MONETARY POLICY FOR 2006

The world and Albanian experience have clearly indicated that macroeconomic stability is an indispensable precondition for ensuring a sustained and long-term economic growth. This stability implies a balanced development of various sectors of economy, smoothing of business cycles and a fluctuation as small as possible of economy growth indicators, employment, inflation, and interest rates. The creation of such conditions is accompanied by reduced risk in economy and efficient allocation of production factors. The economic theory recognises two instruments, which may be used for controlling the macroeconomic stability: monetary policy and fiscal policy.

The Bank of Albania, the monetary authority of the Republic of Albania, has the exclusive right to design, approve and apply the monetary policy. The monetary policy is designed and applied in view of achieving the primary objective of the Bank of Albania: ensuring and maintaining the price stability. It aims at administrating the monetary variables of economy – the monetary supply, interest rates and exchange rates – in view of achieving this objective in a mid-term and long-term period. The monetary policy is applied through the Bank of Albania’s intervention in the financial markets. In generic terms, the monetary policy includes: The theoretical mechanism used to design it; the framework of objectives; as well as the instruments used to apply the monetary policy.

The Document of Monetary Policy for 2006 is drafted in continuation of the “Medium term development plan of the Bank of Albania (2003 – 2005)” and the Monetary Policy Document for 2004 – 3005. The basic strategy of the monetary policy for 2006 and its operational framework will maintain the main forms attended during 2005. However, the Bank of Albania will apply gradual modifications to it, aiming at increasing the efficiency and applying more advanced standards. These changes are dictated by home and foreign experience in the field of monetary administration and by structural changes of Albanian economy.

In this document, the Bank of Albania details all concrete elements of the monetary policy for 2006, particularly in the field of monetary policy
objectives and operational framework. This document serves as a basis for orienting the coordination of monetary policy with other economic policies of the government. This document analyses concretely the commitment of the Bank of Albania to be a transparent institution.

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LEGAL GROUNDS

Pursuant to Article 161 of the Constitution of the Republic of Albania, the Bank of Albania is granted “.... the exclusive right to independently apply the monetary policy”.

Pursuant to Article 3, paragraph 4a\(^1\), of the Law No. 8269, dated 23.12.1997 “On the Bank of Albania”, the main task of this institution is “to independently design, approve and apply the monetary policy of the Republic of Albania, in accord with its primary objective”.

Pursuant to Article 3, of the Law No. 8269, dated 23.12.1997 "On the Bank of Albania", the primary objective of the Bank of Albania is “to ensure and maintain price stability”.

Pursuant to Article 43, paragraph a, of the Law No. 8269, dated 23.12.1997 “On the Bank of Albania”, the Supervisory Council of the Bank of Albania has the following competencies: “To approve the monetary policy of the Bank of Albania, determining the limits of Bank of Albania’s transactions in the open market, interest rates for deposits with the Bank of Albania and discount and lending rates of the Bank of Albania, as well as the level of reserves and required reserves that commercial banks should hold with the Bank of Albania”.

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MONETARY POLICY ROLE

The monetary policy aims at influencing the economic variables through changing the short-term interest rates. The central bank is in a position to influence the short-term interest rates through the recognised monopoly of making money: physical money and reserves of commercial banks. In the

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\(^1\) According to amendments made to the Law No. 8893, dated 25.07.2002.
short-run, a change of the monetary supply or interest rates in the money market puts into motion a range of mechanisms that influence the overall economic activity: production, occupation and price level. Meanwhile, in the long run, that is after all changes and corrections in the behaviour of economic agents take place in economy, the change in the quantity of money would be reflected only in a change at the level of prices, without infringing the real variables of the economy. Actually this conclusion enjoys a large support by the theoretic thought and its implementation in practice, including even our country’s experience.

On the other hand, fluctuations in the level of prices, inflationary and deflationary situations are harmful to the economy. The most genuine contribution that the central bank may render to economy is the maintaining of price stability. This is the main principle that guides the Bank of Albania’s monetary policy. Also, the Bank of Albania deems that even the Albanian public at large shares the same principle.

**COORDINATION WITH OTHER MACROECONOMIC POLICIES**

The Bank of Albania coordinates its monetary policy with the needs of the country’s economic development and with the strategies designed on it. Particularly, a special attention is paid to the coordination with fiscal policy, as an important determinant of the country’s economic development.

Simultaneously and without infringing the principle of the coordination of the country’s economic policies, the Bank of Albania independently determines the approval of monetary policy by the Supervisory Council of the Bank of Albania and its implementation through monetary instruments. The monetary policy decisions shall not go against the need of achieving the objective mandated by law, which is to ensure and maintain price stability.

**INFLATION TARGET FOR 2006**

Yearly the Bank of Albania publicly explains its mandate, thus testifying its institutional accountability, in compliance with the indispensability for a transparent attitude to monetary policy issues. Explanation of the mandate implies defining price stability in quantity terms. Parallel to it, the Bank of Albania provides information related to ways and instruments it is going to use for achieving it. This process helps the orientation of public expectations toward inflation targeting.
Achieving price stability means achieving low positive rates of inflation or changes in consumer prices. Maintaining price stability means being able to ensure low positive inflation rates for relatively long periods of time.

**In concrete terms, the Bank of Albania is committed to maintain inflation rate at 3 per cent, with a fluctuation band of ± 1 percentage point around it. Inflation targeting is estimated as the annual growth of consumer price index measured and published by INSTAT.**

The quantitative rate of inflation target stated above reflects the reality of the Albanian economy as a developing economy. Such economies are characterised by larger fluctuations of relative prices toward finding the proper equilibrium of market economy. The target to have lower inflation rates might impose high cost to the country’s economy. On the other hand, the maintaining of inflation target at the same rate with that of 6 preceding years would positively contribute to consolidation of inflationary expectations around the announced target of the Bank of Albania.

**Targeting Level**

Maintaining inflation on low levels will positively contribute to the Albanian economy development. First, since it is a positive inflation rate, it takes into account the technological evolution of products and their quality progress. Also, many studies have proved that inflation performance has an internal statistical tendency to record positive values. In fact, an inflation level close to zero may correspond to a deflationary situation. Second, a low inflation rate helps in maintaining positive real interest rates. Positive real interest rates help in channeling the public savings in the banking system, contributing to the stability of this system and the maintaining of its ability to supply the needs of the economy and government for monetary assets. Third, such an inflation rate is consistent with the needs of the Albanian economy development, as an economy in transition. It eases the relative price mobility providing a positive contribution to the instructive role this mechanism has on the allocation of funds in the economy. Most of the developed countries define price stability as an inflation level of about 2 percent. Since Albania is a transition country, a higher inflation level reflects a higher structural risk in the Albanian economy as well as a larger mobility of relative prices. Fourth, being at the same level with inflation targeting during the last four years, it will have a positive impact on the stabilization of inflationary expectations in the economy and the increase of confidence in economic decision-making. On the other hand, such an inflation level and the monetary policy required to attain it shall impact positively on the economic growth rates, as it has been proved over the recent years.
Also, the inflation target at the level of 3 per cent is consistent with the country’s desire for membership to the European Union in an as short period of time as possible. The intention to control price rise to a close level, but higher than the target of the European Central Bank\(^2\), enables a real convergence to Albanian economy, allowing at the same time the needed space to perform proper structural changes.

**Form of targeting**

**Inflation target will be kept within the rate of 3 percent for 2006.** Since inflation is frequently subject to the influence of supply factors or the increase of administered prices, the fluctuation of consumer prices may not always be outcome of monetary policy influence. Although the monetary policy is prudential even towards these factors, they are not subject of continuous intermediations from the monetary policy. For this reason, the defining of inflation target in the form of a band, with a fluctuation tolerance of ±1 percentage point around the central rate shall positively impact on the monetary policy stability over medium-term period.

**Other measurements of inflation**

The Bank of Albania shall employ other measurements of inflation, in view of increasing the quality of decision-making. These measurements provide a broader framework in making more realistic decisions. Other categories of inflation are:

- **Core inflation.** The Bank of Albania will work constantly during 2006 to set up the time-series of core inflation and refine the methodology of its calculation. The core inflation will have a significant input in the process of monetary policy decision-making.

- **Average annual inflation rate.** This category represents the average annual inflation rate for the last twelve months, providing valuable information about the expectations of consumer price developments. As such, the average annual inflation rate will be an important vector in the process of monetary policy decision-making.

\(^2\) The European Central Bank intends to maintain inflation close to, but not higher than 2 per cent in a mid-term period.
Also, in compliance with its commitment to adopt in the near future the inflation targeting regime, the Bank of Albania will do its best to foster its analytical capabilities; to extend the range of information used in decision making; to increase the efficiency of transmission channels; to raise the quality and quantity of its communication with the public.

More concretely, during 2006 the Bank of Albania will pay more attention to the setting up of time series and to the usage of information obtained from the following indicators:

- Business confidence index;
- Consumer confidence index;
- Real estate market index.

INTERMEDIATE AND OPERATIONAL OBJECTIVES

The control of inflation is based on control of other indicators, which on the one hand are strongly related to inflation target, and on the other hand are under a more direct control of the Bank of Albania. These are the intermediate and operational (quantitative) objectives. Intermediate objectives are orienting (indicators), while operational ones are followed rigorously. These objectives, together with the primary target of the Bank of Albania constitute the Bank’s framework of objectives.

The annual growth of money supply (M3) is the intermediate objective for 2006. The defining of M3 annual growth as an intermediate objective is based on the argument that inflation, being in general a monetary phenomenon, is impacted by monetary supply growth. Therefore, the Bank of Albania aims to control the increase of monetary assets in economy so that the supply of monetary assets corresponds with the need of economy for real monetary assets. The Bank of Albania, based on the expectation of economy growth for 2006, Bank of Albania target on inflation rate, monetary development trends, aims to maintain the monetary supply growth at the level of 11.8 per cent for year 2006.

The Bank of Albania will continue to maintain a free floating exchange rate. The ALL value against foreign currencies will be freely determined in the exchange market, as a reaction to law on demand and supply. The Bank of Albania will be present through special interventions in foreign exchange market, aiming at smoothing the short-term fluctuations of LEK exchange rate, which are contrary to long-term tendencies and observance of net international reserve objective.

The framework of monetary policy objectives is competed by the identification of monetary policy operational objectives. They establish a closer relation among monetary policy operations, its main and intermediate objectives, achievement and maintenance of price stability. Net domestic
assets and net international reserves of the Bank of Albania compose the operational objectives for 2006. A quantitative level is set for each of these objectives so as to control the work on their achievement. Also, the Bank of Albania, to the effect of monetary policy, follows and monitors even the net domestic credit to government, though it is not its operational objective.

- **Bank of Albania net domestic assets** represent the amount of Bank of Albania claims, excluding its foreign currency claims on non-residents. Here are included the Bank of Albania claims on Government (net) as well as its claims on commercial banks. An upper limit is established on these claims, meaning that the Bank of Albania may not increase the position of net domestic assets beyond the limit established.

- **Bank of Albania net international reserves** represent Bank of Albania net foreign assets minus all foreign currency holdings of commercial banks with the Bank of Albania (required foreign currency reserves plus foreign currency excess reserves). To establish a lower limit, the accruals are based on foreign exchange rate as of the end of December 2003.

- **Net domestic credit to Government** represents total banking system claims on Government minus Government deposits placed with both, the Bank of Albania and commercial banks. The establishment of an upper limit is aimed to maintain the budget deficit crediting by the banking system under control and within the required levels. **The upper limit of domestic budget deficit financing is LEK 23.8 billion for 2006.**

These quantitative levels will be reviewed along the year, in compliance with the performance of monetary developments and corrective measures projected by the Bank of Albania in the monetary program.

The Bank of Albania, under the conditions of the extension and rise of Albanian banking market competitiveness, will pay a considerable attention to the management of interbank market interest rates. Though the inter-bank market interest rates will not serve as an operational objective of the Bank of Albania, they are an indicator of monetary situation in economy and an important determinant of economy progress.

**MONETARY POLICY INSTRUMENTS**

The Bank of Albania will employ indirect monetary policy instruments to achieve its objectives. The monetary policy instruments will be oriented toward the meeting of Bank of Albania operational objectives. In compliance with monetary policy principles for 2006, previously defined in this document, the Bank of Albania will continue to apply a flexible exchange rate regime.
Open market operations tend to manage the economy interest rates, the liquidity situation in the market, as well as to signal the monetary policy.

Open market operations include:

- Repurchase agreements and reverse repurchase agreements;
- Outright transactions;
- Open market operations.

The main instrument used to transmit the monetary policy signals is the interest rate applied in the one-week repurchase and reverse repurchase agreements. **The interest rate applied by the Bank of Albania in these transactions plays the role of core interest rate in economy.** The Supervisory Council of the Bank of Albania decides on the core interest rate and the Bank of Albania uses it in the weekly auctions of repurchase agreements (repos). This rate determines even the overnight deposits and loans interest rates of the Bank of Albania. It impacts on the inter-bank market interest rate, Lek deposits rate of commercial banks, T-Bills rate and the Lek credit extended to economy.

**Standing facilities**

Standing facilities impact liquidity situation in the banking system, and impede considerable fluctuations of interest rates. Standing facilities are always possible and exclusively performed through the initiative of commercial banks. Commercial banks are the sole counterparty of the Bank of Albania in these operations.

The standing facilities supplied by the Bank of Albania are as follows:

- Overnight deposits;
- Overnight loan;
- Lombard loan.

**Required reserve**

Through the instrument of required reserve, the Bank of Albania obliges commercial banks to deposit a required reserve either in Lek or in foreign currency at the Bank of Albania. The Bank of Albania aims through this instrument to adjust money supply, liquidities and banking system interest rate as well as to preserve banking system security.

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3 The attached glossary presents a more detailed description of the functioning of monetary policy instruments.

4 Transactions of repurchase and reverse repurchase agreements are respectively recognized as repo and reverse repo.
The Bank of Albania will, depending on the Albanian financial market conditions and monetary policy needs, go on reviewing its monetary policy instruments. These reviews will take place in order to increase the efficiency of their usage.

TRANSMITTING THE MONETARY POLICY DECISIONS

The monetary policy and the decisions made on its implementation are transmitted to the public through the following documents:

- Monetary policy document, which describes the main principles of this policy adopted for a year.
- Monetary policy statement, which describes the previous six-month monetary developments and expectation on the forthcoming six months.
- Quarterly assessment of the economy, which describes the quarterly economic and monetary developments.
- Monthly Report of Monetary Policy, which describes the monthly monetary developments and an assessment on the stance in the future.
- Publication of the Bank of Albania Supervisory Council’s decisions on interest rates, within 48 hours from the making of the decision.
- Press Conferences of the Bank of Albania Governor to transmit and address the monetary policy decisions.

The monetary policy transmitting is performed also through the publication of all regulations and other acts that have to do with the instruments applied on monetary policy implementation.
GLOSSARY

- Repurchase agreements/ reverse repurchase agreements

These agreements constitute an instrument employed by the Bank of Albania to either temporarily withdraw or inject liquidity in the banking system. Repurchase agreement is an instrument used to temporarily reduce banking system liquidity. Reverse repurchase agreement is an instrument used to temporarily increase liquidity in the banking system or banks’ ability to increase lending activity or currency in circulation. Repurchase and reverse repurchase agreements of one-week maturity are executed through standard auctions. Quick auctions are employed in the case of one-day, one-month and three-month agreements.

- Outright transactions

The Bank of Albania reduces liquidity in the market through outright sale transactions and increases it through outright purchase transactions. These transactions are executed in the form of T-bill purchases or sales of up to one-year maturity or debt securities of high credibility.

- Foreign exchange operations

Foreign exchange operations are performed by the Bank of Albania through purchasing and selling foreign currency in the market. These operations are carried out to fulfill the policy defined in this Document.

- Overnight deposits

Overnight deposit assists commercial banks to operate under the conditions of excess liquidity, through depositing it solely for one day with the Bank of Albania. It also helps to withdraw excess liquidity from the banking system and to smooth-out large fluctuations of short-term interest rates. Overnight deposit interest rate represents the lowest market rate supplied by the Bank of Albania.

- Overnight loan

Overnight loan is a fully collaterized loan extended to assist commercial banks to satisfy their overnight liquidity needs and to mitigate short-term interest rate fluctuations. Overnight loan interest rate is higher than the core interest rate.

- Lombard loan

Lombard loan is used to assist commercial banks to satisfy their temporary liquidity needs. It is a fully collaterized loan of up to three-month maturity. The interest rate of this loan represents the highest interest rate established by the Bank of Albania.