

BANK OF ALBANIA

# MONETARY POLICY: INSTITUTIONAL AND OPERATIONAL FRAMEWORK TOWARD A FORWARD LOOKING REGIME

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## ABSTRACT

*Monetary policy at the BoA has evolved to approach itself in line with contemporary frameworks that meet most elements promoting efficiency and effectiveness. In this paper, we make an attempt to outline the introduction of new aspects as well as improvements to the current set up. In the past two years, The Bank of Albania has arranged two Forums, in December 2005 and 2006, in order to assess the conditions for a formal revision of its institutional and operational procedures of monetary policy. In addition, these Forums have contributed to escalate and institutionalize the BoA's efforts to promote financial development and infrastructure as well as improve its operational and institutional framework for a more effective monetary policy. In this year's meeting, we come up with an overall outline of the tasks completed, mostly proposed and elaborated in the last two forums, and a general assessment of the most required conditions towards a fully-fledged IT regime for Albania.*

## INTRODUCTION

The literature on central banking and monetary policy provides a thorough review on policy framework design and policy objectives over the past. While the objectives have changed from money value to exchange rate and price stability, the policy and instruments have shifted from quantitative and overall variables towards qualitative and market oriented ones. The ultimate objective of monetary policy, to contribute to society's welfare over the medium-term, has required measurable, reliable and effective economic variables on high frequency. Until the '90s, most central banks have focused on stabilizing one or more of economic growth, financial volatility and/or price increases. After the '90s the role of monetary policy on prioritizing price stability as a main objective of monetary policy has been increasingly on consensus.

Inflation is a monetary phenomenon and money is considered neutral to real variables over the medium term. As such, monetary policy is supposed to promote society welfare through maintaining price stability. Central banks have relied on three main regimes to fulfil their objective, a monetary regime, exchange rate regime and direct (forecasted) inflation regime. The three have in common an intermediate variable or target to influence the ultimate objective of inflation and an instrumental (operational) independence. Though not all central banks enjoy legal target autonomy exclusively towards price stability, most central banks have put a priority to it. In addition, almost all central banks have had instrumental independence to fulfil their main objective. The mix of those elements, the main objective, presence or lack of target as well as instrumental autonomy (independence) have all defined central bank regime and performance.

The Bank of Albania has been operating a monetary regime since 1993, initially due to a lack of foreign reserves and lack of, or underdeveloped financial system and market economy. Over the years, the economy has shifted towards a market-oriented structure, as the presence of public sector in providing goods has diminished and the financial system has been the front-runner.

In line with such developments, the Law on the Bank of Albania has been revised in 1997 and the Bank of Albania has further pushed for improvements of its internal operational procedures. It published a target for inflation within 2-4 per cent and it shifted from direct towards indirect instruments in 2000. Indeed, the intention to maintain inflation close to 3 per cent had been made clear since 1998. In past years, the BoA has been referred to as a lite inflation targeter mostly due to its publication of a numeric target for inflation and to its independent operational framework through a base interest rate in the economy aiming at the target fulfilment (Stone, 2003). Trying to explain the negative correlation between lack of central bank independence and price stability, Cukierman (2001) has included Albania as a case among other transitional countries that confirms such a relationship.

Monetary policy at the BoA has evolved to approach itself in line with a contemporary framework that meets most elements promoting efficiency and effectiveness. In this paper, we have outlined the introduction of new elements as well as improvement of the current set up. In the past two years, the Bank of Albania has arranged two Forums, in December 2005 and 2006, in order to assess the conditions for a formal revision of its institutional and operational procedures of monetary policy. In addition, these Forums have contributed to escalate and institutionalize BoA's efforts to promote the development of the financial sector and its infrastructure, as well as to improve its own operational and institutional framework for a more effective monetary policy. In this year's meeting we come up with an overall outline of the tasks completed, mostly proposed in the last two forums, and a general assessment of the most required conditions towards a fully-fledged IT regime for Albania.

While some of the changes in this framework are a requirement for a more effective monetary policy, notwithstanding the regime, others are typical IT requirements. That makes a distinction between elements initiated to promote monetary policy performance in general and those that are definite requirements for a typical IT regime:

- a clear legal mandate to maintain price stability as a main objective, that comes with: (i) institutional independence (ii) a performance and accountability framework of objective fulfilment;
- a public numeric target for the inflation rate;
- a monetary policy framework, aiming at fulfilling its main objective, underpinning the evaluation of inflation expectations and forecasts, based on a broad range of economic and financial/monetary information;
- improved monetary policy communication and continuous survey of market reaction in terms of expectations, as additional means of monetary transmission mechanism.

## I. INSTITUTIONAL FRAMEWORK

### I.1 CENTRAL BANK MANDATE AND ACCOUNTABILITY

Central banking best practices foresee the institutional endorsement of providing macroeconomic stability under the central bank jurisdiction. While the ultimate objective of central bank policies is to promote society's economic welfare, it does so through ensuring price stability in the economy and financial efficacy of the monetary intermediation network. Clearly, price stability has become a prior objective and the policy set in the central bank hand for achieving its objective is mainly identified with monetary policy.

Avoiding double objectives for one single instrument, monetary policy is a benefit in setting a priority for price stability as the main objective. Our view has gone beyond the mere priority of price stability, recognizing that the publication of a numeric objective for inflation does help to minimize *time inconsistency setback* inherent in monetary policymaking. It promotes its effectiveness in at least three ways:

- The publication of a numeric objective for inflation is equivalent to a public mandate to focus monetary policy towards price stability. Announcing an inflation numeric target



as a means to fulfilling the price stability objective, clearly communicates to the households, agents and institutions that other variables like exchange rate, unemployment or economic growth are not a priority of monetary policy over the long run. It highlights the consensus that central bank money, in itself, cannot improve the welfare of the society over the medium to long run.

- A numeric target for inflation provides a basis for communication with the market agents, who promote the effectiveness of monetary policy transmission. As such, the communication of achieving the inflation target becomes a means for transparency and accountability towards the public (see *Transparency and Accountability*).
- Central bank institutional commitment to a numeric inflation target enhances de-facto independence of central bank in conducting monetary policy.

- *Prior objective of Bank of Albania*

The current institutional framework has the priority of price stability incorporated in the legal framework of the central bank<sup>1</sup> (Lybek, 2005). Such a definition underscores the autonomy of the central bank in regard with the target. As the Law clearly stipulates the priority of the goal, to maintain price stability, it charges the bank with a high degree of responsibility in terms of fulfilling the objective. The Bank of Albania has the autonomy to set the target itself, while the Law also assumes full authority on the use of its instruments, thus granting instrument independence to Bank of Albania. The latter, instrument independence, assumes a role for the central bank to resolve time-inconsistency problem inherent in the use of monetary policy instruments.

Under such a legal framework, Bank of Albania's responsibility rests on two aspects:

- The Bank of Albania is accountable for fulfilling the target it determines, as the Law defines.
- The Bank of Albania is liable to ensure that the target it has determined is consistent to the price stability objective that the bank is legally in charge of.

The second aspect internalizes the expertise and the experience of the central bank on handling the target in line with the objective of delivering price stability in the economy. It internalizes the advantage that rests on the banks access to compiling and analyzing pertinent information, and the potential for special expertise in assessing the output gap.

The Bank of Albania will consider price stability the main priority of monetary policy, in line with the legal basis, and a cornerstone of its institutional framework. As currently standing, the Law has provided sufficient target autonomy for the Bank of Albania (Lybek, 2005; Gogu et al, 2006). It provides sufficient room to adopt a possible IT regime and avoid time-inconsistency issue inherent in monetary policymaking. The new Law, to be revised before 2010, might consider further clarification of its subsidiary objectives, including the pre-eminence of medium-term financial stability towards economic growth<sup>2</sup>. Over the medium term, price stability will be the best contribution of monetary policy to long-term macroeconomic prosperity. Delivering price stability to economy enhances the BoA's pledge for a stable financial system as a basis for continuous economic growth and development.

- *Central bank - Institutional and instrumental independence*

The institutional framework requires sufficient formal as well as de-facto independence in order to conduct a sound monetary policy consistent with its main objective, without prejudice to the monetary policy regime.

- In terms of institutional management, central bank independence is expressed through a seven-year term mandate of the Governor and other members of Supervisory Council.
- The law grants exclusive right on the choice and use of monetary policy instruments, providing de-jure instrumental independence to avoid time-inconsistent behaviour on the conduct of monetary policy. On this basis, central bank assumes operational and policy independence, including the setting of base interest rate.

The instrumental and institutional independence have become two cornerstone requirements to promote an independent monetary policy. Notwithstanding the high degree of formal independence granted to the central bank, the credibility of the central bank towards the public is an important determinant of the cost of maintaining close to or bringing inflation back to target. As such, the cost of fulfilling the objective is very much dependent on the real independence of the central bank with regard to households, firms and domestic or international financial institutions.

There are two potential threats to central bank credibility that the Bank of Albania needs to resolve over the medium term in order to successfully implement a fully-fledged IT.

- The removal of direct or indirect deficit financing by the central bank, foreseen in the current Law

Under the current legal framework, the Bank of Albania is allowed, at her own discretion, to finance the deficit at an amount equivalent to 5 % of the average fiscal revenues for the latest three years. The revision of the BoA Law, foreseen for no later than in 2010, assumes synchronizing the Law in line with the Status of European System of Central Banks (and the Treaty Establishing the European Union). One of the amendments consists in removing the right to finance budget deficit in order to improve the real independence of the central bank<sup>3</sup>.

- Minimizing the dominance of fiscal policy in the financial system and consecutively, in monetary policy decision making

In the absence of direct deficit financing by central bank, the intermediation role of the banking system has been dominated by the public sector demand for money to finance the deficit. The greater role of public sector demand and the underdeveloped banking system over the past several years has led to a crowding out effect, financing fiscal deficit instead of extending credit to the private sector (see *1.2 Macroeconomic Stability*). Its effect in financial and money markets diminishes the efficiency of monetary

policy. While, banking system has developed fast over the last few years, the dominant role of domestic borrowing in domestic money market still hinders the efficiency of the transmission mechanism of monetary policy. Though, in the past few years, fast growth in credit market to private sector in domestic currency has slightly reduced the fiscal share, its role in money market short- and medium-term equilibrium remains dominant.

- *Transparency and Accountability*

Current framework on transparency is based on the ongoing work and experience of Bank of Albania, through gradual introduction of additional elements of transparency. The outline of a basic set-up for additional transparency was presented in the Open Forum in 2005, and was further elaborated as a strategy in December 2006. There have been several elements of transparency in place since 2006:

- A clear central bank mandate on maintaining price stability and the publication of a numeric target that guides communication on monetary policy stance has been a basic building block of transparency (see *Prior objective of Bank of Albania*)<sup>4</sup>.
- On the decision-making and operational phase, the BoA has applied press releases for Supervisory Council (SC) decisions on monetary policy. One year ago, the BoA has introduced the arrangement of press conferences to announce changes in the monetary policy stance -through change in base interest rate- by SC.
- Besides arguments that support the SC decision on monetary policy, press releases or conferences include an evaluation of the inflation risk in the economy and main threats to the target in the future.

The feedback received in the two forums of the last two years has shaped the path the Bank of Albania has moved through in terms of transparency this year. During 2007, the Bank of Albania has moved a step further towards a more transparent institution and monetary policy conduct.

- Since 2006, the BoA publishes the dates for the year forward in which SC meets to discuss monetary policy. Four of these meetings are exclusively dedicated to monetary policy discussions and decision-making. During 2007, SC has met to solely discuss and decide on monetary policy respectively. Press releases and press conferences in case base rate has changed, have taken place immediately after the meetings.
- During 2007, quarterly Monetary Policy Reports have substituted the monthly and quarterly reports. The structure of the reporting and its focus have shifted further towards inflation analysis. The current structure allows a deeper analysis of inflation developments and real sector indicators that affect the inflation perspective.
- In its press releases, as well as in its Monetary Policy Reports, the BoA explains the sources for inflation deviation from the target. It tempts to provide a full picture of the arguments for inflation deviations from the target. Such a move is strongly supported by verbal hints of potential future base interest rates movements to express the view of SC on its future stance. Both forms of communication, explaining the deviations and providing possible views on how SC potentially sees future monetary policy stance, will ensure maintaining and further promoting the central bank credibility.
- In the fourth quarter of this year, the BoA has published the Business Confidence Index (BCI) and the Consumer Confidence Index (CCI). Prior to that, the BoA had published only the methodology and an evaluation of their reliability in order to promote the public understanding and absorption on these two indices.
- At the end of 2006, the BoA approved a new regulation that aimed at disclosing the rules and procedures behind the foreign exchange operations in the domestic market.

In the timeframe towards a fully fledged IT, the BoA will seek to implement several features, aiming at further improving the communication with the public and increasing transparency of the monetary policy conduct:

- Publishing inflation forecasts in the periodic reports. While the BoA has published in its forums several of its working papers, further refinements of these models are taking place. Over the intended period towards fully fledged IT, the BoA foresees to start publishing a graphical presentation of inflation forecasts. As the inflation forecasting models receive further refinement and their reliability improves, the BoA will consider publishing inflation forecasts in numeric values or fan charts based on one of its models for the forward time horizon.
- In addition, the BoA will publish a macroeconomic model as a general framework of the main macro developments for the period ahead. The model intends to communicate to the public the general overview of indicators that will influence real activity and the sources for potential inflationary pressure.
- Implementation of other elements of the Communication Strategy will aim at anchoring inflation expectations and improving the Bank of Albania credibility over the medium term. Further implementation of the Communication Strategy should aim at anchoring inflation expectations, while maintaining actual inflation in line with the target will remain a long-term support for the credibility of the BoA.

## 1.2 MACROECONOMIC STABILITY

- *Coordination of Monetary Policy and Fiscal Policy*

The real independence of central bank in conducting monetary policy does require a developed financial system. The legal basis is a necessary but not sufficient aspect of real independence. Underdeveloped financial systems cannot completely absorb fiscal policy operations. As such, fiscal domination in financial market conveys its effects to monetary policy transmission mechanism, frustrating its objective of price stability.

Fiscal dominance takes place in certain conditions. In most cases, circumstances for fiscal dominance arise when (Masson, 1998):

- (i) Direct fiscal deficit takes place by the central bank or banking system. In these cases either commercial banks, or other actors of financial system, afford deficit financing in terms of size.
- (ii) It assumes dependence of *seignorage* as a means of supporting development and growth policies.
- (iii) Financial system and markets are underdeveloped to fully support debt raised by public or private sector.
- (iv) Serving unsustainable public debt becomes a source for fiscal dominance and instability in financial markets.

The prohibition of fiscal deficit financing by the central bank will require a more effective management of fiscal account. Financial costs of a temporary expanding domestic fiscal borrowing, due to quick increasing interest rates, would spread out costs on overall domestic debt, raising questions on short-term macroeconomic performance.

- Coordination of monetary and fiscal policy foresees the gearing of these policies towards fulfilling the Maastricht Performance Criteria in a long-term perspective. Currently, the coordination role is integrated in the PRGF / EFF agreement among Ministry of Finance, the Bank of Albania and IMF. The agreement assumes a domestic borrowing at benchmark level that pledges the continuity of the fiscal discipline of the last several years. On a medium to long run, such a role will be inherited to the Stabilization and Association Agreement (SAA). The main frame for coordination will be based on the chapter on monetary issues according to *Acquis Communautaire*, which foresees a gradual convergence of fiscal indicators towards 3 % budget deficit and 60 % debt ratio.

Over the long term, there is a coordination role inherent in SAA, while short to medium term expansionary fiscal policies or fiscal account mismanagements do spill over on monetary policy performance for a small economy. The risk is incorporated in higher interest rates and higher opportunity cost for the trade off balance between price stability and overall macroeconomic

stability that monetary policy faces. Averting the macroeconomic costs through coordination of fiscal policy and monetary policy in the short term will remain a challenge<sup>5</sup>.

- As an additional measure, the BoA looks forward to the further development of the financial system as a means of diminishing the dominant role of fiscal policy on monetary policy performance (see *1.3 Financial System Development*).
- *Exchange rate*

An effective monetary policy aiming at delivering price stability requires macroeconomic environment in line with fundamentals in order to endorse its discretion towards the main objective. In a small open economy, monetary policy that adopts interest rate as a main instrument (or implicitly money supply) to achieve price stability, has to allow flexible exchange rate to adjust to external account developments, relative productivity changes and other external shocks.

- The Bank of Albania will assume a freely floating exchange rate in line with the fundamentals of the economy. The equilibrium of these fundamentals (price, external and financial stability) will be under the influence of monetary policy (indirect) instruments, mainly base rate.

The presence of potential Balassa-Samuelson (BS) effects in the economy may drive exchange rate over the medium term towards gradual appreciation or depreciation. Olters (2005) makes a tentative evaluation of the BS effects in Albania. According to him, there is evidence that the BS effects have affected the exchange rate movements over the last few years. Partially, BS effects should be absorbed by a higher inflation target of BoA vis-à-vis the inflation target for Eurozone<sup>6</sup>.

- Over the medium term, the BoA intends to apply its policies towards maintaining credibility in terms of current account sustainability. In a developing economy, ensuring a level of



international reserves consistent to comparable standards for other developing small economies will be part of policies to preserve external stability in a long-term perspective<sup>7</sup>.

- A considerable degree of dollarization in the financial system raises additional challenges for monetary policy and financial stability. About 70% of credit portfolio and around 45% of total deposits in banking system is denominated in foreign currency<sup>8</sup>. The BoA will address issues related to financial dollarization of the economy through strict and prudent supervision in order to keep it immune from shocks (*1.3 Financial System Development*).

### 1.3 FINANCIAL SYSTEM DEVELOPMENT

Unconsolidated financial systems and the absence of capital markets overstate the effects of fiscal deficits on monetary policy performance. The banking sector makes up about 90% of the financial system and is still the main source of deficit financing. As such, its intermediation function in the economy has been overshadowed by its support of public demand for money, and so has been its role in the transmission mechanism of monetary policy. Over the last couple of years, the crowding out effect has diminished due to a fast growing banking system and higher share of households in deficit financing. Yet, there is a strong need for further deepening the financial system beyond banking network. Before such enlargement of the system takes place, the Bank of Albania has undertaken several measures to enhance the stability of bank and non-bank financial institutions.

In 2006, the Bank of Albania initiated several measures:

- New Banking Law approved at the end of 2006 has become effective this year. The Law requires banks to raise their capital provisioning for credit to the private sector. Due to high credit growth rates to private sector, mostly denominated in foreign currency, the Bank of Albania has implemented tougher regulatory framework for the lending activity of commercial banks. The newly revised framework,

since the end of 2006, intends to improve the quality indicators of the loan portfolio for the whole system.

In addition, the BoA is in the process of drafting new measures for the foreign currency credit that aim at raising the prudence by the banks on crediting the private sector in foreign currency. The measure aims mainly at maintaining /improving credit portfolio quality and bringing credit growth rates towards long-term equilibrium rates.

On a macro level, the measures will spill over towards smoothing implicit exchange rate risk on the banking system. Higher costs in financing the private sector in foreign currency usually further develop the domestic currency credit market.

- During 2007, microcredit institutions licensing has been integrated under the authority of the BoA, certified as non-bank financial institutions and supervised by the Supervision Department of the BoA.
- The new delivery versus payment system has been introduced to enhance the efficiency of the payment system and reduce transaction costs in the banking system.
- On the operational side, the BoA has revised its operational framework of its function as a lender of last resort. The new regulatory framework on repurchase agreements foresees the transfer of collateral from the borrowing commercial banks to the BoA ownership. It aims at fostering interbank market and reducing operational risk of the BoA in the market. In addition, the new Credit Information Bureau set-up within the BoA will be effective in the beginning of 2008.

- *Measures to Foster Financial Development*

Further measures aiming at financial development should continue as other aspects of institutional and operational improve for a fully-fledged IT regime. The improvement of the financial system is a keystone towards improving the monetary transmission mechanism and minimizing fiscal dominance

on monetary policy operations. Those measures will aim at broadening and further deepening the financial system.

- The BoA is also involved in fostering the development of secondary market for government securities. In addition, further financial market deepening should continue through maturity extension for securities. The BoA will cooperate to promote the access of non-bank agents in government securities market of longer than one year.
- In coordination with the Ministry of Finance, the BoA intends to amend the treasury-bill auctions at once per week, in order to encourage secondary market development for these securities.
- Further financial system development calls for enlargement of non-bank financial system. The BoA, in collaboration with Financial Supervision Authority, should seek to foster the introduction of pension and investment funds as additional intermediaries of a growing financial market.
- Regulatory framework should cover contamination risks in the region. Host-to-host supervision should be further promoted in order to mitigate risk concentration on the banking system. Cooperation agreements with regional and other central banks should allow for a broader supervision of foreign banks and minimization of risks to regional contamination.

## II. OPERATIONAL FRAMEWORK: IMPLEMENTATION SET-UP

### II.1 DEFINING THE OPERATIONAL REQUIREMENTS

Implementation of a fully-fledged IT regime requires a fine balance between the main objective and the instruments in order to produce positive spill over effects towards other - secondary- objectives of the central bank. The operational framework assumes the definition of a numeric target that is consistent with price stability, the adoption of an intermediate objective that fulfils several criteria and the implementation of

operational instruments that are related to the intermediate objective. In addition, the operational framework requires well-defined transparent relations among the three, making them as a whole monetary policy transmission mechanism.

- *A public numeric target for inflation*

The Bank of Albania has quantified the achievement of price stability as an annual growth of general price level in the economy of around 3 per cent. The target assumes a tolerance band of about +/- 1 percentage point around the point target. The definition was revised from a band target of 2-4 percent to a point target of 3 per cent in 2006 in order to raise the role of the target in shaping the expectations. The Bank of Albania considers the current set up of the 3% point target an adequate quantitative specification to promote macroeconomic stability.

- The 3 per cent point target is about 1 percentage point higher than the ones of the Albania's trade partners, currently at an advanced stage of development with a fully liberalized market economy.
- Over the last 10 years, the target band of 2-4 has served well to produce domestic and external stability as well as to promote growth in the economy, while public expectations are anchored close to this target.
- A higher target than the inflation target of 2 per cent for Eurozone assumes to account for the potential effects of BS effects and the rigidities in the economy, while it allows a growth potential for the economy to catch up with other advanced countries.

The current point target clearly communicates the BoA's aim to focus the expectations towards the 3% policy target. The consistency of the monetary policy target and the expectations will diminish potential inconsistency costs inherent in maintaining and bringing inflation in line with its objective.

This specification of a point inflation target, besides anchoring the public's expectation to a single inflation rate by eliminating

the upper boundary bias in the case of a band specification, reinforces the BoA's commitment in achieving the inflation target. In addition, it allows a more flexible conduct of monetary policy, especially in the case of short run shocks that are out of the BoA's control. There are time lags, uncertainties, and unexpected shocks in the transmission mechanism of monetary policy that make inflation vary around the target. Overactive monetary policy may produce a more instable economy in terms of other secondary objectives, as the benefits in terms of inflation rate, while not possible, are insignificant at best. The BoA acknowledges those concerns and the need for flexibility in monetary policy conduct through a tolerance interval of +/- 1 percentage point around the point target, a common design among inflation targeters.

- *Price Index of Inflation*

The Bank of Albania will maintain the current use of Consumer Price Index (CPI) as a formal measure for inflation in the economy<sup>9</sup>. The CPI measured by Institute of Statistics in Albania (INSTAT) in charge to produce a general price index for the economy, is the best available measure of living costs in the economy. In addition, the CPI has several other advantages:

- It has the highest frequency and is most familiar to the public,
- It is available at a very short time period after the reference period (at the 8-th of the consecutive month),
- It is not revised,
- It has the authorship of an independent institution, promoting credibility in monetary policy conduct.

However, for the conduct of the monetary policy the BoA has long acknowledged the usefulness of including measures of core inflation in its analyses (Çeliku, 2003). During 2007, this topic gained further attention by the BoA, resulting in a set of different advanced measures of core inflation (Çeliku and Hoxholli, 2007). Even though having headline inflation as a final target of monetary policy, the BoA is considering

publishing core measures of inflation available to the public by incorporating them in the quarterly monetary policy report. Such a move assumes higher public understanding about what monetary policy can and cannot do. In addition, it assumes higher bank accountability towards the public.

- *Main policy instrument and policy reactions to shocks*

Inflation targeting regime has been identified as an implementation framework of monetary policy that ensures limited discretion in decision-making. Through a public numeric target, it ensures that monetary policy decision-making body remains responsible and accountable while achieving the target. Yet, the IT framework allows sufficient discretion in the use of its instruments and includes a built-in operational flexibility towards unexpected shocks. Monetary policy flexibility is addressed through a 1-percentage point tolerance interval and a Communication Strategy for the Bank of Albania.

- The main policy instrument of the Bank of Albania will be the base interest rate applied in repurchase agreements. Currently, repo agreements have a weekly frequency. The use of the instrument will maintain the focus towards inflation expectations.
- The Bank of Albania will continuously promote the role of inflation forecasts as an intermediate objective towards a fully-fledged IT regime. As such, inflation forecast of the Bank of Albania in a medium term horizon will drive monetary policymaking and decision-making with regard to base rate.
- Monetary policy reactions towards supply shocks on inflation and output will be assigned a greater role in terms of communication with the public. In addition, central banks in developing countries put a significant weight on inflation deviations from target. Such a distinction from more advanced countries mirrors the lower stage of development against advanced countries, the short central

bank background essential to its experience and the low credibility inherent in relations with central banks operating in developing countries.

Inflation target deviations should carefully evaluated not only in terms of the main objective but as well as in the significant role they play in terms of the Bank of Albania's credibility. Towards a fully-fledged IT, the Bank of Albania will address these deviations in order to build the necessary credibility by:

- Prudent measures in terms of using main instrument, the base rate, in order to contain inflation pressures;
- Communication explaining the arguments for deviations from the target;
- Policies aimed at bringing inflation back in line with the target, as well as the time horizon required.

In line with that, before a fully-fledged IT takes place, the BoA should develop the necessary tools and models that provide reliable evaluations of the shocks and their effects in forward inflation and in output gap in the economy. Accordingly, the development of those tools requires reliable statistics from the real sector of the economy.

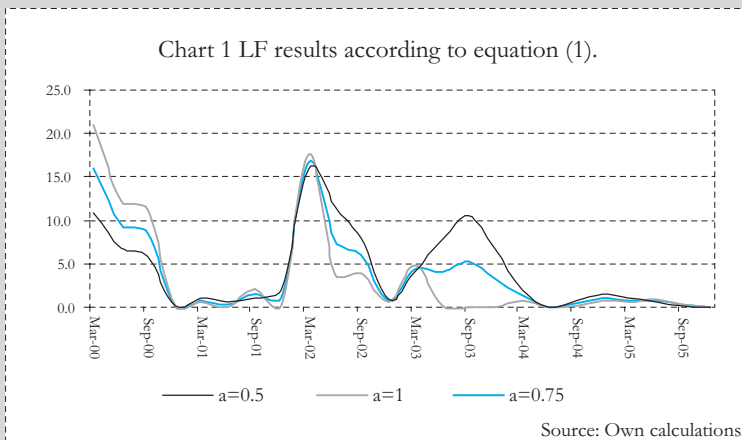
*Box 1. Secondary Objectives: The weight of economic growth in MP decision-making. A loss function for Monetary Policy.*

*The effectiveness of monetary policy is estimated through a minimization Loss Function (LF). The purpose of this function is the orientation of central banks' monetary policy under inflation targeting regime toward a flexible equilibrium. The LF, in the long term, generates an index of weighted sums of inflation and national production deviation toward respective targeted or potential levels. LF function presents the preferences to minimize the variations (losses) of the respective indicators from the targeted levels. The inflation variation is measured by the difference between annual inflation rates with the respective*

target, beginning from the year 1990. The output objective is the economic potential growth estimated through the H-P filter. The weights of the LS function refer to bank preferences for the deviation of inflation variation and production fluctuation.

$$L_t = \sum_{i=1}^k \text{weight}_i * (\text{variable}_{i,t} - \text{objectiv}_{i,t})^2 \quad L_t = a(\pi_t - \pi_t^*)^2 + (1-a)(y_t - y_t^*)^2 \quad (1)$$

The weights that are used match cross-panel study results of countries that are under inflation targeting regime (Cecchetti, 1998). The chart shows the results according to the equation by applying three diverse weights for the period 2000-2005. During the year 2001, the losses of the monetary policy slumped to further increase during the banking crises of 2002. At the beginning of the year 2004, losses start to minimize.



Monetary policy becomes complex when the economy is subject to supply side shocks. In this case, inflation rate tends to overshoot the target, while the economic growth tends to undershoot its respective potential trend. In the loss function, the interaction in opposite sides of the inflation rate against the economic growth may generate a net zero effect of supply side shocks. In this perspective, the Loss Function may produce a balancing effect depending on the significance of the two variables, inflation, (and inflation expectation anchoring) and short economic growth.



*The intensity at which monetary policy reacts largely depends on the alpha coefficient of inflation importance against that of economic growth. For developing countries, hard-won credibility imposes a tough stance on inflation. Maintaining inflation within the target over long time-periods becomes the main source of the credibility required to conduct monetary policy.*

## II.1 IMPLEMENTATION OF DECISION-MAKING FRAMEWORK

Implementing the IT regime requires, besides institutional improvements, a rearrangement of procedural structure towards decision-making. An IT regime requires a new intermediate objective and public acknowledgment of its role in monetary policy transmission mechanism. It still requires communicating to the public the flexibility of the central bank towards the main objective and the secondary ones.

- *Forecast tools*

IT regime owes its success partly to the special emphasis it puts on the forward-looking perspective of monetary policy. The IT framework addresses time-inconsistency problems in two aspects. Unlike other regimes, under IT the time horizons for the monetary policy instruments to affect the intermediate and the final target are equivalent. In addition to time horizon, the intermediate target and the final target are quantitatively equivalent and the transmission mechanism affects them through the same channels. In a fully-fledged IT regime, the intermediate target will be forecasted inflation expectation and the final target will be inflation. Forecasted inflation fulfils the criteria as a functional intermediate target:

- Forecasted/expected inflation is closely related to final target of inflation, though development of reliable forecasting tools remains a keystone in implementing fully-fledged IT, not least for the sake of credibility,

- Forecasted (expected) inflation is manageable through a policy transmission mechanism,
  - Forecasted (expected) inflation is a relevant intermediate indicator for signalling to the central bank and the public the forward policy approach.
  - Publishing the forecasted inflation increases central bank transparency and its functionality in terms of communicating central bank assessment of monetary conditions and inflationary pressures.
- *Single Inflation Models*

Forecasting of inflation through models of different frequencies is a continuous process at Bank of Albania. Currently, the 12-month forecasts are being used in decision-making. The Bank of Albania is employing several models in its decision-making practice:

- A monthly model assumes inflation on past values of money, exchange rate and unemployment, while a similar quarterly model adds import prices and mirrors some type of a Phillips curve,
- A similar method is applied towards the groups of CPI basket and weights them to produce an overall forecast for headline inflation,
- A core inflation rate and a core forecast rate is being produced by the BoA staff to assist in bringing up the monetary pressure underlying headline inflation.

Further development towards longer horizon should take place to provide solid and reliable models for longer horizons. It will require additional models and a revision of the CPI basket to increase the representative role of CPI as an inflation measure in line with trends of household expenditures.

- *Macro econometric Model - MP Transmission Mechanism*

The assessment of a full transmission mechanism becomes an essential requirement under a fully-fledged IT. In Albania, the

conduct and implementation of monetary policy faces obstacles due to underdeveloped financial market, partial dollarization, and informal economy leading to unreliable statistics. The issues become of a crucial significance when adopting fully-fledged IT in terms of conducting monetary policy due to unclear transmission channels or unstable forecasts, while high dollarization impedes effectiveness. The Bank of Albania is inclined to work on addressing the issues through institutional and operational measures before a formal IT adoption.

On an institutional level, the Bank of Albania is fully collaborating in further formalizing the private sector transactions through the banking system. The project, adopted in accordance with a broader institutional arrangement, aims at channelling the salary payment and other private sector transactions through the banking system. The project should result in a higher monetization of GDP and a greater role for monetary indicators.

In addition, the BoA's new regulatory framework on foreign currency crediting, aiming at promoting financial stability, is expected to spill over on slowing down dollarization and improving the transmission mechanism effectiveness. Further measures are under way to lead the development process of the financial system (see *1.3 Financial System Development*).

Simultaneously, in the last two years, efforts have been made to progress on assessing a core macroeconomic model and a formal transmission mechanism (Dushku et al 2007; Shijaku et al 2007). Details on the refinements of the model and the work already done will be part of this round.

- *Decision-making process at Bank of Albania*

Under a forward-looking framework, policy monetary stance will focus on forward expected inflation. Similarly, current developments are not subject of present monetary policy actions but to past policy actions. These basic principles underlying IT imply a condition for the success of the regime itself. These

basics are built upon the central bank's ability to forecast and release their benefits through banks credibility in terms of stabilizing business cycles in the economy. As such, inflation rate and its consistency with the target, is not an ultimate objective in itself but a quantitative assessment of the monetary policy success in maintaining a stable economy. Thus, the decision making process within the BoA should have in focus conducting a monetary policy that maintains expected (forecasted) inflation rate in line with the target in a medium term horizon, in order for the economic activity to take place at regular pace.

The decision-making process starts with the assessment of macroeconomic conditions, real sector developments and monetary conditions, to produce a reliable forecast of inflation. On monthly follow-up reports, analysis rely more on monetary and financial data, while the full-scale quarterly reports cover a broader real sector analysis.

### *Box 2. Monetary Policy Decision-Making*

*A full-scale report focuses on:*

- a. Analysis of inflationary pressures present in different sectors of economy;*
- b. Assessment of monetary conditions;*
- c. Evaluation of external factors – prices for imported goods and net effect of external account;*
- d. Assessment of aggregate demand and supply;*
- e. Forecasted inflation and underlying assumptions;*
- f. Base rate proposal.*

*Phase one. CPI data published by INSTAT and other monetary and real sector data are the input for an overview of the possible base scenario of the economy by the staff. It provides a consistency check of real sector, monetary/financial and survey data to set up a baseline scenario.*

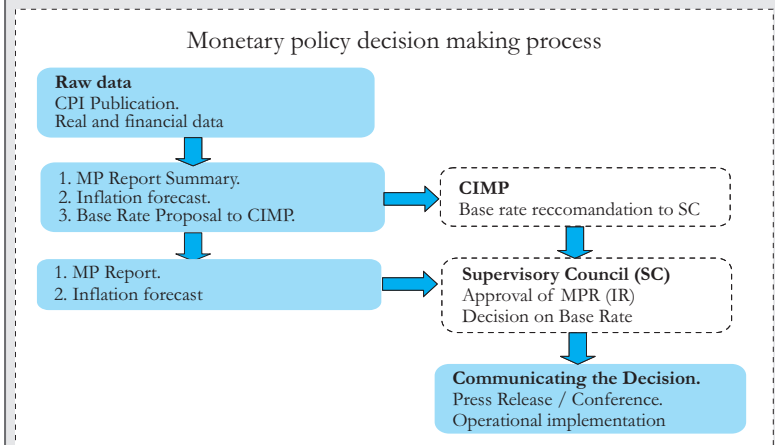
*Phase two. A draft summary is prepared based on sectorial information. The draft summary analysis takes into considerations assumptions and judgment by Monetary Policy Department. The*

base rate proposal includes a description of the arguments supporting the proposal, a balance of risks the baseline scenario faces and the potential costs of such a deviation. Inflation team produces several forecast scenarios for the decision makers, providing a quantitative assessment of the risks underlying the baseline scenario.

Phase three. A week before the SC meeting the draft report goes to the Committee on Implementation of Monetary Policy (CIMP)<sup>10</sup>. The Committee produces recommendations on the overall state of economy and discusses the underlying factors behind the forecasted inflation, as well as takes into account different aspects of the proposed MP stance. CIMP makes its recommendation to SC with respect to the proposed base rate.

Phase four. CIMP suggestions and comments on Monetary Policy Report (Inflation Report) are considered in the final draft. The final draft of the report is completed a week before the SC meeting takes place. The report on economy, and inflation forecasts as a part of final report, and the proposal go to SC.

Phase five. Supervisory Council assesses the report and the base rate proposal in line with the forecast. Recommendations and suggestions of SC take place in the report. SC votes the proposal and the decision is taken on simple majority vote. Governor's vote is the decisive one in case of a tie. The decision is made public through a press release or a press conference within 24



hours from the end of the meeting. In last two years, The Bank of Albania has arranged for press conferences by the Governor after a base rate change.

Supervisory Council meets at least 12 times, on each monthly report. Four of these meetings are completely dedicated to the quarterly reports. The monetary and macroeconomic developments are discussed in depth. The other monthly reports provide a follow-up of the inflationary and monetary conditions in the economy. At the end of each year, SC publishes its agenda for the next year meetings on monetary policy.

Box 3. Legal framework for decision-making in central bank.

Current Law foresees the right of the Supervisory Council (Sc) to set-up committees and delegate tasks and/or competences to them with regard to implementation of monetary policy (Gogu et.al. 2006). In line with this framework, SC has set up a Committee on Implementation of Monetary Policy (CIMP) as an advisory body and has charged this committee with the main task of advising SC with regard to monetary policy stance and implement monetary policy approved by SC.

Decision-making process should be addressed in the light of the expected review of the Law on The Bank of Albania before 2010, foreseen in the Stabilization and Association Agreement between Republic of Albania and EU. Still, the arrangement of the decision-making process remains sanctioned in the Constitution of the Republic of Albania. The new Law may consider the role of the SC as a managing body that oversees the decision-making process delegated to a special team specialized on monetary policy by SC itself. The delegating and overseeing powers may be balanced in an effective way to provide for monetary policy decision-making process to receive greater flexibility. Currently the CIMP is an advisory body to SC.

In addition, the new law is supposed to include a sanction on removing the deficit financing by the central bank (see Central bank - Institutional and Instrumental - Independence).

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## ENDNOTES

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<sup>1</sup> Article 1 of the Bank of Albania Law No.8269, date 23.12.1997, states that "... the main objective of The Bank of Albania is to achieve and maintain price stability".

<sup>2</sup> The revision of the Bank of Albania Law in line with the principles of *acquis communautaire* is foreseen in the Association and Stabilization Agreement between Albania and European Union before the year 2010.

<sup>3</sup> National Plan for the Implementation of Association and Stabilization Agreement with EU, June 2006

<sup>4</sup> After the Supervisory Council approval, the BoA publishes "Medium-Term Development Plan of Bank of Albania" for a three-year term as well as a Monetary Policy Document on annual basis, that both communicate to the public the objective, target consistent to that objective and instruments in place for achieving the target.

<sup>5</sup> Domestic financing has been reduced down to an average of 2.5-3.0 % of GDP since 2000, down from about 11 % in 1997.

<sup>6</sup> Inflation models of The Bank of Albania find that exchange rate significantly influences inflation in short to medium term. Other indicators are broad money, import prices, fiscal expenditures and regulated prices (Çeliku et.al, 2006).

<sup>7</sup> As a rule, a developing country is supposed to maintain a level of international reserves equivalent to around 4 months of imports. Currently the level is defined and included in the PRGF/EFF Agreement with the IMF (and Ministry of Finance).

<sup>8</sup> The share of foreign currency deposits to total deposits is on an upward trend. Currently, this ratio stands at about 43 %, up from around 36 % at the end of 2005.

<sup>9</sup> All or most IT central banks have chosen headline inflation as a formal or public measure to target. Yet some countries use a net inflation derivative to account for expected liberalization in some administrated prices, or highly volatile commodity prices (Bernanke et. al. 1999).

<sup>10</sup> Current set up of CIMP: CIMP members are the Governor, the Deputy Governor, Heads of Monetary Policy Department, Research Department, Supervision Department, Financial Stability Department, Legal Department and Deputy Heads of Monetary Policy and Operations Departments.

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