Governor's Panel

MONETARY POLICY IN AN INFLATIONARY ENVIRONMENT

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1. The importance and role of central banks in new circumstances

After more than a decade of trying to bring inflation up to target, we now find ourselves in a completely different situation. Inflation has jumped up far above the target, growth prospects are weakening, and financial vulnerabilities are rising – including high public debt levels. Our top concern is inflation. The pandemic and the war in Ukraine are causing massive supply-side disruptions, at a time when post COVID-19 demand is still strong. What started as a transitory phenomenon, is proving to be both broader and more persistent, increasing the likelihood of current high inflation becoming entrenched in expectations. I believe preserving price stability is the single biggest challenge to our economies and societies over the next few quarters.

In this environment, the role of central banks is crucial. As monetary authorities, they *can and should* act to control inflation, anchor inflation expectation and to avoid a price-wage spiral. They need to be proactive to avoid losing credibility: any entrenchment of inflation expectations will cause more shocks to the economy. The experience of the 1970s (the spike in oil prices due to the OPEC actions) is a strong reminder of the economic damage caused by leaving inflation unattended. However, since then, the institutional framework of central banks has evolved: by and large, central banks are now independent and accountable institutions, with clear mandates to control inflation.

So, in line with the basic principles of inflation targeting policy – credibility and proactivity – the Bank of Albania acted promptly to anchor inflation expectations. We increased our policy rate by an accumulated 125 basis point to 1.75%, while communicating to the markets our intention to continue along this trajectory going forward. We have added a flexibility dimension to our forward guidance, by conditioning the future path of our monetary normalization – both speed and scale – to incoming data. Given the high uncertainty and the trade-offs associated with our decisions, I believe this flexibility is necessary to avoid undue policy errors.

While almost all central banks in the world are facing the threat of high inflation, for our region the challenge is more difficult given our short history with democratic institutions and credible policy regimes. Nevertheless, as with the previous crises, I believe we can stand up to the challenge.

We can effectively anchor inflation expectations by communicating clearly our decisions, by leveraging on our credible monetary policy frameworks, and by protecting our independence. In doing so, we can reduce the amount of policy tightening required to bring inflation back to our targets.

2. Reach and limits of monetary policy measures in easing inflation with no negative effects on economic growth

Monetary policy cannot affect high commodity prices and it cannot address supply bottlenecks. Therefore, high inflation will be with us for some time. What monetary policy can do is to ensure that monetary conditions are aligned with inflation target, that price inflation expectations remain anchored and – once supple bottlenecks loosen their grip on prices – inflation will eventually return to target. For this to happen, monetary policy must respond by raising the policy rate. When, by how much, at what pace and for how long are all good questions. The answers to these questions will determine the output cost of our decisions. Our aim here is to engineer a soft landing – bring inflation down without restraining growth sharply or causing a surge in unemployment. However, there should not be any illusion that monetary policy normalization will dampen demand and quite possibly growth.

What are the chances in Albania?

Our forecasts say that we have a good chance of a soft landing, i.e. bringing inflation back to target while avoiding recession, though this path is narrowing with every successive update of the EU economy. Our baseline outlook foresees growth to remain in positive territory and inflation to gradually decline as global bottlenecks gradually resolve and tighter monetary policy works its way through the economy. We envision a gradual increase of the policy rate going forward, with the policy rate reaching its neutral level in about two years. This means that there is a long way to go before monetary policy becomes restrictive for growth and employment.

In addition, there are some factors that should give us a hand in navigating the narrow path. First, the recent economic resilience and the dynamic labour market in Albania should provide some inertia in the short term. Second, the banking sector is strong and resilient against shocks. Consequently, credit supply should remain intact. And, third, the timely start of the normalization cycle is assuring the markets of the unconditional commitment of the central bank to price stability. Medium term inflation expectations in Albania remain consistent with the inflation target.

On the other hand, there are significant risks that would make the job of delivering a soft landing here in Albania and in the region much harder. First, the external environment is becoming ever more challenging, as energy crises escalates. Second, the potential emergence of price – wage spirals on the back of tight labour markets, would require faster and bigger policy rate increases.

To conclude, I would like to emphasize that central banks cannot single-handedly ensure growth by keeping an accommodative stance in all conditions. Structural reforms are the ultimate promoters of growth and prosperity.

3. Is the time of cheap money and record low interest rates definitely in the past?

In the current environment of high inflation and monetary policy normalization, we should expect higher interest rates in the coming years. But to answer the second part of the question – are low interest rates definitely in the past – we need to form an opinion about two important tenets of the monetary policy frameworks: the natural (or equilibrium) interest rate and the Philips Curve (PC).

Over the past few decades, the dominant view was that the Phillips curve was flattening and the natural rates had fallen significantly due to lower trend productivity growth, an ageing society and excess savings. This view is held by both advanced and emerging economies, with research showing the same behavior in Albania.

This economic configuration – lower natural rate and flatter PC – has several implications for monetary policy over the medium term:

- *First*, while the low interest environment of the past decade might indeed be a thing of the past, we should not expect a sustained return to the high interest rate environment of the period 2000 to 2010.
- *Second*, monetary policy should react stronger to achieve the same results as the flatter PC implies less sensitiveness of the economy to interest rates;

But are these structural trends – lower natural rate and flatter PC – intact after the pandemic and the war? There is no clear-cut answer as of now. The underlying trends of global warming, the potential unwinding/decoupling of supply-chains, and geopolitical tensions might provide for a new economic environment. That is a subject for future research and empirical observations.

That said, finally and most importantly, I believe both the public and the private sector should prepare for higher debt servicing costs for the foreseeable future.

4. Can Central banks in the region look up to FED and ECB

Most of the countries in the region, including Albania are economically linked to the Eurozone and financially exposed to it. Our economic cycles are by and large synchronized to the Eurozone while our financial systems are considerably euroized. Furthermore, our banking systems comprise banks controlled by EU banking groups, though their presence has been shrinking in the last years. This exposes us to the Eurozone macroprudential policies and risk appetite across the EU banking sector.

Against this backdrop, I would argue the ECB monetary policy stance is more relevant to our economies; it has a stronger and more direct impact in our monetary conditions and in our financial systems. On the other hand, the FED monetary policy impacts us less, mostly through indirect channels, such as oil prices and the overall global financial conditions.

The current stance of the ECB is in line with the monetary policy cycle across the region, though one can argue the ECB is somewhat lagging in its reaction with respect to other major central banks. In general, synchronized monetary policy cycles help reduce macroeconomic volatility, when faced with common shocks. In addition, by attempting to bring down inflation in the Eurozone, the normalisation of monetary policy of the ECB will alleviate foreign price pressures in Albania and in the region. Furthermore, being 'on the same page' with ECB gives us the degree of freedom to pursue our own normalisation policy, reducing thus the odds for large and abrupt exchange rate fluctuations due to interest rate differentials.

5. Stable exchange rate in unstable times - an anchor in a storm

As many of you might know, Albania operates an inflation targeting regime coupled to a fully flexible exchange rate. As a small open economy, with a relatively high level of euroization and a financial system development like ours, the flexible exchange rate regime has paid off, especially in times of crisis. One example being the GFC, when the exchange rate depreciated in response to current account deterioration, thus acting like a shock absorber and facilitating the adjustment of the economy.

This time around, when faced with the pandemic and the war in Ukraine, the flexibility of the exchange rate has enabled lek to reflect our country's specific economic development and the increasing trust our people have in the domestic currency. Let me elaborate further these last two episodes.

During the recent shocks – the pandemic and the war in Ukraine – lek appreciation was driven by a strong demand for tourism, at first from countries in the region, and increasing FDIs and remittances. In addition to the improvement of the external sector of the economy – and its sound financing sources; mostly FDIs – the psychological reactions of the market to the shocks are becoming more contained over time. This reflects the market achieving a higher maturity and consolidation and an increasing trust in the domestic currency.

Exchange rate in Albania has been indeed a stable anchor in these turbulent times. It has saved us a lot of headaches through not propagating risks for financial stability, while at the same time cushioning somewhat domestic inflation from foreign price pressures.

Albania is not overly exposed to short term capital inflows. However, we should remain mindful that the monetary global policy tightening will affect the flow of international capital. Any major episode of capital outflows in our economies will be reflected in weaker exchange rates and will exacerbate the inflation outlook. Therefore, we need to be attentive to the emergence of this phenomena and stand ready to deploy any and all available to mitigate their potential impact.

6. The effects of expansive fiscal policy on monetary policy

The pursuit of an expansionary fiscal policy right now is like throwing gasoline to the fire. Such a policy through stimulating demand and raising concerns about fiscal credibility – given the historically high debt levels and the need to consolidate – would end up adding to already elevated levels of inflation. It would also require a stronger tightening of monetary policy with negative implications for the broad private sector. Thus, it will be far from the best possible policy mix to our economies.

Our advice for fiscal policy *has been* to deliver temporary and targeted fiscal assistance to those most in need, without increasing budget deficits. Subsidies should be temporary and targeted at lower income households, which are hit hardest by inflation, and aim at ensuring the continued delivery of basic public sevices and key public and private sector infrastructure. On the other hand, it will require cutting back on non-priority spending, especially in the area of public sector investment. This approach will ensure that the support provided is fair and effective, while limiting its effects on the government budget and inflation.

The Albanian government has taken several measures to mitigate the effects of elevated prices on households' budgets. On the other hand, the government is following a fiscal consolidation path and fiscal deficit and debt numbers are actually on decline.

To sum up, I think the policy mix right now should be: a normalization of monetary and fiscal policies combined with temporary fiscal support. A touch of structural reforms aimed at raising the growth potential of the economy and supporting its resilience would also be beneficial.

7. Stability of the banking system in the region - what we learned from the 2008/2009 crisis

The broad set of reforms we undertook in the aftermath of the Global Financial Crises (GFC) made our banking sector stronger. A lot of reforms were undertaken and a lot of effort was put to improve the health of the banking sector.

These efforts included:

- A comprehensive plan to improve the credit environment and reduce NPLs, which proved successful in reducing credit risk. NPL actually stand at around 5.3%
- Right-sizing and consolidating the banking sector by encouraging mergers and acquisitions, which increased the efficiency and competition in the banking system. We are seeing very positive results from this process, manifested in a higher competition and more balanced credit growth;
- A package of measures to encourage the use of the national currency in financial activity. The effects so far are encouraging. The currency structure of lending has almost reached parity between the lek and the currency, from a 3/1 ratio in favor of the currency five years ago;
- Aligning our regulatory framework to the ESCB standards; and
- Continuous dialogue with the market, bringing them together and trying to come up with solutions to the challenges that banks face in fulfilling their intermediary role in the economy

As a result, the banking sector entered the pandemic with solid health indicators, in terms of liquidity, profitability, capitalization and operational standards. Its resilience was severely tested by the pandemic, a test which our banking sector passed with flying colors. By and large it served its role of shock absorber. The banking sector continued to provide credit and liquidity to the economy throughout the crisis. Furthermore, and just as important, it took upon itself a sizeable part of the financial cost of the pandemic, through accepting a mandatory – though temporary – moratorium on the payment of credit as well as through voluntary credit restructuring. This has been a welcome change compared to the past, where – in general – banking sectors across the region tended to act more as shock propagators.

I think some of the lessons we learned are:

– The importance of prudent, coordinated and countercyclical regulation to foster financial stability;
– The importance of financial safety nets to preserve the credibility of the system and to mitigate systemic risks;
– The importance of local and international cooperation to avoid regulatory arbitrage and negative spillovers; as well as,
– The importance of proper governance and proper risk management practices amongst banks and other financial intermediaries.

Though our banking system direct exposure to Ukraine and Russia is very small, the new environment – characterized by high inflation, raising interest rates and high uncertainty – will be very challenging. The resilience of the banking system will be tested again. On our part, we will be very attentive to tackle on time the emergence of pockets of vulnerability and address them accordingly.

8. Preventing and limiting the growth of risky loans to an acceptable measure in uncertain conditions

I believe the best service we can do to this objective is – first – to preserve monetary and financial stability and –second – to make sure we minimize any negative impact that high inflation and our monetary policy response will have on growth.

It goes without saying if we manage to bring inflation target within a reasonable timeframe and with minor impact to economic activity, there should be no reason for a major bout of higher NPLs.

At this juncture, I believe we should avoid any temptation to engage in any facilitation of credit restructuring or credit moratoria, such as we undertook during the pandemic. Such actions will hamper the profitability of our banking sectors and will foster moral hazard and long term credit risk.

9. Priorities of monetary policy in the short and medium term

In the short term, our priority is to preserve monetary and financial stability. This translates into bringing inflation down in a sustainable and timely manner, while limiting as far as possible the cost to economic activity and to the banking sector balance sheets. Achieving this requires a delicate balancing act between conflicting objectives in a period of high uncertainty.

I would like to highlight three challenges that monetary policy is facing over the short to medium term.

- *First*, getting the timing and the pace of policy tightening right. This is especially crucial given the adverse impact that tighter financial conditions will exert on aggregate demand, economic growth, and potentially asset quality of the banking sector. Any policy mistake might be costly, be it an overtly tight or overtly loose monetary policy. Given the high uncertainty, it is extremely important to carefully and continently review macroeconomic conditions, in order to adjust the pace of tightening accordingly. While monetary policy should not be a source of uncertainty, it also cannot be put on autopilot.
- *Second*, we need to build a broad consensus on the appropriateness of our policy course. We need to be sufficiently clear that an unchecked inflation is a much bigger threat to the economy than temporarily tighter financing conditions. We need to have the broad public on our side, as well as the public and financial sector. The more accepted our monetary policy stance, the more efficient the transmission mechanism is. This can only be achieved through careful dialogue with all the relevant stakeholders in the economy.
- *Third*, we have to be mindful of the potential adverse impact our tighter policy stance might have. On one hand, it might deteriorate the asset quality of the banking sector, mostly through the interest rate risk channel. Strong capital cushions mean that banks are in a much better position to take the hit than they were during the GFC. However, we will continue to ensure banks' ability to withstand shocks

through our ongoing supervisory efforts. On the other side, it will also raise the financing costs of the public sector, which will have an impact on public budgets for the foreseeable future. The government needs to be made properly aware of this.

Over the medium term, while being committed to deliver price stability, the BoA will continue to update and fine-tune our policy toolkit, including transparency and communication to be better prepared for the future as well as to develop further our domestic financial markets as major player for the efficient conduct of monetary policy.

10. Stimulating the growth of credit activity without endangering the stability of the banking system

Credit growth is strong in Albania; it is currently expanding at an annual rate of 13.8%. In addition to growth, lending is showing a number of positive features I would like to point out.

- *First*, bank lending is broad based, serving both businesses and households, for investment and current expenditures purposes. Especially during the pandemic, it has been instrumental in ensuring corporate sector liquidity and has helped finance the gradual pick-up in private investment and consumption.
- *Second*, lending in lek has been growing at a steady pace leading to the rebalancing of the credit portfolio structure. Actually, lek and FX credit are almost at par. This rebalancing is a positive development that increases the efficiency of the monetary policy transmission mechanism and lowers exchange rate risk.
- *Third*, the NPL ratio has been on a declining trend suggesting an improving quality of lending.

Thanks also to our reforms – NPL resolution, de-euroization – and to our firm supervision, banks have made significant improvements in recent years, increasing their capital ratios and cleaning up their balance sheets. In addition, the banking sector consolidation has created conditions to increase competition and efficiency and to unlock the credit potential. Consequently, credit supply should remain intact, supporting the expansion of consumption and investments going forward.

However, there is no room for complacency, as banks are still operating in a demanding environment. The economic outlook is not optimistic and monetary policy is normalising. In this context, I think credit quality deserves close attention.

We will continue to monitor carefully the potential adverse implications of the situation on the banking sector's balance sheets, while actively pursuing prudent regulations and continuing structural improvements in the banking sector.

11. Monetary and fiscal policies on the same mission - two sides of the same coin

Faced with another shock, monetary and fiscal policy should again align to protect people from the economic and social costs inflicted by the abrupt changes in global economic conditions. But, things need to be done differently this time around: monetary should normalise to fight inflation, while fiscal policy should provide relief to growth, through targeted and temporary measures.

We discussed at length, why the pursuit of an expansionary fiscal policy is not desirable. I would like to see it from another angle which is relevant for Albania, at least.

In the current circumstances, a general fiscal impulse should be avoided for two reasons:

- First, even though we are increasing the policy rate, the real interest rate –corrected for inflation – is negative. Based on our projections it will remain low and below the neutral rate over the coming 2 years, indicating that monetary policy will be supportive to the economy;
- Second, with very high levels of debt, fiscal policy itself is at a crossroad, trying to find the right balance between the need to restore debt sustainability with the need to shield people from raising living costs. Again, our advice to the government has been: to employ measures that are temporary and targeted at the most vulnerable strata of the society; to reprioritize spending toward the most productive investments; and to use any windfall – generated by record high revenues due to price increase – to reduce debt.

Over the medium term, the Albanian government is committed to a consolidating fiscal policy in order to put the public debt in a downward trajectory, to rebuild policy buffers and to strengthen credibility. The latter is important for both the actual and the future presence of Albania in the international financial markets, as well as for the conduct of monetary policy. We support this course of action. At the same time, the challenging environment puts a premium on commitment to push forward structural policies.

12. New challenges for central bankers

The global economy is undergoing rapid structural changes, stemming from a multitude of factors. On one hand, technological innovation has induced a revolution in financial markets. Cryptocurrencies, big data and Fintech innovators are challenging traditional financial intermediaries' business models, especially banks, complicating further the financial landscape for financial regulators. On the other hand, the underlying trends of global warming, global ageing and the potential reversal of globalization, will raise volatility, lower growth, and raise costs on a permanent level.

These trends pose complex challenges for central banks, including the central banks of our region.