



BANK OF ALBANIA

**MONETARY POLICY DOCUMENT FOR
THE PERIOD**

2012 - 2014

MONETARY POLICY DOCUMENT FOR THE PERIOD 2012-2014

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INTRODUCTION

The Bank of Albania is the monetary authority of the Republic of Albania. Pursuant to the legal framework in force, it has the exclusive right to design, approve and implement the monetary policy in Albania. The monetary policy is designed, approved and implemented with a view to accomplish the mandated objective of the Bank of Albania: achieve and maintain price stability.

Through the Monetary Policy Document, the Bank of Albania:

- publicly explains its primary objective of price stability, by defining it in quantitative terms and laying out its time frame;
- describes the theoretical framework that will guide the design of monetary policy;
- details the quantitative and qualitative indicators that will steer the Bank of Albania's decision-making in the area of monetary policy;
- introduces the framework of instruments employed to implement the monetary policy; and
- presents the main channels and instruments of communicating the monetary policy to the public.

The Monetary Policy Document for the period 2012-2014 has been designed as a follow-up of the Monetary Policy Documents for the period 2004-2011. It is formulated in line with Albania's comprehensive medium-term development programme and the Bank of Albania's Medium-Term Strategy.

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In general terms, the monetary policy strategy for the period 2012-2014 will maintain the key principles and arrangements pursued during the recent years. It will, however, be complemented with new elements in the areas of economic analyses, forecast and the decision-making, in line with the most recent practices of monetary management and the economic and financial market development in Albania.

This Document explores, in concrete terms, the commitment of the Bank of Albania to being a transparent institution. The disclosure of the key monetary policy components enhances the transparency and accountability of the Bank of Albania. In addition, it serves to anchor the economic agents' expectations to the inflation target, thus providing a direct impact on the enhancement of the monetary policy efficiency.

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I. LEGAL BASIS

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

Pursuant to Article 3, paragraph 4a of the Law No. 8269, dated 23 December 1997, “On the Bank of Albania”, the basic task of this institution is “to independently formulate, adopt and implement the monetary policy of the Republic of Albania, consistent with its main objective”.

Pursuant to Article 3, paragraph 1 of the Law No. 8269, dated 23 December 1997, “On the Bank of Albania”, the primary objective of the Bank of Albania is “to achieve and maintain price stability”.

Pursuant to Article 43, paragraph a of the Law No. 8269, dated 23 December 1997, “On the Bank of Albania”, the Supervisory Council of the Bank of Albania has the following competences: “To approve the monetary policy of the Republic of Albania, defining the limits of the Bank of Albania’s operations in the open market, the interest rates on deposits held with the Bank of Albania and on the discounts and loans of the Bank of Albania, and the reserves and level of reserves that commercial banks are required to hold with the Bank of Albania”.

Pursuant to Article 161, paragraph 1 of the Constitution of the Republic of Albania, the Bank of Albania “... holds and manages the official foreign reserves of the Republic of Albania”.

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Pursuant to Article 3, paragraph 4 of the Law No. 8269, dated 23 December 1997, “On the Bank of Albania”, the basic task of this institution is to “...*formulate, adopt and execute the exchange arrangement and the exchange rate policy in the Republic of Albania*”.

II. 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. Global theory and practice suggest that price stability is the greatest contribution that the central bank can make to sustain the long-term economic growth of the country. More specifically, by ensuring price stability, the Bank of Albania makes a direct contribution to sustaining the macroeconomic balances in the country, lowering the risk premium, promoting a stable economic growth and improving the long-term welfare, as well as safeguarding the financial system’s stability.

III. EXCHANGE RATE REGIME

The Bank of Albania will continue to implement a free-floating exchange rate regime. The value of the Lek against the other foreign currencies will be freely determined in the foreign exchange market by its supply and demand. The free-floating

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exchange rate regime allows the Bank of Albania's monetary policy for maximum flexibility in achieving the inflation target. In addition, the implementation of this regime reflects and enables the free movement of goods and capital in Albania's commercial and financial exchanges with its trading partners.

Consistent with its monetary policy, as a guarantee to cope with the severe shocks on the real sector of the economy, and in order to safeguard the country's financial stability, the Bank of Albania is committed to holding a sufficient level of foreign reserve. In line with the best international practices, the Bank of Albania will determine the sufficient level of foreign reserve based on the concurrent observance of these two quantitative criteria:

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

In order to increase the level of foreign reserve and contribute to the stabilization and development of the domestic financial markets, the Bank of Albania may intervene in the domestic foreign exchange market. These interventions, however, will not reflect the monetary policy; they will neither affect nor prejudice the achievement of the primary objective of the Bank of Albania. The Bank of Albania will intervene in the foreign exchange market in accordance with the relevant internal regulations. The latter are made transparent to the public.

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IV. INFLATION TARGET FOR THE PERIOD 2012-2014

“Achieving and maintaining price stability” implies pursuing low but positive inflation rates and preserving them for relatively long periods of time. In quantitative terms, the Bank of Albania defines price stability as the keeping of the consumer price inflation rate at 3.0%, with a tolerance band of ± 1 percentage point around this central numerical figure. The inflation target will continue to be measured by the annual rate of change in the Consumer Price Index, which is calculated and published by INSTAT.

This quantitative definition of price stability reflects the level of development of the Albanian economy as a small, open and emerging economy. As such, it is characterized by a high relative price volatility, towards finding stable structural balances of the market economy. In addition, the quantitative inflation target of 3.0% supports the EU integration process, enabling a reasonable time span for the real and nominal convergence of the Albanian economy with the EU. Lastly, keeping the inflation target at the same numerical figure as in the previous years will contribute positively to better anchoring the public’s inflation expectations around the Bank of Albania’s announced target.

TARGET LEVEL

The Bank of Albania estimates that the monetary policy will continue to provide a positive contribution to the progress of the Albanian economy by targeting an inflation rate around 3.0%. Evidence from recent years has shown that this quantitative inflation target

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and the monetary policy employed to achieve it affect positively the level and stability of the economic growth rates.

First, as this rate is positive, it 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 the price level unchanged - that is an inflation rate close to 0 - may correspond to a deflationary situation.

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

Third, this targeted inflation rate is consistent with the development needs of the Albanian economy as an interim transition 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 about 2.0%, our inflation target of 3.0% reflects the need for a higher relative price volatility.

Fourth, the inflation target of 3.0% facilitates the convergence process with the developed economies. The inflation 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 objective¹ provides enough room for making the necessary structural adjustments.

¹ The aim of the European Central Bank is to keep the inflation rate below, but close to, 2.0% over the medium term.

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Fifth, being at the same numerical level with the inflation target of the previous years, it will provide a stabilizing drive to the inflation expectations in the economy and augment certainty in the economic decision-making process.

TARGET MEASURE

The inflation target for the period 2012-2014 will remain a numerical point of 3.0%, with a tolerance band of ± 1 percentage point. This specification helps guide the public's inflation expectations and strengthen the Bank of Albania's commitment to achieving this target.

On the other hand, inflation is subject to unexpected shocks beyond the control of the monetary policy, which have a material, albeit short-term, effect on inflation. Under specific circumstances, the monetary policy response to these shocks would be risky and undesirable (see the following relevant section for a more elaborate description). The Bank of Albania will, therefore, allow the inflation rate to fluctuate within a tolerance band of ± 1 percentage point around this central numerical figure, considering this consistent with the objective of price stability.

V. THEORETICAL AND ANALYTICAL FRAMEWORK OF MONETARY POLICY

Monetary theory and practice suggest that the monetary policy decisions are transmitted to the economy with time lags, which

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mostly depend on the level of development of the financial markets. Monetary policy aims to and is able to affect future inflation developments, but not the present inflation rate. Central banks make interventions in the economy based on their forecasts of future price developments. Accordingly, they identify some economic and monetary indicators, which allow the timely identification of inflationary pressures and the monetary policy response.

The Bank of Albania will base its monetary policy decision-making on a comprehensive analysis of economic and financial indicators. The deviation of the medium-term inflation forecast from the target, based on a comprehensive analysis of economic indicators, will be the main indicator of the balance of inflationary pressures in the economy and of the desired monetary policy response. In case of large and steady deviations of forecast inflation from the target, judging also on the causes leading to these deviations, the Supervisory Council of the Bank of Albania decides on the monetary policy direction. This decision will be also based on the balance of risks associating with these projections and the decision-making. The results of analyses and baseline projections will, therefore, be complemented with possible shock scenario analyses, based on macroeconomic models available at the Bank of Albania.

In addition, the Bank of Albania will use the broad money aggregate (M3) as an indicator of inflationary pressures in the economy. The informative role of broad money finds support in the argument that inflation is a monetary phenomenon over long time periods, and consequently, it is affected by the growth of money supply in the economy. Accordingly, the growth of broad

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money beyond the demand of the economy signals and provides room for mounting inflationary pressures.

The annual growth rate of M3 aggregate and its confrontation with the real demand of the economy for money will serve as an indicator of monetary inflationary pressures. The quantitative adequacy levels of money growth are revised over the course of the year, consistent with the performance of monetary developments and the corrective measures proposed by the Bank of Albania in the monetary programme.

TIME FRAME FOR ACHIEVING THE TARGET

In response to various shocks on inflation and given the lags in the transmission mechanism, the Bank of Albania - in compliance with its legal mandate - will aim to bring inflation back to the 3.0% target over the medium-term. Present assessments suggest that monetary policy instruments have a maximum effect with a time lag of 3 to 8 quarters. However, the effect and velocity of the transmission mechanism are subject to constant changes depending on the economic cycle. The Bank of Albania will seek to always match the time horizon necessary to achieve the target with the time lags of the transmission mechanism.

HARMONIZATION WITH FISCAL POLICY

Without prejudice to its legal mandate, the Bank of Albania will seek to coordinate its monetary policy with the Government's fiscal policy. This coordination will, in the first place, aim to enhance the

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efficiency of monetary policy. In cases when and to the extent that this coordination does not prejudice the achievement of the inflation target, the monetary policy will aim at supporting and facilitating the achievement of fiscal policy.

In any case, the Bank of Albania enjoys full institutional independence and its decisions will be oriented towards meeting its primary objective: achieve and maintain price stability.

The Bank of Albania deems that, in the long run, fiscal policy should be oriented towards safeguarding public debt sustainability and other parameters of budget soundness. Fiscal policy should anchor on a clear, credible and transparent fiscal rule. This commitment will create the premises for lowering the risk premium, safeguarding macroeconomic and financial stability and promoting stable and long-term economic growth. A sustainable level of public debt enhances the flexibility and efficiency of pursuing countercyclical fiscal and monetary policies, with a view to smooth the short-term economic fluctuations.

The coordination between monetary and fiscal policy will be based on the continuous exchange of information on the fiscal and financial sector strategies and policies, as well as on the fiscal measures having an impact on the economic activity and the level of prices.

MONETARY POLICY AND SUPPLY AND DEMAND-SIDE SHOCKS

Inflation is often subject to the effect of temporary factors, which affect directly demand, output, intermediate costs, final prices

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or economic agents' expectations. These shocks may be in the form of:

- negative effects of natural disasters;
- fluctuations of prices in the international markets;
- fluctuations of regulated or administered prices²;
- changes in the structure of taxes, taxation and excises; and
- sharp fluctuations in economic agents' confidence and the risk premium.

These factors cause the consumer price inflation not to always be a consequence of the monetary conditions and not to reflect the monetary policy stance. They hit, or may simultaneously and in opposite directions hit, output and prices in the economy. Monetary policy will remain attentive to these factors, but its response to them will be oriented towards the medium-term achievement of the inflation target and the minimization of undesired fluctuations in the economy. Accordingly, the decision to respond through the monetary policy will depend on: the transitory or non-transitory nature of these shocks on inflation; their effect on inflation expectations and the degree of their spreading to other goods and services' prices in the basket; and the judgment on the side effects of monetary policy response on the economic activity and the financial markets.

² According to Bank of Albania's estimates, about 14% of the consumer spending basket, used to measure inflation, accounts for goods and services at regulated or administered prices. These prices are subject to frequent revision, but at irregular intervals, and they usually have a rising tendency with material effect on inflation. The average several-year effect of the rise in regulated and administered prices on the CPI inflation is about 0.7 percentage points.

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In case the above-mentioned supply or demand-side shocks cause movements in inflation, which are considered as transitory and without any effects on inflation expectations, and the response to which would yield large and undesired side effects, the Bank of Albania will accept the deviation of inflation from the target for short periods of time.

VI. OTHER ASPECTS OF THE DECISION-MAKING

THE DECISION-MAKING BODY

The Supervisory Council of the Bank of Albania is the supreme decision-making body of the central bank. It is responsible for the design of monetary policy and the approval of guidelines to implement it. Monetary policy decisions will continue to be taken every month according to a pre-announced schedule. They aim at maintaining inflation close to the 3.0% target and bringing it back in case it deviates.

OTHER INFLATION MEASURES USED IN THE DECISION-MAKING

In addition to measuring inflation as the annual change in the Consumer Price Index, the Bank of Albania uses other measures – namely core inflation, tradable and non-tradable inflation, and the inflationary expectations of economic agents - in order to improve the monetary policy decision-making process. These measures provide a more comprehensive basis for more pragmatic decisions.

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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 basket of goods those goods and services that are subject to higher price volatility³.

In addition to core inflation, the Bank of Albania also examines in its analyses the performance of tradable and non-tradable inflation⁴. The inflation of tradable goods in the consumer basket measures better the inflation trends in the international markets, while the inflation of non-tradable goods reflects more the domestic inflationary pressures. Identifying the source of inflationary pressures is important for the monetary policy response. Moreover, the inflation spread between these two sources provides information on the degree of competitiveness of the Albanian economy and the speed of convergence to the EU countries.

The Bank of Albania has paid ever-increasing attention to building time series on the expectations of economic agents, namely the Business Confidence Index, Consumer Confidence Index, survey on commercial banks' expectations for inflation, exchange rate and the interest rate, as well as to developing the House Price Index and Rental Price Index. These indices provide useful information for the actual and expected inflation, and the balance of risks in the economy.

³ See "New Core Inflation Measures: Their Usage in Forecasts and Analysis", 2009.

⁴ See "Contribution of Tradable and Non-Tradable Inflation to Headline Inflation: The Case of Albania", 2003.

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VII. OPERATIONAL OBJECTIVE OF MONETARY POLICY

The operational objectives establish the link between monetary policy operations and its primary objective: achieve and maintain price stability. The choice of these operational objectives is based on the monetary policy regime implemented, and the level of economic and financial market development.

The operational objective of the Bank of Albania's monetary policy will be steering the short-term interbank rates close to the Bank of Albania's key interest rate, set by the Supervisory Council, and smoothing their movements.

Steering the short-term interbank rates close to the Bank of Albania's key interest rate aims at enhancing the efficiency and transparency of monetary policy, thus contributing to a better control of long-term interest rates in the economy. In addition, this operational philosophy of the Bank of Albania adds to a better management of short- and medium-term liquidity in the banking system.

This operational approach is considered optimal in a background of low inflation and in the presence of an unstable demand for money. In comparison to the use of quantitative money variables as operational objectives, experience shows that this operational approach smooths 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

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respond to the changes in the short-term rates to an expected extent. In addition, the operational targeting of the interest rate allows for a clear signalling of the monetary policy stance.

VIII. MONETARY POLICY INSTRUMENTS⁵

In order to achieve its objectives, the Bank of Albania will employ market instruments. The monetary policy instruments will be oriented towards the achievement of the Bank of Albania's operational objective. Consistent with the monetary policy principles for the period 2012-2014, as defined in the present document, the Bank of Albania does not have any exclusive commitments with regard to the interventions in the foreign exchange market and the exchange rate.

The Bank of Albania may, however, intervene in the foreign exchange market, in order to observe its net international reserve target and smooth short-term and risky fluctuations in the Lek's exchange rate. These interventions are made in compliance with the relevant regulations⁶.

The interest rate on (reverse) repurchase agreements of one-week maturity, applied in the regular weekly auctions of the Bank of Albania⁷, is the main instrument used to transmit the monetary

⁵ 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).

⁶ Regulation "Procedures for the Intervention of the Bank of Albania in the Domestic Foreign Exchange Market", approved by the Supervisory Council's Decision No. 75, dated 11 October 2006.

⁷ Operations of repurchase and reverse repurchase agreements are known respectively as repo and reverse repo.

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policy signals. The key interest rate is set by the Supervisory Council of the Bank of Albania, and it states the central bank's monetary policy orientation/stance. It also serves as a reference rate for other monetary policy instruments of the Bank of Albania.

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

OPEN MARKET OPERATIONS⁸

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

⁸ Open market operations also include foreign currency operations. However, in contrast to domestic currency operations, they do not seek to manage the 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.

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Bank of Albania in these operations.

The Bank of Albania provides the following standing facilities:

- overnight deposit; and
- overnight loan.

ADDITIONAL LIQUIDITY-PROVIDING OPERATIONS

The main purpose of additional liquidity-providing operations of the Bank of Albania is to deal with the liquidity problems of individual banks. They aim to facilitate long-term structural adjustments of liquidity in individual banks, and smooth their impact on the systemic indicators.

The Bank of Albania provides the following additional liquidity providing operation:

- Lombard 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 that commercial banks hold a given amount of reserve in Lek and in foreign currency with the central bank.

The Bank of Albania will continuously revise its monetary policy

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instruments depending on the conditions of the Albanian financial market and the monetary policy needs. These revisions will aim at enhancing the efficiency of their use.

IX. COMMUNICATION OF MONETARY POLICY DECISIONS

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

- Monetary Policy Document, which describes the main principles of the monetary policy adopted for a given period of time.
- Quarterly Monetary Policy Report, which analyzes the economic, monetary and financial developments over a quarter, in order to assess the pressures on the actual and expected inflation performance.
- Periodic analyses, which aim at complementing the description of macroeconomic developments elaborated in the Quarterly Monetary Policy Report. These quarterly analyses elaborate on the external sector, financial intermediation and international market developments.
- Semi-Annual Monetary Policy Statement, which describes the economic, monetary and financial developments, and provides assessments of the expected economic outlook. Through this Statement, the Bank of Albania meets its legal requirement to report to the Parliament of the Republic of Albania twice a year.

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- Release of the Bank of Albania Supervisory Council's decisions on the interest rates within the day the decision has been made.
- Frequent press conferences of the Governor of the Bank of Albania, which are held to communicate and explain the Bank of Albania Supervisory Council's monetary policy decision-making.

Monetary policy is also communicated through the release of all regulations and other acts that regulate the instruments employed to implement the monetary policy. Educational publications, such as booklets and brochures, are another way the Bank of Albania communicates its monetary policy to the public. Their main purpose is to introduce the public to the monetary policy objective and the instruments employed in its pursuit. In addition, the Bank of Albania publishes research papers, which focus on aspects of the monetary policy framework, contributing not only to the introduction of the monetary policy transmission channels, but also to enhancing the financial literacy of the interested public.

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