

MONETARY POLICY DOCUMENT FOR YEAR 2005

INTRODUCTION

The Bank of Albania, the monetary authority of the Republic of Albania, is the responsible institution for designing, approving and applying the monetary policy. The monetary policy is designed in view of achieving the primary objective of the Bank of Albania: to ensure and maintain price stability.

The monetary policy, alongside the fiscal policy, is one of the fundamental macroeconomic policies. It aims at administering the monetary variables of the economy – the monetary supply and interest rates level – in view of achieving the objective of price stability in a medium-term run. The monetary policy is applied through the intermediation of Bank of Albania in the financial markets. In generic terms, the monetary policy includes: the legal basis on which it relies; the framework of objectives; the theoretical mechanism used to design it; as well as the instruments used to apply the monetary policy. The purpose of this document is to define and publish the principles on which the monetary policy is designed and applied in the current year.

Considering the importance the proper understanding of the monetary policy decisions has to the public, the channels of communication between the Bank of Albania and the public on the monetary policy decisions are as well an integral part of the monetary policy. This document suggests a summary of the major communication means used by the Bank of Albania in communicating the monetary policy.

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 apply the monetary policy."

Pursuant to Article 3, paragraph 4a¹, of 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 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 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 Republic of Albania, determining the limits of Bank of Albania's transactions in the open market, interest rates for deposits

¹ According to the ammendment made to the Law No. 8893, dated 25. 07. 2002.

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."

The Bank of Albania coordinates its monetary policy in conformity with the needs of the country's economic development and with the strategies designed on this policy. In particular, a special attention is given to the coordination with the fiscal policy, as an important determinant of the country's economic developments.

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 being mandated by law, which is to ensure and maintain price stability.

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Designing, compiling and applying the monetary policy of the Bank of Albania are all based on a proper understanding of the role the monetary policy may play through the analysis of monetary policy impact on the economy. The estimation of this role relies either on the contemporary theoretical thoughts or on the foreign and Albanian practices.

MONETARY POLICY ROLE IN THE ECONOMIC DEVELOPMENT

The monetary policy aims at influencing the economic variables through changing the short-term interest rates. It includes all the theoretical, analysing and operational aspects related to this process. 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 short-term 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 level of prices. Meanwhile, **in the long-term run, that is after all changes and corrections in the behaviour of economic agents take place in the 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: production, revenues and employment.**

On the other side, the world experience and the general consensus of the economic scholarship suggest that fluctuations in the level of prices, inflationary and deflationary situations are harmful to the economy.

Price stability sustains the potential of the economic growth in the long-term periods through the positive influence it has in the allocation of resources and in the country's financial stability.

ALLOCATION OF RESOURCES AND SOCIAL WELFARE

The allocation of resources in the economy, the decision-making on investments, production and consumption are subject to the relative prices of products. Ratios between these prices provide efficient information on the products or more profitable activities, orienting later on the allocation of resources toward them. But, in an inflationary environment, it is difficult to the economic agents to distinguish a change in the relative prices from a rise of the general level of prices, so from inflation. As a consequence, during the inflationary periods, the production factors may be oriented to wrong uses, evading their optimal allocation.

Inflation makes difficult the assessment of the real interest rate, which regulates the decisions of households on consuming or savings, and those of companies on investments. Furthermore, fluctuations of inflation rate make that creditors ask for an inflation premium to compensate the risk of keeping nominal values for long-term periods. By reducing this risk, the monetary policy has a positive impact on the extension of the financial intermediation and on the mounting of effectiveness through which the financial markets allocate the resources in the economy. In such a situation it results to have increase of investments in the economy.

Inflation impacts on the reallocation of resources from the categories of fixed revenues (employees, pensioners) to the categories of revenues indexed with inflation (producers and traders). Also, for lack of a fiscal system indexed with inflation, the latter may result to know disproportional increase of fiscal obligations, thus diminishing the motivation for investment and work.

FINANCIAL STABILITY

Financial stability is necessary for a sound economy. It fosters the capacity of an economy to ease the effect of possible shocks: energy price rise, great technological changes, contingent developments in the economies of the trading partner countries, and so on. Such events bring about misuse of resources, but a sound financial system may absorb these shocks, ceasing their harmful impact on the economic activity. Under these conditions, the economic activity would be less influenced than it would have been under the conditions when the financial sector would enlarge and disseminate the effect of shocks.

An economy with low inflation seems to have little chance to know pronounced fluctuations in the prices of assets and in the expectations of these prices. The problems related with the misevaluation of the prices of financial assets, and the expectations on them, are closely similar with the problems related with the

evaluation of the changes of relative prices under the conditions of inflation, a situation described above. The investors and creditors may misinterpret the signals they receive from prices. Under these circumstances, the financial resources are not exploited properly or the protection from this risk would require an additional financial cost.

Based on the aforementioned arguments, the Bank of Albania estimates that maintenance of price stability constitutes its essential contribution toward achieving wider economic objectives: economic growth and standard living growth.

INFLATION TARGETING FOR YEAR 2005

The Bank of Albania is interested to publicly explain its mandate, which is the interpretation of price stability, serving its transparency and fostering its accountability. This process helps the orientation of public expectations toward inflation targeting. Simultaneously, the Bank of Albania informs on the ways and instruments it will use to achieve this goal, which is inflation targeting.

Achieving price stability means achieving low positive inflation rates or changes in consumer prices. Maintaining price stability means being able to ensure low positive inflation rates for relatively long periods of time.

The Bank of Albania has already determined in its three-year strategy "Medium-term Development Plan of the Bank of Albania (2003-2005)" the inflation targeting for this period. The strategic objective of monetary policy over medium-term period is that of maintaining low positive inflation rates that ensure market stability and sustain the economic growth.

In concrete terms, the Bank of Albania is committed to continue maintaining the inflation rate within the two-to-four percent targeted range for year 2005. Inflation targeting is estimated as the annual growth of consumer price index measured and published by INSTAT.

Level of targeting

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, the low inflation rate helps in maintaining positive real interest rates. Positive real interest rates help in channelling the public savings in the banking system, contributing to the stability of this system and the maintenance 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 in 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 side, 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.

Form of targeting

Inflation targeting will be kept within the two-to-four percent targeted range for year 2005. As it has been explained before, inflation is frequently subject to the influence of supply factors or the increase of administered prices. These sources of price mobility are out 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 definition of inflation targeting in the form of a band 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 on a continuous basis during 2005 to set up the time-series of core inflation and refine the methodology of its calculation. By setting up and testing the time-series, 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.

INTERMEDIATE AND OPERATIONAL OBJECTIVES

The control on 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 Bank of Albania target constitute the Bank's framework of objectives.

The annual growth of money supply (M3) is the intermediate objective for 2005. 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 2005, BoA target on inflation rate, monetary development trends, aims to maintain the monetary supply growth at the level of 9.4 per cent for year 2005.**

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, to smooth the short-term fluctuations of LEK exchange rate, which are contrary to long-term tendencies and observance of net international reserve objective.

Identification of monetary policy operational objectives completes the framework of monetary policy 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 2005. There is set up a quantitative level for each of these objectives to control the work on their achievement. The Bank of Albania, to monetary policy effect, follows and manages 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 reserve 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 budget deficit crediting by the banking system under control and within the required levels. **The upper limit of budget deficit domestic financing is LEK 23.4 billion for 2005.**

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 inter-bank 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 of 2005, previously defined in this document, the Bank of Albania does not have any concrete commitment regarding interventions in foreign exchange market.

➤ Open market operations ²

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.**

² The attached glossary presents a more detailed description of monetary instruments' function.

Main instrument used to transmit the monetary policy signals is the interest rate applied in the one-week repurchase and reverse repurchase agreements³. **The applied interest rate by the Bank of Albania in these operations plays the role of core interest rate in economy.** The Supervisory Council of the Bank of Albania decides on the core interest rate. The Bank of Albania uses it in the one-week repurchase agreements auctions (repo). This rate determines even the overnight deposits and loans interest rates of the Bank of Albania. It impacts the inter-bank market interest rate, Lek deposits rate of commercial banks, T-Bills rate and the Lek extended credit to economy.

➤ **Standing facilities**

Standing facilities impact liquidity situation in the banking system, and impede the 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.

Following are listed the standing facilities supplied from the Bank of Albania:

- **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. 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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The Bank of Albania will, depending on the Albanian financial market conditions and monetary policy needs, go on reviewing its monetary policy instruments over the year 2005. These assessments will be employed to grow the efficiency of their usage.

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³Transactions of repurchase and reverse repurchase agreements are respectively recognised as repo and reverse repo.

TRANSMITTING THE MONETARY POLICY DECISIONS

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

- Monetary policy document stating the main principles of this policy adopted for a year.
- Monetary policy statement, describing the previous six-month monetary developments and expectation on the forthcoming six months.
- Opinion on the economy situation over the quarter, describing the quarterly economic and monetary developments.
- Monthly Monetary Policy Report, describing the monthly monetary developments and an assessment on the stance in the future.
- Publication of the Bank of Albania Supervisory Council' 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 instruments employed by the Bank of Albania to either *temporally* withdraw or inject liquidity in the banking system. **Repurchase agreement** is an instrument used to *temporally* reduce banking system liquidity. The **reverse repurchase agreement** is an instrument used to *temporally* increase liquidity in the banking system or banks' ability to grow 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 fulfil the defined policy of 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 banking system and to smooth-out large fluctuations of short - term interest rates. Overnight deposit interest rate represents the lowest rate in the market, supplied by the Bank of Albania.

– **Overnight loan**

Overnight loan is a fully collateralized 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 collateralized loan of up to three-month maturity. The interest rate of this loan represents the highest interest rate established by the Bank of Albania.