



BANK OF ALBANIA

MONETARY POLICY DOCUMENT FOR THE

2009 - 2011

PERIOD

Revised in June 2010

MONETARY POLICY DOCUMENT FOR THE 2009 - 2011 PERIOD

Monetary Policy Document for the 2009-2011 Period was revised in June 2010 with the purpose of reformulating the operational objective of the Bank of Albania. The revision became effective upon Decision No. 43, dated 30 June 2010, of the Supervisory Council of the Bank of Albania.

INTRODUCTION

The Bank of Albania is the monetary authority of the Republic of Albania. It has the exclusive right to design, approve and implement the monetary policy in Albania with a view to accomplish its mandated objective: achieve and maintain price stability.

The Monetary Policy Document of the Bank of Albania publicly explains the primary objective by defining it in quantitative terms, laying out its time frame, the associated criteria and the indicators, which guide the Bank of Albania's monetary policy. It also introduces the framework of the instruments employed to achieve the objective. The Monetary Policy Document for the 2009-2011 period has been designed as a follow-up of the Monetary Policy Documents for the 2004-2008 period. It is formulated in line with Albania's comprehensive medium-term development programme and with the Bank of Albania's Strategy for 2009-2011.

In general terms, the monetary policy strategy for the period 2009-2011 will maintain the key principles and arrangements pursued during the recent years. However, it is complemented with new elements in the area of economic analyses and the decision-making process, in line with the most recent practices of monetary management and the economic and financial market development in Albania. During this period, the Bank of Albania will be committed to enhancing its analytical skills, expanding the range of information used in the decision-making process, increasing the transmission channels' efficiency and improving the communication with the public in both quantitative and qualitative terms.

This document explores the commitment to being an open institution. The disclosure of key monetary policy components augments the Bank of Albania's transparency and accountability. Furthermore, it assists in the anchoring of the economic agents' inflation expectations to the inflation target, thus providing a direct impact to increasing the monetary policy effectiveness.

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I. 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 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 Bank 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 adopt 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 maintain with the Bank of Albania".

II. BANK OF ALBANIA MONETARY POLICY OBJECTIVE

According to the Law "On the Bank of Albania", the primary objective of the Bank of Albania is to achieve and maintain price stability. By ensuring price stability, the Bank of Albania provides

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a direct contribution to sustaining macroeconomic balances in the country, promoting economic growth and improving the standard of living, as well as safeguarding the financial stability of the system.

EXCHANGE RATE REGIME

In tandem with having an objective for inflation, the Bank of Albania will continue to implement a free-floating exchange rate regime. The value of Lek against other foreign currencies will be freely determined in the foreign exchange market by its supply and demand. 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.

III. INFLATION TARGET FOR THE PERIOD 2009-2011

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 an inflation rate at 3.0 percent, with a tolerance band of ± 1 percentage points. The inflation target will be measured by the annual rate of change in the Consumer Price Index, calculated and published by INSTAT. This target is applicable throughout the 2009-2011 period.

This quantitative definition of price stability is concurrent with Albania's status as an emerging economy, whose main priority is economic integration with the European Union countries. In the

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process of finding the proper equilibrium as a market economy and achieving the necessary structural convergence, emerging economies are characterized by higher relative price volatility. Both the keeping of the inflation target at the same numerical figure as in the previous years and the extending of the time span for the announced inflation target will positively contribute to the better anchoring of 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 at around 3.0 percent. Evidence from recent years has shown that such a level of inflation and the monetary policy employed to achieve it helps promote the economic growth of the country.

First, as this rate is positive, it takes into account the technological evolution of products and their qualitative improvement. Several influential researches 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 generates savings and financial flows, which promote investments in the economy and safeguard the banking system's stability and its financial intermediation role.

Third, this inflation rate is consistent with the growing development necessities of Albania as an interim transition economy. It

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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 percent, our inflation target of 3.0 percent reflects the need for a higher relative price volatility.

Fourth, the inflation target of 3.0 percent 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 but higher than the European Central Bank's objective¹ provides enough room for making the necessary structural adjustments.

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 2009-2011 period will remain a numerical point of 3.0 percent, with a symmetrical tolerance band of ± 1 percentage points. This specification helps guide the public's inflation expectations and support the Bank of Albania's commitment to achieving this target.

Taking into account the possible risks of inflation shocks and the need to maintain a stable monetary policy over the medium-term, the Bank of Albania will allow the inflation rate to fluctuate within

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

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a tolerance band of ± 1 percentage points around the target, considering it in line with the objective of price stability.

The Bank of Albania will aim to maintain an inflation rate of 3.0 percent over the medium term, implying that the actual inflation rates may temporarily deviate from target. This deviation is acceptable especially when the economy may be hit by external shocks or unforeseen circumstances beyond the control of the monetary policy. The latter's efforts to correct or remove the consequences of these circumstances in the short-term would generate undesirable and additional costs to the economy.

IV. THEORETICAL ASPECTS OF THE DECISION-MAKING PROCESS

POLITICAL AND ANALYTICAL MONETARY POLICY FRAMEWORK

Monetary theory and practice suggest that the monetary policy decisions are transmitted to the economy with time lags, which mostly depend on the development level of the financial markets. Monetary policy aims to and it is able to affect future inflation developments, but not the present inflation rate. Central banks make decisions based on their forecasts of future price developments. Accordingly, central banks establish some indicators which allow the timely identification of inflationary pressures and their magnitude.

The Bank of Albania will base its monetary policy decision-making on a comprehensive analysis of economic and financial indicators.

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The extensive analysis of economic variables and the deviation of medium-term inflation forecast from target will be the main indicators of inflation pressures in the economy. These outcomes will be also supplemented with possible shock scenario analyses, based on the macroeconomic model built and developed by the Bank of Albania experts. All the analytical and forecasting models will be further improved during 2009-2011, in order to strengthen their reliability and the effectiveness of monetary policy decisions.

The suitability of the monetary conditions and monetary policy decisions is assessed based on projections for price developments over the medium term, taking also into account the balance of risks involved. In case of deviations from the target, the Supervisory Council of the Bank of Albania makes a decision on the interest rate, after scrutinizing the causes that led to these deviations.

In addition, the Bank of Albania will continue to monitor the growth rate of money supply, as an indicator to medium-term inflation pressures in the economy.

Looking at the annual growth of money supply, M3, as a medium-term indicator of inflation pressures finds support in the argument that inflation is mostly a monetary phenomenon in the medium and long run. Accordingly, the growth of the money supply beyond the demand from the economy signals and provides room for augmented inflation pressures.

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

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with its legal mandate - will aim to bring inflation back to the 3.0 percent target over the medium-term. Present assessments suggest that monetary policy instruments have an effect with a time lag of 3 to 6 quarters. However, it is important to emphasize that the effect and velocity of the transmission mechanism are subject to constant changes. The Bank of Albania endeavours to match the time lag necessary to achieve the target with that of the transmission mechanism.

HARMONIZATION WITH FISCAL POLICY

In view of meeting its legal mandate, the Bank of Albania attempts to coordinate its monetary policy with the fiscal one. This relationship is based on the continuous mutual exchange of information with the Government on its fiscal policy strategy and measures that have an impact on the economy as a whole and especially on price developments. In this context, the Bank of Albania will insist on creating a fiscal rule over the medium term with the purpose of further harmonizing the monetary with the fiscal policy, hence adding an extra margin to the country's economic development. Nonetheless, the Bank of Albania enjoys full institutional independence and its decisions will be oriented towards meeting the main objective, achieving and maintaining price stability.

SUPPLY-SIDE SHOCKS AND MOVEMENTS IN ADMINISTERED PRICES

Inflation is often subject to supply-side shocks or rises in regulated or administered prices, in which case the consumer price movements are not a result of monetary conditions or subject to

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monetary policy. These shocks may refer to considerable shifts from projections on the prices of raw materials and basic foods in the global market; changes in the administrative measures which would have considerable effects on inflation, namely changes in the tax structure or components of administered prices; unforeseen changes in the conditions of agricultural production that affect its prices; natural disasters or other similar circumstances that affect demand, producer prices and ultimately, prices.

Monetary policy is attentive about these issues as well, but it does not necessarily respond to them. The decision whether to respond or not depends on the transitory or permanent nature of these shocks and simultaneously bearing in mind the need to preserve the monetary and financial market's stability. The Bank of Albania will accept deviations from the target for short-term periods, when significant movements in the inflation rates are caused by major supply-side shocks, large fluctuations in administered prices, or unforeseen demand-related events. Large fluctuations in administered and regulated prices are defined as movements, whose contribution to consumer price inflation is higher than 1 percentage point.²

V. OTHER DECISION-MAKING ASPECTS

DECISION-MAKING BODY

The Supervisory Council of the Bank of Albania is the supreme

² This impact refers to the average contribution for several years of administered and regulated prices to consumer price inflation.

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decision-making body of the central bank. It is responsible for the formulation of monetary policy and the approval of guidelines to implement it. Monetary policy decisions are taken every month according to a pre-announced schedule. They aim at maintaining inflation close to the 3.0 percent target and bringing it back in case it deviates.

OTHER METHODS TO MEASURE INFLATION, WHICH ARE USED IN THE DECISION-MAKING PROCESS

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

Core inflation represents the stable and long-term part of headline inflation. It is measured by excluding certain items from the basket of goods that are subject to high volatility as a result of temporary shocks and are out of the monetary policy's scope. During 2009-2011 period, the Bank of Albania will further intensify research on finding and applying other methods to measure core inflation.

In its analyses, the Bank of Albania examines thoroughly the time series constructed by central bank's experts on tradable and non-tradable inflation. Tradable inflation is measured based on prices of imported goods and services or on goods and services, whose prices compete with foreign products both in the domestic and international market. Non-tradable inflation is measured based on prices of goods and services that generally do not

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face foreign competition, including fully administered prices and services. Services fall into this category given their 'static' nature. Items with fully administered prices fall into this category despite their share in imports, given that their prices are not affected by external conjunctures, but by the Government's administrative decisions.

During the following period, the measurement of tradable and non-tradable goods and services' inflation will be further improved in order to meet the economic criteria used in classifying these items.

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 of inflation, exchange rate and interest rate, as well as to developing the House Price Index. Major steps forward have been made in terms of analyzing and using these series to improve the monetary policy decision-making process, which is regarded as main priority for the 2009-2011 period.

VI. MONETARY POLICY OPERATIONAL OBJECTIVES³

The operational objectives play a role in establishing a close relationship between monetary policy operations and the main objective, achieving and maintaining price stability. The choice of these operational objectives is based on the monetary policy regime applied and the development level of the economy and the financial market.

³ Amended by the Supervisory Council of the Bank of Albania in June 2010.

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

Steering the short-term interest rates in the interbank market close to the Bank of Albania's key interest rate aims at enhancing the efficiency and transparency of monetary policy, contributing to a better control of long-term interest rates in 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 money multiplier and stable money demand. Relative to the use of quantitative money variables as operational objectives, experience shows that this operational approach smoothes the volatility of interest rates in the financial markets. By controlling the short-term interest rate in the interbank market and enabling the predictability of its changes through a clear strategy of monetary policy, the medium and long-term interest rates respond to the changes in short-term interest rates to a predictable extent. In addition, the operational targeting of the interest rate is simpler to be comprehended by the economic agents and enables better signalling of the monetary policy stance.

VII. MONETARY POLICY INSTRUMENTS⁴

In order to achieve its objectives, the Bank of Albania will employ market instruments. Monetary policy instruments will be oriented

⁴ The attached glossary provides additional information on the monetary instruments.

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towards the achievement of the Bank of Albania operational objective. In compliance with the monetary policy principles for the period 2009-2011, as defined in the present document, the Bank of Albania does not have any exclusive commitments with regard to interventions in the foreign exchange market and the exchange rate. However, the Bank of Albania may intervene in the foreign exchange market in order to observe its net international reserve target and/or to smooth risky short-term fluctuations in the Lek exchange rate or to make any corrections when the latter does not comply with the economic fundamentals. The provisions of these interventions are based on regulations.

OPEN MARKET OPERATIONS

The main purpose of open market operations is to steer the short-term interest rates in the interbank market in compliance with the operational objective of the Bank of Albania. In addition, these operations contribute to the short and medium-term management of liquidity in the banking system.

Open market operations include:

- (Reverse) repurchase agreements;
- Outright transactions;
- Foreign exchange market operations.

The interest rate on (reverse) repurchase agreements of one-week maturity⁵ is the main instrument used to transmit monetary policy signals. The key interest rate is set by the Supervisory Council of the Bank of Albania and it is employed by the latter

⁵ Operations of repurchase and reverse repurchase agreements are known respectively as repo and reverse repo.

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in the weekly auctions of repurchase agreements (repos). It also serves as a reference rate for setting interest rates on the Bank of Albania's overnight deposits and loans.

It also affects the interest rate in the interbank market, the interest rate on Lek deposits held with commercial banks, on Treasury bills and on Lek loans to the economy.

STANDING FACILITIES

The main purpose of standing facilities is to affect the liquidity situation in the banking system and prevent large interest rate fluctuations. They are always and exclusively initiated by commercial banks and in these operations they are the only counterparties dealing directly with the central bank.

The standing facilities provided by the Bank of Albania are:

- Overnight deposit;
- Overnight loan.

REQUIRED RESERVE

The Bank of Albania requires that commercial banks hold reserves in Lek and in foreign currency with the central bank. Through this instrument, the Bank of Albania aims to adjust money supply, the liquidity and the interest rate in the banking system and to safeguard the latter.

The Bank of Albania will continuously revise its monetary policy 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.

VIII. COMMUNICATION OF MONETARY POLICY DECISIONS

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

- Monetary Policy Document, which describes the main principles of the monetary policy adopted by Bank of Albania.
- Quarterly Review of the Albanian Economy, which provides analyses of economic and monetary developments during the previous quarter and makes forward-looking projections.
- Semi-Annual Monetary Policy Statement, which describes the economic and monetary developments during the first and second half of the year.
- 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 Supervisory Council's monetary policy decisions.

Monetary policy is also communicated through the publication of all regulations and other acts that regulate the instruments employed in the pursuit of monetary policy.

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GLOSSARY

(Reverse) repurchase agreements.

In compliance with its operational objective, the Bank of Albania employs (reverse) repurchase agreements to steer short-term interest rates in the interbank market, and to temporarily withdraw or inject liquidity into the banking system. Repurchase agreements are used to temporarily reduce the liquidity in the banking system. Reverse repurchase agreements are used to temporarily increase the liquidity in the banking system or banks' capacity to increase lending or currency in circulation. (Reverse) repurchase agreements of one-week maturity are executed through standard auctions, while agreements of one-day, one-month and three-month maturity are executed through quick auctions.

Outright transactions.

The Bank of Albania reduces the liquidity in the market through outright sale transactions and increases it through outright purchase transactions. These transactions are executed through the purchase or sale of Treasury bills of up to one-year maturity or highly credible debt securities.

Foreign exchange market operations.

Foreign exchange market operations are carried out by the Bank of Albania through the purchase or sale of foreign currency in the market when the central bank intends to intervene in the market.

Overnight deposit.

The overnight deposit assists commercial banks in operating with the excess liquidity, by placing it for only one day with the Bank of Albania. Overnight deposit also helps withdraw the excess liquidity from the banking system and smooth large fluctuations in short-term interest rates in the interbank market. The interest rate on overnight deposit is the lowest interest rate offered by the Bank of Albania in the market.

Overnight loan.

The overnight loan is a fully collateralized loan provided to assist commercial banks in solving their overnight liquidity problems. It also helps to smooth fluctuations in short-term interest rates in the interbank market. The interest rate on overnight loan is higher than the key interest rate.

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