

A REVIEW OF ALBANIAN MONETARY TARGETING REGIME WITH INSIGHTS INTO THE FUTURE

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In this paper we try to analyse whether the monetary targeting regime currently applied in Albania may become inadequate in light of upcoming economic developments. Although its performance thus far has been satisfactory, alternative regimes like inflation targeting could be more appropriate to preserve price stability in the future. We then, concentrate on requirements, problems and the possibility of switching from the actual regime toward a full fledged inflation targeting regime.

1 INTRODUCTION

An effective intermediate target should comprise all the necessary information for forecasting inflation. This may not be the case for monetary aggregates. For this reason, Albania like many other countries, is considering eventually abandoning the reliance solely on monetary targeting and probably moving towards an inflation targeting regime in conducting its monetary policy. The Bank of Albania has already started to announce the end year objective of inflation to the public. However as Mishkin (2002) argues, just reporting an inflation objective might be insufficient to classify a country as inflation targeting. Going from this implicit inflation target regime toward an explicit inflation target regime requires

several other important elements which bear some costs if certain conditions are not met beforehand.

In this paper we try to scrutinize the feasibility of inflation targeting (IT) implementation in midterm by describing the potential problems that might emerge in adopting a formal inflation targeting in Albania. The paper is organised as follows. The next Section gives a general outline of monetary policy in Albania. Section 3 analyses the potential difficulties of communication that the actual regime of monetary targeting may have in conducting monetary policy. Section 4 summarises some of the benefits and the problems that characterise the inflation targeting regime. In Section 5 we concentrate in more detail on problems that are mainly related to Bank of Albania ability in adopting IT regime. Section 6, looks at other threats to IT regime beyond Bank of Albania control. We briefly consider some alternative regimes in Section 7. Section 8 concludes.

2 GENERAL OUTLINE OF MONETARY POLICY IN ALBANIA DURING TRANSITION

Albania has been particularly successful in bringing inflation down. From 237 percent in 1992, inflation was reduced to just 6 percent in 1996. The inflation caused by the uncertainty after the collapse of pyramid schemes was rapidly reduced as well. McNeilly, et al. (1998) attribute the success of Albania in achieving low inflation to the early price liberalisation associated with supporting policies for fostering competition and an early aggregate supply increase in goods and services alongside a restrictive monetary policy implemented by the Bank of Albania (BoA).

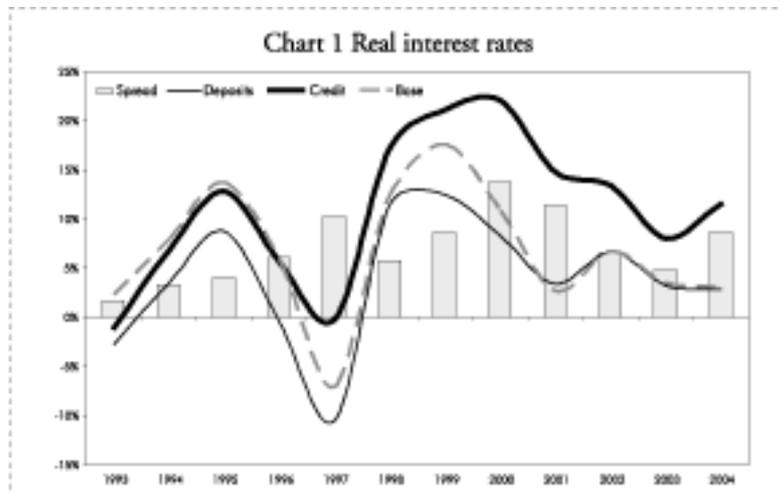
The BoA, initially, relied on direct instruments in conducting monetary policy. Before mid-1995 the supply of broad money (M3) was controlled by ceilings imposed on the total domestic credit expansion of the whole banking system. Credit ceilings consistent with targeted inflation rate and output growth were imposed on banks' total lending to the economy – including the government. Once the ceiling on the Central Bank's lending to the government was subtracted from the total ceiling, the remaining amount was

Table 1 Albania main economic indicators

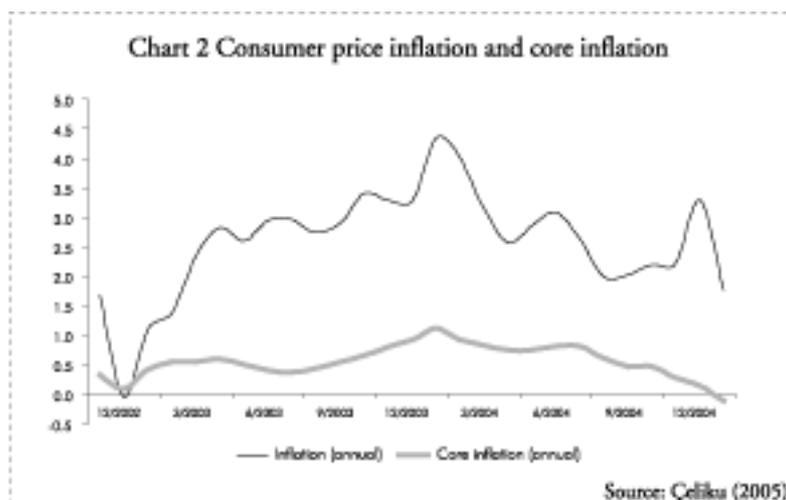
	1998	1999	2000	2001	2002	2003	2004
Real GDP growth (%)	12.7	8.9	7.7	6.5	4.7	6.0	6.0
GDP per capita (USD)	842	1,052	1,086	1,329	1,460	1,833	2,434
Unemployment rate	17.8	18.0	16.9	14.6	15.8	15.0	14.5
Inflation rate (Dec. to Dec.)	8.7	-1.0	4.2	3.5	2.1	3.3	2.2
General govt. balance (% of GDP, excluding grants)	-11.4	-12.1	-9.2	-8.2	-6.9	-4.5	-6.5
General govt. balance (% of GDP, including grants)	-10.9	-9.3	-8.2	-7.6	-6.3	-4.1	-5.85
Domestic debt (% of GDP)	36.2	37.4	42.6	39.5	38.8	38.0	37.2
Trade balance (% of GDP)	-22.8	-19.3	-22.3	-24.2	-23.9	-22.8	-21.5
Current account balance (% of GDP excluding grants)	-7.1	-7.9	-7.4	-6.2	-9.0	-7.6	-7.5
Current account balance (% of GDP including grants)	-3.9	-3.9	-4.4	-3.2	-6.5	-5.1	-5.5
External debt (% of GDP)	36.9	32.3	31.8	28.2	24.4	20.2	21.0
Exchange rate lek/usd (av.)	150.6	137.7	143.7	143.5	140.1	121.9	102.8
Exchange rate lek/euro (av.)	-	146.9	132.6	128.5	132.4	137.5	127.7
Foreign direct investment (% of GDP)	1.5	1.4	3.7	4.8	2.6	2.7	5.0

Source: Ministry of Finance, INSTAT and Bank of Albania.

divided among commercial banks by imposing sub-ceilings on a bank-by-bank basis. From 1995 the BoA tried to enhance its control over M3 through adjustments to bank deposit interest rates. As far as the interest rate policy is concerned, the BoA aimed at keeping interest rates imposed on SOBs' deposits positive in real terms in order to avoid outflows of domestic monetary assets and to prevent disintermediation (Fig. 1). In 1999 the BoA removed credit ceilings to second tier banks while issuing a rule that banks with a ratio of bad loans to total loans of over 20 percent could not extend new loans. In the second half of 2000, the BoA also completely removed direct control over the deposit interest rates switching to indirect instruments for conducting monetary policy. Currently the BoA tries to influence interest rates through open market operations in T-bills (e.g. repos).



So far this regime has shown impressive results in terms of price stability. Inflation has stabilized at moderate levels as measured both at the end and average period figures, though it sometimes has diverged from the target due to unforeseen shocks and speculative factors that have been mainly beyond the central bank's control (e.g. higher bread prices, electricity and telecommunication tariffs) as differences between headline and core inflation in Fig. 2 show. Monetary policy will continue to aim inflation within 2-4 percent target.



However, the bank is trying to foresee threats that may prevent the bank from reaching the target in the future and adapt its monetary strategy accordingly. These threats could be related to the effectiveness of the actual monetary policy regime and/or external threats. The rest of this paper will try to analyse both these issues in more detail.

3 THE COMMUNICATION PROBLEM WITH THE ACTUAL MONETARY TARGETING REGIME

According to Estrella and Mishkin (1997), as inflation is brought under control the informative role of monetary aggregates diminishes because the velocity shocks' relative noise increases. This, according to them, could be an important reason why industrial countries and many emerging market economies do not rely on monetary targeting in the era of price stability. The velocity shocks could be attributed mainly to the instability of money demand that has increased especially with the advances and structural changes of the financial systems.

It is often claimed that Albania is one of the countries that has successfully relied on monetary targeting to bring inflation down. However, it is unclear whether this success can be attributed solely, or to a large degree to this strategy and whether it is going to remain successful also in the future, considering the flaw recognized by Estrella and Mishkin (1997).

The Bank of Albania (BoA) has pursued several objectives over the years such as, reducing inflation, increasing its international reserves, easing exchange rate volatility, improving financial system stability and finally boosting economic development. Regarding its main objective stipulated by the law, stability of prices, communication with the public is carried out by announcing the annual growth rate of broad money (M3) based on the monetary program designed at the beginning of each year and updated quarterly. The money growth is determined based on a quantity equation consistent with a certain level of annual inflation, and projections of the potential output growth and money velocity. This kind of monetary targeting is analogous to the targeting of nominal GDP. Some authors, (Taylor,

1985) argue that this regime works better in accommodating supply shocks since a decline in real GDP automatically leads to expansive monetary policy. In the recent years BoA has also made its official target inflation level public, which has led Stone (2003) to classify Albania as an inflation targeting lite country as compared to the full fledged IT countries.

As can be seen from Table 1, the strategy of targeting monetary aggregates apparently have worked reasonably well considering that the level of end year inflation has been brought under control twice, after 1992 and after 1997. Nonetheless, other observations can also be made. First, the actual growth rate of M3 until 2000 has diverged widely from its target. In contrast, the official inflation objective during the same period has most of the time been undershot. This raises doubts about the relative significance of the nominal anchor used in achieving low levels of inflation.

Second, although from 2000 M3 growth has been fairly close to its target, the growth rates have varied widely, from 5 to 13 percent, compared to the relatively stable inflation rates. This makes it very difficult for the public to understand the real intentions of BoA by merely relying on the announced M3 growth targets. For instance, the 3 percent objective level of inflation can be associated with a wide range of targeted M3 growth rates, from 9 to 15 percent. This

Table 2 Planned vs. actual monetary aggregates and inflation (end year, % change)

Year	MB		M3		Inflation	
	Project	Actual	Project	Actual	Desired Level	Actual Level
1993	-	-5.9	44.1	74.4	-	30.9
1994	-	-2.0	29.0	41.0	24.0	15.8
1995	-	-1.1	23.0	51.8	10.0	6.1
1996	-	2.6	22.0	43.8	12.0	17.4
1997	-	12.0	-	28.5	53.0	44.6
1998	-	14.1	23.0	20.6	10.0	8.7
1999	-	21.6	15.0	22.2	7.0	-1.0
2000	-	24.1	12.1	12.8	2-4	4.2
2001	11.4	18.1	15.4	19.9	2-4	3.5
2002	10.8	11.2	6.2	5.1	2-4	1.7
2003	-0.6	-1.9	9.5	8.3	2-4	3.3
2004	7.9	11.2	10.6	13.5	2-4	2.2
2005	5.7	-	8.3	-	2-4	-

Source: Bank of Albania

brings some support to Estrella and Mishkin (1997) argument, that monetary aggregates lose their informative function at low levels of inflation.

BoA has recognised the above problem in so far as the decisions about changing the monetary policy stance have been based on a wider range of information besides the M3 growth rates. In particular, from some time now, BoA pays particular attention to inflation forecasting which includes various extra information such as: inflationary pressures coming from exchange rate movements, price changes in different markets, including foreign markets, supply shocks, and so on. This running of monetary policy has very much the flavour of an inflation targeting regime. However, there are two important elements that distinguish Albania from formal IT regimes. These are the communication of monetary policy strategy including the publication and explanation of its inflation forecast and a formal mechanism that makes BoA accountable to the announced inflation target.

Although it may seem straightforward, the implementation of IT has several drawbacks too, especially for emerging market economies. In the following Sections we will try to analyse in more details some of the benefits and the problems that BoA may encounter by switching to a formal IT regime.

4 INFLATION TARGETING REGIME: PROS AND CONS FOR ALBANIA

As far as monetary aggregates do not contain all the necessary information to predict future inflation, relying on a monetary targeting regime could be suboptimal. For this reason, BoA has been considering switching to an inflation targeting regime in the medium term. This is based on the idea that the best intermediate target for a monetary policy that aims at controlling inflation is an inflation forecast (Cukierman and Liviatan, 1992; Svensson, 1997). An inflation forecast, in contrast to monetary aggregates, is unrestricted in its coverage of information. Any information that could be relevant for the future inflation can be taken into account.

In the last decade there has been a large body of literature exploring the benefits of an IT regime compared to the other regimes, summarised in a series of paper by Mishkin et al. (1997, 2000, 2002). Some of the major benefits of IT are: the broader information base it utilises, its relatively higher flexibility with regard to supply shocks, the fact that it is easily understood by the public, improved accountability etc.

However, the adoption of an IT regime also poses several problems. The major problem for Albania is related to the increased risk that it may place on BoA's reputation compared to the actual regime of monetary targeting. As mentioned earlier, although the M3 targets have been missed repeatedly up till 2001 (see Table 1) inflation has decreased which shows that BoA's reputation at least has not deteriorated; at best it has improved. This is probably related to the low understanding of the public about the relationship between M3 and inflation, which leaves the bank more scope to explain the missing of the target. In the case of IT regime the missing of the target could be much more costly in terms of bank reputation.

In recent years, BoA's reputation in terms of reaching its inflation objective around the 3 percent level has undoubtedly strengthened. However, claiming that the level of actual reputation is adequate for adopting an inflation targeting regime would be premature. There are several problems that may restrict the BoA's confidence in meeting the low inflation objective and endanger its reputation in the future reaching the inflation targeting. Some of these problems are related to BoA and some others are related to external factors. Let us concentrate in more detail on some of these problems.

5 OBSTACLES WITHIN BANK OF ALBANIA

The problems related to BoA in terms of adopting IT are mostly technical and less institutional. BoA enjoys a relatively high level of independence and by law has price stability as its main objective. However, BoA's high degree of legal independence is not fully translated into actual independence which may still be lower from that stipulated by law. Some empirical evidence (Luci, 1999) suggests

that BoA tries to keep its independence from government although the lack of appropriate instruments and the uncertainty about the transmission mechanism makes it difficult to reach its objectives. An important step in improving the real independence of BoA would be the complete abolition of government financing, which at the moment is at 5 percent (of the last 3 years' average revenues).

This would better insulate BoA from government interference with its monetary policy and would increase pressures to the latter to consolidate further its fiscal policy by either increasing its revenues or reducing the expenditures. Adopting an IT regime may require some further amendments to the actual law but we do not foresee any particular obstacle in this regard. As far as the technical part is concerned, a successful IT regime requires a good understanding of the monetary policy transmission mechanism, a rather good forecasting model for inflation, and an efficient communication framework with the public. While the bank has been working to improve all this components, a lot remains to be done especially in relation to the first two. The Research Department in collaboration with Monetary Policy Department and the Monetary Operation Department has compiled a list of technical problems that need to be tackled, which generally aim at improving our understanding of monetary policy transmission mechanism, of inflation sources, and of the functioning of the Albanian economy as a whole.

The work on these issues may require some time before good results are claimed. In particular two critical problems need to be tackled sooner rather than later to accelerate progress. These are: the inadequate technical expertise to build up the necessary tools for IT implementation, and the poor state of economic data. The former is being addressed through technical expertise of international institution like IMF.

However, to make technical progress sustainable over time, a strategy for developing in-house human capital is also being considered. Regarding statistical data drawbacks, several steps are being taken to improve data sources such as: carrying out surveys, interviews, and assisting INSTAT to improve national account statistics frequency and quality.

6 OTHER CHALLENGES IN ADOPTING IT

Provided BoA puts itself in a position for adopting an IT regime effectively, there may be other external problems that could prevent it from reaching the target. This might involve changes in the administrative prices and structural reforms in general, lack of fiscal discipline, dollarisation, a decrease in foreign remittances and the potential exchange rate volatility, financial system development and stability, etc.

Government-controlled prices could pose a serious threat at targeting the headline inflation. This has already caused difficulties for the BoA in the past. One solution to this problem is to target an inflation definition which excludes the administrative prices. However, this makes the target less clear to the public. Another solution may require the government to endorse a more precise plan for future price liberalisation so that BoA could adjust the final target accordingly.

Several authors (Masson et al., 1997; Stone, 2003) have pointed out the importance of fiscal discipline to the success of the IT regime. Although the fiscal discipline has been a crucial factor in bringing inflation down in Albania several future events, especially certain structural reforms, may force the government to relax its discipline. Among these events an important one is related to the method the new law on compensation is going to take place. If the government is going to cover most of the compensation expenses through its budget this would really put a lot of pressures on inflation.

A high degree of foreign currency substitution (euroisation, dollarisation) can cause serious problems for IT (Mishkin, 2000). Partial dollarisation has the potential to make inflation targeting regime, which requires some degree of exchange rate flexibility, vulnerable to financial instability (Mishkin and Sevastano, 2002).

In Albania the level of dollarisation in terms of foreign deposits to total banking assets is around 20-36% (Sojli, 2003). The problems

related to dollarisation need to be treated with caution in the prospect of the declining foreign remittances that so far has cushioned the impact of deterioration of current account deficit and have ensured a relatively stable exchange rate.

A sound financial system is important to the success of IT for several reasons. A sound financial system could better sustain the negative impact of eventual exchange rate volatility related to the high dollarisation.

Also, considering the several objectives BoA is pursuing, it might be important to examine whether Albania has missed or could miss the inflation target if it conflicts with reaching other objectives such as financial stability. A sound financial system would put BoA under less pressure to trade off between its objectives.

The development of the financial system is also an important factor for the conduct of monetary policy. The actual level of financial development in Albania is far from being adequate for an effective monetary policy. The level of competition among banks at the moment is very low while the money and stock markets are virtually nonexistent. Thus, a lot remains to be done to increase the depth of financial system especially that of the money and stock markets.

The recent privatisation of the Savings Bank is expected to improve the competition of the Albanian banking system and boost credit to private sector. There are some concerns though, about the possibility of credit growth becoming 'excessive', looking at experiences of some other transition countries (Cottarelli, et al., 2004). This is a very critical issue which needs particular attention and further investigation (see Box 1).

Even so, Mishkin and Sevastano (2002) argue that the above mention problems are important issues for other monetary policy regimes too, under the IT regime the cost in terms of central bank reputation could be much higher.

Box 1: Potential credit growth

Fast credit growth, which not a long time ago was considered to be a great achievement, now is becoming a major concern among many transition countries, including Albania that so far has been lagging behind. The volume of credit to the private sector in Albania in percentage of GDP has remained virtually unchanged from the beginning of transition until recently at a low level of around 6%. Underdeveloped business culture and the low transparency of the newly emerging private enterprises seem to have been important obstacles for the expansion of banks' lending activities. Other problems with property rights, law enforcement and poor infrastructure in Albania have also contributed to this outcome. The inefficiencies that characterised SOBs led to the accumulation of a large amount of bad loans by these banks which in turn induced regulatory authorities to first constrain and then completely block their lending activities. At first sight, the delay in the privatisation of SOBs that could have enabled the freeing of their funds for lending seem to have been the main reason for the low level of credit in Albania. However, private banks that were not particularly restricted by regulatory authorities also have a large proportion of their funds not channelled to commercial loans.

	2002	2003	'04-Q1	'04-Q2	'04-Q3	'04-Q4
Domestic credit to M3	70.8	71.5	71.6	69.5	67.4	68.7
to government	61.5	60.2	59.9	57.1	54.9	55.0
to economy	9.3	11.3	11.7	12.3	12.5	13.7
Credit to economy as % of total assets	11.5	13.7	13.7	14.6	14.7	16.6
Credit/Deposit ratio	13.5	15.7	15.8	16.6	16.8	18.8
Credit to economy as % of GDP	5.7	6.8	6.3	6.7	7.2	8.2

Source: Bank of Albania.

Bank of Albania has made continuous efforts to increase the intermediation level of the banking system. This has consisted in clarifying the regulatory framework that regulates the loan activity of banks. Some measures are already taken with the removal of required fixed amounts of collateral for the loan. It is now the responsibility of the bank to judge about the need of collateral and to make sure that its value is appropriate to cover the amount of the loan and any other cost related to its execution. However, in every instance, we shall insist that banks keep high and strengthen their lending administration processes, in order to ensure a balanced and solid growth of the activity. Due to the currency composition of the loan portfolio, mostly extended in foreign currency, banks are pushed to put particular attention on the cash-flow of their borrowers, as this may not be denominated in the same currency of the loan. Any unexpected adverse change in the exchange rate could lead to difficulties, if not foreseen in time.

Furthermore, Bank of Albania has tried to promote lending in domestic currency. Among others things it will improve the effectiveness of monetary policy transmission mechanism. Looking at a broader macro-financial picture, Bank of Albania has contributed to that goal by reducing its REPO rate to historic low levels and closing the lending interest rate differential between domestic and foreign currency.

Despite the easing of monetary policy and the lowering of the policy rate (the repo rate is lowered by 3.25 pps during the last 2 years), the spread of Lek-foreign interest rates on credit remains noticeable. Another factor that supports the interest in FX credit is the nature of the business activity. According to the statistics, the most credited sectors mostly operate with foreign currency. Bank of Albania will continue to support the growth of Lek credit to the economy. We expect Raiffeisen Bank to contribute to a greater expansion of Lek credit since it holds 67 percent of the Lek deposits of the banking system. Roughly, 86 percent of the deposits in this bank are in Lek currency.

Regarding the credit growth over the medium term, we expect it to accelerate considerably starting from 2005, as Raiffeisen Bank begins its lending activity and adds more supply to the market. Although, the impact of this change in the overall bank credit to the private sector, is subject to different uncertainties that relate to the evolution of the institutional and legal environment within which the lending activity takes place. Problems in regulations and practices affecting the creditors' rights aggravate risk conditions in the economy, making it difficult to assess the speed at which the credit expansion will occur. Some preliminary estimates based on the performance in credit growth during the last 3 years, and the credit growth projections revealed by Raiffeisen Bank, and a certain degree of substitution to other banks credit growth, show an annual private sector credit growth at around Lek 30-35 billion, or 45-50 % for 2005.

In the medium term the credit growth is estimated to stabilise at about 3 to 4 percentage points of GDP annually. This is below the critical threshold of 5 percent; However, we are also taking into account the possibility of what has occurred in other countries in the region. To this end some measures are undertaken to get a closer insight of housing market which has already seen a considerable increase in prices in the last two years. If banking lending expands rapidly in housing loans the risk is that it may lead to a dangerous bubble. On one side, if most of the credit is extended in foreign currency it will make difficult for our bank to contract this loan expansion and probably to recur to some sort of direct measures which would mean a step back for the monetary policy. On the other side, it will put some strains on banking supervision to ensure the soundness of banking sector in case of a potential decline in housing prices.

(Source: Various documents of the Banking Supervision Department and the Monetary Policy Department, BoA)

7 ALTERNATIVE REGIMES

The other alternatives to IT and monetary targeting are exchange rate pegging and the so called just do it policy applied by FED (Mishkin, 2002). Exchange rate pass-through in Albania is thought to be high, though asymmetric, given the large proportion of imported goods in consumer basket (approx. 70%). This would make this regime an effective way of conducting monetary policy. However, exchange rate pegging so far has been rejected as a suitable strategy to Albania for different reasons. Initially due to insufficient international reserves and later on the bases of real exchange rate appreciation risks, especially when the fundamentals of RER remain still largely unknown.

While we believe that to leave the exchange rate being decided by market forces is the best strategy to follow, under certain circumstances intervention may prove an effective way to curb inflation, especially when spirals between exchange rate depreciation and unfounded inflation expectation are observed. However, in cases when the source of inflationary pressure is of structural nature such strategy could cause more harm than good.

Most of exchange rate discussion, however, refers to scenarios of controlling depreciation to curb higher inflation. From some time now though, Albania like several other transition countries is seeing appreciation of its currency instead (Fig. 3). While this has helped easing inflationary pressures, concerns about external competitiveness are raising. This has pushed BoA to occasionally intervene in the market and to reduce the local currency interest rates to prevent the lek from appreciating too strongly in nominal terms against the euro. However, it remains unclear whether this appreciation is a return to some kind of long term equilibrium supported by fundamental changes. This shows that exchange rate developments cannot be ignored that easily in monetary policy decision even if committed to the free floating regime.

The other 'just do it' strategy might characterise the actual Albanian monetary policy case rather well. Although there is an explicit monetary target and an implicit inflation target, as mentioned



earlier, the way the monetary policy operates has a lot of discretion elements in it to achieve the main objective of low inflation, while allowing for some sort of supply shocks adjustments. The advocates of this regime oppose the US switching to a formal IT regime by simply saying ‘if ain’t broke don’t fix it’.

However, in the case of Albania maintaining the effectiveness of this strategy for a long time may not be viable considering that BoA does not enjoy the same degree of reputation as FED. According to Stone (2003) this kind of regime should come after a full fledged IT, and it is very difficult and risky for an emerging market country to switch directly to this strategy.

8 CONCLUSIONS

Albanian reliance on monetary targeting, although so far seem not to have experienced any serious problem, may prove to be insufficient to maintain low inflation in the future. In particular, the signalling power of monetary aggregates targeted by BoA may start to deteriorate. Therefore, alternative regimes such as IT that could transmit central bank signals better may be considered. However, premature implementation of these alternative regimes could cause

more harm than good to the reputation of the bank. In the particular case of IT, due to the more explicit and understandable target, there is a higher risk of damaging the reputation of the central bank compared to the other regimes. For this reason, its implementation should carefully assess all the necessary institutional and technical criteria and the adverse scenarios that could jeopardize the success of this regime.

From our short analysis we conclude that despite the difficulties BoA may be facing to comply with the requirements of this new regime, its implementation in medium term is viable, provided that in the meantime the work on this direction is intensified.

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ENDNOTES

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