Bank of Albania

"MONETARY POLICY IN ALBANIA: FROM THE PAST TO THE PRESENT"

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CONTENTS

WELCOME REMARKS AND OPENING ADDRESS 7
Mr. Ardian Fullani, Governor of the Bank of Albania
H.E.Mr. Sali Berisha, Prime Minister of Albania

PANEL I:
A HISTORICAL OVERVIEW OF THE MONETARY POLICY IN ALBANIA 17

BANKS IN ALBANIA AND THEIR ACTIVITY DURING 1839-1925 19
Prof. Dr. Ksenofon Krisafi, President, Albanian Academy of Arts and Sciences

THE ALBANIAN GOLD STANDARD 1912-1938 45
Prof. Aristotel Pano

ALBANIA AND ITALY: MONETARY AND TRADE POLICIES IN THE FASCIST PERIOD 65
Dr. Alessandro Roselli, Honorary Visiting Fellow Cass Business School, City University, London

MONETARY POLICY AND ECONOMIC MECHANISM DURING THE MONO-PARTY SYSTEM IN ALBANIA 77
Prof. Dr. Priamo BOLLANO

PANEL II:
FINANCIAL SECTOR DEVELOPMENT AND MONETARY POLICY STRATEGIES IN SMALL AND OPEN ECONOMIES 91

THE MONETARY POLICY OF THE BANK OF ALBANIA - HISTORICAL PERSPECTIVE AND F UTURE CHALLENGES 93
Mr. Erald Themeli, Head of Monetary Policy Department, Bank of Albania

SOME MONEY AND BANKING ISSUES IN EUROPEAN TRANSITION COUNTRIES 119
Mr. Mark Allen, Senior IMF Resident Representative for Central and Eastern Europe, International Monetary Fund

CAPITAL FLOWS, MONETARY POLICY AND THE IMPOSSIBLE TRINITY 153
Mr. Madhusudan Mohanty, Head of Emerging Markets, Monetary and Economic Department, Bank for International Settlements

PANEL III:
GOVERNORS' PANEL "POLICY COORDINATION IN THE FACE OF CURRENT CRISIS" 173

Contribution by Ardian Fullani, Governor of the Bank of Albania 175

Contribution by Mr. Kemal Kozarić, Governor, Central Bank of Bosnia and Herzegovina 185

Contribution by Mr. Grigoriy Marchenko, Governor, National Bank of the Republic of Kazakhsta 189

Contribution by Mr. Gani Gërguri, Governor of the Central Bank of the Republic of Kosovo 195

Contribution by Mr. Dimitar Bogov, Governor of the National Bank of the Republic of Macedonia 199

Contribution by Mr. Dorin Drăguțanu, Governor of the National Bank of Moldova 203

Contribution by PhD Radoje Žugić, Governor of the Central Bank of Montenegro 209

THE IMPLICATIONS OF THE CRISIS FOR CENTRAL BANKING 217
Gavin Bingham, Systemic Policy Partnership LLP. Ish-Sekretar i Përgjithshëm i forumit të Qeverisjes së Bankave Qendrore

OPENING ADDRESS

*Ardian Fullani**

Your Excellency, Mr. Prime Minister,
Your Excellencies Ambassadors,
Honourable Minister of Finance,
Honourable Governors,
Distinguished Guests and Participants,

I am very honoured to open the proceedings of the Tenth International Conference of the Bank of Albania. This conference is particularly important this year, as it is organised in the framework of activities for the 100th anniversary of the Declaration of Albania's Independence and the 20th anniversary of the Bank of Albania. While retaining its scientific approach, this conference pays tribute to the endeavours made over the years in the areas of money and finance.

In Bank of Albania's view, the past is an essential element of analysis and decision-making, and a requisite for theoretic or empirical research. At present, this is a necessity, a challenge that the economics world is facing.

To scan, diagnose and cure the economic situation, a successful scholar would have to be able to read the human thought. Unfortunately, such a doctor does not exist.

Therefore, in our days, the economic science is turning its attention to individual characteristics such as: history, ethnography and other national traits, considering them as substantial determinants for the stochastic process leading the behaviour of economic agents.

The history also plays a significant role in the formation and development of institutions. The declaration of independence introduced a new era for Albanian state institutions, paving the way for the establishment of a central bank, a unified Albanian monetary system, and administration of economic life through the monetary policy. Despite its short life, the National Bank established in 1913 is a cornerstone in the history of the Albanian state. The then Prime Minister, Ismail Bej Vlora said about it: "I am so proud to say that the Bank's work is the second victory for Albania, after the freedom, from both economic and political perspectives."

The events that followed the declaration of independence, in both national and international aspects, have played a crucial role in the nature and character of these institutions, hence determining the monetary policy stance.

Economic and political partnerships, and the charisma of the Albanian statesmen to build a modern society, led to the establishment of the first functional national bank in 1925, with the distinctive characteristics embodied in the building located in the centre of Tirana.

Historic developments in early 1990s became once again determinant factors for the financial system and the central bank. Introduction of modern economics concepts led to establishment of the Bank of Albania with all the attributes of a modern central bank.

Its institutional evolution brought about development and modernisation of monetary and financial policies. The Bank of Albania became an important institution for the development of the financial and economic systems in Albania.

The challenges of the past 20 years have transformed the central Bank into a modern, responsible and credible institution; a centre

of professionalism; an institution that applies the most modern methods of monetary management; the heart of the financial system.

Aware of the decisive role that modern theories on economic growth assign to institutions for the prosperity of a nation, and taking advantage of the support from the political class and the trust of the Albanian society during these 20 years, the Bank of Albania strives for transforming itself into a modern institution and a dignified public entity across the institutional, moral, professional, ethical and intellectual dimensions. The Bank of Albania considers this as an important task and a significant contribution for a modern and prosperous state.

Its efforts for infrastructural and conceptual modernisation of the institution, including the Bank's construction projects during the last three years, are a requisite to guarantee contemporary standards for managing its activities. In other words, it literally implies rapid approximation with its counterparts in Europe. Upon completion of these projects, the Bank of Albania will be more open to the public, which will benefit from the financial education policies, scientific research, library services, and legislative, history, museum, and numismatic-related activities. These novelties will be offered to the public as a modest contribution to forming a modern and dignified state for the Albanian nation.

The meeting of these objectives is currently difficult due to the negative effects from the global economic crisis. Most evidently, the contracted consumption and investments in the private sector weigh on the labour markets, capital markets and economic activity.

The anaemic reaction of markets has put central banks in a tight corner, i.e. intervene in the economy with all the instruments to address current emergencies, while the other factors are forced to contract in favour of the long-term stability of public and private balances. In this situation, central banks are obliged to take a variety of extreme and unconventional measures, which are untested before and go beyond the imaginary boundaries of the monetary policy.

Actually, politicians are obliged to counter the debt crisis through

an extreme fiscal policy aiming at short-term balancing and long-term sustainability of the fiscal policy. The focus and emphasis of the economic policy is on long-term rebalancing by cutting expenses. A significant part of these measures is greatly focused on short-term issues, hence risking to disregard the undesired long-term effects. Under the pressure from social costs, the philosophy of current policies is to overcome the situation, and maintain social peace and macroeconomic stability at the expense of sovereignty.

This emergency compromise has shifted the focus away from structural reforms, which guarantee rebalancing through the increase of income. Often, the perspective of economic policies does not extend beyond some quarters ahead, while a much longer time vision should be considered. The anchoring of the future should start from the present.

The stabilising policies are currently based on past experiences, believing that the current crisis is similar to previous ones. This reasoning has made authorities insist on recycling stabilising measures. The time, however, shows that the global economy has undergone radical changes. The current crisis is happening as the global economic map is being redesigned in terms of economic size, geographic distribution of savings, debt, and trade and current balances. Advanced economies and emerging ones have changed positions across all these dimensions.

Consequently, old recipes do not provide an exit, given that axioms on which they are based have changed. The solution of current and future challenges requires a new philosophy of thinking based on the new global reality.

This reality, globalisation, is no longer a choice, but a fact that should be considered when formulating long-term development strategies.

Turning to a regional setting, I think that this philosophy should be embraced and supported without hesitation. To make it more productive, we should be more open to one-another and take regional cooperation to new and higher levels.

Individual prosperity of the economies in the region requires that we leave behind the philosophy of competition encouraged by and inherited from the state-formation efforts and sclerotic models that dominated the last century. We should pave the way for economic and financial cooperation and coordination.

We should tear down Balkan barriers and raise, instead, a comprehensive functional infrastructure, a regional payments system, a regional energy system, a regional market of financial products, and the last but not the least, a regional market of production factors. In Martin Luther King's words *"We may have all come on different ships, but we're in the same boat now"*. Dwelling a little longer on the regional theme, I would like to briefly touch on another problem.

The experience of the past year shows that as a result of the regulatory capital requirements imposed by euro area supervisors, various banking groups reduced their participation not only in the euro area markets but also in our region.

This process, known as deleveraging, yielded negative consequences. To prevent such phenomena, policymakers and supervisors of partner economies should cooperate more closely.

In this regard, the Vienna Initiative is a good but limited cooperation platform. It is conceptualised as an instrument to address emergency crisis situations, whereas the current situation requires platforms for dialogue to enable effective and persistent communication among policymakers. This dialogue should aim at preventing undesired mutual effects, whereas a more ambitious programme would aim at drafting and implementing coordinated initiatives of mutual interest.

Nonetheless, potential emergencies arising from contamination from euro area partners would create additional difficulties and huge effective costs for the economies in the region.

Therefore, we call for establishing appropriate mechanisms and instruments for liquidity provision by the European Union to peripheral euro area countries.

I believe that the financial integration makes this common defence more urgent, through proper understanding of the common fate of our trading partner. Given the presence of many central bank representatives from the region, I take the opportunity to call for an en bloc coordinated position in this regard.

Dear participants,

The experience of the latest crisis showed that the countries which had more space to react in the form of healthier fiscal balances or financial systems, and in the form of more reliable public institutions, were able to cope better with the consequences of the crisis. This lesson should not be neglected. Inter alia, it implies taking timely measures and, through counter-cyclical policies, creating the necessary space to buffer potential shocks. Likewise, it implies ongoing efforts by macro and micro-prudential policies to minimise financial misbalances across all sectors of the economy and the financial market.

These policies, which are often known as "leaning against the wind", have been and will continue to be part of the logic behind Bank of Albania's actions.

Concluding, I would like to assure you that the Bank of Albania will make maximum efforts to continue its success story into the third decade of its life. I am confident that the issues I shared with you provide a summarised vision of some of the main directions of our work during this period.

Looking forward to a productive exchange of ideas and opinions during the proceedings of this conference,

I thank you for your attention!

* Mr. Ardian Fullani, Governor of the Bank of Albania

OPENING ADDRESS

*Sali Berisha**

It is an honour for me to warmly congratulate, in this centennial, the staff and the management of the Bank of Albania for their work and dedication to accomplish a fundamental mission, that of monetary stability, which is in fact the stability of our country and society.

We are here, marking this great anniversary, 100 years of Albania's independence and this is an occassion to revere those great men who founded, immediately after the declaration of independence, the Bank of Albania, a fundamental institution for the existence of the Albanian state, for the existence of a state. The founders of independent Albania had the clear vision that a state without its national bank is merely a sand castle. Others, later, made efforts to realise the concept of a central bank. For many years, Allbania was tied to the Latin monetary union, but at the first opportunity, the Albanian currency was introduced and the bank was consolidated. Today it stands up as a key institution for this country.

The history of the Bank of Albania is closely connected to the history of the national currency, whose guardian it is. In this context, nothing else shares the destiny of the society more directly than the currency and the Bank. During the dictatorship rule, the Albanian society, currency, and bank were segregated in a bunker. It was

subjected to an unreal symbolism, to the limit of barely existing. The currency was manacled and could not escape the fixed rate. For 45 years, Albania was the country of zero official inflation. But, the collapse of the iron curtain removed the shackles and led the bank into a new era of freedom.

Ladies and gentlemen,

In the last 20 years, many things have changed in Albania, but nothing else has been transformed as much as the Bank of Albania. It started its new path 20 years ago with USD 4 million as foreign reserve, but today it amounts to EUR 2 billion. The bank of the Albanian state boasts today with a great success story in these 20 years. In the most decisive and swift way, it led the eventual liquidation of a debt that was prohibited under the [old] Constitution. It contributes to safeguarding monetary stability at home and for more than 18 years, the Albanian lek has been one of the most stable currencies in Europe and beyond.

The Bank of Albania was transformed into an influential catalyser for the development of the banking system in Albania. Today, Albania has one of the fittest banking systems. This system, complying with the most serious standards of banking system functioning, did not slip, in any moment, into the financial adventures that destroyed the economies of millions and millions of citizens around the globe and ruined undeservingly the reputation of banks and banking systems. In Albania, the banks showed great commitment and utter seriousness in their activity. They functioned based on the most sound principles. Therefore, today, we are not experiencing the immense problems facing a number of other countries. By contrast, the banks operating in Albania are successfully challenging the current monetary crisis, especially the euro crisis, which has seriously rendered in difficulty the functioning of branches and subsidiaries of euro area parent banks.

Routinely, an anniversary is used as a milestone to look ahead towards a new horizon and Albania needs a new banking perspective. I call, therefore, on the banks operating in our country to take all the measures and re-design their products and services in Albania. You

have made great progress, you have supported Albania's economic growth, under tough conditions, you have faced difficulties coming from all sides; however, you have had the full support of the Albanian Bank and government. Now is the time to enter a new era for your services, modern services for all citizens across the country. The Albanian citizens are totally transformed compared to six years ago. I would like to illustrate this transformation through some figures. Six years ago, the internet penetration rate in Albania was 4.8%, whereas currently in terms of Facebook use, Albanians leave behind 17 EU countries. This is an example to invite you to make more efforts for a rapid and comprehensive modernisation of all the services you provide to citizens.

Ladies and gentlemen,

We are living in a special age. Today, the capitalist system is stronger than ever and has developed and reached unprecendented dimensions. However, some of the main drivers of this system are facing serious difficulties and concerns. The euro area is crisis-striken, primarily caused by the effects of globalisation, in other words, the ignored competitiveness in one way or another. This means that the crisis will last for some time. Even after the new foundations for the euro are established and more and more countries adopt this currency, it may hardly be said that the crisis is over. Not at all! This is a long-term crisis, which essentially relates to competition. It is a crisis that requires deep reflection on developments of the past two decades. There is a big shift towards Asia. When analysed separately, however, Europe has more extraordinary potentials than any other continent.

I pointed this out, because the concentration on finding a solution to the euro crisis is vital, paramount not only to the people and countries of the euro area, but also to all the people and countries of Europe and beyond, due to the significance of this currency in the global monetary market. Outside this area, many countries are suffering the consequences of this crisis and the truth of the matter is that the concentration to limit this crisis to the area where it is located, is almost inexistent. Therefore, I would call on the European Commission and in particular Bretton Wood institutions to elaborate

a strategy to contain the existing crisis and prevent its proliferation. This strategy, however, will not be successful if it is presented as if nothing has happened. This is a deep crisis at the centre, which radiates towards the periphery and has persistent negative impacts. Therefore, an emergent and specific approach is needed.

The euro area countries rightfully point out, all day long, the absence of growth and what is being done about it. Whereas the countries experiencing growth are under the threat of losing it. This would be detrimental and fatal not only to the countries outside the euro area, but also to the euro area countries. A meeting was held in Tokyo of which we heard no news or special outcome. About a year and a half ago, I met in Tirana with the Governor of the People's Bank of China, who informed me that his country had provided the International Monetary Fund with USD 100 billion and that not a single dollar had ended up in developing countries, but the entire amount had been allocated to developed countries. If this approach is taken, the proliferation of the crisis is inevitable. I would call on banks operating in Albania to make all efforts so that together we may boost economic growth, as it is currently the lever of Archimedes to tackle the crisis effects. Albania's economy is vibrant, dynamic and real. It has an excellent proportion between wages and productivity and one of the most flexible labour markets. This economy needs the oxygen to continue to grow incessantly. I am confident that you will continue to accomplish this mission successfully, as you have done so far in Albania. Thank You!

* H.E.Mr. Sali Berisha, Prime Minister of Albania

PANEL I:

A HISTORICAL OVERVIEW OF THE MONETARY POLICY IN ALBANIA

BANKS IN ALBANIA AND THEIR ACTIVITY DURING 1839-1925

*Prof.Dr.Ksenofon Krisafi**

PREFACE

Banks and their activity represent one of the main pillars on which the stability of a modern state rests. The first and oldest central bank in the world is the Bank of Sweden, founded in 1656. The Bank of London was founded in 1694. The tendency of their establishment spread across the entire European continent. Within a period of about three centuries, almost all European countries had their central bank. In the second half of the 19th century, they began to be founded and operate in the Ottoman Empire and the Balkan Peninsula as well. The National Ottoman Bank was established in 1863, Bulgarian National Bank in 1879, National Bank of Romania in 1880, National Bank of Serbia in 1883, Bank of Italy in 1893, National Bank of Albania in 1913, which became operational in 1925, and Bank of Greece in 1928, whose origin dates back to 1841. This process continued and gradually spread across the other continents as well. The establishment of central banks brought about extraordinary progress in the human society. Drawing attention to the great contribution of central banks, the U.S. senator William Rogers considered central banking as one of the three great inventions since the beginning of time, after fire and the wheel.[1]

The issue of securities was the main activity of central banks. Driven by "governments' needs to cover deficits or finance businesses and

[1] Quoted in "Central Banks in the Region", a Bank of Albania's publication, page 6.

wars, their ultimate goal is one: boost economic growth by maintaining price stability".[2] With the passing of time, they concentrated on the issue of domestic currencies, preserving - with a few exceptions - the exclusive right and monopoly for its issuing. This because in the early periods of their existence and activity, the right to issue the currency was not their exclusive monopoly yet. Other banks could issue it too. Therefore, different currencies could circulate within the same country. In the United States, for instance, 7355 banks operating in 1912 were entitled to issue the U.S. dollar. Such a heterogeneous experience opened a debate whether free banking or the right to issue the currency was acceptable and useful or should only be exclusive to central banking? For a number of important specifications, the second idea triumphed making central banks probably the only case in the history of capitalism where monopoly over free competition is absolute.[3]

The history of the origins of central banking is as much different as it is alike. Driven by "governments' needs to cover deficits or finance businesses and wars, their ultimate goal is to boost economic growth by maintaining price stability".[4]

CURRENCY AND BANKS IN ALBANIA

The establishment of the central bank in Albania was addressed along with other elements of the state formation process in the early days of Albania's independence in 1912. The same happened when the Albanian state was re-established and consolidated in the aftermath of World War I.[5]

[2] An article by Prof. Adrian Civici, "Bankat qendrore, fajtore për krizën? Kur u themeluan, çfarë funksionesh kanë dhe në ç'mënyrë drejtojnë financat e një vendi?, Çfarë roli kanë luajtur dhe luajnë në situatën ekonomike globale?", Albanian Newspaper, 22 May 2008.

[3] The same article.

[4] The same article.

[5] The history of the Bank of Albania and its activity has been studied and elaborated by a number of Albanian and foreign researchers, where we distinguish Haxhi Shkoza, Financat e Shqipnis (1839-1934), Tirana, 1935, prof. Iljaz Fishta, Sistemi monetar dhe i kreditit në Shqipëri (1925-1944), University of Tirana, Tirana, 1971, and Ndërhyrja e kapitalit të huaj dhe pasojat e saj skllavëruese për Shqipërinë (1925-1931), Academy of Science, Tirana, 1979, Veniamin Toçi, Ndërhyrja e kapitalit të huaj në Shqipëri dhe qëndrimi i qarqeve demokratike (1921-1925), Institute of History at the Academy of Science in the Republic of Albania, Tirana, 1974, Giuseppe di Nardi, Le finanze publiche dell' Albania, Principi di economia albanese, Padova, 1941, Zivko Avramovski, Italijanska ekonomska penetracija v Albaniju 1925 do 1939 godina, Belgrade, 1963, Historia e Bankës Qendrore në Shqipëri, Tirana, 2003, Preface by Iljaz Fishta and Esmeralda Uruçi, Monedhat dhe Kartëmonedhat e Shqipërisë, Bank of Albania, Tirana, 2002 etc.

The initial concrete activity of banking institutions in Albania dates back to at least 1839, with branches or subsidiaries of Ottoman banks carrying out operations in the Albanian territories. Banks were established relatively later, after Albania gained its independence. However, there is no significant time span between the establishment of the National Bank of Albania in 1913 and other national banks of its neighbouring countries, about 20-50 years.

There is evidence that the minting and circulation of coins in the Illyrian and Albanian territories, which is an important indicator of economic and social developments, date back to antiquity. The workshop where the first Illyrian coins were minted was built in Apollonia around the 4th century B.C. It continued its activity for almost seven centuries until the 3rd century A.D. There were similar workshops in other Illyrian cities, such as Dyrrah, Amantia (Ploça, near Vlora), Bylis (Gradishta in Hekal of Mallakastra), Olympe (in Mavrova of Vlora), Orik (Pashaliman in Vlora Bay), Foinike (Finiq-Delvina), Lisus (Lezha), Skodra (Shkodra) etc.[6]

Under the Ottoman Empire, in its Albanian territories, people used Turkish banknotes issued in 1830, which in fact were interest-bearing handwritten notes called kaime. They began to be printed in 1842 under the Tanzimat reforms. They were called "kaime-i mutebere-i nakdijje" or "kaime-i mutebere-i osmanijje", and served as common banknotes for cash payments.[7]

During the time of Albania's Declaration of Independence and establishment of the modern Albanian state, there were 25 types of coins circulating in the Albanian territories, made of gold, silver, nickel etc. They were denominated as lira, half lira, a quarter lira (gold coins), mejidije (silver coins), groshar (silver coins), gjashtar, tresh, pulur, beshllëk i zi, pare etc. Of them, coins of five, half and quarter liras were used only as women's jewellery.[8]

The Turkish coins circulated for a very long time in Albania. During and after World War I, these coins were used in addition to

[6] Monedhat dhe Kartëmonedhat e Shqipërisë, Bank of Albania, Tirana, 2002, pages 11, 20 and 21.

[7] Haxhi Shkoza, Financat e Shqipnis (1839-1934), Tirana, 1935, pages 786-787.

[8] The same article, pages 787-789.

currencies of other countries occupying different parts of Albanian territories.[9]

The Ottoman Bank, which was first opened on 4 February 1863 (its statute was approved in 1875)[10] began to gradually expand its branches across the entire empire. In the Albanian peripheries, they were opened during 1903-11: in 1910 in the vilayet of Ioannina, in 1903 in the vilayet of Manastir, in 1903 in the vilayet of Skopje[11], and in 1911 in the vilayet of Shkodra. It also opened a branch in Thessaloniki, where several thousand Albanians were living. They were all closed in 1914, except for the branch of Ioannina, which operated until 1921.

Earlier in 1888, another Turkish banking institution under the name of Turkish Agricultural Bank had opened its subsidiaries and agencies in Shkodra, Kavaja, Tirana, Elbasan, Berat, Korça etc. They operated under the financial legislation of the Ottoman Empire, which was supervised by an official appointed by the High Gate. Its capital amounted to 10 million Turkish liras. A 1% tax on villagers' own production was also levied to contribute to the capital formation. This bank proved successful and had the features of a modern financial institution for the time. In 1912, it had lent Albania 6.7 million gold grosh.

There was no central financial institution to play the role of the central bank in the Albanian territories, which were administrative units of the Ottoman Empire. There was not any unique monetary system in place and the currencies were exchanged at rates and in forms varying from one city to another. People used Turkish banknotes issued in 1830, which in fact were interest-bearing handwritten treasury bonds. They began to be printed in 1842 under the Tanzimat reforms. The served as common banknotes to make cash payments.

[9] The same article, page 789.

[10] The same article, page 774.

[11] The same article.

FIRST PROJECTS FOR THE ALBANIAN BANK

The ideas and projects for the establishment of a genuine bank in Albania date back to the second half of the 19th century when the Albanian Renaissance people began to design platforms for the formation of the independent Albanian state.

They addressed the issue of establishing the central bank in Albania along with all the other components of the state formation. One of them, Sami Frashëri, in his masterpiece Albania - what it was, what it is and what it will be, addressed the need of establishing a bank in Albania and issuing the Albanian franc as the most appropriate currency to conduct common monetary operations.[12] Other Albanian, and particularly foreign personalities, also addressed the need and convenience of opening banks in the Albanian territories.

In April 1901, an Italian bank was opened in Montenegro, which operated also in Albania. Two years later, an Italian Deputy A. di San Giulianno proposed its displacement and establishment in Shkodra. The same proposal was made by the Italian Batista Pellegrini, who in his book entitled "Verso la guerra? Il dissidio fra l'Italia e l'Austria", published in 1906, required the Italian government and entrepreneurs to invest in establishing banks in Albania. An economist from Shkodra, Gaspër Guga, materialised further the idea of establishing an Albanian bank in his book entitled "Shqipëria e dy Vilajeteve të Adriatikut. Çështje të morfologjisë dhe të antropogjeografisë në rajonin shqiptar. Marrëdhëniet e saj me Italinë dhe Austrinë. E ardhmja e saj ekonomike" – "L'Albania dei due Vilajet Adriatici. Appunti di morfologia e d'antropogeografia nella regione albanese. I suoi rapporti con l'Italia e con l'Austria. Il suo avvenire economico", published in 1909, in Venice, Italy.[13] In 1907, Banca Commerciale d'Oriente had opened its subsidiary in Shkodra, named Banca "Tozzi and Company". However, it was still too soon for the establishment of the Albanian central bank. Albania, unlike its neighbouring countries, had not gained its independence yet.

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[12] Historia e Bankës Qendrore në Shqipëri, Preface, Tirana, 2003, page 5.

[13] The same article, pages 9-10.

The architects of the Albanian state had understood that banks are an important element of the state formation and that their activity represented one of the fundamental pillars the stability of the modern Albanian state would rest on. This is the reason why they would point out the need for establishing a bank from the early days of Albania's independence.

ESTABLISHMENT OF THE NATIONAL BANK OF ALBANIA (OCTOBER 1913)

Once Albania's independence was declared and the first state structures were set up, foreign banks began to show great interest in investing in the Albanian market. The Provisional Government of Vlora, established by the National Assembly in November 1912, pointed out the need to establish a bank in Albania that would contribute to moving Albania out of backwardness and speed up its economic development, which was, among other things, hindered by the financial hardship surrounding the country. Ismail Qemali, who headed the Government of Albania, believed that the rapid development of Albania could not be achieved without financial assistance from abroad and foreign capital support. In one of his talks held with the French representative of the International Commission of Control, Krajewski, in Vlora, Ismail Qemali had expressed his efforts to receive loans for the new state from London and Paris, but they were unsuccessful. Considering the objective impossibility to establish a bank through domestic capital, he began negotiating with foreigners and gave necessary instructions for the preparation of appropriate legal and institutional framework for the establishment of the bank. The Albanian Government made the first steps by addressing to Vienna and Rome, negotiating for granting some concessions, including that for the National Bank. The official agreement on the establishment of what was to become the first Albanian national bank was signed on 4 October 1913[14] by Ismail Qemali, and Karol Pitner and Oskar Pollak, representatives of Wiener Bank Verein, headquartered in Vienna, and Pietro Fenolio and Guido Ansbaher, representatives of Italian Commercial Bank (Banca Commerciale Italiana), headquartered in Milan. The

[14] Banka Kombëtare e Shqypnies, Vlora, 1914, pages 3-4.

concession agreement establishing the National Bank of Albania[15] would extend its validity for a 60-year period. It provided that if the Albanian Government did not declare the termination of its validity one year before expiration, it would cease to operate. Otherwise, the agreement would renew and take effect for another 30-year period. The capital was to amount to 10 million korona or 10.5 million Italian liras, divided into equal shares for both groups.[16]

Its activity was to be governed by the Administrative Council, which was composed by representatives of both founding parties. The bank had all the privileges and functions of a modern bank, including the exclusive right to issue banknotes with inscriptions in Albanian and French. It had the obligation to create a gold reserve equal to 1/3 of currency in circulation. It was to act as financial agent to the Albanian Government in and out of the country, having the exclusive right to trade Treasury bills and other securities on the account of the Albanian Government. It also had the right to operate in lending, issue guaranteed bonds and conduct mortgage operations.[17]

After signing the agreement, the Albanian government, which was very interested in the immediate commencement of its operations, put its funds into the bank and asked the Albanian traders to deposit their free funds there. The Bank issued the following document to the relevant financial authority of the Provisional Government of Vlora for receiving Government's funds into its initial capital. A document included in Haxhi Shkoza's book "Financat e Shqipnis" (1839-1934) ("Albania's Finances" (1839-1934)), published in Tirana in 1935, has the following content: "The Syndicate of the National Bank of Albania, in Receipt No. 1, dated 6 October 1913, received from Vlora's Finances 545,283 grosh (No. of Receipt Book 930), Withdrawn from the Bank 257,000 grosh through three withdrawals, Left to receive from the Bank 288,283 grosh. These operations remained unchanged until June 1914. No further evidence is found, probably due to domestic turmoil in the following two months as everyone is aware of."[18]

[15] Haxhi Shkoza, page 775.

[16] The same article, page 776.

[17] The same article.

[18] The same reference, pages 779-780.

NATIONAL BANK OF ALBANIA AND FEDERAL RESERVE – FED (CENTRAL BANK OF THE UNITED STATES)

On 23 December 1913, almost two months after Ismail Qemali signed the agreement establishing the first Albanian national bank and, along with his signature, was to throw the fragile foundations of the National Bank of Albania into a hard ground, thousands of miles away, beyond the Atlantic shores, in Washington, Woodrow Wilson, President of the United States, was also signing the founding act of the Central Bank of the United States, known as the Federal Reserve (Fed).

There is a coincidence relating to the time of their establishment at end-1913. But there is also a difference. The Fed was established when its founders considered it reasonable and appropriate, while the concrete conditions and suitable circumstances for its establishment existed long ago. The first U.S. bank, known as the First Bank of the United States, was established in 1791 and was entitled by the Government to issue the new U.S. currency and carry out credit operations. There was only a lack of consensus between the Congress decision-makers as the state already existed and operated smoothly.

Albania was lacking the minimum conditions, beginning from the least to the most important, the state. Albania was under the Ottoman Empire. The projects were therefore designed on a virtual ground and discussions were held only theoretically and doctrinally. There was an immense desire and efforts were made too, but the Albanian state the National Bank was to serve to, was still in renaissance people's thoughts or pretty much in any initial projects.

In two geographical extremes, in two countries, in the world's superstate, the United States, and in one of the smallest countries, Albania, the respective central banks were being established around the same time. The establishment of the central bank in Albania was being perceived as the pinnacle of aspirations for building and consolidating the independent state, as one of its main pillars, while in the United States, as the last legislative tolerance for materialising Fed's project.

When Wilson signed the Federal Reserve Act on December 23, 1913, he said he felt grateful for having had a part "in completing a work ... of lasting benefit for the country," knowing that it took a great deal of compromise and expenditure of his own political capital to get it enacted."[19] This was in keeping with the general plan of action he made in his First Inaugural Address on March 4, 1913.[20]

While Ismail Qemali, the creator and founder of the National Bank of Albania, upon its establishment, stated in the meeting square in Vlora: "Let me say with admiration that the work of the Bank of Albania is, both economically and politically, a second victory for Albania, after that of independence".[21]

BANKING ACTIVITY IN ALBANIA DURING WORLD WAR I

The National Bank of Albania was short-lived. On 8 October 1913, Ismail Qemali addressed to Italy and Austria for financial assistance, but they were reluctant to act. "As incredible as it may seem, this attempt quite clearly in our favour, was again an excuse for a campaign of absurd accusations ... to present Ismail Qemali as sold to both foreign powers to destroy the Albanian economy, which was actually inexistent and Ismail Qemali sought to develop."[22] The events that swept across Albania and the entire region at the outbreak of World War I caused the National Bank of Albania to cease its activity after only a few months from its establishment.[23]

Besides the opposition arising within the country, the concession of the National Bank of Albania also met with staunch opposition from the Entente Powers, which considered it a violation of commercial equality to their detriment. Through their consuls in Vlora, they informed the government of Ismail Qemali that they would consider as valid and definitive only the concessions

[19] Congressional Record, 1951, page 1447, le 22 décembre 1913.

[20] The same article.

[21] Përlindja e Shqypnies Journal, Vlora, No. 23, dated 30 December 1913.

[22] Ismail Qemal Vlora, *Kujtime*, Published by Toena, Tirana, 1997, page 364.

[23] Haxhi Shkoza, pages 770-780.

approved by the International Commission of Control expected to be established pursuant to the decision of the London Conference of the Ambassadors in London in 1913.[24]

Prince Wilhelm of Wied, appointed by the Great Powers to take the throne of Albania, accepted to rule over Albania under the auspices of Austria-Hungary and Italy, which would extend a loan of 75 million gold francs as their contribution to the Prince.[25] However, neither Italy nor Austria-Hungary took any concrete actions to lend him the remainder of the promised loan - 70 million gold francs. Under these circumstances, the Prince addressed to some European countries for financial assistance. Only a few Austrian financial circles responded by confirming their willingness to put a bank into operation. France opposed Austria's initiative, requiring equal participation of the great powers in the bank's capital. On 23 January 1914, France presented Prince Wilhelm of Wied the terms for its participation in the loan guarantee through the Prime Minister and Minister of Foreign Affairs, Gaston Doumergue. France demanded the Bank of Albania to be entirely international, with no special privilege for any of the powers. The Austrian-Italian Bank established on 4 October 1913 had to close or merge into the international bank as two banks could not operate in Albania. Italy also joined the Albanian bank internationalisation project, forcing Austria to withdraw from its initial idea.[26]

In 1914, the financially suffering Government of Albania, headed by Turhan Pashë Përmeti, was in need of borrowing a loan to weather the severe economic situation in Albania. The Prime Minister began a tour of visits across Europe but with no success.

During World War I, in the absence of a central state authority when the country was being governed by foreign armies' commands or authorities, some Austrian banks opened their branches at their own initiative. We could mention here Wiener Bank Verein, Pester Bank and Ungarische Bank. Their activity was mainly limited to

[24] *Historia e Popullit Shqiptar, III, Periudha e Pavarësisë, 28 nëntor 1912-7 prill 1939*, Published by Toena, Tirana, 2007, page 43.

[25] Arben Puto, *Pavarësia shqiptare dhe diplomacia e Fuqive të Mëdha, 1912-1914*, Published by Toena, Tirana, 2012, page 57.

[26] The same article.

lending. Despite the absence of a central bank, the governing bodies of some autonomous regions issued their own currencies. For instance, in 1914, middle Albania issued some small banknotes of 5 para and 10 para, 1 grosh, ½ grosh etc. In 1917, the Republic of Korça issued, upon the decision of the Council of the Autonomous Republic of Korça, local banknotes of 1 and ½ franc.[27]

This practice continued even after the end of war. In January 1920, the Government formed by the Congress of Lushnja authorised the prefectures to issue their own local currencies. Shkodra and Korça issued their own currencies, respectively called qindtar (in Shkodra) and frangë and skënder or qindtskënder (in Korça).[28]

Once the war was over and the independent state of Albania was re-established, attempts were remade to establish an Albanian bank. In August 1920, the Government headed by Sulejman Delvina began the negotiations with representatives of the Italian Government on economic and financial-related issues. Referring to the National Bank of Albania established back in 1913, the Albanian representatives noted that the agreement establishing the bank in October 1913 was no longer suitable for the conditions of the time. It was suggested to propose an Italian financial group to establish an Albanian state bank as a joint venture (Albanian and Italian) but registered as an Albanian legal person. There were also other initiatives, which, however, proved unsuccessful.

The Government, in the meantime, continued its efforts to stabilise the banking and financial situation in Albania. Based on Law No. 41, dated 6 May 1920, Albania issued a domestic loan of 2 million gold francs, of 50 gold franc denomination. In June 1921, a decision was made to base the state revenue on the gold franc, based on the exchange rates of the other currencies in circulation. In March 1922, a law was approved on the issue of the national currency amounting to 3 million gold francs. For different reasons, however, this law did not become effective.

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[27] *Monedhat dhe Kartëmonedhat e Shqipërisë*, Bank of Albania, Tirana, 2002, pages 30-33.

[28] The same article.

MONETARY AND CREDIT SYSTEM IN ALBANIA DURING 1921-24

During 1921-1924, finances in Albania were chaotic. Various authors writing about the history of banks and currencies in Albania, such as Indro Montanelli, Bernd Fischer, Alessandro Roselli, Haxhi Shkoza, Sejfi Vllamasi, Iljaz Fishta, and the authors of "Historia e Bankës Qendrore në Shqipëri" ("History of the Central Bank in Albania", in 2003, Iljaz Fishta and Esmeralda Uruçi, state that currencies of different values and absurd origins ranging from old Turkish currencies, Italian lira, French, Swiss and Belgian franc, Austrian korona, Greek drachma, Serbian dinar, U.S. dollar, to British pound sterling, etc. continued to circulate in Albania during 1921-1924. All this variety of currencies brought confusion and loss of national wealth in terms of the exchange rate depreciation in foreign transactions.

The establishment of the monetary and credit system in Albania was therefore a necessity of time. Endeavouring to improve the economic and financial situation in Albania, on 25 February 1922, the Albanian Government addressed to the League of Nations to send a team of experts to assess the country's potential for foreign investments.[29] The Financial Committee of the League of Nations sent to Albania Albert Calmes, Professor at the University of Luxembourg. After visiting Albania, in September 1922, he submitted to the Financial Committee a comprehensive report on the financial situation. According to Calmes, Albania had in circulation or held in treasury 50 to 100 million gold francs, excluding jewellery and gold decorative items.[30] He also recommended the establishment of an issuing and credit bank of domestic and foreign capital. It would have the right to issue and put currencies into circulation, engage in lending operations, etc. The bank would serve as a tool for facilitating the use of Albania's numerous resources. He concluded the report by suggesting Albania to rely mostly on its own wealth rather than foreign capital.[31]

[29] Journal of Mitrush Kuteli (Dr.Pas) *Nga lufta për të shpëtuar floririn e Bankës dhe disa raporte e kujtime,* MK, Tirana, 2012, page 61.

[30] Albert Calmès, - *La situation* économique *et financière de l'Albanie*, Genève 1922, doc. A.195.

[31] The same article, page 31.

In the beginning of 1923, the Albanian Government approved a law to weather the difficult situation in the country. This law authorised the municipalities to provisionally issue their own currencies of different denominations, amounting up to 80 thousand gold francs. The law became effective and soon after the municipalities of Fier, Korça, Shkodra, Vlora etc. prepared and put their respective currencies into circulation.[32] This policy could not continue for long as it conflicted with the general tendency that aimed at building a centralised Albanian state to weather the difficult economic and financial situation it was going through.

In order to materialise the initiative for establishing a bank in Albania, in April 1923, the League of Nations appointed J. D. Hunger of Holland as financial adviser to Albania. In his project put forward in "Projet de loi pour la nouvelle Banque d'Emission d'Albanie" Hunger recommended Albania's capital to amount to 15 million gold francs, the bank's headquarters to be located in the capital city, and the concession arrangement to last 15 years.[33] In August 1923, the League of Nations designed another project, which suggested the participation of some European countries in the bank's initial capital of 5 million gold francs[34] as shareholders, more specifically England, France and Italy, with 25% each, Belgium 5%, Albania 10% and a few other countries 10%.

At the same time, from June to September the same year, several projects for the establishment of a national bank of Albania were put forward by Albanians and foreigners. There are some very interesting ideas expressed by Avni Rustemi, a deputy in the Albanian Parliament of that period, in an article published in a daily journal in April 1924. He addressed the need to establish a national bank by putting forward his ideas. According to him, the bank should have been established as a national financial institution with wholly-owned Albanian capital.

[32] The same article, page 35-37.

[33] *Projet de loi pour la nouvelle Banque d'Emission d'Albanie*, Genève 1923.

[34] *Banque d'Albanie – Projets de Statuts*, Genève 1923.

ESTABLISHMENT OF THE NATIONAL BANK OF ALBANIA - 1925

The idea for the establishment of the National Bank of Albania was considered as highly attractive and interesting, particularly by Italy, which tried to prevent England and France's participation. To this end, Mario Alberti, Director of the Banca di Credito Italiano, was appointed by the Italian Government to project the establishment of an Italian-Swiss-U.S. or Italian-Swiss-Dutch group, which would be suggested to the League of Nations as the best option for being granted the concession for the establishment of the National Bank of Albania. Bank's capital was to be financed by the Italian National Institute for Foreign Exchange, ensuring wide participation of the Italian capital and almost full control over the Bank. These ideas began to materialise by replacing the U.S. or Dutch partners with representatives of a Belgium company.

After a long odyssey of difficult negotiations, the parties reached the agreement on the establishment of the Bank.

Albania authorised Mufid Libohova, who at that time held the position of Minister of Finance and Deputy Minister of Foreign Affairs in the Albanian Government, whereas the Italian Government appointed Mario Alberti, a high-level executive holding the title of "Grande Ufficiale" and representative of the Italian Financial Group. They concluded an agreement, referred to as the Convention, which established the commitments of both parties, the scope of Bank's activity, headquarters, governing bodies, initial capital, modalities and procedures for its establishment and final certification by the supreme bodies in both countries, etc.

The Convention which, at the same time, constituted the basic act establishing the National Bank of Albania, was formulated as follows:

1. The Italian Group represented by Gr. Uff. Mario Alberti, shall establish, within 90 days from the ratification of this Convention, the National Bank of Albania, with a nominal capital of 12,500,000 gold francs, divided into 495 ordinary

shares at a face value of 25 gold francs each, and 100,000 founders' shares at a face value of 1.25 gold francs each. Out of the nominal capital, 2,500,000 gold francs is subscribed capital, and the Bank shall begin its operations as soon as it has given the Albanian Government evidence that it has transferred the amount of 2,500,000 gold francs or its equivalent to a prominent bank in Switzerland.

2. The Albanian citizens shall have the right to participate to the extent of 49% of the share capital.
3. The Bank shall have its administrative seat in the capital of Albania.
4. This is a 50-year Convention, with the right to be extended under an agreement between both parties.
5. The Bank shall comply with the State laws and may open branches in Albania and abroad.
6. Under the Convention, the Bank shall have the following rights:
   a. carry out any banking and financial operations;
   b. have the exclusive privilege of issuing paper currency, with a legal tender for payments in Albania;
   c. receive government deposits, act as treasury agent, and negotiate government and municipal loans.
7. The Bank shall be exempt from customs duties for any items required for the building or any instalments in the building. Upon the termination of the concession, the Bank's buildings shall be property of the Albanian State, according to a specified price. The price shall be established by a third party, as decided by the agreement between the State and the Bank.
8. All capital and private values deposited at the National Bank of Albania shall be free from any direct or indirect confiscation, sequestration or state control, except for cases of legal and formal decisions by judges, given that the Bank is subject to the State laws.
9. The Bank's central directorate in the capital of Albania shall be composed of two Italian members, who shall have the final vote. The two Albanian members shall be appointed by the Government. Once the Bank has acquired the required development, the central directorate members shall reduce to two, an Italian member of final vote, and an Albanian one.
10. A member and a commissioner of the Bank's administrative

council shall be appointed by the Albanian Ministry of Finance.
11. The Bank shall prepare a metal reserve (gold or silver, in bars or coins) equalling one third of issued banknotes.[35]

The Convention, which also constituted the founding act of the National Bank of Albania, was concluded on 15 March 1925, by Mufid Libohova and Mario Alberti.[36]

According to the Convention, the Italian financial group decided on the initial capital, consisting of 100,000 founders' shares and 15,000 ordinary shares.[37]

In addition to the Italian financial group, some other important Italian banks participated in the initial capital of the National Bank of Albania: Banca Commerciale Italiana, of Milan, 30,000 ordinary shares; Banca Nazionale di Credito, of Milan, 30,000 ordinary shares; Banco di Roma, of Rome, 30,000 ordinary shares; and some other smaller banks, 20,000 ordinary shares.[38]

Part of the group was also a Yugoslav holding, consisting of Banka Zadruga of Belgrade, Serbian Bank of Zagreb, Adriatic-Danube Bank of Belgrade, and Serbian-Albanian Bank of Cetinje, which held 10% of the capital or 50,000 ordinary shares, and some other holdings, such as Commercial Bank of Basel, 50,000 ordinary shares, and Belgian Foreign Bank, Branch of Société Générale of Belgium, headquartered in Brussels, 25,000 ordinary shares.[39]

The National Bank of Albania was also founded by some Albanians, who altogether held 30% of the capital. They were: Ajet Bej Libohova holding 40,000 of ordinary shares, Ekrem Bej Vlora,

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[35] *Official Gazette*, No. 40, dated 31 July 1925.

[36] *Historia e Bankës Qendrore në Shqipëri, Preface, Tirana, 2003, page 19-20.* It is worth noting that there are several dates indicating the signature of the Convention, which do not match. For instance, in "Historia e Bankës Qendrore në Shqipëri", the date given is 11 March 1925, in the *Official Gazette* of July 1925 it is 15 March 1925, and in *Historia e Popullit Shqiptar, Vol. III*, Publication of 2007, it is 15 January 1925 - see *Historia e Popullit Shqiptar, III, Periudha e Pavarësisë, 28 nëntor 1912-7 prill 1939*, Published by Toena, Tirana, 2007, page 258.

[37] *Historia e Bankës Qendrore në Shqipëri, Preface, Tirana, 2003, page* 28.

[38] The same article.

[39] The same article. Haxhi Shkoza, page 799.

holding 58,000 of ordinary shares, and Nexhet Pasha Vlora, holding 52,000 of ordinary shares.[40]

Some Italians also held part of the capital: Ugo Viali, 40,000 ordinary shares, Vincenzo Azzolini, 25,000 ordinary shares, and Massimo Aurelio, 30,000 ordinary shares.[41]

Out of the Bank's total capital, which according to the Convention had a total of 595,000 shares, Credito Italiano held most of the shares.[42]

Although the Bank's share of capital was, according to the Convention, 51% and 49% in favour of the Italians, it later changed. The Albanian party's participation dropped to minimum figures. The quota subscribed by the Albanians reached to 15,384 shares, equal to 3.1% of the total amount of Bank's shares.

On 23 June 1925, the Albanian Parliament adopted the Law regulating the currency, which entitled the National Bank of Albania to the exclusive right to issue banknotes and mint gold and silver coins. The Senate passed the Law on 5 July 1925, while on 12 July 1925, Ahmet Zogu, Chairman of the Albanian State, signed the decree ordering the execution of the legal package starting the activity of the National Bank of Albania, consisting of the following by-laws:

a) Convention of the National Bank of Albania, ratified on 15 March 1925 and published in the Official Gazette on 18 April 1925;
b) Convention of the loan for Albania's public works, amounting to 50,000,000 gold francs;
c) Organic law of the National Bank of Albania;
d) Law regulating the currency, including the amendments made by the two legislative chambers to the Convention and organic law of the National Bank of Albania.[43]

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[40] *Historia e Bankës Qendrore në Shqipëri, Preface, Tirana, 2003, page* 28.

[41] The same article.

[42] The same article.

[43] The same article, page 25.

Upon the completion of the required procedures and approval of the above by-laws, the National Bank of Albania was constituted on 2 September 1925, in Rome, in the presence of shareholders and official representatives of the Italian, Albanian and Yugoslav Governments. Its Administrative Council was also elected on the same day. It consisted of administrative advisers, effective syndicalists, complementary syndicalists, inspectors in Rome and directors of subsidiaries of the National Bank of Albania. There were elected 8 administrative advisers, of whom seven were foreigners and only one a representative of the Albanian Government.[44]

Despite the participation of foreign entrepreneurs, both public and private, in its initial capital, the National Bank of Albania was an Albanian institution. Its Albanian nationality is evidenced by its name, type of activity, primary focus on the issue of banknotes of legal tender and in free will, which is the main attribute of a country's sovereignty, its location in the Albanian territory, the location of its headquarters in the capital of Albania, handling and resolution of conflicts with the third parties under the Albanian jurisdiction and its institutional obligation to implement the Albanian legislation, acknowledgement of the right to receive Government deposits, mission to act as treasury agent, Albanian State's participation in its revenues, intervention by designating its representatives in the Administrative Council, publication of minutes of the Assembly's meetings and its most important operations in the Official Gazette of the Albanian State and, above all, its recognition upon decree by the former President of the Albanian State.

OTHER BANKS IN ALBANIA

During the period 1920-39, attempts were made by other foreign banking institutions to enter Albania. In addition to the 1920-25 attempts, interventions and constant discussions, which, as noted above, also saw the involvement of the League of Nations, numerous offers were made in early 1925 by the British, French, Belgian, Swiss, Dutch, Yugoslav, Greek, etc., capital. Despite the numerous difficulties they had to come across, their representatives kept their efforts going.

[44] The same article, page 27.

In February 1925, a group of British entrepreneurs from the Midland Group visited Albania. Their representatives outlined the scheme for the Bank's concession agreement and proposed the establishment of the Bank with a capital of 500,000 British pounds. However, the talks, which indirectly focused on the amount of money for the bribe to be paid to the Albanian Government, failed. A month later, in March-April 1925, the Serbian-Albanian Bank in Cetinje and the Bank of Athens tried to settle in Albania. The Bank of Cetinje obtained the authorisation on 3 April 1925, which was legalised in May the same year.[45] On 6 May 1934, the subsidiary of the Bank of Export, headquartered in Belgrade, commenced its operations in Tirana.[46] In November 1937, the Bank of Naples, which was soon to become a strong competitor of the National Bank of Albania itself, commenced its operations in Albania as well.[47]

On the other hand, efforts were also made by the Albanian entrepreneurs to involve in initiatives for the establishment of banks in Albania together with foreign entrepreneurs. Given the lending policy pursued by the National Bank of Albania toward the domestic capital, Albanian entrepreneurs, concentrated mostly in the Korça region, proposed in 1927 the establishment of a joint-stock bank.[48]

In June 1931, Mehmet Konica, former Minister in the Government of Ahmet Zogu, and Mark Kakarriqi from Shkodra, advanced another proposal. Encouraged by representatives of British entrepreneurship, they encouraged the establishment of an English-Albanian Bank, named "English-Albanian Bank Ltd".[49]

Striving to find other positive options for developing the country and advancing the banking and financial market, some business people from Tirana and Durrës set up a commission composed of Isuf Beshiri, Aleksander Hobdari, Vlash Dovana etc., in order to draft by-laws for the establishment of a commercial bank in Albania, headquartered in Durrës. The project was to be brought

[45] The same article, page 32.

[46] The same article, page 38.

[47] The same article, page 40.

[48] The same article, page 32.

[49] The same article, page 37.

before the Congress of the Chambers of Commerce for preliminary discussion, but it did not advance further and these attempts proved unsuccessful.[50]

By the time of the Italian fascist invasion of Albania, the following banks were established and operated in Albania: National Bank of Albania, with 8 branches and agencies, Bank of Naples, with 4 branches and agencies, Agriculture Bank of the State, with 4 branches and agencies, and the subsidiary of the Bank of Export of Belgrade, with only one branch.[51]

THE NATIONAL BANK OF ALBANIA HEADQUARTERS AND ITS SUBSIDIARIES

The National Bank of Albania expanded its activity almost across the entire country through the opening of branches or subsidiaries. Its first branch was opened on 29 November 1925 in Durrës, the second on 1 November 1926 in Shkodra, the third on 15 November 1926 in Vlora, and then spreading across the cities of Berat, Elbasan, Korça, Prizren (after the Italian invasion of Albania) and Saranda.[52]

A special event took place after about 13 years from the establishment of the National Bank of Albania. On 30 October 1938, a ceremony was held to inaugurate the headquarters of the General Directorate of the National Bank of Albania situated in Skanderbeg Square, the main square in the capital, Tirana, hence bringing its transfer from Durrës. The new building was designed by the Italian architect Vittorio Ballio Morpurgo.[53] It belonged to the rationalist style, a typical architecture style in the Europe of the first half of the 20th century. It is a large volume building with strong façade lines, which can be easily distinguished to this day in the Bank of Albania building. Its corpus is in the form of an arch due to its positioning at the entrance to the main city square. Its main entrance features an imposing portal door, supported by strong columns laying across

[50] The same article, page 32.

[51] The same article, page 50.

[52] The same article, page 29-32.

[53] The same article, page 44-45.

the height of the façade, decorated with murals in baked clay, in its characteristic colour, which magnifies the building. It was and remains a piece of art and a striking value for Tirana's planning and architecture.

The process for the restoration and reconstruction of the Bank of Albania central building began in 2011. The interventions have been designed by Italian architects based on the initial projects.

FIRST CURRENCIES OF THE NATIONAL BANK OF ALBANIA

The National Bank of Albania began its official operations on 12 September 1925. As stated above, no national monetary system was in place before the establishment of the National Bank. Gold or silver coins were used instead of banknotes. Payments for different transactions were directly made in gold Napoleons or silver koronas. For this reason, Albania did not experience the financial difficulties caused by World War I to the same extent as other European countries. Indeed, compared to many other countries, Albania had a considerable reserve of gold and silver, foreign currencies, etc. This implies that the National Bank of Albania did not begin its operations in a vacuum. However, the governing authorities decided to create and put the official Albanian currency into circulation. They decided on the gold franc, which was denominated in some divisors and multipliers. The lek and qindarka were the divisors: 1 (one) gold franc equalled 5 (five) lek and 100 (one hundred) qindarka, whereas the franc's multipliers were coins of 5 (five), 20 (twenty) and 100 (one hundred) gold francs.[54]

The agreement had given the Italian party (Italian financial group) the right to issue banknotes. It would benefit 50% of the profits arising from printing and minting and putting the currency into circulation, equal to the profit benefiting the Albanian state.[55]

[54] The same article, page 30-31.

[55] The same article, page 34.

The National Bank of Albania was to operate in a specific environment, with people holding a myriad of currencies from the Ottoman Empire and World War I period but rather preferring to operate in gold and silver coins. The Bank therefore decided to apply the gold standard, which at that time was applied in other countries as well. Its application allowed people to convert banknotes into gold or other strong foreign currencies, such as the U.S. dollar, British pound, lira and franc.

The National Bank of Albania, which had been given the exclusive right to issue banknotes under the law regulating the currency, issued also gold coins of 100, 20 and 10 gold francs, and silver coins of 5 and 0.50 gold francs.[56]

The Bank's statute and organic law established that the banknotes could convert into gold coins of the Albanian state, other countries' banknotes, gold and cheques. The conversion into gold coins of the Albanian state or foreign currency could only be made in Durrës, the Bank's headquarters, and according to the standards established by the Bank's Administrative Council and only upon its authorisation.

In order to cope with the international trade deficit and preserve the gold reserve, the Bank banned the export of gold, except for the authorised amounts for minting gold coins of the Albanian state.

Pursuant to the provisions of the Italian-Albanian agreement establishing the National Bank of Albania, the Bank ordered the printing of banknotes and minting of coins from Bradbury Wilkinson&Co. Ltd. in London. The first quantity of banknotes was transported by sea to Banca d'Italia's Bari branch on 19 December 1926. The first banknotes amounting to 5,000 gold francs, of 20 gold franc denomination, were put into circulation on 28 February 1926. Other banknotes of 1 (5 lekë), 5, 20 and 100 gold francs were also put into circulation during the same year. On 10 March 1926, the Bank put into circulation nickel coins of 0.5 lekë denomination, worth 331,000 gold francs.[57]

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[56] The same article, page 30-31.

[57] The same article.

On 31 August 1927, the Bank put into circulation gold coins of 100 gold francs denomination, worth 27,000 gold francs. During 1928, there were put into circulation banknotes worth 10,095,000 gold francs and coins worth 422,000 gold francs. Their entry into circulation caused a considerable amount of old currency to be replaced with new currency, despite the silver korona still being used. The latter's withdrawal from circulation and replacement was to be discussed for many years to come. In its meeting of June 1930, the Congress of Albanian Merchants argued that their replacement was necessary also due to the fact that the absence of coins caused numerous difficulties for domestic transactions.[58] This fact had brought about the artificial increase in the price of silver korona. An agreement between the Albanian and Italian Governments on March 1936 decided to put 1 (one) million gold francs into circulation, which would slightly relieve the situation but not ensure its resolution.

NATIONAL BANK OF ALBANIA DURING 1925-39

The National Bank of Albania was considered by Albanians as an important factor in achieving progress and economic independence, accelerating the economic growth rates and social development, and contributing to prosperity and welfare. Its activity, however, was rather problematic.

Bank's deposits grew at satisfactory rates during 1926, which may also be considered as the first year of its operations. They amounted to 1,734,000 gold francs. By putting banknotes into circulation, it accumulated considerable quantities of gold and foreign banknotes. For instance, from the last quarter of 1925 to 31 December 1926, the end of the first financial year, it issued paper notes against the purchase of gold amounting to 277,000 gold francs, and foreign banknotes convertible into gold (U.S. dollar, British pound and Swiss franc) amounting to 2,962,000 gold francs. During 1927, as the issue of paper notes increased further, it collected gold and foreign currencies convertible into gold amounting to 13,464,000 gold francs. They grew year after year peaking at 20,775,000 gold francs by 1936. A portion of them consisted of deposits of public

[58] The same article, page 37.

entities, banks and financial institutions using the SVEA loan fund of 100,000,000 gold francs granted to the Albanian government by Italy for public works or budget deficit purposes etc.[59] The creation of the Agriculture Bank capital fund, following the approval of the respective acts by the Albanian Government in May 1930 and December 1936, contributed to increasing the deposits further. The Bank collected almost the entire amount of hard currencies circulating in the Albanian market, estimated between 50 and 100 million gold francs in 1922. It also collected foreign currencies entering Albania each year, particularly from Albanian emigrants residing abroad, estimated at about 6,000,000 U.S. dollars a year. The gold reserves deposited with the Bank also grew through the different Bank operations to collect gold and silver items, decorative items, jewellery, etc.

This growth rate would later slow down and hit low levels. For instance, deposits fell to 12,155,000 gold francs by 1938.

Worth noting is that the Bank invested major portion of its monetary assets in bonds and other securities of the Italian state during 1925-39. From its investments of 5,300,000 gold francs in 1926, the Bank's investments in Italian securities reached 8,500,000 gold francs in 1938.

During this time, the Albanian Government addressed to the Bank for a modest loan of 2,500,000 gold francs to cover the state budget needs, but the response was negative. The Bank's lending policy aimed to mainly provide support to Italian businesses operating in industry, agriculture, construction, trade, etc., without neglecting some Albanian merchants, particularly those with preferential relations with Italian entities.

Bank's balance sheet data for each financial year from 1926 to 1943 provided evidence that the issue of banknotes was primarily based on Albanians' savings deposits, purchase of gold and other foreign currencies, and lending operations. During the last period of its activity, the National Bank of Albania had on its asset side an amount of 8,062,826 gold francs covering the banknotes the

[59] The same article, page 39.

Bank had put into circulation. Similar to all issuing banks, it had the right to issue legal tender banknotes. This right was to be used by maintaining a proportional ratio between the amount of issued banknotes and the gold and silver reserve. As noted above, Article 11 of the Convention of 15 March 1925, and Article 22 of the Bank's Statute stated the Bank's obligation "to maintain a metal reserve (gold and silver, in coins and bars) equal to 1/3 of issued banknotes." This ratio was, however, not maintained by the Bank causing the Albanian franc to be one of the strongest currencies in Europe before World War II. For instance, in 1939, monetary circulation had a gold and hard currency coverage of 245.93%, of which 71.94% only in gold. Experts of the time argued that this strong coverage was explained by the deflationary policy pursued by the National Bank of Albania, which, among other things, proclaimed to maintain the currency in circulation below Albania's needs, engage in the obligatory collection of the Albanian gold and silver, increase the franc's value and redistribute the national income.[60] In figures, this deflationary policy was translated into the reduction of the amount of currency in circulation. For example, from 14,020,000 gold francs in circulation in April 1933, the amount had reduced to 10,529,000 gold francs by 1938. Or from about 325,000 gold francs exchanged each year on average in the early years of Bank's activity, the amount reduced to about 8,000 gold francs a year during 1932-33, and to 2,220 gold francs during 1934-35. The deflationary policy was to continue in the later period as well.[61]

The Bank's problematic performance and activity in the later period was further affected by the global crisis of 1929-33. Its consequences on Albania continued until mid-1935. The Albanian franc depreciated by 5-6%, causing panic among the merchants and industrialists, who began to exchange banknotes with Albanian gold coins.

Despite its problematic performance as described above, the National Bank of Albania is considered as the re-establishment and continuation of the first Albanian national bank established on 4 October 1913. From the viewpoint of the history of banks in

[60] Iljaz Fishta, Mihal Ziu, *Historia e ekonomisë së Shqipërisë (1944-1960)*, Tirana, 20, page 50.
[61] The same article, page 34.

Albania, October 1913 and March 1925 mark two events of special importance to the general development of the Albanian state toward its consolidation and acceleration of Albania's economic and social progress.

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THE ALBANIAN GOLD STANDARD 1912-1938

*Prof. Aristotel Pano**

The celebration of the 100th Anniversary of Independence, one of the most historical events in Albania, creates the opportunity to study more objectively the establishment and development of the Albanian banking and monetary system, as one of the most important elements of its independence and development. It is not due to chance that renaissance figures not only were interested in protecting and developing the national language, education and culture but also highlighted the need for creating a banking and monetary system aiming at safeguarding country's independence and economic development. We find this interest in the distinguished book by Sami Frashëri "Shqipëria ç'ka qenë, ç'është e ç'do të bëhet" ("Albania - What it was, what it is and what it will be"), Tirane 1962, which highlighted, among others, the need for establishing an issuing and monetary system bank, able to extend loans and develop the national economy (for more details, see "Shqipëria ç'ka qenë, ç'është e ç'do të bëhet" by Sami Frashëri", Tirana 1962).

For the same reason, Ismail Qemali, following the Declaration of Independence in Vlora in 1912, and the start of activity by the International Auditing Commission in October 1913, began to work for creating a national bank. Under his auspices, the first National Bank was established in Albania on 4 October 1913. Assessing the establishment of this important institution for the fate of Albania,

he stated: "Let me say proudly that the Bank's work is the second victory for Albania, both economically and politically, after that of independence[1].

Until the establishment of this National Bank, in Albania, as part of the Ottoman Empire, two Ottoman Banks had carried out the monetary circulation and lending (Imperial Ottoman Bank and the Turkish Agrarian Bank), certainly without excluding some branches, or agencies of other foreign banks.

The Imperial Ottoman Bank had its main branch in Shkodra and conducted the same operations that it conducted throughout the Ottoman Empire. It was a result of a contract signed in 1856 between the Ottoman Government and the British and French capitalists, ratified immediately by Sulltan Abdulaziz aiming at coping with the financial crisis that had captured the empire after the Crimean war. The Ottoman Bank started its activity on 4 October 1863 with the exclusive privilege to issue currency in the Ottoman Empire, execute treasury intermediary role in the public debt. In 1875, based on a special agreement, its powers extended further, including the control on the state budget. The Empire's monetary system was exactly based on the issue of coins and credit extended by this bank. At the beginning, its capital was £2 700 thousand. Then, it increased to 5 million divided into 500 000 shares. Based on the gold standard, the bank was obliged to hold a golden reserve equal to 1/3 of the currency in circulation. The bank conducted all the operations related to deposits, cambial discount, etc, with a ½% commission. The Ottoman Bank issued ottoman lira = 100 kurush (Gurush, Piastres), and 1 kurush (Gurush, Piastres) = 40 para. Ottoman liras, kurush and para were put into circulation during different years. Turkish lira replaced the Ottoman lira during the First World War, while 100 million Turkish liras were put into circulation in banknotes guaranteed with gold and German bonds. These banknotes were inherited from the Turkish Republic with the name Evr-ak and Nindyze (cash documents=payment documents), which remained in circulation until 1927, when they were replaced by Turkish lira banknotes of 1, 5, 10, 40, 100, 500 and 1000 Turkish

[1] Newspaper "Përlindja e Shqypnisë" (Birth of Albania), Vlore, 1913, No.23, by Iliaz Fishta and Veniamin Toçi, "Ekonomia e Shqipërisë në vitet e para të ndërtimit socialist" (Albania's economy in the first years of building up the socialism), Tirane, 1984, page 33

lira denominations. The Turkish lira was different from the lira issued by the Ottoman Bank.

The Ottoman Bank stopped functioning in Albania, in 1915, and its banknotes remained devaluated in owners' hands. In 1930, the Central Bank of the Ottoman Republic was established to issue Turkish lira.

The Turkish Agrarian Bank was established in Albania, in 1888, based on "regional banks". It conducted the activity through its branches in Durres, Shkodra, Kavaja and some agencies in some other cities of Albania. Till 1912, this bank had provided Albania with about 6, 7 million gold grosh guaranteed by real estates. It stopped its activity after 1912 (see Kadri Zoga "Agrarian Credit in Albania", Manuscript cited by I. Fishta in his work: Monetary and Credit system in Albania, 1925-1944", Tirana)[2].

As Turkish banks weakened in Albania, the Italian and Austro-Hungarian banks tried to enter the Albanian monetary market. In 1901, the Italian capital tried to penetrate into Albania through its bank in Montenegro to help the trading capital of Italian companies. In 1907, the Banco Tozzi, an Italian bank headquartered in Venetia, opened its branch in Shkodra. Beside them, the currencies of many other foreign banks circulated in Albania through big merchants or agencies.

According to the book by Haxhi Shkoza "Financat e Shqipërisë" (Finances of Albania), 1839-1934" (pages 775-778), the first attempt for the establishment of the Albanian National Bank dates back to 4 October 1913, on the basis of the Albanian Government's concession to Mr. Baron Karol Pitner & Mr. Oskar Polak, representatives of the Wiener Bank Verein headquartered in Vienna, and to Mr. Petro Fenoglio and Mr. Guido Ansbacher, representatives of the Banca Commerciale d' Italia headquartered in Milan.

The main terms of this concession were:

[2] Original title:"Krediti Agrar në Shqipëri", Kadri Zoga, dorëshkrim, I.Fishta. "Sistemi Monetar dhe i Kreditit në Shqipëri 1925-1944", Tiranë.

1) The establishment of an anonymous company called "Banka Kombëtare e Shqipnis" (National Bank of Albania), with the exclusive right to issue currency and hold Albania's state revenues. The concession would last twenty years, and could be extended for another period.
2) Bank capital would be 10.000.000 kurush or 10.500.000 Italian lira. This capital would be in golden coins and deposited according to bank's needs. The General Assembly of Shareholders could vote for further capital addition. Both establishing counterparties had the right to give their consent for the capital addition.
3) The Bank would headquarter in the capital city of Albania and had the right to open branches all over the country.
4) The Management Council (consisting of representatives of all parties and Albania) would manage the Bank. The Administrative Council could delegate its rights to the Management Committee. The term of the first Administrative Council would be 5-6 years, while the Albanian administrators would be appointed through collaboration between the Government and the Bank founders. The bank would be governed in compliance with the Albanian legislation and its statute.
5) The Albanian Government would control the issue of banknotes and the implementation of the statute articles and respective regulations. The bank activity would consist of all banking operations, including those related to commodities and trading. Its banknotes would circulate in Albania and abroad. The respective Albanian and French requisites were written on it. A senior commissar would represent the Government at the bank.
6) The Bank had to maintain a gold reserve equal to 1/3 of banknotes in circulation. It would take care for the circulation of the state coins and for its account would purchase precious metals for coin minting or other needs. The Government would not issue any other banknotes or bonds. The Bank would have the exclusive right to sell and purchase government treasury bills and loans. The Government excluded customs duties on import-export operations for the account of the bank. The state provided the bank with free premises, but in case of closure, the bank would turn them back to the state at their accounting

value. The Government was responsible for the Bank's security and protection. Legislation on anonymous companies would regulate customers' unsettled liabilities to the Bank.

7) Disputes arising between the Bank and the Government would be judged by the Federal Court of Lozenge. The Administrative Council would ratify the concession agreement after its signing.

By means of this concession, a private bank with foreign capital would establish to operate in Albania on the gold standard condition. The Albanian state would supervise it. This agreement did not specify the type of the national currency that this bank would issue. However, an accounting entry found states "grosh". In fact, due to the events of that period, the Bank conducted only some local financial operations in Vlora. The only document evidencing its activity is an entry on the financial account in Vlora on 06/10/1913. It shows a deposit of grosh 545.383, a withdrawal of grosh 257.000 and a balance of grosh 288.283. This amount remained unchanged until June 1914.

The Balkan wars and the First World War impeded the free-enterprise initiatives in establishing the Albanian National Bank. Therefore, during the hard times in the period 1913-1918, the monetary circulation in Albania was carried out in foreign currency, usually in those of invading armies. The researcher Haxhi Shkoza describes the discussions in the Albanian Parliament of that time, in which, when addressing the problem of the need for establishing a bank, was stressed that: ".... We will enjoy the advantage of having a national currency, giving an end to the abnormality we see in circulation of: lira in Vlora and Durres, corona in Tirana and Shkodra and municipality papers in other cities of the state" (H.Shkoza, page 783). The same author brings out information on the circulation of Italian Lira, Greek Drachma, Austro-Hungarian Corona, French Franc, simultaneously, in different regions of the country, along with the 25 currencies remaining since the Ottoman Bank. In these circumstances, no one could think of a unique monetary policy. Because of the lack of Albania's national currency, since the beginning of the declaration of Independence, the gold franc of the Latin Monetary Union (its members were France, Switzerland, Italy, Belgium and some other countries) had been used as a monetary

unit. Therefore, all Albanian economic and financial data prior to establishment of the National Bank and creation of the Albanian currency are expressed in gold francs.

After the end of the First World War and particularly the Congress of Lushnja (1920), which represents a historical moment in creating Albania's central and local unique administration, the issue of establishing a National Bank and a national currency came to the forefront again. This comes out clearly in the ardent parliamentary discussions of that time, which on May 16, 1921, stated: "...about the state statistics, we see that imports are higher than exports. This shows that our money goes abroad. Thus, as our gold goes abroad, one day our state will become poor. So to handle this issue, the Parliament should propose to the Government the establishment of a National Bank with the power to issue ...."(H. Shkoza, page 780).

Though Albania had no a national bank and currency until 1925, the respective governments in the period between 1920-1925 (at least 25 governmental cabinets were changed) had addressed different monetary policy issues (see Teki Selenica "Shqipëria në 1927" (Albania in 1927), page XII, Tirana 1928)). The most important measures taken during that period in this regard were:

a) In 1920, the Government of Sulejman Delvina declared that it did not acknowledge the Agreement of 4 October 1913 on the concession on establishing the National Bank and expressed its will for holding new discussions about national bank establishment.
b) On 11 March 1920, the Government, by its decision, prohibited the export of gold and silver in order to save the foreign reserves of the country. Later, on 19 April 1921, it allowed their export only for activity of goods import.
c) In 1921, the Albanian Parliament created an ad-hock commission, headed by the Minister of Finance and 4 deputies, to hold discussions on this issue with Italy.
d) In 1921, discussions were held with the brother of the "Daragjati" Albanian company for establishing an Albanian capital bank. They resulted unsuccessful because of the company's withdrawal.

e) An important monetary measure in 1921 was the Decision of 25 June 1921, with which the Government set forth the exchange rates of other currencies against the golden franc. The British Sterling would be exchanged with 25 gold francs, Turkish Lira with 22 gold francs, US dollar with 6 gold francs, and German Mark with 1,15 gold francs. Also, the Law of 27/11/1921 set forth the exchange rates of the gold franc with the Italian Lira, Greek Drachma, Austrian Corona and French Franc. Thus, we may state that the Albanian Government in 1921, though still without a National Bank and currency, started to intervene in regulating the exchange rates based on the gold franc of the Latin Monetary union.

f) Albania joined the League of Nations on 17 December 1920, and its Financial Committee began to be interested in Albania's economic and financial situation. Therefore, at the request of the Albanian Government, Mr. A.Calmes, a professor from Luxembourg, was sent to Albania in September 1922. He made a report on "La situasion economique et financier del'Albanie". Besides an objective presentation of the situation, the report stated the need for establishing an issuing Bank with a capital of 10-15 million gold francs, a commercial bank and some savings banks. Mr. Calmes stressed in his report that "Albania had better rely on its own powers rather than on foreign capital assistance". But this proposal was not taken into consideration.

g) In 1922, the public opinion requested establishment of a public national bank, while the offers of that time were for a private bank. Such offers were submitted by the Belgian anonymous association "Bank Du Brabant" and the Belgian company "Societe Nationale de Banque de Change". The project of these offers covered the following points:

- Establishment of a private bank called "Albanian National Bank" with the Head Office in Tirana, a concession term of 30 years, shareholders' equity of 1,300.00 napoleons, divided into 65 000 shares with a nominal value of 20 napoleons each. - Albanian citizens enjoyed the right to subscribe half of the shareholders' equity. The bank would start operating by collecting 10% of the value of each share.
- The bank would have the right to conduct all the financial

operations, such as: discounting bills of exchange, trading, trading of precious metals and loan making. The bank would enjoy the exclusive right to issue banknotes, but without having the right to purchase real estates, except objects needed for its banking activity.

- One Administrator and four members would manage the bank, with respective directors subordinate to them. Also, audit, management and commissars councils would be appointed. A Government commissar would supervise the banking operations, particularly the banknote issue, discounting and purchasing of treasury bills.
- Profit or yearly income - as referred to in the project, would be divided into: 10% to paid-up shares, 6% to governments and administrators, 10% to auditors or supervisors, 10% to commissars and the rest to shareholders. As remuneration for the granted privileges, the state would receive: 112 000 napoleons in fully paid-up shares and 32 500 part of 110 000 founders' shares issued with no par-vale. The government rejected this offer because the public opinion preferred a state-owned bank rather than a private one.

h) On 13 April 1923, the League of Nations sent to Albania Mr. Hunger, from Netherlands, to organise the financial and banking system in Albania. Referring to H. Shkoza and other information, this organiser submitted a project on the establishment of a Bank with the following conditions:

- The Bank shall be an institution subject to the private law, with a capital of 15 million gold francs, divided into 30 000 shares with a nominal value of 500 gold francs each.
- Its capital shall be foreign and its concession shall be 15 years. - The bank shall perform an intermediary role free of charge for the State, for all the banking operations and throughout its term of activity, it shall grant the state 5 million gold francs in the form of an advance rent. . - The Bank shall issue the right banknotes and credit trading, industrial, agricultural activities, etc., for a larger amount than its equity. - Bank's net profit shall be divided as follows: 10% to the reserve fund, 6% to shareholders as first dividend, 5% to management committee members, 5% to administrative council, whereas the rest of

the net profit would be divided: ¾ to shareholders as second dividend and ¼ to the Albanian state. In this case, no condition was stipulated regarding the allocation of shares between residents and non-residents. This contract by Mr. Hunger was infringed arbitrarily by Fan Noli Government in 1924, so no concrete action took place as the author left. After Mr. Hunger left Albania, his project was not discussed any longer.

Given the above, no agreement on establishing a national bank was concluded during 1920-1923, while the country's monetary and financial situation was exacerbated. In order to cope with this crisis, on 15 March 1922, the Government passed the Law on issue of 3.000.000 gold francs coins, in the following denominations:

300.000 gold francs in 25 cents, (qindarka),
700.000 gold francs in 50 cents, 1.300.000 in 1 and 2 lek,
700.000 francs in 5 and 10 lek, and 100.000 golden francs in 25 lek

It was the first time when the name "lek", was uses for the Albanian currency. This Law was not implemented because the organiser of finances, Mr. Hunger, was compiling the Bank project mentioned above. Under these conditions, in order to resolve the difficult situation arising in particular, from significant shortages in divisionary coins, on 10 January 1923, the Government passed the law on banknote issue by municipalities, for an amount of 80.000 gold francs. These banknotes would be printed in 0.25, 0.50, 1 and 2 gold francs. Acceptance of these banknotes was compulsory. A person rejecting them would be punished by a fine of 20-100 gold francs or imprisoned from 24 hours up to 2 weeks. These banknotes circulated in Korça and Shkodra. However, the exact amount of banknotes put into circulation is unknown.

As a conclusion, we may state that during 1920-1923, notwithstanding the numerous projects for establishing a national bank, none of them was carried out. The reasons behind this are the internal contradictions among the political forces of the country, and the machinations of foreign financial groups that wanted substantial benefits for themselves.

Regarding the League of Nations, we may say that it only carried out some studies and submitted projects for private banks but it did not grant any concrete financial aid to regulating Albania's monetary system, as it did with regard to other countries. From this point of view, the criticism made by Mr. Ilir Ushtelenca in his study on "Diplomacy of King Zog I", Tirane, 1995, page 76-77[3], was completely right. In reality, the information on the League of Nations (its Financial Committee) reveals that it extended considerable funds to some other countries to regulate their monetary circulation. Hence, in 1923, at Austria's request, the League of Nations loaned Austria 26 million sterling to adjust the budget deficit. In 1924, with the funds extended by the League of Nations, Austria's economic situation was reformed and normalised. Similarly, the League of Nations loaned £ 10 million to Hungary, and sent to Budapest a commissar from the USA. It also made a considerable loan to Greece to systemise the population that had fled from Asia Minor. Also, it made loans to Bulgaria and the city of Dantzing. This shows that, a more objective attitude by the League of Nations and a more active policy by Albanian governments of that time might have led to provision of international funds, without having to resort to private financial groups for Bank's establishment.

One the other hand, the governmental instability and internal contradictions among different political forces of 1920-1923, took considerable dimensions in 1924. As a result of these political contradictions, two important events occurred during this year: June Revolution, which brought to power Fan Noli Government for almost 6 months, and its fall by the forces commanded by Ahmet Zogu in 24 December 1924. Sparing details about the reasons behind the June Revolution and the fall of Fan Noli Government by Ahmet Zogu's forces, for purposes of the issue we are dealing with, we would say that the victory of Ahmet Zogu's forces and the proclamation of the Albanian Republic on 21 January 1925 (later on turned into a kingdom), which had a constitution after the USA model and the support of the main international forces, represented the beginning of a genuine political stabilisation process in Albania. In spite of remarks to Ahmet Zogu Government for about 15 years, we cannot deny that during a short period of time, he built up a

[3] Original title: "Diplomacia e Mbretit Zogu I-rë".

unique state with legislative, executive and legal powers, completed with the respective central and local bodies, imposing order, security and the rule of law welcomed by Albanians and by the foreign powers that wanted to invest their capitals for Albania's economic development. From this viewpoint, Mr. Shkoza rightfully regards Zogu's work as "gigantic", stressing that due to Zogu's work"... the state finance succeeded in maintaining the harmony among loans requested by different administrations. Organisation of the Internal Administration, National Army and National Gendarmerie was at a level that provided invaluable outcomes about different areas, particularly about public order and economic area.

Reformation of Penal Law, Civil Law, Commercial Law are an essential cornerstone for the justice, on the basis of which centuries and centuries will be built. (H.Shkoza, page XII-XIII of the work cited).

Under these conditions, A. Zogu, besides tackling other economic concessions and balancing their allocation to different powers, in 1925 addressed the most important issue, i.e., establishment of the National Bank and currency. In this regard, further to 1923 parliamentary decisions, he started discussions with the Italian financial groups. We think that in selecting the Italian capital for the concession of establishment of the National Bank of Albania, A. Zogu might have considered the impossibility to establish a National Bank of Albania with domestic capital.

It is quite right that for an important institution as the Central Bank, relying on domestic capital would be the best thing for a country's economy. This is quite clear for every country and Government. Truly, A.Calmes concluded that in 1922 Albania possessed a monetary amount of 50-100 million gold francs. However, we should state that this conclusion was an approximate estimate of the monetary amount. Besides, taking into account Albania's conditions at that time, we conclude that this amount was allocated to thousands families, land owners, usurers and merchants who preferred to keep money in pots, being afraid of any other kind of collective investment. Therefore, this amount might not be offered for purchasing national bank shares. The withdrawal

of above-mentioned “Dergjata” capitalist company indicates that Albanians lacked confidence in such investments.

Secondly, A. Zogu related the issue of concession for the National Bank with the provision of loans urgently needed to improve the Albanian economy and revive the activity of foreign companies in the domestic economy.

Thirdly, analyses made by different authors highlight that in international relationships, A. Zogu tried to equilibrate the concessions granted to different countries. In this regard, he might have considered the fact that in 1921, the Conference of Ambassadors in Paris not only had acknowledged the independence, integrity and unchangeably of Albania’s borders, but had also admitted that their violation would be a risk to Italy’s security and strategy. Therefore, Italy had more economic interests in Albania and as such, its economic assistance could be greater.

Given the above, one realises why A. Zogu, after long discussions with the Italian financial groups, carried out by Mufid Libohova in 15 March 1925, signed the 50-year Concession Agreement for the establishment of the National Bank of Albania by the Italian financial group, represented by Mario Alberti, and hence providing Albania with a loan totalling 50 million gold francs, at a 7, 5% annual interest rate and 40-year term of settlement. The signed Agreement, presented in the annex of this paper, consisted of 20 articles. The Albanian Parliament passed it, together with the Organic Law, in the same year. Upon establishment of this bank, Albania adopted the gold standard system, which operated in many countries during that period.

Three types of gold standard monetary system are distinct in the history of economy:

a) The gold specie standard - the gold standard system associated with gold coins and their physic circulation. It was the classical period of the gold standard, when the monetary circulation consisted of gold coins, but other coins of less valuable metal might be made for which a fixed exchange rate was guaranteed. This was the classical form of the gold standard existing only in

the XIX century.

b) The gold exchange standard – Upon the existence of this system, the currencies in circulation were made by silver or other less valuable metals, but the monetary authorities guaranteed their exchange at a fixed amount of gold coins circulating in another gold standard country. This creates a de facto gold standard.
c) The gold bullion standard is a system in which gold coins do not circulate. In this case various banknotes and metal coins are in circulation but the authorities agree to sell gold bullion on demand at a fixed price in exchange for the circulating currency.

The researchers of the monetary system in the National Bank of Albania have considered it as a truncated gold standard, since it actually combined the two last forms of the gold standard. In our view, this is explained by the following facts: First, according to the convention for establishment of the National Bank of Albania, the latter was obliged to hold a reserve of precious metals, equal to 1/3 of banknotes in circulation. This was the coverage ratio of banknotes in circulation in most of the countries that had adopted the gold standard system after the First World War. In that period, there did not exist in Albania any free or limitless exchange of banknotes with gold, On the contrary, the National Bank had a number of restrictions and applied mostly the exchange of gold francs with foreign currency reserves, mainly with Italian liras. That was due to the fact that its gold reserves covered only 1/3 of banknotes in circulation. Therefore, the Bank's statute stipulated an order for the exchange of its banknotes: a part of them with Albanian state gold, then with bank bills issued in foreign countries which applied the gold standard, and then with cheques issued in fix-rate exchangeable coins. On the other hand, the National Bank of Albania still held gold coins in circulation. Thus, in Albania, the situation of gold coins in circulation by years increased, as follows (according to respective balance-sheets of the National Bank of Albania):

Year	Situation in 31 December (in thousand gold francs)	Increase in per cent
1926	112	100%
1928	785	683%
1930	968	642%
1932	1213	1083%

It is clear that during 1930s, in Albania, the gold coins circulated freely but this circulation increased in the period 1926-1932. Finally, Albania's trade and balance of payments shows that its foreign liabilities were settled by using gold or silver bullions. All these elements characterised the gold standard monetary system that operated in Albania in 1925-1938.

An advantage of the gold standard monetary system was ensuring price stability, which countries needed so much during that period of high inflation in the aftermath of the First World War. Therefore, it is understandable that the monetary system adopted by the National Bank of Albania during its first phase, 1925-1931, by ensuring price stability, it helped in developing sustainable production and commodity exchange. Relevant data of that time show considerable growth in agriculture, industry and craft, construction and other sectors' production. Lacking a complete statistical system, indirect budget indicators may confirm this economic revival. Hence, as the production of plants and fruit-growing paid in the budget the tenth and livestock paid the xhelep (tax on livestock during the Ottoman occupation), which was about 1/10 of livestock product, we may draw the conclusion that the budget revenue growth from both sources is a proxy for the agricultural and livestock product growth for that period. In 1930, this growth was about 50% relative to 1925 (Calculated according to data by H.Shkoza, work cited, pages 209 and 247). The same conclusion is drawn even if we see the increase in exports volume over that period, more than 90% of which consisted of agricultural and livestock products exports, or increase in livestock number. Thus, comparing the annual average export volume in Albania during 1926-1930, to that of 1921-25, the increase is over 51% (calculated according to Shkoza, page 421). Industry and craft activities also revived during that period (through the domestic capital and concessions granted to foreign capital in those years). It is worth mentioning that as a result of this recovery, the state budget revenues from income tax on these activities in 1930 were about 3 times higher than in 1926 (H.Shkoza, the work cited, page 338). The 50 million gold francs loan by the SVEA Italian company gave considerable impetus to construction of streets, bridges and other similar works. The length of the street network and the number of bridges during 1925-30 attest to construction activity growth. It suffices to say that

during 1921-30, the import of cement, a very important material for construction, increased about 30 times (H.Shkoza, page 295). Moreover, price indicator of that period did not represent any considerable fall that make producers go bankrupt. Deficiencies of the monetary policy of the National Bank of Albania, headed by the Italian financial group, emerged after 1930, upon upheaval of the big economic crisis in 1929-33. The negative impacts of the big economic crisis on Albania were felt in 1934, as the considerable fall in the industrial product in the main western countries could not affect heavily the Albanian economy, where agricultural product prevailed.

The deflationary policy of the National Bank of Albania made the larger negative impact on the Albanian economy after 1931. Overall, the gold standard system without the intervention of the state may cause a deflationary situation with unpleasant consequences to economy. But in Albania, this impact was considerably higher due to the monetary policy pursued by the National Bank. Against the backdrop of a big economic crisis, the National Bank of Albania, instead of increasing the monetary amount through lending, interest rate cut and currency depreciation, as it happened in the USA and some other countries, pursued the opposite course. Thus, in 1926-31 the Bank increased the monetary amount in circulation from 2,552 gold francs to 12,534 gold francs, while in 1933-38 it reduced the monetary amount in circulation to 12,947 gold francs or about 14%, keeping an interest rate that was several times higher than in Switzerland, France, England, Italy, etc. Upon restriction of the lending amount and the US dollar depreciation by 40% in January 1934, the gold franc appreciated in Albania. If prior to 1933, 1 USD was exchanged with 5.15 gold francs, after the dollar depreciation, it was exchanged with 3 gold francs. This made more difficult the export of Albanian commodities and stimulated import. If prior to USD depreciation an Albanian commodity with a price of 10.3 gold francs cost 10.2/5.15 = USD 2 in the international market, after 1933 its price went to USD 10.3/3=3.4. This was one of the reasons behind drop of the volume of Albanian commodity export from 12 352 thousand in 1930 to 4 284 thousand gold francs in 1934, or -65%. First of all, this drop hit peasants' income, who produced food commodities, as prices fell drastically. Thus, in 1934, compared to 1931, the food price index level fell from 100 to 44%, more than

two times (calculated on the basis of data by S. Hilmia "Main aspects of price policy in the People's Republic of Albania, Tirana, 1976, page 36)[4]. The economic situation of the population, specifically of peasants, deteriorated further after 1933, not only due to lower income from production and related prices, but also due to decline in and depreciation of remittances. Calculations show that the annual remittances before the 1933-34 crisis averaged USD 1.5 million (calculation based on data from the "History of Albania, volume III, page 58)[5]. Prior to dollar depreciation they were converted to 1,5 x 5,15 = 7, 725 million gold francs, whereas after the depreciation they were equal to 1,5 x 3= 4,5 million gold francs. Adding here the fall in remittances as a consequence of the crisis, it is clear that the impact of this factor on the deterioration of the situation was higher. Besides, while people's income dropped over this period, indirect taxes for the needs of the state budget increased.

These results show that the National Bank of Albania instead of taking measures to restrict the negative consequences of the 1929-33 economic crisis, it pursued a monetary policy of greater interest to the Italian financial group, guaranteeing and increasing the capitals and profit of that group, and hence serving the Italian fascism plans to occupy Albania in 1939. If the Albanian state had owned and managed the National Bank of Albania, then it is understandable that the Bank's role would have been completely different. Hence, of importance are the critiques made by many authors, before and after Albania's liberation, about the convention, the organic law and activity of the National Bank of Albania that was owned by the Italian financial group. Of them, we think that the most serious and scientific ones (not containing ideological indoctrinations) are those made in 1932, by the distinguished economist Dhimiter Pasko. We will try to briefly present the critiques stated by him in his work "Three issues related to the National Bank, Tirana 1932")[6]. Studying the practice of other countries in establishing their central bank, Dh. Pasko rightfully stated that the shortcomings and errors in the monetary policy of the national Bank of Albania were:

[4] Original title: "Aspektet kryesore të politikës së çmimeve në RPSH, Tiranë 1976, page 36"

[5] Original title: "Historia e Shqipërisë, vëllimi III, page 58"

[6] Original title: Dhimitër Pasko : "Tre problema në lidhje me Bankën Kopmbëtare, Tiranë 1932"

1) Concessionary period (50 years) was too long compared to many other countries, whose concessionary period was 20-25 years. For such a long period of time, the changes in the country's economic conditions and inspirations of new generations could not be taken into consideration.
2) The ratio of subscribed capital to paid-in capital in Albania was 2/10, which according to commercial codes, it should have been at least 3/10.The Financial Committee of the League of Nations required an integral depositing of the subscribed capital. In addition, the gold reserve that accounted for 1/3 of banknotes in circulation had to be held in Albania and not in Rome, as stipulated in the concession terms.
3) The unfair allocation of shares and their voting right. Though the above-mentioned convention reserved the Albanian citizens the right for 49% of the Bank's shares, the right to foreign group to cancel the subscribing of Albanian citizens and the speculations by representatives of the Italian capitals helped by some Albanian personalities, the specific share of Albanian citizens' participation was less than 49%. None Albanian capitalist group participated in an organised way in the Bank's capital. Thus, granting the voting right at 1 share = 1 vote, without restrictions on big shareholders and facilities for small ones, together with the right stipulated in Article 33 of the organic law, and the amendment to Article 31, granting the decision-making right to the group owning ¼ of the capital, put the National Bank of Albania under complete control of the Credito Italiane Bank, which managed to own more than 26% of its shareholder's capital. Only in this way we may explain the fact that while in 1930s Albania had great need for investments and crediting, the National Bank of Albania, completely owned by the Italian capitals, continued to invest its financial resources abroad, usually in Italy's treasury bills. More convincing is the following comparison of funds that the National Bank used for lending to Albania, and for investing in treasury bills abroad, in its last two years (Source: A. Haxhi, Historical studies, No. 2, 1964, page 174-175).

Year	The amount used for credit in gold francs 1000	The amount placed in treasury bills abroad gold francs 1000	Their ratio
31/12/1930	6352	5304	1 to 1,26
31/12/1934	3010	5208	1 to 0,57,7

Even without considering other investments abroad by the National Bank of Albania, we see clearly the turnover of the ratio of its financial resources used for lending to Albania's economy and those invested in treasury bills abroad.

4) Another shortcoming of the concession convention legalised under the Article 54 of the Bank's organic Law was the unfair allocation of its net profit. According to this Article, the Albanian State received only 10% of its net profit, while in Greece the State received 33%, in Yugoslavia 56.20%, in Bulgaria 77.06% and in Romania 24.66% of the net profit. If we consider the fact that Bank's net profit resulted after deducting all the expenses decided by its Italian mangers, we would see clearly that Albanian State's profit from the National Bank of Albania was small.

   In 1930, compared to 1926, the gross profit of the National Bank of Albania grew 3.24 times, whereas the profit allocated to the Albanian state increased only 29%. Hence, the Albanian state received no more than 1.34% of the total gross profit (calculations based on data by Dh. Paskos), (source: "Diary of an economist, Tirana 2012, page 23[7], and the History of the Central Bank of Albania, page 51, Tirana 2012[8]").

5) The convention concession solved unfairly the issue of small divisionary coin minting, from both viewpoints - the quantity put into circulation and ownership of income yielded form it. First, under Article 15 of the convention, income from minting of the divisionary coin were equally (50/50%) divided between the Bank and the State, while in other countries this income was completely deposited in the state budget, as it was issued on behalf of the state and not for the account of the bank. Besides, the National Bank had not managed to put into

[7] Original Title: "Ditari i një ekonomisti, Tiranë 2012", page 23

[8] Original title: "Historia e Bankës Qendrore të Shqipërisë, Tiranë 2012", page 51

circulation the needed amount of the divisionary coin, which made small-value payments more difficult.

In our view, all the above remarks that have been made since 1932 are completely right. Completely right were also the author's proposals for eliminating them to ensure what the author rightly called: "Albanianisation of the National Bank" (for more details, see Dh. Pasko "Diary of an economist", Tirana 2012).

The above shortcomings of the convention signed in 1925 gave the Italian capital the possibility to completely own the National Bank of Albania, and in many cases to use it not for the development of the Albanian economy but for increasing its own profit. For the sake of historical truth, we should stress that the A. Zogu Government, during the 1930s, debated constantly with the Italian managers of the National Bank about many issues, but its financial needs made it accept semi-compromises, without fundamentally changing the monetary policy implemented by the Bank. (About these contradictions and debates of the Albanian Government with the National Bank, see I. Fishta, " Monetary and Credit system in Albania 1925-1944", page 80-97).

In order to understand the large financial needs of A. Zogu Government in 1930s, it is worth mentioning the deficits in external trade balance and state budget during 1930s. Albania's trade balance deficit amounted to 143 million gold francs, while the state budget deficit amounted to 24 million gold francs in 1930-1938. These deficits forced A. Zogu Government to request new loans from fascist Italy, such as a loan of 100 million gold francs in 1931 and some other new loans, as well as to make concessions to various Italian companies investing in different fields of the Albanian economy. All this forms of Italian capital flowing in Albania, supported by Mussolini's fascism, along with the pro-Italian activity of the National Bank of Albania, provided the fascist Italy with the possibility to prepare in advance Albania's subjugation and occupation on 7 April 1939. After this occupation, it is clear that the National Bank of Albania and other institutions were completely in the service of invaders and were used to finance the invading army, with severe consequences to inflation and other fields of the Albanian economy.

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ALBANIA AND ITALY: MONETARY AND TRADE POLICIES IN THE FASCIST PERIOD

*Alessandro Roselli**

Mr Prime Minister, Mr Governor, Ladies and Gentlemen,

I am grateful for the invitation to speak at this conference, which marks an important event in the life of your Country. In Italy, we have celebrated last year the 150th anniversary of our unification, and we are perfectly aware that these events go well beyond rhetoric. They have a profound significance, reinforcing our sense of unity and community of purposes.

Let me start with a personal note.Curiously enough, I have been involved with the Albanian economic history for quite a large part of my career at the Bank of Italy. It all started in the 1970s, when I was convened at a meeting by the Italian ministry of Foreign Affairs, as a central bank"expert", to discuss what was - to me - the very exoteric problem of the "Albanian gold": a disputation on the gold reserve of the Albanian central bank, that went back to the World War and saw as protagonists the governments of Italy, the UK and of course Albania.

To make a very complex story short, that gold – looted in Rome by the Nazis during the Second World War – was the object of conflicting claims by Italy, Britain and Albania. The Italian government's claim was grounded on the fact that the National Bank of Albania, owner

of that gold, was an Italian bank. The UK government claimed gold as a compensation for damages suffered in consequence of the "Corfu incident" of 1946, in which two British warships had been seriously hit by mines in Albanian waters. The Albanian government considered gold as belonging to the State Bank of Albania, the central bank created by the post-war Communist regime.

So I started studying how this issue had come about. The gold reserve of the National Bank of Albania was the concrete issue at stake, but its understanding required researching many different economic, financial and political aspects: the Italian economic imperialism under Fascism; the working of the gold standard system (a systemthat was collapsing in the inter-war period) in a new, small State that had an unequal partnership with a far bigger neighbor; the final adoption of a "lira standard" after the forced union of Italy and Albania.

When the Albanian gold issue came to a conclusion at an international conference in London in 1997, with the final, albeit partial, restoration of gold to Albania, it was the end of probably one of the harshest and longest political controversies of the Cold War (and anyway of my own involvement in the affair).

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I would like to articulate my comments in three thematic, rather than chronological, sections:

1. The business and political involvement of Italy with Albania, from early 20th century to the annexation and "personal union" of the two Crowns;
2. The foreign component of the Albanian economy and the Italian role;
3. The monetary policy of the National Bank of Albania, in a gold standard regime.

1. ITALY'S ECONOMIC IMPERIALISM

The Italian economic presence in Albania is a story of competition with rival powers, Austria-Hungary first and, later, Britain; of a weak

international institution, the League of Nations, confronting the national interests of some Great Powers; of an uneasy alliance of Fascist Italy withAhmetZogu (later king Zog); of his expulsion from Albania by the Italians; and of the final Italian collapse in the Second World War.

Italy's interest for the Balkan region dates well before Fascism and the very creation of the Albanian State.The tendency to turn towards the near East was a salient feature of the Italian imperialism, not only for new employment opportunities and commercial outlets, but also for the exploitation of potential gains in areas functional to the Italian heavy industry (electricity, transport, land reclamation, oil). Specifically, in Albania, Italian economic initiatives were negotiated against concessions by the local rulers (the Ottoman Empire, and then the new State, after 1912). For example, a joint loan to Albania by Austria and Italy was agreed when the prince of Wied was placed by the western Powers at the helm of the young State in 1914, but the initiative aborted when Italy failed to get concessions in the fishing, forestry and telecommunication industries.

After the First World War, Austria's influence waned, but Italy found another competitor in Britain's interest in exploiting Albanian oil fields. There was a direct link between Albania's entry into the League of Nations in 1920 and a drilling concession to the Anglo Persian oil company. When Zogu became Prime Minister (December 1922), he was able to exploit the competing interestsof Italy and the UK.Zogu for a while kept an uncompromising attitude, having the League of Nations as his main interlocutor.

In a famous report (the Calmès report, 1922), the League gave a rather bleak picture of the Albanian economy, stressing the need for huge infrastructural investments and for creating a monetary system, till then non-existent, even though – as the report observed – large quantities of gold and silver had been stockpiled by the Albanians during the World War. A plan for a central bank was prepared, whose capital would be provided by Italy, Britain and France. But, between 1923 and 1924, the UK disentangled from an active role, and the League left a free hand to the Fascist government of Italy. What emerged was the British appeasement policy towards

Mussolini's ambitions. There was a clear shift from multilateral to bilateral (Italian) assistance. A preferential Trade Agreement was signed with Italy in 1924, followed by a Friendship and Security Pact in 1926, and a Defensive Alliance Treaty in 1927. Zogu consolidated his power and was crowned as king Zog of the Albanians a year later.

For our purposes, the creation of the central bank (1925), as advocated by Albert Calmès in his report, is the most remarkable sign of the profound change in international politics in regard to Albania: far from being a joint international initiative, the National Bank of Albania-NBA was substantially the result of the Italian influence on the young State, even if masked by the formal presence of non-Italian interests. This initiative is also evidence of the reluctant attitude of the Italian private entrepreneurial capital to engage there: NBA, formally a private establishment, had a capital mostly provided by the Italian State,and shareholders who appeared as private individuals, were simply dummies for the Italian government. The NBA's creation was accompanied by the concession of a substantial loan to Albania for infrastructure financing, granted by an ad hoc company, the SVEA, also an Italian State enterprise, thus fulfilling the other main recommendation of the Calmès report.

The Great Depression put at risk the whole scheme of the Italian intervention. A worsening of the Albanian trade position, a temporary suspension of Italian capital inflows, Zog's fear of too strong ties with Italy, led him to seek assistance from the League of Nations, however unsuccessfully. In the end, in 1935-36, it's Italy, again, to provide additional substantial money to the depressed Albanian economy. (more on this in Section 2.)

The Fascist annexation of Albania (1939) was motivated by considerations of both economic and political nature: on one side, the need to take full advantage of the country's resources and thus make the "affair", disappointing until then, profitable for Italy; on the other side, the need to contain the German expansion in the Balkans, after the Nazi "Anschluss" of Austria (not by chance, the Italian annexation of Albania has been called the "Italian Anschluss"). At the fall of Fascism, in July 1943, the Nazis took over. Then, in November 1944, the Albanian Liberation Army put

an end to foreign occupation, and in early 1945 all the assets and liabilities of NBA were transferred to the new State Bank of the Hoxha regime. In September, the handover procedures between the Italian managers of the Bank and the new administration took place, and the last vestige of the Fascist imperialism in Albania disappeared. A new era of the Albanian history was beginning.

2. THE ALBANIAN ECONOMIC SYSTEM: THE EXTERNAL SIDE

It may sound odd to deal first with the foreign component, but the financial involvement of Italy was indeed the "prime mover" of the Albanian economy. NBA was founded in 1925 along the principles of the gold exchange standard, as recommended by the Genoa international conference of 1922. Its banknotes' circulation had to be backed by a reserve, equal to at least 1/3 of the circulation and made up of gold and other currencies, in turn convertible into gold. Its new currency, the Albanian gold franc-AF, was given a gold content equal to that of currencies belonging to the old Latin Monetary Union (0.290322 grams of fine gold for 1 unit of currency). While adopting the gold exchange standard regime can be considered uncontroversial, responding to the "consensus view" of that time, the choice of that particular gold content for the AF may be questionable.The early 1920s were indeed a period when, after the great inflation during and after the World War, and the consequent debasement of most currencies, the main countries had yet to establish new parities, amid political, economic and financial uncertainties. Several countries were unable to restore the pre-war gold parity (Italy, for example, went back to the gold standard in 1927, but with a lira gold content that was a fraction of the prewar'; France returned to gold at a competitive rate). Albania's trade balance was in deep deficit, and a more competitive rate would have been a stimulus to a better performance. On the other side, there were reasons of prestige connected to the old gold parity, and the Italians were well aware of them. In addition, Albania had no severe inflation, given the quasi-barter state of its economy, and a sizeable store of precious metals was stockpiled by the Albanian households (as Calmès had remarked). The AF remained a strong (too strong) currency, testified by its appreciation during the 1930s,

when the main European currencies, and the American dollar, were devalued and abandoned gold convertibility. As mentioned above, the creation of NBA was immediately accompanied by the SVEA 40-year loan of 50 m AF, to finance infrastructure building.

Our short analysis of the Albanian balance of payments is not fully supported by statistical data: the League of Nations statistics are at a certain point discontinued, and the Italian sources are not always reliable (a feature shared however by other countries, when they preferred to be less transparent in showing their weaknesses). However, it is fair to say that, for the whole period between 1925 and 1938, foreign accounts of Albania were characterized by a pretty uniform pattern: a permanent merchandise deficit, not re-balanced by a decreasing surplus in the services sector. Total current account balance showed an increasing deficit (from 1.7 m in 1926 to 10.1 m in 1933). Was this deficit sustainable? Unfortunately, we don't have a series of reliable figures for the GDP and have to rely on educated guesses, referred to specific years only. In this regard, for 1927, whilethe current account deficit was 2.8 m, GDP estimates range between a low of 102 mand a high of 177 m: too wide a range for meaningful conclusions. Anyway, according to them the ratio of current account deficit to national output would have been between 2.7 and 1.6%. Hardly an unsustainable burden.

On the capital account, the gradual release of the SVEA loan, additional capital inflows and another substantial loan granted by Italy in 1931 created an overall surplus in the balance of payments. Was this capital inflow a way to fill the current account gap? The opposite was actually the case. The real drive of the capital inflow - the exogenous variable of the Albanian economy - was the Fascist regime's policy of political penetration in Albania. Not by chance, these capital inflows took sometimes the form of soft loans or simply grants. Albania was reluctant to service the Italian loans, but found in the Italian government a very comprehensive creditor that, through successive moratoriums and cancellations, tolerated willy-nilly the debtor's default.

These huge capital expenses might have been more acceptable to Italy, had Albania increased its imports from Italy: that is, if, in a sort

of "tied loan" arrangement, higher Italian exports had rebalanced the huge capital outflow. This was not the case. In a sign of independent trade policy (of "ingratitude", from the Italian perspective), Albania spent an increasing amount of money for imports from third countries: from 25% in 1925 to more than 54% in 1929.

The Great Depression (1930-1934) deeply affected Albanian exports, as well as the whole Balkan region', given the relevance of the agricultural sector, where prices collapsed. In 1934, total Albanian trade shrank by 60%, in respect to the 1926-'29 average, and trade deficit further increased because, thanks to capital inflows from Italy, Albanian imports were not significantly affected.

This was the "nadir" of the Italian-Albanian relations. There were indeed two conflicting interests: Italy aimed to boosting exports to Albania; Albania, concerned with its trade deficit, aimed to a balanced trade and quotas to restrict imports. Balancing trade through different devices (exchange controls, tariff and quotas, bilateral trade arrangements) was then a common feature in several European economies, confronted with the Depression and short of reserves, particularly in South-East Europe. Italy wanted a Custom Union with Albania, but Zog feared that this union might mean to be bound "hand and foot" to Italy. The king looked around, again trying the road of multilateral cooperation through the League of Nations. These attempts were unsuccessful and a rapprochement to Italy followed. In 1935, Zog distanced himself from the League sanctions to Italy at the outbreak of the Ethiopian war, and in 1936 obtained a new package worth 14 m AF from Italy. Larger capital flows from Italy, however, were accompanied by a further worsening of Italy's trade position, and all the makings of the forthcoming military invasion became, from an economic standpoint, present.

According to a speech delivered in 1939 to the Italian Chamber of Fasces and Corporations by Galeazzo Ciano, the Italian Foreign minister (whose reliability is, however, far from certain), Italy had spent, in loans, soft loans, grants, and unilateral transfers, between 1925 and 1938, 1,837 m ITL, around 295 m AF at the current exchange rate of 6.22. Taking into account that, through moratoriums and write-offs, only a tiny portion of the loans was repaid, that figure

would mean that, on the eve of the Fascist annexation of Albania, the sums poured into Albania were around 170% of the Albanian national output in 1938, estimated at 175 m AF. An interesting comparison: if that amount were actual debt (that was not, however, the case), the external debt of Albania wouldn't be much different from Greece's, today.

With the union following the military invasion (1939), a new institutional framework was put in place. Its focal point was the Economic, Customs and Currency Agreement of the same year, by which a customs union was established, and any direct link of the Albanian franc to gold was cut off. The franc was made fully convertible into Italian lire at the fixed rate of 6.25, a rate that meant a further franc revaluation against the lira, being the market exchange rate at around 6.19. A tiny "lira area" – that (by name only) might remind the larger "sterling area" – was thus established. Another decree introduced a regime of foreign exchange monopoly, to permit a full exchange control. Together with the new institutional framework, a further capital flow went into Albania, and an expansion of bilateral trade gave to the Italian exports that boost that for long time had been elusive.

3. MONETARY POLICY IN A GOLD STANDARD REGIME

Gold standard principles, as recommended at the Genoa international conference of 1922, mean that any expansionary monetary policy is conditioned by a foreign surplus (and vice-versa); that government cannot borrow from the central bank; that the central bank must be independently managed; and that its balance sheet can only be invested in perfectly safe, short term, self-liquidating assets. We can safely say that these principles were fulfilled by NBA management, whose technical skills rested on the tradition of Italian central banking. The main source of money creation in Albania was the foreign channel, through capital inflows from Italy. To the extent that this surplus occurred, NBA was able to expand its credit to the economy, with a corresponding increase, on its liability side, of banknote circulation and bank balances at the central bank:

the "monetary base", in current terminology. Worthwhile observing that, like other central banks at that time, it was practice to extend credit not only to other banks (central bank as the "bankers' bank"), but also to non-financial firms.

Some criticisms were raised, on political and historical ground, against NBA, which - as noted above - was controlled and managed by a team of Italian managers (as Mario Alberti, its first president, and Amedeo Gambino, its managing director):

- NBA was too strict in granting credit to the Albanian economy and therefore contributed to its underdeveloped state: according to the scattered and perhaps unreliable statistics available, the Albanian economy barely grew in the interwar period. For the period 1927-38, with some "heroic" assumptions the cumulative real growth can be estimated at 12%, a yearly growth of 1%. The gold standard unwritten rules, in order to keep gold convertibility, were biased towards restriction. This restrictive stance is clearly visible in the Depression years, particularly 1932-34, but it was a fairly common policy in any gold standard country. However, it seems correct to say that the ratio between circulation and bank balances at the central bank, and their baking in gold and foreign currency, remained low, well within its statutory limits. This would mean that a more expansionary monetary stance might have been pursued. In addition, a devaluation of the AF in the 1930s – by increasing the value, in national currency, of the gold reserve – might have permitted, particularly in the Depression,an expansionary policy and a boost to exports (on a larger scale, this was Roosevelt's policy in America). The economic hardships of Albania might have been less pronounced.
- A second criticism is that NBA's credit did not finance fixed investments in plants, machinery, buildings. It's true, but the necessary liquidity of its balance sheet would not permit this kind of financing, rather to be left to SVEA or other special credit institutions. In this regard, the poor performance of Italian intervention is confirmed by a summary analysis of the money spent in Albania. The Ciano speech, mentioned above, shows that only 49% of the Italian expenditure went effectively

into productive loans and direct investments, 35% regarded the military, while 6% accounted for "political expenses", probably bribes paid by the Fascist regime.

- Another criticism is that the gold standard was exploited by NBA as a means of getting its hands – via banknote issue – on the gold stored by Albanian households: an accusation of clearing Albania out of its gold. The NBA's purpose was, in fact, to introduce the new banknotes and to gather in the old metal and paper currency. In this regard, however, it should be observed that the gold accumulation by NBA resulted from gold purchases by the Bank on the open market, and the resources to buy that gold came from the huge capital inflows from Italy. In a sort of counter factual history we might ask what would have happened if that inflow had not occurred: an imbalance in Albanian foreign payments would have dramatically emerged, with a consequent gold outflow (unless the Albanian government adjusted its foreign accounts by drastically reducing imports, and the standard of living of an already impoverished population). A separate question regards the physical location of the gold reserve. For asserted "security reasons", it was mainly held in Rome (and here is the origin of the long quarrel about the "Albanian gold", mentioned at the start of my remarks), but no legal transfer of gold from NBA to the Italian authorities ever took place.

After the annexation, the gold stock remained basically unchanged and, in an economy by then fully bound to the Italian economy in the same "lira area", the non-gold component of the reserve (essentially, lira assets including Treasury bills) exploded, in connection with large transfers from the annexing to the annexed country, also for war purposes. As a consequence, the inflation rate dramatically increased (wholesale price index climbed from 100 in January 1939 to 1096.9 in December 1943).

The period of the "lira area" was too short to give a final assessment of its consequences. It may safely be told that the institutional integration with Italy was not matched by an effective economic integration, based on complementary aspects of the two economies. A cost-benefit analysis would probably be negative for Italy; and,

at the same time, no real development occurred in Albania, which remained in a state of backwardness.

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MONETARY POLICY AND ECONOMIC MECHANISM DURING THE MONO-PARTY SYSTEM IN ALBANIA

*Prof. Dr. Priamo BOLLANO**

INTRODUCTION

The monetary policy and the entire economic mechanism during the mono-party rule in Albania (1945-90) were totally conditioned by the political, ideological, theoretical, economic and commercial aspects. Due to time restrictions, they were detached from the western economic theory in general and contemporary marketing ideology in particular.

Domestic economic and social developments, and international political and economic developments, especially in the main trading partners, determined and left their hallmark on the nature and extent of correlation between goods and money in the Albanian economy. Furthermore, they affected the content, functioning and role of the main economic mechanism instruments, i.e., price, profit, interest rate, wage, budget funding and bank lending, material and moral stimuli, cost accounting economic management - Khozraschyot and state-run administrative management.

1. ECONOMIC DEVELOPMENT ALTERNATIVE

A requisite for the existence, progress and development of any economic system at macro and micro level, regardless of geography,

place and time, is the response to the following fundamental questions: What?, How?, Who?, When?, and For whom to produce? During the post-war period, Albania was a country with a small and limited territory, mostly rural population (90% illiterate), a small working class in number and formation, great technical backwardness, a semi-feudal economic and social order, weak capitalist relations and destroyed and empty finances. Therefore, the answer to the above questions could not be given beyond the direction that our country and economy was taking.

Choosing the course of direction for the economic development was more imperative because the country had limited production capacity and inherited a very high inflation; trade was almost paralysed; grains and many other commodities such as salt, sugar, coal oil and different medicines were in short supply.

Worker's cost of living was rather high. Risk of hunger and disease threatened the whole country. A gold napoleon was exchanged with 520 Albanian francs in November 1944, from 20 golden francs in l938. The cost of living was about 2400 francs in 1945, almost 30 times more expensive than in the first quarter of 1939 and two times more than the average wages of employees or workers in that year.

This situation needed urgent solution to:

- Reconstruct the country that was destroyed during the war and recover the economy;
- Ensure bread and other necessary goods because the population was suffering from hunger, and close the path to any speculation or black market (primary tasks);
- Establish new economic relations between industry and agriculture, and between a town and a village.

Determining the course of direction for economic development was also the key to solve the above-mentioned problems.

At that time, Albania had to choose between two development alternatives: first, establish a mono-party economic and social system, with a centralised economy, no private property or free

initiative, in accordance with the eastern model; second, establish a democratic social-economic system in accordance with the western and pluralist model, based on private ownership and free-market economy, according to the well-known "laissez fair" principle.

As the National Liberation Front that had fought against Nazi-fascists was the only organisation in power, (with the nationalist organisations having fled the country with the occupiers and hence, not constituting a factor to domestic developments), the country was left with only one development alternative, i.e. the first alternative, provided by the Communist Party of Albania, the only ruling party.

The 5th Plenum of the Central Committee of the Communist Party of Albania, held in February 1946, criticised harshly the liberal views and opportunistic approach of Sejfulla Malëshova -the Bank's president and Chairman of the Economic Commission at that time - for the presence of "two parallel economies" and as a supporter and promoter of the second development alternative. Under the motto "Everything to strengthen the state sector, merciless struggle against private capital", the Plenum ended the discussions on the development alternatives and consequently, the country entered the road of socialist order and socialist transformations.

2. STATE POSSESSED THE GOODS AND MONEY RELATIONSHIP

The first stage extended over 1944 – 1948. It was characterised by the fever and pain of the east, and the monist state's control and possession of money and goods relationship.

In view of this, a broad programme of socialist democratic transformations took place swiftly and violently, stripping the bourgeoisie of foreign financial capital and landowners of their wealth, concentrating the main means of production and circulation in the hands of the state, creating grounds for an economic system without exploiters and exploited.

To this end, the strata of the population that had collaborated with invaders were expropriated rapidly; the mines, joint stock companies

and farms that had been owned by foreign and domestic financial capital were nationalised; the large trading capital earning big profits during the wartime was hit; banks were nationalised; and monetary circulation was put under control; the land reform eliminated the class of landowners and made peasants own plots of land and working tools; the public sector and cooperatives were established in trading; a new financial system was created; old economic-financial laws were repealed; retail and wholesale price setting was put under control; steps were made for a unique and centralized price-setting policy; a special system of collection and rationed supply through food rationed cards was applied.

All the above factors contributed to passing all the key positions of the economy, excluding agriculture, into the hands of the monist state, making it the sole supplier, administrator and regulator of the economic life and trade relations.

The implementation of this programme posed many difficulties. Material and financial means were lacking, while exports could not cover the rising need for imported consumer goods, machineries, primary commodities and other materials. Experience or art of management and administration of the economy were also lacking. On the other hand, the classes overthrown by the political power, dreaming about "their lost paradise", fought against the economic programme designed by the ruling state. They did the utmost to impede and sabotage the economic life, inducing difficulties in the development of the economy and supply to the population. The economic agreements with Yugoslavia, adopted in November 1946, on plan coordination, currency pegging, price unification, and customs unification, put Albania under complete economic and political control of Yugoslavia. Non-extension by Yugoslavia of a loan, non-delivery of projected goods, and also delivery of a small quantity of commodities available in the Albanian market to Yugoslavia, created serious difficulties in the market; banks were collecting large quantities of dinars; the lek depreciated; inflation was high in the country, hence significantly affecting the purchasing power parity.

To encounter them, the monist state was based on material and financial reserves available in the country and on fiscal, monetary and

other reforms. Revenues from extraordinary war profit tax for 1945-1946, accounted for about 50% of the state budget revenues. On the other hand, money stamping impeded the coming from abroad of banknotes that political runaways had taken with themselves and curtailed the monetary circulation by about 20%, whereas the monetary reform, exchanging old coins/notes with new ones, in a 5 to 1 ratio and up to 5000 Albanian francs per family, enabled the state strip the bourgeoisie of a major part of money and decrease (8 times) the banknotes in circulation.

In encountering the difficulties, the monist state was supported mainly by the great enthusiasm and mobilisation of post-war work forces, reinforced by the free-of-charge and violent nationalisation of properties and capital of the rich and use of part of them for Albania's reconstruction and rapid economic development.

As a result, within a short period of time, the backward social-economic structure of the country was transformed into a multi-form economy ruled by the state. In 1947, the public sector owned 100% of industry, trade and external trade, and finances and banks. In retail trade, the public sector and cooperatives accounted for 95% of the money in circulation. They also made grounds for shifting to economic management based on directive central planning in 1947, and restricted the relationship between goods and money and related economic categories.

3. ECONOMIC MECHANISM IN THE FOUNDATIONS OF SOCIALIST ECONOMY

The second phase covers the period of laying the foundations of socialist economy (1949-1960). It is characterised by using the planning-driven economic categories, as powerful leverages to encourage workers to fulfil their tasks.

In the long term, enthusiasm and emulation do not suffice for economic development. Economic and material stimuli are also needed. Economic development had to be based on economic and material stimuli to achieve high results and enhance work efficiency.

To respond to conditions needed for the central planning economic management, the enterprise economic management was reorganised, based on separate accounting, which ensured centralized leadership by the state with their economic-operational independence in fulfilling their tasks; price formation criteria and price structure were perfected and together with them, even the criteria on use of planned profit and off-plan profit by enterprises; state budget became the main financial plan of the economy with the main objective to develop the economy and social-cultural sectors; taxes lost their fiscal character; the state bank became the only centre of currency issue, estimates and credit. To avoid emerging of debit-credit among enterprises, it applied broadly the goods delivery loans (the so-called accreditation). Also, the work-based reward system was put on a fairer basis to materially stimulate the qualified labour, hard work, etc.

Being faced with numerous difficulties arising from the existing system of collection and supply, as of January 1949, the state was forced to change it and adopt a new system similar to the so-called New Economic Policies (NEP) implemented in Soviet Russia, instead of the so-called War Communism.

The new system of collection and supply envisaged that: a) farmers were liable to deliver to the state a certain amount of their produce at fairly low prices; b) They had to administer their excess agricultural and dairy products and could sell them freely in the market or to the state at higher prices than those of compulsory delivery; c) The rationing system would guarantee the supply of urban population, excluding private merchants, restaurant and hotel owners, artisans that were not part of a cooperative, and peasants; d) The rural or urban population could meet their needs for guaranteed supply or mutual trading in the free state market or in the free private market.

Later, work aimed to prepare the economic conditions for eliminating the rationing system, which was not in line with the work-reward requirements. Moreover, it did not give full possibilities to every worker to buy freely in the market with his/her salary, determine on his/her own the order of meeting his/her own needs for various consumer goods. This was so because, while the quantity of income was determined by the quantity and quality of

work done by everyone, the distribution of consumer goods through the rationing cards was based on the number of persons that each worker had under his/her responsibility. Consequently, due to low prices in the guaranteed market, an unqualified worker that had more persons under his/her responsibility, though doing a simple job, could receive more consumer goods for household consumption than another worker who worked harder or did a more qualified work, but who had fewer persons under his/her responsibility.

In the meantime, preparing the conditions for eliminating the rationing system would provide material stimuli for work efficiency to workers in cities and villages for earning greater income and better meeting their material and cultural needs. Therefore, until end-1957, several retail price cuts took place and other favouring measures were implemented, yielding an annual profit of ALL 4.2 billion. Easing measures were also implemented in the fiscal area for peasants, by reducing or forgiving financial and overdue taxes, cutting the rates on compulsory delivery and increasing the prices for collected products. As a result, taxes paid in cash by the peasantry in 1961 were ALL 874 million or about 2.5 times less than in 1955 when ALL 2.1 billion had been posted for such taxes.

Implementation of these measures and use of state credit to boost the economy, in the form of state credit or savings deposits at the Bank on the one hand, and economic aid and loan from the Soviet Union and East Block on the other, gave new encouraging impetus to Albania's development and progress.

Upon completion of the second five-year plan at end-1960, the mono-party state announced the establishment of the economic basis and the country's entry into the phase of building the material and technical basis of socialism. Albania passed from a backward agrarian country to an agricultural-industrial country, eliminated the rationing system and the related guaranteed supply and mutual trading. It passed into a unique state-owned market system that existed alongside the cooperative farmers' market; commodity circulation forms also improved; conditions were created for better implementation of the principle of distribution according to work quantity and quality.

Establishment of economic foundations of socialism liquidated any form of private property and the social, public and cooperative property became the dominant force in production. Accordingly, as underlined by the distinguished professor Aristotel Pano 'the mono-party political and ideological system was followed by the state-controlled economy, property or other social-economic activity'. This marked the full domination of the natural directive central planning, combined with some limited and limp economic categories related to production and circulation of commodities and the restricted enforcement of the law of the value.

4. ECONOMIC MECHANISMS DURING FULL IMPLEMENTATION OF SOCIALISM

This phase covers the period of complete implementation of the socialist society (1960 – 1990). It was characterised by central planning and use of limited and limp monetary relations, as well as by the struggle against any type of economisation.

In the national context, the endogenous factors affecting the monetary policy and economic mechanism were: giving top priority to the Party's policy; application of the self-sustainability principle and prohibition of obtaining aid or credit from capitalist or revisionist countries; application of a severe savings regime everywhere and about everything; gradual departure from any individual interest and material economic stimuli; giving priority to the overall interest and moral stimuli; gradual progression pursuant to the Stalinist theory, i.e., in order to build a communist society, the production of goods and relevant economic laws and categories should be gradually narrowed and restricted until their complete liquidation.

In view of this, more than 200 types of different supplementary rewards were prevented from the economic practice and the phase of equality rewards commenced, setting the 2 to 1 ratio between the maximum and minimum wages. To sum up, from all viewpoints, planning and natural material side were overestimated and the role of the market, economic mechanisms and free initiatives, i.e., the well-known "laissez fair" principle for economic development was denied.

Exogenous (Greek εξωγενής) factors that influenced, besides the presence and aggravation of the cold war of western countries on our economy, were: the disruption of any type of economic relations and aid from the Soviet Union; and, the aggravation of various economic and energy crisis in the capitalist and revisionist world.

The exogenous factors did not impact directly on individual economic units and did not lead them to bankruptcy. However, from the overall economy viewpoint, their impact was complete and significant. In the conditions of self-sustainability, low output because of the scientific-technical backwardness in production, and lack of crediting and aid from abroad, this impact could be encountered only by using irrationally and ineffectively the economic development factors, keeping public consumption low and imposing additional sacrifices, and applying restrictive measures.

The logical result of this course of direction was not workers' higher wellbeing, a fundamental goal of production held forth by the state-party, but the emergence of negative phenomena in a new form, which accompany the economy of production and circulation of goods. Particularly, by mid-1970s, when the economic relations with China broke up, the disproportions in economy and the discrepancy between the material side and the value side of production, which led to discrepancy between supply of and demand for consumer goods and to non-fulfilment of the household basket, emerged in full vigour, in the form of: a) consumption rationing through ration cards and lists not only for home appliances (such as TV sets), but also for basic consumer goods in towns and villages, b) long queues in front of shops, c) promotion of negative behaviour, massive damage and stealing of collective property, as well as fictitious reporting on output and achievements, d) diminished interest in working and improving the efficiency, cultivation of laziness and idleness, e) creation of "excess" money into people's pockets and a lower purchasing power.

The economic situation deteriorated further in early 80s, following the measures for the communisation of the private household farm plot and livestock from cooperative members, as well as the transformation of cooperative farms of the higher type into agricultural enterprises.

Communisation of the private household farm plot and livestock transformed farmers from producers to consumers, similar to city workers. This measure abolished even the last material incentive of the cooperative peasantry to boost production through the free individual initiative. In addition, the nationalisation without compensation of production assets of cooperative farms of the higher type that were transformed into state agricultural enterprises marked gradual transition to restricting and removing production and circulation of goods, relaying economic categories and implementing the law of value.

Consequently, as also many scholars have noted on the Albanian experience, Albania became a unique laboratory of experiments of Enver Hoxha's autarchic ideas for supplying bread from own resources, for self-sustainability, under a severe beleaguering by the bourgeoisie and revisionist countries, under the slogan "Albanians would rather eat grass than stretch their hand for help to imperialists".

In the 80s, everything revealed that the country would collapse, would undergo an economic crisis, a catastrophe. The planned tasks were not fulfilled; market deficiencies were increasing; the quantity of consumer goods was restricted; and, the meeting of workers' needs was difficult. All in all, consumption exceeded production. Statistics showed that at the end of the decade, the gross domestic product per capita of the population was USD 575, or 1.6 dollars per day on average, showing that the country was indulged in poverty; the free monetary assets of the population were estimated at about ALL 1.2 billion, or above 10% of total monetary income, of which ALL 441 million in cash. At the same time, in 1990, the reserve was estimated at ALL 1.7 billion less; net export as an element of GDP formation was minus ALL 1.2 billion; budget deficit was increasing, etc. Though the Constitution prohibited obtaining any loans from abroad, the trade debt was several hundred million dollars due to import's significantly higher figure than exports.

Due to the economic policy and mechanisms implemented since mid 1980s, Ramiz Alia, against the backdrop of a deep economic crisis facing the country, failed to recover the devastated and collapsed economy by deepening the democratisation of life. The resigning of

the household farm plot communisation, livestock collectivisation and implementation of the so-called "new economic mechanism" were supposed to serve this purpose.

In this regard, a number of laws and provisions were adopted. They marked restriction of the central planning action, relinquishment of the party's policy as a priority, and allowed the use of foreign capital and several other measures, besides domestic capital and resources, in order to boost production.

These measures, however, were announced and implemented very late. Popular dissatisfaction and masses outrage that had been suppressed for decades, their ideals for a better and more civilised life, led to peaceful downfall of the mono-party political and economic system, and establishment of a democratic pluralistic system, with private property, free initiative and market economy.

The above presentation shows that the economic system and its instruments, which were based on the priority of central planning to market economy, implemented during the monism period, were nothing else but a type of economic hybrid that operated beyond the requirements of the objective economic laws. Theoretically and practically, central planning did not contribute to meeting the ever increasing needs of workers by increasing production based on advanced techniques. So, central planning could not play the role of a "conductor", in directing the economy, because, while everything was subject to planning, the role of the market was denied and not everything could function "as precisely as a clock". The conductor of an orchestra harmonises and synchronises the sounds of different musical instruments to produce the required melody, while the central planning denied the role of a coordinated action and of other agents in economic development, especially the role of the "invisible hand", as Adam Smith used to call the market and its mechanism.

Practice shows that everything was politicised. The system was based on ideological slogans and voluntary desires and not on economic promotion and individual material interest. So the central planning lost the economic race and did not provide a favourable answer to 'Who' question. Consequently, it did not manage to

prevent the economic life from the negative phenomena related to production and circulation of goods. The only thing it ensured was: full economic equality among the poor people, except the Party officials, the state hierarchy and the nomenclature; and on the other hand, a changed form of the crises, inflation, unemployment, etc.

CONCLUSIONS

Taking into consideration the above analysis, we conclude:

First, even by using advanced methods of mathematics programming in the economy that allow modern electronic techniques, the directive central planning could not take into account and foresee different requests and preferences of millions of people, who have different levels of incomes, which are constantly changing and increasing.

Secondly, in the conditions of the central planning in the economy, money could not play the role of the overall equivalent but only the role of a unit of calculation and the functions as a means of payment and of circulation, as well as a means of savings. Consumer prices, when unchangeable and set centrally by the state and not by the market forces, could not express the value of goods in money and could not play a special role in the quantity and quality of production and consumption.

Third, the above doesn't mean that we are against every type of planning or programming for economic development. The contemporary experience shows that in developing economies with a low technical and scientific progress, like Albania's, such a planning or programming is necessary to coordinate the state's intervention in the economy with the free private initiative and the market mechanism.

Finally, besides the negative aspects that could not be prevented by the natural central planning, this period marked certain achievements in the social-economic developments of the country. However, in a democratic system, which promotes free private initiative and allows for private property and competition among all market agents, these

achievements could have been greater. On the other hand, we would underline that achievements did not express the supremacy of the socialist order, as held forth by the monist propaganda but they were an outcome of: severe violence and huge sacrifices imposed by the dictatorship of proletariat on people, both farmers and communists; total isolation of the country from the outside world; strict restrictive rules of internal movement of population; a high accumulation rate and low consumption.

Thank you for your attention.

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PANEL II:

FINANCIAL SECTOR DEVELOPMENT AND MONETARY POLICY STRATEGIES IN SMALL AND OPEN ECONOMIES

THE MONETARY POLICY OF THE BANK OF ALBANIA - HISTORICAL PERSPECTIVE AND FUTURE CHALLENGES

*Erald Themeli**

1 INTRODUCTION

The evolution of the monetary policy framework in Albania has reflected its dynamic environment of a transition economy. The Bank of Albania (BoA) has always pursued an ultimate goal of price stability and has operated a flexible exchange rate. However, the monetary regime, including its analytical framework, its institutional set-up, its operational tools and its communication strategy, has constantly evolved. The flexibility and pragmatic outlook to policy-making have been one of the ultimate drivers of the success of BoA's monetary policy.

Anchored in IMF stabilization programs, the BoA adopted initially a monetary targeting regime. Strict IMF conditionality ensured fiscal discipline and rapid budget consolidation. Together with other structural reforms, it allowed to the prudent monetary policy to quickly disinflate the economy throughout the 1990's. However, the rapid development of the economy and financial markets made a transmission mechanism based on an assumed stable relationship between money and prices ever less predictable. Money growth became less reliable as an indicator of medium term price developments. This necessitated profound changes in the BoA monetary policy strategy. The BoA modified its monetary policy

by broadening the range of information it included in its decision making, by constantly refining its monetary operations and by continuously improving its transparency and communication. The monetary targeting, as applied in Albania, was thus transformed to adopt an ever increasing number of features of inflation targeting. In an overall benign global and domestic environment, this transformation and flexibility allowed the BoA to deliver on its mission of price stability through its second decade of life.

The institutional reorganizations and technical refinements have created a sound platform on which the monetary policy can build upon in the future. However, several challenges such as domestic financial deepening, international financial integration and economic policy coordination lay ahead. Facing up to them will be crucial to the success of monetary policy in the third decade.

The remainder of this paper is structured as follows. The second section gives a broad overview of monetary policy development during the first two decades. The third section provides a critical review of the overall results of BoA monetary policy while the fourth sketches some challenges we expect to face in the future. The fifth section concludes.

2 EVOLUTION OF THE BOA MONETARY POLICY

The monetary policy of the BoA started life in a challenging environment, with very limited technical expertise, almost inexistent financial markets and little to none financial literacy in the economy. The success and progress it has made in the subsequent period is remarkable. In this section we detail the evolution of the legal and institutional aspects of monetary policy. Later on, we lay out the theoretical and practical rationale for the gradual shift from monetary targeting to inflation targeting, and we describe some of the advancements in monetary operations, transparency and communication strategy.

2.1 THE LEGAL AND INSTITUTIONAL FRAMEWORK OF MONETARY POLICY IN ALBANIA

The history of modern central banking in Albania begins in 1992, with the introduction of the two-tier banking system and the establishment of the Bank of Albania as the country's central bank.[1] The initial Law of 1992 attributes to the BoA the mandate to design and to implement monetary policy. [2] The main objective of the BoA was to "… preserve the internal and external value of the domestic currency." This initial Law was not explicitly clear on what was the ultimate goal of monetary policy: was price or exchange rate stability (or a combination of both) the ultimate goal of monetary policy?

The central bank law passed through several improvements. The new central bank law of 1996[3] marked a noticeable improvement in the legal and institutional framework of monetary policy, by bringing forward a more transparent objective function for monetary policy. This was accomplished by putting price stability as the main objective of monetary policy and by explicitly assigning the function of designing monetary policy as an independent prerogative of the central bank. This law also laid down the first elements of central bank independence, mostly related to the election of supervisory council members and financial remuneration of staff, and also to limiting the financing of the government. The subsequent law of 1997[4], amended in 2002 and still in force today, further clarified the objective of monetary policy by specifically defining its goal as "… to achieve and maintain price stability." At the same time, this version of the Law consolidated further the legal independence of the BoA, especially by limiting budget deficit financing (though not fully removing it). These legal revisions have allowed the technical specification of price stability target to be in the discretion of the monetary authority. Pursuing a transparent strategy, BoA has given

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[1] For a thorough and comprehensive analysis of the evolution of the legal and institutional framework of BoA, as well as its impact in monetary policymaking, see Fullani (2007/2009), "Evolution and Adoption of the Bank of Albania's Monetary Policy: A Forward-Looking Vision and a Call to Be Pre-emptive", published in "Monetary Policy Strategies for Small Economies", 7th Annual Conference of the Bank of Albania.

[2] Law no. 7559, "On the Bank of Albania", April, 1992.

[3] Law no. 8076, "On the Bank of Albania", February, 1996.

[4] Law no. 8269, "On the Bank of Albania", December, 1997.

quantitative definitions of its price stability objective in its periodic Monetary Policy Documents.

The new legal acts have endowed the Bank of Albania with a considerable amount of instrument independence, granting it almost full *de-jure* flexibility in achieving its goals (abolishing legal provisions for government financing would classify the institution as fully independent). It is widely agreed that central banks endowed with a high degree of independence, should be held accountable for achieving their legislated objectives (Smaghi, 1998). Over the years, Bank of Albania has aimed to achieve the credentials of an independent policy-maker, by committing its decisions to medium and long-term objectives set in transparent policy documents. Compared to its regional peers, Albania ranks high in both *de-jure* and *de-facto* independence ratings.[5]

In step with its evolving legal framework, the internal organization and procedures of the BoA have continuously progressed. Responding to changes in its policy framework, its operational tools and its communication strategy (all detailed below), the BoA's decision-making process has evolved, striving to adopt the best practices of modern central banking. In particular, the set-up of the Consultative Committee on Monetary Policy, a professional consultative body within the central bank, has greatly increased the quality of monetary policy decisions and has also enhanced their coordination with other central bank's policies, such as financial stability.

2.2 MONETARY POLICY FRAMEWORK

We discussed the legal environment which has shaped the design and implementation of monetary policy in Albania. However, the choice of a monetary policy regime is ultimately guided by macroeconomic rationales. There is a broad range of options in choosing a monetary regime, from the definition of intermediate targets, to designing policy instruments, to the decision making structures and communication strategies of the central bank. Each

[5] Dvorsky, Sandra. "Central Bank Independence in Southeastern Europe with a View to Future EU Accession", FEEI, OeNB, 2004.

country makes its choice based on a specific set of factors. We argue that the IMF programs and conditionality were instrumental in the initial set-up of monetary policy framework in Albania. Subsequent revisions and improvements were driven by economic and financial developments in the country. They accounted for the development of the economy and a more complex transmission mechanism, but left unchanged the basic assumptions of an independent monetary policy and a flexible exchange rate.

Financial programming and monetary targeting

IMF programs and technical expertise have been an important factor in shaping the policy mix in the country throughout the first decade of transition.[6] As in most transition economies, these programs were constructed around three objectives: economic liberalization, in particular the lifting of price controls, wide scale privatization and the liberalization of the exchange and trade system; stabilization, through tight fiscal and monetary policies geared to deliver macroeconomic stability, and the establishment of the necessary free-market institutions. The implementation of the programs objectives' produced a stable economic environment, creating favorable conditions for fast and stable growth based on economic restructuring and factor redistribution, increased productivity, and increased financial intermediation and domestic demand.

At the core of policy design was financial programming, which served as a flexible tool linking various macroeconomic indicators of the real financial and external sectors, to formulate consistent macroeconomic policies and to monitor their outcomes. Financial programming was shaped by the projection of core macroeconomic indicators - such as real GDP growth, inflation, the current account

[6] Since the early stages of transition, Albania has benefited from the continuous assistance of the IMF, by engaging in seven successive IMF programs during September 1992 – January 2009. After completing a Stand-By arrangement in 1992–93, a three-year arrangement under the (ESAF) followed, though interrupted on the second year. Following the collapse of the pyramid schemes and the resulting political and economic turmoil, a post-conflict emergency assistance program was signed in the second half of 1997, followed by two ESAF/PRGF arrangements. Two following programs – a PRGF 06/2002-11/2005 and an EFF/PRGF 01/2006-01/2009 - were then fully completed.

and the balance of payments – against policy instruments such as the monetary stance and fiscal policy. Considering the complex relationships that exist between these variables and the policy instruments, a key concern of financial programming was to ensure consistency of the macroeconomic framework and coherence of various economic policies in oreder to meet program objectives. It was thus not a strict model to be followed by policymakers. In practice, policy formulation made use of a variety of simple models, techniques, and was subjective to economic judgment. In the realm of monetary policy, financial programming relied heavily on monetary approach to the balance of payments; a theoretical tool developed by the IMF which served to link external and macroeconomic internal imbalances to interrelation of money supply and demand.

Monetary targeting in Albania

In terms of monetary policy, the IMF financial programming usually implied a monetary targeting regime. In essence, these regimes assume that monetary expansion is the key driver of inflation in the medium to long run. Following the impossible trinity critique – namely the impossibility of simultaneously pursuing price and exchange rate stability in the presence of a liberalized capital account - Albania adopted a floating exchange rate regime from the beginning. Furthermore, fixing the exchange rate, as it happened in many peer countries under IMF programs, was not an option at the time.[7]

The monetary targeting framework relied on designing a path for monetary expansion which was assumed to be in line with a medium-term inflation objective. In line with the projections of inflation and GDP growth, and also accounting for changes in money velocity, a broad money growth range was set as an intermediate target. This linkage relied heavy on an assumed stable, or at least predictable,

[7] The Albanian foreign reserves were exhausted in the face of substantial external debt. In 1992, the net international reserves level was sufficient to cover only 3 weeks of imports of goods and services. It was not only insufficient to intervene in the foreign exchange market, but the regime would not have been credible enough to commit to a fixed exchange rate. In July 1992, a decision of the Council of Ministers set a flexible exchange rate regime and allowed the exchange rate itself to be determined by market forces. Ever since, Albania has had a floating exchange rate regime, providing our economy with an adjustment mechanism to external shocks.

money demand function. To operationalize it, the BoA developed various tools and techniques in order to forecast money demand as a function of expected nominal GDP growth and money velocity. Furthermore, the money multiplier concept served to link the expansion of monetary aggregates to the BoA balance sheet.

The conceptual framework borrowed heavily from the financial programming concepts developed from the IMF. All of the IMF agreements (1992-2008) were conditioned upon various performance criteria, three of which were to be closely observed by Bank of Albania. These quantitative performance criteria, which ultimately aimed to control the amount of domestically generated liquidity, were: the Net International Reserves of the BoA, the Net Domestic Assets of the BoA, and the Net Domestic Credit to the Government. The Net International Reserves and the Net Domestic Assets were also considered the operational objectives of Bank of Albania.[8]

The fulfillment of these criteria was assessed every quarter and the objectives were revised accordingly. The frequent revisions indicated a proper understanding of the need for flexibility that this approach to the design and implementation of monetary policy required. The local authorities had the option to request a waiver for any breach of the performance criteria for a limited amount of time, provided sufficient arguments centered on exogenous variables were provided for that. Until 1995, the intermediate target (broad money growth), together with inflation and GDP projections, were published for a one year ahead period under the Medium Term Economic Program of the country. Afterwards they were part of the annual reports of

[8] A brief description of the three operational targets would be as follows:

- *A floor on the Net International Reserves (NIR) of Bank of Albania.* The NIR were viewed as a buffer to external vulnerabilities and thus a floor was deemed desirable to ensure foreign and domestic investors with regard to the sustainability of the external position of the country. Further, a floor target provided the central bank with enough room to intervene in case of disruptive inflows of foreign currency.
- *An upper limit to the Net Domestic Assets of Bank of Albania.* This monetary indicator aimed to control the expansion of domestic liquidity generated by the BoA. Working through the money multiplier channel, by controlling the expansion of reserve money the BoA aimed to steer broad money growth, which was then thought to affect inflation.
- *An upper limit to the Net Domestic Credit to the Government.* Strictly speaking, this performance criterion was supposed to discipline government borrowing in the domestic markets. It was set with the purpose of keeping an eye to budget expenditures and the inflationary impact of fiscal policy.

the bank, being disclosed and assessed at the end of the year period. Starting from 1998-1999, the Bank of Albania announced the inflation rate target at beginning of every fiscal year, committing its monetary policy to achieving this target and indicating the first signs of a policy that aimed to control inflation expectations of the public.

Neither of the two underlying assumptions – namely a stable money demand function or a predictable money multiplier - proved to be stable enough for the design of a successful monetary regime. The monetary policy framework of BoA has been constantly evolving in response to intensive developments in the financial system, structural changes in the economy and rapid integration with our trade and financial partners. The monetary targeting framework provided good results, but the relationship of the intermediate target with the inflation performance was neither stable nor transparent enough to explain to the public. (For example, inflation was kept low even when money growth was way above the target, and vice-versa.) While inflation is a monetary phenomenon in the long-run, there is a large set of economic variables that affect its short and medium run dynamics. Several studies for the Albanian economy detailed the presence of transmission channels beyond the simple monetary one. Tanku and Shllaku indicated the role of inflation expectations in shaping inflation dynamics. Muco et al. and Peeters found the presence of an interest rate channel and evidence for real GDP dynamics affecting inflation. Furthermore, monetary targeting was becoming largely ineffective even from a practical side. In fact, Luci and Ibrahimi (2005) found a clear dichotomy between the success of BoA in delivering price stability and the weak performance of its monetary targeting framework. The monetary targeting regime was observed until 2008, although efforts to gradually move to another monetary policy framework began since early 2000.[9]

The current design of monetary policy regime

The ability of monetary targeting to deliver price stability in a more dynamic environment was clearly disputed. Appreciating

[9] It should be noted that during this period Bank of Albania was still obliged under the IMF agreements and successfully operated on the three criteria. The agreements have terminated in 2008 and the performance criteria have stopped being used as operational objectives in 2010.

this fact, the BoA initiated a medium term action plan intending to move towards inflation targeting.[10] The action plan, set in 2005 and subsequently refined in medium term development strategies, outlined the main areas we had to improve in order to be able to implement inflation targeting. These areas included, but were not limited to: technical improvements in terms of statistics, research, and model based analysis; further developments in financial markets and the monetary policy transmission mechanism; strengthening institutional independence; and up-grading human skills and institutional procedures. Seven years afterwards, we have complied by almost all of them.

The current regime of the monetary policy in Albania is very much in line with the best practices of inflation targeting. After the last IMF arrangement terminated in 2008, the BOA announced a new monetary strategy to the public. The new strategy continued the public commitment to an inflation target of 3%, coupled to a flexible exchange rate regime, but extended the policy horizon to three years so as to give a longer inflation-target time horizon to the public. The new strategy marked a complete break with te past, in as much as it explicitly mentioned the expected inflation rate, based upon the analysis and projection of several real sector variables, as the key driver of monetary policy decisions. Monetary aggregates were also preserved as an indicator of inflationary balances in the economy, but their informative power was clearly subjected to the first pillar of projected inflation. Furthermore, the new monetary strategy clarified some of the theoretical concepts which would guide monetary policy in the future, such as the forward looking nature, the aim to stabilize economic cycles and flexibility expected in dealing with temporary shocks.

[10] While a clear movement away from monetary targeting has taken place, some studies have found a long term relationship between money and prices in Albania. Though their short to medium run relation is subject to shocks, the long-run information content of money on inflation seems to exist. Our monetary policy design thus stands in a two pillar approach. Monetary policy decisions are based on a comprehensive analysis of both, monetary aggregates and a broad set of other macroeconomic indicators. However, inflation forecasts and their deviation from the target have become the main indicator that informs our decisions regarding the monetary policy stance.

2.3 MONETARY POLICY INSTRUMENTS OF THE BANK OF ALBANIA

The Bank of Albania has employed a wide range of instruments in order to affect the transmission of its monetary policy. These instruments have evolved together with the development of the central bank itself. Initially, the BoA relied on a set of direct instruments, comprising acts and regulations imposed on the commercial banks which determined or limited the quantity and price of monetary aggregates and credit to the economy. The choice of direct versus indirect instruments was constrained from the lack of a proper financial market infrastructure and the underdevelopment of the banking system at the time. It was after the primary market started to function in 1996 and after the collapse of 1997, when the banks were not adjusting to Bank of Albania's new limits, that the use of indirect instruments was necessary to facilitate financial intermediation.

In 1992, BoA introduced its first instruments by establishing the limit on the minimum interest rate on deposits (price regulation) and the limit on the total credit to the economy (quantity regulation). Moreover, in 1992, the BoA initiated the statutory reserve requirement for the commercial banks as well as the publishing of the refinance rate. In addition, the reserve requirement entailed banks to keep 10% of their liabilities at a BoA account. Changes of such criteria pertained along the way, among which the application of monthly averaging in calculating the required reserves as well as banks authorization to use up to 40% of their reserves at BoA. The second half of 2000 marked another important amendment of the rule, namely the remuneration of the required reserves. Such changes aimed at alleviating the opportunity costs of required reserves and facilitating the financial intermediation of the banking system.

The development of domestic banking system and internal financial markets made these direct instruments ineffective. The credit limit continued to remain in place as a direct instrument until November 1999 while the floor limit on the deposit interest rates was terminated in September 2000. Conventional indirect instruments, such as Lombard loans and refinancing instruments were introduced in 1996 and become fully operational later on.

Repo and reverse repo agreements were first introduced in 1996 serving as a bilateral agreement between them. The policy rate (7-day repo rate) was first implemented as such in July 2000. Currently, the indirect instruments comprise open market operations, standing facilities and the required reserves. Open market operations are the main instrument used by the BoA to conduct its monetary policy. Bank of Albania conducts open market operations through a seven day maturity repurchase agreement, which is the main instrument for the implementation of monetary policy. It manages the short-term liquidity of the banking system and steers short-term money market interest rates. In addition, BoA conducts fine-tuning operations through repurchase agreements of overnight, one or three month maturity agreements, with the purpose of adjusting the fluctuations in the interest rates driven by unexpected fluctuations in market liquidity. The current framework of monetary instruments includes structural operations such as outright purchases (of treasury bills and treasury notes through an auction system) and standing facilities, such as overnight credits and deposits. The latter two are aimed at absorbing overnight liquidity shocks and restricting interbank interest rate volatility.

A major advancement on our operational strategy was the switch of the operational target of the BoA, from the quantitative performance criteria on the BoA balance sheet described above, to the targeting of short term interbank interest rates. This shift, which was formalized in mid-2010, was in line with both the development of interbank markets and the evolution of the BoA monetary policy strategy. In particular, the end of IMF programs and the gradual shifting of our monetary policy regime towards an inflation targeting one, made this change necessary for both consistency and transparency reasons. In practice, this change marks an almost complete adaptation of the operational framework of our monetary policy to the most modern practices in central banking.

2.4 COMMUNICATION AND TRANSPARENCY

There is a well-spread agreement among academics and central bankers that effective and efficient monetary policy is achieved

through three interrelated institutional pillars, namely: independence, accountability, and transparency. The need for a long-term approach in conducting monetary policy requires a highly independent central bank. However, this independence should be accompanied by a sound practice of transparency and accountability. The importance of transparency as a means of ensuring accountability of increasingly independent central banks has always been clear to the BoA. A highly transparent central bank is rewarded with an increase in the effectiveness of its monetary policy decisions.[11]

Transparency was almost under no consideration in the early years of BoA as a modern central bank. However, along with the increase in its independence transparency came into focus gradually. It is important to mention that the openness towards the public and other economic agents did not happen because of some legal requirements. Instead, it came as a natural step in the process of adopting the best practices in central banking, initiated and fostered by the BoA itself.

In the early years, transparency was not only lacking because of limited legal provisions, but also because of limited institutional tradition and financial literacy in the economy. More specifically, transparency was limited in terms of monetary policy inputs, its technical tools and its policy deliberations. Until 2001, limited improvements were made and they mainly regarded the transparency of the objective of price stability and the publication of a numerical target for it. An important step was the publication of a mid-term strategy of the BoA, presenting its vision, monetary policy strategy, objectives, and instruments.

In the years to follow, the increase of transparency became of central importance. This was achieved, among others, through:

- The periodic publication of the Monetary Policy Document, which lays down the monetary policy decision making framework and its objectives – from final to operational.
- The immediate publication of monetary policy decision,

[11] For an elaborate discussion about transparency and its links with independence, accountability, and monetary policy effectiveness, see Winkler (2000) dhe Geraats (2000, 2002, 2004).

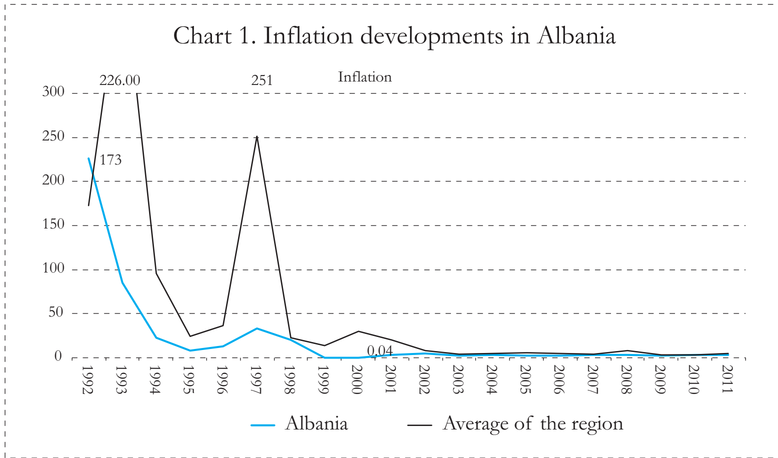
followed by live press conference of the governor.
- The continuous improvement of monetary policy reports, inflation analysis, and forecasting process.
- The publications of the BoA's assessment about current and future economic developments, their impact in inflation, and often, about the future stance of monetary policy.

An important point worth considering in the issue of openness is public understanding. Winkler (2000) expands the definition of transparency to include "… the degree of public understanding of monetary policy process and decisions". Being transparent about what you do is not enough; the public should understand it and be able to achieve a sound judgment out of it. Otherwise, independence and accountability may be heavily compromised.

The BoA has long acknowledged the need to enhance public understanding of what it does. Numerous initiatives have been undertaken in this respect. Special attention has been put to educational campaigns for different target groups, including teachers, students, and the media. Furthermore, periodic meetings with representatives of private business and banks have built the understanding of these economic agents about the central banks. All the efforts made so far have helped align and anchor public expectations about monetary policy and enhance the BoA's credibility and effectiveness.

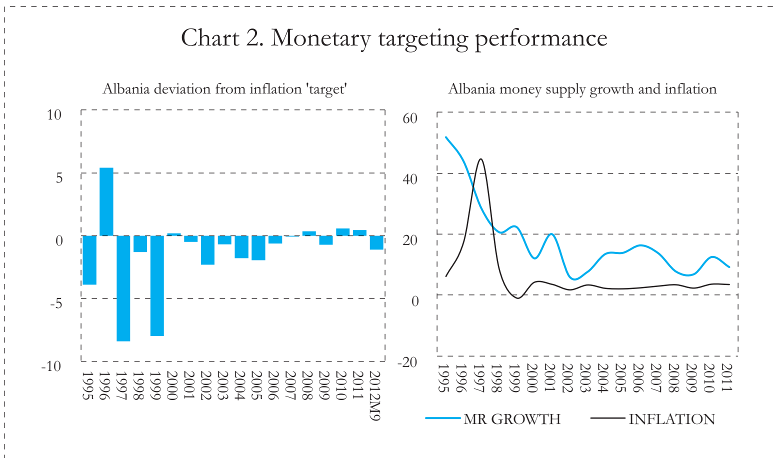
3 MONETARY POLICY RESULTS

The fall of the communist system in 1991- 1992 left the country in a deep economic crisis, with GDP falling by 27.7 percent, exhausted foreign reserves and fast accumulation of foreign debt. Most enterprises suspended production in 1991, dismissing more than 100,000 employees to which the government decided initially to pay 80 percent of their wage (Blejer et al., 1992; Bank of Albania, 1993). The introduction of price liberalization reforms in 1990 gave rise to a quick erosion of the purchasing power and a surge of hidden inflationary pressures, as in all other transition economies. Inflation reached a three digit level in 1991.



However, as compared to other countries, the disinflationary process in Albania was more rapid and sustained. Mc Neilly and Schiesser (1998) argue that the broader scope of (i) early price liberalization was adequately combined with (ii) competition oriented policies and restrictive financial policies, as well as substantial external assistance. Restrictive monetary and fiscal policies contributed to a quick reduction in inflation, which reached 6 percent in 1995.

However, from 1993 to 1995, a faster than forecasted disinflation (of on average - 7.1 percentage points from the annual objectives) corresponded to a higher difference of M3 growth from the target (on average of 23.2 percent).



Though the discrepancy between M3 and inflation was large, it provided some general guidelines for policymakers, especially in a context of generally undeveloped statistical system. Fiscal discipline was extremely important in the disinflationary process but considerable inflows of remittances posed difficulties in the design and implementation of a monetary regime focused on controlling monetary aggregates. On other indicators of macroeconomic performance Albania scored also well. GDP growth averaged close to 9 percent in the first four years of transition, based on initially pent-up demand from the rationing shortages of the centralized past and later on fueled from remittances.

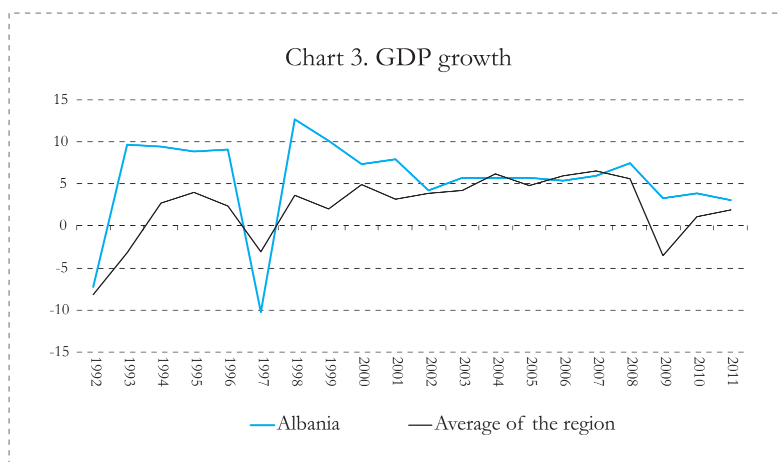
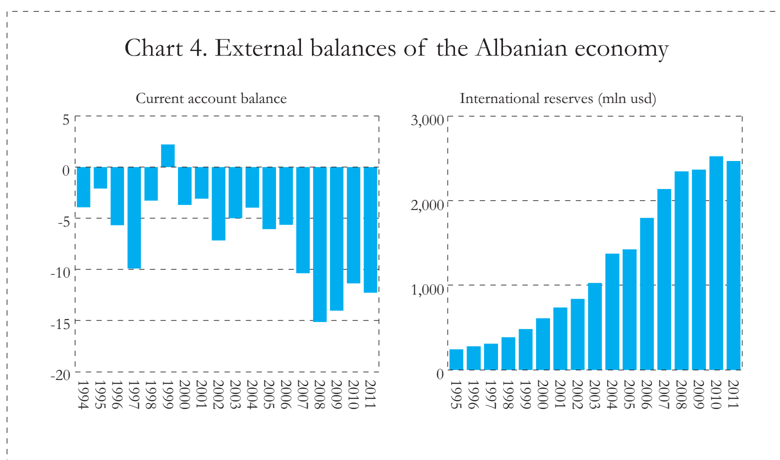


Chart 3. GDP growth

The current account position ameliorated slightly, due to higher savings in the economy which in turn reflected a monetary policy aimed at providing positive real returns on financial savings and a fiscal policy geared to improve fiscal discipline. Private transfers from emigrants continued to be the major source of financing of the trade deficit.

The collapse of the Ponzi schemes in 1997 had devastating implications for the country. Its effects have been largely discussed in the literature; hence, it is worth commenting shortly on how it impacted the monetary policy implementation. Beside a temporary deterioration in inflation performance and a depreciation of the exchange rate, the absence of financial literacy impacted the

Chart 4. External balances of the Albanian economy



public's confidence on the domestic financial system and hindered the transmission mechanism. After the post-conflict emergency assistance program, monetary policy maintained its restrictive stance to control the monetary expansion. Inflation remained low until the beginning of the last decade and monetary policy had the objective of minimizing its volatility and deviation from the announced targets.

On the fiscal side the increase of VAT from 12 -20 percent in 1997 gave an important contribution into restoring budget revenues and freeing the central bank from the pressure of deficit financing. Stabilization was achieved quickly, requiring however larger policy responses in a context of a generally low confidence of the public in the banking sector and high uncertainties. Modern features of monetary policy which now are a crucial part of the transmission mechanism such as the communication and transparency were of little aid. For the monetary policy, the later few years were particularly important as they marked the change of the operational framework, from the use of direct to indirect instruments. The central bank started to publish the quantitative objective of the targeted inflation rate.

Important changes were observed in the transmission mechanism. The adoption of an operational framework based on indirect instruments, reflected a stronger response of inflation to changes in monetary aggregates and a weakening of the exchange rate channel (Muco et al., 2003). However, the exchange rate also continued to be an important variable in determining inflation (Fullani, 2009).

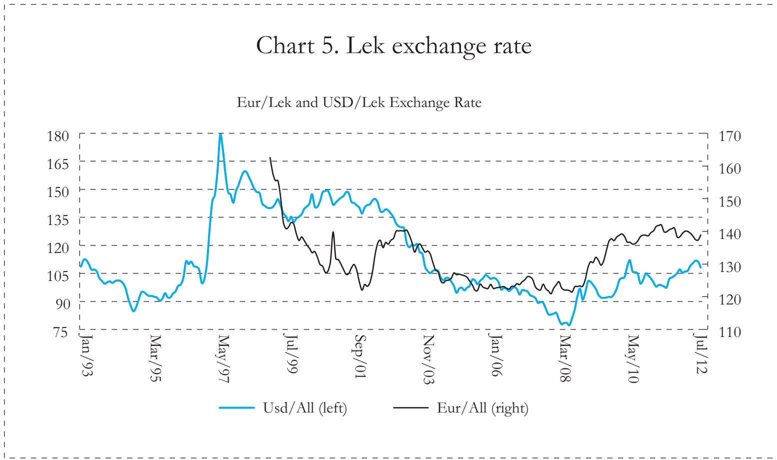


Chart 5. Lek exchange rate

With the further development of the Albanian economy and the sophistication of its financial markets, later studies on transmission mechanism do not find an important role for the monetary aggregates but indicate a greater role for inflation and inflation expectations. The policy rate started to become increasingly influential in determining domestic financing conditions to the private and public sector.

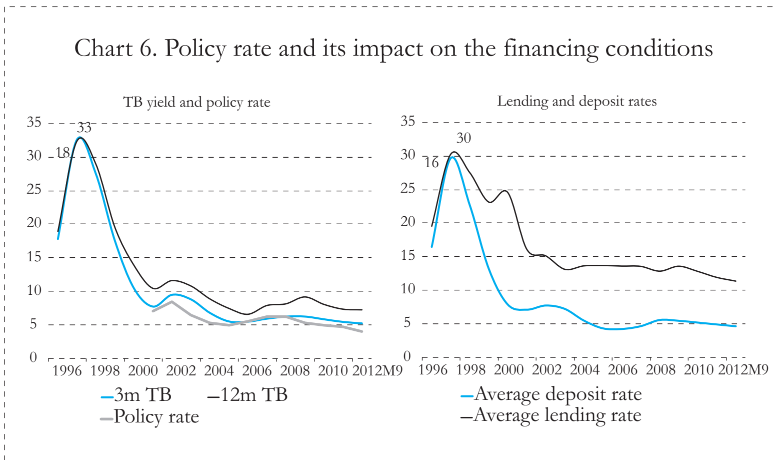
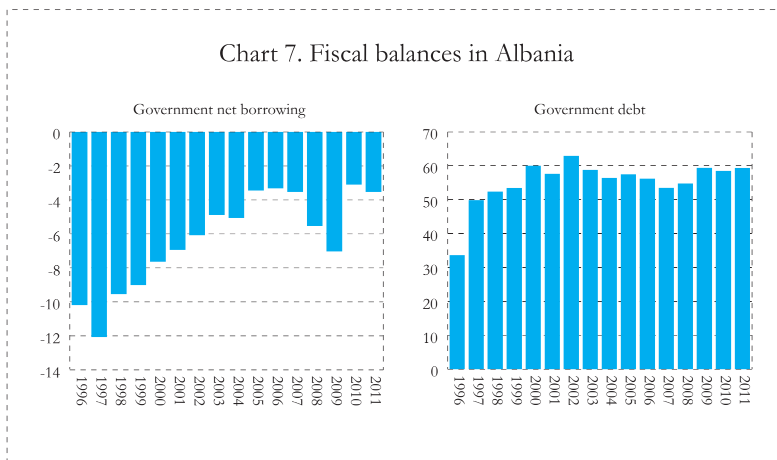


Chart 6. Policy rate and its impact on the financing conditions

The stability of the country has been aided by a consolidation over time of the public finances until 2009 where major infrastructure investments provided a needed stimulus to the economy. This consolidation was very important for the private economy, as it

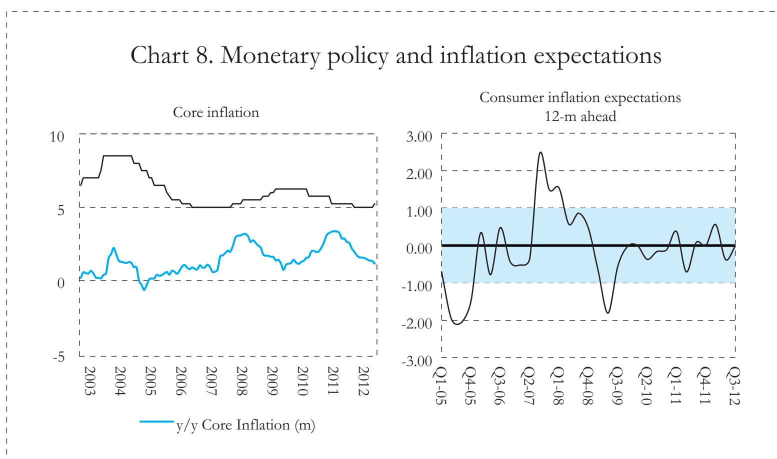
enabled the redirection of savings into private investment. However, the comparatively large level of public debt poses fiscal challenges for the Albanian economy and raises the issue of fiscal dominance in the future.

Chart 7. Fiscal balances in Albania



During later years until the present the monetary policy of the Bank of Albania has gradually been reshaped to include more features of inflation targeting. This was favored (the bank also contributed to) by the low and stable inflation environment while GDP grew steadily around a potential of 6 percent. Monetary policy has been ever more systematic and forward looking (Hossein, 2005). Domestic pressures

Chart 8. Monetary policy and inflation expectations



on inflation as indicated by the core inflation indeed indicate that long term expectations have adequately been guided by the policy rate. On the other hand headline inflation was largely influenced by regulated prices and import prices while the impact of the exchange rate, given its stability (and slight appreciation) have cushioned some negative shocks from import prices. Together with the BoA success in delivering price stability, our consistent monetary policy has helped to anchor inflation.

4 POLICY CHALLENGES FOR THE FUTURE

The last section deals with some of the future challenges of the monetary policy in Albania. Some of these challenges have been evident during or past experience with running an independent monetary policy in a rapidly developing and transition economy, while some others have been perceived and rapidly advanced in light of the recent global crisis. This section only aims to lay them out in general terms, while their future resolution remains up to future work. In broad terms, these challenges can be grouped in three main areas: (i) preserve and enhance the stabilizing role of monetary policy in a challenging environment of a small, open and transition economy; (ii) improve coordination with financial stability, as the recent global crisis highlighted the interconnectedness between these two disciplines; and (iii) improve coordination with the fiscal policy.

4.1 MONETARY POLICY AS AN INDEPENDENT STABILIZATION MECHANISM

The BoA has taken the path of running an independent monetary policy, anchored in an inflation targeting regime and a flexible exchange rate. Our past experience has indicated that such an arrangement has served the Albanian economy well. We have been able to deliver on our mandate of price stability, while anchoring inflation expectations and smoothing output volatility. The flexible exchange rate has played a crucial role in this regard, as it has served as an absorption mechanism to several domestic or external shocks.

However, the benefits of running an independent monetary policy has to be weighed against the drawbacks such a regime has in a small and open economy. One of the often mentioned criticisms of a flexible exchange rate regime is that the scope of running an independent monetary policy in such countries is rather limited. The argument goes that actual or perceived risk premia in the foreign exchange market limit the room for maneuver of monetary policy. In effect, these countries are forced to run an independent monetary policy within a 'limited corridor' of interest rate deviations from the interest rate pursued by an anchor economy, such as the ECB and the Fed. Even while it can be argued that this might be a problem originating in the initial phases of transition, the importance of short term capital flows would corroborate this argument even at a later stage of development. When weighed against the positive effects a fixed exchange rate might bring, such as fostering external trade or internal fiscal discipline, there is clear argument to be made with regard to pursuing a fixed exchange rate regime. Such a path has been undertaken by several countries in Central and Eastern Europe, while others have chosen to adopt inflation targeting. The experience of these countries with such diverging regimes has been mixed. In fact, one can argue that other than the monetary regime per se, the most important factor in explaining differences in economic performance among countries are their underlying structural and overall macroeconomic policies.

Given the past history and success of Albania in operating an inflation targeting framework – a success which is reflected in an improving transmission mechanism and anchored inflation expectations – we would be better served by pursuing this path in the future. In fact, the improving transmission mechanism increases the effectiveness of the monetary policy in the future, while anchored inflation expectations yield more flexibility in pursuing independent monetary policy. A final argument in sticking with the current strategy would be often cited opinion of the European Commission that inflation targeting and independent monetary policy is their preferred path of convergence to the EU. Such a path is likely to yield better structural and cyclical convergence.

Nevertheless, several issues remain to be discussed and solved in the future:

- What is the role of exchange rate in an inflation targeting framework? Up until now, this question has had a straight forward answer: monetary policy should account for the exchange rate developments in as much as they affected inflation and inflation expectations. However, given the role that exchange rate volatility plays in economic and financial indicators and probable misallocations that exchange rate misalignment can have on economic resources, the central bank might have reasonable cause for concern regarding short to medium term exchange rate developments.
- Can and should the central bank use foreign exchange intervention as an added instrument at their disposal in order to affect liquidity conditions in the economy? This issue has both theoretical and practical considerations, but it is also raises the problem of monetary policy communication with the public.

4.2 COORDINATION BETWEEN MONETARY MACROPRUDENTIAL POLICIES

The recent crisis has further exposed the interlinkages between these major areas of macroeconomic policy. Such interlinkages are related both at an objective level and at the transmission mechanism of these policies. For example, at an objective level, a low inflation environment may encourage excessive risk taking and gradually contribute to the building-up of imbalances in the financial system. At the same time, a tight stance of macroprudential policy may promote financial stability but hamper the transmission mechanism of monetary policy. Concurrently, on an instrument level, a rising of the policy rate may deteriorate the health of banking system balance sheets' while a rising of liquidity or capital adequacy requirements may hinder the credit channel.

The lessons from the recent past have instructed monetary authorities and policy makers in general, to pay more attention to such variables: as leverage and liquidity ratios in the financial

system; capital adequacy under several stress-test assumptions; real estate and asset prices in the capital markets. While the building of adequate risk metrics is, at most, a work in progress, the general aim would be to avoid risk miss-pricing at a systemic level. The previous orthodoxy with regard to the central bank behavior towards financial market activity has relied on two pillars: (i) benign agnosticism on the level of risk undertaken by the financial system and its implication, and (ii) a consensus that a better strategy would be to mop-up the consequences of financial bubble than to try to prick it. Such a consensus has proven to be wrong.

The BoA has been one of the pioneering institutions to establish both an Advisory Committee on Monetary Policy and an Advisory Committee on Financial Stability. Besides their specific mandates, the aim of these committees is to facilitate the exchange of information between these two areas, as well as to consult with each other on planned specific measures. Beyond this, there remain several areas that require further elaboration and resolution in the future:

- To what extent, if any, should monetary policy account for the implications of its decision-making on financial stability (and vice-versa)?
- What are the technical tools and models that should be used to detect risks to financial stability and what is the appropriate mix of policy responses to them?
- What are the appropriate coordination modalities between the price and financial stability functions of the central bank?

These open questions remain at the fore-front of the theoretical discussion worldwide. An emerging consensus and technical apparatus will surely influence the BoA's response to this issue. However, our impression is that we should also rely on our pragmatic and successful practice in the past.

4.3 COORDINATION WITH FISCAL POLICY

The coordination between monetary and fiscal policy has been an issue long debated in the academia, and mostly agreed upon. The

monetary policy should take the lead in stabilizing the economy and inflation, while fiscal policy should concentrate on preserving sound fiscal balances and – possibly - provide assistance at low levels of interest rates (zero lower bound) where monetary policy loses its effectiveness. The recent crisis has amply demonstrated the importance that the fiscal position has for macroeconomic stability. Not only does a sound fiscal position allow for more countercyclical policies, but a low level of public debt is also beneficial for financial stability in as much as it gives credibility to all the system.

Albania has long been characterized by high public debt levels and recent debt dynamics do not appear to be favorable. The BoA has argued the need of a fiscal rule which would both discipline short to medium trends of fiscal policy and ensure long-term debt sustainability and, ultimately, lower the risk premia in the economy. Such a rule should be treated as a question of urgent priority by the fiscal authorities.

Beyond this issue which would enhance the overall architecture of macroeconomic policies in the country, there remains still work to be done in order to better facilitate the flow of information and, to the extent possible, to coordinate fiscal policy with monetary policy. Such coordination should start from a common understanding of the cyclical stance of the economy and overall macroeconomic equilibria, and proceed to design the best course of action in order to achieve the mutually desired objectives.

5 CONCLUSION

In its first two decades of life, the monetary policy of the Bank of Albania has constantly evolved to adapt to a changing legal, economic and financial environment. The policy framework has evolved from a pure monetary targeting regime to an inflation targeting one; the operational framework has adopted the best international practices; and, the institutional procedures and communication strategy has improved considerably. The BoA has an admirable record in delivering price stability and smoothing economic volatility in the country. In fact, this flexibility in monetary policy making may be one of the

ultimate factors explaining our success in delivering price stability to the Albanian economy. The BoA faces several challenges in its third decade of life. Such challenges include: a better understanding of the role and limits of monetary policy in a small and open economy; a rapidly evolving transmission mechanism; and developing better coordination tools and mechanisms with macroprudential and fiscal policy. The institutional flexibility and desire to improve shown in the past two decades serve as a valuable lesson for the future.

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SOME MONEY AND BANKING ISSUES IN EUROPEAN TRANSITION COUNTRIES

*Mark Allen**

The opening of the financial sectors of Central and East European countries (CESEE) to internationally operating banks has brought considerable benefits to the region. But with the international financial crisis and the stresses it is placing on West European banks, problems in the relationship have also become apparent. This short paper discusses the pros and cons of cross-border ownership of financial systems in Central and Eastern Europe, and some of the challenges policy makers face in managing economies with largely foreign-owned banking systems.

STRUCTURE OF PAPER

The paper starts with a brief review of the pros and cons of the CESEE banking model, one where the majority of bank assets, or a very substantial part of them, is held by foreign-owned banks. It reviews how the system came through the global crisis of 2008-9, when the CESEE region was under great pressure. At the time there were concerns that developments in this region might substantially weaken the parent banks. The paper then looks at how the system is coping with the current stage of the crisis (2011-12), where the main problems are in the parent banks and their home economies. Finally it considers some of the challenges facing the banking model in the countries of the region, and especially in South-Eastern Europe

(SEE), once the crisis has been overcome and normal conditions resume.

PROS AND CONS OF CESEE BANKING MODEL

In the socialist economic systems in the region before the transition of the early 1990s, the financial system was subordinate to economic administration. In essence, the mono-bank played a passive accounting role, allowing the tracking of financial flows around the economy, and provided the financing needed to support the fulfillment of tasks set for enterprises through the political system (EBRD (1998), p.92). In Yugoslavia, markets, including financial markets were more developed, with a two-tier banking system having been established in the 1960s, but the banks were generally closely intertwined with the self-managed enterprise sector (Šević 2002, pp.4-5). Two principal approaches were taken to the development of banking when the transition started, one based on allowing new banks to be established, often by large enterprises, and the other on splitting up the mono-bank inherited from the planned economy (EBRD (1998), pp.96-7). Once the transition to a more competitive market economy started, the existing banks found themselves with assets that had not had to meet the test of viability in a market economy and without the human, technological and legal resources to cope with the banking needs of a modern economy.

The quality of bank balance sheets deteriorated further with the onset of the transition. As enterprises faced a more challenging competitive market environment, they both found it more difficult to service past indebtedness and required further funding through the banking system to continue to operate. The higher interest rates that macroeconomic stabilization policies required put additional pressure on enterprise finances. Governments were understandably unwilling to allow widespread bankruptcy of the enterprise sector and for enterprises to stop functioning, and so tolerated continued bank lending and an accumulation of bad debt in the banking sector. The result was that virtually every transition economy faced a banking crisis in the period 1990-1996. (Table 1 based on Laeven and Valencia (2012))

Table 1. Banking crisis after transition

Year	Country	Maximum NPLs as percent of lending	Gross fiscal cost as percent of GDP
1990	Romania	30	0.6
1991	Bulgaria	75	14
1991	Georgia	33	…
1992	Estonia	7	1.9
1992	Poland	24	3.5
1992	Slovenia	35	14.6
1992	Bosnia and Herzegovina	…	…
1993	Macedonia	70	32
1993	Belarus	…	…
1994	Albania	26.8	…
1994	Armenia	…	…
1995	Azerbaijan	…	…
1995	Kyrgyz Republic	85	…
1995	Latvia	20	3
1995	Lithuania	32.2	3.1
1996	Bulgaria	75	14
1996	Czech Republic	18	6.8
1998	Croatia	6.9	10.5
1998	Russia	40	0.1
1998	Slovakia	35	…
1998	Ukraine	62.4	0

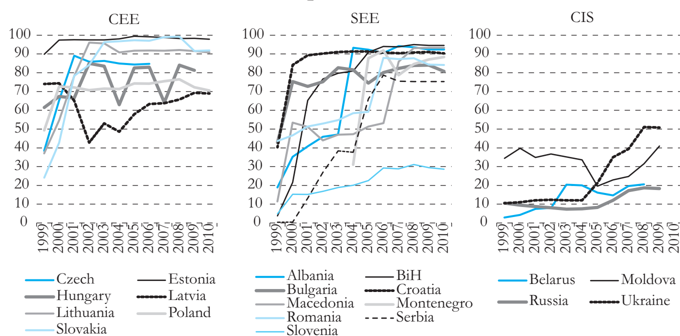
Note: Laeven and Valencia consider a systemic banking crisis to occur when there are significant signs of financial distress in the banking system (as indicated by significant bank runs, losses in the banking system, or bank liquidations);

and significant banking policy intervention measures in response. Measures are considered significant if at least three out of the following six measures have been used: 1) extensive liquidity support amounting to five percent of deposits and liabilities to nonresidents; 2) bank restructuring gross costs of at least three percent of GDP; 3) significant bank nationalizations; 4) significant guarantees put in place; 5) asset purchases of at least five percent of GDP); and 6) deposit freezes or bank holidays or both.

Source: Laeven and Valencia (2012).

The current model of cross-border banking in CESEE resulted from the clean up after this round of post-transition financial crises. The financial costs of the crises had been large, and governments recognized the need to put in place much stronger and market-oriented financial systems. For capitalization of a new banking system, they mainly turned to foreign partners. Domestic capital was either hard to mobilize, or was associated with owners who might be too compromised to be fit and proper people to run banks. This left the foreign banks, which were keen to expand into the region.

Figure 1. Asset share of foreign-owned banks
(percent)



Source: EBRD transition reports.

In 1996, only Latvia had a majority of bank assets in the hands of foreign-owned banks (51 percent) (Figure 1), followed by Hungary (44 percent), Armenia (38 percent) and Lithuania (29 percent); in all the remaining countries the figure was no greater than 15 percent (EBRD (1998), p. 95). The process of foreign bank penetration happened very rapidly at the end of the 1990s, with SEE starting somewhat later than CEE. Foreign bank ownership of banking system assets reached between 70 and 100 percent in all the countries of CESEE, with the exception of Slovenia, where the authorities preferred to keep most of the banking system in local hands. It also happened to a lesser extent in Belarus, Ukraine, and the other CIS countries. In these countries, a good share of the banking system stayed in local hands, while Russian, rather than West European, banks played a large role in that extension of foreign ownership that was permitted.

As a result, a network of cross-border banking developed in CESEE (Table 2).

Table 2. Western European Bank Presence in CESEE (as of end 2010)

Home country	Bank	Host countries
Italy	Unicredit	Bosnia, Bulgaria, Croatia, Czech Rep., Hungary, Poland, Romania, Serbia, Slovakia, Slovenia, Ukraine
	Intesa Sanpaolo	Albania, Croatia, Hungary, Serbia, Slovakia
Austria	Erste	Croatia, Czech Rep., Hungary, Montenegro, Romania, Slovakia
	Raiffeisen	Albania, Belarus, Bulgaria, Croatia, Czech Rep., Hungary,Romania, Serbia, Slovakia, Ukraine
	Hypo	Bosnia and Herzegovina, Croatia, Serbia
Sweden	Swedbank	Estonia, Latvia, Lithuania
	SEB	Estonia, Latvia, Lithuania
	Nordea	Latvia, Lithuania
Belgium	KBC	Czech Rep., Hungary, Slovakia
Germany	Comerzbank	Poland
Netherlands	ING	Poland
Greece	Eurobank	Bulgaria, Serbia
	National Bank of Greece	Bulgaria, Macedonia
	Alpha	Romania
	Piraeus	Albania, Bulgaria
France	Societe General	Croatia, Czech Rep., Macedonia, Moldova, Montenegro, Romania, Serbia, Slovenia
Hungary	OTP	Bulgaria, Montenegro
Slovenia	NLB	Macedonia, Montenegro

Note: Banks with shares in the sectors assets above 5 percent.
Source: Bankscope.

Austrian banks (Raiffeisen, Erste, and Bank Austria, later purchased by Italian Unicredit) acquired the widest presence in the region, and the region loomed large in the parents' balance sheets. Swedish banks largely focused on the Baltic states, while Greek banks created a network of subsidiaries primarily in the Balkans. Belgian KBC created an extensive network in Poland, the Czech Republic, Hungary, Bulgaria, Russia, Serbia, Slovakia, and Slovenia that constituted a large part of the group's assets[1]. While the exposure to the region was less important for other countries, French, German, British, Dutch, Italian, and even Irish and Portuguese banks acquired operations in the region. And some of those relatively few large banks

[1] Some of this network was later sold off as a condition for regularizing state aid to the parent bank.

that remained in local hands, such as Slovenia's NLB and Hungary's OTP, also set up subsidiaries in other countries in the region, with NLB's network in the West Balkans being quite extensive.

The benefits of widespread foreign ownership of banks were several. Firstly, the new owners imported the technology of modern banking to their subsidiaries in the region. They transformed the banks, making a service culture dominant, providing the population and the business community with a similar range of services to those available in Western Europe. And importantly, they attached the reputations of their brand names to their operations in the region. At a time when there was widespread concern about nontransparency in the privatization process and concerns about informal networks extracting rents from the economies, it was very valuable to have a large part of the banking system stand outside this environment. There have been relatively few scandals connected with the operations of foreign-owned banks in the region. (For a couple of exceptions see The Economist (2003) and Bakker and Klingen (2012), p.43.)

It was not only in internal management that the foreign ownership of banks contributed to reducing the scope for corruption and fraud in the banking sector, but foreign-ownership had the advantage of importing more advanced supervision. The construction from scratch of modern bank supervision systems in the transition countries was an arduous task, requiring legislative and regulatory frameworks to be put in place, as well as the training of a large cadre of staff (Bonin and Wachtel, (2003) p.8). With a substantial part of the banking system owned by banks supervised outside the country, local supervisors had a large part of the responsibility for the safety and soundness of the major banks taken from them, leaving them more able to concentrate on the remaining, usually smaller, domestic banks. In addition, the need for cooperation with the supervisors of parent banks helped in promoting the spread of modern supervisory practices.

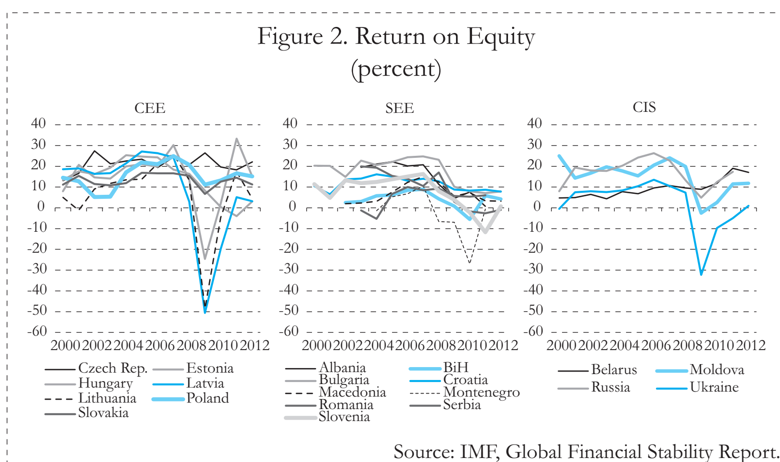
A major impetus to the opening of banking systems to foreign banks was the EU accession process. Those countries negotiating membership had to adopt the acquis communautaire in the areas of capital account liberalization and free trade in financial services.

And even those whose membership of the Union was a more distant prospect followed a similar policy approach. This created an environment that made it relatively easy for banks to take advantages of the freedoms associated with the EU to branch into these countries or to set up or purchase subsidiaries.

This process took place at a time when international banking was expanding worldwide. The increase in cross-border banking activity and the growth in the international operations of large international banks is well documented elsewhere (CGFS (2010) pp.6-7). European banks were faced with the challenge of competing with rapidly growing banks based in the major financial sectors and at a time when their own domestic banking markets were growing relatively slowly. Central and Eastern Europe represented an obvious area for them to expand their activities. The area was regarded as severely under banked (CEPR (2011) p.31).

And this venture turned out to be very profitable. Until the crisis of 2008-9, return on equity was generally in the range of 10-20 percent, with the countries of CEE recording rates at the higher end. (Figure 2).

Figure 2. Return on Equity
(percent)



Source: IMF, Global Financial Stability Report.

Data on the profits of Austrian banks show that the share of CESEE subsidiaries in total consolidated group income was much

higher than their share in total consolidated group assets, and that this situation continued even through and beyond the 2008-9 crisis. (Figure 3)

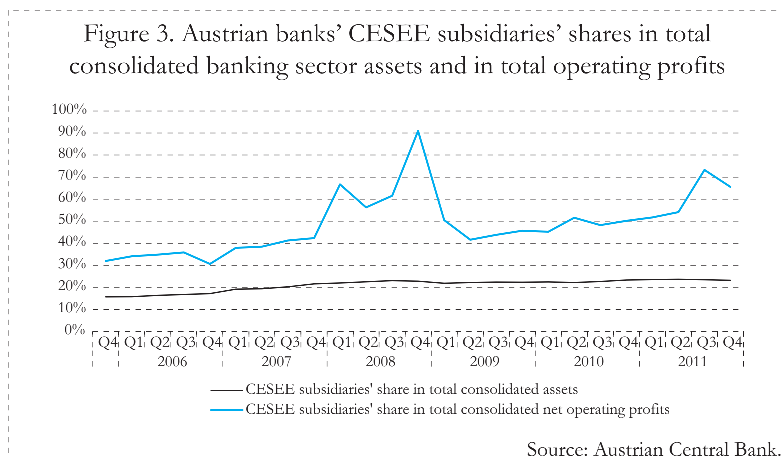


Figure 3. Austrian banks' CESEE subsidiaries' shares in total consolidated banking sector assets and in total operating profits

Source: Austrian Central Bank.

Foreign ownership of the bulk of the banking system was however a mixed blessing. It provided a channel for capital to flow into the region, but these inflows went primarily into consumer loans and the real estate sector, rather than into the expansion of productive capacity. The inflows fueled a boom in consumption and a bubble in the construction sector and housing market in many of the countries of the region, and left the region highly vulnerable at the onset of the 2008-9 global financial crisis.

A feature of much of the lending, particularly to the housing sector, was that it was denominated in foreign exchange. This left the borrowers, often households, vulnerable to any movement of the exchange rate, and the banks vulnerable to a cut-off in foreign exchange funding. The lending was justified on the demand side by the lower rates payable and the longer tenor of such lending, together with the view that the exchange rate was either fixed, with membership in the Eurozone only a short time ahead, or would tend to appreciate as Balassa-Samuelson effects came into play. On the supply side, the parent banks had plenty of foreign exchange liquidity to supply their subsidiaries. And while some noted the growing

vulnerabilities of countries with rising debt and large current account deficits, others saw this as the natural effect of convergence in the European Union framework. (See Bakker and Klingen (2012), pp. 23-29)

While the ownership structure of the banking system facilitated these capital inflows and the rise of foreign exchange indebtedness, these activities were not confined to foreign-owned banks. Banks without parents willing to finance them were able to tap liquid international interbank markets and engage in the same lending activity. Competitive pressures to gain or preserve market share may help explain this activity of domestically owned banks, but another factor was the mood on international capital markets. The boom in Central and Eastern Europe might be considered just the local manifestation of the exuberance prevailing in this period on capital markets in general, and not primarily the result of the ownership structure.

In those cases where the local supervisor was concerned about the growing riskiness of this activity, or the emergence of asset price bubbles on the local market, it was hard to take effective measures where foreign-owned banks were concerned, especially when the country was within the European Union framework of free trade in banking services and free movement of capital, and when the parent and the parent's supervisor was unwilling to curtail such profitable lending. Attempts to constrain the activities of subsidiaries could be undermined by direct lending from the parent bank to local borrowers, or by the use of non-bank subsidiaries. (See Bakker and Klingen (2012) pp. 20-22)

HOW THE SYSTEM CAME THROUGH THE CRISIS OF 2008-9

Central and Eastern Europe was the most vulnerable emerging market region in the world at the time of the Lehman Brothers failure (IMF (2008) pp.85-88). And the crisis in financial markets hit the region hard. Indeed, the Baltic states were already in crisis before the collapse of Lehman Brothers, and Hungary too had been facing difficulties in rolling over its public debt. The fear was that the

capital inflows financing current account deficits of up to 20 percent of GDP might not only come to a sudden halt, but be reversed. The resulting balance of payments pressures would act to deplete reserves or push the exchange rate down, which in turn would worsen the quality of the portfolio of foreign currency denominated loans. In these circumstances, banks might find themselves severely under-capitalized and questions of solvency might arise. Given the fragile state of financial markets in 2008-9, there was a fear that the problems of subsidiaries in the CESEE region might create serious difficulties for the parent banks. Figure 4 shows that the rise in CDS spreads on parent bank debt at that time was most severe for the Austrian banks, Raiffeisen and Erste, and to a lesser extent the Italian Unicredit, all heavily exposed to the region.

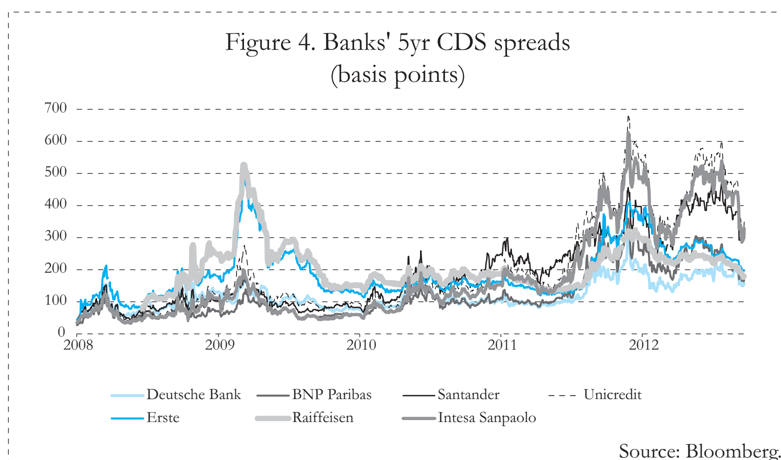


Figure 4. Banks' 5yr CDS spreads
(basis points)

Source: Bloomberg.

In the event, bank crises in Central and Eastern Europe were largely avoided and the economic crises in host countries were contained. The IMF provided large financial support for the countries most seriously affected, and for EU members, by the EU as well (Bakker and Klingen (2012), p.78). New IMF arrangements were approved for Belarus, Bosnia and Hercegovina, Hungary, Latvia, Romania, Serbia and Ukraine (Table 3). These arrangements were large relative to the countries' IMF quotas and disbursements were front loaded. Some included special provisions directing resources to funds backing up the banking system, as well as generally supplementing the foreign exchange liquidity available to the central bank. Precautionary

arrangements were put in place for Poland (Flexible Credit Line, FCL) and FYR Macedonia (Precautionary and Liquidity Line, PLL).

Table 3. IMF arrangements for CESEE and Central Asia approved after 2007

		Date of approval	Date of expiration	Program type
CEE	Hungary	11/6/2008	10/5/2010	SBA
	Latvia	12/23/2008	12/22/2011	SBA
	Poland	5/6/2009	1/17/2015*	FCL
SEE	BiH	7/8/2009	9/25/2014*	SBA
	Kosovo	7/21/2010	12/26/2013*	SBA
	Macedonia	1/19/2011	1/18/2013	PCL
	Romania	5/4/2009	3/30/2013*	SBA
	Serbia	1/16/2009	3/28/2013*	SBA
CIS	Belarus	1/12/2009	4/11/2010	SBA
	Kyrgyz	12/10/2008	6/19/2014*	ECF
	Moldova	1/29/2010	4/30/2013*	EFF/ECF
	Tajikistan	4/21/2009	4/20/2012	ECF
	Ukraine	11/5/2008	12/27/2012*	SBA
Other	Armenia	11/17/2006	6/27/2013*	EFF/ECF
	Georgia	9/15/2008	4/10/2014*	SBA/SBCF**
	Mongolia	4/1/2009	10/1/2010	SBA

Note: SBA: Stand-by Agreement, FCL: Flexible Credit Line, PCL: Precautionary Credit Line, , EFF: Extendet Arrangement, ECF: Extended Credit Facility, SBCF: Stand-by Credit Facility.

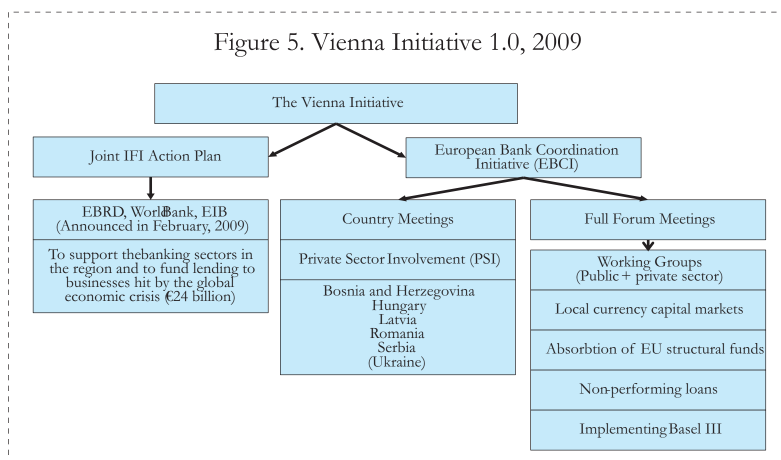
* extended

** currently treated as precautionary by authorities

There was a risk that parent banks, under pressure themselves and in a fragile international financial environment, would run for the exit and withdraw support of subsidiaries if that would strengthen the position of the parent. However, such an action would serve to make the situation of the remaining banks worse and could trigger a similar reaction by others. This was a classic collective action problem, where the interests of the banks (not to mention the countries involved and those supplying emergency balance of payments financing) would be best served if the banks collectively remained engaged in the region. This was the motivation for the Vienna Initiative in early 2009, where all parties came together to ensure that appropriate support was provided to the countries' adjustment programs.

The broad umbrella of the Vienna Initiative covered a number of actions (Figure 5). (See EBRD (2009), p.18). Firstly, for those countries that had arrangements with the IMF, an agreement was sought that the parent banks would maintain exposure, cooperate with the local supervisory authorities in stress testing their subsidiaries, and ensure that the latter were capitalized up to the indicated level[2]. This approach of obtaining exposure commitments from the private sector was similar to the PSI (private sector involvement) mechanisms used in the Latin American debt crises of the 1980s and during the Asian crisis. It was important to limit the extent to which the large amount of public financing being provided by the IMF and the EU to these countries merely financed the withdrawal of capital by others, rather than easing the adjustment burden of the countries in question. The agreements created formal monitoring arrangements, and were generally successful in preventing the wholesale withdrawal of funds. Of course, as conditions in the countries stabilized, the incentive for withdrawal of exposure diminished (De Haas, etc., (2012)).

Figure 5. Vienna Initiative 1.0, 2009



The second element was the Joint IFI Action Plan to provide financial support to the banks in the region and to fund lending to business affected by the global economic crisis. (See Vienna Initiative (2011b).) Under this Action Plan, some €24 billion was

[2] The agreement in the case of Ukraine was somewhat less formal than the other cases (Bosnia and Herzegovina, Hungary, Latvia, Romania and Serbia), possibly reflecting the smaller role played by West European parent banks in that country.

committed by the European Investment Bank, the World Bank and the European Bank for Reconstruction and Development, and in the event, €33 billion was made available as of end-December 2010. The final element of the original Vienna Initiative was to utilize its capacity to bring together the public and the private sector as a forum to discuss developments in the region. Four working groups were established looking at the questions of the utilization of EU funds, the application of Basel III standards, the development of local capital markets, and the treatment of non-performing loans.

The strains on local banking systems were significant, but in the event, parent banks and their regulators supported their subsidiaries in the region. The only countries in the region which experienced systemic banking crises were Latvia and Ukraine, and a bit further afield and slightly later, Kazakhstan (Laeven and Valencia (2012) p.6). In each case the problems originated in local banks. In the case of Latvia, the problem was Parex Bank, the second-largest bank, where there was a deposit run and the authorities had to intervene at a cost of about 2.5 percent of GDP. In the case of Ukraine, deposit runs on a locally-owned bank, Prominvest, required intervention by the authorities totally about 4.8 percent of GDP. In both cases the amount of assistance was substantially less than had been needed in earlier banking crises. (See also Bakker and Klingen (2012) pp.76-7). There were also some near misses, in which the systemic crisis criteria of Laeven and Valencia were not quite met. (See note to Table 1). These included Hungary, where OTP bank required assistance, Slovenia, and Russia. Again, the problems were related primarily to locally owned banks.

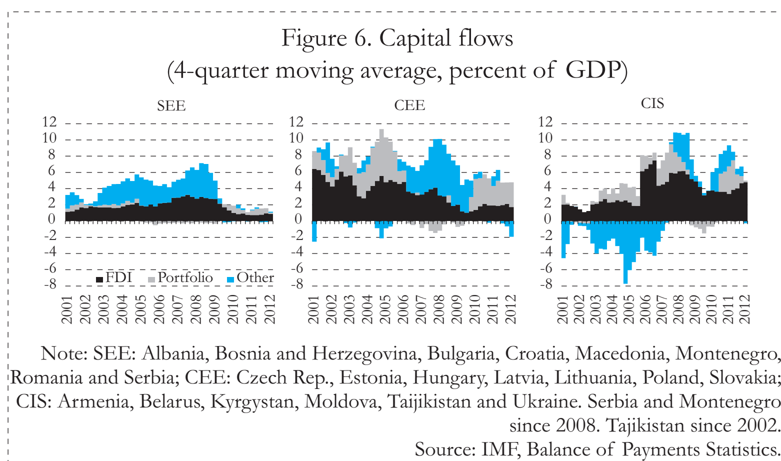
At the same time, many of the home country banking systems were facing systemic crises. Laeven and Valencia list banking crises in 2008-11 in Austria, Belgium, Germany, Greece, Ireland, Netherlands, the United Kingdom and the United States, just to mention countries with banks operating in the CESEE region. The problems of these banks, with the possible exception of Austrian banks, were not primarily related to developments in the CESEE region. De Haas et al. (2012) find using bank by bank data that the Vienna Initiative seemed to have stabilized lending in 2009 by the banks that were part of the initiative, and that the spillovers of

this to other countries were more likely to have been positive than negative. In all, the ability and willingness of parent banks and home authorities to bear the costs of strains in their subsidiaries in CESEE must be accounted a very substantial benefit to those countries with largely foreign-owned banking systems. This benefit was diffused beyond those countries that were the subject of formal exposure agreements in the Vienna Initiative.

HOW THE SYSTEM IS COPING NOW

The flood of capital that poured into the CESEE economies through the banking system came to a sudden stop in 2008. (See Figure 6, based on balance of payments data, and where bank flows are the predominant element in the "other" category). Foreign direct investment inflows were also sharply reduced, reflecting the impact of the recession on international investment plans and a lower level of profits for reinvestment. The data show that until 2011, cross-border bank lending stayed fairly steady as the stabilization programs in CESEE and the Vienna Initiative had their effect, but since then there has been some outflow of capital through the banking system. The gap caused by the stop in bank inflows has been partly compensated by a sharp increase in portfolio investment, particularly in the form of non-resident purchases of government bonds.

Figure 6. Capital flows
(4-quarter moving average, percent of GDP)



Note: SEE: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro, Romania and Serbia; CEE: Czech Rep., Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia; CIS: Armenia, Belarus, Kyrgystan, Moldova, Taijikistan and Ukraine. Serbia and Montenegro since 2008. Tajikistan since 2002.
Source: IMF, Balance of Payments Statistics.

The fall in inflows through the banking system has been reflected in a sudden stop in credit growth, and indeed its stagnation in most of the countries of the region. Credit growth in many of the countries was indeed far too high before the crisis and, as discussed above, financed excessive consumption growth and property bubbles. It led to sharp increases in the debt levels of households in many of the countries, with a significant part of that debt denominated in foreign exchange. The shock of the crisis has made borrowers in the region more cautious and concerned to correct their balance sheets. At the same time, the authorities in a number of countries have taken action to discourage lending in foreign exchange. Thus the adjustment to the crisis has meant that the demand for new credit has fallen sharply.

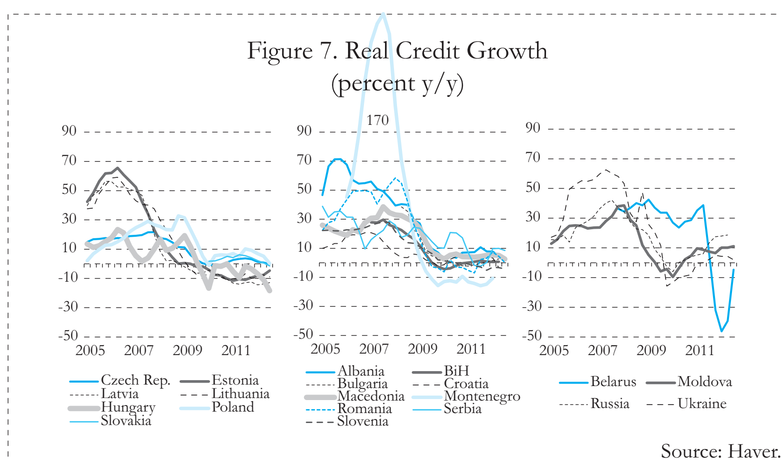


Figure 7. Real Credit Growth
(percent y/y)

Source: Haver.

Nevertheless, there is also evidence that the supply of credit is also constrained. Over-leveraged parent banks have not been willing to increase their exposure to the region at a time when they are under pressure from markets and regulators to shrink their overall balance sheets. Bank balance sheets in the region are also encumbered with growing non-performing loans and it is proving difficult in some countries to remove these speedily from balance sheets. (See Figure 8 and Bakker and Klingen (2012) p.73). A Vienna Initiative Working group looked at this issue in some detail and made a number of recommendations for comprehensive action to tackle the problem (Vienna Initiative (2011a). Bank profitability also took a severe hit in many countries during the crisis, although there has been a

recovery of that indicator, although in general not to the pre-crisis level (Figure 2).

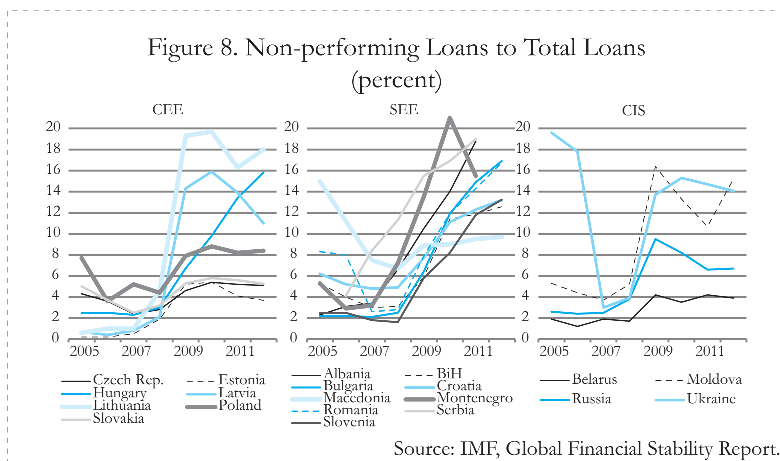


Figure 8. Non-performing Loans to Total Loans (percent)

Source: IMF, Global Financial Stability Report.

A study by BIS staff of the determinants of cross-border bank flows cast light on the relative role of pull and push factors in CESEE (Avdjiev et al. (2012)). As shown in Figure 9, cross border banking flows to the wider region moved from positive to negative in 2008, and have stayed negative. The authors try to disentangle supply factors from demand factors in the country-by-country cross-border flows. As proxies for demand for credit, they look at real GDP growth and sovereign CDS spreads; as proxies for the supply side, they use indexes of the CDS spreads of the home country banks

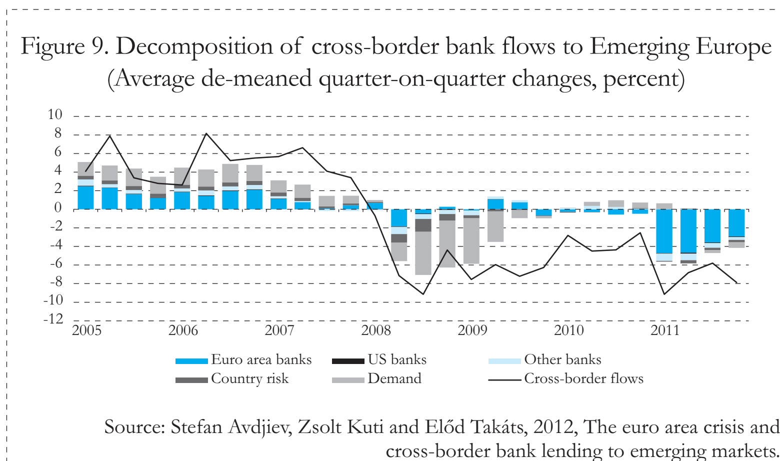


Figure 9. Decomposition of cross-border bank flows to Emerging Europe (Average de-meaned quarter-on-quarter changes, percent)

Source: Stefan Avdjiev, Zsolt Kuti and Előd Takáts, 2012, The euro area crisis and cross-border bank lending to emerging markets.

and of financial sector equity price volatility. The results conform with the general narrative of the five years since 2008. The initial reversal of banking flows in 2008-9 was associated with worsening conditions in the host countries of CESEE. Since then, however, the parent banks themselves have come under pressure, and the most recent reduction in exposure since mid 2011 is closely associated with their own difficulties.

Nevertheless, the reduction in international exposure to the region in the twelve months starting mid-2011 has varied from country to country. As shown in Figure 10, outflows have amounted to about ten percent of GDP in Hungary and Slovenia. In the former, the outflows are related to the actions taken by the authorities that have sharply lowered bank profitability, while in Slovenia – a country where the banking system remains largely in domestic hands – the reduction has been of international funding of parent banks and direct cross-border lending. The even larger outflows in the case of Estonia reflect changes in supervisory requirements following the country's joining the Eurozone. In most other countries, foreign bank funding has also fallen. However, this has not caused a similar decline on the asset side of the local banking system, since the external funding has been replaced to a greater or lesser extent by increased domestic deposits. This issue is discussed at greater length below.

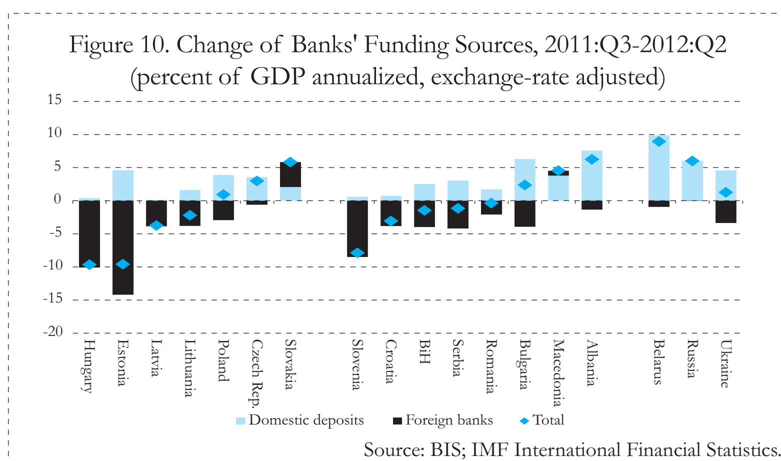


Figure 10. Change of Banks' Funding Sources, 2011:Q3-2012:Q2 (percent of GDP annualized, exchange-rate adjusted)

Source: BIS; IMF International Financial Statistics.

In the first part of the crisis, as shown above in Figure 4, the banks that came under strong market pressure were the Austrian and Italian banks particularly exposed to the CESEE region. Once stabilization programs were put in place and the Vienna Initiative tackled the collective action problem, pressure on these banks, as measure by CDS spreads, declined. However, the outbreak of the Eurozone crisis in Greece and Ireland raised fresh questions about the soundness of major European banks. These banks are much more leveraged than, say, their US counterparts, and total bank balance sheets are on average four times the size of US banks as a share of GDP, making the potential claims on the fiscal back-stop that much larger. Funding pressures on European banks, and their perceived riskiness has since risen sharply, particularly for those countries in the Eurozone where the fiscal capacity to back the banks is weakest.

Regulators have taken action to require banks to strengthen their balance sheets. A series of stress tests of major European banks was undertaken to estimate the capital needs of the banks should financial and economic conditions worsen substantially, and to ensure that banks have sufficient liquidity to ride out difficulties in funding markets. International agreement on capital and funding standards was reached in the Basel III agreement, and a process is under way to incorporate those standards in the European Union's Fourth Capital Resources Directive (CRD IV). The European Banking Agency announced an acceleration of the timetable to meet the Basel standards, and in early 2011 set a target of nine percent tier one capital for major banks by midyear.

The combination of market forces and regulatory action have put the parent banks under pressure to adjust their balance sheets in a number of ways. One is to raise more capital, although market conditions have not been that propitious and in some cases existing shareholders do not want to be diluted. Another is to shed assets, either by letting loans run off or by disposing of business units. Banks have been obliged to rethink their business models, and for some of them, cross-border banking into CESEE does not fit in with the new model. In some cases, this has led to changes in ownership of subsidiaries in CESEE. The extent of this has not been large, as the obvious buyers of such subsidiaries, other banks, are often not

in a position to purchase. Another reason may be that the CESEE subsidiaries are better capitalized than the parent banks as shown in Figure 11. Thus when the group's accounts are consolidated, the ownership of such subsidiaries may improve the overall position of the group.

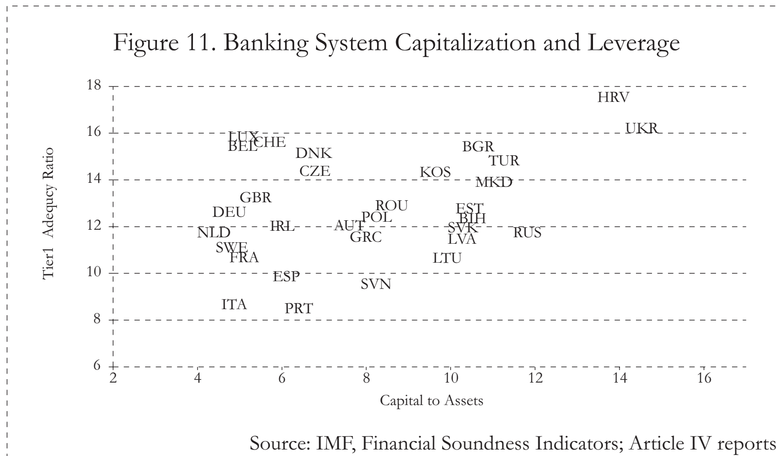


Figure 11. Banking System Capitalization and Leverage

Source: IMF, Financial Soundness Indicators; Article IV reports.

The desire to reduce assets is leading to a very substantial contraction in cross-border exposure of major European banks, in which process, the reduction in exposure to CESEE does not seem disproportionately large, although as discussed above, as a fraction of CESEE GDP can be quite significant. There is evidence that some banks have sought to limit credit expansion by subsidiaries, or have raised group-wide lending standards in a way that has the same effect.

Banks have been facing very severe funding pressures at various points since the outbreak of the crisis, and face regulatory requirement to meet a net stable funding ratio (NSFR) by 2018 and a liquidity coverage ratio (LCR) by 2015. This has led them to seek to conserve liquidity and to build up sources of longer-term more stable funding. The extent that banks in CESEE could fund themselves through relatively short renewable lines from parent banks has been reduced, and this in part explains the efforts that the banks in the region have made to build up domestic deposits. There are still questions about

whether local banks in the CESEE region will be able to meet the NSFR in the time allotted, since the underdeveloped state of local capital markets makes it more difficult to find the long-term funding sources needed to meet the target.

The urgency of resolving the problems of the major European banks is increased by the growing link between markets' assessment of banks and of the state that has ultimate responsibility for resolving that bank. The correlation between CDS spreads on sovereigns and banks has been increasing. As questions are raised about the creditworthiness of banks, markets see a growing potential liability of the sovereign and the latter's creditworthiness is affected: as the perceived creditworthiness of the sovereign declines, the markets note that the value of the bank's holdings of sovereign bonds declines and that the strength of potential support is diminished, causing further downgrading of the bank. Concern about such a feedback loop motivated the Austrian authorities in late 2011 to introduce a number of supervisory measures that affected the operations of CESEE subsidiaries of Austrian banks. Of particular concern in some countries was the requirement that in those subsidiaries where loan to deposit ratios were above 110 percent, new lending be limited to the extent that it could be funded by local deposits. In the event, this requirement does not seem to be as severe as the authorities of some of the affected countries feared at the time.

CHALLENGES AHEAD

Domestic market responsiveness

A lot of advantages of cross-border banking are discussed above. But there are also a number of drawbacks that may be more serious when conditions on banks' home markets are more difficult. Banks that form part of a foreign banking group are likely to be less responsive to conditions in the host economy than those which do the bulk of their activity there. The issue here is not primarily foreign ownership, since a foreign owner, just as a domestic owner, has an interest in the bank doing as much profitable business as possible in the country where it operates. The issue is ownership by a foreign financial institution which is itself subject to regulatory and market

pressures in its home country (and possibly political pressures too), and as a group is forced or encouraged to respond in ways that do not take into account host market conditions. Pressure on funding at the group level or the market's assessment of the soundness of the group may require changes in the group's strategy that have an impact on the subsidiary. The transmission of pressures on the parent to the actions of the subsidiary may be exacerbated by consolidated supervision and accounting for the group's operations. Actions may need to be taken by the subsidiary if the group is to achieve compliance with the requirements of the home supervisor or convince the markets to provided the group with funding at a reasonable price.

Some elements guard against this problems becoming too severe. Subsidiaries are of course subject to all the banking laws and regulations of the host country, but in the case of Poland, for example, certain decisions, in particular those involving risk management, must be taken by the local board of the subsidiary without reference to outside instructions. As a further measure to ensure that important decisions are taken locally in response to local conditions, Polish law provides that all Polish banks be floated on the Warsaw Stock Exchange and maintain a substantial free float. The principle is that minority shareholders will have an interest in ensuring that the value of their share in the bank is not compromised by actions that solely benefit the parent bank, and from the supervisory point of view, Polish company law governing joint stock companies can help ensure that this not happen. (In practice, some banks have been given time to meet the requirement of a local floatation.)

In practice, it is not clear that these provisions are particularly effective, even in a market that is as large and profitable as Poland's. Kawalec and Gozdek (2012) show that credit expansion to the corporate sector by banks controlled by foreign banking groups in the period 2007-2012 was less stable than that by locally owned and controlled banks, and that the latter reflected market conditions in Poland more closely. The rules requiring decision making to reflect local market conditions are very difficult to monitor, and if the local board takes the decision that the parent bank wishes it to take, who is to say that it was not arrived at independently? But with the parent

bank and its representatives having a dominant position on the bank board, and with the selection of local bank management and its remuneration tied to decisions of the parent, it is perhaps naïve to imagine that the interests of the parent are not going to have a major impact on the decisions of the subsidiary. And in cases where the imbalance in size between the parent and the subsidiary is even more marked than in the case of Poland, this impact will be even larger.

This can affect the functioning of domestic financial markets and the monetary policy transmission mechanism. Efforts to control domestic financial conditions and inflation may be more difficult if the transmission mechanism is not functioning properly. The effect of changes in reference interest rate will be reduced if the local banks are loosening or tightening credit standards in response to the needs of the international bank group, and if the market is dominated by the subsidiaries of such groups, they may all be responding to similar international pressures. This reduced responsiveness to monetary policy signals is likely to mean that interest rate and other central bank intervention policies have to have a wider amplitude for them to have the same effect, and this is likely to add an element of instability to domestic market functioning.

One example of the influence of the situation of parent banks on local market conditions has been the functioning of local interbank markets since the Lehmann Brothers collapse. The initial result of the collapse was a sharp increase in the perception of counterparty risk involved in lending to other banks, and internationally the interbank market seized up. Central banks mitigated this effect by in effect operating as intermediary counterparties to ensure that funding was available to sound banks that needed it. The seizing up of interbank markets also occurred across the CESEE region, despite the relatively high capitalization and low leverage of local banks. However, decisions about extending credit to another bank on the interbank market were constrained by instructions from parents concerned about their group's exposure to other banking groups. And again, local central banks had to step in as intermediaries on this market. In the four years since the Lehmann Brothers collapse, this problem has not been completely resolved, nor do there seem to be the instruments to get national interbank markets functioning again

properly until the parent banks are prepared to take on the risk of exposure to other groups.

Another set of cases has arisen where consolidated group accounting and consolidated supervision seems to be affecting detrimentally the operations of subsidiaries. Here the problem seems to be that while the local bank makes lending decisions based on its local capital and local risk weighting, when the group's operations are consolidated in its financial statements and its reporting to the home supervisor, home country risk weights may be applied. Thus lending to the sovereign in local currency may have zero risk weight for the local bank in accordance with Basel principles, when the group's accounts are consolidated, that exposure to sovereign receives the risk weighting it would get if the lending were done from the parent bank. If the parent group is under pressure to improve its risk-weighted capital adequacy, it may be easier to reduce lending operations in the subsidiary than in the parent, since the former bear higher risk weights in the standards applied at the group level.

Supervisory cooperation

Cooperation in cross-border supervision and regulation is becoming increasingly important for the region. Home supervisors are intensifying their control over their resident banking groups, and this has spillovers to the host countries. At the level of the European Union, the European Banking Agency (EBA) has been established to ensure a level playing field in the supervisory area, promote supervisory convergence, and strengthen cooperation between home and host supervisors. In this connection, a network of supervisory colleges has been established. While the mandate covers the entire European Union, third countries in the CESEE region are also affected. Proposals are under consideration for an European Directive on recovery and resolution plans, and there is also a directive governing deposit guarantee schemes. On top of this, the decision to establish a Banking Union, with a single Supervisory Mechanism at its heart, will also have implications for the countries in the region, even if the Banking Union is largely confined to the Eurozone.

At the heart of the problem of supervisory cooperation for CESEE is that because of their small size, most of the CESEE banking systems are highly concentrated. Figure 12 shows that for many economies in the region, six banks or less account for over 75 percent of bank assets. This makes many of these banks systemic as far as the host country is concerned. It is thus of vital concern that these banks are properly supervised and managed and focus on their tasks in the host country market. At the same time, as Figure 13 shows, for most bank groups, their CESEE subsidiaries are not that significant to the group as a whole, the exception being some of the Austrian banks. This runs the risk that issues of major concern to host countries will not receive sufficient attention by either the parent bank or by its supervisor. The CESEE supervisor, for whom the subsidiary bank is systemic in a number of ways, may not qualify for membership in the core college of supervisors since the bank is not of sufficient weight for the group as a whole. While the EBA guidelines for the functioning of supervisory colleges require advance discussion of issues that affect the stability of a country's financial system, it is not clear that this is always observed, especially when the host country is not a member of the European Union.

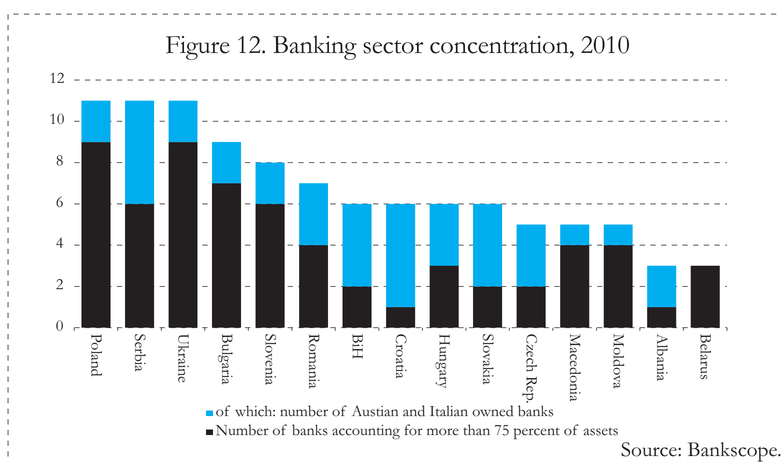
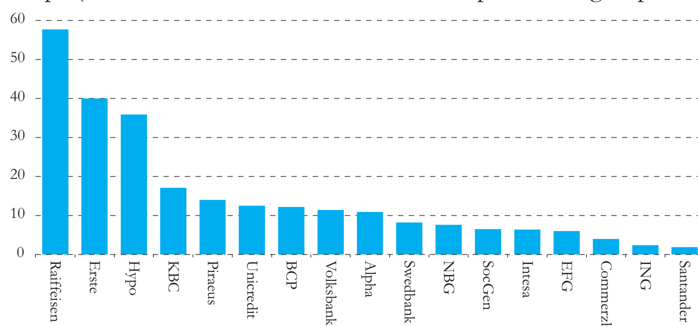


Figure 12. Banking sector concentration, 2010

Source: Bankscope.

Before the crisis supervisory cooperation was not always effective. In cases where host supervisors tried to restrain domestic credit expansion to take some steam out of the boom, some home

Figure 13. Major Euro area Banking Groups With Subsidiaries in Eastern Europe (Share of assets of CEE subsidiaries as percent of group assets)



Source: Raiffeisen Research, CEE Banking Sector Report 2012.

supervisors did not see themselves obliged to support this action. Banks that wished to continue expand lending in a given EU market were able to circumvent the restrictions of the host supervisor by lending directly from the home office, or through branch (rather than subsidiary) operations (Bakker and Klingen (2102) pp.20-22). With the outbreak of the crisis, host supervisors have been concerned to ensure that the local banks had plenty of capital and access to funding. In some cases they have tried to ring-fence the local subsidiaries, requiring that profits be retained in reserve accounts or that withdrawal of funding lines from the parent be subject to advance notice and monitoring. At the same time, as mentioned above, home supervisors have taken action to tighten controls on parent bank groups without specific reference to the impact on countries in which the group has subsidiaries. These issues need to be resolved in a cooperative fashion if the cross-border banking is to have a future.

The revived Vienna Initiative (Vienna Initiative 2.0) focuses on these issues. This time the focus is not on exposure maintenance agreements. There is recognition that financial conditions in most of CESEE have returned to normal, and several of the IMF-supported programs have expired. It is also neither necessary to freeze the funding pattern, nor is it desirable. As the stock of foreign exchange lending is reduced, the need for parent funding declines. Local deposits are a growing source of funding for operations, and with the

demand for credit subdued, resources can be used more profitably elsewhere in the group. However, given the pressures on the parent banks to reduce their leverage, the institutions involved in the Vienna Initiative are monitoring carefully changes in international banking flows and their implications for host countries.

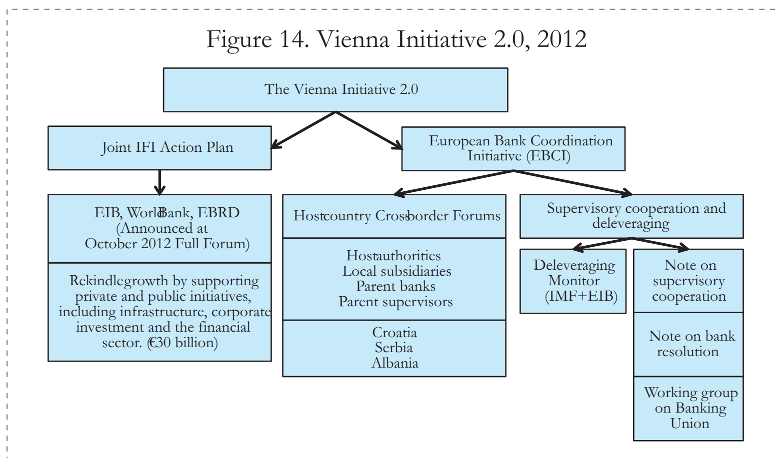


Figure 14. Vienna Initiative 2.0, 2012

The main focus of Vienna Initiative 2.0 is supervisory cooperation. The challenge as described above (Figure 14) is to discourage supervisors from acting at cross-purposes, and to ensure that host countries retain the capacity to maintain stability in their domestic financial systems. To this end, the parties to the Initiative have produced a report on how supervisory colleges are working in practice and recommended some improvements. They have also formulated a note on considerations that need to be taken in account in establishing recovery and resolution plans for banks. The implications of EU proposals, both in terms of financial stability and costs to the tax-payer, may be quite different for a country dealing with its own banks than for one where most of the banks are subsidiaries of foreign parents.

Another leg of the Vienna Initiative is the establishment of Host Country Cross-border Banking Forums (HCCBF). These are intended to build on the mixed public-private nature of the Vienna Initiative forums and provide a venue for a substantive discussion between the host country financial and supervisory authorities,

locally systemic banks, these banks' parents and the parents' supervisors. This brings together all the main agents whose activities have an impact on the local banking system. This fills a gap in the institutional framework. In countries where the bulk of the banking system is locally owned, there is no obstacle to the discussion of such issues between the financial authorities and the banks, and so there is no need for such a forum. The supervisory colleges look at issues of stability from the perspective of the banking group. The HCCBF allows this to be done with the focus on the stability or financial development of the host country.

Finally, the Vienna Initiative 2.0 also includes a renewed and enlarged Joint IFI Action plan to provide support to business and to banks in CESEE countries.

Domestic savings

The Report of the World Bank Growth Commission (Spence et al, (2008) pp. 54-7), looking at cases of rapid growth in developing and emerging market countries in the last forty years, stresses that "there is no case of a sustained high investment path not backed up by high domestic savings." Reliance on foreign savings can be risky, a development already seen in the emergence of vulnerability in the CESEE countries before the crisis. However, the scope for public savings is limited, among other factors by political developments, and the scope for increasing corporate savings in a region where the corporate sector is not particularly strong may not be large. The factors that determine the level of household savings are not well understood, but they would appear to be critical to the growth process. The report speculates that important factors in promoting such savings may be the existence of suitable saving vehicles.

The report suggests that a well-developed financial system can be crucial in mobilizing savings, allocating funds to investment, and redistributing risk. In that respect, the banking systems of CESEE probably score well on accessibility of savings vehicles, although their record on fund allocation does not seem that bright, given the housing and consumption booms that the countries have been through. The report also stresses the need for sound property rights

and the means to enforce them, as a basis for lending to establish businesses.

Rajan, Subramanian and Prasad draw attention to the Lucas paradox, that in general capital does not flow into the less capital rich countries (See Prasad et al. (2007)). Indeed the spectacular growth performance of the East Asian countries is associated with savings rates that are well above their high investment rates. Rajan and colleagues show that for non-industrial countries, there does not seem to be a positive association between growth and reliance on foreign capital. In fact, there is generally a negative correlation suggesting that non-industrial countries that are more reliant on foreign capital grow less. They find that within countries that invest more, those that save more (and thus run lower current account deficits) grow at a rate of about one percent a year more than countries that save less. It would seem that non-industrial countries do not have tremendous absorptive capacity for foreign capital in general, though particular forms of foreign capital such as FDI may be useful.

It is harder to tell why this might be. Prasad et al. speculate that, in the absence of domestic savings, financial systems are unable to finance the necessary complementary investments to FDI. Another reason why foreign borrowing may retard growth is that the inflows cause exchange rate appreciation, making export-led growth more difficult. This phenomenon may have been apparent in the CESEE region before the crisis. The implication of Rajan et al. analysis is that successful developing countries have been less reliant on foreign capital because of their limited capacity to absorb it. Opening up to foreign capital may not help much unless the domestic financial sector and the tradable sector also develop. This analysis implies that raising domestic savings and ensuring that the financial system can allocate it appropriately could be key for CESEE.

Friedrich, Schnabel and Zettelmeyer (Friedrich et al. (2010)) note that emerging Europe is an exception to the pattern discussed in Prasad et al.. Financial integration, as measured by current account deficits, appear to be positively correlated with growth for the European transition economies in the period preceding the crisis.

They suggest that political integration is the main reason for this effect, and once that variable is accounted for, the performance of transition Europe is rather similar to that of other emerging markets. Political integration may affect investors' expectations about future institutions and policies, and this in turn may enhance the growth effect of foreign capital. They also find that the presence of foreign banks may have contributed to the growth effect of financial integration. Whether the results of Friedrich, Schnabel and Zettelmeyer are replicable if the sample period also covers the longer period of slow growth following the crisis is not certain, but their message seems to stress again the importance of institutional development in creating positive growth outcomes in the transition economies.

Local capital markets

Institutional development will be particularly important if longer-term funding sources are to be developed in these countries and vehicles created to mobilize longer-term domestic savings. In that respect, local capital markets in the region have only been developing slowly.

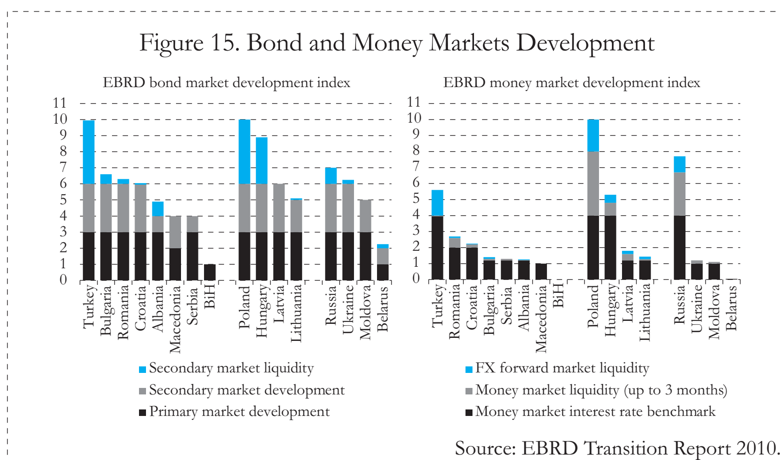


Figure 15. Bond and Money Markets Development

Source: EBRD Transition Report 2010.

There are three main reasons why development of local capital markets is lagging in the region. Firstly the financial strategy of the region has implicitly been modeled on the West European universal

bank model, which places less reliance on raising capital directly from investors on the capital market. Secondly, macroeconomic conditions have not been conducive in most countries to locking in longer-term financing instruments. And thirdly, the legal and administrative infrastructure has not reached the standards that such markets require. In addition, the economies are small, which makes it hard to ensure the liquidity that such markets need.

The model of universal banks catering for all aspects of the financial needs of firms was an attractive one, particularly at time when enterprises were learning to stand on their own feet and when financial expertise was in short supply. In addition, until the crisis, the banks seemed to be an excellent channel for bringing savings in to the country, and the shortage of domestic savings was not perceived as strongly as it is now. It is possible that there is no real alternative to bank-based capital financing for small economies, unless they can be integrated into a larger currency and financial area.

However, the model is facing headwinds. With stresses in the parent banks evident, it is not clear that they will have the capacity or appetite to take the risk of financing longer-term projects in the region. The new Basel III requirements make it more difficult, in that they introduce a stable long-term liquidity ratio, requiring longer-term investments to be financed predominantly from stable longer-term resources. This may be achievable at the group level, but is hard to do in individual CESEE countries where long-term domestic currency lending will need to be balanced with long-term domestic funding. Banks are interested in issuing covered bonds as one instrument to achieve this, but legal problems and collateral enforcement can be an issue. Other forms of longer-term funding in these countries are even more problematic.

In many countries, macroeconomic conditions have not been favorable to the issue of long-term liabilities. While inflation rates have been brought down in most countries, a track record needs to be established and confidence created that inflation will indeed remain low. Governments have pushed out the yield curve by issuing debt of longer maturity, but this process still has a way to go in most countries. In several countries, particularly in the West

Balkans, dollarization (or euroization) remains an issue, with the bulk of deposits and lending being in foreign exchange and with the local currency financial market remaining very small. This situation was exacerbated in many countries by the wave of foreign-currency mortgages during the boom years. And with all EU members in the region committed to joining the Eurozone, and most of the remaining countries seeking to join the EU, there has been an understandable reluctance to make the effort to develop local currency capital markets if they were soon to be swallowed up in the Eurozone capital market. Only in the case of the Czech Republic out of those countries that have not already joined the Eurozone, were these negative conditions not present.

There is still a long way to go in most countries in the region to create the necessary legal infrastructure that underpins security markets and to show that it can be administered in a way that promotes the transparency necessary for such markets to function. Company law and insolvency and creditor rights legislation often still needs much improvement. This agenda is part of a more general "doing business" agenda containing widespread reforms to make business function more smoothly and administrative burdens lighter and less capricious. The region does not score all that highly on the World Bank's Doing Business index. Eliminating the broad range of obstacles to efficient business is essential to maintaining the competitiveness of the region and to allowing it to raise growth rates beyond those experienced since the crisis. At the same time, it can lay the foundations for local capital markets that can support growth (See Vienna Initiative (2011a).

Finally, the small size of the domestic markets is going to remain an obstacle. One way of tackling this is to develop regional institutions to provide the necessary market infrastructures, and to consider the benefits of linking the capital markets of a number of countries.

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CAPITAL FLOWS, MONETARY POLICY AND THE IMPOSSIBLE TRINITY

*Madhusudan Mohanty**

I would like to thank the Bank of Albania for inviting me to this Conference, and for the very warm hospitality. My focus in this presentation is on monetary policy challenges in a small open economy, and on related target and instrument issues facing central banks in a globalised world. Let me stress that what I have to say reflects my personal views, and not necessarily those of the BIS. And my presentation deals with emerging market economies (EMEs) in general, not specifically with the central and eastern European economies. The regional aspects have been very well covered by my two co-panelists, Mr. Themali and Mr. Allen.

As is well known, the traditional concerns for central banks in small open economies arise from volatile capital flows that can cause sharp changes in exchange rates and asset prices. Dealing with these challenges is not easy, as it involves choosing one objective over the other, with obvious economic and social consequences. Over the past five years, this challenge has been accentuated by very low interest rates and unconventional monetary policies in advanced economies, channelling large amounts of short-term capital inflows into EMEs. What could central banks in small open economies do to reduce risks tomonetary and financial stability? Can sterilised foreign exchange intervention completely insulate monetary policy from the influence of capital flows? To what extent can other policies help?

A key lesson from the review of the past decade of policy response is that exchange rate is a crucial asset price in most EMEs for monetary and financial stability. As resistance by countries to strong appreciation pressures has intensified, so has been risk of monetary and financial imbalances from large scale foreign exchange intervention. Additional policy instruments such as macro-prudential policy can address some of the risks from large capital inflows but they are unlikely to resolve the problems of policy inconsistency arising from the dual exchange rate and monetary policy objectives.

1. THE CORNER SOLUTION

The standard textbook solution to challenges from capital inflows is given by the trilemma literature (the so called "impossible trinity"). According to the theory, if financial globalization is unavoidable, the central bank has to choose between a fixed exchange rate and independent monetary policy. The reason is that it cannot indefinitely control the exchange rate and the interest rate, so one of the objectives has to be sacrificed. This is the classic argument of Mundell (1968).[1]

How far countries can control both the exchange rate and the interest rate, of course, depends on the nature of the shock. In the case of a rise in global risk aversion leading to sharp depreciation of the exchange rate, the central bank can stem that depreciation by selling foreign currency reserves in the market, but probably only for a limited period. At some stage, depleting reserves will make an interest rate increase inevitable. This means that there is a finite limit to resisting currency depreciation.

By contrast, a positive capital flow shock, arising, for instance, from the perception that a country's growth prospectshave strengthened, presents a very different problem. In this case, the challenge for the central bank is to avoid sharp appreciation of the exchange rate. The limit on preventing appreciation is, however, less clear cut, because reserves can keep rising. But that does not mean that there is no limit on how long currency appreciation can

[1] For a discussion, see Frankel (1993) and Mohanty and Turner (2005).

be resisted. Because intervention prevents the domestic interest rate from falling, continuing intervention would attract further capital inflows and continue to increase the need for the central bank to sterilise excess bank reserves. Eventually, either the interest rate will fall or the exchange rate will rise. In the long run, therefore, appreciation becomes inevitable, because even in the former case the resulting inflation and increase in money supply will lead to an appreciation of the real exchange rate.

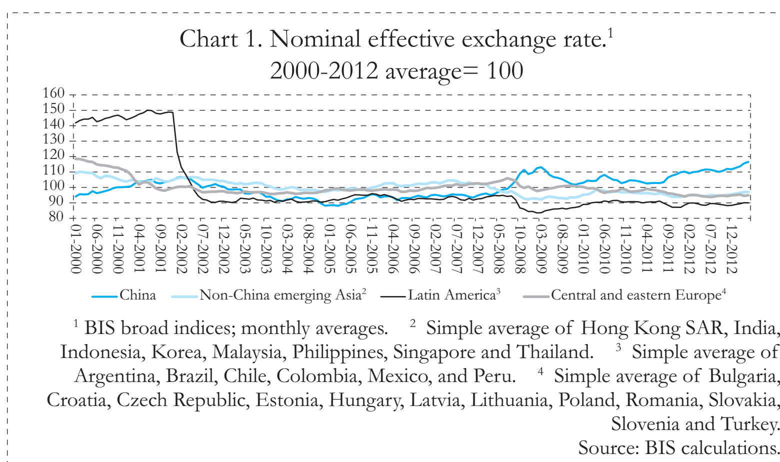


Chart 1. Nominal effective exchange rate.[1]
2000-2012 average= 100

[1] BIS broad indices; monthly averages. [2] Simple average of Hong Kong SAR, India, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand. [3] Simple average of Argentina, Brazil, Chile, Colombia, Mexico, and Peru. [4] Simple average of Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia and Turkey.
Source: BIS calculations.

Following a series of crises in the 1990s, many EMEs formally abandoned their fixed or semi-fixed exchange rate regimes and replaced them with inflation targeting combined with floating exchange rates. With growing financial globalization, defending a fixed exchange rate has proved more difficult than it was in the previous decades. The past experience suggests that nothing short of a hard peg, such as a currency board or a currency union, is successful in reducing the chances of speculative currency attacks. In addition, a flexible exchange reduces an economy's vulnerability to external shocks. In particular, it protects the economy from adverse terms-of-trade shocks and reduces financial stability risks by weakening the private sector's incentive to borrow in foreign currency.

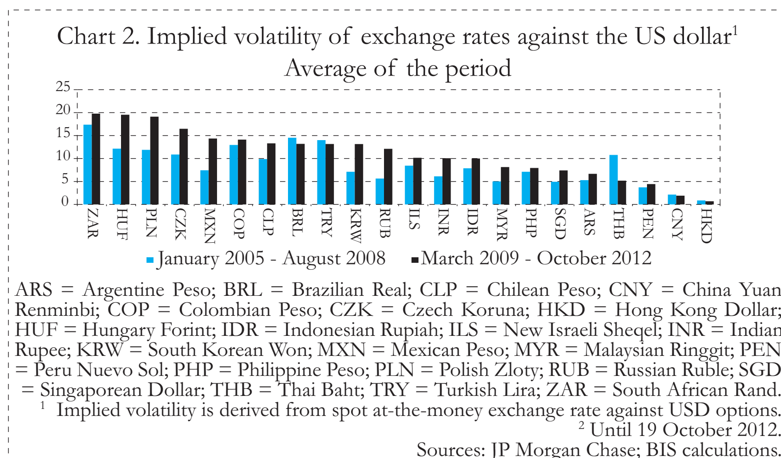
Have exchange rates been flexible in practice? Chart 1 shows average nominal effective exchange rates in various regions since

2000. In most parts of the world exchange rates were relatively volatile during the early 2000s. The crisis in Argentian and turbulence in Brazil in 2003 led to a large downswing in the exchange rate in Latin America as a whole.However, exchange rate flexibility weakened a great dealin all regions in the following years, up to the beginning of the 2008 financial crisis. During the past three years, the crisis has had a very considerable effect on exchange rates in EMEs. Most EME currencies depreciated sharply following the collapse of Lehman Brothers in September 2008and have recovered only slowly during 2010-2012.

Some large economies such as China have a semi-fixed exchange rate. Between 2002 and 2012, China's nominal effective exchange rate has been relatively constant, although it has tended to appreciate at a faster rate since mid-2011 than it did in the previous decade. Focussing on Central and Eastern Europe (CEE), we see a broadly stable average exchange rate. This is partly because the average includes a number of Baltic countries that have formally adopted a fixed exchange rate regime. Note, however, that limited exchange rate flexibility is not unique to CEE, but is shared by Asia and Latin America even though both regions have adoptedflexible exchange rate regimes.

Chart 2. Implied volatility of exchange rates against the US dollar[1]

Average of the period



ARS = Argentine Peso; BRL = Brazilian Real; CLP = Chilean Peso; CNY = China Yuan Renminbi; COP = Colombian Peso; CZK = Czech Koruna; HKD = Hong Kong Dollar; HUF = Hungary Forint; IDR = Indonesian Rupiah; ILS = New Israeli Sheqel; INR = Indian Rupee; KRW = South Korean Won; MXN = Mexican Peso; MYR = Malaysian Ringgit; PEN = Peru Nuevo Sol; PHP = Philippine Peso; PLN = Polish Zloty; RUB = Russian Ruble; SGD = Singaporean Dollar; THB = Thai Baht; TRY = Turkish Lira; ZAR = South African Rand.

[1] Implied volatility is derived from spot at-the-money exchange rate against USD options.

[2] Until 19 October 2012.

Sources: JP Morgan Chase; BIS calculations.

Another indicator of exchange rate flexibility is investors' expectations of the future exchange rate, represented by the implied

volatility derived from options prices. This is shown in Chart 2 for the period before the collapse of Lehman Brothers in September 2008 and for the period following it. What is important to note is that the implied volatility of Asian currencies has been smaller than volatility in the other two regions, and that it has changed very little following the recent crisis. By this indicator, some CEE currencies, such as the Polish zloty, the Hungarian forint, and the Czech koruna, appear to be more flexible than Latin American currencies such as the Mexican peso or Brazilian *real*, particularly since 2009.

Economists have long debated the reasons for relatively heavy management of exchange rates by EMEs. The "fear of floating" literature (eg Calvo and Reinhart (2002)) focussed on two such arguments: First, a history of high inflation in EMEs and low policy credibility implies that the pass-through of exchange rate to consumer prices is often swift and high, which gives the exchange rate a central role in inflation stabilisation. Second, economies with large foreign currency debt are vulnerable to sharp exchange rate depreciation, which can intensify risks of bankruptcy and economic collapse.

However, by most indicators, both reasons appear to be far less important today than they were in the 1990s. A number of studies have demonstrated that the pass-through of exchange rate to inflation has fallen sharply in EMEs throughout the 2000s (Mihaljek and Klau (2005)). In addition,the extent of currency mismatches has fallen, with many EMEs reducing their foreign currency debt and accumulating large foreign currency assets. Mehrotra, Miyajima and Villar (2012) provide estimates of several measures of currency mismatches in EMEs. Most Asian economies now enjoy large net FX asset positions, ranging from 190% of exports in China to 8% in Korea at end-2011, in contrast to their large net FX liability positions of the early 2000s. In Latin America, the ratio was about 28% in Brazil and 3% in Mexico. This means that currency depreciation now tends to improve rather than worsen balance sheet positions for many countries. In CEE, the balance sheet situation is quite different, because, generally speaking, the region has accumulated large foreign currency debt on the expectation that it would adopt the euro in near future. For instance, the net foreign currency

liabilities of Hungary and Poland stood at 31% and 15% of exports, respectively, in 2011.

There are, of course, other reasons why countries may like to manage their exchange rates. Perhaps most notable is the desire to promote exports through a competitive exchange rate. Foreign exchange intervention may be designed to prevent appreciation when foreign inflows surge but allow the exchange rate to depreciate either fully or partially when the flows reverse.

The impact on the economy depends on the starting position as well as the source of the foreign inflows. Take the case of appreciation pressures led by a significant rise in the current account surplus. Assuming that the exchange rate was initially in equilibrium, such a shock will normally require a stronger exchange rate to bring about the necessary balance of payments adjustment. Any resistance to appreciation is likely to lead to an undervalued exchange rate. In countries with large net foreign asset positions, such depreciation has major expansionary effects, because the favourable trade effects are reinforced by the positive wealth effects. Another case is appreciation pressures resulting from capital inflows led by stronger economic fundamentals (eg higher potential growth). In this case, intervention would lead to a weaker exchange rate than would be desirable, because the equilibrium exchange rate has also moved up. On the other hand, intervention to resist appreciation from short-term capital inflows (attracted, for instance, by higher interest rate differentials) may be warranted if it forestalls potential overvaluation of the currency and higher exchange rate volatility in future.

Recently, some theoretical models have rationalised an undervalued exchange rate on the grounds of market imperfection (Rodricks(2008)). The argument is that poor economies suffer from institutional weaknesses (eg lack of property rights) and market failures (eg learning externalities, credit market imperfections,etc) that disproportionately affect the tradable sector by reducing incentives for innovation. Under these circumstances, Rodrick argues, an undervalued exchange rate can help to boost investment and growth. Such views have, nevertheless, gone contrary to the findings of many other studies to the effect that a flexible

exchange rate reduces output volatility (Obstfeld and Rogoff, 1995). Gadanecz and Mehrotra (2013) report a U-shaped relationship between exchange rate volatility and output volatility in EMEs. Their evidence suggests that greater exchange rate flexibility reduces output volatility up to a point, implying that extreme volatility can have adverse consequences for the economy.

Another oft-cited reason for intervention is "excessive" exchange ratevolatility that can expose the financial system to risks. Several recent studies have indicated that EM central banks do attempt to curb excessive exchange rate volatility that threatens the stability of the financial system (BIS, 2005). One dimension of the risk involved is that the exchange rate may "overshoot" because of speculative market positioning by investors. For instance, a steady appreciation of the exchange rate may create speculation on future appreciation, leading to larger capital inflows and further rapid appreciation. Investors who bet on such appreciation would gain when the local currency has finally appreciated, boosting the dollar value of their investment. The limited market size of EMEs means that they are more vulnerable than mature markets to such self-fulfilling exchange rate expectations.

Another dimension of the risk is that foreign holding of EM local currency debt and equity has risen significantly in the past decade, shifting the exchange rate risk from the issuers of these assets to the investors. In the long term, this is a desirable development for EMEs, reducing their exposure to currency mismatches and strengthening the monetary policy transmission. But larger foreign holding of EMEs' local currency bonds and equity also creates new risks. For instance, unexpected exchange rate depreciation can cause large losses to foreign investors in local currency assets,which could precipitate further capital outflows and a collapse of asset prices. This, in turn, can create risks for the financial system.

Not surprisingly, given all this, there is little evidence from data and country experiences that exchange rate regimes in EMEs have become very flexible. Aizenmann (2011) notes that "while mainstream economists by now view Trilemma as a truism, most countries are not at the vertices of the Trilemma". This is also evident

from a review of the long history of the policy trilemma by Obstfeld, Shambaugh and Taylor (2005) and the recent experience of Asian economies described by Filardo and Grenville (2012). In sum, few countries have opted to either fully fix or fully float their exchange rates, and have instead chosen to stay in the middle by combining various degrees of financial integration, exchange rate flexibility and monetary independence.

The new thinking also seems to be that financial stability should form an independent fourth objective, extending the debate on the policy trilemma to the policy "quadrilemma" (Aizenmann(2011)). In this view, central banks not only have to choose between a fixed exchange rate and monetary independence, but also have to ensure that their choice is consistent with the goal of financial stability.

2. THE TRILEMMA (OR QUADRILEMMA) AND FOREIGN EXCHANGE INTERVENTION

How do central banks pursue multiple objectives? And how sustainable are the multiple targets? One answer to these questions is that monetary authorities have employed more instruments than just the interest rate to simultaneously pursue several objectives. Yet it is not clear that the problems of policy inconsistency have been eliminated.

The instrument that has been used most over the past decade is sterilised foreign exchange intervention. A typical sterilised intervention involves the central bank's exchanging domestic assets – usually government bonds or its own securities – for foreign exchange assets. The table below provides a simple illustration with a stylised central bank balance sheet. The assets of the monetary authority comprise foreign and domestic assets, while the liabilities are currency, bank reserves (collectively, monetary liabilities), its own securities, other liabilities (collectively, non-monetary liabilities) and equity capital. The currency item is largely determined by the public's demand for cash balances. Equity capital represents government transfers to the central bank (plus accumulated profits and losses). The remaining liabilities are within the control of the central bank.

Assuming that equity capital is constant, an increase in foreign assets requires financing in some form. A measure of the financing requirement is given by the excess of foreign currency reserves (in domestic terms) over currency in circulation. As intervention takes place, the central bank will have to finance this gap by either reducing its holding of government bonds or by selling additional governments bonds or its own securities.

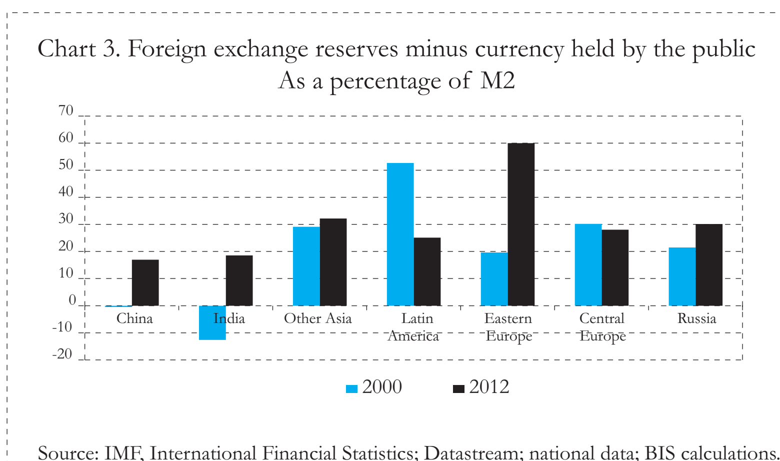
Assets	Liabilities
Net foreign assets	Monetary liabilities
Net domestic assets	• Currency
	• Bank reserves
	Non-monetary liabilities
	• Central bank securities
	• Other
	Equity capital

In theory, sterilised intervention can facilitate the achievement of several objectives. First, assuming that domestic and foreign assets are imperfect substitutes, sterilised intervention implying substitution of assets should affect the exchange rate. An increase in the relative supply of domestic bonds vis-à-vis foreign bonds as a result of resistance to intervention implies a weakening of the exchange rate, while a reduction in the relative supply of domestic assets leads to a strengthening. Second, to the extent that sterilised intervention insulates domestic liquidity conditions from FX operations, the short-term interest rate is unchanged. This helps the monetary authorityto maintain its focus on inflation control. Third, because sterilised intervention leads to changesin FX reserves, it has implications for the exposure of the financial system. In particular, a large stock of reserves can reduce countries' vulnerability to sudden capital stops.

That said, the effectiveness of sterilised intervention in insulating domestic monetary policy remains a debatable issue. Mundell (1968), for instance, argues that sterilisation policy is inconsistent because it prevents the money supply and nominal income from rising to restore equilibrium in the goods and asset markets. The constraint, according to him, is that "if the central bank sells securities at the same rate as it is buying reserves it cannot buy reserves at a rate

fast enough to keep the exchange rate from appreciating. And if the central bank buys reserves at a rate fast enough to stabilise the exchange rate, it cannot sell securities fast enough to keep the money supply constant" (p 255). In other words, central banks face a finite limit on sterilising their reserves purchases. In addition, because prolonged intervention leads to large changes in the central bank's balance sheet, in the banking system and in the private sector, it has monetary and financial sector implications (Mohanty and Turner, 2006).

Chart 3. Foreign exchange reserves minus currency held by the public
As a percentage of M2



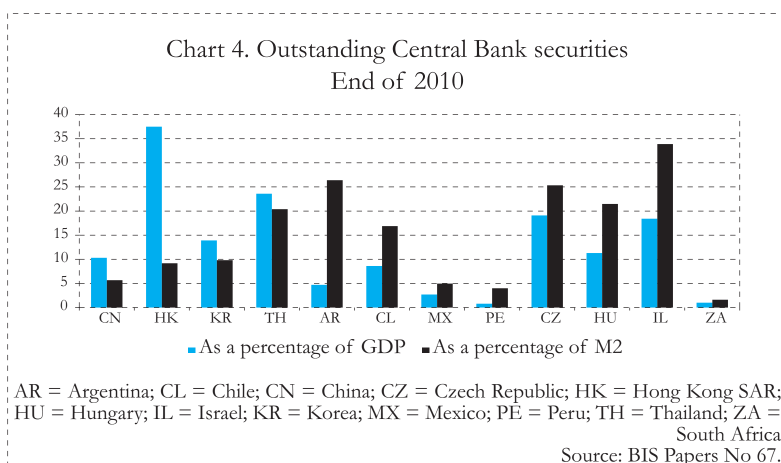
Source: IMF, International Financial Statistics; Datastream; national data; BIS calculations.

Over the past decade, intervention to resist appreciation has been much greater than seen in any previous decade. As a measure of the size of intervention, Chart 3 shows central banks' financing gaps (foreign currency reserves in excess of currency in circulation) as a percentage of M2 in 2000 and 2012 in several major EMEs. The gap has increased sharply in China, India and Russia, as well as in a number of countries in Eastern Europe, and has remained quite high in other Asian as well as Central European countries. When interventions in the FX markets are small, or where net positions tend to reverse quickly, preserving the stance of monetary policy through sterilised operations will be comparatively easy. But as intervention becomes larger, or goes on longer in one direction, the conflict between monetary and exchange rate objectives become progressively harder to resolve.

One reason is that intervention becomes difficult to sterilise because of the rising fiscal costs of holding reserves. Such intervention is potentially inflationary when governments run large deficits. Estimates of carrying costs (the difference between domestic and foreign interest rates multiplied by the stock of reserves in domestic currency) vary depending on the state of the business cycle. Reckoned at historical interest rates (average for the 10 years up to the recent financial crisis), some estimates show that carrying costshave been between 1 and 2% of GDP in many EMEs.[2] These costs are much larger if the relevant opportunity cost is the underlying return on domestic investment rather than short-to medium-term interest rates.

Second, the effectiveness of sterilised intervention also depends on the use of instruments to drain excess liquidity. Because large-scale intervention typically raises banks' underlying liquidity positions, it can most effectively be sterilised by selling long-term bonds. The assumption is that banks sell these bonds to the non-bank sector, which then reduces its deposits in the banking system. In the equilibrium, the non-bank sector increases its holding of government bonds and lowers its holding of cash balances, leaving the stock of monetary assets unaltered. By contrast, when intervention is sterilised by issuing short-term government or central bank securities – mainly to banks – the monetary effects of such sterilisation are not completely neutralised. This is because banks simply replace excess cash reserves with another highly liquid asset, namely, short-term bonds.

Chart 4. Outstanding Central Bank securities
End of 2010



AR = Argentina; CL = Chile; CN = China; CZ = Czech Republic; HK = Hong Kong SAR; HU = Hungary; IL = Israel; KR = Korea; MX = Mexico; PE = Peru; TH = Thailand; ZA = South Africa

Source: BIS Papers No 67.

[2] See Mohanty and Turner (2006) for details.

Chart 4 shows, as at end-2010, outstanding securities issued by EM central banks for the purpose of sterilising FX reserves purchases as well as for other standard monetary policy operations. Not only are these securities sizable in relation to GDP and monetary aggregates, but also their average maturity tends to be very short – in most cases under one year. Banks are likely to hold most of these securities.[3]

The fact that short-term government debt is expansionary is well recognised in the literature (BIS (2012). Tobin (1963) provided a framework to study the effects of debt maturity from a monetary policy perspective. In his view, banks consider short-term government debt instruments to be close substitutes for excess reserves because they are subject to little capital loss and can be easily sold to finance new lending. In addition, to the extent that liquid assets provide an easy way for investors to leverage up on their balance sheets, short-term securities have implications for aggregate risk exposure in the economy.

Finally, sterilised intervention can itself increase the risk to financial stability. While building a war chest of FX reserves and limiting exchange rate volatility mitigate risk exposure to external financial shocks, such intervention may accentuate other imbalances. For instance, incomplete sterilisation can lead to rapid growth in bank credit and excessive investment in sectors such as property markets. Another possible impact is that resistance to currency appreciation may increase expectations of future appreciation, leading to more short-term capital inflows and overvalued stock markets. This risk rises when investors believe that intervention is ineffective in preventing long-term appreciation.

More generally, interventions to restrict the flexibility of the exchange rate can reduce the efficacy of macroeconomic and monetary policy. There is a risk that exchange rate policy may send wrong signals about monetary policy (Mohanty and Turner, (2005)). For instance, intervention to resist appreciation may confuse

[3] What matters as far as the monetary effects of government debt are concerned is the size and the maturity of public holding of consolidated public sector liabilities (issued both by the government and central bank net of intra-government holdings). Estimates presented by Filardo, Mohanty and Moreno (2012) show that at the end of 2011 the sum of the monetary base and the outstanding short-term debt securities (less than one year) was 30-50% of the consolidated liabilities of the central bank and the government in many EMEs.

the market when the central bank is raising interest rates to fight inflationary pressures. There is a danger that the exchange rate policy will dominate monetary policy. Turman (2003) points out another problem, which he calls "distraction risk". Authorities may postpone fundamental adjustments, hoping that intervention will succeed in stabilising the economy. However, delays in tightening monetary and exchange rate policies not only accentuate macroeconomic and financial imbalances but also require larger subsequent adjustments.

3. THE ROLE OF MACRO-PRUDENTIAL TOOLS

Another instrument that has been used extensively during the recent capital flow episode is macro-prudential regulation. Two aspects of macro-prudential policies have received much attention (CGFS, 2010; Turner, 2012). First, macro-prudential tools can help to reduce the "pro-cyclical"bias of the financial system (the tendency of the financial system to amplify macroeconomic or global financial shocks). By reducing the feedback effects of capital flows on asset prices, as well as banks' risk assessments and the resulting "herding" behaviour, these measures can lower the sensitivity of credit growth to changes in financing conditions. Second, macro-prudential measures can also help reduce the inter-connectedness of financial systems (due to common exposures and leverages) that tends to increase during capital flow episodes. Both of these approaches foster conditions for a stable financial system.

Macro-prudential tools can be designed to address different aspects of the financial system's vulnerability to financial shocks (CGFS, (2012)). For instance, the capital-based tools require banks to build enough buffers during times of rising capital inflows to withstand losses when the inflows reverse. This implies measures such as counter-cyclical capital buffers (relating banks' capital requirements to business cycles), dynamic provisioning (linking capital levels to bank-specific credit growth) and sector-specific capital requirements (linking capital to imbalances in specific sectors).

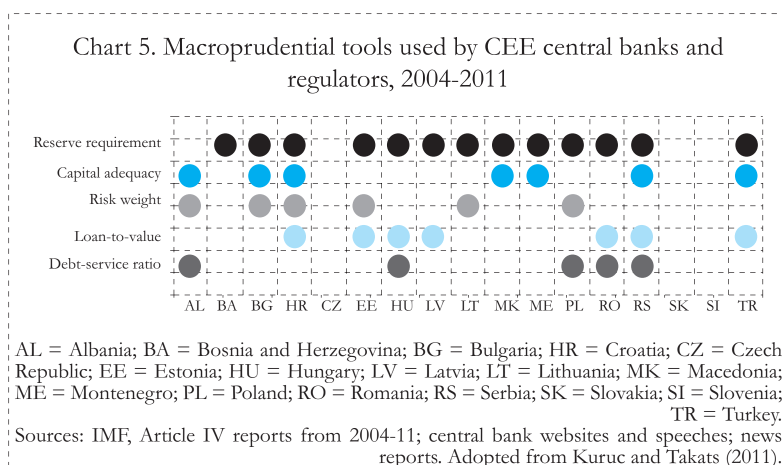
A second set of measures comprises the so called liquidity-based instruments that help to reduce the vulnerability of financial

institutions to sudden changes in liquidity conditions. These include counter-cyclical liquidity requirements, including liquid asset ratio, loan-to-deposit ratio requirements in the banking system, and various margin requirements. Liquidity-based tools address the risk of contagion in the financial system spreading because of the illiquidity of a particular financial institution or market.

A third set of macro-prudential tools involves asset-based measures that directly affect the borrowing constraints of households and firms, and thus the availability of credit in the economy. These include loan-to-value ratios and debt-to-income ratios, which contribute to regulating debt accumulation in the private sector. By reducing overall leverage and the probability of default in the economy, asset-based measures can help limit the amplitude of the credit cycle during major episodes of capital flows, and enhance the resilience of the financial system.

A recent survey by the Committee on the Global Financial System (2010) showed that the use of macro-prudential instruments has expanded rapidly in EMEs over the past decade. Many EMEs use asset-based and liquidity-based measures to safeguard the financial system against adverse financial shocks. In an effort to reduce the accumulation of exchange rate risk, a number of countries have also implemented regulations to limit open currency positions or derivatives transactions by financial institutions. Chart 5 provides

Chart 5. Macroprudential tools used by CEE central banks and regulators, 2004-2011



AL = Albania; BA = Bosnia and Herzegovina; BG = Bulgaria; HR = Croatia; CZ = Czech Republic; EE = Estonia; HU = Hungary; LV = Latvia; LT = Lithuania; MK = Macedonia; ME = Montenegro; PL = Poland; RO = Romania; RS = Serbia; SK = Slovakia; SI = Slovenia; TR = Turkey.
Sources: IMF, Article IV reports from 2004-11; central bank websites and speeches; news reports. Adopted from Kuruc and Takats (2011).

examples of macro-prudential measures in Central and Eastern Europe. As the chart makes clear, many countries in the region use macro-prudential tools for risk management, and almost all countries use reserve requirements as a monetary policy tool. Indeed, CEE countries have pioneered the implementation of several macro-prudential tools.

Can macro-prudential policy be an answer to policy inconsistency problems arising from multiple objectives? A view has emerged over the past five years that macro-prudential policy can contribute to macroeconomic management. Because they have a moderating influence on credit cycles, macro-prudential controls can supplement traditional interest rate policy in stabilising inflation. For instance, during a domestic boom, loan-to-value ratios can be tightened to reinforce the impact of higher interest rates. In fixed exchange rate regimes (such as Hong Kong's) macro-prudential policies can effectively replace monetary policy as the instrument of macroeconomic control.

There is also wide agreement among economists and policymakers alike that macro-prudential measures can play an important role in containing risks in the financial system, and thus mitigate the traditional concerns of financial stability highlighted by the "quadrilemma" literature. Not only can a less-exposed and well-regulated financial system absorb exchange rate volatility better, but it is also less likely to need a large stock of FX reserves to defend its stability. And to the extent that macro-prudential tools can be used to manage some of the adverse side effects of FX intervention discussed in the previous section, they can make such intervention last longer.

That said, macro-prudential tools cannot resolve fundamental macroeconomic imbalances, nor does their use alter the stance of the monetary and exchange rate policies. Moreover, macro-prudential controls are less effective in controlling risks when monetary and exchange rate policies are themselves inappropriate. Turner (2012) argues that macro-prudential policies operate like automatic stabilisers – higher capital and liquidity requirements for banks increase the marginal cost of borrowing and lending, reducing

the strength of credit and asset price growth, in the same way as a higher tax rate reduces the strength of an economic upturn. Changes in macro-economic and structural policies are therefore likely to be necessary. Countries experiencing strong growth and large current account surpluses require real exchange rate appreciation to stem capital inflows. FX intervention and macro-prudential controls designed to resistan underlying adjustment are likely to intensify inflation risks. The BIS (2010), for instance, has argued that "macro-prudential measures cannot substitute for tightening monetary policy and exchange rate flexibility as means to promote orderly and sustained domestic and external adjustment".

4. CAPITAL CONTROLS

Capital controls are the classic mechanismto ensure consistency between monetary policy and exchange rate policy. The objective behind most capital controls is to create a systematic wedge between domestic and foreign interest rates, so that the monetary authority can control the interest rate more effectively without being concerned about capital flows or their effects on the exchange rate.

The attractiveness of capital controls rises as the cost of other interventions becomes prohibitively high. More often than not, measures to restrict controls have come as the last option on the menu of policy instruments. For instance, reviewing the experience during the early 1990s capital inflows, Reinhart and Reinhart (1999) observed that sterilisation policies were either abandoned or replaced by capital controls when it became evident that high domestic interest rates were attracting more capital flows.

During the early 2000s episode, many EMEs dealt with such inflows by relaxing controls on outflows. But with inflows surging, particularly in the wake of low global interest rates and quantitative easing by many industrial country central banks, the policy has increasingly shifted to controlling these inflows. Several EMEs have imposed minimum withholding period for foreign investment on domestic assets (eg Argentina and Colombia), while some have used reserve requirement or taxes on inflows. In 2011 Brazil introduced

taxes on financial operations by foreigners, which was abolished in mid-2013 as the inflows reversed following greater uncertainty about future interest rates in industrial countries.

It is clear that capital controls work only when there are no leakages in their implementation. The general evidence is that selective controls are less effective in restricting capital inflows in countries that have already dismantled comprehensive capital controls, although they may be somewhat more effective in changing the composition and maturity of inflows (Ostry et al,(2010)). In addition, capital controls come at a price, given their adverse long term effects on investment and growth.

5. CONCLUSION

In conclusion, monetary policy challenges in small open economies have been complicated by large capital inflows, particularly given exceptionally low interest rates in advanced economies since 2008. In most EMEs, the exchange rate is a crucial asset price for monetary and financial stability. Although some of the concerns about a floating exchange rate appear to be easing with significant improvement in inflation and balance sheet conditions in EMEs, worries about exchange rate volatility have persisted or even increased. The classic problem of policy inconsistency remains unresolved.

A key issue is how far additional policy instruments can help ensure consistency between exchange rate and monetary policy objectives. In principle, sterilised foreign exchange intervention should help, although its effectiveness depends on how such sterilisation is achieved in practice. Using short-term government or central bank paper to sterilise large reserves purchases is likely to be less effective in controlling monetary conditions than using long-term bonds. It raises the risk of incomplete sterilisation and potentially higher future inflation.

Among other policy instruments, macro-prudential tools have been a useful complement to foreign exchange intervention in reducing some of the financial stability challenges stemming from

capital flows. But these instruments are unlikely to resolve the problems of easy monetary policy or an undervalued exchange rate. In this context, the greater use of capital controls by countries to maintain monetary and exchange rate policy consistency is hardly surprising. In a globalised world, the inevitable exchange rate and interest rate adjustment cannot be avoided.

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PANEL III:

GOVERNORS' PANEL "POLICY COORDINATION IN THE FACE OF CURRENT CRISIS"

CONTRIBUTION BY MR. ARDIAN FULLANI, GOVERNOR OF THE BANK OF ALBANIA

CENTRAL BANK PROSPECT

For decades, central banks have been viewed as independent institutions dedicated to price stability. Having served for a long time in the banking system and the central bank, I recall, as I am sure most of you do, those days when the influence of the interventions, for example, from the Bundesbank and the Fed during '80s and Bank of New Zealand during '90s had on the importance of controlling inflation.

The recent financial crisis, however, has prompted discussions about the central bank's role in delivering financial stability. In the newly-created reality, things are happening in the mega form and the resulting outcome is different from the one that used to be. The mandate of the central bank should be clearly defined and may not be changed for the mere reason that a mega crisis has risen from problems in the system, in the political and economic setting. We all know this crisis was conceived twenty or thirty years ago and the mandate of the central bank may not be changed because something needs to be corrected in the broader scale.

ROLE AND MANDATE

Giving central banks greater authority on financial stability or

them assuming this responsibility is subject to ongoing discussion. The more powerful the institutions, the greater their control is. On the other hand, if central banks have more than one mandate, can they retain the independence they need to deliver price stability? This question needs to be addressed accordingly.

Moreover, the central bank is not a solitary, independent and stand-alone star and though it cannot solve all the problems, it is a very important, accountable, and transparent institution. As such, the risk of its control is hedged very easily. Then it may be said that the role of the central bank has not changed, but rather the conditions and the situation have changed. The role of the central bank remains the same one, that is, price stability. We are not putting something strange like financial stability because as Jacques de Larosière and Paul Volcker were saying twenty years ago, the mandate of central banks, that is financial stability, is natural because they are lenders of last resort first and responsible for the payments system. So it comes naturally and they are naturally a part of price stability and financial stability.

In 2005, the Bank of Albania undertook a number of reforms and changes. Though unaware of the coming crisis, we were very well aware that we wanted to have a better balance between monetary policy, price stability, and financial stability in Albania. We put a lot of efforts on financial stability to have in place the credit information bureau, amended the law on the banking system and reorganised the supervision process. A lot of discussion took place at that time and it still goes on about the kind of the supervision system. We considered many issues and deliberated that the implementation of the IT system is indispensible for the reforms. We started with the reforms later because we wanted to implement the IT system first considering the reforms as very important in terms of monetary policy and price stability.

The conditionality to success was that many reforms had to be implemented in the context of the central bank, the Ministry of Finance, the market, the banking system, the governance, transparency and price stability. Therefore, we put a lot of efforts on price stability and our underlying motto was: “We may not know the right balance in the central bank, i.e. whether to put more efforts on

monetary policy, price stability or financial stability, but we do know that a good effort in financial stability will make monetary policy more effective". This approach proved successful and Albania was more resilient to shocks compared to other countries, when the crisis eventually came. In other words, the new mandate is the old one plus the new conditions.

With regard to the discussion for a new mandate, my view is that the central bank should focus on price stability and much has to be done in this regard. Extensive structural reforms should happen in the global scale, hence calling for more cooperation, transparency and professionalism.

CORE FUNCTIONS

Being independent, central banks may coordinate and reconcile their action and policies with other public policy authorities to contribute to the country's prosperity. Central banks are often seen as the last line of defence, lenders of last resort. In some senses, that is their traditional function, besides that of price stability.

Price stability and financial stability are two existing pillars supporting the work of the central bank. The Bank of Albania is working now on a third pillar, financial literacy, which assumes particular importance, since we want to anchor inflation expectations over the period ahead. We have to address and assure the people that we are responsible for the value of our currency. If we do it right, we have done a great job as a public institution.

On the question of how intimately supervision and regulation are bound together, or how logically they can function separately, our experience has shown that having both regulation and supervision in one place works. In my view, the justification that having both supervision and regulation functions under the roof of the central bank may jeopardise its role and function is invalid. On the contrary, it makes the work of a central bank more efficient. To illustrate this point, eight years ago - before the crisis came - a high-profile governor in the BIS said they did not do supervision by law, but even if he were bound by law to do that, he would rather play tennis.

And we recently witnessed the financial problems this country experienced.

Time calls for more supervision. I don't see any threat if both supervision and regulation functions are in the central bank, at least in our case. In countries similar to Albania, but also in a broader scale, we should not be afraid of the independent central bank.

Several years ago, the World Bank took an initiative after the Enterprise and Financial Sector Assistance Project (EFSAP), in cooperation with the IMF to assess developments in our region. After a visit to the region, proposals were advanced and strategies were set up on both regulation and supervision functions.

Some of the central banks opted to adopt them both in, others left one out of the central bank. When the crisis came, I think that the economies whose central banks sheltered both regulation and supervision under the same roof, proved more resilient to the shocks. By separating the two functions, some control of the central bank may be lost, confusion is created, and information is inefficient. Besides, the insofar experience shows that capacities to have so many institutions are limited. If you refer, for example, to some European central banks – some 10 or 15 years ago – the supervision function was separated not for technical, economic or financial reasons but only for political reasons. Taking this function away from the central bank and giving it to the Ministry of Finance means you have more direct control over the market through the Ministry of Finance.

INTER-INSTITUTIONAL COOPERATION

By nature, the cooperation between the central bank and the Ministry of Finance should be closer. The central bank is an independent institution that produces a lot of expert information and has the duty to share it. When done properly, a sound basis of understanding between the central bank and the Ministry of Finance is established as both institutions serve the state and the public. Cooperation may lead to the harmonisation of policies in real terms. On the other hand, though this may be very tricky, it can work, if you speak the same language based on the same figures.

A good relationship between the central bank and the parliament is as important as the relationship between the central bank and the government. A central bank needs to be consulted in legislative matters related to its areas of responsibility - price stability and financial stability. I think that amendments to laws and by laws need their time. You cannot change laws and regulations because something happened or something will happen. There is a lot of technical assistance available from international organisations but there is also a lot of capacity in the central bank or elsewhere in the country to consult.

Concerning laws, it is our duty to draft the law and present it to the Ministry of Finance, which then forwards the law to the Parliament for approval. A lot of people are involved in it. Sometimes these steps are not enough to have it through. There have been cases when the central bank advanced a law and the way the law was passed in Parliament created a lot of problems.

I will show you an example to illustrate my point. In 2002, we were imposed by the World Bank and the IMF, mostly by the former, to pass the law on deposit insurance. At that time I was working for a private bank and served as the Head of the Banks Association. The commercial banks were not ready and opposed the fast approval and implementation of the law, given the uncertainties that might arise from public misunderstanding of this sudden measure, but the central bank insisted to pass it. Within nine days after the hasty approval, the banking system quickly lost 220 million euros because of deposit runs, for the simple reason that the public felt ambivalent about the deposit insurance.

Therefore, in addition to the central bank, the Ministry of Finance and the Parliament, the market and the public behind them are important stakeholders in this process. When a law is drafted you have to consider all the stakeholders in place and study the issues thoroughly. You have to be there for a long time and see all the prerogatives and things behind the law. Coordination, hard work, and professionalism should be highly appreciated. As our countries are evolving from transition towards emerging markets, stronger support is needed from institutions like the European Council and

the EU, to bring the best experiences so that we do not have to try to reinvent the wheel.

On a different aspect, when deleveraging decision of EBA-s exerted pressures (liquidity,..) on bank lending in Albania, we tried in vain to determine which institution in the EU was responsible for what. We shuttled for about a year. First we met with the national central banks and they redirected us to EBA. Then we went to the regulator and the regulator sent us back to the central bank. But the bank raised its shoulders. In the meantime, deleveraging was very strong and we were completely in the dark. All these institutions were passing the responsibility from one institution to the other and there was no decision-making. It's also a matter of responsibility, clarity, information and efficiency.

REFORMS AND RESILIENCE

There is a significant effort to try to put in place resolution, the mechanisms that will permit large and complex institutions to fail without risking the financial system. In many countries the question of "too big to fail" is being addressed, but I think the issue is broader. Countries like ours are vulnerable to risks. Though the financial system has improved a lot, it is still fragile. Moreover, a small and open economy will always run that risk.

The banking system in Albania has shown resilience because it had already undergone many structural reforms. When the global crisis hit us, the system was prepared to withstand. A small bank may fail and creates a big problem but the major risk that the crisis posed was the bank's credibility and not their solvency or liquidity. The Lehman case shows that nobody thought that it was insolvent or illiquid; it happened and now it is gone.

Analysing the events afterwards is like analysing a body of what happened once the body is dead, but the body is passed. When a crisis happens, contagion effects can create large problems to the economy. Deposits could flow out and bank panic will spread. It is not a matter of whether a bank is big or small. Of course, you have to take care of the capital adequacy and all other ratios. The central

banks, in my opinion, do have the power and capacities to detect problems in the banking system. We have developed numerous top-down and bottom-up stress tests and results so far showed a relatively stable situation. However the case of the Herstatt Bank shows that they are not enough. Although the bank was awarded the certification as a good bank, it became insolvent in 15 days. History tells that it can happen again.

In practice, situations change extremely rapidly. Some would say there is no such thing as an illiquid bank, meaning that any illiquid bank will soon be insolvent. The fine distinction between a liquidity problem and a solvency problem may vanish in times of crisis. We have to be prepared and design resolution plans.

A lot of discussion is taking place around the globe about which money to use to mitigate the crisis, but there are mechanisms and resolutions in place that show how it could function. Certain international organisations could work as automatic stabilisers, but they are not doing it. This is the core issue. There is a lot of talk, but no actions yet. Should something happen in our countries, I am afraid money will not be easily available, and we would have to fall back on our resources.

First, we need to safeguard the system by keeping the ratios high, primarily the capital adequacy ratio. In Albania, this stands at 15.6%. During the crisis, we tried to keep it up and, fortunately, the attitude of all the banks, including big banks, has been very good. During the crisis, banks brought in fresh capital from parent banks for the 15.6% level.

I think the central banks have the power, the mechanism and the expertise to do it. They should execute the mandate and demand boldly and urgently and there should be no compromise on this point. We have all the powers, either to fire the management or the board or to call another board, everything. We need to stick on the power of the central bank and ensure compliance for all the ratios we have approved.

Furthermore, in addition to technical assistance, international

organisations could help with such funds that will work automatically and specifically in this regard, should something happen.

On the other side, each country has to do the homework to be prepared for any circumstances. The management has to be prepared for running a bank, receiving it, liquidating it, and proceeding with it. The public should be also prepared and informed in advance on the potential events and outcomes of the resolution processes.

REPUTATION AND RESPONSIBILITY

Trust is a very important issue not only for central banks but also for the commercial banking. One significant issue when a central bank is responsible for supervision is the potential reputation damage that can arise when a banking crisis occurs, often seen as a failure of authorities. Reputation is about responsibility. You have to be responsible. Reputation is not earned in a minute, it takes time. However, you may lose it in a minute. And you need institutions, professionalism and consistency. You have to be consistent, steady, and firm.

Let me tell you another story. When working for a private bank, I was asked to allocate provision for loans about one third of the capital in the first quarter of the year. Bewildered, I responded that it was impossible. The Italian shareholders, who used to work with the Banca d'Italia, told me that if the central bank asked for something, that had to be done. We had to thank the central bank saying: "Very good, I didn't think about it. You thought about it, immediately". It is an important matter of culture, education and reputation. You win time.

When the central bank is vested with powers and responsibilities by the law, it has to use these powers and reputation in a timely and proper fashion. Otherwise, the central bank may think that it is buying time, but it is actually losing reputation and confidence, and practically everything.

You have to think in advance. The Bank of Albania was proposed by international institutions to expand supervision to include

insurance services, at that time. The central bank did not agree and the Albanian government was on the central bank's side having understood that the market was not so developed as to include insurance companies in the scope of supervision. In this regard, the structural reform is very important. First the structural reforms take place, the industry is upgraded to the same level, and only then it is put under the same umbrella.

CONTRIBUTION BY MR. KEMAL KOZARIĆ, GOVERNOR OF THE CENTRAL BANK OF BOSNIA AND HERZEGOVINA

- Will current economic, social and political developments have an impact on the future of central banking and in particular on what its mandate and objectives are and how policy is implemented?

The global economy, our national economies including society in general are facing turbulent times and the end of crisis is not in the foreseeable future. Along with the problems in our national economies, there is additional burden of economic distress coming from other developed countries. Obviously, such scenario has never taken place before and has never been anticipated. Our transition process is not yet completed and we face problems of low-income countries with high poverty ratio together with incomplete transition, which means there are weak institutions with limited potential to cope with crisis effects. In addition, our transition to market economies is not completed yet, meaning that our economies do not have the required flexibility for quick adjustments that are needed. There are challenges for central banks to do more than before and, in some cases, to undertake actions which were not there under their previous mandates. Hence, besides keeping the monetary and financial stability as their key goals, central banks are very often asked to find new options for resolving fiscal problems and financial needs of the whole economy. For quite a long time, central banks pursued policies, which aim at maintaining overall macroeconomic stability.

In my opinion, it has to be our primary goal in the future as well. The central banks should not be engaged in any activities that undermine their basic task, financial stability. The future development in central banking should take more focus on closer cooperation between the monetary authorities of different countries, because of global nature of crisis and spillover effects.

- Should the central bank be concerned with the entire set of current economic problems facing the country? How should its mandate be? In particular, what is the role of monetary policy in dealing with the problems and what should the role of the central bank be in fostering financial stability?

It should be definitely, as the constant monitoring of all aspects of economy is one of key tools which the central banks use in assessing and creating its policies. The central banks usually have more information than other institutions and that is why they were the first to send a warning message about the looming crisis. This was definitely the case in our country when we tried to send a warning signal about increasing public spending just before the breakout of the crisis. In Bosnia and Herzegovina, the central bank has been advocating for some time a need for much closer coordination on fiscal issues and financial stability. Eventually, we created two bodies – Fiscal Council and Financial Stability Committee, where governments and monetary authorities have been working together on these two important sets of issues. This has proved to be a very effective model during this crisis. Our bank is, in a similar manner, engaged in external debt management and statistics, where we share information and experiences and influence work in these two areas. Gradually, the mandate of central banks has been expanded, as they have become more engaged in different areas of the economy. Nonetheless, it seems that the financial stability remains the area where central banks are assuming the leading role, since other institutions either lack adequate expertise in these areas, or are not concerned with the aspect of systematic risk.

- How should conflicts between different policy areas be addressed and resolved both in the classic case of price stability and employment and in the more topical ones of financial stability and

growth, financial stability and price stability and financial stability and efficiency in the financial system and the economy more generally?

Different times bring different tasks, so the focus for central banks, just few years back, was price stability. All of a sudden, we become increasingly focused on financial stability. We need to remind ourselves that several decades ago the key focus of central bankers was employment, but some new mandates, such as ECB's do not have this word in mind. Thus, the times are changing, especially with the large volume of financial integration worldwide. Central banks in relatively small transition economies are asked to do a lot and should not ignore any of the aspects. It seems there will be more and more work done by the central banks and that there will be different monetary policies, but all having one thing in mind – providing stable macroeconomic conditions, which cannot solve old problems, but no new problems, on the other hand, can be solved without it.

CONTRIBUTION BY MR. GRIGORIY MARCHENKO, GOVERNOR, NATIONAL BANK OF THE REPUBLIC OF KAZAKHSTAN

FUTURE ROLE AND MANDATE OF CENTRAL BANKING

First of all, I would like to thank my friend Governor Fullani for inviting me here. It is my first time in Albania and I am very pleased to see that differently from other international conferences, there are still a lot of people after the lunch break because usually we lose about half of the audience and clearly it's not the case.

Addressing to the issue, I would say, you have a perfectly good example. The Governor of Chilli wants to keep it narrow because the pension system is fixed. And he, as a central bank governor, should not be involved that much. I mean, we did a similar reform in Kazakhstan in 1998. But in Europe, I mean, if you believe that you are concentrated on price stability but the solidarity system is going to be bankrupt in 10 years, there is not going to be such thing as price stability in your country after this bankruptcy happens. There are also lots of other issues, where central banks will have to be involved whether they like it or not.

We can see it in the European Union. We can also see it in the United States that politicians are simply not fulfilling their duty. And it's up to governments and central banks to compensate for it. We

all know, I mean, the book says that you can compensate with the tough or relax fiscal policy for a couple of years, but you cannot compensate for the long-term. You cannot do it for the long term. If politicians are not ready to bite the bullet, then the public and the market expect you to do more.

Basically, there are two options in this area: One option: We go back to 1970s. We have central banks back under ministry of finance and politicians spending money from the reserves, like I have seen in some countries in the region, or at least wishing to do so. Another option, which is a preferable one in my humble judgement, is not to enhance the responsibilities of central banks, but it is to make finance ministries more like central banks.

In the 1980s, there was an agreement across the world that central banks should be made independent and I think something similar should be done in fiscal policy. We have seen that lots of problems ,now obvious in Europe, United States and Japan, were because of politicians trying to be nice before the elections and spending a lot of public money. A lot of things were funded by increasing debt through the notes and actually we all have now to pay for it. I mean, if finance ministries are made independent, either in any given country or through creating a super finance ministry in Europe, for instance, then there is no need to expand the mandate of central banks because then independent fiscal authorities would do a much better job.

COLLABORATION AND COOPERATION WITH OTHER INSTITUTIONS

This is actually very simple and it answers your little song from “My fair lady”. We appoint a deputy governor of the central bank the finance minister. It works extremely well in Kazakhstan. Our finance minister is my former deputy. We have very good personal and institutional relations. It could be done elsewhere in the world. In fact, there are at least two countries that have done it. And it works very well. I mean the opposite which they tried in Japan, Korea and a few other countries, when you appoint deputy finance minister a governor of the central bank, it never really worked.

So I think you can always hire a bunch of academics to do a study, but there is an old German saying "Sie haben 25 professoren und sie verlieren das land" that means you have 25 professors and you lose the country. But, on institution side, there are other arrangements, namely, for instance, each and every central bank would have good quality technical committee - or it would be called investment committee - and we meet every week and we discuss what should be done on the money market, what king of interventions, also if there is something on the effects, market as well.

And the ministry of finance, treasury usually have a similar committee, taking place every week at least, discussing what kind of securities they should place in the market on the government securities market of the next week. And if you plant the representatives of the central bank in the technical committee or investment committee of the Ministry of Finance and vice-versa, that works reasonably well because that bounds you to take into account what their plans are. Because there could be sometimes contradiction and we have always had the situation that the Ministry of Finance issues government securities from 1 to 10 years and we issue three, six and nine-month short-term national notes. But we don't really compete with the Ministry of Finance. So, if they are saying that they want to borrow more in any given week, we will clearly borrow less, or we wouldn't have any options of our notes.

And in that sense, I think that's the best way of doing work in institutional relationship because each and every institution would have a committee like that and the board, I mean, we have the Minister of Finance as the member of our board. But I think it's more important to have cooperation on working level.

THE ROLE OF THE PREROGATIVES OF PARLIAMENT

If the Parliament adopts some piece of legislation without consulting the central bank on financial issues, the president of the country wouldn't sign it or would impose a veto on it. In 1990s, we at the central bank or the ministry of finance were pushing some

pieces of legislation through the Parliament, which was, maybe legally, not so well constructed because we thought that substance is more important. And it wasn't good legislation; it didn't work for too long time.

On the other hand, there were attempts by our so-called civilists - experts on civil law - to push some legislation without properly consulting the central bank and they failed as well. And so I think that there is consensus now. I mean, we should find common ground. You cannot really try to push financial legislation without asking the opinion of the central bank but you cannot really hope to push something purely technical without explaining to the members of the Parliament what it's all about. In 1990s, it took us two to three months to get a law adopted. Now it's 18 to 24 months. Yes, it's more bureaucratic; yes, it's lengthy but there is more sustentative discussion in the process. And I think that the results are better.

SUPERVISION AND REGULATION: INTIMATELY BOUND TOGETHER OR LOGICALLY SEPARATED?

I see three practical points:

Point No. 1. The most important regulations to financial sector are in the law of the country and the parliament really hates it when any central bank has too much power. So there is always a big debate whether all the regulation should be in the law itself or there should be some room for the central bank. And it's being debated all the time. And the parliament usually would like to see most of it in the law itself. For instance, any regulation considering mandatory reforms of insurance abide by civil code in the law. We cannot have any separate rules.

Point No. 2. Most of the countries now have this financial stability council. It includes the minister of finance, minister of economy, and deputy head of president's administration but what's more important, it includes representatives of the financial sector. And any substantial piece of regulation is first discussed there. So when you

move to Basel III for banks, when you move to solvency tool for insurance companies, you first discuss it at this council. And you ask the banks: What is the timing? I mean, in the case of Kazakhstan, we are moving in 2013 but it was agreed 18 months ago, and there was a lot of discussion in these areas. I mean the ideas that you shouldn't hit the financial sector with some sort of regulation out of the blue. And when you discuss the spirit and the letter of the regulation with the financial sector, it would be hugely difficult for a supervisor, be it independent or part of a regulator, to do it differently, to have a different point of view because people would immediately say: Look, we have discussed it at the Financial Stability Council and that is not what we have agreed to.

Point No. 3. Somewhat differently than in the United Kingdom, but in our part of the world, by constitution, if banks and insurance companies disagree with the penalties, or they disagree with the supervision, they go to courts and they sometimes win. So there are at least three checks and balances: 1. from the parliament; 2. from the financial stability council; and 3. from the court system.

CENTRAL BANK AS LENDER OF LAST RESORT BUT NOT CAPITAL PROVIDER OF LAST RESORT

A couple of points: There was a question: What mechanism should be when you persuade the government to spend some money to recapitalise the bank? The only and appropriate mechanism is to create a stabilisation fund or future generation fund. In Kazakhstan, it is called national fund because the government or any government simply doesn't have the money to recapitalise the banks in the current budget. Because, it usually happens during the crisis, and during the crisis the revenue of the budget goes down.

Only if you have a substantial amount of money set aside for a rainy day, then you have money for the recapitalisation of banks. It's quite clear where it is coming from. And then as a central bank, you could be spared or you won't be expected to use your own reserves. On the issue of reputation, you are blamed for everything that is

happening in your country anyway. I mean, if the exchange rate is going down, you are favouring the exporters; if the exchange rate is going up, you are favouring the importers; if the exchange rate is stable for three years, you are hiding something from us. I mean, you cannot get it right. You are blamed for everything. So it's much easy to blame everything on Americans or on the FED because it's their fault anyway. And that's the only reputation risk management tactics that we could recommend.

CONTRIBUTION BY MR. GANI GËRGURI, GOVERNOR OF THE CENTRAL BANK OF THE REPUBLIC OF KOSOVO

FUTURE ROLE AND MANDATE OF CENTRAL BANKING

The question is very straightforward. On a side note, it is not good that all governors agree among each-other because then something is not OK. Referring back to the topic in question, I would just emphasise that it s not enough to simply have a central bank that is independent, professional, and competent. It is also important to have a proper overall environment, primarily meaning that other political institutions in the country should at least follow that path of development we see in central banks in most countries.

Second, with regard to the future changes: Yes, we have seen throughout the history that there have been changes in central banking but not so many. Maybe this is a good part of that and most of the central banks have managed to deliver monetary stability, which should continue to be in the future the cornerstone or the main pillar for a central bank to deliver stability. Of course, other tasks and objectives may be added as they arise during future developments. In the past, we were taught that independence means that when the governor is in the office, the minister for finance may call him and it will be assessed whether he will pick up the phone, whether he will answer or not, or whether he will implement the call

of the minister of finance. But nowadays, we can see the difference: we see most of the governors calling the ministry of finance. Thus, the question of accountability and responsibility should be viewed with a more objective sense.

COLLABORATION AND COOPERATION WITH OTHER INSTITUTIONS

We should take into consideration that there is no one-size-fits-all model for all countries. I come from a country with a completely different state of affairs. This is a call that every country should also develop institutions that will fit to their specific circumstances, because this is the only way to do your part of the homework. Otherwise, if you try to mimic other countries, you will lose the direction and we should respect this rule.

Second, I agree with Governor Fullani regarding supervision and regulation because, in fact, the definition of supervision is just to make sure whether the regulation works or not, whether it is functioning in practice or not.

Third, on the coordination with the ministry of finance, I am more in the favour of the idea that it depends on the country circumstances, to have clarity in this relationship for avoiding the introduction of cultural surprises, which can, in turn, have severe implications for the country.

TOO BIG TO FAIL

Again, I come from a country with a small, open and growing economy. With regard to the question on the too big to fail, we see this problem from our perspective in the sense that we have some foreign-owned banks that are systemically important for the stability of the financial sector. To address this problem, however, we have to first look at the monetary arrangement in the country.

In our case, due to the unilateral eurosation on our side, similarly to Montenegro, we have to put almost all efforts to prevent financial instability, rather than doing something that you see in many

countries that apply the monetary policy, where they act ex-post. If a big event happens, they have got some resources to act against the big failure of that big bank in that country.

In simpler words, our efforts are primarily directed in being proactive ex-ante, which means that supervision and regulation come as the first tool, and then the enhancement of the macro-prudential, micro-prudential and crisis management framework becomes very important to solve these problems.

BRINGING SUPERVISION INTO THE CENTRAL BANK

This is of course very important for every central bank, but I will refer back to what was said by other panellists about expanding, adding the objectives to a central bank in the future. I think that as the scope of tasks increases, so does the reputational risk vis-à-vis the central banks.

I will take the example of our central bank. We are a central bank and, in an euroised economy, we are the sole authority vis-à-vis the financial sector, in charge of licensing, regulating and supervising everything that falls under the definition of a financial institution. This is very good in terms of efficiency, ensuring prompt reaction, and financial stability. On the other hand, with regard to the reputational risk, it is quite sensitive.

Let me bring here a very trivial example. We can do very good on the banking stability but if someone, suppose, from the insurance sector is unhappy with the compensation from the car accident, the central bank may very easily end up in the headlines for allegedly failing to do its job. This brings to the conclusion that yes, for the future, we have to think carefully what we should add to the mandate of the central bank.

CONTRIBUTION BY MR. DIMITAR BOGOV, GOVERNOR OF THE NATIONAL BANK OF THE REPUBLIC OF MACEDONIA

FUTURE ROLE AND MANDATE OF CENTRAL BANKING

Financial stability naturally comes as a function of the central bank. Hence, it's nothing strange that the central bank is getting it now upon itself, and officials very often introduce this additional goal of the central bank in the law.

When talking about this, we have to know that a central bank can ensure financial stability only if it has banking supervision powers. Otherwise, it cannot be very efficient. It would be very difficult because if a central bank does not have banking supervision under its own hospice then it will be left with only one policy tool, the monetary policy. With only one policy tool, it can pursue only price stability although it can influence, to some extent, the financial stability. For example, if asset prices are going up and the central bank feels a bubble is being created, it can raise interest rates. This, however, would not be very efficient in preventing the asset price bubble. At the same time, it could damage other segments of the economy.

Therefore, it would be much more appropriate if the central bank had the power of macro-prudential tools, which would be

very efficient, if banking supervision were under the same roof. In that case, a combination of macro-prudential tools and monetary policy can be very effective. The central bank could ensure price stability and at the same time financial stability. We have to bear in mind that one does not go without the other. If we do not have financial stability, then macroeconomic stability would be in danger and vice-versa. I think it is very clever that now many central banks have set financial stability as the second goal. In many cases, banking supervision has been out of the central bank. Nowadays, the reversal process is taking place. Banking supervision is coming again under the roof of the central bank.

SUPERVISION AND REGULATION: INTIMATELY BOUND TOGETHER OR LOGICALLY SEPARATED?

It would be better if they were under the same roof. Because banking supervision means that when you control the banks, you assess the risks. If problems, some systemic problems, were observed in the banking system, who then would take the necessary measures? The supervisor should contact the regulator and discuss about it. So the supervisor will be losing time in convincing the regulator what measure is necessary to take. It's so questionable, I would say. If the central bank has banking supervision functions, it has the power to take measures that very often go through the regulation.

TOO BIG TO FAIL?

This is a very interesting question and a very hot issue these days. Actually most of our countries are facing this issue, not that we have banks that are immediately in danger but in the respect that we are active to prevent something like that from happening in the future.

I would agree that prevention is in the first place. When I say prevention, I mean that we are taking care for these foreign-owned banks to have adequate level of capital, not to fall below a certain level. We request a little bit high capital ratios. This is the buffer that we request, not only from foreign-owned banks but from all banks. It is a standard.

One of the reasons why the banks in our region did not fail during the crisis may have been because we requested substantially higher capital adequacy ratios before 2008 than in other countries. For example, for Macedonia the minimum level for every bank was 12%. For riskier ones, even 15%. In addition, we have to keep in mind that we have a riskier profile of banks than that in developed economies. Thus, if banks in Spain had capital adequacy minimum of 7-8%, it is understandable why they collapse when they get to the level of 6-7%. In our cases, our banks could sustain the level of 10-15% without major problems because they had substantial capital buffers.

And this is the solution for foreign-owned banks as well. It's true that we would have difficulties to resolve such banks. While they are systemically important for our banking systems, for their banking groups they are negligible. They can write them off without any problem, but for us, it is an issue. We are now raising our voice in dealing with these banking groups. We do not want to leave these banks in such a situation that they may be in danger. On the first sign of capital adequacy deteriorating, we act, we convince them to recapitalise. Till now we have succeeded in this regard.

Referring back to the question about too big to fail, a central bank can help as far as it is the liquidity problem. Central banks definitely can help and it is their duty to help. But when it comes to a solvency problem for the bank, the central bank alone cannot do much. The government has to step in to re-capitalise and resolve the solvency of the bank and then the central bank could join with liquidity. This is the only solution in such situations. Otherwise, if a central bank alone tries to save the bank through re-capitalisation, it exposes itself to a big danger to lose the whole capital. This approach would not be very wise because the central bank is responsible for the systemic risk in the banking sector.

CENTRAL BANK AS LENDER OF LAST RESORT BUT NOT CAPITAL PROVIDER OF LAST RESORT

Actually, it is extremely difficult to distinguish whether a bank has only a liquidity problem or a solvency problem as well. That is tricky. We are aware of this difficulty, I would say. The issue is that

we have to increase the capacities and improve the skills of the staff working on these issues. We have to develop some models that can, in a very short time, detect whether it is only a liquidity or a solvency issue as well. It is not easy. It is very difficult and that is why, in some border line cases, a central bank would have to step in together with the government. And that is why I think most of our countries have already established financial stability committees.

In our case, for example, in the statute of this financial stability committee, we have provided for such situations that the central bank and the ministry of finance are stepping in together. In such border line cases, for many of them probably, will not always be easy to differentiate whether it's liquidity or capital problem.

CONTRIBUTION BY MR. DORIN DRĂGUȚANU, GOVERNOR OF THE NATIONAL BANK OF MOLDOVA

FUTURE ROLE AND MANDATE OF CENTRAL BANKING

When things were going well, 20 or 10 years ago, no one was questioning that probably the best thing a central bank can do for the economy of a country is to ensure price stability.

I believe that price stability is actually the fundamental and only mandate of the central bank that should be retained. Of course, during a crisis, the situation may be different. There is major frustration among politicians, when they see that they cannot change things, for various reasons. When they see that they have exhausted almost all available political tools, especially fiscal and budgetary onse, they are looking for other quick and immediate solutions. And of course they notice that there is a very appealing and apparently strong tool called – the central bank. "Why not use this tool to solve our problems?" – they may think. "And why not ask scholars and academicians to write a book or several ones about the need for an additional mandate of a central bank, say ensuring full employment or maintaining a steady nominal GDP growth and after that politically enforce a new mandate? But here everybody has to be very careful. Why does there exist a common view that a central bank is a powerful and effective institution? The answer is

simple, because the central bank was left to focus on price stability and preserve its credibility.

The philosophical or academic discussions about the legal mandate or multiple mandates of the central bank may generate serious political risks for central banks. Actually, we may lose the whole focus, the whole idea of an independent central bank. In time, we may weaken the central bank to an extent that it will not be able to ensure neither price stability nor the financial stability or any other mandate. There is one saying I like, of a vice governor from a neighbouring country: "If we would compare the real life to a soccer game, everybody knows that a central bank is a goalkeeper but at the same time everybody is expecting the goalkeeper to do a lot of work, which other team-mates are supposed to do, moreover they expect it to score and score a lot, in order to win the match."

The general public should understand that regardless of the economic or political situation, sometimes there is a strong temptation to use the central bank to quickly solve certain problems. People should understand that, in fact, the central bank is the last line of defence and it is pursuing a long-term goal, which is price stability. A central bank can implement a quick solution, without impairing its fundamental mandate. Any other transitory problem should be solved by other players in the game. Of course, the pressure will persist. Of course, elected politicians will ask for more accountability from a central bank. However, I find it a very dangerous path, because you start with "more accountability" and you end up with the Minister of Finance or some Members of Parliament in your board. This would be the end of an independent monetary policy and a threat to the central bank credibility.

Therefore, I believe central bankers must be a bit more flexible in the way they communicate with the public and with state institutions. This idea was actually discussed at a central bankers' conference in Warsaw last week. The central bankers should be seen as participating in the discussion about financial stability and economic growth. They should not isolate themselves behind the price stability mandate. They should continuously explain what they can do to help solve a current problem and what they can not.

We need to participate more actively, to have more meetings with politicians, to be more transparent in the way we publish our reports and to improve the way we explain our reports to the general public. In this way, we will protect ourselves from the situation when someone in the Parliament or in another institution will say: "We do not understand what the central bank is doing. It must be more accountable. We need to have a greater control on its activities".

In my opinion, price stability must remain our main legal mandate. By keeping the inflation under control we are contributing to financial stability on long term. We are doing this anyway. It is difficult to introduce the financial stability mandate in the law. How do you measure this? How do you assess whether the central bank fulfilled its mandate? So, stick to price stability and be more transparent and more flexible, in order to protect the credibility and the unique position that the central bank has in the economy.

SUPERVISION AND REGULATION: INTIMATELY BOUND TOGETHER OR LOGICALLY SEPARATED?

What is the point to have a strong supervisor, if the regulations are weak? What is the point to talk about financial stability in the mandate of a central bank, if the stability depends on the way regulation was developed? Of course people may talk a lot about a conflict of interest, a mini-state in the state, because the central bank is both writing and implementing regulations and is supervising the banks and other financial institutions. I do not believe that we have a conflict of interest here. The central bank is a unique and special institution in a state. The banks and other financial institutions are too close to the contributors pockets. Because of that, the lawmakers are conferring special powers to the central bank, which cannot be compared to any other institution.

Personally, I do not believe in an effective co-existence of a separate regulator and a separate supervisor on a long-term basis. Good personal relationships between two heads of those institutions would help. However, if something goes wrong, precious time may be lost in the initial big argument about "who is guilty?" Was regulation poor, or supervision weak? During a crisis, we do not

have time to waste. If the central bank is not the supervisor, then there is the issue of the quality of the information available to the lender of last resort. There will be no time to collect and verify any new additional information. The central bank should have timely and reliable information in order to properly intervene in a troubled bank. And finally, the credibility of the central bank will be at stake. If it is only the supervisor, it can not hide behind the argument that the regulation was poor. If it is only the regulator, it risks leaving its credibility in the supervisor's hands. The dispersion of responsibility is actually extremely risky in the long term and may be a source of future financial instability.

TOO BIG TO FAIL?

This is an extremely interesting question. First, we have too many banks, in our small countries, which are too big to fail. It is just that the economy is small compared to the size of certain financial institutions. And of course, here we are all running some kind of risk, of uncontrollable deterioration of the situation.

The National Bank of Moldova (NBM) is the regulator and supervisor of the banking system. Knowing the strong institutional capacity of the NBM, the lawmakers decided to resolve troubled banks in an extra-judiciary process, i.e. the NBM has a resolution role as well. Taking into consideration the level of our development as a new democracy and as a young free market, any judicial process may take too long. If we had a systemic banking crisis, we would not have time to spend in Court. So the lawmakers gave us the right to liquidate any troubled bank, following clear legal requirements, but solely at our discretion. We have gone through such a process twice within the last three years. We were brought to the Constitutional Court and to the Supreme Court of Justice and we won. We have tested it and it works.

Yes, in the future, when the judicial system will work properly and corruption will be eradicated, when financial literacy will be improved and all other tools will be available, we can think of changing the current resolution framework. But for now, the NBM can implement special administration and take full control of a

bank. We can sell individual assets. We can conduct purchase and assumption transactions. We can sell either parts of a bank or the whole bank.

I discussed with some international experts and they actually told me that by having these rights, the central bank puts itself at major risk. An expert told me "Dorin, you are the mother and father of the banking sector. You can do whatever you want. You can open banks, close them, split them, merge them, and things like that". This is a lot of power, but this is also a lot of risk, financial and reputational risks. Indeed, as governor, I feel a little bit uncomfortable because we have seen in the past that when the bank has too much power, part of the society becomes nervous and attracts unnecessary political pressure on the central bank. However, for the moment this is the only way we can efficiently resolve a bank. We are still too far from the U.S. or other developed countries models. The laws are not working as quickly as they should, in order to resolve a troubled bank over the weekend. So, for the time being, the NBM should have the resolution role as well.

CONTRIBUTION BY PHD RADOJE ŽUGIĆ, GOVERNOR OF THE CENTRAL BANK OF MONTENEGRO

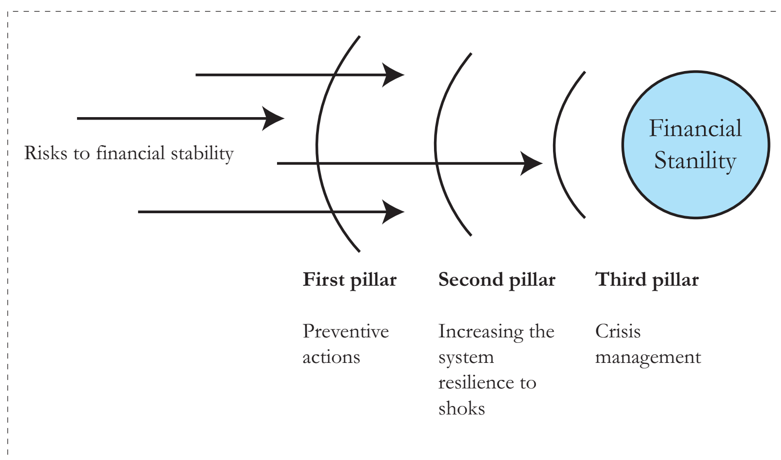
I CHALLENGES OF MONETARY POLICY IN A CRISIS

The financial crisis that set many complex challenges to monetary authorities put the issue of financial stability maintenance in long-term into the focus of attention of almost all central banks.

The primary objective of the Central Bank of Montenegro (CBCG), as one of few banks that legally prescribed this as their mission, is the maintaining of financial stability. The CBCG works proactively on minimizing weaknesses that have led to excessive risk-taking, accumulation and improper managing of (all) risks in the banking system in the previous period, with the long-term objective of fostering and maintaining a "sound" core of the financial system, that is, the banking sector.

Therefore, the approach of the CBCG as regards maintaining financial stability may be described as a policy involving three lines of defence. The first one is prevention. This phase means not only monitoring and meeting statutory parameters, but primarily the analysis of tendencies that may point to "negative" development of an event. The second line refers to increasing the system resilience to shocks through the strengthening of administrative capacities and

standardisation of legislation. The third one is the most expensive and it means management in a system already displaying crisis elements. All three dimensions are equally important, but we believe that the first one is the most important because the sooner the problem is recognised, the fewer problems are created to be managed later.



Regulation primarily affects the risk level. Regulation and competition are often in the midst of conflict between interests and objectives. On one hand, a rigid and voluminous regulatory framework may act stable yet restrictive, and the latter, inter alia, to banks' lending activity, and thus to contraction in the corporate sector up to restrictive results and recession effects on the macro level. Another negative effect is a possibility that banks, in adjusting to new regulations, are trying to avoid complying with those requirements.

There are many examples of such regulations that led to unfair competition between banks and non-banking institutions, due to stricter regulation of banks.

Deregulation or a lack of regulations leads to increased risk, which, in turn, leads to increased profit. Consequently, competition grows, but only in the short term. In the long-term, inadequate risk management may aggravate not only competition, but also stability of a bank's operations. Proper balance between stability, measured

by the volume and quality of regulations, and efficiency and/or competitiveness of the banking market, measured by the price of applying such regulations, is the key challenge for the policymaker as well as for the relevant supervisor..

The dominant issue for the banking sector in the post-crisis period is a clear identification of risks, the assessment of their level and management quality, so as to avoid underestimating or overestimating their level and effects.

Thus, it may be concluded that the success of a bank is measured through quality and quantity of taking, managing and/or diminishing all risks in transactions. Finding the optimum relation between risk and profit and adequate yield rates, means long-term sound operations from a bank's point of view, while from our perspective as the supervisor, it means financial stability and uninterrupted intermediation in the economic system.

In order to respond to this task, central banks develop core principles which serve as the basis for operations of a responsible monetary institution. These are the development principles of sound market operations:

1. Building fair and open environment (the level playing field);
2. Implementing standards and sound banking practice;
3. Fostering sound competition (without cartelisation of entities in the market).

Today, we live in the time where excessive risk taking has resulted in a deep crisis, and consequently, in the need for more rigid regulation. On the other hand, more rigid regulation comes with a price. Namely, strict regulation may reduce and slow down economic growth. Slowing down growth in longer term may have stronger negative effects than big financial crises occurring over relatively wide time spans. Obviously, a proper balance between these two objectives is needed in order to release economic growth potentials.

II REGULATORY FRAMEWORK AND BANKING SYSTEM DEVELOPMENT IN MONTENEGRO

The banking system in Montenegro went through three different stages of development. The first stage covered the period until 2006 and it indicated stable economic conditions and market expansion. The second stage covered the period from 2006 until the last quarter of 2008 and it was the period of credit boom. This stage was characterised by extremely high lending activity, loose supervisory practice with regard to risk taking, intensified market competition, and a high inflow of international liquidity. The third stage covers the period of the Global economic crisis emergence from the last quarter of 2008 until present. In this period, the banking sector shared the fate of crisis adjustments and crisis impact with the remainder national, but also a wider global, economy. This stage was characterised by credit contraction, deterioration of asset quality, loan portfolio in particular, and declined banks' risk appetite.

Strengths and weaknesses of our system have been discovered in these stages. This actually pointed to the ratio between risk taking and the banking system competitiveness. Strong market expansion in the pre-crisis period, accompanied by high risk appetite, has led to the crisis which even today jeopardises competitiveness and, ultimately, the stability of operations.

What are the results of the market competition that has not sufficiently taken into account the risks, that is, what were the consequences for the Montenegrin banking sector of the inadequate risk management?

These are:

1) Assets quality and structure, measured by the share of individual classification categories, and particularly the share of NPL;
- Workout models (existing and future);
- NPL trends.
2) Fluctuation of solvency ratios and the latest stress testing;
3) Deposit interest rates with elements of unfair competition; their high level may provide short-term opportunities, yet aggravate a bank's financial position in the long-term. Lending interest

rates have identical effect, although indirectly through affecting clients' creditworthiness.

1) Effects on assets quality and structure

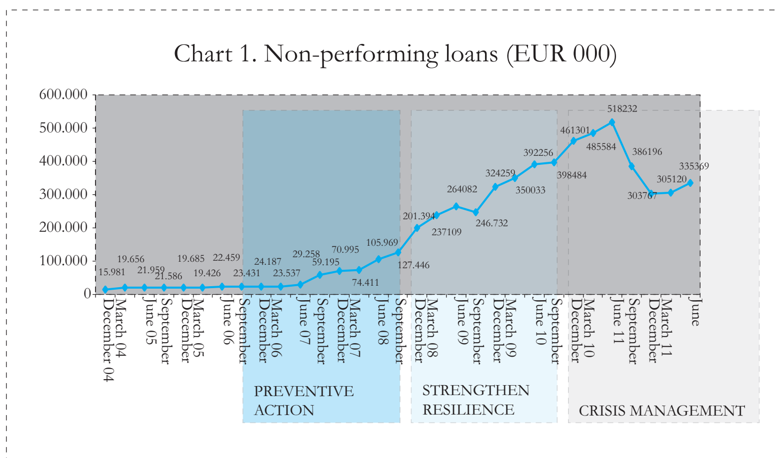


Chart 1. Non-performing loans (EUR 000)

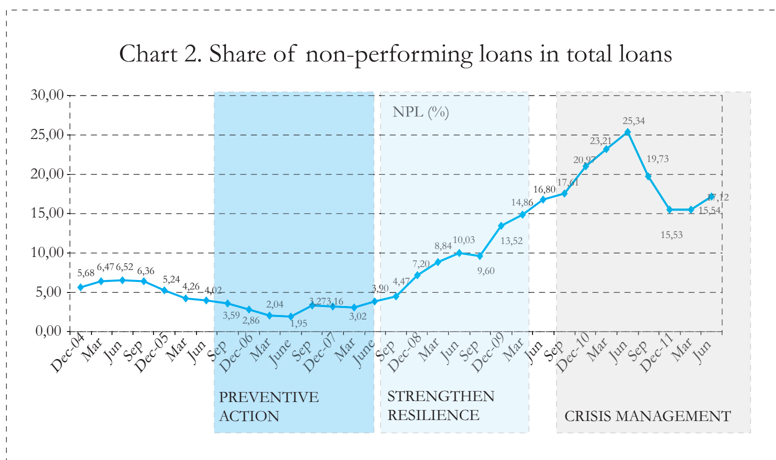
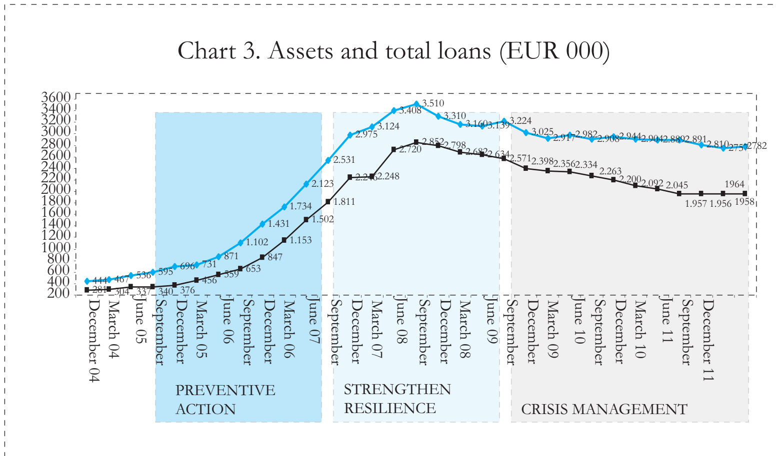


Chart 2. Share of non-performing loans in total loans

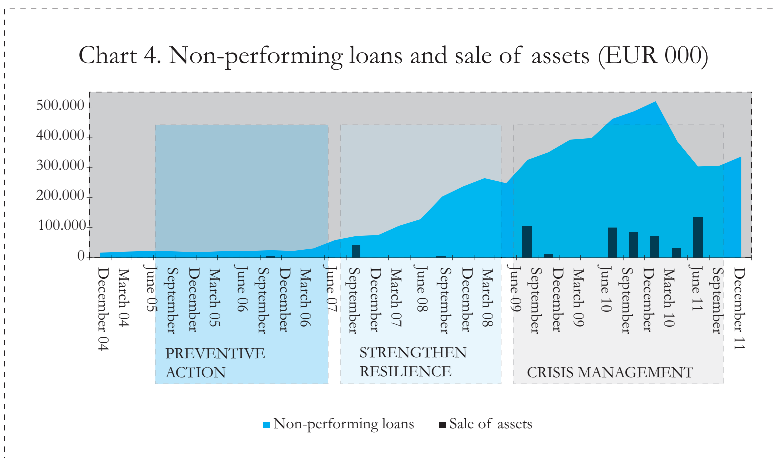
- Workout models (existing and future);

A high share of non-performing assets in total assets required proper treatment to avoid further contraction of banks' operations and jeopardizing of financial stability. Some banks – those accounting

for the highest share in the system – have found the solution in the sale of their assets.



The above shows that although banks had other possibilities to influence the level of non-performing assets (such as the collection of claims or loan restructuring), the aforesaid transfers largely contributed to its decline in the given period.



2) Fluctuation of solvency ratios and stress testing

The increased level of risks in the system reflected through an increase in the amount of weighted balance sheet assets and capital requirements for risks influencing a decrease in banks' solvency ratios. The solvency ratio reflected the performance of banks, their risk profile determined by the level of risks taken over the three development periods. The ratio fluctuated over these periods, depending on performance indicators, as well as on the applicable regulations which influenced its level and structure. It can be said that this indicator of the banking system serves as a reflection of situation in the overall macroeconomic environment. Thus, in the period of crisis intensification in this region, the solvency ratio declined from 15.64% in September 2008 to 11.89% in June 2009. By adopting temporary relaxation measures, the CBCG helped the banks overcome short-term oscillations in their operations. The banking system maintained its stability throughout the entire crisis period also owing to strong parent banks which supported their subsidiaries in Montenegro via recapitalisation and credit lines to supply long-term funds for their undisturbed operations, and owing to domestic investors. Over the past two years, the solvency ratio remained stable at around 15%, while the minimum legal requirement is 10%.

3) Effect on lending and deposit interest rates

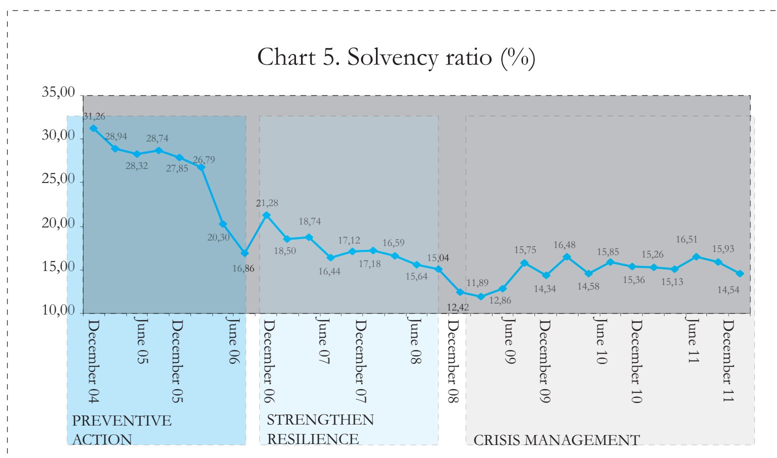


Chart 5. Solvency ratio (%)

Requirements for risk control and stability of operations have reflected on the level and changes in interest rates. Weighted average lending effective interest rates in the three-year period have continued growing. The rates on newly granted loans are, I dare say, rather high. It is obvious that market and regulatory changes have influenced the price of money in Montenegro.

Recovery of the banking sector (clearing of the balance sheets, increasing capital, establishing more adequate risk management, showing greater commitment to clients) comes with a price.

New preventive actions:

The regulatory framework in Montenegro is directed towards the establishment of long-term stability, including not only a mere monitoring of the performance indicators and risks but a wider approach to the oversight of overall trends existing in the economy and the financial sector. Therefore, the conservative approach to creating regulation, attributed to us, has a restrictive effect on risks and competitiveness; however its effect on long-term stability is positive. The question of balance reflects the quality and success of monetary and prudential policies.

Regarding the above, Paul Krugman, an eminent expert in this area, said that the lesson to be learned from the current crisis, when regulation is concerned, should be clear – everything that needs to be saved in the period of crisis, because it is of crucial significance for financial mechanisms, should be regulated in the crisis free period for the purpose of prevention of excessive risk taking. Thus, the regulation balance is achieved and the price of regulation is not as high as when it is randomly created, as required for the purpose of crisis management and recovery from its effects.

THE IMPLICATIONS OF THE CRISIS FOR CENTRAL BANKING

*Gavin Bingham**

The role of the central bank as a public policy institution has changed radically in the more than four hundred years since the first institution that now plays this role was established. The world's oldest central bank, Sveriges Riksbank, was established in 1668 by the Swedish Parliament in the wake of the collapse of a private bank whose founder, Johan Palmstruch, not only lost his banking license but was also sentenced to death.[1] At first, the Riksbank had none of the policy functions now ascribed to central banks. It did not even have the right to issue bank notes. Over time, it and analogous institutions in other countries acquired this and additional public policy functions. They assumed the role of lender of last resort in the 19th century, and took on monetary policy functions in the 20th.

We are now at another watershed in central banking. The crisis in the industrial countries that began in 2007 is changing views about the appropriate role of the institution responsible for monetary conditions in the jurisdiction where it holds sway. Before the crisis, price stability was widely seen to be the primary objective of the central bank. Now financial stability is viewed as an equally important — some would say more important — responsibility.

1 The death sentence was subsequently commuted to life-long imprisonment. Still, bankers faced much more serious sanctions for mismanagement than they do today.

This change has profound implications for the nature of the policies pursued by the central bank, for its position in the policy and for the governance of an institution that needs to be both autonomous and accountable. The challenge is to determine how to make a central bank with an explicit financial stability mandate more accountable without stripping it of the autonomy it needs to achieve its public policy objectives.

THE MODERN ORTHODOXY

Prior to the crisis, the standard view of the central bank embodied in the legislation passed in the preceding decades, had three components. The first was that the central bank should have a clear but narrow mandate. That mandate was to achieve and maintain price stability. Typically this was done using market-based tools that involved transactions affecting short-term interest rates, instead of using credit ceilings, interest rate controls and other administrative measures that had been commonplace in the preceding decades.

The second element was that the central bank should be shielded from the short-term political pressures by giving it a suitable degree of independence. If politicians can shape the policy actions of a central bank charged with controlling inflation, they will be tempted to exploit the short-term trade-off between inflation and economic growth in order to secure re-election, even if there is no such trade off in the longer run. For this reason, it became widely accepted that it is better to assign responsibility for the policies that affect inflation to an independent body, the central bank, controlled by technocratic professionals with a longer-term time horizon.

The third component was to rely on transparency about objectives, actions and the rationale for policy measures in order to make the central bank accountable for achieving its clearly and narrowly defined task. Inflation is measurable and observable. Even without an explicit inflation target, it is possible for the man in the street to determine whether the central bank is achieving its objective. The central bank could be held to account directly by the public at large without relying on its elected representatives. This re-enforced its autonomy.

Underlying this concept of central banking was a widely accepted intellectual orthodoxy about how economies function that relieved the central bank of direct responsibility for financial stability. Markets were seen to be efficient in the sense that they reflected all available public information. New private information could affect markets, but once it became publicly available, it would be reflected in publicly observable prices. While euphoria and herding could lead to bouts of exuberance, there was a natural self-correcting mechanism that came into play when market participants understood, possibly with a lag, that the underlying changes in performance did not warrant the prices prevailing in the market.

The role of the central bank in securing financial stability was indirect. By removing the inflationary component in prices, it made them a better means of conveying information about a constantly changing economic landscape. The central bank did not have superior wisdom about whether asset prices were rising on account of innovation and other fundamental factors that justified the exuberance, or whether they were rising on account of false rumour, excessive optimism and herd psychology that was leading to a bubble. For this reason, it was not sensible for it to try to prick asset price bubbles. Doing so might inadvertently hamper economic growth generated by the re-enforcing interaction of innovation, rising prices and further innovation prompted by the expectation of still higher prices. What the central bank could do, however, was to seek to prevent a sudden and substantial revision of views about the sustainability of rising asset prices from leading to a downward spiral of economic activity into recession. Many observers now think that this asymmetric bias in central bank response, commonly called the "Greenspan put", was itself one of the causes of asset bubble that preceded the crisis of 2007.

Another prevalent view, closely allied to the belief in the capacity of unfettered markets to achieve socially optimal outcomes, was that the financial system was as strong as its component parts. All that was needed to secure financial stability was for the supervisory authority to ensure that each individual financial institution was sound. The natural equilibrating forces of the market would do the rest. And the instrument of choice of the microprudential supervisory was capital.

Liquidity controls were not seen to be necessary because a solvent institution could always obtain liquidity. A corollary of this view was that supervision was a function that could effectively and usefully be performed outside of the central bank. The central bank could then focus on macroeconomic matters and the achievement of price stability.

IMPACT OF THE CRISIS ON THE PARADIGM FOR CENTRAL BANKING

The crisis has demonstrated that financial stability is an important public good that requires public policy action. It has also shown that the central bank is one of the public policy institutions that need to act in order to secure financial stability. Assuring price stability is not enough. The central bank needs to pay due regard to financial stability, both because this is of value in its own right and because, without it, the central bank will not have the markets and the means to achieve price stability.

The basic reason for the central bank's involvement is that it is the fountainhead of liquidity in the economy. It, alone, can create base money. This enables it to step into the breech when sharp swings from greed to fear threaten to cause a collapse of the inverted pyramid of credit. During the recent crisis central banks in the main industrial countries provided huge amounts of liquidity to banks, to governments and to the economy as a whole. The size of their balance sheets increased many times over. They engaged in a wide range of unconventional operations and they assumed substantially more financial risk than they typically bear.

Such operations are not to be undertaken lightly or frequently. Any expectation of such action runs the risk of creating just the asymmetric behaviour that leads to a financial bubble. It is far better to rely on effective resolution regimes that preserve essential functions performed by failing financial institutions. However, when the source of the distress is generalising fear among all creditors, the central bank is justified in stepping in and substituting for dysfunctional financial institutions. During the crisis, this is just what they did.

While providing liquidity in a crisis is a classical central banking function, there are numerous other actions that are needed to promote financial stability. The macroeconomic imbalances and financial excesses that can lead to a financial crisis need to be held in check. A suitable set of laws and rules is needed to shape the actions of those who supply and use finance and the intermediaries that stand between them. Supervisors should have the powers and resources to enforce these laws. Deposit insurance arrangements need to be designed and operated so that they reduce the risk of runs on banks without creating moral hazard. Effective resolution procedures are needed to wind down the operations of financial institutions that are not viable, without putting the financial system at risk, and money may be needed to recapitalise failing banks.

For the central bank, the questions are: What role it should play in each of these areas? Should it be given exclusive responsibility or should the responsibility be shared with other authorities? If the central bank is given a wider mandate, how can it be best held to account? The answers determine the appropriate design and governance of the institution.

BROADER MANDATES

The shift in the paradigm that is now taking place implies that the central bank will have a broader mandate. It will not only be responsible for ensuring price stability but will also need to seek to foster financial stability. For monetary policy this constitutes a subtle but important shift. Such policy will need to take into account its impact on macroeconomic imbalances that can give rise to financial stability. In some circumstances, the central bank will need to lean against the wind even when there is no immediate threat to price stability. For other potential areas of responsibility, it implies a wider range of powers in the areas of macroprudential policy, regulation and supervision, crisis management and resolution.

It is useful to consider just how wide a mandate the central bank should have because a balance has to be struck among advantages such as expertise, professionalism and the greater capacity of

extracting synergies against the disadvantages of the creation of an excessively powerful institution, diffuseness of objectives and the difficulty of holding such an institution to account. There is no single right answer, and the balance will differ from jurisdiction to jurisdiction. It is still useful to consider the options and some of the arguments. In almost all cases the question is not one of all-or-nothing responsibility, but of the extent and nature of the central bank's involvement.

MACROPRUDENTIAL POLICY

The crisis has led to the now almost universal recognition that the regulation and supervision of financial institutions will not suffice to assure financial stability. A mechanism needs to be found to conduct "macroprudential" policy. Because of its expertise and instruments, the central bank is destined to play an important role in the policy area.

There is, however, no consensus on just what "macroprudential policy" is. At one end of the spectrum, there is the view that it suffices to use prudential instruments and other administrative measures to address system wide concerns. In the middle is the view that such tools need to be accompanied with changes in the way monetary and fiscal policies are conducted. At the far end of the spectrum is the view that these two approaches need to be supplemented by significant changes in the structure and operation of the financial system.

In part because there is no consensus on what needs to be done, there is no consensus on how the responsibility for the function should be allocated across public authorities and what precise role the central bank will play. Each jurisdiction takes an approach suitable for its institutional, political and historical circumstances, including the existing allocation of tasks among the authorities and the willingness to countenance a concentration of power in a single institution. In some jurisdictions such as the United Kingdom and Malaysia, the central bank is given exclusive responsibility. In other cases such as the United States and Germany, responsibility is given to a committee consisting of high-ranking representatives of the

central bank, the finance ministry and the regulatory authorities. In some cases the committee is chaired by the finance minister, in others by the central bank governor, and still others, such as South Africa, a co-chair formula is used.

SUPERVISION AND REGULATION

The arguments for and against locating the supervision and regulation in the central bank are finely balanced. Roughly speaking half the world's jurisdictions have decided to place it in the central bank an half have opted for a separate authority. Over time the balance has shifted.

In the period when price stability was in ascendency as the sole or overriding objective of the central bank, there was a tendency to move supervision and regulation out of the central bank. This occurred in countries as disparate as China and the United Kingdom. The crisis has led to a reversal of this tendency, at least in the industrial countries. Supervision and regulation are being moved (back) into the central bank, e.g. in the United Kingdom and the EU. In the United States, the Dodd-Frank Act gives enhanced Federal Reserve's supervisory powers over systemically significant institutions.

ACCOUNTABILITY

Central banks are being made more powerful, and more powerful institutions need to be more accountable. The following techniques can help provide for greater accountability without stripping the autonomy they need to perform their tasks from the institution.

CLEAR DEFINITIONS AND CLEAR SPECIFICATION OF OBJECTIVES

In a number of instances, central banks' responsibility for financial stability is implicit or derived from other responsibilities, such as

a duty to ensure the integrity of the payment system. Although financial stability cannot be given the same quantifiable precision as price stability, it is possible to set out an explicit definition and to assign a clear objective for financial stability to the central bank. This is the first step in assuring that the central bank is accountable. No institution can be accountable if it is not clear what it is accountable for.

CLEAR ALLOCATION OF RESPONSIBILITIES

Once there is clarity about definitions and objectives, there needs to be clarity about who is responsible for actions that bear upon the objective. This involves making it clear what powers different authorities have and determining whether they are used severally or jointly. Only in this way will it be possible to identify sins of omission and commission.

TRANSPARENCY ABOUT DECISIONS AND ACTIONS

Knowing how and why decisions are made is essential for holding an institution to account. This involves creating decision-making protocols that set out procedures for bringing relevant information to bear, ensuring that the full range of reasonable options are considered and specifying who and how decisions are made, documenting the decisions, setting out the reasons for them and establishing methods to review, reverse and appeal the decisions.

In cases where there is a high degree of concentration of power or where the institutions require strong legitimacy, it may be useful to ensure that there is a "double key", so that one party proposes and another decides, or one party decides and another confirms. Clarity about decision-making implies disclosure of the decisions themselves, the procedures used to make the decisions and the reasons for them. It does not, however, imply that all this information should be made available at the time the decisions are made. This is particularly true in the area of financial stability, where real time disclosure could

have an adverse impact on financial stability. Ex-post provision of sensitive information should suffice. The knowledge that a decision will be subject to subsequent scrutiny acts as a powerful incentive to make the best possible decisions with the information available at the time.

DELEGATED MONITORING BY BOARDS AND PARLIAMENTARY COMMITTEES

Financial stability is different from price stability. There is no precise metric for determining success or failure and no way for the ultimate beneficiaries of the policy action — the citizenry at large — to judge whether the public authority responsible for financial stability has achieved its objective. For this reason transparency about decisions and actions is not enough. Some form of scrutiny through delegated monitoring is needed. Central bank boards and parliamentary committees are the most natural candidates for this job. Ensuring that they perform it can go a long way in addressing concerns about concentration of power.

Boards traditionally oversee the operation of institutions, both public and private. About half of the central banks around the world have some form of oversight board. The crisis has led the authorities to consider ways to make boards of banks more effective. The boards of central banks also need to be made more effective too. The advantage of doing so is that they can then subject the institution to strict scrutiny in a manner that does not involve direct intervention by those with short-term political interests. In this way the central bank can be given the autonomy it needs yet still be held to account. To do this, the board needs to be given an explicit mandate to exercise specific forms of oversight over the financial stability function. Two areas where board oversight would be particularly appropriate is in the use of resources, both financial and human, and the application of state-of-the-art procedures in performing its tasks. By contrast, second-guessing policy decisions or evaluating them in light of new information not available at the time of the decision is counterproductive and inappropriate.

The composition of central bank boards needs to be appropriate for such a role. The board should consist of members who are professional, impartial and free of conflicts of interest. In many cases, membership in the central bank board is honorific or a device to ensure that differing interests have at least a nominal say in the operation of the institution. Such a board is less able to exercise effective oversight than the one composed of members who have the appropriate set of skills to understand the exercise by the body of its public policy responsibilities.

Parliamentary committees have the political legitimacy to exercise oversight. The practice of ensuring that their composition spans the political spectrum introduces checks and balances into their operation. The common-sensical questions that they ask can be very effective in making senior central bankers explain their actions in a manner that the citizens can understand. However, the primary function of the legislature is to make laws, not to exercise oversight, and members of parliament often do not have the expertise or time needed to perform this function effectively. Regular review by Parliamentary committees can nonetheless be an important component of accountability mechanisms.

External reviews of the structure and operation of the central bank by impartial experts are also a way of promoting effective and efficient performance of public policy responsibilities. Such reviews should take place periodically. They can be commissioned by the board, by the government or by Parliament.

JUDICIAL REVIEW AND THE RESOLUTION CONFLICTS OF OBJECTIVES

The financial stability authorities need to be shielded from nuisance litigation by providing them with legal protection when performing their public policy. At the same time aggrieved parties need some form of recourse. Judicial review provides this with respect to the interests of individuals who are adversely affected by administrative decision or action. The arrangements need to be designed in a way so that the legitimate action of aggrieved individuals does not harm

the public interest. One way to achieve this is to provide for financial compensation to aggrieved parties, but not to unwind a public policy measure.

Finally, mechanisms need to be in place to address conflicts of objectives in a wide range of areas of public interest, economic growth, employment, price stability, financial stability, competition, consumer protection, etc. The risk of conflict will be reduced by clearly articulating mandates and responsibilities, but conflicts can still emerge. Their resolution requires political and societal consensus and cannot be foreordained.

CONCLUSIONS

Central banks face the prospect of a significant change in their position in society. Fundamental shifts in the intellectual foundations of central banking are taking place. As a result, central banks are being given greater responsibility for financial stability. This will require major changes in their governance. A wider mandate makes central banks more powerful, and more powerful institutions need to be subject to strong checks and balances. The arrangements need to be structured so that the central bank has the autonomy it needs to achieve its public policy objectives. This requires clear objectives, suitable mandates, appropriate powers, transparent decision-making processes and effective oversight.

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