



BANK OF ALBANIA

MONETARY POLICY DOCUMENT

January 2015

MONETARY POLICY DOCUMENT

*The Monetary Policy Document was approved by Decision
No. 4, dated 28.01.2015 of the Supervisory Council
of the Bank of Albania.*

INTRODUCTION

The Bank of Albania is the monetary authority of the Republic of Albania. The Law¹ has tasked the Bank of Albania with maintaining price stability in Albania, and has granted it the exclusive right to formulate, approve and implement the monetary policy. Monetary policy is the set of principles, measures and instruments, through which the central bank intervenes in the financial markets and in the economy, to achieve its price stability objective.

The Monetary Policy Document fulfils a permanent commitment of the Bank of Albania for transparency and accountability. Through this Document, the Bank of Albania presents its objective of price stability in a clear, concrete and transparent manner. This Document also describes the theoretical framework guiding the formulation of monetary policy, and the instruments employed for its implementation. Lastly, the Document presents the main communication channels of monetary policy. All these elements constitute the monetary policy strategy.

The development of new theoretical and operational concepts, and the structural changes in the economy and financial markets, may require further changes to the monetary policy strategy, which will also be reflected in the Monetary Policy Document. These changes will be enacted whenever deemed necessary, and will be transparently announced by the Bank of Albania.

¹ Pursuant to Article 161 of the Constitution of the Republic of Albania, and Law No. 8269, dated 23.12.1997 “On the Bank of Albania” (as amended).

SUMMARY

The main objective of the monetary policy is to achieve and maintain price stability. In practice, this objective means achieving low but positive inflation rates. In numerical terms, the Bank of Albania aims to keep the annual increase in domestic consumer prices at 3%.

The Bank of Albania is independent in formulating and implementing its monetary policy. The Supervisory Council of the Bank of Albania is, by law, responsible for formulating monetary policy and adopting guidelines for its implementation. For matters of monetary policy, the members of the Supervisory Council shall neither request nor accept any advice or instructions from entities or other individuals outside the central bank.

The Bank of Albania operates an inflation targeting regime. Monetary policy decisions are based on a comprehensive analysis of economic, monetary and financial indicators. The main indicator of the balance of inflationary pressures in the economy is the deviation of the medium-term inflation forecast from target.

The Bank of Albania implements a free-floating exchange rate regime. The value of lek against foreign currencies is freely determined in the foreign exchange market.

In formulating and implementing its monetary policy, the Bank of Albania is guided by the following principles:

- *Monetary policy guarantees price stability in the economy.* Monetary policy and the instruments used for implementation are always consistent with achieving the inflation target in

the medium term. Compliance with this principle enhances accountability, strengthens reliability and improves the effectiveness of monetary policy.

- *Monetary policy is forward looking.* Monetary policy effects on the economy are transmitted with time lags. The time lags depend on the response of financial markets and the real economy to the monetary policy measures. Monetary policy is, therefore, guided by the expected performance of inflation in the medium term. Compliance with this principle enhances the effectiveness of monetary policy and smoothes the volatility of instruments and financial markets.
- *Monetary policy is balanced.* Besides abiding by the primary objective of inflation, monetary policy can and will be used to smooth short-term fluctuations in the economy. In the formulation and implementation of monetary policy, the Bank of Albania will, therefore, strike a fair balance between restoring inflation to target and smoothing economic fluctuations. Compliance with this principle contributes to enhancing overall economic welfare.
- *Monetary policy is robust.* Monetary policy always acts in the presence of uncertainties related to the assessment of the current situation and expected developments in the economy. The Bank of Albania will, therefore, ensure that its monetary policy takes into account an acceptable range of assumptions and remains within those reasonable boundaries. Compliance with this principle reduces the scope for monetary policy errors.
- *Monetary policy is transparent.* By being transparent, the monetary policy becomes easier to understand and predict.

MONETARY POLICY DOCUMENT

Thereby, unnecessary surprises to the economy and financial markets can be avoided. The Bank of Albania will make sure to inform the public on the objectives, principles, assumptions and instruments of its monetary policy. Compliance with this principle increases accountability and improves the effectiveness of monetary policy.

Monetary policy implementation is consistent with the free market principles. It is conducted through a framework of indirect monetary instruments, which are summarised in this Document. The regulations of monetary policy instruments are transparent to the public, and the results of Bank of Albania's interventions in financial markets are disclosed periodically.

The operational objective of monetary policy is to steer the short-term interbank rates towards the Bank of Albania's key interest rate, and minimise their volatility. Bank of Albania's monetary operations are oriented towards achieving this objective. By controlling short-term interbank rates and anchoring inflation expectations, the Bank of Albania affects the general level of interest rates in the economy and economic agents' decisions on consumption, savings and investments.

The communication of monetary policy aims at enhancing its transparency and accountability. Through an open and transparent communication, the Bank of Albania helps anchor inflation expectations and enhances the effectiveness of monetary policy. The Bank of Albania communicates the monetary policy through strategic monetary policy documents, periodic reports, press releases and press conferences subsequent to monetary policy decisions, as well as other channels and means of communication.

I. MONETARY POLICY OBJECTIVE OF THE BANK OF ALBANIA

According to the Law “On the Bank of Albania”, the primary objective of the Bank of Albania’s monetary policy is to achieve and maintain price stability.

Economic theory and global practice suggest that keeping a stable level of prices is the greatest contribution the central bank can make to a sustainable and long-term economic growth of the country.

By guaranteeing price stability, the Bank of Albania helps reduce uncertainties in the economy and extend the time horizon of Albanian households and businesses’ decision-making. Accordingly, monetary policy contributes to enhancing the effectiveness of resource allocation and supports sustainable and long-term growth of the country. Keeping a low and stable level of inflation also curbs unexpected and unfair redistribution of wealth, contributing to the improvement of overall welfare. Lastly, a low and stable inflation helps develop the banking system and safeguard the stability of the financial system.

Economic theory and global practice suggest that monetary policy can be used to smooth short-term fluctuations in the economic activity, but it cannot be systematically used to boost economic growth and employment.

As a tool of aggregate demand management, monetary policy can be used to smooth short-term fluctuations in the economy stemming from aggregate demand shocks. By pursuing a flexible monetary policy, the Bank of Albania helps mitigate demand-side

shocks and stabilises output and employment close to their long-term trends. However, a country's long-term economic growth and the employment level are determined by structural factors, such as the development and qualifications of human resources, technological progress, economic structure and functioning, and the country's economic and financial stability. Accordingly, monetary policy does not affect and cannot be used to promote long-term economic growth. However, by guaranteeing price stability, it enables the economy to fully utilise the resources for long-term economic growth.

INFLATION TARGET

“Achieving and maintaining price stability” means achieving low but positive inflation rates, and preserving them for relatively long periods of time. In practice, a number of indicators are used to measure the increase in prices in the economy, such as the consumer price index, production price index, wage index, or other indices measuring the prices of specific products. To assess price stability and steer monetary policy, the Bank of Albania uses the Consumer Price Index, as measured and published by INSTAT.

In quantitative terms, the Bank of Albania defines price stability as keeping the annual change in consumer prices at 3.0%. In practice, inflation is subject to various unexpected shocks, outside the scope of monetary policy. Accordingly, it will constantly fluctuate and deviate from Bank of Albania's target. However, monetary policy aims to keep consumer price inflation in the Albanian economy, on average terms and for long time periods, at 3.0%.

TARGET LEVEL

An inflation target level of 3% reflects the development stage of the Albanian economy as a small, open and emerging economy. This level is set based on several arguments.

First, targeting a positive inflation rate takes into account the technological evolution of products and their qualitative improvement. Many studies have proved that, statistically, the inflation rate has a positive bias. In practice, keeping inflation close to zero may correspond to a deflationary situation.

Second, a low inflation rate helps maintain positive real interest rates. These help generate savings and financial flows to promote investments in the economy, and safeguard the banking system's stability and its ability to carry out the financial intermediation role.

Third, this targeted inflation rate is consistent with the development needs of the Albanian economy as an emerging economy. It facilitates the relative price movement by aiding the informative role of this mechanism in the allocation of resources within the economy. While most developed countries define price stability as an inflation rate of around 2.0%, our 3.0% target reflects the need for higher relative price volatility.

Fourth, the inflation target of 3.0% facilitates the convergence process with the developed economies. This target is consistent with Albania's aspiration to join the European Union over the medium term. The goal of maintaining the rise of the price level close to, but higher than the European Central Bank's objective²

² The European Central Bank aims to keep the inflation rate below, but close to, 2.0% over the medium term.

provides enough room for making the necessary structural adjustments. The target level allows a reasonable time span for real and nominal convergence of the Albanian economy with the European Union.

OTHER INFLATION MEASURES USED IN DECISION-MAKING

The inflation target is expressed in terms of the annual change in the Consumer Price Index. To improve the monetary policy decision-making process, the Bank of Albania also uses other inflation measures, such as core inflation, tradable and non-tradable inflation, and the inflation expectations of economic agents. These measures provide a more comprehensive basis of information for more effective decisions.

Core inflation represents the stable and long-term part of headline inflation. As such, it reflects more clearly the monetary conditions in the economy and the long-term inflation trends, thus providing useful information for the monetary policy stance. Core inflation is measured by excluding from the consumer price index basket those goods and services that are subject to a higher price volatility.

Besides core inflation, the Bank of Albania analyses the performance of tradable and non-tradable inflation. Inflation of tradable goods in the consumer basket measures better the inflation trends in the international markets, whereas inflation of non-tradable goods reflects more the domestic inflationary pressures.

The Bank of Albania has paid increasing attention to building time series on the expectations of economic agents (such as the Business Confidence Index, the Consumer Confidence

Index), and surveying financial agents' expectations for inflation, exchange rate and the interest rate. These indicators provide useful information for the actual and expected performance of inflation, and the balance of risks in the economy.

II. THEORETICAL FRAMEWORK OF MONETARY POLICY

Monetary policy is transmitted to the economy with time lags. These time lags are conditioned, firstly, by the response of financial markets to the instruments employed for monetary policy implementation, and secondly, by the response of households and businesses to interest rates and liquidity conditions in financial markets. This chain of effects is known as *the monetary policy transmission mechanism*. Generally, it covers a medium-term horizon of one to three years, forming the monetary policy-relevant horizon.

Therefore, monetary policy is guided by forecasts for the expected performance of inflation in the future. In practice, central banks set up a comprehensive framework of analysis and forecasting, which enables the timely identification of possible deviations of inflation from the target and informs monetary policy decision-making accordingly.

The Bank of Albania bases its monetary policy decision-making on a thorough analysis of economic, monetary and financial indicators. The main indicator of the balance of inflationary pressures in the economy is the deviation of the medium-term forecast inflation from the target. This monetary policy analysis and assessment regime is known as the inflation targeting regime.

Monetary policy plays an important role in medium-term forecasts. The actual and expected key interest rate during the forecast horizon determines the performance of other macroeconomic indicators. Under these circumstances, the task of monetary policy is to determine the trajectory of the key interest rate that achieves the primary objective most effectively.

Besides the principle that monetary policy is forward looking, the Bank of Albania decision-making process will be guided by the following principles:

- **MONETARY POLICY GUARANTEES PRICE STABILITY**

Achieving the inflation target is the main criterion of monetary policy formulation and implementation. The degree of its achievement in long-term time horizons is a good indicator for the evaluation of monetary policy effectiveness. Hence, it contributes to greater monetary policy accountability. The degree of its achievement also affects the level of inflation expectations anchoring. Well-anchored expectations enhance the effectiveness of monetary policy as they make the economy and inflation less sensitive to short-term shocks and reduce the degree of monetary policy response to them. In addition, a nominal anchor for the economy and financial markets improves Albanian businesses and households' long-term decisions, allowing the extension of contracts in the economy and a more effective allocation of resources.

Therefore, monetary policy and the instruments employed for its implementation will always be consistent with the achievement of the inflation target within the monetary policy-relevant horizon.

- **MONETARY POLICY IS BALANCED**

Monetary policy affects not only the level of prices in the economy, but in the short and medium-term, it also affects aggregate demand and economic growth. Smoothing cyclical fluctuations in the economy is a desirable result for monetary policy as it implies - among others - a more sustainable employment level. In most cases, restoring inflation to target and the economy to equilibrium are not conflicting objectives for monetary policy. In special cases, when they may be conflicting, such as in the presence of supply-side shocks, meeting the price stability objective is always given priority. By complying with this principle, the Bank of Albania contributes to improving the country's welfare.

Therefore, the monetary policy pursued by the Bank of Albania is not a mechanical process. Monetary policy is guided by the direction and magnitude of inflation deviation from target; however, its formulation and implementation will be also determined by the reasons behind this deviation and the strength of the monetary policy transmission mechanism.

- **MONETARY POLICY IS PRUDENT**

Monetary policy acts amid uncertainties both in terms of interpreting the actual economic situation and its expected performance in the future. Moreover, monetary policy can have undesirable effects on different economic and financial indicators, which increase the risks to price stability at a future time. Addressing these risks systemically reduces the room for monetary policy errors.

MONETARY POLICY DOCUMENT

Accordingly, the Bank of Albania strives to make the monetary policy effective within an acceptable range of assumptions. To enhance prudence in monetary policy decision-making, the Bank of Albania will also consider alternative scenarios of the economic and financial developments, if deemed necessary.

MONETARY POLICY DECISION-MAKING

The Supervisory Council is the supreme decision-making body of the Bank of Albania. The Supervisory Council convenes periodically to make monetary policy decisions according to a schedule released at the beginning of each year. Each Council member is independent in forming and expressing opinions on the monetary policy stance. Supervisory Council monetary policy decisions are based on periodic reports and materials prepared by the technical staff of the Bank of Albania. The main focus of these reports is inflation forecasting and identification of possible monetary policy measures to restore inflation to target.

III. EXCHANGE RATE REGIME

The Bank of Albania implements a free-floating exchange rate regime. The value of lek against foreign currencies is freely determined in the foreign exchange market. Exchange rate fluctuations reflect the free movement of goods and capital and the financial transactions of Albania with its trading partners.

The free-floating exchange rate regime provides the Bank of Albania's monetary policy with maximum flexibility in achieving the inflation target. It also provides the Albanian economy with

a useful tool to cope with various economic shocks by quickly restoring the equilibrium in trade transactions with abroad.

Consistent with its monetary policy, the Bank of Albania is committed to holding a sufficient level of foreign reserves. This serves as a cushion to cope with severe shocks that might hit the real sector of the economy, and to safeguard the country's financial stability. In line with the international best practices, the Bank of Albania will aim at holding a sufficient level of foreign reserve for the concurrent observance of the following two quantitative criteria:

- The foreign reserve levels should be sufficient to cover at least 4 months of imports of goods and services in the medium run;
- The foreign reserve levels should be sufficient to cover the short-term external debt of the Albanian economy in the medium run.

In accumulating reserves above the floor as established in the above adequacy criteria, the Bank of Albania will also take into account the costs for the accumulation and the holdings of reserves.

The Bank of Albania may intervene in the domestic foreign exchange market to increase the level of foreign reserve and/or to contribute to the stability and the development of domestic financial markets. These interventions do not reflect the monetary policy stance; they neither aim to affect the exchange rate path nor prejudice the achievement of the primary objective of the Bank of Albania. The Bank of Albania intervenes in the foreign exchange market in accordance with the relevant regulations, which are made public.

IV. OPERATIONAL OBJECTIVE AND MONETARY POLICY INSTRUMENTS

OPERATIONAL OBJECTIVE

Operational objectives establish the link between monetary policy operations and its primary objective, achieving and maintaining price stability. The choice of these operational objectives depends on the monetary policy regime and the level of economic and financial market development.

The operational objective of the Bank of Albania's monetary policy is to steer short-term interbank rates close to the Bank of Albania's key interest rate, set by the Supervisory Council, and to minimize their volatility.

Steering short-term interbank rates close to the Bank of Albania's key interest rate enhances the effectiveness and transparency of the monetary policy, thus contributing to a better control of long-term interest rates in the economy.

Experience shows that this operational approach mitigates the volatility of interest rates in the financial markets. By controlling the short-term interbank rate and facilitating the predictability of its changes through a clear monetary policy strategy, the medium and long-term interest rates respond to the changes in short-term interest rates to a predictable extent.

MONETARY POLICY INSTRUMENTS³

In order to achieve its objectives, the Bank of Albania employs open market instruments. Monetary policy instruments are oriented towards the achievement of the Bank of Albania's operational objective. Consistent with the monetary policy framework principles, the Bank of Albania does not have any commitments with regard to interventions in the foreign exchange market and the exchange rate.

The interest rate on repurchase agreements of seven-day maturity, applied in the regular weekly auctions of the Bank of Albania⁴ is the key rate used to transmit monetary policy signals. This interest rate is set by the Supervisory Council of the Bank of Albania and states central bank's monetary policy stance. It also serves as a reference system for other interest rates of the Bank of Albania.

The following makes a brief description of the instruments employed to implement the monetary policy.

OPEN MARKET OPERATIONS⁵

Open market operations represent the purchase or sale of market securities by the Bank of Albania. They aim at steering

³ For more detailed information on the types and use of monetary policy instruments at the Bank of Albania, please refer to *"Bank of Albania's Monetary Policy Instruments and Procedures for their Execution"* (www.bankofalbania.org).

⁴ Operations of repurchase and reverse repurchase agreements are respectively known as repo and reverse repo.

⁵ Open market operations also include foreign currency operations. However, in contrast to domestic currency operations, they do not seek to manage interest rates or liquidity in the system and signal the monetary policy. The main purpose of foreign currency operations is to change the level of the international reserve and smooth high and risky fluctuations in the exchange rate.

the short-term interest rates in compliance with the Bank of Albania's operational target, and managing the level of liquidity in the money market.

Open market operations include:

- (reverse) repurchase agreements; and
- outright transactions.

STANDING FACILITIES

The main purpose of standing facilities is to adjust the level of liquidity in the banking system and steer short-term interest rates in the money market. They are always and exclusively initiated by commercial banks. The latter are the sole counterparties to the Bank of Albania in these operations.

The Bank of Albania provides the following standing facilities:

- overnight deposit; and
- overnight loan.

REQUIRED RESERVE

Through the required reserve instrument, the Bank of Albania aims to adjust money supply and the level of liquidity in the banking system, as well as to steer interbank rates. The Bank of Albania requires commercial banks to hold a certain amount of reserve in lek and in foreign currency with the central bank.

The Bank of Albania will continuously revise its monetary policy instruments depending on the conditions of the Albanian financial

market and monetary policy course. These revisions will aim at enhancing their effectiveness.

OTHER INSTRUMENTS

The above instruments are conventional monetary policy instruments. In particular circumstances, the Bank of Albania may consider employing other instruments, in order to enhance the effectiveness of the above instruments or to complement their effectiveness. These instruments are in compliance with the legal framework of the Bank of Albania. By nature, they can only be used occasionally, as deemed necessary by the Bank of Albania.

Forward guidance is such a monetary policy instrument. Bank of Albania's public commitment to pursue a certain monetary policy path in the future helps to reduce the uncertainties in the financial markets and to increase the effectiveness of its conventional instruments.

V. INDEPENDENCE, TRANSPARENCY AND ACCOUNTABILITY OF MONETARY POLICY

MONETARY POLICY INDEPENDENCE

The Supervisory Council is independent in formulating and implementing the monetary policy. Its independence is guaranteed by law, which specifies that the Bank of Albania "is independent of any other power to achieve the primary objective". Independence ensures that the decisions are taken in a long-term context, generating confidence in achieving the inflation

target. It is now widely accepted that guaranteeing central bank's independence creates better conditions for maintaining price stability.

MONETARY POLICY TRANSPARENCY

The concept of being independent is complemented by transparency and accountability. The Bank of Albania has the legal obligation to report to the Assembly of the Republic of Albania on monetary policy matters twice a year. It should also state its opinion on economic developments publicly every three months. Beyond these obligations, the Supervisory Council has adopted a more transparent approach to communicating its judgement.

The Bank of Albania communicates its monetary policy and decisions to the public through the following main documents:

- *Monetary Policy Document.* This document describes the main principles of the monetary policy pursued by the Bank of Albania.
- *Quarterly Monetary Policy Report.* This report analyses the economic, monetary and financial developments, and identifies the factors expected to affect inflation in the future. It communicates the expectations for inflation and explains the implications for monetary policy.
- *Periodic analyses.* These materials aim at complementing the analysis of macroeconomic and financial developments elaborated in the Quarterly Monetary Policy Report.

MONETARY POLICY DOCUMENT

- *Periodic reporting to the Assembly of the Republic of Albania on monetary policy matters.* These are statements that make an assessment of the monetary policy effectiveness in achieving and maintaining price stability.
- *Release of Bank of Albania Supervisory Council's monetary policy decisions* within the day the decision has been made.
- *Press releases* on Supervisory Council's monetary policy decisions, which comment on the considerations underlying the decision.
- *Regular press conferences of the Governor of the Bank of Albania* to communicate and explain monetary policy decisions.

Monetary policy is also communicated through the release of all regulations and other acts that regulate the instruments employed to implement the monetary policy. The Bank of Albania also publishes research papers, which focus on aspects of the monetary policy framework, contributing not only to the introduction of monetary policy transmission channels, but also to improving the financial literacy of the interested public. To communicate its monetary policy, the Bank of Albania uses different types of innovative media, adapted to the public it addresses to. In general, they are intended to inform different segments of the public of the monetary policy objective and the instruments employed for its implementation.

MONETARY POLICY ACCOUNTABILITY

The Bank of Albania is committed to being an accountable institution in the area of monetary policy. This commitment is materialised through regular reporting to the Assembly of the Republic of Albania, with a view to meeting all the legal obligations. It is also complemented by full transparency in the area of monetary policy, by explaining in public the reasons and the results of each monetary policy action.

*Bank of Albania, Sheshi “Skënderbej”, Nr. 1, Tirana
Tel: +355-4-241 93 01/2/3; +355-4-241 94 01/2/3
Fax: +355-4-241 94 08
E-mail: public@bankofalbania.org*

www.bankofalbania.org

Printed in: 500 copies

Printed by Albdesign Printing House