, have primarily introduced strict measures to increase credibility, including open policy arguments and interpretation of economic data.

A distinguishing feature of inflation targeting is that the intermediate target of forthcoming inflation is not an observed variable.

So from an operating viewpoint, inflation targeting may be regarded as a two- step-process, where the monetary authority first of all provides an inflation forecast to assess whether inflation under the current policy will stay within the target band or not. The second step will arrive on the stage if the forthcoming inflation is expected to fall out of the targeted band.

In this case, a well-defined rule that joins the decision-making process with the projected inflation should determine the direction for the monetary policy instruments to enable the channelling of projected inflation within the targeted band.

By definition, inflation targeting is a medium-term monetary policy, which implies five major elements:

1) The announcement of inflation rate as a target to be achieved on a medium term;
2) The institutional commitment to consumer price stability, as the principal target of monetary policy on which depend all other goals of monetary policy;
3) Preparing a strategy to include many variables, besides monetary aggregates and exchange rates which have been used to establish the framework of monetary policy instruments;
4) The growing transparency of monetary policy strategy through public and market communication of monetary authority plans, targets and decisions;

5) Increase of the central bank's responsibility to hit its inflation targets.

All above-mentioned elements (the fifth of them) are important; however, the most conspicuous of them is, surely, the announcement of the target rate for the coming year.

However, to pretend that the adopted regime corresponds to inflation targeting is important to adhere to four other principles.

This is a highly indicative fact for economies in transition, because many of them report their inflation target, partly as a routine of the economic plan of the government for the coming year, while the strategy of their monetary policies is not yet characterized as an inflation targeting regime, which requires even the application of four other elements, as a potential support beyond the medium term periods.

VII. INFLATION TARGETING PRIORITIES

Inflation targeting has several priorities, as a medium term strategy of monetary policy.

Contrary to a fixed foreign exchange regime, inflation targeting allows the monetary policy to concentrate in concrete situations and react to the shock effects of economy. Contrary to a monetary policy which has money growth as intermediate target (monetary targeting), inflation targeting has the advantage of a living reality of a stable relation between money and inflation which is not a key factor for achieving success of monetary policy. This strategy does not depend on such a relation, but it uses all the available information to define the best group of monetary policy instruments instead of it. Inflation targeting has also another larger priority: it is easy to be understood by the public and very transparent at the same time.

Based on the fact that we have to do with a concrete inflation

rate, the central bank accountability grows, while the possibility to be entrapped in the time instability decreases.

Time instability appears in the type of political pressures over the central bank intending the undertaking of expansive monetary policy initiatives. In this context, inflation targeting has the advantage of channelling the political debate more to what central bank can do for long-term periods, such as: inflation control, rather than on what it can not do, such as: the increase of production, decrease of unemployment, enhancement of external competitions, etc.

To be successful with inflation targeting, it is very important to have a strong institutional commitment, where to specify consumer price stability as the principal target of the central bank. This is particularly important for free market economies in transition, which have had monetary management deficiencies in the past. Institutional commitment implies legal support for a central bank independence, which should have two basic features:

1) Complete separation of the policy makers of the central bank council from other politicians (government members and others) to be protected from arbitrariness;
2) Conceding the central bank a comprehensive and exclusive control for the selection and use of monetary policy instruments.

The institutional commitment to maintaining consumer price stability also requires conceding a central bank mandate where to specify the consumer price stability as its primary target. This mandate should also clarify that in case of inconsistency with other targets, such as the exchange rate stability or the increase of employment rate, the consumer price stability should be of priority.

Inflation targeting underlines the indispensability for making the monetary policy ever more transparent and for maintaining communication with the public; these features have actually been

at the centre of success of the strategies applied by industrialized countries. Central banks have made a step forward in terms of inflation targeting: they publish the inflation report (for the first time it was published by the Bank of England), a printed document to clarify the present, past and future viewpoints on inflation and monetary policy performance.

Another important feature of inflation targeting is that the increase of transparency follows the same intensity on the central bank responsibility to the public. The constant success of monetary policy, measured as an achievement of the announced inflation target, even in the absence of legal, well-defined standards to appraise or object it, would lead to the establishment of public support for an independent central bank.

VIII. INFLATION TARGETING WEAKNESSES

Critiques on inflation targeting have been concentrated in some directions of this monetary policy strategy. The first to specify is that inflation targeting under a single announced figure as a target constitutes a very strict regime which under specific circumstances would cause instability in production, bringing decline in the economic growth of the country.

These weaknesses have been discussed over by Mishkin (1999) and Bernanke (1999) and actually they do not comprise serious problems for an inflation targeting strategy compiled appropriately.

Serious weaknesses are related to adoption of this monetary policy regime in transition economies. First, inflation targeting could lead to weakening of central bank accountability. In addition to inflation control difficulties encountered in transition economies, the effect of monetary policy instruments becomes more tangible in a second relatively distant period.

Inflation control difficulty becomes more problematic especially in economies where inflation has dropped to very low levels,

from some relatively high ones. Under these circumstances, inflation forecasts will embody big mistakes. Therefore, inflation target will not be attained. So, it would be hard for a central bank to gain the credibility from such a strategy; moreover it would be impossible for the public to understand the reasons of these deviations.

According to some authors, inflation targeting is assessed as an efficient strategy even if it is applied after a relatively long disinflationary period.

On the other hand, the degree of institutional collaboration, fiscal evasion and the accompanying risk of a flexible exchange rate are assessed as the main factors to compromise the success of an inflation targeting strategy. Another factor to affect the inflation control, mostly evidenced in the developing countries is the presence of consumer prices officially checked up. As a result, inflation targeting may require a high level of coordination between monetary and fiscal authorities on the term and magnitude of future changes in controlled prices, or alternatively excluding all of them from consumer price index, which would serve as inflation target (the case of the Czech Republic).

Inflation targeting is not sufficient to guarantee an efficient fiscal discipline; moreover, it does not eliminate the application of irresponsible fiscal policies from governments. The high fiscal deficits cumulative on long-term periods would lead to inflation rise and cause a complete failure of inflation targeting regime.

Prevention of fiscal disorder is the key for an inflation targeting strategy. Building institutions will help in the control of fiscal policy, assessed as of primary importance in the achievement of success. In the same line, a solid finical system is another crucial element for its success. However, the financial stability and the fiscal consolidation make up the basis of success for any monetary policy strategy.

Finally, a high dollar level of economy may provide a serious potential problem for inflation targeting. Actually, many

countries of economic emergency, the balance sheet of banks, companies and private businesses on both sides of it (including the long-term debt) is expressed in dollars. That's why, inflation targeting requires a flexible exchange rate; however, the latter oscillations are unavoidable.

The high and abusive deprecations may increase the weight of debt denominated in dollar. This would lead into the deterioration of balances, raising the risk for financial emergencies.

Therefore, it has been suggested that developing economies should not ignore the exchange rate, when they try to apply an inflation targeting strategy. Another suggestion is that this strategy, in partly dollar economies, may not be stable, that's why prudent adjustments should be undertaken to control the finical institutions, so that the whole system is resistant to exchange rate shocks.

IX. INFLATION TARGETING REGIME IN ALBANIA

For about a three-year period, inflation has dropped to very low levels, under a high economic growth situation in Albania. Privatization revenues for 2000 and aids received for 1999 released the government duty in covering budget expenditures, maintaining the budgetary deficit at the planned levels.

Notwithstanding the efforts made, unemployment remains at a constant rate, while GDP has not reached the 1989 rate yet (basic year).

Notwithstanding the achievements in the consolidation of macroeconomic stability, other factors, to assure long-term stability are still considered as secondary factors, and continue to be sidestepped for many reasons (both objective and subjective).

This phenomenon is observed in achieving structural reforms, which continue to be characterized by unjustifiable lags, despite

the privatization of some institutions and relevant entities, such as the NCB, AMC, the Cement factory, the Beer factory, etc. Furthermore, markets continue to be characterized by a general tumult and the obscure economy remains prevalent.

This introduction briefly includes a condensed reflection of the overall economic environment, where the authorities should decide whether the monetary policy should change, of course, in favour of the adoption of inflation-targeting regime. To fully reply to a similar question, perhaps, it should be more rational to reflect on the previous year policy and the achieved results, as well.

X. MONETARY POLICY IN THE PREVIOUS DECADE

Monetary policy in Albania was for the first time compiled and applied in the mid-1992, as a part of the IMF support, when some monetary decisions, introduced for the first time, aimed at establishing control over the money supply through the use of direct instruments. Since the first law of the Bank of Albania, maintaining the value of the domestic currency and ensuring the consumer price stability was stipulated as the main target of monetary policy. In the Bank of Albania's Annual Report for 1992, the consumer price stability, the increase of production and the observance of a full balance in the foreign position of the country were mentioned as final targets of the monetary policy. The monetary base was chosen as an intermediate target of monetary policy, while the basic instruments of the monetary control were two: the credit ceiling and the interest rate on LEK time deposits at the state-owned banks. Since July 1992 onward a "free-flowing" exchange rate regime was adopted, while current account transactions were fully liberalized.

These measures, together with the adoption of a tight fiscal policy and the liberalization of most of consumer prices, led to a brusque refraining of further imbalance of macroeconomic balance. The galloping inflation of years 1990-1991 began

to fall, accompanied by a ceasing in the further decline of production. The macroeconomic consolidation of the country went on with rapid steps in years 1993-1995. It must be stressed that amongst the factors affecting the achievement of this macroeconomic situation, monetary policy decisions occupy a special position. The instantaneous growth of interest rates and the established control on credits to economy forced stopping of the vast monetary haemorrhage at 1999-end and the consumer price rise was only 6 per cent.

The consecutive two-year period corresponds to the "rise" and "fall" of pyramid schemes. The high interest rates of the pyramid schemes totally "replaced" the interest rates offered by banks and the effect of monetary policy was significantly reduced in the aftermath.

The high interest rates led to high deposit placements at the windows of these pyramid schemes, while their investment in securities and production was smallest compared to the collected amount.

Moreover, there was noticed the re-investment phenomenon of both the principal and the earned interests.

Their incapacity to manage the collected deposits made these companies post them at commercial banks, providing them with excessive reserves in huge quantities, which went directly for treasury bill purchasing. In conclusion, at the end of 1996, inflation resulted three-times higher than the previous year-end, reflecting high growth of credit to the government.

Breakdown consequences of these rental companies were comprehensive and carried along a considerable economic charge. At end of 1997, the downfall in production was accompanied with an acceleration of inflation, deterioration of the foreign position of the country and an unemployment increment. However, the Bank of Albania' efforts to raise the interest rates by about 32 per cent began to yield their results.

Monetary policy and fiscal results became more tangible at end of 1998. As part of the Post-Conflict Emergency Program, signed with the IMF, some quantitative restrictions were enforced on the growth of Net International Reserves, on the growth of Bank of Albania's credit to the Government. Year 1999 and the year we just left by registered inflation[5] rates uncommon for an economy as that of Albania. Though during 1999 Albania was forced to face the apostolic exodus of the Kosova people, still for many reasons explained above, inflation remained at low rates. From this moment till end of 2000, interest rates have recognized constant cutting, though remaining very high in real terms.

On the other hand, the market reaction has not been instantaneous and this is also reflected in the high spread existing between the minimum deposit rates and the Treasury bill yields. Under these conditions, considering rational the removal of the floor limit on ALL time deposit rates at state-owned banks, the Bank of Albania intended to tread on a new path, that of the monetary control through market rates.

Drawing some conclusions about the whole period of 1992-2000, the monetary policy was generally characterized by:

- A final and clear target, i.e., maintaining the consumer price stability. As part of the various programs through which the economic progress of our country has moved on, every year has been recognizing quantitative targets on inflation at the end of each fiscal year, though the applied discretion has never been transparent. However roads to run this stability have generally been unclear. There has been discovered no durable connection between inflation and money growth throughout the whole period. On rare exemptions, monetary aggregates have not stuck to their programmed rates; however, inflation has been maintained under control (in many cases, significantly below the target).
- Fixing an intermediate target for money growth. Money growth is considered as an intermediate target, which

would lead to the meeting of the final objective of the Bank of Albania. In fact, money (the monetary base) is one of the unique indicators that the Bank of Albania can comprehensively control. In spite of that, as above mentioned, inflation and this indicator revealed no durable connection, so other factors, specifically the exchange rate, are assessed as direct determinants of the behaviour of inflationary pressures on the economy.

- The application of quantitative restrictions on the asset side. Since the second half of 1992, there were established upper and floor limits on the position of monetary indicators, such as: Bank of Albania's Net Foreign Assets (floor limit), Net Domestic Assets of the banking system (upper limit) divided into Net Credit to the Government and Credit to the Economy. The so-called criteria for achieving success continue to be applied even nowadays, though somewhat differently from the years before transition. Not dealing specifically with the type of those used actually, we would like to underline that the three quantitative targets have been realized within the fixed limits, at least for the period of 1998-2000. In the meantime, the actual realization of the monetary indicators, particularly the money reserve and monetary aggregates are far from their programmed rates.
- Exercising a direct monetary control. The application of direct instruments of monetary control was finally abrogated in the third quarter of 2000, when the Supervisory Council decision "played off" the minimum interest rate for time deposits in Lek, set at second-tier banks of state-owned capital. In the meantime, new credit restrictions were removed earlier.
- Uncertainty and low efficiency of monetary transmission mechanism. Since the third quarter of 2000, the Bank of Albania began to control the money supply through the application of indirect instruments, where Repo auctions occupy the main place in the money market. In reality, the history of applying indirect instruments is earlier, since mid-1992.

In spite of that, it must be noted that their efficiency has been low and monetary policy decisions have been mainly transmitted through the administrative interest rate in all cases. This is true as long as it has been attempted to restrain further rise of inflation for other periods; it has been tended to ease the monetary policy, though this measure has not been very helpful.

From this viewpoint, it's right to ask the question: Will the Repo rate be able to transmit Bank of Albania's decisions to economy? This question is relatively difficult to answer. In spite of Bank of Albania's efforts, the money market is still undeveloped, inflexible, concentrated, etc. The number of transactions remains low in it, where the Savings Bank is a party in most cases, and the volume of performed transactions does not make up any relevant amount. It is a fact that for many years from now, the state budget has been a regular consumer of the excessive reserves.

Restrictions of bank supervision have deprived the banks of considerable lending capacities (NCB and NB) of financing the economy, and their excessive reserves have been transformed into operating budget expenditures, consequently.

This situation has made the Treasury bill market be dominated by the Savings Banks, something reflected in maintaining a relatively high spread between the Treasury bill yields and bank operating costs. Though for some time from now the market is being regulated through Repo auctions, it's unclear whether there exists any optimal level for the position of excessive reserves in the system.

A high credit supply to the Government. Banks managed to purchase the greatest part of government debt initially in a direct form and latter on through Treasury bill issuing. In this way, the state budget was transformed into the largest money "consumer". By all signs, the scenario of treasury bill issuing and purchasing by banks (mostly by the Savings Bank) is likely to be repeated even in 2001 and it seems that the basic interest rate will be the treasury bill yield of 12-month maturity.

A decrease of the money demand on the budget side would reduce the Treasury bill yield and the reverse; an increase of the money demand would intensify the Treasury bill yield despite the Repo rate rise or fall in the money market. A change of the interest rate by the central bank would influence the market credit rates, securities investments, fixed assets prices and overall expectations in the same direction. In the case of an undeveloped banking market, a highly concentrated Treasury bill market and a formal credit market where most borrowings are in foreign currency, it is understandable that the central bank signals can hardly penetrate in the "terrain" and in consequence, the efficiency remains modest.

XI. DO WE REALLY HAVE TO ADOPT INFLATION TARGETING IN ALBANIA?

Replying to the above question, we may state that inflation targeting is a successful strategy when it finds a sound macroeconomic and institutional situation on the one hand, and when it is put forward to an audience (of economic agents, individuals and common public in general) that realizes and welcomes it as a strategy.

Recently, one of the most applied expressions is the one that cites the further crystallization of macroeconomic stability. In fact this expression is mostly found in official statements (including those of the IMF), while other analysts talk about achievements and non-fulfilment, as well as about a large tumult caused by the actual data. Many suspicions, even by Bank of Albania have been raised on how to measure inflation.

Referring to each of the above-mentioned aspects, we would start with:

XI.1 MACROECONOMIC ASPECT

XI.1.1 Inflation

Literature generally recommends that a period of 2-3 years with a low inflation should generally precede the adoption of

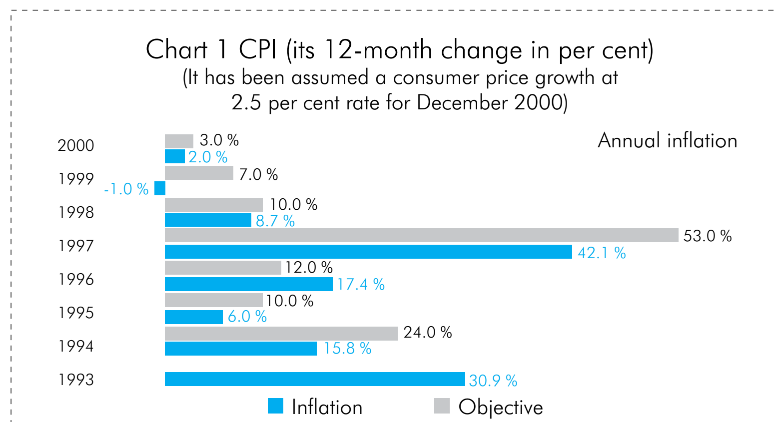
inflation targeting regime, where a low inflation rate implies a rate fluctuating between 2-3 per cent.

Currently, inflation is at very low levels, resulting for the third year in succession below the announced target (chart 1). On the whole, the inflation rate reduction has been a tendency of the last years.

However, the shock factor has been present in different years, either for high or low inflation rates.

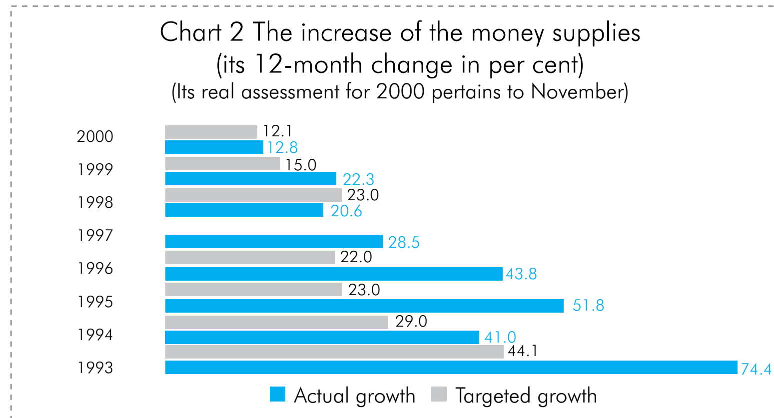
The annual average rate of inflation for January 1993 - November 2000 has been 26.2 per cent, while only for the three last years it has been 7.4 per cent.

If we cast a glance at each year of the latest period, we would have 21.6, 0.4 and 0.2 per cent, respectively for 1998, 1999 and 2000.



What's most noticeable from the chart is that actual inflation has been lower than the targeted rate in all cases, except in 1996, while in other years, including 1999, it has been far from the targeted rate. A similar phenomenon but on the reverse direction has occurred with the increase of the money supply (measured by M3). A similar thing is demonstrated by Chart 2,

where most noticeable in all cases is the higher than the forecast growth of M3.



From a theoretical viewpoint, both charts disclose a sort of paradox; higher than expected growth of the monetary supply has led to reduction of inflation below the target?!

Such sort of paradox highlights once more the question whether the announced inflation is real or the program compilers have been wrong during all the period? In fact, analysts (like, Haderi and Mytkolli, Kunst and Luniku 1998) have drawn the conclusion that the money-inflation relation is still weak and other factors are believed to have a stronger effect on inflation. Finding an answer to the above question is really an integral part of an inflation targeting strategy. In consequence, based on the so-far inflation performance, though it has been low for only two years, we may state that there premises for the application of an inflation-targeting regime.

XI.1.2 Exchange rate

The exchange rate is one of the strongest points for adopting inflation targeting regime. In our country's case it is real luck that the Bank of Albania has the exclusive right for making the decisions, which select and manage foreign exchange policy within the territory of the Republic of Albania. Moreover, since

1992, the Bank of Albania has chosen a free-float foreign exchange regime, whose main feature is the fixing of the currency price on the basis of the demand-supply. The application of this regime is one of the criteria for the application of inflation targeting. So, we may state that even this indicator makes up a strong point of support to start with the application of inflation targeting regime.

Recent years have recorded important steps in relation to fiscal consolidation. It is a fact that the state budget of both years 1999, 2000, had the "advantage" to collect considerable income in foreign currency (in the type of aids and privatization income). According to the 2001 forecasts, the state budget will continue to collect privatization revenues in foreign exchange.

These revenues have significantly mitigated the pressure of fiscal policy over the monetary one, and in consequence the banking system has not been faced with liquidity shortages, while the Bank of Albania has observed the limits defined by law in budget deficit financing.

However it is still early to talk about fiscal consolidation and stability. For such kind of assessment we take into account the structure of budget revenues (where incomes from customs duties still occupy the greatest part), the high level of fiscal evasion and somewhat arbitrary practices in tax collection and in the application of reference prices. On the other hand, the fiscal authority has not adopted appropriate degree of transparency. This means that the efficiency of using the budget revenues is not completely clear.

Finally, the low standard of living in Albania (being the fourth poorest country in Europe), high unemployment rate and not-good practices in managing budget revenues are factors that exert a strong pressure on the authority for budget expansion and weakening of the fiscal position and stability.

From this viewpoint, given the difficulties in recognizing that part of inflation caused by the fiscal policy, it could be asserted

that as long as the treasury bill market is the only securities market in Albania, as long as government borrowing from the Bank of Albania will not be legally forbidden and as long as the political parties lack a total and reliable commitment to a strict and transparent management of fiscal revenues, etc., the successful application of inflation targeting will be hard to apply.

XI.1.4 Financial stability

Considering the financial system crises, Albania has not encountered such ones. This is partly due to that part of economy otherwise called formal economy. Notwithstanding the establishment of two institutes of social insurance, the financial system de facto may be identified with the banking one in Albania. On the other hand, we should not forget that though the 1997 was not a product of the banking system, it still had in its core a typical financial phenomenon, whose consequences weighted very heavily on the main macroeconomic indicators, such as on domestic production, inflation, unemployment, balance of payments, etc.

Given the above, a question arises: Which is the immune system of Albania against financial crises?

Notwithstanding the constant efforts made for strengthening the banking supervision, the banking system in Albania still remains undeveloped and offers a low rate of intermediation. It appears as highly concentrated and operates under a high-risk reality (for the whole spectrum from the political to the operational one). Its regulative framework is incomplete and marks defects in the application of rules and regulations, etc.

On the other hand, markets and other financial institutions remain infantile and reflect a high rate of exposure. Notwithstanding the bitter experience, there are data to provide showing that borrowing still exists, though in small dimensions. As already noticed, the immune system of Albania against financial crisis reveals several problems, which although recognizable

in time are not yet managed to eliminate. This weak immunity makes the Albanian economy have a high rate of exposure and in consequence, a very important prerequisite of inflation targeting remains unfulfilled.

XI.2 Institutional aspect

While the macroeconomic aspect includes factors that encourage the selection of inflation targeting as a monetary policy regime, in institutional aspect it is deemed that more weight depends on its weak points.

XI.2.1 Central Bank Independence

Although the central bank is legally provided with an independent position, however, bank independence remains far off the legal standard and under menace. Other authorities should bear the tendency to comply with the central bank independence. And on the other side there no sufficient guaranty that independence vested under the current law (entirely or buy separate elements of it) will not be submitted to latter changes.

XI.2.2 Central Bank Transparency

The Bank of Albania is engaged in enhancing its transparency, though it is still far from the standards. The Bank of Albania is not yet transparent in its core: in explaining the decision-making process, especially for monetary policy issues.

XI.2.3 Central Bank Reliability

It can not be affirmed that the Bank of Albania has finally won the public confidence. It should be realized that Albanians initially needed to know about the existence of the central bank, named the Bank of Albania. On the other hand, public confidence will be hard to ensure in general and still harder under the conditions of inflation targeting. As inflation is highly affected by shock and speculative factors, its possibility to deviate from the target remains high in Albania.

XI.2.4 Central Bank Accountability

The Bank of Albania by law is assigned a considerable level of accountability, estimated by its reporting duties. However, in reality the central bank accountability should be raised. The Bank of Albania is engaged in the observance of all the reporting duties, but the quality of this reporting is subject to further improvement, which is expected to raise its real accountability.

XI.2.5 Not good relations with the fiscal authority

The level of coordination between the fiscal and monetary authority is not in the level required by inflation targeting. Practically, this lack of coordination impedes the Bank of Albania to efficiently apply the instruments for achieving monetary policy.

Thus, the whole institutional aspect is considered as a weak point for adopting inflation targeting.

XI.2.6 Public Awareness

Albanians took the first practical lectures on what inflation is at early 90's. With the passing of time everybody realized that the consumer price rise corrodes their income and savings and very few of them understand that the difficult mission for keeping them stable belongs to the institution named the Bank of Albania.

Albanians really understood one fact that "to enjoy tomorrow, they should save today", a strong appeal made by both political parties at the time of their coming into power.

In spite of this, they failed to see the mechanism that leads from the (destroyed) present to the richer and safer future. The prolonged transition period and numerous failures along it (mainly because of subjective reasons) also contributed to this.

A limited number of people are capable of explaining why such deep reforms are needed, while the rest is found in the

position of the disillusioned and the majority, with its indifference, accepts them as they are.

From this viewpoint, it is hard to believe that the Bank of Albania will find reliable "partners" to properly realize and interpret its own decisions. When the public understands and welcomes the central bank policy, it is transformed into a sort of factor for determining inflation in the future.

Practically public awareness, its familiarization with the monetary and banking policies and improvement of the overall institutional framework constitute a task of the moment, which does not need to wait for the meeting of other prerequisites.

The following highlights the paths, where the Bank of Albania should focus its efforts:

1. Enhancing the Bank of Albania's transparency. To this end, it has increased the number of publications, especially explanatory ones, media presentations, public contacts, meetings and workshops, and has adopted a strategy and a regulation on transparency.
2. Commitment to improving the relations with other state-owned institutions. To this end the Bank of Albania has adopted a more intensive stance in all inter-institutional organizations (such as: EU Integration, the Pact of Stability, the discussion of papers such as the strategy for the development of SME). More striking is the activity in the framework of the debt committee.
3. Commitment to raise accountability. The Bank has intensified contacts and the reporting to the People's Assembly, trying to raise the level of explanations for its decisions.
4. Commitment to enhancing its credibility. Besides achieving the objectives and advertising this fact, the Bank of Albania is trying to win the public and arrange systematic communication with it. The Bank is organizing campaigns (the credit campaign), is approaching to the business to realize its expectations, etc.
5. Commitment to carry out education. Education involves

the Bank of Albania itself, other authorities and the public. To this end, the Bank of Albania has offered its financial support.

6. Commitment to enhancing the central bank transparency:
7. Commitment to other issues that are not a direct duty of the Bank of Albania, but influence the establishment of prerequisites for adopting inflation targeting regime. As such we would mention its engagement in the projects for improving statistics. On this basis, the Bank of Albania is capable of establishing models for inflation analysis and forecast and for improving the transmission mechanism.

The fulfilment of each of the above-mentioned conditions or their improvement needs a period of 2-3 years, or perhaps even more. This period of time is specified, above all, based on the Bank of Albania's lack of clarity about other authorities' commitment to the regime, the way the public would react, the need for setting up a macroeconomic model (including a test period), the increase of the financial market efficiency, its extension through absorbing informal activities, the strengthening of banking supervision, etc., further improvement of the monetary market in order to establish an efficient instrument of control on money, etc.

NOTES

* Gramoz Kolasi, Vice director, Research Department.

[1] The deriving conclusions have been published by a group of English conjectures in their publication "Monetary policy frameworks in a Global Context" - Maxwell Fry, DeAnne Julius, Lahavan Mahaveda, Sandra Roger and Gabriel Stern - 1999.

[2] The Bank of England performed the survey by means of questionnaire disseminated in 77 countries, including the most industrialized countries, many countries in transition and a great number of developing economies. The results of this survey have been published in "Monetary Policy Frameworks in a global Context" - Maxwell Fry, DeAnne Julius, Lahavan Mahadeva, Sandra Roxher and Gabriel Sterne -1999.

[3] Bank of Albania has resigned the use of direct instruments to control the money supply from the third quarter 2000.

[4] A kind of monetary policy where inflation is a mid-term target.

[5] The paper has been prepared before the announcement of the inflation rate for 2000-end; as such, it refers to the November data. However, the rate of December 2000 is one more argument to the attention that must be shown while adopting inflation targeting.