# PRECONDITIONS FOR INFLATION TARGETING IN ALBANIA

Bank of Albania

Open Forum, Tirana, Albania, 1-2 December 2005

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# ABSTRACT

*INTRODUCTION*

*The monetary policy regime of inflation targeting has been successfully implemented in developed but also in developing countries. The number of countries that adopted inflation targeting has increased steadily. Since the early 1990s when New Zealand publicly claimed to implement inflation targeting, the number of countries following the same policy has reached 23, out of which 16 developing countries. Since 1992, the BoA has implemented a pure monetary targeting regime, with price stability as the final objective.*

*After the 1997 crisis which followed the collapse of pyramid schemes the BoA moved from using direct monetary policy instruments to indirect ones in an attempt to bring back inflation under control. Later, by the end of 2000, the BoA publically announced its intention to keep inflation within the interval 2-4 per cent. This target was communicated as annual inflation at the end of the calendar year, when the inflation rate usually picks up. Supported by fiscal discipline, ongoing structural arrangements and the progress made towards central bank independence, this policy paved the way for significant gains on the road to price stability.*

*Over time, harmonization with the floating exchange rate regime has increased and considerable progress has been made in the formation* *of a suitable environment for the monetary policy to function smoothly. During the last years, the confidence in the central bank has augmented and inflation expectations have slowly started to converge to the target band announced by the BoA. During 2005 inflation averaged around 2.4 per cent recording stable low rates for a prolonged period. Worries pertaining to the continuity of fiscal discipline have eased. Both fiscal and monetary policies have mutually worked to strengthen macroeconomic indicators. Financial markets have become deeper and the financial sector has become less fragile.*

*While working on a form of "implicit" inflation targeting, the BoA has taken several steps for making its communication policy more effective, expanding its information set and improving its inflation forecasting methodolgies. Besides these achievements, significant progress have been made in the area of central bank independence, pertaining to its practice.*

*Considering the recent experience as an inflation targeting lite approach, we committed ourselves in evaluating with caution the odds to be successful under a fully fledged inflation targeting regime in December 2005 .*

*At that moment, to be precisely on December 1-2, 2005 an Open Forum was organized by the central bank that marked the beginning of a medium term assessment period of defining and meeting the preconditions for an effective implementation of the IT regime. The purpose of the Open Forum was to confront the BoA experts' opinions with those of distinguished policy makers and experts from other central banks and international institutions. The opinions and feedback shared in the Open Forum have been laid down in this Manuscript, which serves as a starting point towards a potentially fully fledged IT regime that can be adopted in the future. It is on the basis of the new insights gained by the Open Forum that we have continued our work in the central bank on IT this year.*

## *2. EXECUTIVE SUMMARY OF THE MANUSCRIPT*

*The Manuscript describes to a certain extent the main elements of the desired policy and provides a broad picture of the necessary preconditions for the full implementation of the IT regime.*

*The Manuscript served a double purpose. During the Open Forum, it helped us focus our discussion on the most sensitive areas of the*

*Albanian experience. For this purpose, the Manuscript was divided in three chapters; each of them dealing with a defined set of IT related issues. The first chapter provides an analysis of external factors that are of concern for the change of the policy regime, from the development of financial markets to the relations of the BoA with other institutions. The second chapter puts forward our proposals for the technical arrangements of the IT, such as the form of our inflation target, the nature of our inflation forecast and the general features of the technical processes inside the BoA. The third and last chapter deals with the internal arrangements within the BoA that are deemed necessary for a successful and efficient launch of IT. Among other issues, it openly discusses the case for an internal reorganization of the policy-making committees and processes. All these issues were debated with an open mindset and at a highly professional level during the two days when the Open Forum took place.*

## *CHAPTER ONE*

*From the early beginning we have been aware that a successful implementation of IT requires a broad set of measures and the sincere cooperation of other relevant "actors". Revising monetary policy, one of the main pillars of macroeconomic policy, requires a careful study of the implications for fiscal policy. For this reason, a special part of the first chapter is dedicated to the relations between the BoA and the Ministry of Finance. These issues cover two broad areas: the preconditions for launching IT and the relations between the BoA and the Ministry of Finance after launching IT.*

*The guiding principle for the first set of issues would be independence. In order to anchor inflation expectations, IT necessitates a fully independent central bank. The Manuscript makes this case, including our commitment for abolishing the existing debt monetization option in the central bank law. At the same time, we present in the Manuscript our intention to cooperate with the Ministry of Finance in the future on all the areas of economic policy, based on transparent and formal agreements. The participants broadly accepted the BoA's points of view. While emphasizing the need for a legally and practically independent central bank, they were in particular supportive of our commitment to legally end the debt monetization option.*

*The other relevant "actor" is, without any doubt, the financial system. The BoA presents in the Manuscript a program for the development* *of the financial system. This covers a broad range of topics, from the structural problems that need to be tackled for increasing competition and enhancing the efficiency and effectiveness of the financial system, to the legal and supervisory issues that have to be taken for ensuring the soundness of this system. This program is not strictly related to the IT regime; it would enhance the transmission mechanism of whichever policy regime chosen. However, it takesthe opportunity of evaluating the preconditions of IT to launch a comprehensive strategy for the financial market development. The feed-back taken from the comments at the Forum were largely positive and in line with our proposed measures. They stressed the need for well-developed financial markets for the functioning of the main channels in the monetary policy transmission mechanism.*

*This first chapter on Institutional Relations deals also with other relevant actors. Specific topics deal with BoA relations with the Parliament, with the public, with the press, with other governmental agencies and international institutions. The proposed features of the future relations are modeled to the best practices witnessed in the world, along with a flavour of Albanian experience. All in all, the consensus of the discussants seems to be that the proposed outlines represent a good starting point for building our future relations.*

## *CHAPTER TWO*

*The second chapter of the Manuscript lays down the structure of monetary policy in terms of quantifiable objectives, the monetary policy conduct, the forecasting procedures and other relevant issues under a regime that holds price stability as on overruling objective against other potential indicators. One crucial requirement under this regime is again the abolishment of the monetizing of the fiscal deficit. In view of its main objective of achieving a certain inflation target under IT, the central bank should not be forced to provide its cooperation to excessive fiscal spending. In addition, the IT regime supports the maintenance of the flexible exchange rate regime. A floating regime provides Albania a smoother adjustment to economic shocks than a fixed exchange rate regime. Experience has shown that the transparency and credibility of the monetary policy regime in anchoring expectations tends to enhance the efficiency with which a flexible exchange rate operates in absorbing macroeconomic shocks. In line with that, panelists have encouraged the absence of any objective for the level of exchange rate, implying a flexible regime subject to macroeconomic fundamentals.*

*Taking a detailed look, the proposed framework maintains that the objective of price stability will be fulfilled when the inflation rate remains close to 3 percent with a tolerance interval of +/-1 per cent. While quantitative definition of price stability remains the same as in the current regime, the framework proposes a further extension of the zone for policy purposes. This extension has been seen by our discussants as not contributing any added value to the current definition. Also, the IT framework proposes the measurement of inflation under IT modified as an annual percentage change in the CPI at a quarterly basis. Important feedback regarding the measurement of inflation concerns the monthly figures as they provide valuable feedback from markets. Any breach of the target in a particular month should not be seen as a threat to general price stability.*

*The proposed IT framework further suggests a forward-looking approach to policy decision making and towards inflation. As a main characteristic of the IT regime, the Manuscript assumes that the main policy instrument is the base interest rate with an aim at influencing future inflation, the latter to be forecasted by the BoA. Feedback has been in line with the forward looking approach, implying further that policy decision making should take place after considering the whole picture of current and future macroeconomic developments and experts' views rather than looking technically at inflation forecasts. Also, it implies that over time the forward looking approach should be extended to longer than one year. A further increase in transparency and enhancement of communication channels with the public is suggested in this framework, that was supported by participants.*

*In general, the proposed IT framework tends to increase the transparency and the credibility that the central bank enjoys towards financial markets and economic agents promoting price stability. As such it can further enhance macroeconomic stability that is required for the achievement of sustainable economic growth for Albania in the medium to long term.*

## *CHAPTER THREE*

*With a special view on IT, but not limited to that, there seems to be a strong need to strengthen the decision making rules as a premise to conduct efficient and effective policies. Despite the vast available literature on this topic, making arrangements for decision making in practice is a difficult task. This is especially so when one has to consider the political, legal, educational and cultural setting. These are all matters we tried to input* *in the third chapter, which tempts to design what we think might not be ideal though a plausible decision making frame. As we speak, BoA is governed by one Supervisory Board, which is by law granted all the rights to set targets, to implement policies, to supervise banking system and all other managerial decisions related to a central bank. In this respect, Bank of Albania favorably enjoys full autonomy. We propose introducing a new decision making body which will be responsible for setting policy instruments – interest rates, liquidity arrangements and foreign exchange operations, for achieving the monetary policy targets established by Supervisory Council. We believe that this design will strengthen the accountability structure within the BoA and will add to the efficiency and effectiveness of monetary policy. Why so, if everything has worked fine so far? For one thing, with the improvements in the financial markets and economic conditions of the country, when there is an increasing awareness of the role of the central bank and accordingly an increasing demand for accountability, implementing monetary policy becomes a time consuming process and highly responsible. It is a strategy that requires a high degree of expertise, abroad perspective and independent thinking. By creating a special committee, which we refer to as Monetary Policy Committee also for simplicity of comparing it with its homologues, the attention will be brought to monetary policy inducing more public confidence in monetary policy decisions.*

*At the Open Forum we had a lot of sound discussions for the sensitivity of the issues it covered. With no doubt, all the discussants agree that establishment of an MPC is necessary to increase the quality of monetary policy decisions and to boost BoA credibility. With a particular focus on IT, MPC is in better position to respond to the forecasting capabilities, technical skills, data collection and inflation analysis that the regime demands. MPC members will have to work closely with the staff and discuss technical issues, as they meet regularly to decide on interest rates and other operational issues. A lot of arguments were given on the composition of the MPC and the qualifications of the MPC. A general assent is to have members of MPC internals, who have a deep understanding of monetary policy issues at BoA, as well as externals that are able to bring an experience judgment from other domains. In drafting their qualification list, priority is given to avoidance of conflict of interest and dismissal grounds, hence ensuring independence of the MPC. Apart from the general guidelines, our proposal includes also country specifics, i.e. Albania is a relatively small developing country with a limited pool people that possess the skills to meet all qualifications needed for prudent and sound monetary policy decision making..*

*Another advantage of having a MPC is that it adds to transparency standards. Members of MPC are encouraged to talk frequently to the media. They should inspire public confidence in what they do and decisions they take. Minutes of the meeting are proposed to be published within a small delay for transparency purposes. Separate votes will though not soon be published, given the fragile receptive environment from the public. In any case, transcripts of meetings and discussions will be recorded so that, as mentioned by few panelists, there is a perception that responsibility is shared and that there is no dominance from particular members.*

*As I tackle to explain the role of the MPC in the monetary policy decision making framework, I would certainly highlight the role of the Supervisory Board in it. It is not a parallel system, but rather a check-and-balance one. The Supervisory Council remains the governing body as stipulated by the law, and it sets policies and demands explanations from the MPC for the implementation of its policies. Hypothetically being the chairman of MPC as well as I am currently chairman of the Supervisory Council, I will be held responsible as governor of the BoA to speak with "one voice" in front of the Parliament and the public.*

*The outline of changes I just mentioned is drafted in consideration of the available room for maneuver given the legal framework. Substantial amendments to the BoA law and Constitution are required and the success of it will depend on broad support not only from legislative bodies, but also from the whole community.*

## *3. THE FUTURE AVENUE FOR BANK OF ALBANIA*

*The BoA will launch inflation targeting when conditions are ready. Some necessary conditions are to be fulfilled, where some were mentioned here before. I am referring mainly to the required amendments in the central bank law on the financing of the government deficit, the strict requirements of all elements of a adequate monetary decision making process, and the institution building of the central bank.*

*The fulfillment of these requirements will depend on progress made by ourselves but also on the support and aid provided by the politicians, economic agents and public at large. The process of passing an amended central bank law will take some time. Also, the institution building will take some time. We need to invest in our human capital, hire new employees* *with strong skills in monetary and macroeconomics and make our current staff contestable in the field of inflation targeting. These employees will be put to the test once the new monetary policy framework is being launched as it is to be communicated transparently and wisely to the Albanian public and the further outside world.*

*For now, we have in mind a trajectory of a couple of years.*

*To make significant steps for the preparation we initiated within the central bank at the beginning of 2006 a Task Force on Inflation Targeting under my guidance. This Task Force takes as a main goal to establish some major achievements concerning eight main topics for this year 2006, i.e.:*

*(1) prioritizing the preconditions for inflation targeting in a realistic time path*
*(2) improving the statistical framework, mainly on real sector statistics*
*(3) developing of a pilot inflation report*
*(4) evaluating and further developing the inflation forecasts models*
*(5) initiating a macro-economic model for Albania*
*(6) outlining the communication strategy for inflation targeting*
*(7) improving the coordination with the Ministry of Finance*
*(8) further studying and defining the legal amendments.*

*In my view these eight topics have inside the central bank priority for this year. In the Task Force we involve many experts from the different departments from the central bank in order for reaching useful synergies and making all our noses within the central bank point in the same direction that determines the direction of the new monetary strategy.*

*At the end of 2006, in December, we will take stock of our achievements at a Round Table or let us say "Mini"-Forum. With the help of the participants at this Forum we intend to draw an agenda with the main priorities for the year 2007. In this way we move surely on our future avenue concerning the monetary policy. Price stability in the short to medium term will be the objective. In this respect we contribute at the same time to the main macro-economic objectives for our country of reaching a sustainable economic growth.*

*Outside the central bank in Albania we also need to take efforts for a further development of the financial markets and other transmission channels. We cannot do this on our own. We have to establish a deeper* *constructive collaboration with other national institutions. We should elaborate with the Ministry of Finance and the Parliament on the legal issues for strengthening the central bank's independence. With the Ministry of Finance we have already many projects, such as the anti-cash, credit office, T-bills market but a topic high on our and the agenda of the Ministry of Finance's agenda should be the statistical framework. Statistics need to become timelier and need to be improved for the purposes of policies by the central bank as well as by the government. As discussed also these days, we should take all efforts in bridging the gap between the BoA and the other central banks in Europe. The central bank law served Albania at the time it was laid down. After signing of the stabilization and association agreement, we all agree that it needs amendments.*

*I am fully aware that adopting fully fledged Inflation Targeting is a process that requires hard work with several preconditions in place. It should be a smooth process. This holds in particular for a transitioning country like Albania. Our country faces different challenges and virtues compared with developed countries.*

*Then, I further keep in mind that the ultimate objective for Albania is the accession to the European Union. This implies a full membership with as a consequence, the adoption of the euro after the accession date. EU-accession will ultimately induce pegging the domestic currency to the euro (entering into ERM II), and thereafter adopting the full legal tender of the euro notes and coins. There will be an automatic adherence to the monetary policy of the European Central Bank in Frankfurt at that moment. But these projected achievements still belong to the future. Based on the currently available information with a view to EU-accession, Albania will keep its own currency and consequently an independent monetary policy for a significant number of years from now on. In this period Albania needs to conduct the most appropriate monetary policy.*

*So, our action plan at the central bank is elaborate for the years to come.*

*GOVERNOR OF BANK OF ALBANIA*

*MR. ARDIAN FULLANI*

# WELCOME SPEECH

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

*Ladies and Gentlemen,*

It is with great pleasure that I welcome you to the Open Forum "Preconditions for Inflation Targeting in Albania". I am extremely pleased and proud that I have the honor to welcome so many distinguished national and international guests.

For the Bank of Albania it is the first time to organize an event of this character and with so many distinguished guests. I am very grateful that you accepted my invitation and warmly welcome you. I look forward to hearing your comments on the proposals that the Bank of Albania will be presenting today and tomorrow. There will be ample time to hear all your comments and to exchange ideas on Albanian policies.

Our main theme in this Forum is concerned with the principal objective of the central bank. According to our central bank law the principle objective of the Bank of Albania is to achieve and maintain price stability. The regime we are going to discuss here for achieving this objective is Inflation Targeting.

Our present formal monetary policy regime is called a heterodox Monetary Targeting. But within the central bank we use even different names for it. Some call the monetary regime a “two pillar” approach as it has features of Monetary and Inflation Targeting. Often also, the current regime is already referred to as Inflation Targeting.

Under the present monetary policy regime the Bank of Albania adheres to a monetary program. Monetary policy aims at administering the money supply and interest rates with the view of achieving price stability in the short to medium term. The exchange rate is freely floating. The Bank of Albania is considering to move to a fully fledged Inflation Targeting regime. Based on the available information today, we consider this regime to be a good choice. We envisage moving smoothly to this new framework within a realistic time frame. I say here deliberately smoothly. Many steps have to be made gradually in time. Furthermore we have to analyze carefully all the new information that will become available to us.

The main reasons for adopting Inflation Targeting concern (more) transparency and (more) credibility. The central bank wants to move to a more transparent monetary policy regime with a strong anchoring of expectations over the medium term. According to the Bank of Albania, Inflation Targeting is considered to be the appropriate monetary policy regime for Albania in these respects. In our current conduct of monetary policy we follow rules but also take discretion. A regime that provides well-defined and unambiguous objectives would bring us more “constrained discretion”.

The discussions today and tomorrow will focus on the conditions that we have to meet before formally launching Inflation Targeting. Here in Albania we are aware that essential requirements have to be fulfilled for obtaining a successful IT regime. Some of these preconditions do not depend on the Bank of Albania, such as the fiscal stance. Other preconditions do not only depend on the Bank of Albania, such as structural reforms or deepening of the financial system. During these two days I hope to find out on which of the listed preconditions for Albania we share the same views, and where our views differ.

Next to this open discussion on the conditions for a successful monetary policy regime, there is another important reason for our gathering here. By means of this Forum the central bank adds to transparency and contributes to the enhancement of the cooperation within the region. I refer here to the region in a broad sense. The Bank of Albania finds good relations with neighboring countries extremely important. Coordinated efforts to meet conditions and requirements that are set internationally are paramount for Albania and the Balkan region to attain the deserved place on the European map. They will bring economic and social prosperity to the Albanian people and other people in the region.

Albania is a relatively small country and for that reason we have to remain modest. But at the same time I can honestly say that I am proud, extremely proud, that the central Bank of Albania can help in opening the way to a further and hopefully rapid convergence of Albania with Europe and other, more developed countries. Better communication lines between the Bank of Albania, regional central banks and international organizations will pave the way for a further development of commercial banks and other institutions. Ultimately a solid bridge will be built between Albania and the outside world, entailing a soundly developed financial system, a sustainable economic rate of growth and higher welfare levels for Albania.

In order to have productive discussions I wish to emphasize the open character of our meeting here. The Forum is deliberately called an Open Forum. I will appreciate any comments that can contribute to the further institutional building of the central Bank of Albania up to the highest international standards. Only a discussion free in spirit – or as we say in Albanian "i hapur" – can bring us closer to each other at the same high levels.

Now coming to the end of this speech, I wish you all some fruitful but at the same time pleasant days here in Tirana. I am sure that our representatives of the Bank of Albania will present their main views in a transparent way and I look forward to the discussion that will be started by the Panel Members.

I now give the floor to the Chairman for starting the Open Forum.

# INTRODUCTORY REMARKS FOR THE SESSION ON INSTITUTIONAL RELATIONSHIP

*By Marko Škreb, Former Governor of the Croatian National Bank*

Thank you Mr. Governor. It is indeed a true privilege and a genuine pleasure to be here in Tirana again. As I consider myself an old friend of yours and of Albania allow me to start on a private note with reminiscence of two events in the past, one ten and one five years ago. I met governor Fullani for the first time 10 years ago. Croatian National Bank organized a conference to mark 5 years of the fall of socialism in Dubrovnik. He actively participated in this event which became a tradition. Not much was known about Albania at that time, but his enthusiasm and presentation on Albania did a lot to promote Albania to the international audience that participated in this conference. It is exactly 5 years ago that I have visited Tirana for the first time. Tirana was a very different place, believe me. You could not see the main park or the banks of the Lana River due to "kiosks" (which were in fact two-floor concrete illegal buildings). Traffic was hectic and all the houses were gray and decaying. The Bank of Albania was just abolishing its main instrument of monetary policy i.e. the floor on deposit interest rate (July 2000). Savings Bank was the main collector of deposits (with 76% of total deposits at that time) and buyer of T-bills (80% of total T-bills outstanding), so it was a quasi fiscal institution at best. People spoke a lot about events in 1997, when Albania collapsed. For those of you that are not so familiar with Albanian recent history, due to pyramid schemes (Ponzi's schemes) fraud not only has the financial system of a country collapsed, but the country and its institutions collapsed as well (police, military, etc.)

For me it is absolutely amazing to see Tirana today, to see how this town has transformed itself in only five years. But not only are the colors of houses different, so is monetary policy and financial market as well. Repo and reverse repo are everyday monetary instruments, and Savings Bank privatization in 2004 is changing the landscape of the banking industry in Albania[1]. It is worth remembering that this country has a proven track record of swift and deep reforms.

But we are here today not to discuss history, or to glorify rapid changes, but to participate in a joint intellectual exercise of having a look into Albania's future, especially the monetary future. Inflation targeting (IT) is gaining popularity among more and more countries around the world[2]. As the old saying by an unknown author would have it: "My interest is in the future because I am going to spend the rest of my life there."

As the governor rightly pointed out, Albania knows where it wants to go. And this is very important. Again a saying, these time a Chinese one: "If you do not know where you are going, every way will lead you there". This is EU, but EU is, as we have heard, pretty far away (and the Euro even further). We need to focus on the optimal path between where Albania stands now and where it will end. Governor has given us the broad framework within which we should think during those two days so I will not repeat what he said.

As a chairman I have a somewhat unpopular role. This is first to explain the rules of the "game". We have three main topics, three sessions each with a different presenter from BoA and a group of panelists that will comment/give their views on the subject. Presenters from BoA will have 20 minutes followed by each panelist in the order that is indicated in the program. If there is a Pareto superior distribution of panelists that will emerge, I will be happy to oblige. Each panelist will be given up to 20 minutes as well. This will be followed by a very brief reply from the presenter. Broad discussion will start with moderators giving some common features and some features that presenter and panelists disagree. We should discuss them thoroughly. At the end each will be given time to react to direct questions etc. Moderators are responsible to steer discussion and observe the timing. This is very important as we are all familiar with the crowding out effect. Those that do not observe the timing simply crowd out either the discussion time or speakers that are scheduled later in the program. During the Open Forum I see my role closer to a low profile referee, not a player. As long as the rules of the game are observed and the fair play is predominant, I will try to remain quiet.

I think we are ready to move to our first Panel. I have to switch hat now and play the role of a moderator for our first Panel. The title of this is Institutional relationship. In the broadest term Institutions can be defined as the: "…set of formal rules – and informal conventions – that provide the framework for human interaction and shape the incentives of members of society." (North according to WEO[3] p. 126). There is no doubt that money and prices are very important for human interaction and shape incentives for all members of society. Therefore it is the utmost responsibility of the BoA as the institution to provide adequate incentives for the economy to prosper. Central banks have a very broad role to play in a society, much broader than first meets the eye.

Today there is ample evidence that good institutions are relevant for economic growth[4]. Or in other words if institutional quality goes up, income per capita could significantly increase. However, institutions in a country are a result of a complex interaction of economic and political factors (history, culture, political factors and economic structure). Institutions tend to be persistent, have a lot of inertia. Changing them is a difficult process. Significant political will is needed and measures to reduce the opportunities and incentives for groups to capture rents. For good institutions we need two groups of circumstances: economic environment which does not promote rent seeking and appropriate checks and balances in the political arena. Factors that are associated with institutional transition and higher quality of institutions are: trade openness and accountability of political institutions. Neighbors with high quality institutions (regional approach) and higher level of education promote the institutional transition. Aggregate aid does not play a role in this.

But there is one thing worth specifically pointing out. External anchors are very relevant for institutional changes. And accession to EU is a great example of a successful external anchor. The ten new members as well as rapid institutional changes in candidates demonstrate its efficiency. And this is wonderful news for Albania, its future and welfare of all its citizens. Remember, increasing the quality of institutions will have strong impact on growth.

The first panel focuses not on institutions themselves, but on the institutional relationship between the central bank and other relevant stakeholders in the IT framework in Albania. Needless to say, this panel will focus on the central bank's perspective. Credibility is gained by putting your action where your mouth is; therefore I will stop here and simply invite the first presenter from the Bank of Albania, Mr. Erald Themeli to take the floor now.

## REFERENCES

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## NOTES

[1] *For more details on the present status of the Albanian financial system see the recent FSSA (2005) on Albania.*

[2] *Stone (2003) or WEO (2005).*

[3] *WEO (2005)*

[4] *Based on WEO (2005).*

# CHAPTER 1

# INSTITUTIONAL RELATIONSHIPS

*Presented at the Open Forum by Mr. Erald Themeli, Deputy Director at the Bank of Albania*

## 1 INTRODUCTION

This chapter describes elements of the institutional relationships between the BoA and other national and international institutions or actors in the economy. The proposals, requests or requirements of the BoA when introducing IT are set out.

## 2 ROLE OF THE BOA IN THE FINANCIAL SECTOR

Besides its responsibilities for the design and implementation of monetary policy, the BoA performs regulatory and supervisory duties concerning parts of the Albanian financial system.[1] The aim of these functions is to promote the stability of the financial system as stated in the Supervisory Mission Statement. Being the supervisor is a substantial advantage for a small organization like the BoA as it can exploit the synergies between monetary policy and supervision. At the same time, appropriate confidentiality barriers need to be ensured.

The BoA has a distinct interest on the soundness and efficiency of the Albanian financial system, going beyond its legal mandate. The financial system is the first and most important actor in the transmission mechanism of the monetary policy. Thus, a sound and efficient financial system enhances the effectiveness of monetary policy. A sound and efficient financial system will also enhance the credibility of domestic institutions, being a precondition for price stability. Finally, a sound and efficient financial system might help to absorb and shorten shocks to economic activity as well as lead the integration with world markets.

With a view to IT the role of the BoA in the financial sector will be oriented towards the following:

- Developing and improving the transmission channels of monetary policy
- Increasing the confidence in the banking system
- Monitoring potential vulnerabilities and risks

The following paragraphs will deal with specific issues of the financial system that are of special importance to the monetary policy process.

## 2.1 Commercial Banks

The Albanian banking system is a relatively advanced sector of the Albanian economy with regard to financial performance and soundness, to business practices and to degree of regulation. Nevertheless, there is room for improvement in several areas. These improvements will increase the effectiveness of the banking system and enhance its financial soundness and credibility. The BoA's future work will aim at:

A sound banking system. A sound banking system is a dynamic reflection of a sound economy. The BoA will build upon it through:

- Improving the regulatory framework. The regulatory framework of the BoA will be oriented towards the protection of customers, increased competition and convergence with international standards.

- Enhancing and promoting fair competition in the banking system. Besides regulatory concerns, this will require an effective involvement of the Albanian Authority of Competition. The BoA will use its institutional leverage for promoting the independence and technical capacities of this Authority. Furthermore, it will seek a bilateral agreement with the Authority, establishing the proper share of responsibilities, the necessary procedures and flow of information.

- A consolidated banking system. The BoA aims for a banking system in which individual banks are able to cope with competitive pressures. The BoA wants consolidation to be a market outcome, so will not force anyone, but reserves the right to use its institutional capacities in promoting consolidation.

Encouraging banks towards the adoption of the best practices in governance. The Open Forum is a clear reflection of the BoA's commitment towards the adoption of best practices in central banking issues. The BoA will encourage banks to work in the same direction, providing them with technical assistance if requested, and making sure all its banking system regulations comply with their spirit. This will help the convergence of the Albanian banking system, in its entirety, to EU-standards. The BoA intends to organize an event in 2006 focusing on this issue.

Improving customer protection and transparency of the banking system. As a corollary of the first issue, the BoA will seek improvement in these fields, as they will lead ultimately to increased competition and increased credibility of the banking system.

Establishing the Credit Information Bureau. In cooperation with international donors, such as the WB, the BoA intends to establish this bureau at the earliest possible date. Initially, the bureau shall be established and run by the BoA as it will benefit from its expertise and enforcement powers in banking system issues. At a later stage, depending on the technical capabilities of the Bureau and the development of other institutional players in the system, such as the Banker's Association, the BoA will consider the future location of the Bureau.

Further developing the early warning indicators. As required by Law, the BoA publishes a semi-annual Statement on Financial System Stability. This statement seeks to give a balanced view of the development of the financial system with a specific emphasis on the potential threats to its stability. Its content will be boosted by raising its profile into a comprehensive Financial Stability Report.

The BoA will seek the cooperation and involvement of all the relevant institutional actors, interested in the promotion of the Albanian banking system. A special place in this regard is bestowed on the Albanian Bankers' Association. The BoA will try to further increase its partnership with this institution to reach convergence within and outside the country.

### 2.2 Other Financial Institutions

A well-developed financial system will complement the banking system in offering a broad range of financial intermediary services to the real sector. The BoA will cooperate with the relevant authorities towards enhancing the effectiveness of the financial system.

The BoA will seek to:

A. Increase the cooperation with other supervisory agencies of the financial system. The BoA has recently signed an agreement with the Insurance Supervisory Authority and the Securities Commission aimed at the exchange of information. It is deemed necessary for the future cooperation to include the establishment of fair competition among different segments of the financial industry, so as not to favor one branch over the other. This will entail a complete coverage of the financial system, elimination of its unregulated or under-regulated parts, a harmonization of the regulatory framework and a standardization of the supervisory practices.

B. Promote the consolidation of the supervisory agencies outside of the BoA. The BoA sees this as a necessary step to increase their effectiveness and enhance the development of the financial system, particularly taking into account the features of our financial system. Learning from the other countries' experiences, we think this should be done sooner rather than later, as the cross-sector blurring is not as developed. The merit of having a consolidated supervision for the entire financial system, whether inside or outside of the BoA, should be discussed at a later stage.

C. Increase the financial intermediation by increasing the pool of financial instruments in the economy. For this, the BoA will actively promote the introduction of longer term government securities in the market and will encourage further developments of electronic means of payment. The BoA sees the joint-program for reducing cash transactions in the economy as a good framework for discussing and developing the financial instruments and financial intermediation.

*Box 1. Financial System in Albania*

*The Albanian financial system is a relatively young entity. An increased interest in the Albanian financial system is seen during recent years, with several new banks and insurance companies entering the market. The financial system is dominated by the banking system, which holds over 90 per cent of the total financial assets in the economy. The recent privatization of the Savings Bank (the largest bank, holding over 65 percent of Lek deposits) put all the banking system on private ownership.*

*Financial intermediation: some key ratios*

| | |
|---|---|
| • Total assets of the Banking System / GDP | 57 % |
| • Broad Money / GDP | 65 % |
| • Deposits / GDP | 49 % |
| • Credit / GDP | 12 % |
| • Government securities / GDP | |

*Number of Institutions of the Financial System*

| | |
|---|---|
| • Banks and foreign bank branches | 16 |
| • Non-bank financial institutions | 7 |
| • Foreign exchange bureaus | 55 |
| • Saving and loan associations | 130 |
| • Unions and saving and loan associations | 2 |
| • Insurance companies | 10 |
| • Pension funds | 1 |
| • Brokers and dealers | |

*The Regulation of the Financial System*

- *The BoA – supervises and regulates the banking system, the foreign exchange bureaus and the credit unions.*
- *The Insurance Supervisory Authority – supervises and regulates the insurance and reinsurance agencies.*
- *The Securities Commission – supervises and regulates the capital market.*
- *The Authority of Competition – insures fair competition across the financial system (as part of its obligation towards ensuring competition across the economy).*

*Note: For a more complete overview of indicators see the FSSA from the IMF (2005)*

## 3 RELATIONSHIP OF THE BOA WITH THE PARLIAMENT

The BoA is accountable to the Parliament under the Central Bank Law. Currently the Governor and the SC-members are elected and appointed by the Parliament, upon the proposals of the Parliament, Council of Ministers and the SC itself. According to Article 2.2 in the Central Bank Law every six months the BoA shall deliver to the CoM and the Parliament of the Republic of Albania a policy statement that shall be published containing:

a) an assessment on the accomplishment and maintenance of price stability during the preceding six months and a prospective prescription for the next six months;
b) an assessment of the monetary, credit and exchange rate policy implemented by the Bank of Albania during the preceding 6 months;
c) a description of, and an explanation of the reasons for, the monetary, credit and exchange rate policies to be followed by the Bank of Albania during the next six months; and;
d) a description of the principles that the Bank of Albania proposes to follow in the adoption and execution of monetary, credit and exchange rate policy during the next two years, or such longer period of time as the Bank of Albania may decide.

A necessary requirement for starting IT is to have the support of the Parliament for launching and conducting IT. The BoA will ask the Parliament to approve all the necessary changes in the legal framework which will be detailed below.

## 4 RELATIONSHIP OF THE BOA WITH THE GOVERNMENT

The relationship between the BoA and the Government will be based on the principles of cooperation and independence. The BoA is the major financial regulator in the economy, the sole issuer of domestic currency in the economy and the entity responsible for the design and implementation of monetary policy. The BoA will be able to carry out these functions to the letter as a result of its independence. At the same time and without prejudice to its independence, the BoA will seek to coordinate to the maximum possible, its monetary policy to fiscal policy and other macroeconomic policies.

### 4.1 Ministry of Finance

The BoA and the MoF are the two principal actors in the field of macroeconomic management. By sharing the same ultimate objective, the BoA and the MoF must closely cooperate with each other through information exchange and advice, albeit within the limits imposed by the legal status of the central bank independence.

*Agreements*

A. One relationship between the BoA and the MoF is defined in a series of agreements, of which the most recent was signed on March 26, 2003. This agreement contains three main points:
- The BoA will change the agency agreement with the MoF and charge the MoF for the services it currently offers for free, e.g. for the retail auction window for treasury bills in the BoA's main building.
- The net profits of the BoA go to the State Budget within four months after the end of the financial year.
- The procedure for extending loans to the government according to the Central Bank Law of 1997 in Articles 30.3-30.4 [2].

B. There are two other agreements between the BoA and the MoF:
- The procedure for auctions of T-bills where currently the BoA provides individuals with T-bills in its windows, but is moving these activities gradually fully to the commercial banks.
- The procedure for government bonds that are sold at the BoA main building, but mainly to commercial banks.

C. Besides these agreements there are two debt committees in which the MoF and the BoA both participate:

- The Committee for the Administration of the Domestic Debt. The BoA and the MoF are the only participants, and hold irregular meetings to exchange information on the refinancing of the existing domestic debt.
- The Committee for the Administration of the External Debt (currently only debt inherited from the period before 1990). The BoA intends to have a very active and clear role in the process of debt reconciliation and settlement. At some point in the future, Albania will no longer have access to the soft-funding provided by the PRGF programme and will have to rely increasingly on borrowing on commercial terms. Clearing and settling issues related to the existing debt will increase Albania's profile in the international markets.

D. Anti-money laundering will continue to remain another joint-project of importance. It will be carried out in the spirit of full compliance with international standards and with extreme thoroughness.

One proposal of the BoA for the future is to

A. Arrange monthly 1-2 hour meetings between the Governor and the Minister of Finance where topical macroeconomic, monetary and financial developments are discussed on the basis of a predetermined agenda two days before the meeting. The agenda points will be set by the MoF's and the BoA's staff. One important topic of common interest for the Albanian economy is the reduction of informal markets. The dealing at these markets contaminates the official markets and therefore remains a potential cause for financial instability in Albania. Other topics will concern monetary or fiscal policy.

Necessary requirements for starting IT are to

B. abolish the possibility of financing the government deficit according to EU-standards and the standards in all IT countries. The upcoming years provide a period for the MoF for making the following arrangements. It can improve the short-term liquidity forecast by gathering information from commercial banks or the treasury branches in a timely manner. The forecast errors could be reduced in this way. Even if considerable forecast errors occur, the lack of funds by the government can be solved by selling securities in the secondary market at any time. In an extreme case of widespread uncertainty leading to liquidity problems the central bank can temporarily shift its focus to financial stability.

C. fulfill the further requirements for the full independence of the BoA from the government such as the budget of the BoA and the wage setting in the BoA. By Central Bank Law the BoA is to be exempted from the Law on Salaries in the Government Sector as it is a threat to independence.

## 4.2 Other Government Bodies

### *Other Ministries*

There are inter-ministerial meetings on an irregular basis where the Governor participates.

The BoA proposes that the Governor acts as an advisor in these meetings. S/He shall therefore not have the right to vote. For transparency reasons, the BoA should have the right to publish its points of view as expressed by the Governor in these meetings.

### *Instititute of Statistics*

A. The BoA bases its monetary policy on consumer price data published by the INSTAT. The Consumer Price Index shows the developments in prices of 262 goods and services grouped into 12 groups. The weights of the individual items are obtained from a Consumer Survey conducted and processed by INSTAT in 2000 and 2001 respectively. They have been kept constant until now.

B. In addition to consumer price data, the BoA makes use of other macroeconomic data such as National Accounts Statistics, labour market data, foreign trade data, production, sales and investment data by economic sectors. These statistics are heavily used in the periodical reports prepared by the BoA.

C. Since data at the micro level are more difficult to obtain, the BoA conducts in collaboration with the INSTAT quarterly or less frequent surveys to collect quantitative and qualitative information. Quantitative data are obtained from the tourism and the foreign direct investment survey, while qualitative data are generated from the consumer confidence and business sentiment survey. Information at the micro level is helpful to analyse the economy at the macro level due to the small scale of the Albanian economy. The presence of the informal economy is also a strong reason for finding alternative ways of measuring and estimating economic activity.

One request of the BoA to INSTAT is

A. to have quarterly inflation figures published by INSTAT, measured as the average of the year-on-year consumer price indices of the three months in the quarter. [3] This will avoid any confusion among the general public as inflation is measured by INSTAT and forecasted by the BoA.
B. and one proposal of the BoA for INSTAT is
C. to have relative weights in the consumer basket updated more frequently than every five years as the consumption pattern of the average consumer in Albania has been changing very rapidly and changes are expected to occur over the coming years.
D. to attempt to measure the Harmonized Index of Consumer Prices as defined in the euro zone for comparison reasons.
E. to have in addition to the statistics that INSTAT already provides, timely, accurate and complete information on gross domestic product, wages and productivity.
F. Furthermore the BoA requests the elimination of the gap in the legal basis of the BoA for making data provision enforceable and including penalties for non-compliance. The current law does not make it compulsory for resident entities to report to the BoA for statistical purposes. At present, the Law on Statistics makes INSTAT the only authority entitled to collect statistics and information from economic agents. A similar authority should be given to the

BoA as the sole compiler of the balance of payments of the country.

## 5 GENERAL RELATIONSHIP WITH THE PRIVATE SECTOR

The relationship between the BoA and the private sector will focus more on achieving a communication line on monetary policy issues that is consistent, clear and credible. It aims at increasing the knowledge and awareness of the public concerning monetary policy and at gaining confidence in the central bank and the whole banking system.

### 5.1 Public

Apart from the regular press communiqués, the BoA will communicate monetary policy issues via the website. The website will in the future be updated and upgraded to diminish the room for misinterpretation, both in the Albanian and English wording, between the Bank Law, the framework of IT as outlined on the web from the start of the IT regime onwards, the press communiqués and the minutes of the monetary policy makers' meetings for accountability and transparency reasons. Furthermore, the site will be adapted to make monetary policy easier to understand for a broad public. Also, ad hoc meetings of the Governor or employees of the BoA will take place in several places in the country on predetermined themes related to monetary policy. The BoA will also disseminate more information on monetary policy decisions via the informal contacts of its branches with companies and others in the region. Disseminating information in the educational system will continue.

### 5.2 Media

The BoA considers the media to be an important communication channel of its monetary policy. Therefore it aims at having a good relationship through briefings concerning monetary policy. The Governor will continue arranging press conferences and informal meetings. The BoA will react adequately to false or tentative statements in the press that may damage the reputation of the BoA.

### 5.3 Chamber of Commerce

The BoA seeks contact with the Chamber of Commerce in Albania for gaining further information on Albanian companies and possibly the real estate market for businesses to expand regional coverage of the surveys it currently conducts through its Branches in five regions. Information from the Chamber of Commerce would include companies in the main cities of Tirana and Durrës that are not included in the Branches' surveys.

## 6 THE RELATIONSHIP WITH SUPRANATIONALS

The BoA deems its role with the international institutions at least as important as its national role. There is a national interest in putting Albania more transparently on the (European) map and, vice versa, the Albanian economy gains from international experience. Most channels of cooperation will feed through the central banks and payment authorities in the region, i.e. from Bosnia-Herzegovina, Croatia, Greece, Italy, Kosovo, Macedonia, Montenegro, Serbia and Turkey. Possibilities for cooperation will be found in conferences, workshops, forums and exchanges of experts. The relationships with supranationals are outlined here below.

### 6.1 EU Institutions

A. The BoA will fully support all efforts that the country is making for future membership into the European Union. In this respect, close ties will be kept with institutions of the European Union, such as the European Investment Bank, the European Central Bank and the central banks of the European System of Central Banks.
B. For the central bank, accession to the European Union will require meeting the standards of other EU central banks. A fully from the government and commercial banks

independent decision making process on monetary policy, as spelled out before, is one of the core characteristics of the 25 central banks of the EU.

C. Another requirement is the fully free movement of capital across borders. Albania is committed to fulfil the WTO and EU requirements by 2010. Albania has made considerable progress in this field. Capital inflows are completely liberalized, while the remaining restrictions on capital outflows will be lifted gradually.[4]

D. At the domestic market all market principles should be achieved, including fair competition. In this context the Authority of Competition plays an important role. In particular the market position of Raiffeisen Bank can be mentioned here. Raiffeisen Bank acquired the former State Bank and possesses 48.8 per cent of the banking market in terms of assets (end 2004).

### 6.2 BIS, IMF and WB

Since October 15 1991, just after the fall of communism in Albania, the IMF and the WB have developed strong relationships with Albania. The BoA hopes that close relationships remain. Agreements with the IMF should not contain conflicting objectives. In case of a shift to an IT regime under an agreement with the IMF, commitments made to the IMF will remain binding. Establishing a good relationship with the BIS is essential for the BoA for reaching the international convergence towards modern central banking standards.

NOTES

*[1] According to the Central Bank Law, BoA issues licenses and regulations for the banking system, the foreign exchange bureaus, the credit unions and the mutual funds as well as on-site and off-site supervision.*

*[2] Article 30.3 Bank of Albania loans to the Government of the Republic of Albania shall be disbursed, denominated and made payable in Lek only. All such loans shall be collateralized by debt securities in bearer form that bear interest and market rates, that have maturities of the loans that they secure, and that are issued and delivered by the Government of the Republic of Albania to the Bank of Albania. For each loan there must be a written loan agreement executed between the Government of the Republic of Albania, represented by its Minister of Finance, and the Bank of Albania. The agreement shall clearly state the principal amount of the loan, its maturity, and the applicable rates of interest and other charges.*

*Article 30.4 At no time shall the aggregate principal amount disbursed and outstanding on Bank of Albania loans to the Government of the Republic of Albania exceed the equivalent of five percent of the annual average of the Government of the Republic of Albania ordinary revenue for the three financial years immediately preceding for which accounts are available; provided that for the purposes of this Article "revenue" shall not include borrowing, grants and other forms of financial assistance.*

*[3] For a full understanding of this point see point V and Box 3 in chapter 2.*

*[4] See also Shtylla and Cani (2003).*

# NEW OPPORTUNITIES IN THE INSTITUTIONAL RELATIONSHIP BETWEEN THE GOVERNMENT AND THE BANK OF ALBANIA

*By Mr. Ridvan Bode, Minister of Finance in Albania*

First of all, I would like to greet the organizers and participants in this Forum and assure that the Albanian Government highly appreciates the contribution to this discussion as a valuable help to the implementation of its priority of speeding up the reforms which would bring our institutions closer to the western standards which we are inspiring. This debate truly bears a significant interest and importance, related to the fact that our country is soon meeting the preconditions and concludes the negotiations for the signing of the Stabilization and Association Agreement with the EU, and it shall be involved in a new engagement, where the objectives and results of the monetary sphere and financial system are of a crucial significance. So far, the progress and Government's engagement in an ambitious reform program constitutes a fine initial premise to the success of this vital undertaking for the country.

The inter-institutional cooperation in determining the objectives, participation and responsibilities has a major significance in the process. The Bank of Albania in its mission stipulated by the law and for the role it plays in the economy of the country, constitutes a privileged partner for the government. The legal responsibility of this cooperation and the generally positive experiences in this area need to be enhanced to a new level.

The necessity of strengthening the institutional relationship, first of all between the Ministry of Finance and the Bank of Albania, are owed not only to the fact that these two represent the main agents in programming, supporting, and guaranteeing macroeconomic stability, but also because the programming and implementing the entirety of reforms in the field of economy and finance cannot prove to be successful without the provision of a coordinated participation of these two institutions.

I believe that the unification of the main common objectives, programming of measures, which enable and support the mutual realization of special objectives, specific to each institution, constitutes the foundation and the first conditions for a stable institutional cooperation. Being faced with the behaviours and prevalence of departmental interests, or even worse, the efforts to draw more on oneself through comfortable and secure minimalist objectives, a well-known tendency in the stance of these two institutions, it is considered as indispensable the establishment of another level of cooperation experience which would be dominated by self-responsibility and reciprocal accountability. Definitely, this should neither be considered as a matter of wish or personal will, nor as a product of the existing circumstances or third "arbiters", frequently being international institutions. The maintenance of a reciprocal institutional independence and the obligation of an efficient cooperation require the improvement and enhancement of legal and stable instruments.

In the context of the cooperation between the Ministry of Finance and the Bank of Albania there are several agreements and practices, which on the whole have been assessed as very productive. Nonetheless, time is ripe to review and reflect the new achieved standards and objectives and the program engagements in the context of the reforms which increase the functioning standards of the two respective institutions. The formulation of these agreements is best to be grounded not only on the mandatory relations resulting from the reciprocal agreements with the IMF, WB or other institutions assisting the country, but it should also be a result of an internal reflection about the mutual needs for the implementation of programs approved officially and consulted preliminarily. The establishment of weekly meetings between the Minister of Finance and the Governor based on an agenda prearranged by the respective staff would be a fruitful practice and I very much support this idea initiated by the Governor.

The possible directions of expanding and enhancing this cooperation are numerous. To my view, several directions are to be considered as crucial.

Public debt management, both domestic and external, is a joint challenge of the Ministry of Finance and BoA. The Ministry of Finance is improving and consolidating its own internal structures as well as the procedures for an efficient and sound management. A special organic law concerning debt is being drafted and shall be approved soon. Besides the cumulative increase of debt, the established reality from the ownership and structure viewpoint in the commercial banking market increases the emergency of formulating an adequate strategy for servicing the debt. In this context, a specialized assistance supported by foreign donators has been required and planned. The set up of the whole infrastructure requires an active and programmed participation of the Bank itself. Functional opening of the network for secondary market of treasury bills, increase in participation of households in the Treasury bill market and the diversification of servicing the product become a priority of our close cooperation. Minimization of this market risk, which has become threatening at certain times during the year, would be the most evident contribution of the government to the programmed strategy of Inflation Targeting. The current situation with debt under control and at appropriate levels, the fall of domestic debt as a share of GDP (planned at 2.6% of GDP for 2006), and the first nonnegative budget balance in the last 15 years are not sufficient for a prudent management of cumulative debt in the future.

The considerable ease of the fiscal pressure that has been resulting from balancing the primary budget deficits, due to reduction of annual budget deficit by the government and significant increase in fiscal revenues, should not be an adequate criterion for the non-participation of the Bank in financing the deficit. A common challenge we should face simultaneously is the further increase of crediting to private sector with a direct effect to real economy. This year has marked a significant progress in respect to that. Share of credit to private sector to GDP is up to 11% from around 7-8% that has been in the last few years, though it is still much lower than in other economies in the region. Commercial banks have much greater potential of providing loans to the economy. Generally speaking, the immediate abolishing of Bank's participation in the Treasury bill market would boost the crowding out effect to financing the real economy. In this regard, the initiative of reducing the budget deficit financing by the Bank should be taken in coherence with other elements of the strategy for economic development.

Another field of priority of our immediate cooperation is the drastic improvement of the high scale of economic and financial informality. The results of the anti-cash campaign are encouraging, but the high scale of informal economy and corruption of public administration can also be fought through the channeling in the banking system of payrolls for the public employees. With the assistance of the IMF, the Ministry of Finance has arranged a contemporary scheme aiming at fundamentally improving the management and introduction of taxes. Modernization of this system is closely related to the quality and capacity of service by the banking system in order for payments and other financial operations to be completed through the banking system. Banking system is gradually gaining the trust of public, though the cost of these services remains at unattractively high levels. It is necessary that the whole banking and financial system become more attractive for the businesses and attached to the government program for the fast reduction of informal economy in our country.

Besides the need for fundamental improvements in the functioning of the real economy, further deepening of financial sector privatization and the improvement of their functioning are expected to have a positive effect on withdrawing and investment potential of remittances through the banking system. The volume of remittances is of a crucial importance for the further development of the country in the short term while considering their impact on inflationary pressures at seasonal peaks.

Non-bank financial system proves to be another meeting point in our current activity. Stability in the financial sphere, and the monetary stability in particular, as well as the positive economic developments on the whole, call for the need of a stable and sound financial system. While the banking system generally shows positive developments, the non-bank financial sector still remains problematic. At present, this market is supervised by independent boards and in a few cases the government plays a notable role. The standards of such supervision are weak and the performance of several sectors, mainly the insurance market, private pension funds, etc., require immediate measures to be taken. The government is drawing up an organic law aiming at strengthening these standards and guarantees, as well as unifying the supervisory authority of the non-bank financial sector in one single board, following the successful model of many other countries in transition. Improvements in the sector shall be followed by the privatization of public companies and the establishment of a more competitive and transparent reality in the financial market. I believe that such an attention is to be paid to other centres of the financial market, like Tirana Stock Exchange, which still remains a judicial reality, a number of public funds, semi public and private funds which exist but are poorly supervised, as well as some agencies which may in fact be more efficient in the market. The involvement of the Bank of Albania in this process is indispensable; apart from the need of overcoming the backwardness of this sector and minimising the risk generating from the market, it is possible to develop and at the same time introduce new financial products and instruments. This has to be an important objective in the global strategy of the Bank regarding inflation targeting.

Albania, as an active participant in the world coalition in the fight against terrorism has been engaged in several activities, among which money laundering prevention in a broadly informal market, constitutes a challenge in itself. The Ministry of Finance and the Bank of Albania have many responsibilities fully related to this field. A General Directorate operates by the Ministry of Finance on this purpose. In order to put this structure in efficiency, pursuant to the law, the financial and banking system is obliged to provide updated information according to a standardized approach. Nevertheless, the problem continues to persist. The set up of a data bank with necessary information requires a closer cooperation and improvements in transmitting the information, in all its accuracy and speediness of delivery.

The Bank has provided a significant contribution to the solution of outstanding debt, inherited from the period before the 90s and the Governor is Deputy Chief of the Government Committee of Foreign Debt Negotiation. The Bank experience in this field makes its direct involvement in the new program of the Committee indispensable to solve the remaining part of the debt, which should be completed in two years. Speeding up the solution to this issue is also pushed by the fact that the country should gradually enter the trade credit market without restrictions and obstacles inherited from the past.

Strengthening the cooperation in the abovementioned fields and others related, requires the establishment of an adequate legal infrastructure and a reciprocal exchange of information. The Government is willing to support any initiatives aiming at strengthening Bank's independence and guaranteeing the non-interference of any other authorities. It is the responsibility of the Bank's authorities to assure that this independence is not being misused and to respect the essential morality of the state of rights and reality in the country. We appreciate the ambitious aim of the Bank to rapidly reach the average level of the European Central Bank and to approach these standards, and the government shall be engaged in fulfilling its duties required to achieve the standard. We all have to be aware that for this commitment to be successful, we do not only need legal acts complying with the required standards, but also deep reforms which would improve the standards of the whole financial and economic system.

This means that the sphere of reforms, transformations and improvements in this strategy must be much more ample than the Bank itself. Otherwise, we would create a virtual model of a non-operational, non-functional and inefficient Bank in relation to the economy as a whole.

Another crucial element, where this cooperation is to be channeled, is the improvement of communication and information exchange. Ministry of Finance and other dependant institutions are undertaking projects aiming at modernizing and accelerating operations performance and their information. Tax and Customs General Directorates shall within next year finalize a unique network of all fiscal operations that they perform. Treasury Department has already started establishing the national network of public expenditure operations. The Bank of Albania and the banking system are making the same efforts. By means of a joint program it is necessary to integrate the data system we are using in a unique network, which would in fact enable a faster and more efficient communication.

In conclusion, I would like to thank you for giving me the opportunity to express my positive considerations on the institutional cooperation between the Bank of Albania and the Ministry of Finance, as well as propose new directions for improving our cooperation which would serve to enhancing the efficiency of our institutions.

# COMMENTS WITH PARTICULAR FOCUS ON INSTITUTIONAL RELATIONSHIPS

*By Mr. Servaas Deroose, Director for the Macroeconomy of the euro area and the EU in the Directorate-General for Economic and Financial Affairs (DG ECFIN) of the European Commission*[1]

## 1 INTRODUCTION

The Manuscript on "Preconditions for inflation targeting in Albania" reflects the Central Bank's determination to adopt a formal inflation targeting framework when conditions are right. It is widely recognised that the feasibility and success of inflation targeting hinges essentially on the authorities' commitment and ability to plan and drive the necessary institutional change. Furthermore, in order to prevent credibility losses, and ultimately, weakening the monetary framework, a number of prerequisites should be in place prior to formal adoption of inflation targeting. Against this background, the manuscript contains very relevant proposals, addresses very pertinent questions and raises numerous interesting issues for discussion.

This comment is inevitably selective and focuses, as requested, mainly, albeit not exclusively, on institutional relationships (i.e. the first of the three main themes identified in the Manuscript). Using a generic definition of institutional relations, some thoughts are presented on four main topics: (i) preconditions; (ii) monetary transmission channels; (iii) relationships with government and other public sector bodies; and (iv) financial stability. Given that the three themes identified are closely interrelated, the commentary will also touch upon topics examined in chapters 2 and 3 of the Manuscript.

## 2 PRECONDITIONS

At first sight, the environment seems favourable for introducing a fully-fledged inflation targeting framework in Albania. Recent macro-economic performance has been impressive, with output growth the highest in the region, relatively low inflation and good progress in public finances. Also, volatility in output growth and inflation has been relatively subdued in recent years. Furthermore, the banking sector has been strengthened and the prudential framework has been reinforced. Finally, the current monetary framework already includes some valuable elements of inflation targeting (i.e. a well publicized objective for inflation; a considerable degree of central bank independence; and a flexible exchange rate).

Nevertheless, a number of considerations warrant a closer look at some prerequisites, which are worth pursuing in their own right. Firstly, recent favourable trends should not necessarily be extrapolated into the future. In a setting of very strong credit growth, which may not be very responsive to changes in domestic currency interest rates, significant shifts in interest rates and the exchange rate could at some point be necessary to prevent overheating in the economy. Secondly, some necessary features for a successful introduction of full inflation targeting are still largely absent. Thirdly, the positive experience of other European transition countries, which made a switch to an inflation targeting strategy, may not be directly comparable. These countries had a different income level and a different economic and financial structure.

A first necessary precondition is clarity of policy objectives. The proposed inflation targeting framework is clear about this: price stability pursued by an independent central bank as a well-defined primary objective, with a secondary objective of supporting sustainable growth, to the extent that price stability is not jeopardised. Translating this policy objective into the conduct of actual monetary policy can prove to be rather difficult, in particular in the event of considerable volatility in output growth and inflation. Furthermore, there are several possible strategies to achieve and maintain low and stable inflation, and inflation targeting (perhaps better labelled inflation expectations or inflation forecast targeting as the central bank's inflation forecast becomes an explicit intermediate target, see Svensson 1997) is but one of them. Finally, a clear, unambiguous and transparent inflation target is of crucial importance, both for the credibility of the inflation targeting framework and for external communication purposes. There are strong arguments to target headline inflation. However, in many transition countries, there is a real question how to handle administered prices, whose level and changes are potentially considerable, which are beyond the direct control of the central bank. Defining a target without administered prices may be deemed too opague, whereas providing for a specific tolerance range may question the validity of the framework. [2]

In order to assess the merits of a form of inflation targeting, it is paramount to consider whether the prerequisites are in place to prevent credibility losses and a weakening of the monetary policy framework from a premature introduction. In this context, the functioning of the transmission mechanism and the development of financial markets and institutions are key parameters. Is the transmission mechanism to inflation strong enough and are the links well enough understood (bearing in mind potential concerns of price stickiness, unsterilized capital flows, and the strength of exchange rate pass-through)? If, despite a trend towards more financial intermediation and higher leverage, the interest and credit channels are rather weak it may be difficult to target inflation and inflation expectations with the instruments available. Section 3 on monetary transmission elaborates briefly on this issue.

Several other technical factors merit consideration, including the capabilities of the central bank in terms of, for instance, inflation and liquidity forecasting. Building the necessary operational and analytical capabilities at the central bank can possibly be achieved relatively quickly. At least, this is suggested by the experience of emerging economies that (apparently) successfully introduced inflation targeting.[3] Moreover, in the Albanian case a lack of timely and reliable statistical time series on key variables seems to be an important practical obstacle. Thus, the quality of statistical data provision should improve drastically. A fully independent statistical office, i.e. institutional, personal and financial independence, including the endowment with sufficient resources, is indispensable to ensure the credibility of the inflation targeting framework. Finally, there is the need to keep the informal financial market under control.

Astutely, the Manuscript does not propose a concrete starting date for a shift to full inflation targeting. This suggests that it is likely to be a fairly gradual process, involving meeting firstly the minimal prerequisites and building subsequently analytical and operational capabilities. This seems an appropriate approach. It would leave time to organise the inflation targeting framework, embed it in a legal and institutional set-up, communicate the strategy and its target clearly to the foreign and domestic public, and choose the appropriate moment in time to officially launch it.[4]

## 3 THE RELATIVE STRENGTH AND STABILITY OF THE MONETARY POLICY TRANSMISSION CHANNELS

As effective inflation targeting depends on the strength and the stability of the monetary policy transmission mechanism, a deepening of financial markets and a strengthening of institutions should be pursued. Albania has relatively shallow financial markets. Although credit to the private sector is growing rapidly, it has done so from a very low base. At present, the only significant financial markets are the primary auctions of Treasury bills (there is no developed secondary market yet) and a more or less informal interbank foreign exchange market. Furthermore, despite some recent issues of three-year bonds, outstanding long maturities remain tiny and the yield curve does not effectively extend beyond six months. Moreover, a very large share of credit to the private sector is denominated in foreign currency, and the credit expansion seems to be driven to a large extent not by the interest rate but rather by the availability of creditworthy customers and the development of the financial sector.

Dollarisation (and increasingly euroisation) of money flows and balance sheets merits attention. Dollarisation in Albania, is not as strong as in most transition countries, but it may still pose problems for inflation targeting. Dollarisation (euroisation) weakens the monetary transmission mechanism by reducing the share of private sector lending denominated in domestic currency, thus weakening the ability of the central bank to affect demand, economic activity and, ultimately, inflation (Balino, Bennet and Borensztein 1999). This is evidenced by the fact that in Albania there seems to be no tight relationship between policy interest rates and foreign currency deposit rates, which rather follow foreign inter-bank rates. Possible wealth effects in response to exchange rate movements may exacerbate this effect. At present, the degree of dollarisation in Albania is relatively low compared to other countries in the region with respect to the share of foreign currency deposits, while bank lending to the private sector mostly takes place in foreign currency. Given the low level of credit, it is not clear that the interest channel would have been much stronger in the absence of dollarisation. Nevertheless, there is a risk that dollarisation (euroisation) may increase and thus further weaken the transmission in the future, i.e. at the time of a possible switch to inflation targeting, as credit growth is picking up and foreign currency lending accounts for an increasing share of total credit to the private sector.

The role of the exchange rate as a transmission mechanism needs special attention. As a small, open economy, with large capital inflows, which to a substantial extent reflect remittances from residents living abroad and transfers from international institutions, and significant foreign currency (dollar/euro) lending, the exchange rate is probably the strongest transmission channel through which monetary policy affects prices. On the one hand, the important capital inflows exert nominal appreciation pressures. On the other hand, unsterilised capital inflows may lead to liquidity growth with inflationary consequences in the medium term, especially in the large part of the economy which is effectively shielded and which may suffer from price stickiness and a lack of price transparency and competition – making it hard to bring existing inflation under control. Introducing an inflation target will clearly limit the possibility to control money growth and the nominal exchange rate. Through feedback effects higher volatility in these latter variables may in turn complicate inflation targeting, depending of course on the stability of money demand and the strength of the link between monetary aggregates and inflation. Hence, while the existing floating exchange regime has served the country well and in the future no objective, explicit or undeclared, for the level of the exchange rate against any foreign currency or basket of foreign currencies should be pursued, there will be merit in continuing to keep a close eye on the lek exchange rate. This resembles to some extent the way actual monetary policy is conducted in several countries, including some EU Members States which officially run (managed) floats but in fact try to influence the exchange rate as a means to avoid excess volatility in activity and inflation.[5]

## 4 SECURING CENTRAL BANK INDEPENDENCE AND A STABLE MACROECONOMIC POLICY MIX [6]

A comparison of Albanian laws governing the central bank with international best practice clearly reveals that important steps still have to be taken, in particular as regards institutional and personal independence and prohibition of monetary financing of budget deficits. However, such a comparison should not be seen as a gap that Albanian legislation has to fully close in the near term, rather the distance to international best practice may be used as a reference for guiding longer term goals. For instance, the legislation that prevails in the euro area governs what is arguably the most independent central bank in the world, and gives a benchmark which many would have difficulty to meet. Nevertheless, for efficiently carrying out a forward-looking monetary policy some legal issues need to be settled early on.[7]

Admittedly, it will take some time to fulfil the legal prerequisites for a fully independent central bank. Nevertheless, for an optimal monetary policy, an early and decisive move to clarifying the key objective of the central bank and to granting instrument independence is needed, regardless of how exactly one would label the strategy pursued. For the proposed inflation targeting, where the central bank needs to clearly communicate the target and should be accountable for meeting it, it is clear why this is imperative. The Manuscript rightly emphasises the need to prevent monetisation of the budget deficit, so as to provide the central bank with the necessary credibility with respect to its commitment to price stability. Thus, the current possibility for the Bank of Albania to provide monetary financing to the government (either directly or indirectly) should be removed as quickly as possible. Moreover, the Bank of Albania should charge the Ministry of Finance for the services it currently offers for free. Moreover, it would seem very important to set up an effective public debt management agency within the Ministry of Finance (that can take over the current public debt management task from the Bank of Albania). This is needed not only to eliminate monetary financing of budget deficits, but also to ensure that liquidity provision to the government does not burden operations in carrying out forward looking monetary policy. As regards the legal environment for statistical reporting, progress is also needed in the near term. Given the presence of a large informal economy, there is a clear need to find alternative ways of measuring and estimating the economic activity. In this context, there are good reasons to give Bank of Albania legal authority for making data provision enforceable and for imposing penalties for non-compliance. The intention to remove the remaining restrictions to the free movement of goods and capital is in line with EMU acquis, although the paper does not address the actual feasibility of such measures.

There is a wide-ranging consensus that fiscal discipline is an essential ingredient for an effective inflation targeting. In

Albania, public finances seem currently to be in relatively good shape. However, the current budget deficit of around 5% of GDP is too high and further fiscal consolidation is therefore needed. In particular, the need for fiscal policy to contribute to a sound policy mix is heightened in an environment of rapid real and financial sector catching up. A recent study sets out some broad principles which all seem relevant in the current situation of Albania.[8] Firstly, this study highlights the need to accelerate fiscal consolidation at times of strong convergence, in order to provide a cushion against volatility in the real economy and to ensure headroom for shocks to the public debt - including contingent liabilities from the financial sector. Secondly, it flags the risk that over-reliance on a tight monetary policy could trigger volatile capital inflows and unwarranted appreciation of the real exchange rate, as well as spurring the tendency to borrow in foreign currencies that offer lower nominal interest rates. Thirdly, it emphasises the need for prudence in estimating the underlying fiscal position during convergence booms - which are periods when there are risks of over-estimating potential growth (and thus overestimating the strength of the underlying budgetary position); when asset price increases may inflate budget revenues temporarily; and when the composition of GDP may be biased toward consumption and hence particularly tax-rich. Finally, the study notes that building sound fiscal institutions can help underpin the sustainability of fiscal policy and influence expectations positively. In Albania, there is a need to modernise and enhance the efficiency of the public administration. The needed reforms are manifold: strengthening oversight, enhancing the fiscal administration to secure a broad enough tax base, presenting realistic tax revenue projections, and improving the quality of public spending and of public sector management.

Achieving an appropriate policy mix is above all a question of establishing a healthy institutional balance between various policy makers with a truly independent central bank pursuing its target of price stability, having control over the relevant instruments, and not being allowed to monetize the fiscal deficit (Bernanke et.al 2005 Inflation Targeting). Instrument independence also covers the relationships with the government, ways to foster fiscal discipline, and financial relationships with the authorities. It is also a matter of good oversight guaranteeing financial stability and sound payment systems (see the section on financial stability below). All this does not come about automatically. There are numerous examples of monetary and fiscal authorities not working together in an appropriate and co-operative manner. In such a situation there is a great risk of undermining confidence among investors and the public at large in the conduct of macro-policy with potentially grave consequences, such as a rise in inflation expectations, higher risk premia on interest rates, a reversal in capital flows, and pressure on the exchange rate. In such an environment, credibility will be low and it becomes increasingly difficult to steer inflationary expectations in the desired direction (see also Blanchard 2004).

In sum, an institutional set-up is needed which safeguards central bank independence, protects monetary policy from interference in response to (unexpected) changes in the political landscape, maintains credibility with financial markets and investors, and guarantees efficient external communication. Ample room for manoeuvre exists in setting up the details of institutional relationships that embed monetary policy. Within the EU there has been a wide range of institutional arrangements, shaped by country-specific and historical circumstances and many of them have worked quite well. The Manuscript rightly notes that the necessary legal changes will not only require a broad support from legislative bodies, but also from the whole financial community. The envisaged creation of a Monetary Policy Committee partially composed of technical experts is an idea worth contemplating, to the extent that it helps improving the general framework for decision-making on monetary policy and enhancing the Bank of Albania's credibility. In fact, in many countries there has been a move towards setting up Monetary Committees in one form or another, often involving people from outside the central bank's ranks. Drawing in 'outsiders' may be a good idea also to communicate monetary policy externally, provided members have sufficient expertise and are truly independent. Whether or not minutes and voting records should be published is to a large degree a matter of preference and of subsidiarity. But in some circumstances, for instance in the critical early stages of establishing a track record and credibility, it may be better not to publish details of the decision-making process.

## 5 SAFEGUARDING FINANCIAL STABILITY

The Manuscript rightly lays emphasis on the importance of financial stability as a mandate of the central bank and among other things proposes upgrading the current financial stability assessments to a fully fledged review. This topic is also highly relevant to the specific question of relations between the Bank of Albania and other players in the economy and highlights the need to consider possible challenges ahead, and their implications for the broader set of issues addressed in this Open Forum.

Financial stability is challenging to analyse in any economy, but perhaps especially so in the context of economic and financial catching-up. In any economy it is difficult to know whether credit or stock exchange booms are warranted by favourable shocks to productivity – or whether they have tipped over into destabilizing "financial exuberance." But catching-up involves, intrinsically, a long period of strongly expanding bank credit, financial deepening and rising asset prices. Depending on the relative productivity performance and competitiveness in different sectors, it may also involve a trend appreciation in the real exchange rate. In Albania, such effects begin to play a role in the recent very rapid credit growth – even though credit is expanding, of course, from a very low base.

The stylised risks in a catching-up situation are clear. Among others: first, agents may tend to borrow in foreign currencies, and, second, with collateral and judicial systems still strengthening, and information asymmetries, there may be a tendency to lend to households and for construction rather than for "productive projects." It is also possible that foreign providers of capital may rely on perceived implicit guarantees of interbank liabilities, rather than being attracted by rates of return on the real economy, and that inflows to the banks may help finance an unsustainable expansion of domestic credit.

A forward-looking analysis of the behaviour of all players in the financial system will be important in this environment, and a key question will be what factors are influencing the major financial flows in the economy – a topic the central bank is exceptionally well-placed to assess. This is relatively easy to track, because the financial system in Albania is not yet widely diversified. Stress-tests can help pick up some of these risks, but a forward-looking assessment will draw also on techniques such as foreign exchange early warning systems, balance sheet analysis; and, crucially, traditional analysis of the current account of the balance of payments – its financing, its counterparts in domestic investment and consumption, and its underlying sustainability.

The inherent financial risks, as Albania continues on a path of rapid catch-up, suggest a continuing dialogue with all the sectors of the economy, not just mainly the banks. The experience with several new Member States which are in transition has been that financial stability issues can well arise from the risk behaviour of firms and households – for example in taking on unhedged foreign currency liabilities – even in a situation where the banking system as such has matched positions. And of course, when one sector is tightly supervised, it is likely that flows will divert to other sectors, in a form of regulatory arbitrage (so bank credit will slow down, but leasing will expand and insurance companies will buy credit derivatives – not just in advanced economies but in cases such as Poland or Slovenia, from which these examples are taken). This is a powerful argument to bolster supervision not only in banking but also in other sectors, such as insurance in the financial sector. In absence of cross-sector conglomerates posing systemic risks it is less clear whether supervision in the financial sector should be unified or not at an early stage, as long as it is strengthened across the board, with a view also to enhance competition in the wider economy.[9] Again, as noted above, it can be the public finances that expose the economy to stability risks – for instance through the profile of external liabilities and assets or through the impact of the deficit on real interest rates and capital flows. In other words, financial stability is a property of the economic and financial system (not just its parts), and it is influenced by prevailing policy regimes – which can serve as an aid in diagnosing potential stability risks.

So economic and financial catching-up poses difficult diagnostic challenges, and the central bank can play an invaluable analytic role in presenting its analysis through financial stability reports, based on relations with a wide range of actors. One perhaps should consider going farther than this. The analysis in financial stability reports is particularly valuable if it also serves to trigger a discussion not only among market participants but also – perhaps confidentially – between the key public sector players on issues of supervision and financial stability. Some countries have instituted regular meetings among central bank, finance ministry and supervisory authorities to discuss the implications of evolving stability conditions (in order to guarantee the independence of the central bank in carrying out monetary policy, it should be understood that this should not be used as a means to influence this). This may well benefit also from a short and confidential appraisal of the key challenges by the central bank, in terms going beyond those appropriate for a public report in an area where confidence is a sensitive element.

Turning from analysis of financial stability to policies, the central bank's relations with other policy makers can again be a key concern. In the short run, the variables that attract attention in evaluating financial stability risks – for example, credit, asset prices, the real exchange rate – are not the goals or intermediate objectives for any policy. This is familiar in the case of monetary policy, with the debate whether to factor in asset price movements. But it also applies of course to fiscal policy and the micro-prudential concerns of supervisors. So when financial stability concerns start to emerge, it typically requires imagination and close policy co-ordination to address them. One example will serve. To contain unhedged foreign currency borrowing requires inputs from monetary policy (sufficient variability in the exchange rate to encourage hedging); fiscal policy (to help assure low domestic currency interest rates); and supervisory policy (to help restrain indirect risk exposure of banks) while co-ordination is key.

In sum, then, the mandate of financial stability is indeed a crucial one, including achieving the degree of policy co-ordination that is essential for a well balanced monetary policy. Through strong analysis and close consultation with other players the central bank can help ensure this. But it requires regular analysis of all sectors in the economy, including firms and households. And it implies a continuing process of consultation with the finance ministry and other supervisors to try to achieve macro and micro policy stances that help to pre-empt risk.

## 6 CONCLUDING REMARKS

The efforts by the Central Bank of Albania to try to improve further the monetary policy framework in Albania are highly welcome. Few would doubt that the focus on inflation as the primary target of an independent central bank is the right choice, but it leaves open some questions about its actual implementation. In particular, one may wonder whether an attempt to start implementing full-fledged inflation targeting of a type resembling advanced economies is appropriate for Albania, given its starting point. In any case, sound institutional foundations need to be laid. In particular, central bank independence has to be secured and the relationships with other actors that determine the policy mix have to be clarified so as to ensure stability-oriented policies. To this end, the relevant legislation needs to be amended. From a practical perspective, these changes will probably have to be implemented in a stepwise manner and a lot of discretionary choice remains on how and when to carry out the various steps in the transition process. A lot will also depend on the speed at which financial markets can develop. But as Albania ultimately strives to become an EU Member, some of the targets (legal and practical) to which it has eventually to converge are clear.

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NOTES

[1] *Without implicating them, contributions by Ronald Albers, Maxwell Watson and Baudouin Lamine are gratefully acknowledged. The views expressed are those of the author and do not necessarily reflect those of DG ECFIN or the European Commission. I herewith also commend the Bank of Albania for its impressive efforts to improve the framework for designing and implementing monetary policy in Albania. The high quality of the Manuscript and the highly transparent working method, involving all the stake holders, are truly exemplary.*

[2] *Some may indeed argue that formal inflation targeting may be better postponed until administered (regulated) prices have reached such a level that their catching-up no longer blurs inflation dynamics.*

[3] *See for instance, IMF (2005), Carare et al. (2002) and Mishkin (2004).*

[4] *In this context, it is noticeable that a gradual approach has been used more often in introducing inflation targeting. This was, for instance, the experience at the Swedish Riksbank, which first started with a period of 'implicit inflation targeting', before moving to a phase were its own inflation forecasts were given a more prominent role (Berg 1999).*

[5] *This should not be misinterpreted as advocating an alternative exchange rate strategy as opposed to inflation targeting. There is a broad consensus in the literature that an exchange rate peg has severe risks and drawbacks for emerging economies that are in a relatively early stage of catch-up in terms of income and economic and financial structure (Flood and Marion 1999) unless it is needed to bring down run-away inflation and thus get a country back on track again. Fortunately, Albania has had quite stable and relatively low inflation in recent years and therefore is not in need of an exchange rate peg in one guise or another to regain credibility and to anchor inflation expectations. A special feature of emerging market economies is that they are likely to have greater concerns about exchange rate fluctuations than industrialised countries. Hence central banks in these countries do not pursue benign neglect of exchange rates even when they*

*are inflation targeting. This may lead, however, to a "fear of floating" (see Mishkin 2004).*

[6] *It is very important to stress that there is not a single and easy answer to this question, and what follows should not be seen as a prescriptive approach. For instance, it is often not fully appreciated that within the EU, sovereign Member States still have a lot of room for the design and conduct of actual policies. A fortiori, this applies the more so the further away countries are from EU membership.*

[7] *The so-called Copenhagen criteria for countries that wish to join the EU have some reference to macro policies. Compliance with the so-called Copenhagen criteria means that monetary policy should be supportive of a functioning market economy that can withstand market forces and competitive pressures within the Union. More concretely, on macro-economic policies this entails that a country has achieved macro-economic stability, which covers price stability and stable fiscal and external accounts (European Commission 2004). In the run-up to euro participation more stringent rules apply, covering among others exchange rate stability and participation in the exchange rate mechanism ERM II (see, for instance Deroose and Baras 2005 and ECB 2005).*

[8] *See study in European Commission's (2005) Public Finance Report on the role of fiscal policy in the new EU Member States, eight of which are in the process of converging toward average EU living standards against a transition background, and are also experiencing rapid trend growth in credit.*

[9] *For the financial sector, unsupervised informal financial intermediation could be a special issue for concern.*

# COMMENTS ON THE INSTITUTIONAL RELATIONSHIPS

*By Mr. Radovan Jelašić, Governor of the National Bank of Serbia*

Let me first express my satisfaction that there are so many central bankers here and the Minister of Finance. When you give a speech in your own country you always are alone and everybody enjoys the critics against the central bank.

I am going to be very short. First of all, I will express what I am doing here today with you. I cannot tell you what is the inflation targeting because in Serbia we still do not have inflation targeting. But we are definitely facing problems that you are facing now.

Let me first tell that I think that all central bankers here in the region are facing very similar problems. This is from the institutional standpoint and especially from the legislation standpoint. I think that by copying laws from the EU we can basically do exactly what they are doing there. So most of the laws here in the region, right now, are becoming more popular concerning price stability, the main job of central bank.

Once laws are passed you become a central banker, and you become a governor and suddenly you realize that you are in a battle, but you don't have the tools, you don't have the means to achieve things, and sooner or later you are also facing the problem that you have to go out to the public, tell them that the law says it, but this is going to be a little more hard, a little more tough to achieve whatever the laws tells you.

It is needless to say that for many central banks here in the region there is a very good alternative mechanism to achieve things with the exchange rate. So what is happening actually in most countries is that people just grab this safe tool that is called the exchange rate mechanism. You just use it to bring down inflation and trust me it is relatively easy, in Serbia in 2001 we had a similar thing.

We fully stabilized the exchange rate, we implemented the managed float and for me it's the most preferred word because it includes everything from the management to a full float. In a couple of months in 2001 - 2002 - 2003 we put the efforts on the management and not on the float and we brought down the inflation from 110% to 7.8% in 2003.

But then as the time goes by, we unfortunately brought ourselves in the problems similar to the ones in '70-'80s as politicians realized that there is something even more important than inflation, being growth. So, sooner or later they also realized that for establishing growth something must be sacrificed. This sacrifice is inflation.

As I mentioned before, in 2003 we had a rate of inflation of 7.8% and the growth rate was 2.5%. In 2004 the inflation was 13% and growth 5.6%. This year we are going to have even a higher inflation of 17% and a growth of 5%. I am not surprised about this year. Next year is going to be a challenge as far as the inflation is concerned and the economic growth rate is going to be even lower.

So, once more I want to emphasize the relation between growth and inflation and always there is the same thing that you can use, the exchange rate which I believe is not good for the long term.

Let me give some concrete proposals as far as the institutional relationships are concerned. I already mentioned at the beginning the issue of transmission channels.

Developing and improving the transmission channels of the monetary policy. In transition economies with a high level of euroization, it is difficult to develop the transmission channels to monetary policy. Despite the yield offered for local currency, banks are hesitant to invest in such papers since:

- Their customers prefer foreign currency as a mean of savings;
- They have set limits for the level of exposure;
- Banks do not invest in changing the behavior of the citizens but accommodate it with the purpose of maximizing profit in the short run (banks will not spend time explaining what is best for the client, but will try to get most out of the transactions with him based on his consumer habits).

The memory of private individuals is much deeper than that of the institutional investors, and therefore they are less inclined to invest in local papers despite the yield offered. In addition, people know that the time of euro is coming and that is also shaping their expectations.

Improving customer protection and transparency of the banking system is very important indeed and it will take a long fight with the banking industry. While the goal of the central bank is to improve transparency, banks have exactly the opposite interest although with that behavior they are hurting their long-term business and profit prospective as well. For example, if the central bank implements APR (annual percentage rate) type of regulation, forcing banks to show in one number all costs related to lending, banks will look into all possibilities to publicly undermine it (calling it among others: price control) and to circumvent it (issuing loans in foreign currencies, e.g., Swiss francs).

## PROMOTING THE CONSOLIDATION OF THE SUPERVISORY AGENCIES OUTSIDE BANK OF ALBANIA.

The experience of many countries in the region shows a clear benefit for consolidated financial supervision within the central bank. In addition in Serbia, insurance, leasing and voluntary pension funds supervision is also placed within the central bank. A similar path with a different level of consolidation is done in Croatia, Slovakia, the Czech Republic and so on. Not only knowledge but also HR capacities and credibility need to be present in the central bank in order to carry out the responsibility, as such decisions put the central bank under substantially more pressure. Needless to say, the Central Bank of Albania also needs to think ahead on what it will do after the implementation of Euro as a legal currency in Albania.

Necessary requirement for starting the IT system are to have the support of the Government and it is very important that everybody understands what it means for the exchange rate. That will slot much more flexibility. This implementation of IT will have a lasting impact not only on Government but on the companies and private individuals as well.

## ONE PROPOSAL OF THE BANK OF ALBANIA FOR THE FUTURE

It is a key for success to have constant communication between the Governor and the Minister of Finance. Our practice shows that the presence of the Governor at the Government sessions is very beneficial, as well as the presence of the Minister of Finance at the meetings of the Monetary Board in the NBS.

## COMMUNICATION WITH THE PUBLIC

Communication is the key and all the media available should be used actively. Needless to say, a helping hand from the Government, as well as from a journalist who understands the topic well, is more than welcome.

# CHAPTER 2

## INFLATION TARGETING FRAMEWORK

*Presented at the Open Forum by Mr. Bledar Hoda, Specialist at the BoA*

### 1 INTRODUCTION

The IT regime will follow the current regime of monetary targeting. The BoA will target an annual inflation rate of 3.0%. It will carry out its monetary policy through the use of indirect instruments in full compliance with an open market economy. The policy rate of the BoA will be the interest rate on its repurchase agreement with a maturity of one week.

This chapter presents the IT framework in terms of quantifiable objectives, monetary policy conduct, forecasting methods and other relevant issues. One requirement is that the central bank does not finance the Government deficit. Ending of budget deficit monetization removes the direct impact of monetization on inflation and tends to provide the central bank with the credibility en route to its commitment to price stability.

In addition, the IT regime requires the maintenance of the flexible exchange rate regime.[1] A floating regime provides Albania a smoother adjustment to economic shocks than a fixed exchange rate regime. Experience has shown that the transparency and credibility of the monetary policy regime in anchoring expectations tends to enhance the efficiency with which a flexible exchange rate operates to absorb macroeconomic shocks. The central bank may intervene occasionally in the foreign exchange market only for the purpose of smoothing excessive and/or speculative fluctuations in case of attacks.

## 2 OBJECTIVES

I. The principal objective of the BoA shall be to maintain price stability.[2]

II. Subject to the principal objective, the BoA shall support the general economic policies of the government leading to sustainable economic growth.[3]

## 3 INFLATION CONCEPT AND INFLATION MEASURE

III. Price stability shall be defined as low positive inflation. Low positive inflation is a rise in the general price level so that the movement in prices does not impact the decision-making process of economic agents.

IV. The measure of inflation in Albania shall remain the change in Consumer Price Index published by INSTAT and shall be called headline inflation. The CPI is an aggregate index of prices of goods and services consumed by the average Albanian consumer, and it is the best measure of the cost of living in Albania. See Box 2.

V. For monetary policy purposes, the inflation rate shall be expressed as the annual percentage change in the CPI at a quarterly basis. The quarterly CPI shall be measured as the average of the CPI of the three months in the quarter. See Box 3.

*Box 2 Why Headline Inflation?*

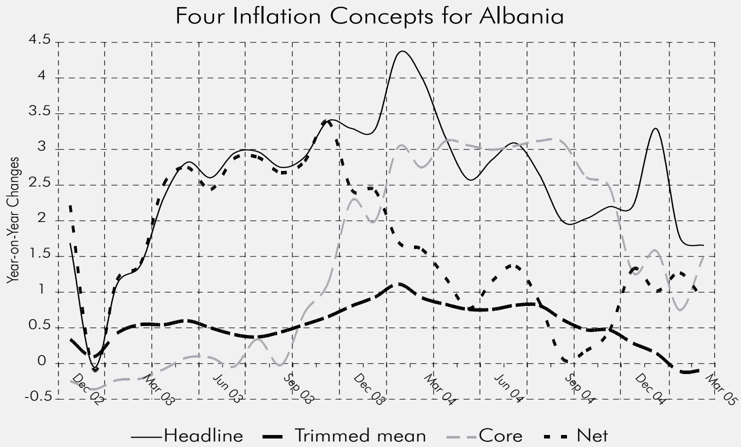
*Common inflation concepts by central banks are the following:*

*a) Headline – total Index of Consumer Prices containing all goods and services*

*b) Trimmed-mean – headline CPI excluding the most volatile prices in each period*

*c) Core – headline CPI excluding food & energy prices*

*d) Net – headline CPI excluding regulated prices*




*It is transparent to the public that headline inflation comes straight from INSTAT. The narrower measure trimmed-mean is an inflation concept created by the central bank, not easily verifiable and therefore less credible. Core inflation is easily verifiable but excludes a substantial part (32%) of the goods and services in the index, making it unrepresentative. The alternative narrow measure of net inflation is preferred to headline inflation as it excludes the prices of goods and services that the central bank cannot control. This concept is however also only measured by the central bank and based on the central bank's own judgment concerning those categories of goods and services that have regulated prices.*

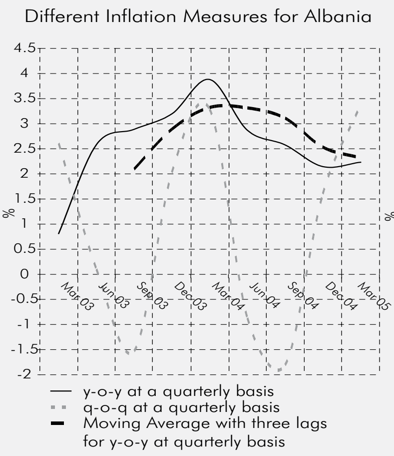
*Note: For more detailed information see Luçi (2005) and Çeliku (2005) and Çeliku, Shtylla, Hashorva and Hoxholli (2005)*

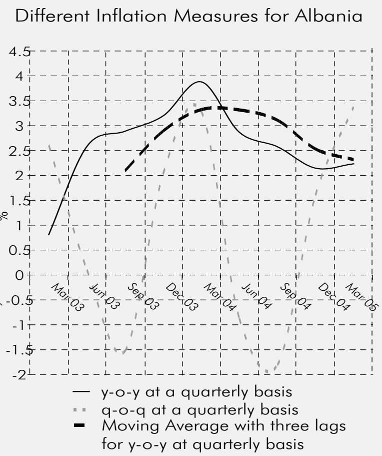
*Box 3 Why Annual Percentage Changes at a Quarterly Basis?*

*Common inflation measures by central banks are the following:*

a) *Annual changes at a quarterly basis*
b) *Annual changes at a monthly basis*
c) *Quarterly changes at a quarterly basis*
d) *Monthly changes at a monthly basis*
e) *Moving average of annual changes at a monthly basis*

*The BoA will measure inflation by the annual rate of change for each quarter. The measure of annual inflation at quarter t will be* $100*(QCPI_t\text{-}QCPI_{t-4})/\ QCPI_{t-4}$ *where QCPI is the average of the CPI of the three months in the quarter.*



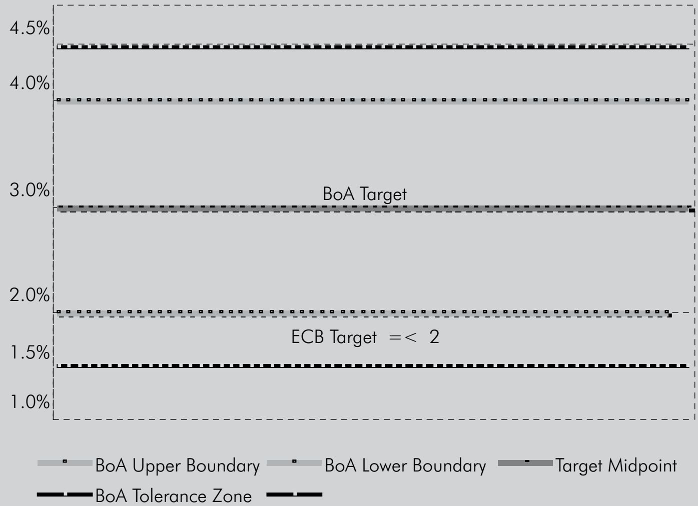




*From quarter to quarter a lot of information becomes available to the BoA. Annual changes make the series at a quarterly basis sufficiently smooth for making monetary policy decision makers each quarter accountable. Quarterly changes at a quarterly basis contain a large amount of (seasonal) volatility. A high volatility can definitely be found in series at a monthly basis, even in the case of annual changes. Taking smoothing series by taking a moving average is more cumbersome to explain to the public.*

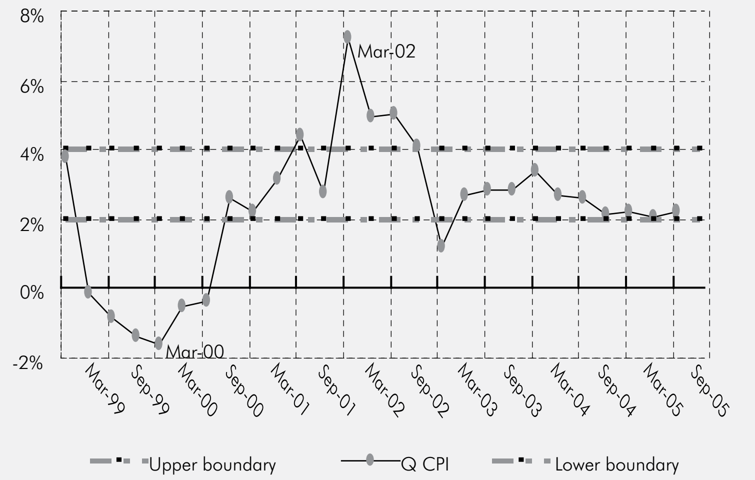
*Note: For more detailed information see Luçi (2005)*

## *Box 4 Why an Inflation Target of 3.0%?*

*The inflation target is 3% with a margin of 1 percentage point, so there is a target zone of 2.0%-4.0%. The extended target zone is 1.5-4.5%. The tolerance zone is 1.5-2.0% and 4.0-4.5%.*




*Economic agents in Albania are used to the BoA's current target of 3.0%. The inflation rate has been within this zone during the last seven years, apart from the periods of the Kosovo crisis in 1999 and the confidence crisis in 2002. This zone fits the catch-up process of Albania with the euro area that has a target of close to but below 2%, as in view of the potential Balassa-Samuelson effect the midpoint of 3% for Albania seems compatible with the 2% of the euro area. This 3% target allows for structural changes that take place in a transition country like Albania. Moreover, a 3% inflation target with +/- 1 percentage point corridor has been working well in other emerging market countries facing similar challenges. The presence of 15.6% of regulated prices of goods and services in the CPI-basket calls for a tolerance zone for not making monetary policy unnecessarily over-reactive.*




*Note: For more detailed information see Luçi (2005)*

## 4 INFLATION ZONE AND INFLATION HORIZON

VI. An annual inflation rate of 3.0% shall be considered by the BoA as low positive inflation. The BoA deems inflation in this zone beneficiary and appropriate for fostering a sustainable long-term economic growth in Albania. See also Box 4.

VII. The target for inflation in the medium term is 3%, while +/- 1 percentage point is allowed. The BoA will aim at the 3.0% target midpoint. The target is symmetrical, implying that inflation outside the zone, whether above or below the target zone, is considered equally undesirable. See Box 4.

VIII. There shall be an extended target zone ranging from 1.5% to 4.5%. The zone from 1.5% to 2.0% and from 4.0% to 4.5% will be called the tolerance zone. See Box 4.

IX. The BoA shall aim at keeping inflation at 3.0% +/- 1 percentage point all the time. The tolerance zone is designed to account for unforeseen shocks in regulated prices that drive inflation beyond the zone of 2.0-4.0%. See Box 4.

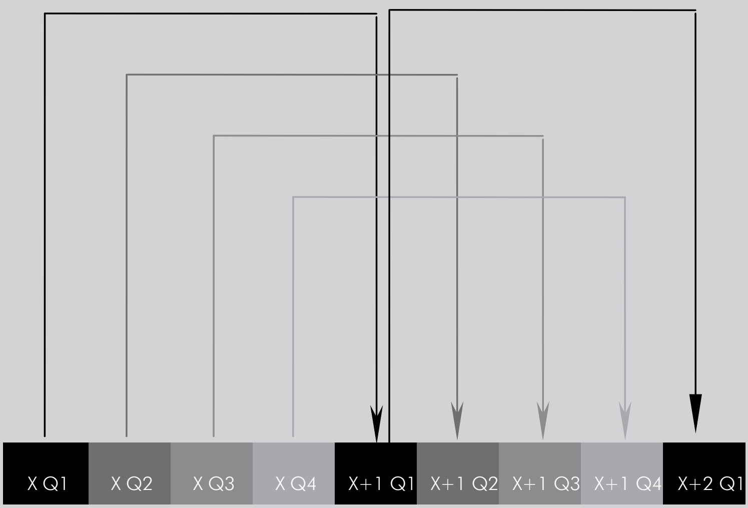
X. Under the IT regime, the BoA will seek to achieve price stability in a forward-looking manner by targeting forecast inflation one year ahead.[4] See Box 5.

## 5 MONETARY POLICY UNDER THE IT FRAMEWORK

XI. The main document of the BoA monetary policy shall be the quarterly Inflation Report.[5] The IR will include the forecast for the four quarters ahead as well as the main assumptions and explanations of policy. This report will also include an analysis of current inflation developments in the face of past forecasts.

XII. The decision-making body of the BoA shall base its decisions on the inflation forecast. The inflation forecast at time T will be the forecasted annual rate of change of the CPI at a quarterly basis for quarter T plus one year ahead. Forecasts for core inflation and other relevant information shall be considered also.

*Box 5 Why a Forecast Horizon of One Year?*




*The forecast horizon will be one year, i.e. four quarters. Supposing that IT will start in the first quarter of year X, a forecast will be made in this quarter for each quarter from the first quarter in year X until and including the first quarter of year X+1. The BoA will present these forecasts in the quarterly IR. The BoA will include in the IR an evaluation of the forecast that was published one year before from the first quarter in year X+1 onwards, i.e. the first quarter for which the BoA published forecasts.*

*The BoA opts for a one year horizon as survey results on consumer confidence suggest that people in Albania are familiar with a one year horizon. Opting for a shorter horizon and using strong transmission channels in order to dampen inflation is not necessary as Albania does not suffer from high inflation. Opting for a horizon longer than one year hampers the making of reliable long-term forecasts in view of structural and integration reforms that Albania currently undergoes.*

*Note: For more detailed information see Luçi (2005)*

XIII. The forecast will be based on assumptions that express no policy view regarding monetary policy, implying fixed interest and fixed exchange rates. Basic assumptions on external factors, other than the base interest rate, will be approved by the monetary policy decision-making body of the BoA.

XIV. The inflation target will be met in case the annual inflation rate is within the target zone. The BoA will present and comment on inflation outcomes – i.e. the actual inflation rate - in its IR. The BoA will have to explain any inflation outside the tolerance zone extensively in the IR and possibly in other public releases. The Governor may have to be accountable to the parliament in these circumstances.[6]

XV. Should the economy suffer from temporary external shocks, the actual inflation rate may depart from the target zone. Attempting to keep inflation within the target may cause undesirable volatility in output. Under these circumstances the BoA will aim at bringing inflation back into the target zone while trying to minimize output volatility.

XVI. The BoA shall explain in depth a deviation of the inflation forecast of more than 1 percentage point in absolute terms from the borders of the extended inflation zone in the IR, in case the actual inflation is not within the target zone.

## 6 FORECASTS

XVII. The inflation forecast will continue to be made on the basis of econometric models[7]. Several models[8] explain inflation by its past, the exchange rate, monetary aggregates, import prices, fiscal expenditure, unemployment and interactions between price developments of the different groups of goods and services.

XVIII. The BoA will use the models for running shadow inflation forecasts. After a year the forecast will be evaluated. Based on the performance, a final choice among the quarterly models will be made by the BoA.

XIX. In addition to the inflation models a macro-econometric model is under construction that envisages capturing the transmission channels in the Albanian economy from monetary policy to inflation. By means of this model the sizes and time patterns of the responses of macro-economic variables to shocks hitting the economy will be analyzed for Albania.

XX. Apart from the assumptions, the forecast will be provided by an independent unit of specialists within the BoA, where independence indicates that their work will not be influenced by policy makers.

NOTES

*[1] This is in the hands of the BoA, see the current Central Bank Law and the Constitution.*

*[2] This differs from Article 3.1 of the current Central Bank Law: The principle objective of the Bank of Albania is to achieve and maintain price stability.*

*[3] This is a proposal for changing the current Articles 3.2-3.3 of the BoA Law: The BoA shall also, to the extent consistent with its principal objective and internal banking market, promote and support the development to a market-based the foreign exchange system, the internal financial market, the payment system, and foster monetary and credit conditions conducive to the orderly, balanced and sustained economic development of the country. The other objectives of the BoA, which shall be subordinated to the primary objective of the Bank of Albania, shall be to foster the liquidity, solvency, and proper functioning of a stable market-based banking system.*

*[4] Under the current regime the BoA targets the annual inflation rate of coming December.*

*[5] The BoA currently publishes a monthly report focused on inflation. The forecast and proposal for the monetary policy stance are confidential and available only to the SC. One example can though be made available upon request.*

*[6] See also section 3.3.6 in Chapter 3 on this accountability issue.*

*[7] See the Monetary Policy Report.*

*[8] See the Report Forecasting Inflation in Albania by Çeliku, Shtylla, Hashorva and Hoxholli (2005) with monthly and quarterly models for total inflation, inflation subgroups and core inflation.*

# COMMENTS ON THE INFLATION TARGETING FRAMEWORK

*By Mr. Bill Allen, Senior Economist, Brevan Howard Asset Management LLP and former Director of the Bank of England*

I am honored to be invited to contribute to this very important conference on the monetary future of Albania. In the comments I make, I will assume that the decision has been taken to introduce an inflation target in Albania. Therefore, I will not spend time discussing the merits of that decision. My comments are those of someone who knows something about inflation targeting, but who knows nothing about Albania, and that should be borne in mind when reading them. There are four general issues that I plan to discuss in these comments.

## MEASUREMENT

If Albania adopts an inflation target, the measurement of inflation will become a matter of even greater importance than it is at present, since inflation will be the main objective of monetary policy. The measurement of other macroeconomic quantities such as GDP and unemployment will also be extremely important.

This has major implications for the statistical agency responsible for producing the data (INSTAT). To be specific:

- The statistical bureau INSTAT should be independent from both the government and the central bank, so as to provide assurance to the public and to financial markets that its estimates of the rate of inflation and other macro-economic variables are not subject to influence by the government or the central bank. Such independence will help to ensure the credibility of the inflation target and of monetary policy.

- INSTAT should have sufficient resources and sufficient status to enable it to attract talented people so that it can measure inflation and other macro-economic variables comprehensively and reasonably accurately.

I should add that the British government has very recently announced its intention to make the British Office of National Statistics independent. The terms of its prospective independence are not yet clear, but the decision is both welcome and overdue.

## LEARNING BY DOING

More than 20 countries now practice inflation targeting, and Albania can surely learn from their experience; indeed, that is part of the purpose of the present conference. However, every country is unique, and to a large degree, however much it learns from other countries, Albania is going to have to 'learn by doing' – that is, to find its own answers to the questions posed by inflation targeting. In some respects, the Bank of Albania manuscript seems to me to anticipate the answers to questions which might be better left open until the Bank of Albania has had some practical experience. Let me give some specific examples.

- I have two possible reservations about the stipulation that 'for monetary policy purposes, the inflation rate shall be expressed as the annual percentage change in the CPI at a quarterly basis'. First, even though, as Box 3 of the manuscript explains, annual percentage changes in the

CPI on a monthly basis, and shorter-period rates of change in the CPI, may contain a lot of volatility, they may also sometimes contain useful information, and it would be most unwise for the Bank of Albania and others to decide as a matter of policy to ignore them in all circumstances. For example, if there were to be a step change in indirect taxes, or a large change in the exchange rate, the month-to-month change in the CPI would be a matter of enormous interest. Second, I think it would be quite acceptable for the Bank of Albania to ask INSTAT to publish quarterly inflation data in addition to monthly data. However, I think it would be quite wrong for the Bank of Albania to ask INSTAT not to publish monthly data (assuming that that is what is intended by paragraph 1.4.2 of the manuscript), partly because, as explained above, the monthly data might contain useful information, but more fundamentally because such a request would undesirably infringe the independence of the statistical agency and damage the credibility of the statistics.

- The arguments in the manuscript for stipulating the time horizon at which the Bank of Albania should aim to hit the inflation target, and that the time horizon should be a year, seem to me unconvincing. In principle, there is a strong argument for trying to hit the inflation target at the time horizon at which monetary policy actions have their most powerful effect on the rate of inflation. I imagine that, in Albania, there is no certainty about what that optimal horizon is. If so, I think it is unwise to stipulate at this stage what horizon the Bank of Albania should choose. The arguments in Box 5 that it is difficult to make forecasts for longer than a year, and that the Albanian public is familiar with a one-year horizon, do not seem to me sufficiently strong to override the principle that the horizon should be a matter for the MPC to decide in the light of research and experience.

- Experience of macro-economic models is that they are generally unable to explain recent economic developments, or forecast even the near future, to the degree of accuracy required for monetary policy purposes. A large degree of judgment about the current situation and likely future developments is required from policy makers. In my view, it is unrealistic to believe that the Bank of Albania will be able to choose a single quarterly model that will meet all its needs, as suggested in the manuscript. Most central banks, recognizing that they can never know which model is most appropriate in any particular situation, use a range of models to inform their judgment. I think the manuscript should accept the need for judgment on the part of those responsible for making monetary policy decisions, informed perhaps by several different models.

- The manuscript says that the MPC's forecasts should be based on the assumption that interest rates will be constant throughout the forecast period. International practice on this issue is changing, and some central banks have started assuming instead that interest rates change in the future as implied by market rates, or according to some other predetermined path. Constant interest rates may well be a good assumption for the Bank of Albania to make in its initial forecasts, but the matter should be kept under review, and the MPC should be free to change its practice if it thinks that would be desirable.

## ACCOUNTABILITY

It is standard practice for central bank monetary policy committees to be said to be 'accountable' for their actions. What does this mean? It normally means that they have to explain their decisions, often to a specialist committee of the legislature, and that they also have to explain the reasons for the rate of inflation. Obviously, if inflation is not in line with the target, they have to explain why not. If they have missed their inflation target, the need to answer these questions can be embarrassing to them. Yet it is widely understood that there can be circumstances in which it is entirely acceptable for an inflation target to be missed. For one thing, no-one expects any central bank to have perfect control of inflation. Second, the measurement of inflation is not perfect (and can never be perfect). And third, there can be ‘supply shocks’, such as rises in energy prices, which unavoidably drive the rate of inflation away from target. If the central bank reacts too sharply to such supply shocks by adjusting monetary policy to get inflation quickly back to target, it can cause undesirable volatility in output and employment: it would be better to tolerate a temporary deviation from the inflation target.

For this reason, accountability is not simple. The legislature cannot simply dismiss or otherwise discipline central bankers who miss their inflation target, because that would infringe the independence of the central bank. Thus accountability is inevitably limited. The worst thing that can happen to a central banker is that his or her explanations of a deviation of inflation from the target are thought to be unconvincing. The importance of embarrassment in public life is not to be underestimated, but central bankers’ jobs are secure, at least until the end of their terms of office.

I do not think that the existence of a target zone, let alone two target zones, as proposed in the manuscript, adds anything of value to the accountability process. Central bankers need to explain the reasons for the current rate of inflation even if the target is in the form of a single point rather than a zone (or two zones). In that light, no purpose is served by setting a target zone, rather than just a single point.

I would like to make one further point on accountability. Some inflation-targeting central banks, which have target zones set for a year at a time, have at times abused the targeting process. In the course of a year, it has become clear that, for whatever reason, inflation was going to fall outside the target zone. When that has happened, they have changed the target zone in mid-year, so as to bring it into line with the expected rate of inflation. Thus the rate of inflation hasn’t hit the target, but the target has hit the rate of inflation. I do not understand what logic has driven central banks to behave in this way, but it has caused serious damage to their credibility in international financial markets: much more serious than if they had simply announced that they had missed the target and explained the reasons.

## INDEPENDENCE OF FORECASTERS FROM POLICY MAKERS

The manuscript proposes that forecasting should be delegated to an independent unit of specialists, as is the practice in the European Central Bank. This is not the only possible model. Another model is based on the view that analysis of the current economic situation, and forecasting, are integral and inseparable parts of policy making, and that the MPC should be deeply involved in compiling the forecast. On this view, it makes no sense for the forecasters to be independent from the MPC – they are the servants of the MPC.

# COMMENTS ON THE INFLATION TARGETING FRAMEWORK

*By Mr. Már Gudmundsson, Deputy Head of the Monetary and Economics Department of the Bank for International Settlements*[1]

The plans envisaged in the document Preconditions for inflation targeting in Albania are in many ways ambitious, considering Albania's recent history and level of economic and financial development. It is, however, a reflection of recent achievements that the proposals do not seem unrealistic. There are three main reasons for this. First, the transition to a market-based system has created an economy that is increasingly responsive to indirect monetary control. Second, macroeconomic stabilisation has already delivered low inflation. Third, the Bank of Albania is de jure free to use its instruments in order to attain whatever sensible macroeconomic goals it might set; ie it has, what is often called, instrument independence.

## PRECONDITIONS FOR INFLATION TARGETING

This does not mean that Albania meets the preconditions that have been listed in the literature for the introduction of inflation targeting.[2] The most important of these are the following:

Institutional framework. First, the central bank is given goals that it can reach with the instruments at its disposal. In sufficiently developed financial systems, the central bank can, in the long-run, influence nominal variables, ultimately the rate of change of the price level and real variables in the short-run. A goal of price stability and short-term output stabilisation would be consistent with this. Second, political interference or fiscal dominance does not impede the central bank from using its instruments in a manner that is consistent with the goals. Instrument independence and a ban on direct lending to government by the central bank are sufficient conditions in this respect.

A transmission mechanism, ie a causal link from central bank instruments, predominantly short-term interest rates, to inflation. This requires the fulfilment of three conditions. First, a sufficiently developed and healthy financial system must be put into place so that changes in central bank instruments are transmitted to the exchange rate on the one hand and to financial conditions facing households and firms on the other.[3] Second, the economy must be sufficiently market-based in order for financial conditions to have a significant effect on domestic demand. Finally, the domain of deregulated prices must be large enough for demand conditions and import prices to be the main drivers of inflation.

Institutional capabilities. The central bank must be able to understand the basic contours of the transmission mechanism in order to calibrate its instruments and explain its actions. Furthermore, it should have the capability and the data to make conditional forecasts of inflation.

Albania fulfils some of the above-mentioned preconditions. It has instrument independence and there is a transmission mechanism, partly due to the development of the financial sector. Institutional capabilities remain, however, untested and the need still exists of closing all possibilities of direct central bank financing of the government borrowing requirement. That presupposes the development of a sufficiently deep short-term money market and liquidity management capabilities in the Treasury, but will in turn give a further boost to the development of financial markets.

However, it is not clear how important it is that the above-mentioned preconditions are met a priori. First, many of these preconditions apply to any stability-oriented monetary policy strategy. It is not clear that it is somehow better to miss out on these criteria when targeting the exchange rate or monetary aggregates than when on a numerical inflation target.[4] Second, most countries that have moved to inflation targeting have done so without first meeting these criteria. Industrial countries may have been structurally better placed than emerging market countries. However, many industrial countries moved to inflation targeting in the wake of a complete breakdown of the former monetary strategies, often associated with financial crises. The transmission mechanism was likely to change in an uncertain way under those conditions. Furthermore, some of these countries lacked tools for, and experience in, making conditional inflation forecasts. Moreover, central bank independence was not always ascertained de jure. Some of the emerging market countries that have adopted an inflation target have, in addition to these problems, been faced with the problem of making conditional forecasts of inflation in conditions of big structural changes, where there is a lack of data and where no estimated models of the transmission mechanism of monetary policy exist. These problems have not stopped the success of inflation targeting in anchoring inflation expectations at the target without significant costs in terms of output loss and volatility of real variables.[5]

However, we should not take this argument too far. Most of the inflation targeting countries moved quickly to fulfil the criteria ex post. In a sample of 20 inflation targeting countries[6] that I will refer to repeatedly in what follows, all have instrument independence - although it was, in some cases, granted by law ex post - and none allow fiscal dominance. The central banks moved quickly to develop forecasting models and frameworks for risk assessments. All now make such forecasts and provide them to the public through published reports. It could be that inflation targeters have been successful precisely because there was the willingness and ability to move to fulfil the important preconditions quickly after the adoption of the framework. The central banks were eager and the governments willing to do what was necessary so that they could get on with it. I have seen or heard nothing that indicates that Albania could not do the same.

## WHAT ARE THE CHARACTERISTICS OF INFLATION TARGETING?

Before discussing the proposed framework we need to identify the distinguishing characteristics of inflation targeting. The literature provides a wide variety of definitions. However, in some cases these include aspects that are common with other frameworks. Partly adopting the definitions of Berg (2005) I consider the following to be the key aspects of inflation targeting:

1. The central bank aims to achieve a publicly explicit numerical target for price stability.
2. The central bank has instrument independence.
3. Given the lags in the transmission mechanism, the central bank calibrates its instrument(s), usually short-term interest rates, so that forecasted inflation is on target.[7]
4. The central bank regularly publishes reports that describe the prospects of achieving the target.
5. The political system holds the central bank accountable for achieving the objective. Less formally, but at least equally forcefully, the markets tend also to hold the central bank accountable, which is facilitated by the enhanced transparency that is associated with many inflation targeting frameworks.

So the keywords of inflation targeting, as in other potentially successful monetary frameworks, are goals, instruments, transparency and accountability.

These definitions then delimit the key aspects of any inflation targeting framework. Some of the questions that arise are the following:

Target: Who sets the target? The government, the central bank or both? How is the numerical target defined? In terms of headline or some measures of core inflation? Is the numerical value a point or a band? Is there a target zone or a tolerance interval? Are there escape clauses in the sense that deviations from the target are allowed if they are caused by major terms of trade shocks, natural disasters, etc? Can the government override the target in certain conditions?

Forecast: What is the horizon of the inflation forecast? What are the assumptions regarding policy instruments and the exchange rate? Who 'owns' the forecast and how is it published? How are uncertainties and risks around the forecast treated and how are they presented in an 'inflation report'?

Monetary policy action: How are decisions on the use of monetary policy instruments taken? How are they communicated? What is the weight given to output stabilisation and financial stability considerations when setting monetary policy?

Accountability: How is accountability organised? Is there an open letter or a report when inflation is off-target or outside a tolerance interval? Are there hearings in parliament?

## WHAT CHOICES HAVE INFLATION TARGETING COUNTRIES MADE?

Looking at those aspects that are relevant for the issues raised in Chapter 2 on the framework, what do our 20 central banks do in this respect?

Target: In an equal number of cases, the target is set by the central bank (8) and jointly with the government (8). Only in 4 cases is it set by the government. Headline inflation has been adopted as the target in the overwhelming majority of cases (17). Countries are split evenly between point targets and band targets. Almost all of those on a point target have some form of tolerance interval. The exception is the UK, but even in this instance an implicit tolerance interval exists as the central bank will have to write an open letter to the government if inflation is more than ±1 percentage point from the target. Most countries (17) have bands, target zones or tolerance intervals inside the 1-5% zone.

Output stabilisation: At least 6 inflation targeting countries have explicit escape clauses and several have indicated that certain shocks may give acceptable cause for temporary deviations from target.[8]

Forecast: All inflation targeting central banks publish inflation forecast. Most (14) do this quarterly, but 4 publish three times per year, 1 twice and 1 twice with two updates. The forecast horizon is, in most cases, longer than 12 months, although only 7 have a forecast horizon of a full two years.[9] A two year horizon is, however, in some sense optimal as this is, in most countries, assessed to be the required time for central bank interest rates to be fully reflected in inflation. More central banks make the forecasts based on constant interest rather than using either market-expected or endogenous interest rates. This does seem to be changing as more central banks shift camps or publish scenarios based on market expected interest rates. However, it seems that less than half of inflation targeters are still using constant exchange rates in their inflation forecasts. Most inflation targeters (16) show confidence intervals for the inflation forecast that reflect the assessment of risks and all have some kind of discussion of risks and uncertainties surrounding the forecast in their inflation reports. Finally, the ownership of the forecast varies significantly. However, in most cases it is either the policy making body (11) or the bank as a whole (4).

## THE PROPOSED FRAMEWORK FOR ALBANIA

With this background in mind, let me begin by singling out those aspects of the proposed framework for Albania that seem mostly uncontroversial. First, the objectives of price stability and the support of the general economic policies of the government, if consistent with the primary objective, may be considered standard best practice. Second, the choice of a 3% midpoint is sensible and well-argued. It is compatible with most common international practice and, at the same time, by virtue of being above the ECB target, will accommodate some of the catching-up process. Third, targeting annual changes in headline inflation is sensible and compatible with international practice. The public will see inflation in terms of the headline and, using Greenspan's definition of price stability, it is therefore the appropriate target. The volatility in the headline rate is dealt with by the medium-term orientation of the goal and the fluctuation band.

This brings me to the more problematic parts, which are mainly three, ie the formulation of the target and tolerance zones, the forecast horizon and the treatment of risk and uncertainty. Let us consider them in turn.

The proposed 3% inflation target seems sensible. However, having both a target zone of ±1% and a so-called "extended target zone" from 1.5% to 4.5% inflation might, if implemented, complicate the communication of monetary policy. In this connection, we need to make a distinction between a band target and a point target. With a band target, the fluctuation zone is part of the target. The problem with a band target is, however, that it is difficult to make the case that the welfare losses associated with inflation have a kink at the edges of the band and thus warrant more drastic monetary action than otherwise.[10] Why should we not worry about 3.9% inflation but use the full force of monetary policy instruments to bring it under control if it goes up to 4.1%? Additionally, a band target creates the temptation of targeting inflation close to the higher edge. The probability of getting outcomes consistently in the band when aiming for the middle is already low enough. The probability is lower still when aiming towards an edge. Having an "extended" target zone around a band target might increase this temptation significantly. However, the statement in the proposals that the BoA will aim for the target midpoint will hopefully provide a strong antidote against that temptation.

For the above reasons, I personally favour the point target framework that exists, for example, in the UK, Iceland and Sweden. In that framework, monetary policy aims at all times to keep inflation at the target. However, it will never completely succeed in doing so due to unforeseen shocks and uncertainties about the transmission mechanism. Therefore, point targets are ideally complemented by tolerance intervals. These serve two purposes. One is to send a signal ex ante that monetary control is always imprecise. The other is to activate an accountability mechanism, like sending an open letter to the government. Additionally, the target could be supplemented with an ex ante escape clause. The purpose is to explain that major terms of trade shocks, natural disasters or big increases in indirect taxes might take inflation temporarily off target without prompting a monetary policy response. Monetary policy would then be geared towards avoiding any second-round effects and keeping medium-term inflation expectations on the target.

The problem with the proposal is that it has a tendency to mix elements of band targets and point targets. Furthermore, adding an "extended" target zone of ±0.5% to the target zone will not give much leeway to meet unforeseen shocks. One way out of this is to have a 3% point target and a tolerance interval of either ±1% or ±1.5%. When inflation moves outside of this tolerance interval, the Bank of Albania would then make some kind of public explanation. The nature of the monetary policy response would, however, depend on the causes of the deviation. The process of bringing inflation back to target would also depend on the nature of the deviation and considerations given to short-term output stabilisation.

A serious consideration should be given to making two year forecasts due to the lags in the transmission mechanism. Additionally, in the face of major shocks, such a forecast horizon might ease the communication regarding the adjustment path back to target and thus help in anchoring long-term inflation expectations. My experience is that it will not add as much to the difficulty of the exercise as it would initially seem. Partly meeting that concern, I suggest that the Bank consider cutting the frequency of forecasts from 4 to 2 or 3 per year. Given the resource demands of the forecasting exercise, some central banks have recently been moving in this direction (ie Norway and Iceland). The medium-term nature of monetary policy means that there should not be a serious drawback to such a move. At any rate, there is a need to supplement the information coming from the forecasting exercise with a more frequent look at important indicators and information derived from contacts with various players in the economy.

The proposals contain rather little discussion on how risks to the outlook and uncertainty about the transmission mechanism and other factors will be treated in the presentation of the forecast and how they might factor into the monetary policy decision process. For long-term credibility, it is very important to communicate to actors in the economy that due to its forward-looking nature, monetary policy operates in an environment of uncertainty. One way to communicate the risks is to produce a so-called fan-chart, showing the probability distribution of future inflation outcomes as assessed by the monetary policy committee or the forecasters. It is my view that these fan-charts are to be seen as communication devices, above everything else. The process of producing them though, has the advantage of imposing discipline on the assessment of the risk factors inside the central banks. However, although these fan-charts are resource heavy, there is a significant element of assessment and judgement involved. To my mind, it is as important, if not more important, to analyse the major risk factors that are identified during each forecast round in more qualitative terms and include a discussion of these in inflation reports, sometimes supplemented by simulations of scenarios. It is thus not necessary for the Bank of Albania to commit to publishing a confidence interval or a fan-chart at this stage. The Bank can start without it and add it later, once it has full command of the technique and is convinced of the value-add. However, some kind of analysis and discussion of risk factors is imperative.

Let me conclude by discussing two issues where the answers are less clear-cut, ie the weight to be given to output stabilisation and the exchange rate and interest rate assumptions underlying the inflation forecast.

All inflation targeters give consideration to output stabilisation in their pursuit of the primary inflation target. In this sense, they are - what has in the literature been called - flexible inflation targeters as distinct from strict inflation targeters. It is also important to bear in mind that keeping inflation at the target is, in the long-run, not contradictory to output stabilisation over the short. The whole presumption of inflation targeting is precisely that price stability will, in the long-run, create the best conditions that monetary policy can deliver for stable and sustainable long-run growth. Even in the short- to medium-run, inflation targeting does not need to come into conflict with the goal of output stabilisation. When the economy is hit by demand shocks, then the required monetary reaction is the same for inflation and output. The issue comes to the fore, however, when it is hit with supply shocks or when inflation has, for whatever reason, veered significantly off target. The concern for output stabilisation is, in some such cases, partly built into the framework through the tolerance interval, an explicit escape clause, an explicit horizon for bringing inflation back to target or one that is defined in each case when inflation goes outside the tolerance interval. Apart from that, there is not much that can be said in general terms. Quantitative weights for output stabilisation cannot be given a priori as they will optimally be case-specific. What is crucial, in this connection, is the degree of credibility of the inflation target as reflected in long-term inflation expectations, which is, in turn, a function of the overall credibility of the central bank. The more credibility the central bank has developed, the more room it will have giving weight to output stabilisation. That gives rise to the irony that central banks build room to be more flexible by starting out being less flexible.

As previously mentioned, central banks have various approaches regarding the assumptions for exchange rates and interest rates. In some sense, the issue of the exchange rate is easier. If central banks think that they can make a better forecast of the exchange rate than is generated by a random walk -

which implies a constant rate during the forecasting period - then they should ideally incorporate this into their inflation forecast. However, we know that predicting exchange rates is, in most cases, almost an impossible exercise. Additionally, it might create communication problems for the central banks. Those central banks that have not opted for constant exchange rate have, therefore, either used market-expected rates, which presupposed developed financial markets, or the exchange rate is, jointly with the interest rate, endogenously generated by a model. The key issue is therefore the interest rate. There is, of course, a communication issue involved here, whose pros and cons have been debated at length in the literature. However, what is, to my mind, important for Albania at this juncture is that an interest rate assumption of anything other than a constant policy rate either presupposes a rather developed financial market, allowing expected short-term interest rates to be inferred from an established yield curve, or a model of the transmission mechanism in which we have enough confidence to generate the interest rate path that is consistent with the target. I am not sure if either of these conditions are, at present, met in Albania. It is, therefore, sensible to begin the journey as most others did by making the forecast conditional on an unchanged policy stance.

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## NOTES

[1] *Views expressed are those of the authors and do not necessarily represent the views of the BIS. I would like to thank David Archer, Dubravko Mihaljek and Paul Moser-Boehm for their useful comment. The usual disclaimer applies.*

[2] *See for instance Eichengreen (1999).*

[3] *A relatively healthy financial system does also reduce the likelihood that financial stability concerns come to dominate inflation objectives.*

[4] *The relative ranking of the criteria will probably vary between strategies though. Inflation targeting places more demands on institutional capabilities than, for instance, exchange rate targeting. However, exchange rate targeting is very likely to fail over the medium-term if fiscal and interest rate policies are not consistent with it. Furthermore, the cost of failure is usually much higher than in the case of inflation targeting.*

[5] *See Pétursson (2004a) on the effects of inflation targeting on macroeconomic performance. Batini and Laxton (2005) do also analyse these effects. Additionally, they provide an interesting analysis on the preconditions for adopting inflation targeting. They show that most inflation targeting countries did not meet these preconditions.*

[6] *See Berg (2005) and Pétursson (2004b). These 20 countries are those that in the literature were early this year considered to be inflation targeting countries with the exception of the borderline case of Switzerland. Truman (2003) does not classify Switzerland as an inflation targeting country but Pétursson (op.cit) and Batini and Laxton (2005) do. The SNB itself is somewhat ambiguous on the matter. Here the issue is avoided without necessarily taking sides. Additionally, latest entrants to the club, like Romania are not included.*

[7] *This is sometimes stated that the inflation forecast is the intermediary target of monetary policy in the same way as the exchange rate is in exchange rate targeting or a specific monetary aggregate in monetary targeting.*

[8] *At least Canada, New Zealand and the UK have also formal override provisions in law.*

[9] *See Fracasso et al (2003).*

[10] *This problem might be mitigated if the band target is interpreted to be an average over the cycle and/or a thick point, as in, for instance, Australia.*

# COMMENTS ON THE INFLATION TARGETING FRAMEWORK

*By Mr. Hans-Joachim Klöckers, Director Economic Developments, European Central Bank, Frankfurt* [1]

## 1 GENERAL ASSESSMENT

The proposal for the new monetary policy framework of the Bank of Albania (BoA) can be seen as an important step towards achieving lasting price stability. Its main features are (a) a clear focus on the one objective a central bank can indeed achieve and be held accountable for, namely price stability, and (b) important provisions governing the independence of the central bank in the pursuit of its mandate, including the prohibition of monetary financing of the government. In view of this generally positive overall assessment, the following sections focus on those issues where further room may exist for sharpening the clarity of the framework. Section 2 discusses the 20 proposals outlined in Chapter 2 of the manuscript. Section 3 includes some comments on the other parts of the dossier. Section 4 concludes by recalling the main preconditions for inflation targeting in Albania.

## 2 COMMENTS ON THE PROPOSED INFLATION TARGETING FRAMEWORK

While the focus on price stability as the primary objective of monetary policy is essential, one may argue about the best way to achieve this objective. The BoA thinks it would be optimal for Albania to adopt an inflation targeting regime. It stresses that the experience of many other emerging economies has proven that such a framework can also be very effective for a small open economy with a view to steering private sector expectations and eventually achieving and maintaining price stability.

While I would agree with these considerations, I would like to note that in principle other strategies may also exist for the BoA to achieve price stability. The current characteristics of the Albanian economy, notably its small size, the weak monetary transmission channel, a still underdeveloped statistical system, the underdeveloped state of capital markets and significant ongoing structural change, do not make Albania a priori a natural candidate for an inflation targeting framework.

This notwithstanding, I do not think that it should be impossible for Albania to adopt inflation targeting, especially in the context of the overall reforms outlined in the manuscript.

Against this background, I assume it is most helpful for the BoA if I focus my comments on the precise proposals made in the manuscript, with a view to implementing an inflation targeting regime as efficiently and effectively as possible. At the same time, I will refrain from discussing alternatives to inflation targeting.

### 2.1. The objectives

The objectives are laid down in paragraphs I and II. The formulation of these objectives very closely resembles that of the objectives laid down for the ECB. A clear primary objective is specified, namely "to maintain price stability". At the same time, subject to the achievement of this objective, the BoA shall support government policies leading to "sustainable economic growth". The formulation is very clear and should be helpful in leaving no doubt in the day-to-day conduct of monetary policy as to what the central bank should focus on.[2] It is particularly useful that paragraph II explicitly specifies that the focus should be on "sustainable" economic growth as this helps to avoid any notion of a short term-oriented policy stance.

I would not see a need to add any further objectives to those mentioned in paragraphs I and II. This also applies to foreign exchange policy. A flexible exchange rate is fully in line with the intended inflation targeting framework. The central bank notes that it "may intervene occasionally in the foreign exchange market only for the purpose of smoothing excessive and/or speculative fluctuations in case of attacks" (p. 22). However, intervention must be kept within limits as it could otherwise undermine the focus on the domestic price objective. In the end, the objective of price stability should always be given priority over the objective of foreign exchange stability.[3]

## 2.2. Definition of price stability and specification of the inflation target

However, one can argue whether the proposed inflation target of keeping inflation at 3% (+/- 1 percentage point) per annum is ambitious enough to be compatible with "price stability". The ECB, for example, has defined price stability in the euro area as "below 2%" annual inflation.

The starting-point for any definition of price stability must be "0% inflation corrected for measurement bias". There may also be other considerations which give reason to argue for small positive inflation rates, such as (a) the zero bound of interest rates, and (b) possible downward rigidities in wages and prices, which can make a deflationary adjustment process relatively costly.[4]

A further argument which may justify a somewhat higher inflation rate for Albania than for the euro area is related to the existence of Balassa-Samuelson effects. Owing to these effects, Albania should in principle see a real appreciation of its currency vis-à-vis the euro over the coming decades. This can be achieved either by a higher inflation rate than in the euro area or by nominal foreign exchange appreciation against the euro, or by a combination of both. By targeting a higher inflation rate, the BoA signals that it wishes to absorb at least part (if not all) of the Balassa-Samuelson effects through higher domestic inflation than in the euro area.

Against this background, and given that information on most of the above determinants of the optimal inflation target is scant at present for Albania, I would consider the objective of 3% +/- 1 pp. to be a reasonable starting-point, particularly when taking into account that Albania has been able to keep inflation broadly in a range between 2% and 4% over recent years.

However, in the very long run, there may be reasons to aim at shifting this target downwards in order to come closer to the ECB's formulation and achieve true price stability. The BoA could consider whether it wishes to guide expectations of such a long-run process already at this juncture or only at a later stage (e.g. when there is more clarity about the process of potential accession to the EU).

### 2.3 Inflation measure, accountability and width of the inflation target

For an independent central bank which wishes to maintain the support and trust of the general public, it is highly recommendable to target the headline price index as this index most closely matches the true cost of living for consumers. It is therefore to be welcomed that the BoA intends to focus on this index. It is also to be welcomed that the index will be collected by a separate entity, the statistical institute, as this ensures that the success of the central bank's policy is measured by a third party, independent from the central bank itself. In this respect, it goes without saying that the statistical office itself also needs to be independent from government influence in the pursuit of its functions.

It is very desirable that the inflation measure should be available at a high frequency with little delay. In addition, it is important to ensure a broad coverage of the CPI data. Another aspect concerns the proper updating of basket weights. This is of particular relevance given the rapid changes that the Albanian economy is experiencing. In addition, attention should be paid to deriving sound seasonally-adjusted inflation time series in order to be in a better position to assess shorter-term inflation dynamics. Finally, it would be desirable to move over time towards using the EU's Harmonised Index of Consumer Prices, at least if and when a path of accession to the EU becomes clearer.[5] [6]

As headline inflation measures are typically relatively volatile, headline inflation-targeting central banks have to identify the period over which they want to be held accountable and the width of the target band. In this respect, the BoA proposes to aim to keep inflation "all the time" within a rather wide target band (+/- 1 percentage point plus an additional tolerance zone of +/- 0.5 percentage point designed to cover shocks in regulated prices). This set-up implies that it will be permanently possible for the public to monitor whether or not the central bank achieves its inflation objective.

The central bank commits itself (paragraph XIV) to explain any fluctuation of inflation outside the target zone to the public and, through its governor, to parliament. In view of this rather ambitious framework for accountability, it is understandable that the central bank wishes to focus on quarterly averages of the inflation data (paragraph V) in order to be able to put into the right perspective monthly outliers of inflation.[7]

Overall, there are pros and cons to the proposed approach. A strength is that it is a transparent way of ensuring accountability and demonstrating the commitment of the central bank to its inflation objective. At the same time, the combination of the various elements has the disadvantage that the "target plus tolerance" band is relatively wide (3 percentage points) and that the combination of a target band and a tolerance band may not be easy to communicate to the general public.[8] In addition, in view of the fact that the CPI is very much subject to one-off shocks coming from the agricultural sector or from import prices, aiming to maintain inflation within the band "all the time" may be somewhat overambitious.[9]

### 2.4. The forecast horizon and monetary policy

I have two comments relating to the proposal to "target forecast inflation one year ahead" (paragraph X).

(a) The horizon of one year appears to be relatively short. The main argument for a longer horizon is that the lags of monetary policy are longer than one year, i.e. it is not possible for monetary policy to steer inflation one year ahead in a smooth manner, without imposing high volatility on (some sectors of) the real economy.[10] As there seems to be evidence of a rather weak transmission of monetary policy in Albania, it is unclear whether the BoA should indeed aim to focus on such a short horizon.

The manuscript points out in this context that it is difficult to forecast inflation beyond one year in view of the "structural and integration reforms" (Box 5) that Albania is currently undergoing.

There are two possible ways out here: either the central bank nevertheless makes an attempt to forecast inflation at longer horizons, or it plays down the role of the forecast in its decision-making process.

This leads me to my second comment.

(b) The link between the inflation forecast and monetary policy decisions appears unnecessarily close.

There are good reasons for the BoA proposal to make the forecast a "staff forecast" outside the responsibility of the MPC (paragraph XX). This keeps the forecast process free of policy interference and enhances transparency. However, if the forecast is a staff forecast, it can only be an input into the decision-making process and should not be mechanically linked to monetary policy decisions. Indeed, forecasts are always based on a series of assumptions and depend on the quality and mix of the tools and other inputs used (including judgement). The MPC of the BoA must understand the strengths and weaknesses of these tools and must be free to base its decisions on its own judgement, possibly deviating from the forecast.

Taking these points together, the BoA may consider (a) preparing forecasts at longer horizons and (b) reducing the emphasis on the role of the forecasts in the decision-making process.

### 2.5. Forecasting methods

The BoA plans to base its inflation forecast on several econometric models (paragraph XVII) and to eventually make a final choice for one of the models (paragraph XVIII). In addition, it is building a macroeconomic model (paragraph XIX).

All these modelling activities are to be welcomed. Even in an economy undergoing significant structural change, it is crucial to provide the MPC with a sound quantitative basis for decision-making.

In this respect, nothing argues against employing several models in parallel. Various models, using various techniques, can serve different purposes and can shed light on the same issue from various perspectives. What is crucial, however, is that the particular strengths and weaknesses of the models are always well understood by the users and kept in mind when results are presented and interpreted.

While models can help to construct the forecast, it may also be advisable to add to this some expert judgement, particularly in an economy undergoing considerable structural change.

Relying on a purely model-based forecast may be too rigid an approach for a rapidly developing economy like Albania.

The proposals for the interest rate and exchange rate assumptions underlying the forecast (paragraph XIII) are very much in the tradition of inflation-targeting central banks. More recently, central banks have started to use market interest rates as derived from the yield curve as the main interest rate assumptions for the inflation forecast. This approach helps to avoid certain inconsistencies in the forecast and also produces more realistic outcomes. However, it poses a slightly greater communication challenge for the central bank. In addition, in view of the state of development of the Albanian financial markets, it may be difficult at this juncture to reliably derive interest rate expectations from market yields.

A forecast based on market interest rates needs to be distinguished from a forecast based on the policy-makers' own views on future interest rates. Such forecasts are currently produced and published only by very few central banks. The reluctance to use this technique stems from, among other things, the fact that a) decision-makers do not see a need to spell out quantitatively the details of the future path of interest rates, and b) any publication of an intended policy path may be easily misconceived by the public as an unconditional commitment (i.e. the central bank may have difficulties in communicating to the market the notion that the policy interest rates used in the forecast are conditional on future events). Given such misconceptions, deviations of future actions from past policy interest rate announcements/assumptions used in the forecast can then cause confusion in the market. Against this background, it may be safer for a central bank to adopt as forecast assumptions constant or market interest rates instead of envisaged policy interest rates.

An unclear aspect of the proposal is that the "basic assumptions on external factors" will be "approved" by the MPC (paragraph XIII). If this were to mean that the MPC would need to approve the assumptions for the global economy, for example, it would blur the distinction between the staff's responsibility for the forecast and the MPC's responsibility for the monetary policy decisions.

### 2.6. The inflation report

The publication of a quarterly Inflation Report (IR) is to be welcomed (paragraph XI). Such a report helps to explain the policy conduct and the MPC's assessment of current and future economic developments to the public.

It is clear that in the IR the BoA always needs to explain in detail its inflation forecast and its monetary policy conduct. In this respect, there should not in principle be a need for a specific provision, as in paragraph XVI, spelling out the conditions under which the BoA shall explain deviations of the forecast from the objective. Such deviations should always be addressed in the report, irrespective of their size.

The central bank may also consider how it will present its forecast. In order to show the uncertainty surrounding forecasts, several central banks have chosen to show their forecasts in the form of ranges or fan charts. Such a presentation also helps in justifying why monetary policy decisions are not mechanically linked to the forecast.

One critical issue is whether the bank wishes to show the inflation forecast a) as it went into the decision-making process, i.e. before monetary policy decisions were taken, or b) as it emerges after the latest monetary policy decision has been taken.

The first option has the advantage of ensuring transparency of the decision-making process but implies the risk that the published forecast may give a misleading signal about the likelihood of future events. In contrast, the second option may imply that, in practice, the forecast hardly ever deviates from the target, as it can be assumed that the MPC normally takes decisions with a view to keeping future inflation broadly in line with the target.

Various inflation-targeting central banks have found different solutions to this problem. Obviously this problem is small if the central bank bases its forecast on market expectations for future inflation rates (see comments above), since the most recent policy decision, if it had been expected by the market, should then normally have little impact on the forecast.

Within the IR it will be useful to clearly identify which parts are written under the responsibility of the MPC and which are prepared under staff responsibility. If the forecast is prepared under the staff's responsibility, this should be made clear in the IR.[11]

As noted in the manuscript, the IR will only be one aspect of the communication strategy of the BoA. Indeed, the importance of a wide range of communication tools, targeting various audiences (public, markets, schools, foreign observers, etc), can only be underlined for a successful monetary policy in a modern market economy.

## 3 COMMENTS ON OTHER ASPECTS

### 3.1. Relations with the government and parliament

(a) The current degree of monetary financing of the government by the central bank is of great concern. It is extremely important that this channel of monetary financing be abolished as soon as possible in order to ensure the lasting solidity of the macroeconomic policy framework in Albania. The proposals 6 and 7 on page 17 of the manuscript are to be strongly supported.

(b) The current framework does not establish a sufficiently clear demarcation line between the government and the central bank. A clear framework for macroeconomic policy requires giving the central bank responsibility for the objective it can achieve, which is price stability. At the same time, the government will have other objectives, notably the improvement of the allocation of resources and the fostering of sustainable growth. These responsibilities need to be clearly defined and attributed to individual policy actors in order to ensure genuine accountability. A blurring of responsibilities is not helpful in setting proper incentives for policy-makers.

Seen from this angle, a prudent policy approach should not contain ex ante agreements on the setting of instruments across various independent policy actors. Interaction between the policy-makers should rather focus on the regular exchange of information in order to ensure that individual policy actors are aware of each other's assessments and planned actions and can take these into account as well as possible in their independent decision-making. Institutionalising the provision of "advice" from the ministry to the bank (as proposed on page 15) could run counter to the objective of making the independence of the central bank credible in the eyes of the public.[12]

(c) It may be useful to maintain clear rules regarding the Governor's appearances before parliament. Such appearances should preferably be scheduled according to a predefined scheme to protect the central bank from encountering undue political pressure, e.g. by being subject to frequent ad hoc invitations whenever interest rate discussions are on the table.

### 3.2. Decision-making arrangements

(a) The manuscript proposes that the Supervisory Committee should set the inflation target and the "time horizon" (page 34). In this respect, it is not clear what is meant by "time horizon". It could either refer to the period over which the central bank is held accountable (which is "all the time", according to paragraph IX) or it could be the forecast horizon ("one year ahead", paragraph X). If it is intended here that the Supervisory Committee only sets the broad framework, it should probably only define the former aspect, namely the accountability period, and not interfere with the design of the actual tools used by the MPC to reach the target set by the Supervisory Committee.

(b) The MPC will delegate decisions relating to day-to-day objectives to the Committee for the Implementation of Monetary Policy. The manuscript does not elaborate further on the details of this delegation. If the MPC is to remain in charge of the conduct of monetary policy, a clear governance framework for the conduct of liquidity management and foreign exchange intervention needs to be specified to ensure that the decisions of the Committee for the Implementation of Monetary Policy do not undermine the authority of the MPC decisions.

(c) Finally, a clear (legal) governance framework would also need to be established for the relationship between the Supervisory Committee and the MPC.

## 4 CONCLUSION: WHAT ARE THE MAIN PRECONDITIONS FOR INFLATION TARGETING?

Overall, there are a number of preconditions to be fulfilled for the successful implementation of inflation targeting in Albania. I would like to name as the most important the establishment of full independence for the central bank, including the effective prohibition of monetary financing. In addition, priority must be given to further developing the statistical framework for Albania in order to strengthen the ability to monitor and forecast economic trends in the country. Furthermore, the smooth development of the Albanian economy towards a more market-oriented system and a stronger development of the financial sector in Albania will be needed to strengthen the monetary policy transmission process. Once these conditions are in place, the central bank would have not only the formal power to pursue a clear mandate but also the practical means to be in a position to steer price developments and anchor inflation expectations in a credible manner.

NOTES

*[1] The views presented in this note are entirely my own personal ones and should not be attributed to the European Central Bank, the European System of Central Banks or the EU.*

*[2] However, in order to avoid any ambiguities in the interpretation of the objectives, paragraph II could be rewritten as follows: "Subject to the achievement of the principal objective, the BoA shall support the general economic policies of the government with the aim of fostering sustainable economic growth."*

*[3] Note that the Treaty on European Union (Article 4.2) states that the "primary objective" of the "foreign exchange policy" is "price stability".*

*[4] See ECB, "Background studies for the ECB's evaluation of its monetary policy strategy", 2003.*

*[5] There is also a need to further develop other statistics, notably national account statistics, in Albania.*

*[6] In order to assess inflation dynamics, it will also be useful for the BoA to monitor other inflation indicators than the CPI as well as indicators of asset price developments and to include its assessment of these in its monetary policy considerations.*

*[7] In practice, however, as inflation data become available on a monthly basis, it is desirable that the central bank also comments on any monthly outliers in order to explain its current assessment and justify its policy course.*

*[8] In fact, I am not aware of any other central bank that has a tolerance zone on top of a normal band.*

*[9] The ECB, for example, has chosen to maintain inflation close to its price stability objective over "the medium term". Other central banks have chosen to achieve their objective "over the cycle".*

*[10] In this respect, paragraph XV rightly emphasises that the BoA will always aim to bring inflation back into the target zone "while trying to minimise output volatility".*

*[11] In this light, care needs to be taken to ensure that the provision that the supervisory council "approves" the IR (page 39) does not blur responsibilities for the forecast.*

*[12] Note that Article 108 of the Treaty on European Union not only guarantees the independence of the ECB but also asks governments to respect this independence. Notably, it states that "governments … should not seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks".*

# CHAPTER 3

## DECISION MAKING ARRANGEMENTS

*Presented at the Open Forum by Ms. Doriana Lama, Head of Unit at the BoA*

### 1 INTRODUCTION

The move to the IT framework alters the monetary decision making in the BoA. Among the countries that have adopted IT there is a variety of central banks governance structures. The adopted structures seem to depend upon the national history, in particular their national legal framework and their country specific way of building credibility.

The implementation of the IT regime requires a high degree of analytical perception of matters and appropriate skills to assess and project relevant indicators. Sensible decisions should be based on technical expertise as well as sound judgment and practice. Next to this, the process is time consuming and focused. Having a specialized decision making body that concentrates on monetary policy adds to the efficiency of properly formulating and implementing monetary policy, as well as to an increase of flexibility in case of possible reviews of inflation target.

In our view, it is important for Albania to treat monetary policy decision making separately. The proposed arrangements in this chapter aim to increase the effectiveness of monetary policy and to maintain the desired bank autonomy, accountability and credibility that will support the IT framework.

This chapter provides a suitable and practical approach of monetary policy decision making arrangements for the move to IT in Albania. The outline of changes proposed takes into account the seemingly available room for manoeuvre in the current legal framework as well as the feasibility of introducing new changes to the law, which will legitimate the functioning of the proposed arrangements. We keep here cautiously into account that substantial amendments to the law will not only require a broad support from legislative bodies, but also from the whole community. Albania does not have a good track record, since discussions on governing bodies of public institutions are viewed with suspicion and as such may contribute to lowering the credibility of the institutions. By means of our proposals we intend to challenge others in the open discussion about the specific situation of monetary policy governance in Albania, preferably in comparison to other countries.

## 2 OVERVIEW OF CURRENT STANDING

The activity of BoA is based on article 161 of the Constitution of the Republic of Albania, on BoA Law[1] as well as on a wide regulatory package. The BoA Central Bank Law gives the bank the authority to independently define and implement monetary policy, to regulate and supervise the banking system including licensing of new commercial banks, to issue domestic currency, to define the exchange rate policies of the country, to manage foreign international reserves and to develop a sound payment systems.

The central bank consists of the BoA main building in Tirana (employing almost 300 people) and five regional branches (employing 60 people). Monetary policy making takes place at the BoA main building, while the branches perform part of the operational tasks.

According to the Constitution and the BoA law, the BoA is governed by the Supervisory Council in meeting its objectives. The SC is composed of nine members including the Governor and two Vice Governors. The three (Vice) Governors are appointed from the Parliament for a period of seven years based on propositions from the Parliament (5), from the Government (3) and from members of SC (1). Criteria for their election or dismissal are specified in Article 44.3 in the BoA law:

"Candidates for membership in the Supervisory Council must be citizens of the Republic of Albania, they must be persons of recognized integrity, and

a) economic or jurisprudence high education;

b) professional experience in monetary and banking matters;

c) postgraduate professional qualifications;

d) experience not less than 5 years in public administration or in financial and banking institutions."

The SC usually meets each two weeks for discussing and to deciding upon a wide range of issues pertaining to functions of the BoA. The most important ones are the formulation and implementation of monetary policy, the exchange rate policy, the administration of foreign reserves, the banking supervision, the approval of BoA budget and operational expenses, the human resources and the approval of various regulations. Minutes of the meetings are not published and that is stated also in the BoA law. The day-to-day management of the bank is delegated to the Governor and two Deputy Governors. The SC is accountable to the Parliament for the performance of the monetary policy, issues of financial stability within the scope of BoA and financial statements of the BoA. The SC is represented by the Governor.

## 3 MONETARY POLICY DECISION MAKING ARRANGEMENTS

The following proposal stems from the argument that central banks under IT should establish clear governance procedures for monetary policy decision-making, laying down who is responsible for what and how the exercise of that responsibility can be assessed.[2] The proposed scheme is though not specific to the case of IT.

While the SC maintains its unique role of governing the BoA, certain tasks pertaining to monetary policy decision making process shall be delegated to a committee composed of experts in monetary policy issues. The Monetary Policy Committee's main responsibility will be the setting of interest rates compatible with the target. Monetary policy will be defined by the SC, by setting the target and the time horizon.

In the vast range of decisions that the SC takes every meeting, it seems essential to treat monetary policy decision making separately from the other decisions that the SC has to take. The outcome is expected to enhance both the quality of policies – as a group of experts will be employed for this purpose only – and the independence and credibility of the institutions – as the MPC members and the meeting procedures will be governed on principles of personal independence and transparency. This sequence will entail the anchoring of expectations and increase the effectiveness of monetary policy.

### 3.1 MPC Responsibilities

The MPC will be responsible for the conduct of monetary policy within the bank. It will decide on the appropriate monetary policy instruments in order to achieve price stability. As such, the MPC functions will include setting interest rates compatible with reaching the target, approving liquidity and required reserve arrangements, and foreign exchange operations. In addition, the MPC will advise the SC on matters of defining/changing the target zone or/and horizon in tune with the present economic and financial conditions of the country and the forecast.

When carrying out its activities, MPC will be independent from outsiders, including the Parliament and the Government.

The MPC will delegate decisions related to day-to-day market operations, liquidity management and foreign exchange intervention, to the Committee for the Implementation of Monetary Policy.[3]

### 3.2 MPC Composition

The MPC will consist of five members, comprising the Governor of the BoA and the Deputy Governor of the BoA with the responsibility of monetary policy, and three other members. This composition of MPC should maintain a balance of professional and practical approaches and ensure a sound judgement of experts. We do not exclude the possibility of appointing members from areas other than within the BoA (provided that there is no conflict of interests). The appointment of external members seeks to bring in diverse perspectives, for bringing a more impartial look, raising controversial issues for debate which help to bring credibility, and building a constituency for low inflation.[4]

The number of MPC members across countries seems to be seven on average. We believe that for the case of Albania five is optimal, as the pool of competent experts without a conflict of interest in Albania is small.

For the conduct of monetary policy in Albania an advantage can be achieved by making use of internationally obtained IT knowledge. For this reason we propose to open the possibility of attracting part-time foreign advisors to the members of the MPC.

Considering that the MPC will ideally provide independent expertise in monetary policy decision making, criteria for electing members will be clearly defined. An attempt of that follows:

(a) A member of the MPC can be a resident or a non-resident who (i) is fully competent to perform legal acts; (ii) has completed relevant university education; (iii) has a recognized standing and professional experience in monetary policy matters and the banking system; and (iv) has not been lawfully convicted of criminal offence.

(b) Membership of the MPC will be incompatible with any activity which might cause a conflict of interest between performance of this activity and membership of the MPC.

(c) A person is disqualified for appointment as member of the MPC or shall resign if s/he holds an official position with any political organization, or is member of the legislative body, government departments, supervisory or inspection bodies of other banks or other financial institutions.

(d) Except for the Governor and Deputy Governor, no member of the SC will serve at the same time as a member of the MPC.

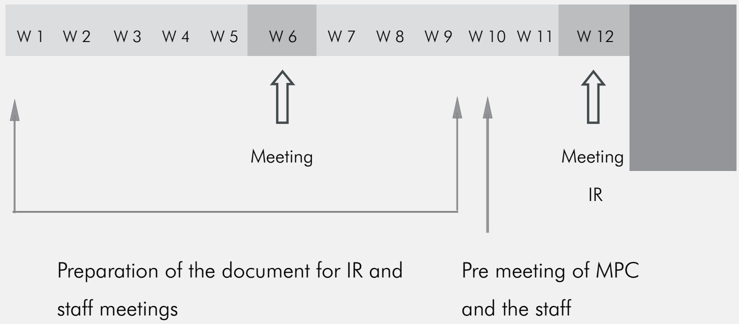
(e) A member of the MPC will vacate office when (i) the term of office expires; (ii) submits a resignation letter; (iii) there is a failure to fulfill the conditions required to perform respective duties; (iv) is found guilty of serious misconduct (v) s/he has been absent for more than three cumulative MPC meetings without the MPC's consent.

The Governor will act as the chairman and representative of the MPC. In his/her absence, this position will be held by the Deputy Governor responsible with monetary policy.

### 3.3 MPC Meetings and Publication of Statements about Decisions

The MPC will meet at least eight times a year (approximately every six weeks) to assess the performance of running policies and to take decisions on interest rates. The Governor -or in his absence the Deputy Governor responsible for monetary policy- or any other two members may summon a meeting at any time on giving such a notice whenever the circumstances may require according to his/her judgement. Meetings may take place by teleconference.

*Box 6 Time Schedule for the Monetary Policy Meetings*




While the IR will be released each twelve weeks, the meeting discussing the IR will take place as follows. Two weeks before the policy meeting, the MPC will meet to receive from the staff the available information that will be used for the IR, namely an internal document with a complete assessment of the economy and inflation together with alternative paths for the economy. On the basis of this material, MPC will discuss the inflation developments and establish its view. Based on this view, the staff will write the report. Until the last moment up-to-date information will be provided.

Decisions are taken by consensus among members of MPC. Discussions are recorded regularly and a summary of them will be included in published minutes. A transcript of the meeting will be recorded and possibly published at a later moment in time.

Once the MPC members are given the assessment of the economic situation and the inflation forecasts, they will not be allowed to give public opinions, which in any way can reveal the forecasts and can indicate the future course of monetary policy, until the next MPC policy meeting takes place.

Coordination of fiscal and monetary policy is crucial. For this reason there should be a two way provision of information so that both monetary policy and fiscal authority understand what the other is doing. With the authority given by the SC, the MPC can ask for information on the short term actions of fiscal policy and include them in the forecasts.

### 3.4 MPC Transparency and Communication

Decisions on media contact should be left to individual members. An important part of the duties of MPC members is to explain the MPC's views in a complete and non-discriminatory way. It is recommendable that the MPC's views are expressed by one voice only.

A written press statement will be released after each MPC meeting and minutes will be published after two weeks.

A communication strategy will be developed by the Foreign Relations, European Integration and Communication Department covering issues such as:

- Publication of the Minutes
- Press statements after each policy meeting
- The Governor's appearance in the parliament twice a year
- Publication of the inflation forecast model(s)
- Publication of the macroeconomic model

### 3.5 MPC Appointment

After consultations with and approval by the SC, three MPC members will be appointed by the Governor. Apart from the Governor and the Deputy Governor, appointment term will be for a period of five years with a staggered appointment. The initial members shall be appointed for three, four and five years respectively and they will be granted the possibility of renewal of the term once.

The terms of the Governor and the Deputy Governor as members of MPC will continue equivalent to the terms assigned to them in the position of the Governor and Deputy Governor, respectively. The remuneration of the MPC members will be set by the SC and will be competitive with salaries in the private sector.

### 3.6 MPC Accountability

The means of accounting for the implementation of monetary policy are drafted considering focused responsibility and enhanced transparency. The Governor, representing the MPC, will report to the SC on the coherent implementation of policies, while the publication of minutes of monetary policy meetings will satisfy desired transparency practices.

The decisions and meeting procedures (including data collection) of the MPC will be supervised by the SC, at their request, to check whether they fit the main objective of the BoA.

Minutes of the MPC meeting will be published within two weeks after the meeting. They will usually contain a brief assessment of the economic and monetary conditions based on preparatory documents submitted before the meeting, any decision taken in the meeting, together with a summary of discussions on the underlying assumptions.

The quarterly IR will be published and distributed timely among the stakeholders after the approval of the SC.

The Governor, as chairman of the SC, will appear regularly in the Parliament to account for the monetary policy performance and attainment of the target as well as to explain central bank actions accordingly.

At the request of the Parliament, the BoA will submit an extraordinary report on monetary developments within 30 days or the Governor will appear in Parliament for providing explanations.

The five Branches of the BoA in Elbasani, Gjirokastra, Korça, Lushnja and Shkodra perform basic payment system transactions. Since 2001 information is also collected twice each year from the commercial banks and lending institutions in their corresponding regions via the Branches. The information concerns deposits and lending activities with the banks' and institutions' clients. With more personal involvement of the Branches' personnel, in July 2005 the Branches started gathering quantitative information from the main companies in their corresponding regions at the request of the central bank headquarters in Tirana. The regional knowledge and personal contacts of the Branches' employees with the companies' management enables accuracy and completeness. This new information on production, price setting and the labour force at the micro level will be used for monetary policy decision making purposes in addition to the quarterly qualitative business confidence survey held by INSTAT since mid 2002. In view of the long time lags of one to two years in the other data releases by INSTAT on real GDP and wages, the timeliness of the company surveys is one of the biggest virtues for policy making. It enhances the monitoring of developments in the real economy.

The regional branches of the BoA:

- will continue surveying these companies at a quarterly basis. The data collection and processing shall become efficient in time with modern communication tools like the internet;
- and (the branches);
- will become a stronger chain in communicating monetary policy to the region. The informal personal contacts with the banks and companies will be used for transmitting decisions and information from the central bank on monetary policy decisions and possible other decisions taken at the BoA main building to the region. Vice versa, as described, the main building will gain from any regional information related to macro-economic and price developments either anecdotical or structural.

NOTES

[1] *No. 8269 that is dated December 23, 1997.*

[2] *See also the FSSA by the IMF, 2005.*

[3] *The CIMP is already operational and meets weekly on Tuesday morning. Members are the Governor, the First Deputy Governor, the Head of Governor's Office, the Directors of the Monetary Operations, Monetary Policy, Research and Supervision Departments and the Deputy Directors of the Monetary Operations and Monetary Policy Departments. The Governor chairs these meetings.*

[4] *See Anita Tulathar (2005).*

# COMMENTS ON DECISION MAKING ARRANGEMENTS

*By Mr. Tonny Lybek, Senior Economist at the International Monetary Fund, Washington DC*

Thank you for the invitation to participate in the panel on decision making arrangements. The Open Forum is a commendable initiative. It shows an open mind, interest in learning from other countries, and willingness to discuss different approaches to challenges where there are no clear first best solution, but pros and cons. The well-written and comprehensive Manuscript provides an excellent basis for these deliberations. The following comments provide an overview of various central bank governance structures, putting Albania in this context, whereupon the proposal to establish a Monetary Policy Committee is briefly discussed.

## DECISION MAKING BODIES IN CENTRAL BANKS

There is now broad agreement on the fact that price stability is the best contribution monetary policy can make to sustainable economic growth, and that this best can be ensured by the central bank being autonomous, having adequate authority to achieve its primary objective, namely price stability, and being accountability for the authority delegated to it. Nevertheless, there is less consensus about the design of the structure of the governing bodies and management of a central bank. The governance structure is often the most contentious issue to address. It is important to recognize that often several options can work as long each option is internally consistent with the objectives and tasks assigned to the central bank as well as the type of autonomy delegated to the central bank.

## OBJECTIVES

Clearly defined and prioritized objectives of the central bank facilitates accountability. Central banks are different from commercial enterprises, which in principle have the objective to maximize the owners' wealth, and government agencies that have clearly assigned functions to perform but at as modest costs as possible. In my view, achieve and maintain price stability should be the primary objective for a central bank. Without prejudice to this objective, financial sector stability—which may be elaborated to fostering a sound, stable, and efficient market-based financial system—should be given priority. Without prejudice to these objectives, a central bank should support the general economic policies of the government. The latter helps to ensure coordination with the government.

Financial sector stability is important indeed, but price stability should be given priority. Financial sector stability—payment systems, banking supervision, if this is done by the central bank as in Albania, etc.—is important for ensuring a stable transmission mechanism. It can be argued that without financial sector stability, it is not possible to conduct effective monetary policy. Nevertheless, if the financial sector is experiencing looming systemic problems and price stability is not given priority, a central bank may feel tempted to—or even feel obligated to—ease monetary policy to allow banks to "grow out" of these problems. Forbearance, instead of up front strengthening the supervisory framework to address these problems, usually amplifies and worsens such problems. This is less likely to happen if the central bank has price stability as its primary objective.

The objectives in the current law are fairly clear, although some minor refinements may be useful. Since the Bank of Albania has already achieved price stability, it is understandable that it is proposed to "only" maintain price stability.

## DIFFERENT TYPES OF CENTRAL BANK AUTONOMY

It is useful to distinguish between four types of autonomy, since it has implications for the type of decisions to be taken by the various bodies of a central bank. Goal autonomy means that there is no clearly defined or prioritized objective in the central bank law. There may be several objectives, which in the short run may be competing, as in the case of the Federal Reserve System in the United States. The central bank must decide the priority of these competing objectives. Target autonomy means that there is a clearly defined primary objective, but the central bank has the authority to determine and specify the target.

This is the case in Albania and the European System of Central Banks. Instrument autonomy means that the target is determined outside the central bank, ideally in coordination with the bank, but the bank is autonomous and has adequate authority to implement the target. This is, for instance, the case in Canada, New Zealand, and Norway. Finally, some central banks still function as government agencies.

They take instructions from the government, which has many competing objectives in the short run, hence there is a perception that monetary policy may be manipulated and the general public demand a higher interest rate, which impedes sustainable economic growth. Table 1 shows that there are many countries, like Albania that have target autonomy.

*Table 1 Type of Autonomy in Selected Central Bank Laws, end-2003*

| | Goal Autonomy | Target Autonomy | Instrument Autonomy | Limited Autonomy [1/] | Total (diminished autonomy) [2/] | |
|---|---|---|---|---|---|---|
| | (percent of laws in each group) | | | | | (number of laws [3/]) |
| High income | 11 | 46 [4/] | 36 | 7 [5/] | 100 | 28 (5) |
| Upper middle income | 16 | 42 | 42 | -- | 100 | 12 (4) |
| Lower middle income | 16 | 29 | 52 | 3 | 100 | 31 (12) |
| Low income | 20 | 50 | 13 | 17 | 100 | 30 (20) |
| Total | 16 | 42 | 35 | 7 | 100 | 101 (41) |

Source: Reproduced from IMF Working Paper WP/04/226.
Note: The survey covers 101 selected central bank laws. Income classification as defined in World Bank Atlas of August 21, 2003.

[1/] Central bank laws where the central bank basically is a government agency.

[2/] Diminished autonomy means that there are important deficiencies vis-à-vis good practices.

[3/] Number of surveyed laws.

It may be useful to summarize five possible monetary policy decisions/functions to be made by a central bank with target autonomy. Namely: (i) determining the target; (ii) determining how to change monetary policy instruments to achieve the target, i.e., the implementation decisions, which requires specialized expertise; (iii) the day-to-day implementation of the implementation decisions, which typically is the responsibility of a management board, the governor, or a general manager; (iv) an advisory function, which may be established to ensure that adequate consideration is given to various regions, sectors of the economy, or to bring special expertise in play; and (v) the oversight of the central bank checking that it is achieving the target.

Often several of these functions are done by one body or there could be a body (board, council, committee) to each make one of these different types of decisions (Table 2). The Central Bank of Hungary is perhaps the best example of the latter. However, there is also merit in having a simple structure, bearing in mind the pool of potential members and to avoid diluting responsibilities.

*Table 2. Type of Autonomy and Structure of Governing Bodies, end-2003*

| | Directors | | | Total | Management | | Total |
|---|---|---|---|---|---|---|---|
| | | | | | Governor | Governing Board | |
| | (percent of laws in each group) | | | | | | (number [1/]) |
| Goal autonomy | 69 | 19 | 12 | 100 | 94 | 6 | 16 |
| Target autonomy | 55 | 24 | 21 | 100 | 67 | 33 | 42 |
| Instrument autonomy | 69 | 25 | 6 | 100 | 83 | 17 | 35 |
| Limited autonomy | 88 | -- | 12 | 100 | 88 | 12 | 8 |
| Total | 63 | 23 | 14 | 100 | 78 | 22 | 101 |
| Source: Reproduced from IMF Working Paper WP/04/226. | | | | | | | |
| [1/] Number of surveyed laws. | | | | | | | |

Nevertheless, it becomes complicated, if the same body is overseeing that the decisions it takes also is consistent with the objective(s), i.e. it is basically overseeing itself.

## THE PROPOSAL

It is proposed to establish a Monetary Policy Committee (MPC), which in principle is a sound approach, as it strengthens the check and balances within the Bank of Albania. The Supervisory Council (SC) will continue to have the authority to determine the target, but it is envisaged that the implementation decisions—when to increase and decrease interest rates and change other monetary policy instruments to achieve the target—be delegated to a MPC. The SC will oversee the MPC, hence strengthening the internal checks and balances. In addition, it would ease the burden on the SC, which is dealing with a broad range of issues, and it would allow that special expertise be applied in the more technical monetary policy implementation decisions.

An MPC, particularly if it has decision making authority, needs a clear legal mandate. The implications of Article 161 in the Constitution—there are two different English translations of this Article—must be clarified. It may be possible to delegate some of the SC's authority to an MPC, but it may not be possible to delegate its responsibility. It is different if the SC is responsible for the implementation decisions or if it is responsible for overseeing that the implementation decisions achieve the determined target and follow the specified procedures. The Bank and the Government should seek independent legal council to interpret this article before any amendments to the central bank law are considered.

There are different MPC designs. It is more important to ensure an informed and balanced debate rather than having a high number of members. In some countries the decisions to change interest rates is taken by a small management board—in some cases only three members—or even the governor alone, but then often supported by an advisory MPC. While a small number of members helps to avoid diluting responsibility, there is much to be said in favor of having a specialized collective body taking such important decisions. MPCs may include or exclude external members, but the key to success really is to ensure that all members contribute and do not have conflicts of interest. It may be useful indeed to include external members. Regarding non-residents, they may bring experience that adds to the credibility of the process, but they can obviously not bring much local knowledge, which is important for the judgment calls a MPC ultimately will have to make. As experience is gained, there is likely to be less benefit from including non-residents.

The governor would seem to have strong influence on the MPC. This is not that unusual, as long there are checks and balances. However, the Manuscript does not explain who has the authority to determine if a member should be dismissed for serious misconduct. Another way of preventing the MPC from being dominated by one person, and thereby ensuring an open and balanced debate, would be to require an explicit voting arrangement. It should be possible for members to put dissenting views on record. This would be important in case of parliamentary inquiries. It is a separate decision, however, to decide to publish if there are dissenting views within the MCP. It is important that the published minutes provide the reasons for the MPC's decisions.

Initially, an informal and internal Monetary Review Committee could be established to gain experience before drafting amendments to the central bank law.[1] The Committee on Implementation of Monetary Policy (CIMP), at its weekly meetings, functions as a liquidity committee, which is different from more forward looking discussions of monetary policy. The CIMP, for instance, could have monthly meetings discussing the economic outlook and the monetary policy stance—in effect function as a Monetary Review Committee—a shadow MPC—making recommendations to the Supervisory Council. The first item on its agenda should be how to observe the monetary program. The second item should be what would have to be done to achieve an inflation target. Experience gained with information packages and procedures would be useful for a future MPC.

Finally, I would like to add that the references in the Manuscript to arrangements with the IMF being inconsistent with inflation targeting could be misinterpreted. The IMF has over time had arrangements with a broad range of countries with different monetary frameworks, including some having inflation targeting, like Brazil.

NOTES

[1] *This was not mentioned or discussed at the conference.*

# COMMENTS ON PROPOSED DECISION MAKING ARRANGEMENTS AT THE BANK OF ALBANIA

*By Mr. William H. Stone, First Vice President at the Federal Reserve Bank of Philadelphia*[1]

## INTRODUCTION

It is a great pleasure to be invited to participate in a discussion concerning the implementation of inflation targeting in Albania. As you are probably aware, the notion of inflation targeting in the United States has been a topic of lively discussion and ongoing research lately, both inside and outside the Federal Reserve. In light of that, I appreciate the opportunity to participate in this conference so that we can share ideas and learn from one another.

I will begin my comments with some observations about the overall structure of the proposal, and then move specifically to the provisions for decision making described in Chapter 3 of the "Proposals" document.

## GENERAL OBSERVATIONS

The "Proposals for Discussion" shows careful consideration of both the theoretical and operational aspects of inflation targeting. Importantly, the Proposal takes account of the need for central bank independence, the usefulness of a numerical objective for inflation, the importance of not having a similar numerical objective for output or employment, and the key requirement that policy be transparent and communicated on a regular basis. Of particular note is the Proposal's recognition that the central bank can have no requirement for funding the government's debt.

More specifically, the Proposal carefully defines what is meant by price stability – a band for inflation of 2-4% -- and how inflation should be measured – annual growth in the headline CPI. This range seems well aligned both with Albania's recent inflation experience and with inflation targets set in other emerging market countries, including the Czech Republic. Additionally, a slightly wider tolerance range is included to accommodate excessively large shocks such as big movements in the terms of trade, events that are often relevant for a small open economy.

The Proposal, as it currently stands, does not specify what behavior is required should inflation move outside the target bands. Of course, different situations may require different policy responses. Still, some general statement regarding the likely speed that inflation or inflationary expectations will be brought within the target band should receive consideration.

The Proposal does make clear the type of communication that the public can expect. Both the types and frequency of this communication take account of best practices among inflation targeting central banks.

As I noted earlier, the Proposal eliminates any requirement for the Bank of Albania to fund the government's debt, which is a necessary precondition for conducting an independent monetary policy. In that regard, the Proposal's provision for regular dialogue between the Governor and the Minister of Finance just prior to monetary policy meetings might be reconsidered, as this could weaken the perception of the central bank's independence. A regularly scheduled meeting, unrelated to the timing of monetary policy meetings, would appear more appropriate.

One more observation along those lines: The independence of central bank decision making from the influence of government is more politically tenable, and hence more credible and sustainable, if the government's decisions are likewise independent of any influence from the central bank. Consequently, the proposal to remove the Governor of the BoA from voting positions on government committees might be strengthened to remove him from any formal advisory role on these committees as well.

## PROPOSED DECISION MAKING ARRANGEMENTS

Under the Proposal, Parliament will continue to establish the overall goals of monetary policy, assigning primacy to the goal of price stability, and the Supervisory Council (SC) of the Bank of Albania (BoA) will continue to establish the operational goals of monetary policy, setting the range and time horizon for the inflation target. Within the Bank, the day-to-day monetary policy operations will remain in the hands of the Committee for Implementation of Monetary Policy (CIMP). The innovation in the proposal is the insertion of the Monetary Policy Committee (MPC) between the SC and the CIMP. The Bank of Albania will need to proceed judiciously in implementing this new structure. For the MPC to be effective, it must be clear of its legitimacy under current law or any new legislation.

The MPC, as a small group of experts in monetary policy making, will be responsible for adjusting the settings of the policy instruments – interest rates, liquidity arrangements, reserve requirements and foreign exchange operations – so as to achieve the operational IT goals established by the SC. The MPC will also advise the SC as to possible adjustments to the IT goals themselves in light of evolving economic and financial conditions.

The MPC will meet eight times a year to consider alternative policy actions, and decide by consensus. A press release will follow immediately from each meeting, and an Inflation Report, explaining recent inflation experience and projecting inflation for the year ahead will be issued every quarter.

The Governor will continue to provide strong leadership and continuity to monetary policy. He or she will chair the SC, the MPC, and the CIMP. On behalf of the Bank, he or she also will formally report to Parliament on monetary policy performance twice each year and as requested.

In my view, the proposal makes good use of the existing supervisory and management structure at the BoA. At the same time, I fully support the introduction of the Monetary Policy Committee (MPC). As I will explain below, I believe a well-functioning MPC will substantially improve the central bank's efficiency and effectiveness in achieving the macroeconomic stabilization goals established for it, and in properly setting the goals themselves.

Accordingly, the remainder of my remarks will focus on two issues: first, in what specific ways can the MPC improve the central bank's monetary policy performance? What characteristics and qualifications does this require of MPC members?

## CONTRIBUTIONS OF THE MPC TO MONETARY POLICY PERFORMANCE

Simply by creating an MPC and implementing its processes and procedures, the central bank will bring greater internal focus to monetary policy issues and more careful deliberation to decision-making. To the extent that the MPC includes outsiders, it may also introduce additional expertise, more independent thinking, broader perspectives, and fresh ideas to the proceedings.

In addition, positioned between the SC and the Bank staff, the MPC's ongoing interaction with both should deepen understanding of the economy and monetary policy throughout the organization. Given the composition of the SC, this process will, in turn, deepen the appreciation of monetary issues within Parliament and the government generally.

MPC members can also build public knowledge and understanding of the economy and monetary policy issues. Indeed, I note that the Proposal indicates that individual MPC members are encouraged to talk with the media and publicly "explain the MPC's views in a complete and non-discriminatory way." I would add that MPC members can increase public confidence in the objectivity of monetary policy decisions, and the confidence of the financial markets as well, by expressing their individual perspectives on monetary policy matters. On the other hand, in the interest of preserving the independence of monetary policy, it is appropriate that MPC members not comment publicly on fiscal policy matters.

A number of economists have noted the dynamic nature of the benefits of IT. Once having put an IT program in place, the nation's monetary policy capabilities should be further developed in order to take full advantage of its benefits. By improving data collection, forecasting capabilities, and policy analysis, the central bank can use the IT framework to improve the macroeconomic performance of the country. The MPC is the logical entity to drive this evolution.

In the area of data collection, the Proposal calls for the Institute of Statistics to upgrade the quality, breadth, and timeliness of its data. It also calls on Parliament to broaden the Bank of Albania's authority to collect data and includes plans for the regional offices of the Bank to expand and improve their collection of data from local firms and financial institutions. These are worthwhile initiatives. In order to implement the inflation-targeting regime successfully, the policymakers need accurate statistics not only on inflation and inflation expectations, but also on an array of macroeconomic variables. The MPC might reasonably be empowered to encourage and advise these efforts so as to ensure their success. The MPC might also be empowered to consider using the statistics from other external organizations if such data are available and credible.

In the areas of forecasting and policy analysis, improvements are likely to come via ongoing economic research and econometric modeling efforts. To secure these improvements, sufficient resources must be devoted to maintaining a staff that is well-versed in economic research and to ensuring that the research is reflected in the models that the MPC uses to make and explain policy. Accordingly, the MPC might also be empowered to oversee the BoA's macroeconomic research staff and its research agenda.

Ultimately, monetary policy decisions and their outcomes, in terms of inflation and other measures of macroeconomic performance, are the responsibility of the MPC. Similarly, in the quarterly Inflation Report, both the accuracy of the inflation forecasts and the coherence of the analysis of recent inflation will reflect on the capability and credibility of the MPC. Thus, the MPC has a strong incentive to develop good statistical and analytical resources and to put them to their best use. Accordingly, it makes good sense to give the MPC the budget and scope of authority to carry out this process.

## CHARACTERISTICS AND QUALIFICATIONS OF THE MPC MEMBERS

Under the proposal, the MPC will be composed of the Governor (Chair), Deputy Governor (Deputy Chair), and three other members. It is filling these three seats that requires some consideration.

Given the broad roles and responsibilities of the MPC within the monetary policy process, the proper characteristics of its members should not be construed too narrowly. Day-to-day and very technical issues ought to be handled by the CIMP and Bank staff.

For the MPC to achieve its maximum effect, its members must be individuals recognized for good judgment, reasonable perspective, and commitment to goals. They should be good leaders and strong communicators.

When it comes to ensuring that the outside members of the MPC are of the highest caliber, there is a tradeoff to be addressed. The requirements must be stringent enough to ensure that the MPC members are properly qualified in a number of dimensions, yet not so stringent that they unduly limit the pool of eligible candidates. The proposal recognizes this tradeoff and offers a reasonable set of selection criteria. I am sure that alternative criteria were debated and discussed in arriving at those proposed. Nonetheless, I will offer several alternatives that I think may warrant additional consideration. Two of my alternatives would tighten the criteria; two would loosen them.

The first dimension in which the criteria might be tightened is to limit eligibility for the MPC to resident Albanian citizens.

Residence in Albania would ensure that the MPC member is familiar with economic and financial conditions both in fact and in appearance. This is particularly valuable at a time when conditions are evolving quickly and the timely availability of reliable statistical indicators may be limited.

Citizenship would both imply and convey that the interests of the MPC member were aligned with those of the nation. This is particularly important in that the MPC is empowered to make policy decisions that have a direct bearing on the welfare of the Albanian economy.

Thus, requiring both residency and citizenship would bolster public confidence in the integrity of the MPC and its decisions.

A second dimension in which requirements might be tightened is that concerning ethical behavior. The proposal prohibits those who have been lawfully convicted of a criminal offense or found guilty of serious misconduct from serving as members of the MPC. Perhaps that is enough, but emphasizing that members should be above reproach with respect to their professional and financial affairs might be considered.

Moreover, MPC members will routinely have an insider perspective on the economy and the likely future course of monetary policy. In the days between their meeting and the release of the quarterly Inflation Report, they will have inside information that once released could move markets. Consequently, restrictions should be placed on MPC members' asset holdings and the types of financial transactions in which they can engage to avoid the appearance of conflicts of interest.

Recognizing that it may be a significant challenge to identify and attract a sufficient pool of qualified candidates given all the restrictions, there are two criteria that might be relaxed.

First, it may not be necessary to require that every MPC member hold an advanced university degree or have professional experience in monetary policy matters. Substantial technical expertise will reside with the BoA management and staff. Given that, it may be more valuable for the MPC to bring to the table individuals of good judgment with sound business perspectives and experiences.

Second, and rather simply, MPC members might be considered for a second five year term.

## CONCLUSION

My overall assessment, is that the "Proposals for Discussion" is a carefully thought out document that considers the many important aspects associated with inflation targeting. The Proposal sets the groundwork for further refinements, and so points Albania in the direction of a workable inflation targeting framework that will evolve and develop with the economy itself.

The decision-making process put forth in the Proposal preserves the assignment of responsibilities currently embodied in the Central Bank Law. This is appropriate and, as a practical matter, improves the prospects that it will be fully implemented. Within that context, the creation of a new Monetary Policy

Committee, comprised of qualified individuals, including some from outside the central bank supervisory and management structure, will provide both the focal point and catalyst necessary for successful inflation targeting.

Thus, while the precise details of Albania's IT program may warrant some refinements, I think the overall design, including the creation of the MPC, bode well for its success in ensuring price stability in Albania.

NOTES

[1] *My comments reflect the perspectives of myself and several colleagues at the Federal Reserve Bank of Philadelphia: Loretta J. Mester, Senior Vice President & Director of Research; Michael Dotsey, Vice President & Senior Economic Policy Advisor; and Herb Taylor, Vice President & Corporate Secretary.*

# COMMENTS ON THE INSTITUTIONAL SET-UP OF INFLATION TARGETING IN ALBANIA

*By Mr. Zdeněk Tůma, Governor of the Czech National Bank*

Monetary policy is without any doubt one of the most powerful tools for macroeconomic management. While the theoretical background for target-setting is well established, the task of making practical arrangements for conducting policy in order to achieve targets in an efficient way is certainly a very difficult one. Designing a well-functioning system for decision making is thus at the very top of the agenda for any central bank striving to establish a sound monetary policy framework. It is therefore highly commendable that the Bank of Albania is addressing the related issues well in advance.

Today, I would like to make several comments on the issues where I feel the Czech National Bank can pass on some observations and know-how based on its almost eight-year experience with decision making under an inflation targeting regime.

The discussion about the proposed institutional set-up in Albania provokes a more general debate about the properties of the 'ideal' monetary policy decision-making system. Such a discussion of this general issue could reveal some practical implications for the Bank of Albania. Indeed, regardless of whether decisions are taken by a general Bank Board or a specialized Policy Committee, the 'ideal' system for decision-making should encompass the following basic properties:

a) diversity of opinions
b) regularity
c) separateness
d) staff independence
e) openness
f) dealing with uncertainty

Diversity of opinions is a consequence of the basic lesson we have learnt from the history of monetary policy. Milton Friedman said in 1968: 'The first and most important lesson that history teaches about what monetary policy can do – and it is a lesson of the most profound importance – is that monetary policy can prevent money itself from being a major source of economic disturbance'. This implies that relative smoothness in practical decision making seems to be desirable for any monetary policy practice. In this regard, international experience and experimental research[1] have shown that decisions taken by a 'decision-making body' seem to be superior ex post to decisions taken by an individual, as the latter are more vulnerable to sudden changes in monetary policy stance. It is argued that a significant improvement in policy conduct can be associated with policy makers learning from each other's decisions.

Regularity means not only that the decision-making body should meet on a regular basis, but in particular that the decision-making process should be taken in a standard framework and should be based on a standard set of policy documents. All the more, ad hoc policy meetings based on ad hoc policy documents should be minimized. This not only helps the central bank in its communication with the public, but also helps the decision-making body to maintain internal discipline.

Separateness emphasizes that special attention should be paid to monetary policy in the central bank's agenda. In order to avoid any attempt to displace the policy agenda by any other 'extremely important' issue, separate meetings should be established for policy discussions. Indeed, a policy decision is worth a special 'policy day', split into:

(i) a staff presentation, when staff present the outcome of their analysis (based on a standard set of policy documents)
(ii) a discussion of the analysis
(iii) the policy decision
(iv) communication of the decision to the public

Staff independence should protect the members of the decision-making body from the filtering of undesirable information which can occur whenever a particular decision maker directly manages the 'Economic Department'. Although such behaviour is, with high probability, not intentional, this member can influence the interpretation of the 'staff' analysis in a way convenient to his own opinions. It could happen that the rest of the decision-making body members receive a biased analysis. Moving the role of 'Chief Economist' towards the director of the 'Economic Department', and letting him be more independent of any particular body member (making him responsible to the decision-making body as a whole), can help to solve this problem of information filtering.

Openness is a consequence of 'staff independence'. Allowing staff to be more independent at the same time requires the decision-making body members to take an active approach towards the analysis produced by the staff. Since a perfect understanding of the message contained in the 'policy documents' is a prerequisite for proper policy conduct, interaction between the decision-making body members and the staff should be assured at different levels.

And finally, a need to deal with uncertainty properly arises as a consequence of the uncertainty surrounding monetary policy practice. Therefore, it is highly desirable to discuss the implied risks at different levels:

(i) First, the risks should be discussed by the staff.
(ii) Second, an evaluation of the risks should be performed

interactively by the decision-making body members and the staff (alternative scenarios can be produced on the basis of these discussions).

(iii) Third, the risk and the alternative scenarios should be discussed by the decision-making body members during the policy meeting.

It is clear that all the above-mentioned properties can be satisfied when either a Bank Board or a Policy Committee are making the decisions. Over the years it has been proven that both systems can work well. On the one hand, a Policy Committee automatically encompasses the property of separateness and the full devotion of its members towards monetary policy. On the other hand, Bank Board members are probably identified more closely with the institution and offer a more diversified view of policy conduct. Indeed, it is really difficult to distinguish which system is superior; the prevailing solutions are determined by tradition and other local conditions.

Nevertheless, what is, in fact, of critical importance is the legal framework that is used as the background for the decision making. The decision-making body's mandate should arise directly from the central bank law, or even the constitution, and should be sufficiently 'clear'. Any internal agreement shifting policy responsibility towards somebody who is not explicitly referred to in the central bank law, and thus assumed to be policy responsible, could be highly vulnerable and unstable. This could become apparent as soon as a period of tough decisions arrives.

The implications of all this can be split in two groups. The first group covers a rather general implication that can be summarized as: the policy decision-making role should be performed by a body that is well defined in the central bank law. In addition, regardless of whether the decision-making body is a Bank Board or a Policy Committee, it should fulfil the properties of diversity of opinions, regularity, separateness, staff independence, openness, and dealing with uncertainty. The second group of implications then offers more a practical view which can be summarized as follows:

a) the ‘policy decision-making’ body should have a strong background in law,
b) the meeting devoted to monetary policy should not deal with any other issue,
c) the forecast and economic analysis should be submitted by the staff so as to constrain ‘information filtering’,
d) the decision makers should interact with the staff.

NOTES

[1] *For further details see Lombardelli, Proudman and Talbot’s article ‘Committees Versus Individuals: An Experimental Analysis of Monetary Policy Decision Making’, published in International Journal of Central Banking, Vol. 1, No. 1, May 2005.*

# SPEECH

*by Mr. Malcolm Knight, General Manager of the BIS*


## ABSTRACT

There are three key elements to the consensus that has emerged about successful central banking: first, a clear mandate and objectives; second, sufficient autonomy to perform mandated functions; and third, accountability for policy actions and the stewardship of resources. The clear objective and substantial autonomy given to the Bank of Albania in the 1997 law provide a good foundation for its operations. Continued clarity of message, further refinements in the monetary policy process and constant attention to the sound management of the central bank are essential for retaining public trust and permitting the central bank to achieve its policy objectives.


Institution-building is a gradual and complex process, especially in the field of central banking. A key ingredient is to think ahead, and I congratulate the Bank of Albania on doing so by organising a meeting like this one. It is a pleasure to be here.

My talk on the “secrets of success” for a central bank will be brief - and not only because this is a dinner speech. More importantly, many of the purported “secrets” of a successful central bank are already well known here at the Bank of Albania. The Bank has statutory independence and is widely respected, and this goes a long way to explain its success in keeping inflation in a 2 to 4% target range. This will be the first point of my remarks.

In the second part of my talk I will discuss some concrete aspects of inflation targeting. Third, I will say a few words about the appropriate institutional arrangements for monetary policy decision-making. Finally, I will argue that even very successful central banks need to remain vigilant and work to ensure continued success. Because the Bank of Albania is highly respected, it is important for it to remain focused on core tasks, to manage reputational risks, and to continuously demonstrate its good stewardship of resources.

## SOME "SECRETS OF SUCCESS"

Over the past few decades, a consensus has emerged about what makes for good central banking. This has permitted central banks to deliver a very important public good - price stability - and has afforded them the opportunity to contribute to greater financial stability. One way of summarising this consensus is in terms of three key elements that make the central bank effective as a policy institution.

The first element is for the central bank to have a clear mandate. As Yogi Berra - the legendary American baseball player and manager of the New York Yankees - once said, "If you don't know where you're going, you will wind up somewhere else". Central banks know where they are going. New central bank legislation generally accords primacy to price stability as an objective. Where statutory changes have not been made, existing legislation has been interpreted in such a way that achieving price stability is seen as the sine qua non for attaining mandated objectives. More generally, the public has come to expect central banks to deliver price stability.

The second key element is autonomy. If central banks are to achieve the objectives that have been set for them, they need to have sufficient autonomy to do so. Without it, there is a risk that short-term political or fiscal considerations will dominate. Therefore, central bank policy decisions need to be shielded from undue political pressure or sectarian interests.

Accountability is the third key element of effective central banks. It is closely linked with the other two. If a central bank is given autonomy to achieve a certain objective, it needs to be held to account for its success or failure; and the clearer the objectives, the easier it will be to determine success or failure.

How does the Bank of Albania score in these three areas? De jure, very well indeed. In many ways, the Bank of Albania Law, which was passed in 1997 - the year the pyramid schemes collapsed - is an example of very modern central bank legislation. The first three articles of the Law cover the three key principles that I have just mentioned. Article 3 stipulates a clear objective "to achieve and maintain price stability". Article 1 provides that the Bank shall be "entirely independent from any other authority in the pursuit of its objectives and the performance of its tasks". And Article 2 specifies that the Bank "is accountable to the People's Assembly of the Republic of Albania". These are essential attributes for a successful modern central bank. Nevertheless, there always is scope for further enhancements, as is recognised by holding this Forum. Abolishing the possibility of direct central bank financing of any government deficit is key in that connection, since experience across many countries has amply demonstrated that fiscal dominance can quickly undermine any stability-oriented monetary strategy.

Turning from model statutory provisions to practice is never easy. A number of countries have only begun to do so, and even in long-standing open societies there is no guarantee that the autonomy of the central bank will always be respected. Against this backdrop, I find it particularly impressive that the autonomy of the central bank appears to be well and widely accepted in Albania. This has no doubt helped the Bank of Albania to deliver price stability.

As you know, there are many forms of inflation targeting, and there is no sharp behavioural distinction between central banks that have formally adopted inflation targeting and those that do not use this term to describe their actions. Even those that use the label follow significantly different practices. You can argue that two of the Bank of Albania's current practices - the use of a numeric inflation objective and the regular publication of a report on monetary policy – are important ingredients of any inflation targeting approach.

However, inflation targeting is of course more than that. All inflation targeting central banks publish conditional forecasts of inflation. These forecasts serve the dual purpose of being a key element in monetary policy decisions and a communication tool. Taking this step when you are in the initial stages of modelling your inflation process and understanding the transmission mechanism of monetary policy is no small task.

That brings me to the internal aspects of an inflation targeting framework - aspects that are of key importance. These are the activities and procedures that take place behind the scenes of a central bank to implement a monetary policy that will achieve its stated objective. As the central bank enhances its technical work and expertise in monetary analysis and operations, there is often heightened demand for econometric research, analysis of current economic developments, and systematic forecasting procedures.

If monetary policy decisions are made by a committee, there is increased demand for staff to support the work of all the members of the committee. And there is a greater need for professional staff to formulate the regular, systematic communications that are part and parcel of an inflation targeting framework. The past successes of the Bank of Albania and the ambition and motivation behind this meeting are to me strong indications that it will continue to make a big effort to meet this challenge.

## DECISION-MAKING ARRANGEMENTS

Several factors are commonly mentioned in favour of collegial decision-making in a central bank. More information and a wider range of views are brought to the table. Decisions are better grounded in the community. And there is less risk of clandestine influence by the government.

Collegiality can be achieved in a committee with a single function, such as the Monetary Policy Committee of the Bank of England. Or it can be achieved by relying on a board that performs several functions, as in Australia and Sweden. However, on the whole, it is increasingly common to have a separate monetary policy committee, or for the principal board of the central bank to meet separately to discuss monetary policy issues (the Governing Council of the ECB is an example).

If a decision is made to move in the direction of collegiality in policymaking, there are of course several ways to get there. One is to change the law, as happened in the United Kingdom. Another is to adopt practices that are consistent with the law - the Monetary Policy Committee at the Bank of Thailand and the Governing Council at the Bank of Canada are cases in point. The choice in this area will depend on the political landscape of the country concerned and on the willingness to accept the risk of opening a Pandora’s box.

## MEETING FUTURE CHALLENGES

The media, markets and politicians place powerful demands on a modern central bank. This is particularly true in a small country where the central bank is one of the most professional and highly reputed institutions. However, there are some demands that can deflect the central bank from achieving its basic objectives. A young central bank in a small country needs to think hard which of these demands it should seek to meet. For example, central banks are often urged to do as the Bank of England and the US Federal Reserve do and publish minutes and voting records of monetary policy meetings, as well as to publish the full spectrum of reports, including an annual report, a regular monetary policy report, a financial stability review, a research bulletin and a monthly statistical report. Yet the release of information that attributes specific positions to named individuals risks exposing the policymaking process to political pressure. And the production of massive amounts of information is costly and risks obscuring key messages. In some cases less is more. The options need to be weighed carefully.

A key imperative for a successful central bank is to continuously demonstrate its impartial professionalism. It needs to show that it keeps its own house in order. Internal controls and audit, an effective procurement system, contingency planning, information management, risk mitigation and a range of similar subjects need to be on the Governor's and the Board's agenda in the same way as attention to new advances in the art of monetary policymaking.

Let me conclude by distilling what I take to be the true "secret of success" for a central bank. It can be put very simply. The true secret is that there are no secrets. Transparency and clarity of message and mission are the hallmarks of successful central banks the world over. To be successful, central banks need to be open and transparent.

By contrast, the secret of success for me as a speaker this evening is to come to a close and to be that elusive one-handed economist, who simply raises his glass to toast the success of this Bank of Albania Open Forum.

# CLOSING REMARKS

*By Mr. Marko Škreb, former governor of the Croatian National Bank*

I am sure I share everyone's opinion that in the last two days we had a privilege to participate in an extremely interesting forum both intellectually stimulating and enjoyable. Attempting to wrap up the main conclusions, as the title of this part indicates in the program sounds too ambitious, at least for me. Furthermore, the Governor will, I am sure, give you his own views on the Open Forum and lay down the agenda for the Bank of Albania in the future.

And it is the only appropriate way. BoA and the Governor should be accountable for their actions, as was repeated many times during the OF, and so eloquently in yesterday's speech by Malcolm Knight (General Manager of the BIS) on "secret" success of central banking. We advisors can at best give advice, share our views, knowledge, experience, with authorities, but that is all. In the last couple of years the Breton Woods institutions speak more and more about "ownership". And the more I travel and work in other countries the more I understand its importance.

Therefore I will try to organize some of my final thought on the subject not in a normative way, what should be done, but in the form of what I have been doing in the last 5 years, and that is giving advice. I will try to have a look from a broader perspective, not only a narrow inflation targeting (IT) technical view. It is not that the latter is less relevant, but I am trying to exploit my own comparative advantage. I have ten advice for the governor and BoA and there is no hidden symbolism in their number.

First advice. Never forget the ultimate goal of any economic policy making: increasing the welfare of people. Sometimes policy-makers embark on a reform without asking themselves whether by this they fulfil the ultimate goal of increasing the standard of living of people (welfare). True, central banks should focus on what they do best, deliver public goods called price and financial stability. But let us not forget that inflation targeting and price stability have an ultimate goal and that is increasing welfare of the people.

Second advice. It is not enough to know or even to conduct good policy; others have to understand this as well. People have to understand why reforms are necessary and what policy-makers are doing. David Mayes was the first one to point it out (education) but others have repeated it very often. This is especially true for new economic policies which should be treated like a new product. It is the responsibility of producer - policy makers - to overcome the information asymmetry and inform the consumers – population and politicians - of the benefits of this product (inflation targeting) and sell it successfully. What we know today is that if central banks want to be successful they should be much more "customer oriented" and educate the public and politicians about the benefits of their main products: price stability and financial stability. Otherwise no one will "buy" their product, or the demand will be less than optimal, especially if there is no social capital to value them adequately.

Third advice, linked with the second one is: be transparent. Only twenty years ago central banking was among the most secretive professions in the world. Today governors, at least some of them, have the status of international superstars in popularity, minutes of central bank boards meetings are very often published, some central banks have press conferences following their meetings, etc. Most central banks today "swear" to transparency[1]. Again yesterday evening we have heard that transparency is the key to success.

Fourth advice, on top of achieving and maintain price stability and clarity of mandate (which is another "secret" success of central banking), don't forget other central bank functions and especially financial stability and more generally financial markets. Numerous panelists have pointed this as a necessary precondition for IT. A lot of time was spent on the need to understand the transmission mechanism and the need to deepen and broaden the markets. A sound financial system is not only necessary for IT, but for any monetary regime. The bottom line is that if regulation and supervision are inadequate, bad banks will emerge (or proliferate more than otherwise would be the case). As a consequence there will be large incentives to redistribute resources and not use them in production. Therefore by having a stable banking sector the central bank sends clear signals that production is important. In general if private returns on predation are larger than private returns on production, this will send "wrong" incentives to people and the society will not develop in the warranted direction. Therefore we have to make every effort to "get the incentives right".

Fifth advice. Do not attempt to move too rapidly without thorough preparations, but don't procrastinate either. Sometimes in economic reforms speed is essential, a political window of opportunity (to change the law for example) may open up for a short period of time only. If this happens, grab the chance. But sometimes just like fast food, fast changes can end up by choking your arteries and a bypass (in the form of an IMF emergency program) may soon be necessary. This surgery may save your life, but your goal is to try to avoid the hospital in the first place. The only way to minimize risks is to maintain a healthy lifestyle. What are the principles of a healthy lifestyle in central banking? I will just mention that today the BIS and organizations around it like Financial Stability Forum (FSF), together with IMF and others are constantly upgrading the standards and codes[2] in the financial system and this is a great privilege for many central banks today. They have a set of benchmarks to look at, a set of standards and codes to adhere to. In short, I think that the old Latin saying is very appropriate here: Festina lente (hasten slowly).

Sixth advice. Know what is going on in your economy. Follow and analyze the situation very closely. This is the reason why good data are needed. A lot of panelists and the floor pointed clearly out the need for good statistics. Servaas Deroose, Bill Allen and other panelists have strongly pointed out the precondition of having adequate statistical data. And you need to invest in statistics within the BoA and outside as well. Keep in mind that for an adequate product you need qualified demand. So by your demand for more data you will send incentives to others to produce them.

One should be pragmatic and collect as much data as possible. Official data are needed, but one must not neglect other sources as well, including "circumstantial evidence". So do not hesitate to talk to commercial banks and other market participants and get their views. More generally this is sometimes referred to as "open line policy". Collect evidence from all available sources including daily monitoring of markets and relevant variables (both prices and quantities). But statistical data are backward looking.

Seventh advice would be you should be forward looking. It is very difficult to forecast in general, but you have to do it. With any policy action you can only influence the future and a big benefit of IT is exactly that the mind set is in the future, which was not the case in the past. Central banks used to explain their change of interest rate by past inflation, not their forecasts as if either they can influence what has happened or assuming implicitly that the past is the only predictor of the future.

Eight advice. Invest in people, in your staff. From our previous discussions I know that you are fully aware of this. However I view this as so important that I have to repeat it here. As a minimum, the staff should be able to: a) understand well economic development in a country and especially have a global economic picture including linkages among main economic sectors b) be able to make reasonably accurate forecasts of economic variables c) be able to "translate" modern economic ideas to the management of the bank, d) be able to give advice/comment on central bank decisions, usually under tight deadlines.

These are all very demanding tasks. Therefore the management of the central bank would be well advised to invest in staff. The management should be aware of the main characteristics of the research production function like: high fixed costs, long activation period, increasing returns to scale, economies of scope, and externalities. Investing should be done with good governance principles in mind.

Ninth advice. Keep an open mind and be pragmatic. IT is definitely a very good monetary framework, but paradigms in economics do change. No one was speaking about IT twenty years ago; monetary targeting on pegging the rate one way of another was the way to go. Today's prevalent views are that your hands should not be tied (or if they are it, the "rope" should be very firm). But more and more economists are expressing their views that central banks should not neglect asset prices, like before they were focusing on money aggregates. Is a price index enough? I do not have an answer, but I advice you and your staff to follow very carefully what is going on with IT, especially, as I have mentioned, emerging market experiences with IT, which is still relatively scarce, but will grow every year. In the meantime you have to live on. Policy makers have to take decisions in an uncertain word. Use your own brain (i.e. collective wisdom at the BoA) and be pragmatic. There is a need for fusion. Not nuclear, not in modern cuisine, not optical or spinal. Here by fusion I mean melting together your understanding of how Albanian economy operates and modern economics principles and again be pragmatic. It doesn't matter whether the cat is black or white as long as it catches mice.

Tenth advice. Be an optimist. I have started my introductory remarks yesterday on a personal note by looking backward first

10 and then 5 years from today. What I will do now is look forward 5 and 10 years from now, at least explain what I would like to see 5 years from now? I would like to see yellow stars on the blue background to keep company to a two headed Albanian eagle formally. What I would like to happen 10 years from now is that we meet again, but this time in Frankfurt and discuss about Lek, but only in the past tense, as I hope it will not be your currency any more. Are my wishes overly optimistic? Maybe, but 50 years ago Sir Winston Churchill has famously proclaimed:

"For myself I am an optimist - it does not seem to be much use being anything else."

(speech at the Lord Mayor's banquet, London, November 9, 1954).

Thank you so much for your attention. Mr. Governor, the floor is now yours.

NOTES

[1] *Central bank's transparency. The Economist, December 3, 2005. p. 76.*

[2] *For more details on standards and codes visit either http://www.fsforum.org/compendium/about.html or http://www.imf.org/external/np/exr/facts/sc.htm*

# CLOSING SPEECH

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

*Ladies and Gentlemen,*

I want to conclude this Forum by saying first and foremost that we have had two very productive days! It was a great pleasure for me to listen to your views, constructive suggestions and fruitful ideas concerning monetary policy in Albania. I thank you very much for all your contributions!

At the end of this Forum I would like to give my personal views on the road ahead for Bank of Albania. But I will first put some developments in perspective.

Since 1990 and until today in 2005, the Albanian economy has been transformed from an isolated centrally planned to an open market economy. Before 1990 there used to be only a state mono-bank. Nowadays, there is a central bank with a network of commercial banks and other financial institutions. In 2000, the central bank began to fully rely on indirect instruments for conducting its monetary policy.

As you can see, the Bank of Albania has a relatively short history of central banking. In my opinion, the central bank is moving in the right direction. But time has come to decide how to proceed in the near to further future. This has been the main reason for organizing this Open Forum.

For our country, an ultimate objective is the accession to the European Union. Accession to the European Union implies a full membership. As a consequence, it implies eventually the adoption of the euro after the accession date. EU accession will ultimately induce entering into ERM II, and thereafter adopting the full legal tender of the euro. There will be an automatic adherence to the monetary policy of the European Central Bank. However, these developments still belong to the future.

Having this EU-time path in mind, we are aware of the changing world surrounding us. Albania as a small and open economy is part of this dynamic world. Today, we observe a rapid globalization, liberalization, continuous financial deepening and broadening, with new financial innovations in an always more interconnected world. Albania is influenced by these developments on a day to day basis. Albania therefore, needs a daily monitoring of new developments and it needs to cope with these international challenges.

Before reaching the ultimate EU-accession objective in this constantly changing world, there is still a long distance to cross. As it concerns monetary policy, the Bank of Albania today thinks that Inflation Targeting is the way to take. Better highways will bring us more quickly from Tirana to the Airport. Likewise, the better monetary policy is able to maintain price stability, the quicker Albania can take the road and reach the levels of neighboring Europe with their higher welfare levels.

We are fully aware that adopting fully fledged Inflation Targeting is a process that requires hard work with several preconditions in place, as these two days have underlined. Getting to Inflation Targeting is more of a marathon than a steeplechase. Our two days here have shown that it is not a discrete one-time decision that resolves all problems. It should also be a smooth process. This holds in particular for a transitioning country like Albania. Our country faces different challenges and virtues compared with developed countries.

Now, how is our Working Agenda set?

I want to distinguish between the working areas within and outside the central bank. And the working area outside the central bank can be split into Albania and the international environment.

I see the further building of the central bank as a recognized and respected institution as one of my primary tasks. Qualified young and ambitious people need to help us bringing our internal discussions and work to higher levels. Cutting-edge discussions and fundamental studies are needed to make the central bank choose the best policies, on monetary policy as well as on supervision and financial stability (in a broad sense). The human resources capacities need to be secured. Inflation Targeting is to be further scrutinized in all respects. Econometric models need further development for forecasting inflation and analyzing transmission channels. More statistical work needs to be done, in particular on micro information from the real side of the economy. A specialized unit should concentrate on all areas that cover the consumer price index. A clear and professional communication strategy is to be developed. Information on monetary policy is to be translated into a language for the different population groups in our country. Next to all these activities, we need to continue our discussions on the Monetary Decision Making arrangements that are deemed essential for Inflation Targeting. These activities within the Bank of Albania are on my agenda for tomorrow.

Outside the central bank in Albania we need to take all efforts for a further development of the financial markets and other transmission channels. We cannot do this on our own. In this respect we should establish a deeper constructive collaboration with other national institutions. We should elaborate with the Ministry of Finance and the Parliament on the legal issues for strengthening the central bank's independence. With the Ministry of Finance we already have projects, such as the anti-cash, credit office, T-bills market and so on. But a topic high on our and the agenda of the Ministry of Finance's agenda should be the statistical framework. Statistics by means of INSTAT need to become timelier and need to be improved for the purposes of policies by the central bank as well as by the government. As discussed also these days, we should take all efforts in bridging the gap between the Bank of Albania and the other central banks in Europe. The central bank law served Albania at the time it was laid down. Now at the brink of the year 2006 we all agree that it needs amendments.

Governance at the central bank needs to reach the levels of governance at the central banks in more developed countries. We need a full independence of monetary policy on the one hand, and of fiscal and other government policy on the other hand. We need more professionalism. We need monetary policy conducted with a view to the future. We need to improve on accountability. We need to make our people contestable within and outside Albania as it concerns the policies. I would like to see more open discussions where we discuss elaborately about our differences in opinions but at the end of the day also reach agreements that - as their sole purpose - benefit the Albanian economy.

Our cooperation with international organizations like the International Monetary Fund will be maintained and open discussions about consistency issues with the new monetary strategy will carry on. Cooperation with the European Commission should become intensive in order to harmonize all central bank requirements in line with EU standards. In my view EU is one of the highest priorities on the Agenda of Albania, and the central bank will provide all cooperation in making its central bank law and all further rules and regulations according to EU-standards.

Next to this, the relationships with the Bank for International Settlements and the European Central Bank need to become closer. As a special point I want to highlight again the cooperation with the central banks in the region. We can more often share our views about monetary policy, supervision and financial stability. We can more often have common projects. One of the big projects I have in mind is the process of preparation for the accession to the European Union.

As you see, our Agenda is quite full. Probably not only in the short term but also for the medium term. But let me stop here.

I am sure we will meet again in the future. But I conclude here by saying that I hope to meet you again in the very near future. At these occasions I will update you about any steps and progress we have been making within the Bank of Albania! Today I spoke a lot; tomorrow we will start implementing what we said today.

Once more, thank you very much and have a safe return home.

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# ABBREVIATIONS AND GLOSSARY

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|---|---|
| BIS | Bank for International Settlements |
| BoA | Bank of Albania |
| CIMP | Committee for the Implementation of Monetary Policy |
| CoM | Council of Ministers |
| CPI | Consumer Price Index |
| ECB | European Central Bank |
| ESCB | European System of Central Banks |
| EU | European Union |
| FSSA | Financial System Stability Assessment |
| IMF | International Monetary Fund |
| INSTAT | Institute of Statistics |
| IR | Inflation Report |
| Lek | Albanian currency |
| MoF | Ministry of Finance |
| MPC | Monetary Policy Committee |
| PRGF | Poverty Reduction and Growth Facility |
| SC | Supervisory Council |
| WB | World Bank |

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