REGIONAL FINANCIAL MARKET AND FINANCIAL STABILITY

SIXTH ANNUAL CONFERENCE OF THE BANK OF ALBANIA

TIRANA, OCTOBER 30 - 31, 2006

REGIONAL FINANCIAL MARKET AND FINANCIAL STABILITY

SIXTH ANNUAL CONFERENCE OF THE BANK OF ALBANIA

Tirana, October 30 - 31, 2006

CONTENT

OPENING SPEECH

*Ardian Fullani**

Honorable Mr. Prime Minister,
Honorable Colleagues,
Distinguished participants,

Is my great pleasure and privilege to open the Sixth Annual Conference of the Bank of Albania and to welcome you to Tirana.

This conference will focus on financial stability. The analysis and understanding of imbalances in the financial markets and of their causes is essential in central banking. The extent of social benefits and advantages that money, as a public good, creates to the society is dependent on the efficiency and capacity of financial markets to facilitate trade, production, capital accumulation, economic growth and social welfare.

Therefore, financial stability may be regarded as a "public good" and hence it represents a public economic policy objective. The question is who is in charge of providing this good? Personally, my attention has been drawn by Paul Volker who describes the natural role of central banks in ensuring the financial stability. The central bank's traditional role, as lender of last resort on one hand, and as monetary policy authority on the other, requires that central banks ensure financial stability in both standpoints as a provider and a beneficiary. Our role of monitoring the contagion process and financial and monetary crises, illustrates this idea very well. At the same time, the monetary transmission mechanism is another factor that witnesses the vested interest of the central bank in preserving the soundness of the financial system.

The developments observed in the last decades, and particularly in the '90, brought the importance of financial stability to the fore and highlighted its key position among the most important economic policy objectives assigned to monetary authorities across the world. In spite of the emphasis and the vast literature on the issue, it is difficult to give a widely accepted definition of "financial stability". Definitions of well-known academics and colleagues describe financial stability as a set of decisions and policies that deal with macroeconomic, monetary, supervisory aspects of economy and regulations of financial markets.

I am confident that those characteristics of financial stability will be widely covered in the proceedings of this conference.

After a long deliberation of literature, I chose Garry Schinasi (2005) to define the financial stability, and I quote him: "Financial stability is a condition, in which an economy's mechanisms for pricing, allocating, and managing financial risks are functioning well enough to contribute to the performance of the economy" (1). This definition implies that the financial system is capable of accomplishing appropriately its three main roles. Firstly, the financial system is capable of achieving effective distribution of economic resources over time. Secondly, it identifies and manages financial risks appropriately. Thirdly, it can softly absorb shocks and surprises that occur to the financial system and the real economy.

I think that the goal of this conference is to analyze financial markets concentrating on these three aspects, and to steer our efforts towards evaluating and guaranteeing the achievement of financial stability in our region. Our economies are quickly developing, and are experiencing rapid changes, and we, as representatives of central banking in our countries, must adapt to these changes and promote growth without losing sight of prudential supervision. Latest trends towards expansion, liberalization and privatization of the financial system in the context of a fast-paced globalization of the world economy have put the goal of financial stability on top of the priorities in our region.

During the last few years, the financial sector has recorded positive growth rates in all the countries of our region. However, I think that the merit for such a growth goes to the most vital segment of the financial system, that is, the banking system. The rapid privatization of banks, which is, at present, almost complete has been the key factor to the successful growth and consolidation of the banking system. This process has opened the way to the arrival of well-known international banks that have brought foreign capital, expertise and confidence in the region. The entry of those banks, besides the positive aspect of fostering growth and development, calls for higher prudence in the supervisory role of central banks.

As a result of the above developments, the degree of financial intermediation in our region has further increased. Credit to economy has played a considerable role towards the deepening of financial intermediation. Albania has recently joined the group of countries experiencing a credit boom, as annual growth rates have been in the range of 60-70 per cent in the last two years.

An interesting indicator of banking system transformation is the EBRD indicator regarding "banking system reform and liberalization of interest rates", which combines the quality of supervisory and regulatory base, the ownership structure of banking system and the degree of public access into the banking system. Based on latest data, the South-Eastern European Countries have progressed admirably with regard to their banking systems. It is crucial to understand that transformation of the banking system has been a key element in the long transition to a market economy. I want to emphasize that this process has brought development, has strengthened the macroeconomic stability, by positively influencing institution built-up and its consolidation, by encouraging faster structural reforms and by setting up the regulatory frameworks related to economic policies.

Giving a glance at the Albanian banking system, I would emphasize that qualitative developments have taken place during 2006. The banking system assets during eight first months of the year have increased by 12 percent and are estimated at about 60 percent of Gross Domestic Product. The banking system has resulted in profit, is liquid and capitalized. I would like to mention the entry of a new bank into our system, the Sao Paolo IMI Bank, which, besides its shares at the Italian-Albanian Bank, has preliminarily agreed with the owners of American-Albanian Bank to buy its 80 per cent of the shares. This opens the way to further consolidation of the banking system in Albania.

Now, let us give a glance at the rest of the financial system. It should be accepted that it still manifests problems of development and consolidation. The concerns relate to the magnitude of operators, the regulatory framework and particularly the supervision. In this way, their contribution to financial intermediation is low.

It should be understood that, besides our role, the establishment and consolidation of the financial stability can not be ensured only through banking supervision. Therefore, further to FSAP recommendations for a more updated supervision and regulation, the new public agency of financial sector supervision is established. Representing the Bank of Albania, we are deeply open to provide our assistance, so that the financial vigilance precedes the development. This will precede the expected developments in the insurance companies, pension funds, and financial intermediaries in general.

Elaborating this matter further, I would briefly point out some weaknesses of the financial systems in the region.

Financial systems in all countries of the region are still dominated by commercial banks. Other segments play a second-hand role. Capital markets, in spite of the recent developments, are still lagging behind. The number of banks in our region is relatively high. Taking into consideration the size of economies in our region, there is room for further consolidation, mainly through mergers and acquisitions. On a regional level, notwithstanding the credit growth rates, the outstanding credit as a share of GDP is small, compared to that of the new members of the EU. This shows that banking sectors have a limited role in financing the economy needs for investments. One of the main factors slowing financial intermediation growth is the high interest rate spread on loans and deposits.

This phenomenon could be the result of several developments, among which we would mention the lack of efficiency and competition among banks, the lending risk that is still high, problems concerning collateral, problems in the functioning of the rule of law, and other issues of similar nature. The low level of efficiency and competitiveness in banking activities is also reflected even by the high capital adequacy ratios. The injection of foreign capital in our countries has remained low, showing, among other things, the inability of our financial systems to facilitate the absorption of foreign investments in our national economies. The absorbing capacities can be improved significantly, if investors and banks conceive their strategies at regional level and not fragmented in separate countries. In this way, the financial system may serve as an accelerator of the inevitable process of the region's integration into the European Union.

Dear honorable participants,

I believe our mission is vital to our future. What I have just said should not be linked only to the issues already mentioned above but to a greater goal, to that which for the moment has become the main aspiration of each country in the region, to the European integration. Mr. Trichet has emphasized that "the speed at which South-East European countries progress towards accession to the EU depends on the policies followed. It is the culture of stability and the exercise of the responsibility in economic policy making that are the crucial ingredients to achieve the bright prospects that lie ahead for the region".

Personally, I have often mentioned in my public speeches that the opportunities of the region for quick and stable prosperity are linked, among other things, to our capability of acting as a team. In line with that, we do not exclude financial stability in all its complexity.

It is a pleasure for me to observe that in the field of central banking, we have achieved a fruitful and productive cooperation through our activity in the last couple of years. The presence of the regional Governors in the Conference of the Bank of Albania makes the case evident.

I am confident that I share the same opinion with my colleagues present in this room, that financial stability is a delicate matter, which must always be part of our agenda. Today, the Bank of Albania is honored to be the host of this event, but I am sure that in the future this forum will be hosted by other countries of the region.

I believe that this conference is openning a door, which I consider a door to the region. On this occasion, I would like to ask you to consider this conference not only as a sign of the willingness for cooperation. I think that it is our obligation and responsibility to identify future priorities for consolidating the financial stability in the region, as an important precondition for its European integration.

*Ardian Fullani, Governor, Bank of Albania

GREETING SPEECH

*Sali Berisha**

Distinguished Governors,

Honourable Directors of the Banks of the Country, of the Region and International Banks,

Honourable Governor Fullani,

Honourable Minister Bode,

Honourable Representatives of the Guest Institutions,

It is a great pleasure for me to greet the proceedings of this conference and to express the concern of the team I lead for the financial sector, its stable development and long-term stability.

As the Prime Minister, I would say that the sustainable economic growth and employment remain two most primary objectives of the economic program of the Albanian government. Albania is, and will continue be characterized by high and stable growth rates and the sustainability of this economic growth remains our task from now onwards.

Our prime objective is to accelerate the economic growth and I firmly believe that Albania can be a country with fast and steady economic growth. It is clear that the financial system development contributes to the rapid and stable economic development. We regard the macroeconomic stability of the country as a fundamental condition for this development. We also conceive stability and especially the financial stability as a dynamic process, and not as a status quo. The status quo only devours and destroys the developing countries.

On the other hand, I would like to express my appreciation for the idea of treating this problem in a regional context. In the framework of regional integration and cooperation, it is indispensable and imperative not only the joint treatment of economic and institutional cooperation, but also the harmonized development of the financial sector.

The financial system of the region must be in line with the constant changes taking place in the European financial architecture and even broader. Undoubtedly, every step of this process should be made prudentially, since the financial stability is a prerequisite for the financial integration.

The current conditions of the financial system of the countries in the region indicate that in general, the same group of banks operates in the market, and as a consequence, this increases the risk of transmitting the financial system instability from one country to the other.

Therefore, it is important that each country is faced with the weaknesses of its own financial systems and with the indispensability for strengthening the surveillance on these systems, because of the increased demand in these countries, and each country should correct them prior to or during the integration process. The quality and manner of reform implementation in the banking system and in other financial markets should be the main indicators of this delicate process.

Reforms, stability and financial integration are needs for the developing markets and are driven by the market forces themselves. However, the policymakers should facilitate this financial integration, serving as catalysts in this process. We should reduce such obstacles as the legal, regulatory, competitive ones, of fiscal policy, or even technical ones, which the financial institutions may face during their interregional activity. In the regional plan this will be a support for undertaking financial integration reforms according to the unified standards and updated practices.

The process of regional cooperation and integration progresses every day, every week and every month. The regional financial cooperation is a key condition for this process. In this context I would like to re-emphasise that this conference is very important not only for Albania, but for the whole region.

The government has often expressed its full commitment to this process. We are deeply committed to create a reliable climate in Albania, aiming at creating a more attractive environment for foreign investments. Being the executive, right from the beginning of our governance mandate, we showed special care to the fiscal consolidation, reduction of informality and continuation of the financial system consolidation. In the reforms undertaken by the government, priority has been given to the fight against organized crime, corruption and money laundering, and to the launching of new promoting ideas, without leaving behind our major projects on infrastructure.

We have built a constant dialogue with the banking system in Albania. We have attentively listened to its problems and requests. We have drafted many laws and bylaws, aiming at increasing its participation in the economic development of the country. I believe that this dialogue, this partnership is giving results and this system will become a big support to the country's economic development. Its potential is of course much bigger, meaning that the government and the Bank of Albania should seriously analyze it, so that this sector can actively participate in the economic development of the country.

We will soon pass a law on public-private partnership. The banks will have a new large place in the financing of the public sector, but mainly of the private sector, in a country which has an economic growth of almost 6 %, which however is not enough to satisfy the needs of this country for its economic development.

Soon the Parliament of Albania will pass the draft-law on the banking law in the Republic of Albania. The amendments to this law are a clear evidence of the reforms undertaken to improve the legal, regulatory and supervisory framework for the banks operating in the country. They aim at supporting the integration process, and directly relate to the implementation of the "National Plan on the Approximation of the Legislation".

Also, the consolidation process of other financial institutions is completed and the Financial Supervision Authority has started to operate, with the purpose to strengthen the supervision and undertake sound financial reforms.

Personally, I am convinced that the country's finances should have a financial board, given the positive tradition of the central bank of the country, but let us consolidate this institution, the supervisory authority of non-bank financial markets, so as to encourage their development. This is crucial for the country, since an undeniable progress exists in some aspects, but in some others we should accept that these markets are really rudimentary.

My presence here is a signal of our full support for the reforms that will bring about long-term economic growth in Albania. I strongly believe that not only Albania, but the whole region which has come out of a phase of conflicts will be transformed into one of the most dynamic regions in the economic level of the European continent. In this context, I firmly believe that such a thing will take place only if its nervous system, i.e., the banking system of the region, operates in a proper way.

In conclusion, I wish successes to this conference.

*Sali Berisha, Prime Minister, Republic of Albania

MONETARY AND FINANCIAL STABILITY: CHALLENGES IN SOUTH-EASTERN EUROPE

*Lorenzo Bini Smaghi**

I would like to take this opportunity to thank the Bank of Albania and the organisers of this event for their invitation.

The central theme of this conference – regional financial integration between national borders and globalisation – is familiar to the ECB and to the central banks of the member states, for institutional and historical reasons.

From an institutional point of view, I would like to recall that the mission statement of the Eurosystem includes the promotion of European financial integration, which plays an important role in the transmission and implementation of the single monetary policy for the euro area. Furthermore, according to the Treaty, the ECB and the National Central Banks of the Eurosystem have the task of contributing to the smooth conduct of policies of the authorities in charge of prudential supervision in order to monitor and safeguard financial stability.

From an historical perspective, several EU countries experienced in the past some of the macroeconomic challenges that are now relevant in south-eastern Europe, like coping with capital flows while opening and integrating their economies. Any economic region has its own peculiarity and we cannot stretch similarities between the EU in 1980s and 1990s and south-eastern Europe today. The situation in the region is much more complex and, to a certain extent, similar to that of other emerging market economies.

I would like to start by addressing some of the specific features of financial integration in south-eastern Europe before addressing the main challenges of monetary policy and financial stability in the region, adding a few personal thoughts on what I think are the priorities for policy makers in a context where national boundaries tend to wane.

FINANCIAL INTEGRATION IN SOUTH-EASTERN EUROPE

Let me summarise very concisely some peculiarities of the process of financial integration in south-eastern Europe.

Over the last decade, the financial sector has converged towards a universal bank-based system, which is largely foreign-owned with, in particular, a strong presence of EU financial institutions. Capital flows channelled through the banking sector have been fostering rapid domestic credit growth in almost all countries. By contrast, the non-banking sector, security and stock markets play only a marginal role in financial intermediation.

The presence of foreign banks is associated with a more stable lending environment, as well as better governance and risk management, which has been supported by the process of convergence of domestic banking supervisory standards to the EU regulatory framework. Financial integration with the EU is very similar to the one experienced in the new EU member states. Empirical evidence on transition economies shows that foreign ownership leads to greater efficiency in the banking sector, which translates into a lower cost of capital.[1]

Financial deepening and improvements in the institutional environment have preceded the full opening of the capital account, which seems to be the best approach to financial globalisation.

According to recent research, the establishment of minimum conditions in terms of financial market development, institutional quality, governance as well as macroeconomic policies allows developing and emerging economies to better reap the benefits of financial globalisation.[2] A growing body of academic literature confirms that the development of sound and deep financial markets and institutions promotes economic growth.[3]

In spite of these developments, financial deepening and convergence of institutional and governance standards to best international practice is still far from being completed in south-eastern Europe. As with any other transition and catching-up process, the path towards a new equilibrium is fraught with risks and presents a number of outstanding challenges. These challenges may be broadly classified under three general headings: institutional, macroeconomic and financial stability.

As regards institutional challenges, legislative reforms are still unfinished and, as already noted, important segments of the financial market - such as securities markets - are in several cases missing or underdeveloped. Above all, it is important to recognize that it is not legislation alone that really matters, but the actual implementation of reforms. A weak judiciary system, weak property rights, ineffective contract enforcement and corruption are all factors that hamper an efficient development of bank and financial intermediation and hinder long term lending to the corporate sector. I will not further delve into these issues, but this does not - by any means - diminish their importance.

I will instead focus on the issues that are closer to the concerns of central bankers, namely macroeconomic policy and financial stability.

MONETARY AND MACROECONOMIC POLICY CHALLENGES

The main task of monetary policy is to ensure monetary stability. Both economic theory and past experience show that monetary stability is the primary and most appropriate objective of monetary policy. This is the rationale for establishing independent central banks with a clear mandate for maintaining price stability. Central banks that are protected from political pressures will not sacrifice the long-term objective of price stability to obtain transitory short-term gains.

Monetary policy frameworks in south-eastern Europe range from inflation targeting and independent floats to hard pegs in the form of currency boards. Over the last years, these monetary frameworks have been put to test by large capital inflows, driving rapid credit growth and domestic demand in the region. While this has recently led to some inflationary pressures, overall inflation has in general been contained. The main impact has been on the external balance, with capital flows constituting a major factor underlying the widening of current account deficits.

Large external deficits pose a challenge for the implementation of monetary policy by increasing the risk of abrupt adjustments and large exchange rate volatility that may impair monetary stability. The choice of the exchange rate regime has important implications on the room for manoeuvre of monetary policy.

Let me start with fixed exchange rate arrangements. Several countries in the region have opted for pegs or tightly managed floats with the euro, as an attempt to anchor inflation expectations, following hyperinflation. This has proved to be quite successful. Over the medium to long run, purchasing power parity conditions should ensure that inflation rates in these countries will converge to that of the euro area - allowing for possible divergences due to the Balassa-Samuelson effect. In practice, however, over the short to medium run, convergence does not necessarily occur as the business cycle of these countries is not fully synchronised with that of the euro area, and the monetary policy of the euro area is not necessarily the optimal one for countries pegging to the euro. As a result, some countries in the region have recently seen real interest rates at levels close to zero, or in some countries, even in negative territory, fostering credit growth, domestic demand and thereby contributing to widening current account deficits.

It is well known that with an exchange rate target and an open capital account, monetary policy cannot use the interest rate instrument to contain credit growth and demand pressures. This is why prudential and administrative measures have been occasionally used to limit credit growth. However, as the past experience of EU countries shows, these measures risk being circumvented in the medium run by borrowing through non-bank financial institutions or by direct borrowing from abroad. Thus, these instruments only represent a second-best policy. This leads to the conclusion that to ensure monetary stability under fixed exchange rate regimes, monetary policy strongly needs the support of fiscal, structural and income policies, also to keep external deficits sustainable in the long run.

In countries with more flexible exchange rate regimes, monetary policy is in a position to dampen domestic demand pressures, thereby ensuring price stability and contributing to lower external deficits, by raising domestic interest rates. However, authorities have been quite hesitant to fully use the interest rate instrument to this purpose. Indeed, despite strong growth, real interest rates have been declining also in these countries, albeit from different levels. Exchange rate considerations and the possible impact of significant exchange rate volatility on growth and current account developments have been the main reason for this cautious approach. Moreover, authorities have been concerned that a rise in interest rates may attract additional capital inflows, thereby increasing the potential for sudden reversals that may lead to excessive exchange rate volatility and hinder the achievement of price stability.

Although I understand these concerns, the choice of the exchange rate regime is essential to allow for monetary policy autonomy. But this also means that this autonomy has to be used to achieve price stability. Prudent fiscal and income policies as well as structural reforms can make a major contribution to monetary stability also under an inflation targeting framework and policy makers should be called upon to make this contribution.

A further issue to be assessed is: How much should we be concerned about the rise in current account deficits? This question is not easy to answer as the assessment of the sustainability of large current account deficits and capital flows in emerging markets is not straightforward. Large current account imbalances per se are not necessarily "bad" and may well be the result of the convergence process. According to standard economic theory, it makes perfect sense for a developing or emerging market economy - with a relatively low level of capital endowment and high productivity growth - to borrow in the international markets in order to finance investment needs, and to smooth consumption. In practice, however, we see that several emerging markets – and here I refer in particular to the South-East Asian economies - have become net capital exporters, which does not match at all with the theoretical prediction. This is also in sharp contrast with the current situation in south-eastern Europe as well as in the new EU member states.

How to reconcile then the economic theory with this multifaceted economic reality? The quality of financial institutions is a key to answer this question. In south-eastern Europe, financial integration with the EU improved access to credit for consumers and firms. On the contrary, weaknesses in financial sector corporate governance in South-East Asia contributed to the financial crisis of 1997-98 and, more recently, to consumption credit booms and busts, resulting in a low capacity to absorb foreign capital. In the case of China the lack of market-driven financial institutions – coupled with the lack of a social safety net to provide for health care, education and pensions - may explain the build-up of excessive precautionary saving. Hence, in both South-East Asia and China, financial sector reforms should contribute to the reduction of current account surpluses.

In any case, the risks attached to large external imbalances in south-eastern Europe should not be underestimated. In this respect, it is interesting to note that according to recent empirical evidence - over the past 35 years – the fastest growing developing countries have proved to use less foreign capital and experience lower current account deficits. At the same time, those fast growing countries have also been absorbing more foreign direct investment.[3] Foreign direct investment, which is a relatively stable source of capital and aims at upgrading the productive capacity of the host countries, seems therefore to be associated with superior macroeconomic outcomes.

The other types of capital flows may not necessarily entail negative consequences, but surely come with higher risks, in particular if they lead to excessive consumption and asset price bubbles. Therefore, reducing large imbalances and ensuring that they are financed through less speculative capital flows – such as FDI - should help to increase the resilience of the economies of south-eastern Europe.

FINANCIAL STABILITY CHALLENGES

In addition to the macroeconomic challenges I have just referred to, large capital flows and fast credit growth pose a series of risks for financial stability. When assessing these risks, one has to take into account that this rapid acceleration in private sector credit growth reflects to a large extent a "catching-up" effect, as all countries in south-eastern Europe had – at least until a few years ago - a very low level of financial intermediation. However, empirical research confirms that "rapid" credit growth is one of the main predictors of financial turbulence, but not necessarily leads to financial turbulence. Thus, we may never know ex ante the actual risk that a certain rate of credit expansion may entail for financial stability, but past experience calls for close monitoring of credit growth. Developments suggest that the costs of being complacent with risks are extremely high.

In south-eastern Europe, we can identify at least three sources of risk, which deserve close monitoring. First, there is the perception that too large a share of credit finances consumption rather than investment, creating the risk of over-borrowing by households that have little experience in managing their debt. Second, rapid credit growth makes it difficult to assess credit quality. The large volume of new loans tends to depress non-performing loan ratios in the short term, due to the fact that potential portfolio quality problems usually materialize with a significant lag. Moreover, rapid credit expansion may also entail lower vetting standards, thereby resulting in lending to less creditworthy customers. This may backfire, as the resilience of loan portfolios to economic downturns remains untested. Finally, the high share of foreign currency denominated or indexed loans in banks' portfolios points to the risk of building-up large currency mismatches in the non-financial private sector. To the extent that domestic borrowers do not earn foreign exchange income, as it is often the case, the unhedged foreign exchange risk becomes an important part of credit risk. In Asia, the surge in foreign currency denominated short-term external debt in the first half of the 1990s left the countries of the region exposed to exchange rate risk. When the external value of their currencies dropped, the external debt expressed in domestic currency terms and as a share of GDP mounted, leading to the insolvency of unhedged borrowers and contributing to the severity of the 1997-98 crisis.

All these risks call for strict vigilance by authorities in charge of banking supervision. I understand that the central banks charged with this responsibility in the region are fully aware of the risks and have been taking concrete measures. However, what I want to stress tonight, as my final remark, is the importance for the supervisory authorities to take into account international financial integration on their daily activity. Where large subsidiaries of foreign-based banks play an important role in the banking sector of the host country, with a potential systemic impact, the case for co-operation, exchange of information and co-ordination between the home and the foreign supervisors is very strong. Of course, the implementation of common standards and regulations facilitates the task of supervisors in the home as well as the host country. Therefore, beside the general call for creating and promoting institutional arrangements, which ensure the independence, accountability and sound internal governance of supervisory authorities, financial integration poses the additional challenge of co-ordinating supervisory activities at a supra-national level.

CONCLUSION

I started this talk with a comparison between the challenges in south-eastern Europe today with those of emerging market economies and those experienced in Europe in the past decades. The quality of institutions and economic governance is crucial in explaining different macroeconomic outcomes. Nonetheless, similar challenges lead to similar policy prescriptions for monetary policies and financial supervision. I have brought to your attention two cases where financial integration limits the scope of action of policy makers: the impact of capital flows on domestic macroeconomic policies and on financial stability. The prescription, as regards the macroeconomic sphere, is that monetary policy should remain primarily geared towards the achievement of price stability. In countries operating hard pegs or tightly managed float regimes, monetary policy has a more difficult task and should be supported by appropriate fiscal, income and structural polices to achieve its objective. In countries with more flexible exchange rates, the greater autonomy of monetary policy has to be used to focus on the inflation target.

Finally, financial stability concerns arising from rapid credit growth and currency mismatches require strong vigilance by independent and accountable supervisors. Since the source of this credit growth is beyond the reach of national authorities, there is a strong need to promote the co-ordination of supervisory activities at an international level.

Thank you for your attention.

ENDNOTES

*Lorenzo Bini Smaghi, Member of the Executive Board, European Central Bank.
[1] See Grigorian and Manole (2002) and Fries and Taci (2004).
[2] Kose, Prasad, Rogoff and Wei (2006).
[3] See Levine (1997) and Wachtel (2001).
[4] Prasad, Rajan and Subramanian (2006).

REFERENCES

Fries S. and A. Taci (2004). "Cost Efficiency of Banks in Transition: Evidence from 289 Banks in 15 Post-communist Countries", EBRD Working Paper No. 86, European Bank for Reconstruction and Development, London, April.

Grigorian, D. A. and V. Manole (2002). "Determinants of Commercial bank Performance in Transition: An Application of Data Envelopment Analysis", World Bank Policy Research Working Paper 2850, World Bank, Washington DC, June.

Kose, M.A., E. Prasad, K. Rogoff and S Wei (2006). "Financial Globalization: a Reappraisal", IMF Working Paper 06/189, International Monetary Fund, Washington DC, August.

Levine, R. (1997). "Financial Development and Economic Growth: Views and Agenda", Journal of Economic Literature, Vol. 35, No. 2, pp. 688-726, June.

Prasad, E., R. Rajan and A. Subramanian (2006). "Patterns of International Capital Flows and Their Implications for Economic Development", paper presented at the Federal Reserve Bank of Kansas City Economic Symposium, Jackson Hole, Wyoming August 25, 2006.

Wachtel, P. (2001). "Growth and Finance: What Do We Know and How Do We Know It", International Finance 4:3, pp. 335-362.

IS THERE A REGIONAL FINANCIAL MARKET DEVELOPING?

*Ardian Fullani**

Distinguished Governors,
Dear participants,
Ladies and gentlemen,

When we thought about the topic of this annual conference, there was no doubt about the need to dedicate it to financial stability issues and the cooperation at a regional level. The current time seems to be appropriate because of the developments in the national financial markets and economic developments, as well as in the speed with which the region is moving ahead in adopting best international standards in good governance, market openness and integration, technological improvements and multilateral cooperation.

In my speech today, I will touch upon similarities and differences, but also uncertainties and risks that our financial markets are experiencing in the path toward modernisation and integration in the global financial markets, and I will try to address the importance of regional cooperation in better facing these challenges. I will conclude with some thoughts about practical regional cooperation, which I am sharing with you, hoping to generate further discussions.

At a regional level, nowadays our countries are experiencing a higher growth rate of the financial markets, compared to that of the economic growth. As a consequence, the weight of the financial sector in the national economies, strictly from a quantitative perspective, is growing. At the same time, expansion is accompanied with changes in the market ability to better accommodate market participants' needs for funding, diversification and risk appetite. Undoubtedly, institutional participants in the financial markets find themselves with a larger number of possibilities for business developments and financial specialization.

In addition, general public interest in using financial market products and services has increased dramatically, based on the benefit they perceive from improved efficiency in everyday life activities. These developments highlight the importance of financial markets for our economic well-being, from a qualitative perspective. Let's also recall that economic improvements trigger and support changes in social and cultural aspects of our life, bringing our nations closer to international values and principles, and to each other.

As expected, because of the historical background, our countries have differed in the speed and depth, with which they have moved along the transition phase in the last decade. While we had many similarities in adopting the first basic and urgent reforms including price liberalization, enterprise restructuring and privatization in some economic areas, we were more distinctive in completing other reforms that would allow for institutional building capacities, which on the other hand, would make these changes root deeper in our societies.

Today, our countries enjoy stable macroeconomic environments. We are experiencing low inflation levels, stable exchange rates, a more prudent and responsible fiscal policy associated with limited and manageable budget deficits. National Central Banks have established their independence and are perceived in public as respectable and reliable authorities. There are also common efforts to fully open our economies and to attract foreign capital. As we are in the process of fully opening our markets, we are benefiting from increased competition, improved productivity and efficiency, and increasing quality of services for our citizens.

But, we are also facing several uncertainties and risks. Markets remain segmented and their infrastructure faces difficulties in supporting new and imposed developments. Market infrastructure deficiencies exacerbate their shallowness and make it difficult for various market participants to act in order to meet their business objectives and manage their risks. The technological improvements have to fully show their effect in meaningfully reducing costs of financial services. Regulatory gaps in different areas of local financial markets create the conditions for regulatory arbitrage and may adversely affect the supervisory work.

Therefore, erroneous and costly decisions are unavoidable. The financial situation of single market participants, due to market segmentation, is highly affected by their capacity to find financial support in the international financial markets. In reality, this leads to an increasing gap among so called "big" and "small" or among foreign and locally owned financial institutions. Real economy development is an additional source of risk for financial markets.

Such interaction should be carefully watched to better understand financial market trend in the future and identify financial imbalances in a country and at regional level. Indeed, we are all experiencing a construction "boom", where residential house prices have increased considerably. In some countries this is fuelled by credit expansion but in the whole region there are different views whether this is affordable. At the same time, the pace of general credit expansion, particularly for consumption and in foreign currency is alarming and is forcing us to think of several "what if" scenarios and take preventive actions.

It is our task as monetary and supervisory authorities, to provide a proper environment for a balanced and stable development of our financial markets. This is not an easy task for us, especially when there is no simple indicator to measure our success in achieving financial stability, and when we realize that this is a multifaceted issue that we do not fully control, and even can not fully predict. Above all, pursuing the target for financial stability is a never ending race, where the "finish line" is continuously moving ahead of us.

We have to find and implement appropriate policies, knowing that these policies represent a trade-off between making the system more resilient on one side and affecting its short-term efficiency on the other. In this challenge, we must bring a proportionate or risk-based supervision to the financial market industry, through consistent communication and promoting the adoption of the international standards in good governance.

Based on our legal responsibilities, we have to approach these challenges at a national level. But, due to increasing liberalization of both labour and capital movement, and herd behaviour of financial market participants, we understand that that is not sufficient. We have nowadays the same financial institutions in our countries and the same behaviour of such financial institutions in response to a centralized business development policy, growing cross-border interaction among businesses and households, creating similar trends in the social life.

Monetary and supervisory authorities in different countries of the region have responded to such developments to a large extent, establishing formal cooperation with home country supervisory authorities, particularly in the area of banking system supervision, by signing bilateral Memoranda of Understanding (MoUs). The fact that our countries are at the borders of the European Union (EU) has caused an increased presence of EU financial institutions, including banks.

Hence, MoU's have been signed with EU countries' supervisory authorities. The quality of cooperation varies in different countries, but one can say with reasonable confidence that the willingness of the host countries to cooperate has not always met the same interest from our counterparts. To a certain extent this is expected, because the assets of their banks in our single countries sometimes represent only a fraction of their total assets. Nonetheless, they should take notice of our concern that this cooperation is very important for us, particularly in cases where these foreign banks dominate our local markets.

The liberalisation of the financial markets in Albania has been a desirable move. We consider the inflow of foreign capital an important factor to upgrade the level of our banking system, to improve its efficiency and the quality of its products, by enhancing competition conditions in the marketplace. In most cases, foreign banks have brought with them the expertise and the mentality of modern business development from the more developed countries they come from.

As Mr. Bini Smaghi mentioned in his key note speech, the increase of foreign presence in our financial market has also triggered new ideas on how financial institutions and particularly banks intend to adjust their business volume and size to position themselves better in the marketplace. But this is something where we would like to see a more active and consistent approach, in both establishing active business development policies and bringing good quality and experienced management in applying those policies.

It is indispensable for our supervisory authorities to be informed of the policy of different important financial or banking groups that operate throughout our region. Host-to-host cooperation can help in this regard, because some of us enjoy better communication links with the home country supervisory authority and they can share this information with the rest of the supervisory authorities in the region, within ethics and transparency principles. In practise, this can turn out to be a very valuable approach, because these regional foreign banks tend to adopt similar policies in countries with similar characteristics.

Another area where we could establish a strong cooperation is the discussion that should occur when any of us is adopting certain measures that are intended to control risks that appear from trends in the financial business developments. In return, we would be able to adopt similar supervisory policies, thus reducing damaging regulatory arbitrage possibilities and other risks associated with it.

One implication of the supervision/regulation heterogeneity across counties in the region is the ineffectiveness of indirect measures to control credit growth. Therefore finding ways and pushing homogeneity in this regard would at the same time be also important to compensate the lost effectiveness of monetary policy and the eventual demand pressures.

There are also a few other ideas that stress the importance of pre-emptive regional cooperation, in bringing us as a region closer to fulfilling our target of European integration. By setting up and pursuing coordinated financial market development policies, we help to integrate our national financial markets into the international ones, and pave the way for other economic and social reforms to follow.

The modalities of such cooperation vary. Ad-hoc periodical meetings of Governors in the region, supported by more frequent meetings in a technical level to support the discussion agenda, could be one way of approaching the objective for stronger cooperation. In addition, through a more consistent communication, we can try to identify particular issues which are relevant for our regional financial markets, and pose those issues to our counterparts, being common home country authorities, other supervisory authorities where we turn for assistance, or even professional organizations where our supervisory authorities participate. I am sure our concerns can be taken more seriously if raised as a region. Furthermore, we must avail of the efficiency provided by the technology, in sharing our information.

A joint web-site can be established, where we can find important information, interpretations, or share its experience regarding supervisory issues or financial stability issues. When mentioning these ways of cooperation, I am not trying to neglect what is already happening and I am mindful of the fact that there is a trade-off between the advantages of such cooperation and its costs.

We should also point out that MoUs can not act as a substitution for cooperation in practice. It is important we maintain close contacts with our counterparts, exchanging regular information on general trends and issues of respective banking systems in normal times, as it serves to establish confidence for future cooperation, particularly during distress times. Otherwise, such official cooperation agreements will do little in making a real difference.

Let me conclude by saying that the objective of reaching and maintaining the financial stability is not an easy task but we could contribute a lot to its achievements, by enhancing our efforts to ensure that financial market institutions are performing soundly in a stable macroeconomic environment. Our contribution can be much more effective, if it is properly coordinated regionally.

Such cooperation will ease our efforts in improving supervision capacities, avoiding cross-border regulatory arbitrage, and will serve our efforts to meet our objective of integration in European financial markets. We can enrich the modalities of such cooperation, keeping in mind that the basis of good cooperation is established in normal times, through regular contacts.

Thank you.

*Ardian Fullani, Governor, Bank of Albania

PROSPECTIVE EU MEMBERSHIP – CATALYST FOR FINANCIAL INTEGRATION IN THE SOUTH-EAST EUROPEAN REGION

*Antonio de Lecea**

Mr. Prime Minister,
Governors,
Ladies and Gentlemen,

I am honoured to be here today in this important and timely conference on "Regional financial market and financial stability". I congratulate the Bank of Albania to this initiative. This event certainly also reflects the recent progress in the development of financial markets in the region, and the need to now look ahead.

My presentation will show that financial integration is a long and arduous process. So, obviously we need an early start if we want to go the full way toward financial integration in Europe. I understand this may be why this issue features so early in the day and early in the agenda of these two days. In what follows I will try to outline some of the most important characteristics of the process of financial integration in the European Union in terms of

- economic rationale,
- forces that are driving it,
- progress achieved so far and
- future challenges.

I shall also take a look at its potential relevance for the South-East European financial markets.

I. WHY FINANCIAL INTEGRATION IN THE EU

1. Studies undertaken on behalf of the Commission estimate the net benefits of a well integrated financial market in the EU as high as 1% of the EU GDP over ten years. This is significant. Financial integration is a powerful tool to raise the performance of the financial systems. It helps to enhance the allocation of resources, raise the productivity of capital and thereby improves the welfare of citizens.

The EU experience shows that fully integrating financial markets is a complex task that requires much effort and resources from all stakeholders – governments, industry and supervisors.

The removal of regulatory, legal and fiscal barriers is only a first step.

- The individual countries' financial systems reflect differing socio-economic preferences. They do not adapt instantly to the new challenges and opportunities.
- The financial industry operates on the basis of numerous self-adopted standards and practices.

Therefore, it takes time before a change in regulation and dismantling of administrative barriers translates in visible effects on the industry.

WHAT DRIVES FINANCIAL INTEGRATION

2. In the EU, financial integration has been driven by global and EU-specific forces. We live in a world of liberalised capital movements and increasingly innovative financial markets that are connected by the most advanced information technologies. The process of EU financial integration can hence be seen as part of a progressive globalisation of the international financial system.

3. On the other hand, there are important drivers of financial integration that are unique to the EU.
- The most important catalyst for financial integration was the introduction of the euro in 1999. The single currency removed exchange rate risk for the bulk of financial flows within the EU and investor demand for cross-border financial services has increased dramatically.
- A second EU-specific driver has been the effort to establish a common regulatory framework for EU financial markets. The blueprint was the so-called Financial Services Action Plan.

It comprises 42 measures targeted at a wide range of financial activities in the wholesale and retail sectors. It is now almost fully implemented at EU level. [Among the exceptions of measures not yet implemented are the "Solvency II" Directive on insurance and the "Capital Requirements" Directive implementing Basel II]. The various measures must now be transposed into the laws of the Member States.

WHAT ARE THE CONCRETE RESULTS OF THESE EFFORTS?

4. Progress varies across the different sectors of the financial system, with the integration of the wholesale markets very much in the lead, whereas the integration of retail markets remains at a lower level.

The acceleration in EU financial integration resulted in tangible achievements.

- The euro area has a unified market for inter-bank deposits
- and has also developed largely homogenous government and corporate bond markets, with fairly convergent prices across the euro area and evidence of cross-border portfolio diversification.
- The euro area derivatives market is highly integrated
- and the equity markets are increasingly characterised by cross-border investment.

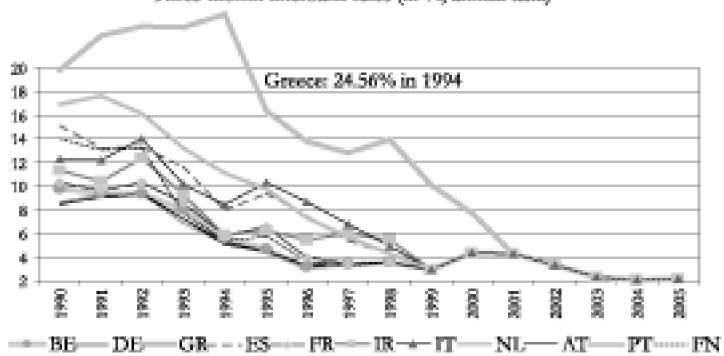
5. As financial markets are integrating we notice a sustained trend towards consolidation among financial intermediaries and infrastructures. The banking sector – as the dominant sector in providing euro area financing – witnesses a significant amount of mergers and acquisitions, although mainly along national lines due to still existing legal and political cross-border barriers.

Notable examples of market infrastructure integration include:

- the merger of four EU exchanges in Euronext [Amsterdam, Brussels, Paris, Lisbon];
- the integrated Nordic-Baltic market, which is made up of stock exchanges from six Nordic Member States [Copenhagen, Stockholm, Helsinki, Tallinn, Riga and Vilnius]; and
- the integration of payment systems, such as TARGET, or clearing and settlement systems, such as Euroclear.

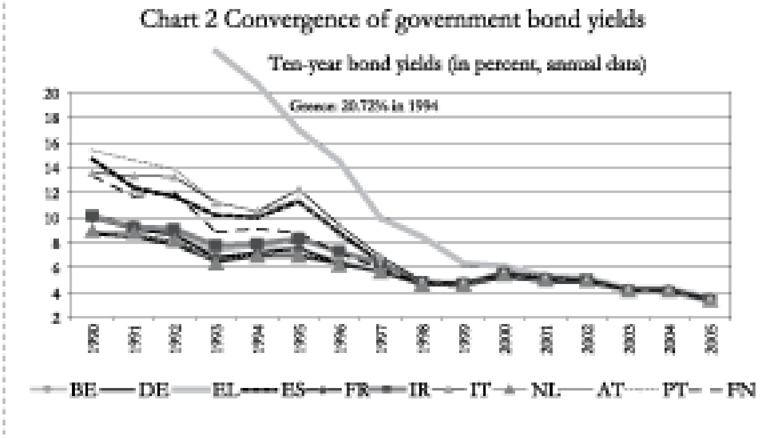
Chart 1 Unification of inter-bank money market rates in the Euro Area

Three-month interbank rates (in %, annual data)



6. Hence good progress has been achieved. But the process is not yet completed. A number of priorities for future action target:
- The still fragmented retail financial markets;
- The fairly slow cross-border integration of banks and insurance companies;
- Full harmonisation of EU regulation and supervision in banking and insurance;
- Last but not least, the integration of prudential supervision

of financial institutions and the creation of a coherent cross-border approach to crisis management represent a significant challenge.



II. RELEVANCE FOR THE SOUTH-EAST EUROPEAN FINANCIAL MARKETS

7. Does this experience in the EU hold any value for the current state and future of markets in South-Eastern Europe? Let me lay out some preliminary views:

Firstly, and most importantly, the economic rationale for financial integration is as persuasive for South East Europe as for the rest of Europe. Financial integration is a powerful instrument of economic reform by

- facilitating corporate restructuring and
- fostering innovation,

yielding substantial benefits in terms of capital productivity and output growth.

Secondly, the South-East European economies have recognized the benefits of globalisation and integration in the international financial markets.

- They liberalised capital movements,
- improved banking and financial supervision and
- opened their economies to international competition.

The prospect of EU membership acts as a catalyst in this respect.

The broad macroeconomic and structural reforms undertaken by the economies in order to fulfil the Copenhagen accession criteria have led to important progress.

This is particularly the case for the banking sector, the predominant part of the financial sectors in the region.

Notable developments are worth mentioning, among which:

- Prudential regulation of banks and the institutional capacity of central banks were strengthened.

Broader regulatory reforms are pursued as regards:

- the implementation of Basel rules,
- on accounting and auditing,
- the enforcement of collateral and
- creditors' rights and money laundering.

According to the EBRD Transition Indicators the reform of the sector appears to be on track, in particular in Albania, Bosnia and Herzegovina and Croatia

Chart 3 Convergence in retail interest rates - (standard deviation)

(EUR-11 up to 31.12.2000 / EUR-12 from 1.1.2001)

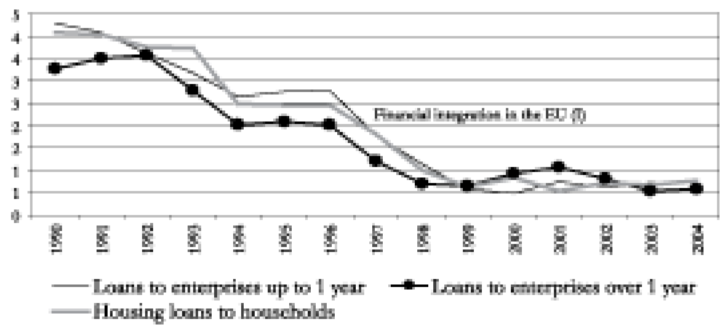
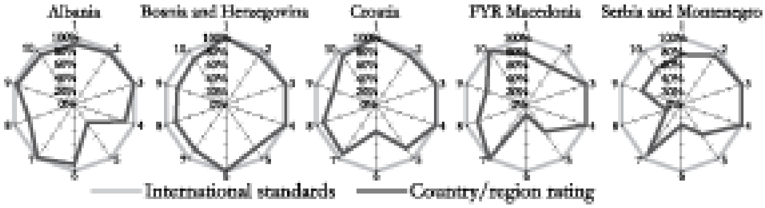


Chart 4 Relevance for the South-East European financial markets (II)

The reform of the banking sector is well advanced



The extremity of each axis represents an ideal score, that is, corresponding to the standards set forth in the Basel Core Principles.

The fuller the "web", the closer the relevant banking legislation of the country approximates these principles.

1. Competence of the banking supervisory authority
2. Discharge of the banking supervisory authority's powers
3. Definitions of the bank and banking activities
4. Licensing authority and requirements
5. Supervision of operations by domestic banks overseas and foreign banks locally
6. Transfer of ownership and major acquisitions
7. Prudential regulations
8. Extension of credits and investment activities
9. Risk management
10. Governance and auditing

Source: EBRD Transition Indicators 2005

- Competition has been fostered by privatisation and openness to foreign investment:
  - Bank privatisation has advanced. State ownership in the banking sector fell from close to 100 percent in the early 1990s to less than 10 percent.
  - Foreign banks have strongly engaged in the banking systems. This contributes significantly to the transfer of know-how and better financial products, improved access to external financing and deeper competition in the market.

In 2005, foreign banks accounted for about 90% of the market share in Croatia and Albania and 66% in Bosnia and Herzegovina.

Levels in Serbia (37%) and the former Yugoslav Republic of Macedonia (48%) are increasing significantly due to privatisations and organic growth of foreign bank subsidiaries.

- Regional consolidation is driven by EU banks, mainly from Austria, Italy and Greece, which have created important banking networks in the economies. Despite high-concentration in the top end of the market, competition remains dynamic as banks struggle for shares of the rapidly expanding markets

Competition in the banking sector remains dynamic despite regional consolidation (mainly driven by EU banks)

	Number of banks		Market Share of top-5 banks (%)
	1999	2004	
Albania	13	16	77
Bosnia and Herzegovina	61	33	61
Croatia	53	37	74
FYROM	23	21	76
Serbia	75	43	47
Montenegro	n.a.	10	77

Source: Joint WB/EC Office for SEE, Bank Austria-Creditanstalt

Progress has been more modest in the insurance sector and capital markets. Capital markets are still rather small and fragmented in the region. The stock exchanges in Ljubljana, Zagreb and Belgrade seem to be better capitalised and more active but still below their potential

Progress has been more modest in the insurance sector and capital markets

		Market Cap. bn EUR	Turnover bn EUR	Companies listed*
Albania	Tirana	0.0	0.0	0
Bosnia and Herzegovina	Sarajevo	3.2	0.2	11
	Banja Luka	1.3	0.05	-
Croatia	Zagreb	11.0	0.6	95
Montenegro	Podgorica	0.9	0.1	35
Serbia	Belgrade	4.5	0.5	31
Total		20.9	1.5	172
Slovenia	Ljubljana	6.7	1.8	124
Austria	Vienna	108.0	74.8	111

Note: *in the official market segment
Source: Joint WB/EC Office for SEE, Bank Austria-Creditanstalt

The entrance of foreign investors and brokerage companies is already delivering positive effects in terms of market deepening and provision of expertise.

However, this is probably the sector which would benefit the most from integration at a regional or European level.

III. FUTURE OF REGIONAL INTEGRATION IN SOUTH EAST EUROPE

8. In the light of this experience, what is the future course of financial integration in the region? We will probably witness an acceleration of this process once the countries will be in full compliance with the acquis communautaire for the financial sector, as a condition for EU accession.

Moreover, the eventual adoption of the euro will be a further powerful driving force that will integrate financial markets in the region, as they gradually become part of the unified EU financial markets.

Further regional integration can enhance economic efficiency and preparing the economies for a subsequent deeper integration.

Yet, we should be realistic about its potential scope and speed.

- The different financial systems in the region do not yet enjoy strong comparative advantages vis-à-vis each other.
- The ongoing integration seems to be mainly driven by the expertise and financial capacity of international financial institutions.
- In addition, the risks to financial stability which derive primarily from the lack of a cross-border regulatory and supervisory framework should be better managed by a gradual adoption of the EU acquis and practices rather than by ad-hoc arrangements.

In addition, it must go hand in hand with preserving and strengthening co-operation with other supervisors in the region.

9. Therefore, regional financial integration might represent an intermediary stage on the road toward full European integration. Conversely, it will be driven by the countries' gradual integration in the EU as well as by a more general trend of globalisation of financial markets.
10. Let me conclude my presentation by summarising what I see

as the immediate policy priorities in South East European countries, in order to foster regional and wider financial integration.

I would highlight four priorities:

a. Gradual adoption of the EU acquis;
b. Strengthening the regulatory and supervision framework, by building capacities in line with the Basel regulatory framework and pursuing close co-operation with other supervisors in the region and beyond;
c. Addressing the regulatory issues arising from the economic catching up, such as rapid credit growth or exposure to currency and other balance sheet risks, and
d. Facilitating market entry and consolidation in the financial sector.

Thank you for your attention.

* Antonio de Lecea, Director, International Economic and Financial Affairs, European Commission

THE DEVELOPMENT OF FINANCIAL MARKETS IN THE BALKANS: AN ASSESSMENT OF REGIONAL PROGRESS

*J. Andrew Spindler**

I am honored to be able to speak at the Sixth Annual Conference of the Bank of Albania, and I want to thank Governor Fullani for inviting me. This is a gathering of growing importance not only in terms of Albania's financial and economic development, but also that of the Balkan region. I want to congratulate Governor Fullani for his commitment to fostering this event as a forum for discussion of key issues facing the region. I would also like to commend him for his leadership in strengthening the Bank of Albania.

At the outset of my remarks, I would like to remember Andrei Kozlov, the First Deputy Chairman of the Central Bank of Russia who was assassinated in Moscow six weeks ago. Andrei was a model central banker and unquestionably the leading bank reformer in his country. He was scheduled to speak at this conference about the importance of banking reform, and I know that he was looking forward greatly to coming here. He understood in the most fundamental way the role of a sound well-governed banking sector, buttressed by the rule of law, as the foundation for a modern market economy -- not just in Russia but in all countries. I feel certain that he would have stressed the importance of those same institutional features for Albania and the Balkan region had he been able to take part in this conference. Andrei was a man of vision and determination as well as a beacon of integrity. Both Russia and the world have lost a great reformer. He set an example for Russia and all countries in terms of his bravery and commitment to such critically important work. That work must continue.

FINANCIAL SECTOR DEVELOPMENT IN THE BALKANS FROM AN FSVC PERSPECTIVE

My organization, the Financial Services Volunteer Corps, has been active in helping to strengthen financial infrastructure in the Balkans for the past seventeen years. FSVC's lead mission to the region took place in December 1990, and was headed by the late former U.S. Secretary of State Cyrus Vance. I was a senior officer at the Federal Reserve Bank of New York at the time, and I had the privilege of serving as the Federal Reserve's designated FSVC volunteer on that mission. The experience of coming to the region during that turbulent period had a profound effect on me on many levels, but one of my dominant memories was of an underdeveloped financial system that, while unified at least within Yugoslavia, was beginning to fall apart.

Subsequent to that initial mission, FSVC was invited by local counterparts to begin programs throughout the region to help strengthen the financial sector, and to help build the banking systems needed to support market economies. The pattern for opening programs was essentially one that extended from North to South over time. With the support of the U.S. Agency for International Development, FSVC established its first programs in the region in Slovenia and Croatia around 1993. With further USAID support, FSVC's program in Albania began in 1995, in Macedonia in 1996, and in Bosnia two years later. We also began work in nearby countries such as Romania, Bulgaria and Moldova.

FSVC is honored to have been given the opportunity to work with leading reformers in the Balkans, and we are committed to continuing that work. We are especially honored to be able to run our largest program in the region here in Albania. We are currently working with a number of local counterparts, including the Central Bank, the Deposit Insurance Agency, and the Financial Supervisory

Authority. We maintain an office in Tirana, and Leeza Timofeeva is our resident Country Director.

Based on the hundreds of projects that we have completed in the region over the last thirteen years, and tens of thousands of hours of volunteer technical assistance, FSVC is in a good position to offer several first-hand observations. First, central banks throughout the region have made enormous progress in strengthening their capacity across a broad range of functions. Bank supervision has improved dramatically in nearly every country. Slovenia and Croatia in many ways are in the forefront in this regard, and in each of those countries bank supervision is largely risk-based, and the legislative and regulatory framework is nearly complete. Albania and Bosnia are both making great strides toward better regulated banking sectors and are in the process of implementing risk-based supervision. In Albania, FSVC has worked with the central bank to strengthen policy and practices in a broad range of areas, including bank supervision, monetary policy and operations, internal audit, payments, research, IT and human resources.

Second, commercial banks have become much more sophisticated, and foreign ownership in this sector has become common and in some cases dominant. Croatia has by far the highest percentage of foreign ownership in the banking sector, followed by Bosnia and Albania. The quality of staff in the sector has improved greatly.

Third, capital markets development has been uneven across the region. Croatia has made tremendous progress in this area, and one can see great development occurring there now in areas such as investment funds and pension funds. But other countries have had a harder time in this area.

And fourth, much work remains to be done. Central banks throughout the region still face challenges. Within the commercial banking sector, the Rijecka Bank in Croatia incurred some 100 million Euros in foreign exchange losses only three years ago, providing a powerful reminder that foreign ownership alone is not a panacea for strengthening this sector. It is also noteworthy that nearly all countries in the Balkans are experiencing credit booms at the moment, with annual credit growth in the 20-30 percent range. But while such credit expansion certainly fuels economic growth, it also poses major risks, and supervisors should be appropriately vigilant.

As a general rule, the non-bank financial sector has not developed nearly as rapidly as the banking sector throughout the region. Insurance markets are lagging behind, and there are few major success stories here yet. In Albania, while a stock exchange exists in Tirana, there is effectively no trading, and no secondary market in government debt.

In sum, we can observe tremendous successes in the development of the region's financial sectors, particularly on the central banking and commercial banking fronts. But many remaining problems still need to be addressed if these financial sectors are truly to serve as an engine for economic growth -- which should be the case.

ASSESSING THE REGION'S DEVELOPMENT FROM A GLOBAL PERSPECTIVE

Given the unusual importance of the Balkans, it is also appropriate to view the region's challenges as well as potential from a global perspective. The Balkans today must make headway in a globalized world -- a "flat" world as Tom Friedman has written. Despite the glories of globalization, it does not offer completely smooth sailing for any country, and it poses particular challenges for small countries. The experience of numerous emerging market countries in the wake of the Asian financial crisis of 1997-98 is highly relevant, and demonstrates some of the risks that a globalized world can bring.

In absolute terms, the Balkan region has generally fared well since the time of the Asian financial crisis. The prospect of EU accession in the near future for at least some of the countries in the region offers the promise of new markets and new economic stability. Inflation has been relatively low in most of the region's countries. Compound average growth rates for per capita GDP have been positive, and in Albania's case reasonably strong at 6.4 percent over the period 1998-2005.

At the same time, however, the Balkans must compete in a broader world full of emerging market countries that are achieving high rates of economic growth and export expansion. Viewed from this global perspective, the region may well be falling behind in relative terms. Phrased slightly differently, Albania and other Balkan countries must be able to attract foreign direct investment and develop export markets in a global marketplace in which China, India, and other emerging market giants are surging ahead.

Against this backdrop it is useful to consider what constitute the key elements that are prerequisites for sustained economic development. What are the most important conditions that facilitate growth? Based on our experience at FSVC, at least five elements would appear to be key. They are as follows:

1. Sound financial institutions, combined with high-quality economic and financial sector management to assure price stability.
2. Free markets and an open trade regime.
3. The rule of law, as evidenced by efficient courts and an effective regulatory structure.
4. Robust savings and investment.
5. The absence of corruption.

How do Albania and the Balkan region fare in terms of these five criteria? Central banks and academic and research institutions are far better positioned than I to provide definitive answers to this question. At the same time, the answers are important, and they go far in explaining why the countries of this region are or are not succeeding in the global race to achieve economic success and prosperity. With the caveat that I have just stated, I would offer the following subjective assessment.

In terms of the first four criteria that I identified, countries throughout this region are making steady progress. The history of the last decade here has been one of considerable achievement in terms of strengthening financial institutions, and particularly central banks; developing freer and more open markets; establishing a stronger and more effective legal and regulatory structure, including improved enforcement mechanisms; and the development of a stronger savings base. Investment, part of the fourth element necessary for economic growth that I identified, has lagged in the region, however. I believe that part of the explanation for this weak performance has to do with the fifth element, the need to strengthen governance and overcome corruption, and here I believe the region has fallen short.

The extent of corruption in a country is hard to quantify. One rough proxy is Transparency International's "Corruption Perception Index", and here at least part of the story starts to become apparent. In terms of global rankings according to this index, many Balkan countries fall low on the list. Slovenia is a striking exception with a global ranking of no. 31 in 2005. Croatia comes next, around the middle of the pack, with a ranking of no. 70. But Bosnia ranks only 88th, followed by Serbia at 97th, Macedonia at 103rd, and Albania at 126th.

Corruption remains one of the main challenges that Balkan countries have to overcome. It has robbed them of tax revenues and social security contributions and has hampered privatization efforts across the region. Most governments in the region have placed fighting corruption near the top of their list of priorities. But while a number of reforms have been initiated, a long road still lies ahead. In fact, according to the Transparency International data, the perception of corruption in most Southeast European countries has remained largely unchanged in recent years or has worsened.

Money laundering also remains a concern. Our assessment at FSVC is that most money laundering operations in the region today are outside the banking sector. Throughout the region, countries have established Financial Intelligence Units (FIUs), AML regulations are largely in place, and banks are required to report suspicious transactions. But a significant amount of money laundering may still be taking place, and it is damaging perceptions of the region.

In closing, this is an exciting and important time for both Albania and the other countries of Southeastern Europe. Much of the foundation for strong economic growth has now been laid, and progress is particularly noteworthy in the strengthening that has occurred at central banks and in banking sectors throughout the Balkans. Important challenges remain, however. And as Albania and other countries in the region chart their economic and financial courses over the coming several years, keeping a global perspective in mind will be more important than at any point in the past.

The global economic race offers huge opportunities to all of the countries of Southeastern Europe. But in order to realize these opportunities, they will have to develop the full range of institutional elements needed to support strong economic growth. All five of the elements that I identified are important, and Albania and other countries need to do more work on each one. For the region as a whole, it will be particularly important to attract higher levels of foreign investment. And a key here may well be to tackle far more effectively the problem of corruption, a problem that ranks in my view at the very top of challenges that Albania and other Balkan countries must successfully overcome.

This work is not easy, and it could be dangerous. Andrei Kozlov certainly understood that. It will take courage to stay the course to build modern market economies in Albania and throughout the Balkan region. In the spirit of what Andrei stood for, I urge you to fight these tough battles to strengthen governance, transparency and integrity in the financial sectors and economies of the region. The future prosperity of Albania and the Balkans may well hinge on the outcome.

Thank you.

* J. Andrew Spindler, President and CEO, Financial Services Volunteer Corps

HOW FINANCIALLY INTEGRATED ARE THE WESTERN BALKANS? PRELIMINARY ANALYSIS AND POLICY ISSUES

*Evan Kraft**
*Marco Škreb***

Mr. Governor, thank you very much for your introduction and also for the invitation. It is truly an honour for me to be here at this very distinguished conference. I would also like to say, on a personal note, that this is only my second visit to Albania. My previous visit was in late 1997 and I am very encouraged. Of course in transition time that's a very long time, but coming back to Albania, to Tirana, the difference is enormous. The progress Albania has made is obvious. I think that this is very positive and encouraging.

In the interest of time I will make this presentation by myself, although it represents joint work with Marko Škreb. I'll begin with a brief macroeconomic overview, followed by a consideration of trade issues and EU issues, and then move to financial reforms, the banking market, and a little bit about inter-regional financial flows. We would really like to raise questions about what sort of financial reforms are appropriate, and what role might there be for financial integration in the region?

So to begin with, the macroeconomic overview. We tried to take all the data from one source, the European Commission, so in some cases the numbers are for 2004, and in some cases for 2005. We want to make just a few basic points here. To start, as everyone has been saying, growth has been rapid (see Table 1). And in general, in most countries, inflation has been low by any definition. These are the accomplishments. But to put things in perspective, when we look at indicators of the size of the countries and the level of development of the region, things look different. The total population of the region, as we have defined it here, is only 5 percent of the EU 25, GDP per capita only one tenth, and aggregate GDP only 0.5 percent. So, we are dealing with a region that is rather small, certainly in comparison to the EU 25, and I think in absolute terms as well.

Table 1: Basic macroeconomic indicators (2004-5)

	Population	GDP/PC	GDP est	Growth	Inflation
	(mil)	(EUR)	(billion €)	(%)	(%)
Albania	3.2	1680	5.4	6.0	2.4
BiH	4.0 (e)	1654	6.6	5.0	0.9
Croatia	4.4	6200	27.3	5.2	2.1
Macedonia	2.0	2170	4.3	4.1	0.5
Montenegro	0.6	2640	1.6	4.1	1.8
Serbia	9.5	2506	18.8	6.5	17.5
Total	23.7	2808 (avg)	64		
EU 25	461.0	28100	13300.0	2.0	2.0
% of EU 25	5%	10%	0.5%		

Source: European Commission, http://ec.europa.ec/enlargement

In trying to think about financial integration, it seems natural to us to also at least briefly consider issues of trade integration as well. There have been several studies in the last few years using the gravity method to see if there is room for significant expansion of trade in the region. And basically, what we find is that among what we call the Westerns Balkan countries, that is, Croatia, Serbia and Montenegro (Serbia and Montenegro are two countries now, but much of the data is of course for Serbia and Montenegro together), Albania, Bosnia-Herzegovina and Macedonia, most of the estimates find that trade among these countries is already at potential levels. Admittedly, as an academic, I have to issue some caveats. Gravity methods have wide confidence intervals. Still, I think that this is a broad, reasonable conclusion, which seems to be supported by several studies and methodologies (Christie 2003, Adam, Kosma and McHugh 2003, Grupe and Kusić 2006, Lamott 2006) Trade between these countries, and between these countries and Bulgaria and Romania as well, seems to be roughly at potential in most cases.

One exception that stands out is bilateral trade between Bulgarian and Romania, which seems to be very low. Additionally, trade among former Yugoslav Republic tends to be above potential (Kernohan 2006). That raises some interesting questions, which I will come back to shortly.

It is also intriguing to note that, in the run-up to the EU accession of Romania and Bulgaria, growth in trade came from trade with the EU 15, not with other South-East European and Western Balkan countries.

Thinking about this a little more conceptually, it seems that there is a lack of comparative advantage-based potential for trade in the Western Balkans. This seems to be the conclusion suggested by Mr. Lecea as well. We may look at revealed comparative advantage. Countries in the region have revealed comparative advantages mainly in similar sorts of things, in primary commodities, and in labour intensive and resource based manufactures. From the comparative advantage point of view, it would not be logical to expect significant increases in trade in the future. From the point of view of new trade theory, in other words from the point of view of attaining economies of scale in a larger regional market, and perhaps using the regional market as a training ground to go further, there seems to be more potential (Grupe and Kusić 2006).

In that sense, efforts to stimulate freer, more extensive trade in the region have some potential. However there is a danger here as well, the danger of a "soft option." This tends to be particularly strong in the former Yugoslavia, where companies already have well-established markets, brands or name recognition, and distributive channels. These existing advantages are fine, and should be used, but if companies rely extensively on the easier option of selling to their established trading partners from various parts of the former Yugoslavia, as opposed to developing and competing on the more demanding European markets as well, productivity growth will be limited and competitiveness may not be improved very much at all.

Croatia is the only candidate country currently negotiating for EU membership among the countries in the region. Macedonia is a candidate but has not started negotiating, and others are potential candidates. Several of the countries are in the stabilization and accession process, either with SAA agreements already or are in the process of negotiating such agreements.

This raises the question of the best way to prepare for EU membership. One proposal is to try to implement "virtual membership". The idea would be to adopt as much of the Acquis Communnautaire as possible even before accession, in fact well before accession. As an example, Switzerland has basically done this, but for various reasons, it has chosen to stay out of the union. And there is a good deal of sense in this position from the Swiss standpoint.

I can say from personal experience, the process of harmonization and transposition of EU legislation is indeed an enormous job. Allegedly someone said: "All you need is a giant photocopy machine and you can get it done", but that is not at all true. The actual transposition of the directives into legislation is very complex, because the directives themselves really are not legislation, they are principles that must be transposed into legislation. And this is a very, very big job and in some respect, there is a good deal of logic in starting the task early.

This kind of legislative reform could be a way of demonstrating maturity and readiness to function in the EU environment, in the EU institutions. However, again I would like to issue some caveats about this idea, because it is very difficult to fully harmonise without close contacts with the EU bodies. In other words, the screening process that Croatia has gone through this year has been extremely valuable, because in the end, it is not always that clear how to interpret the details of directives. And of course, there are many things that simply do not make sense to implement until you are a member, for instance the treatment of EU bank branches (supervision by the home country authorities).

When you are a member of the Union, the principle of home supervision of multinational banks or financial institutions makes sense, but the same principle does not make sense when the host country is not yet a member. Furthermore, I would like to note something that the practitioners in the room certainly know, that it is easy to end up re-writing your laws every three or four years And this creates high costs, not only the cost of the writing efforts, but costs for market participants. Legal instability is really not a good thing, and if you have a fairly good legislative framework, you really should think very carefully whether it is worth creating a law that perhaps is for the most part EU-compatible now, knowing that when you do start negotiating, whether that will be in three, four, five or ten years in the future, once again you will probably have to write a new law. What is the trade-off between improvement in the legislation and the instability you are creating?

Potential EU candidates need strong and coherent reforms. This is not necessarily, of course, simply adopting the Acquis at this moment. Countries should be moving in that direction, but unfortunately the Acquis cannot be seen as a recipe that can be implemented simply. Ultimately, what is needed is an appropriate process of legislative harmonization.

Furthermore, beyond legal harmonization, I would like to underline that what is needed is, above all, nominal and real convergence to achieve low inflation, exchange rate stability and--perhaps the most difficult and most important of all--fiscal consolidation. Many of the countries of the region have already come a long way towards achieving this, and this is what is needed to be really ready for the Maastricht criteria.

Turning now to financial reforms, what we see from Table 2 below is that the region as a whole has a fairly similar level of progress, with rather more progress in banking reform than in the non-bank financial institutions and securities markets. This is understandable and also, of course, reflects the much greater importance of banking in the financial systems.

Table 2: EBRD transition indicators 2005

	Banking Reform interest rate liberalization	Securities Markets and Non-bank financial institutions
Albania	3-	2-
BiH	3-	2-
Croatia	4	3-
Macedonia	3-	2
Serbia and Montenegro	3-	2
Bulgaria	4-	2+
Romania	3	2

Source: EBRD

We see that, except for Croatia and Bulgaria, everybody else is pretty much at a very similar level. As various speakers have already mentioned, the financial systems are very much bank-dominated. In Croatia, about 80% of the total financial system assets are banking assets; in other countries it is usually a bit higher. Also quite important to say is that this banking market has been very lucrative. Return on average equity for banks, on average for the systems and also for individual banks is often between 20 – 25 %, which is really quite good.

All of the systems have experienced financial deepening, and growing concentration. Personally I do not believe that the concentration has occurred at the expense of competition, but rather the opposite. I believe that the creation of a reasonable number of stronger players has actually intensified competition. Nonetheless, one has to be careful to monitor whether this increasing concentration does eventually lead to anti-competitive behaviour.

Introduction of new products has been strong, and generally interest rates and interest-rate margins have fallen. Still, in some countries, rates have not fallen as far as we would like to see them go.

I will not talk about rapid credit growth, which was mentioned by Mr. Bini-Smaghi and others. That is a whole topic unto itself, and clearly a very important aspect of the region's experience at this point. But perhaps it will be useful to put a little bit more emphasis on the issue of what has been referred to as asymmetric exposure. That is, in many of the countries, there are subsidiaries of foreign banks that are systemically important to that country, but constitute a tiny share of the bank group. And that raises important, home-host issues and financial stability issues.

The fact of the matter is that there are a very small number of financial institutions who repeatedly come up as the leading banks in the countries of the region. If we extended the sample to Central and Eastern Europe, many of same faces would appear as well. These are all EU banks. A very small number of them play crucial roles in the region. This carries with it trends to certain kinds of concentration, particularly if the "mother" banks in the EU merge among themselves. In some cases, this raises the risk of dramatic increases in concentration and everything that implies for the financial systems.

Looking at the inter-regional financial flows, they are rather low. In that sense it is not easy to argue that at this point there is a single financial market in the region. All the countries are net capital importers. This is appropriate, given the current level of development and urgent investment needs. At this point, there are no big local banks or other financial institutions, in the sense of domestically-owned players, who really are in a position to compete with that small handful of EU players. And of course, the host countries, when they privatise banks, want strategic investors with strong capital and good reputations. It is simply very difficult for any domestic owners to really compete in those respects.

Another factor impeding capital flows between the countries is that banks are sometimes encouraged by prudential regulations to put some of their funds in safe assets outside of the country, and in practice in more developed markets. For example, Croatia had a regulation requiring banks had to hold a certain percent of their foreign exchange liabilities in highly rated banks outside Croatia.

There is a sense in which some regulations continue to push banks to hold funds outside of our countries. Sometimes this happens because of market processes, and of course, there still are non-economic barriers to integration as well. There are also some cases when the flows or investments occur because they are politically convenient or because ties are actually especially strong between certain entities.

So to try to sum up and I hope to provoke some discussion further in the conference, the region includes several new nations, and there still is a degree of political instability. In many cases EU membership is not even going to be immediately on the agenda. But we do have a common pattern of financial reforms, and macro-economic trends are relatively similar. Financial systems are bank-based.

Summing all of this up, it seems fair to say that we are not a single financial market. The rules, legal rules and regulations, currency, capital restrictions, continue to keep the region from functioning as a single market. Cross-border flows are small, although we have a certain lack of data on this.

We believe that financial integration will grow in the future, but basically the stimulus will be from EU membership. In that sense it will be top-down, and via further international instruments. So, in a sense, we are speaking more of a globalization process than a regionalization process at this point.

Finally, I would like to pose the question: Should there be any further policy measures to promote financial integration in the region? We would like to suggest that perhaps not, perhaps what we have right now is an adequate framework for all of the countries to go forward with.

Thank you very much for your attention.

* Evan Kraft, Director, Research Department, Croatian National Bank,
**Marko Škreb, Former Governor, Croatian National Bank

REFERENCES

Adam, A, T. Kosma and J. McHugh (2003), Trade Liberalisation Strategies: What could South Eastern Europe learn from CEFTA and BFTA?, IMF Working Paper, International
Monetary Fund, Washington DC, May.

Christie, E. "Potential Trade in Southeast Europe: a Gravity Model Approach" WIIW Working Papers (24)

Grupe, C. and S. Kusić, "Integrating the Balkans--Promoting Competitiveness?" South East European Journal of Economics and Business, September 2006, p. 6-19.

Kernoham, D. "Reverse Balkanisation? Trade Integration in South-East Europe" Centre for European Policy Studies Working Document No. 249, August 2006-12-19

Lamotte, O. "Trade Integration in South-East Europe" , FREN Quarterly Monitor, January-March 2006, p. 86-91

THE ROLE OF COMMERCIAL BANKS IN FINANCIAL STABILITY; NATIONAL AND SUPRANATIONAL LEVELS

*Seyhan Pencapligil**

Ladies and Gentlemen,

It is an honour for me to chair the second panel of this morning, where distinguished panelists will be talking about the role of commercial banks in financial stability – at national and supranational levels.

Of the various definitions of financial stability, I will produce the one that is most relevant to this panel's discussion. "A stable financial system can be described as a financial system that is able to withstand shocks without giving way to cumulative processes which could impair the allocation of savings to investments and the processing of payments in the economy. In other words, financial stability requires a set of shock-absorbers so that savings to investment intermediation and payments functions are performed smoothly". Given that such functions are mainly performed by banks, one can then define financial stability as a situation where banks operate normally.

Other than being the direct beneficiaries of financial stability, banks also play a role in getting there. Their role is admittedly much more limited to that of central banks and supervisors, as well as policy-makers, which are universally in charge to secure and maintain financial stability and contain consequences of financial instability.

First of all, the very role of financial intermediation between savings and investment is itself conducive to stability. In an economy where savers lent directly to investors and demanded immediate repayment at the first sign of trouble, stability would be hard to achieve. Commercial banks act not only as intermediaries but also as shock-absorbers in such times. Furthermore, it is through banks that short-term savings can be channeled into long-term investments, which act as an anchor for stability.

Secondly, by making the right credit decisions, which is supposedly banks' core competence, they provide direction to the economy. In the absence of banks, savings could be channeled into wrong investments with potentially destabilizing consequences.

At the international level, multinational banks are arguably less vulnerable to national shocks and hence more powerful absorbers. This is especially true for Albania where an overwhelming majority of the banking assets are owned by foreign banking groups of diverse nationalities, all very well equipped to take the impact of any destabilizing factor within Albania.

Having said these, one must also acknowledge that banks themselves may sometimes act as destabilisers, especially when they are run and supervised poorly. There are many examples of financial instability caused by inadequately managed or supervised banks in otherwise relatively healthy economies. To make things even more complicated, too strict supervision and the inevitable uniformity it brings along may cause herd behaviour and procyclicality; i.e., offering an umbrella in bright weather and withdrawing it as the rain starts to fall. Basel II, for instance, is being criticized precisely for increased procyclicality, although everyone agrees it makes banks more prudent. But I think these are issues more for the regulators/ supervisors rather than commercial banks. What remains an issue for commercial banks, however, is that in order to avoid costly bank runs and bank failures, the sector must show some self-discipline, to meet acceptable standards and expectations of shareholders.

* Seyhan Pencapligil, Chairman, Albanian Association of Banks

FINANCIAL STABILITY IN TRANSFORMING ECONOMIES: THE ROLE OF FOREIGN BANKS

*Giuseppe Cuccurese**

INTRODUCTION

Honorable Governor Fullani,
Honorable Governors of Central Banks,
Authorities,
Colleagues,
Ladies and Gentlemen,

It's a great pleasure and honor for me to be here.

In this panel I would like to focus my speech not strictly on our experience in Albania but in a wider context, because the topic of regional integration, and in particular the integration of the financial systems, is gaining a crucial importance in Eastern European countries, where stronger and deeper links are being developed both within the region and with the eurozone.

These links are working in both directions: the Western countries have often provided a model for modernization, but now many Eastern European countries are outpacing them on economic reform, to the point that nowadays some of them are stimulated to engage in new reforms by the regulatory competition coming from their Eastern neighbors. In five or ten years we could look back and see that not only the West has transformed the East, but also that the East has been a major force for change in Western Europe.

This "virtuous circle" could gain, in the near future, new energy from the South Eastern European (SEE) countries. As we know, the prospective EU membership is an important catalyst for restructuration, but it will work much better with the help of the pressure for change created by a greater foreign competition.

It is therefore in the interest of the SEE (South Eastern European) countries and of their neighbors to strengthen their economic links. The EU is by far the most important trading partner for the countries in this region, accounting for between 50% and 75% of the foreign trade. The process of integration and the export performances have been strong regardless of economic conditions in the export markets.

Economic integration with the EU is testified by the recent increase in inflows of foreign direct investments, very often coming from the Euro area (and this is well known in Italy, which is among the leading investors in this region, including Albania where Sanpaolo IMI has recently invested taking control of Banca Italo Albanese and where it is going to invest even more. This is a new step for a further consolidation in the banking sector).

TRANSFORMATION OF THE FINANCIAL SYSTEMS

This process of integration has resulted in a high economic growth combined with a swift transformation of the financial systems.

If during the nineties the restructuring and consolidation of the banking sector in the region was slowed down by adverse political and economical developments, since 2000 it has gained momentum thanks to a more stable context.

The effects of this transformation are crucial not only in the financial sector: as confirmed by a recent study[1] published by the European Bank for Reconstruction and Development, the transformation of the banking sector in the post-communist economies is stimulating competition in the non-financial sector, improving access to external sources of finance in terms of both the increased quantity and lower borrowing costs, thus facilitating the entry in the markets for goods and services.

As we know, the role of the financial system is to promote growth through an efficient allocation of financial resources.

An essential precondition for future growth is therefore the maintenance of financial stability, even in a context under transformation.

In this regard, Albania can take an important advantage from its geographical and economical position. Actually, considering also its competitive labor cost, the country can really become a platform for the cross-border commercial traffic. In 2006 macroeconomic fundamentals are improving further, in the wake of a consistent policy mix and improving investor and consumer confidence, and of course the signing of stabilization and association agreement with the EU is a first step towards EU membership.

The status of "country in transition" is already part of the past and we should today see Albania as a real emerging economy.

An important feature of the SEE countries' financial systems is the dominance of the banking sector and the relative underdevelopment of the capital markets. These countries have therefore already promoted significant reforms in the banking sector. Important efforts have been made – with the assistance of various international organizations – to improve the legal and regulatory framework and the implementation and enforcement capabilities of the banking national authorities.

Of course, Albania is a typical example of this. We can find here a banking industry which is moving to be extensively prepared to support the market's growth while the Central Bank is moving fast towards the modernization of the system and the banking sector is already in private hands. Now Albania needs to move one step forward in order to obtain an international recognition through the assignment of an official rating and set up the conditions for promoting a genuine financial market. And the presence here of well known international banking groups has brought confidence in the country and could really help to achieve these goals.

ROLE OF FOREIGN BANKS

The second feature to consider is the fact that foreign banks (and in particular banks from EU countries), have acquired a dominant position in local banking systems.

The role of foreign banks in the transformation of the banking system towards a more efficient and stable one has been, and is, crucial.

In fact, technical assistance programs, such as those provided in a massive way by various international organizations, cannot substitute for foreign banks in transferring managerial and technical know-how, providing an organizational and managerial model, and bringing in efficient payment systems and risk analysis.

A more demanding legal and regulatory framework means that the banking sector is able to operate under more stringent supervisory standards: foreign banks have provided local subsidiaries and branches with that ability.

Foreign banks are also contributing to the stability of the financial system through the transfer of expertise, especially in credit assessment and risk management techniques. The overall effects on the whole economy of a correct and reliable credit analysis are of the utmost importance and cannot be underestimated.

In addition, the role of commercial banks in developing either the sources of funding and investments as well as the lending to SMEs is crucial to give financial stability, reducing informal economy and channeling a larger flow of money through the official system.

More generally, foreign banks have contributed to the cost efficiency of the banking sector and to its growth: as far as the first aspect is concerned, a study[2] conducted in 2005 on almost 300 banks in 15 post-communist countries shows that banking systems, in which foreign-owned banks have a larger share of total assets, record lower costs; in the same context, the privatized banks with majority foreign ownership are the most efficient. And last but not least, foreign banks stimulated foreign direct investment in the region.

Another important element that I wish to stress is related to governance: Sanpaolo IMI, like other foreign banks, has invested heavily in improving the governance of the subsidiaries operating in the region.

Finally, it is worth stressing the role foreign banks have in the creation of sound financial infrastructures.

This reminds me that Sanpaolo IMI proposed, when entering the East European Markets in 1989, a pioneering clearing system for cross-border payments between Central European countries. Sanpaolo IMI has played a central role in the experience of the Euro Banking Association and, more recently, in the European Payments Council, and this experience will continue to be a contribution to the creation of efficient payment systems in SEE countries.

NATIONAL AND SUPRANATIONAL LEVEL

Globalization is blurring the boundaries between national and supranational level. This is a "bottom-up" process where the leading banks tend to apply not a "country model" but a cross-border model based on an increasing financial integration and allowing more risk diversification and the use of more advanced risk management instruments and systems.

However, a major hurdle for the functioning of cross-border banks is the organization of prudential supervision, which is still based on a country model.

Nobody wants Governments to give up their responsibility on financial supervision. However, the creation of pan-European banks might involve economic and political issues, in particular in those countries where the banking system has a strong foreign presence (as shown by the recent Unicredit HVB experience in Poland).

That's why in the EU, cross-border banks have asked for the creation of a strong coordination mechanism among national supervisors and the strengthening of the role of the lead supervisor. Although the debate is relatively young, some measures have been taken to improve the situation: the creation of the Committee of European Banking Supervisors (CEBS), the establishment of a role for the consolidating supervisor in the context of the new Capital Requirements Directive (CRD), the elaboration of a memorandum of understanding (MOUs) on cross-border crisis management.

CONCLUSION

Let me conclude by focusing on the prospects, which to a large extent can be summarized in a single word: integration. Looking ahead, this seems to be the best guarantee for the financial stability of the region.

Sanpaolo IMI and even more the new banking group that will be created thanks to the merger with Banca Intesa, being a major player in the EEC region with a leading presence in 10 countries, wishes to contribute to this process, through the transfer of resources and expertise and the cooperation with the regulators, the governments and the local partners.

Thank you.

* Giuseppe Cuccurese, Head of International Activities and Foreign Network, San Paolo IMI

[1] S. Fries, "Politics of banking reform and development in the post-communist transition", EBRD, February 2005.

[2] Steven Fries, Anita Taci, "Cost efficiency of banks in transition: Evidence from 289 banks in 15 post-communist countries", Journal of banking and finance, 2005.

COMMERCIAL BANKS: MAJOR CONTRIBUTORS TO FINANCIAL STABILITY

Agis Leopoulos,***

Thank you very much. I hope I can be heard and I'd like to start by extending my warmest thanks to the Bank of Albania, especially to the Governor Fullani for doing me the honour of participating in this conference.

I hope and I preach this conference will be very insightful in two days for the region and also for the Albanian market, on which I will primarily focus today.

One of the benefits of being the second speaker is that usually the first speaker has covered things so well, you can spend time entertaining your audience, being more flexible and that's what I am trying to do today.

I have a speech, a presentation to highlight some of the issues that I think are important for the contribution of commercial banks, especially Albanian commercial banks to financial stability. This is the area of the financial tango. As it's well known, it takes two to tango, and I think that has been the case very well taking place in the Albanian Market. We need to work with central bankers and that's what we have done, I think, successfully in the Albanian market. On the one hand we have a system which is designed to foster a healthy economic activity; on the other hand we need to make sure that it is inscribed in an appropriate risk management framework. This is a complex scenario to play out, but when you do a good job, everyone benefits, not just banks, but all the actors of economic activity.

Turning to the Albanian case, I think, what I am showing here is that performance has been very good. The real GDP growth has been significant, on average about 5.9 %, so the growth rate to GDP has been the highest in South Eastern Europe area, and price stability has been achieved as per the set targets.

The macroeconomic environment, which is tremendously important for financial stability to support the role of banks is very successful. I think that we have also been very very mindful of the trends of the currency. The local currency has appreciated significantly since the beginning of 2003. We do have a relatively high current account deficit, which is a result of buoyant consumption and investment. What you see on the left-hand side is that over the last five years, the average of current account is 7.2, and the average of FDI is 3.7 % of GDP, so 60 % of that is covered by FDI, which is a positive sign for the economy.

So, in a well-regulated and supervised environment, the Albanian commercial banks are increasingly profitable, well-capitalised and I would say very liquid. They have enjoyed significant lending growth. They have not experienced a significant deterioration of the current sound asset quality and they have contributed significantly to financial stability and common growth.

I think that's demonstrated by a number of things:

On the left-hand side, there is a favourite graph for those who have been using it. I'm sure that the colleagues are familiar with it. It is the general index of the banking system reform. It's the picture of reliability of the banking system, how you can rely on the banking system, how open, how well-managed it is, and you can see that the Albanian banking system has managed to mark important progress from an index of about 2, it goes all way up to 4. It has grown by 7 points in the last few years, which is definitely a significant achievement.

On the other hand, we see that most of the market is dominated by privately or foreign –owned banks, so a picture which is familiar in the region but still very very powerful, very very telling, when you take an outside view.

The credit boom is underway: We see that the compound undergrowth of credit expansion in the last 5 years is nearly 50%, i.e. very significant. Retail loans occupy 75 %; they do raise an issue. I am not talking about the macroeconomic issues. They raise the issue of banks' responsibility to make sure that this is conducted in a proper fashion. So, it's not just about lending, it's about making sure that the proper know how in support of this kind of lending is extended.

We are talking about cash management understanding, credit underwriting. We are talking about enhancing financial transparency for the borrowers, for the companies. It's a partnership advent, where everybody needs support.

We have seen that Albania is still an under-penetrated market, but the credit to the private sector is still about 18.2 %; it has grown out compared to 2.6 % it was 5 years ago. Two thirds of that is in FX, which is something that we banks, think about. By that I mean that the forex exposure of banks in their customer portfolios, coupled with rampant growth, creates a more complex environment for appropriate risk management.

You can see the same about deposits. Deposits have grown less than credits, less than expected. We have only about 15 % growth over the last 3 years; still I think that the deposit penetration is very significant. It's 44 % of GDP and it's quite interesting to note that it's primarily in local currency, which is something definitely noticeable, something that we bankers take a long hard look at before working on the business plans.

How long does the bank deal with this market? How can we help to bring it forward?

Well, you can see that in terms of corporate loans and retail loans, if you put them together; still in Albania we are looking 15 % of

GDP. I am taking the case of Greece, because this is the country I know well, the figure is 4 %, in the Euro area it's over 100% of GDP, in South Eastern Europe it's about 24 %. So, on the left-hand side, which is the credit to the private sector, you can see the way to come in the future.

The customer deposits presented in my previous slide are an important percentage to GDP, significantly higher than in other SEE countries. The ratio is quite impressive. What is also impressive is that they rely mainly on the retail deposits.

So that raises the question about the corporate, and perhaps we, as commercial bankers should think about ways to help corporate to bring deposits to us and help the market circulate in this type of currency. We think that the banks in the Albanian market are well-positioned to expand further in the high yielding retail segment. Banks will be looking at that responsibility, covering the whole spectre of the business.

The capital adequacy ratios are still comfortably at 18-19 %, as you can see on the top left-hand side of the graph, whereas the loans/ deposits ratio is still at 6 %.

On the lower left-hand side, you see that if you take the foreign exchange loans and foreign exchange deposits, something which we always take into consideration, we will have a pretty standard picture, a 67 % ratio, but if you take lek loans to lack deposits, it's only 17 %, which again shows the way forward, and what we expect is that as the market is becoming more local currency denominated, the transactions will be conducted so; the potential is clearly there.

This is something we also take good notice of. It's the quality of portfolios and what we do in this market to address them, because that's part of the overall circle of the business of banks.

NPLs have remained very low in the market so far. This is the whole market, it is actually quite satisfactory. It's up to us to make sure that we have the right teams, the right products, the right know-how, to protect the quality of the portfolio, to protect the efficiency of the transmission mechanism and help the market retain the quality where is lying today. So, that can be a big challenge for all of us, as the market continues to grow, as new types of services and new types of products are offered to the Albanian citizens and companies.

Above all, these slides reveal the large use of local currency. I think that's another point of interest we have been highlighting. Spreads remain high in foreign currency terms, both in deposits and loans, like foreign exchange, both in the Euro and in the United States dollar. Again there is something that we will monitor very closely. We need to see how the markets will be shaped but the competition will obviously turn out to be to the benefit of the recipients of competition, which is companies and individuals alike. I have one last slide and I hope it was not too technical a discussion.

Ultimately, we take a look at these graphs, we see how the average liquidity returns look like and how the average assets returns look like, and both remain highly profitable in Albanian banks.

This is something that shows that business is there. The banks can help in maintaining this business. They have the tools, the playground, the loan terms to deliver on profitable growth, but it has to be to everyone's benefit, otherwise this game, this tango will be brought to a sharp and abrupt end, which nobody wants.

I just wanted to complete this very short presentation by making a comment: Absolute important financial stability comes from one specific component, which is human capital and human resources.

Stability doesn't just come because graphs look nice, because people make them look nice. I think that as banks, we do have the responsibility to try to shape these resources to make a bigger contribution to the economy and to the market in an efficient way.

Thank you very much.

* Agis Leopoulos, General Manager for International Affairs, National Bank of Greece
** PowerPoint presantation not attached.

RAIFFEISEN EXPERIENCE IN SOUTH EAST EUROPE

*Steven Grunerud**

Good Morning. I would like to share with you Raiffeisen International's experience and perspective of banking in South East Europe.

Raiffeisen is one of the largest banking investors in Eastern Europe and certainly one of the most diversified from a geographic perspective. One of our guiding beliefs is that the developing economies of Eastern Europe are less risky than many people believe.

Raiffeisen first entered South East Europe in 1994 with an acquisition in Croatia and followed this with either acquisitions or Greenfield investments in Bosnia and Herzegovina in 2000, Serbia in 2001, Slovenia and Kosovo in 2002, and Albania in 2004. By entering these markets in an early stage Raiffeisen benefits from lower cost to entry barriers and begins the process of early development of local management and business knowledge.

Our experience in entering these and other regional markets early has developed an understanding of these markets from an economic, regulatory and business development point of view. Initially these markets can be generally characterized as non transparent, largely cash based and suffering from a lack of properly allocated credit facilities. Regulatory efforts can mainly be seen as enforcement of regulations derived from 1950s or earlier with little or no knowledge and experience of consumer or SME credit products, never mind electronic banking services or treasury products.

Our understanding and experience of these issues allows us to develop our business models in a manner that can anticipate the changes and help develop these markets building on the experience gained in other countries. To give some specific examples, the basic banking model when entering a new country is to start with Corporate Banking and slowly move down the credit volume scale into SME and eventually consumer lending. This was basically the model used by multinational banks in the early 90s when the first entered Central Europe. It took between 5 and 10 years before they discovered consumer lending. While this was prudent from a cost and effort point of view, they ignored one of the larger and more stable market segments. Now we can see that the need for consumer banking is driving the banking market from both acquisitions and expansion of existing players.

The experience that we have gained allows us to communicate with the regulatory authorities and government agencies from a much more knowledgeable point of view, as most of the countries are following similar economic paths. By bringing the experience from a regional perspective we can show best practices where available and while at the same time explaining more western banking standards. By using regional experience, to help develop the local economy one can achieve faster economic and regulatory transformation, as well as demonstrate to other potential investors that the country is ready and safe for investment.

Albania can be used as a specific example. Nearly 3 years ago the 2nd attempt at privatizing the Savings Bank of Albania was begun and it was unclear whether there would be any potential suitors. As the bank was in reasonable shape, with no loan book, a moderately downsized staff level and a net annual profit of around Euro 15 mln, with the largest branch network in the country and 50% of all deposits, it would be sought after in other countries. However the image and perception of Albania was so negative, that it was expected that no reputable investors would participate. Eventually the bank was privatized for a much higher value than what was expected. In the three years since the number of bank branches and agencies has doubled, total bank loans in the economy has tripled, the number of Bancomats has increased 5 or 6 times and there is real competition in the market. As more credit is available in the economy longer term and larger investments are taking place.

Similar events have taken place in nearly every regional country, once the financial system is more or less stable the rest of the economy starts to grow. The growth in the financial sector helps drive reform or restructuring in other regulatory sectors such as land registration, financial statement standards and reporting and eventually other corporate governance sectors. Of course political stability and will are the most important issues in reforming economies, but a well functioning financial sector can greatly contribute to the speed and depth of the transformation.

Thank you.

* Steven Grunerud, CEO, Raiffeisen Bank Albania

FINANCIAL STABILITY AND SURVEILLANCE

*Ridvan Bode**

IMPORTANCE OF FINANCIAL STABILITY

- Stability is an indispensable condition to have a stable economic development and high growth rates for each country;
- Economic shocks occurring during the 15 – 20 last years have indicated that the financial sphere has been the most vulnerable and at the start;
- The aftermath of financial shocks implicate more than the economy of a certain country, affecting the region and going further than that.

WHAT DOES FINANCIAL STABILITY IMPLY?

Three pillars are needed to sustain this stability:

1. A stable macroeconomic environment, as long as the macroeconomic developments affect the developments of companies in financial market;
2. An effective and prudential surveillance of certain markets and companies by the supervisory and regulatory authorities;
3. A functional financial market infrastructure, which implies banking, insurance, pension, capital market companies, etc.,

and their behaviour in a transparent, competitive and functional market.

The three components are fully interrelated and none of them can separately guarantee a stable financial market. Therefore, a coherent and organized operation of all responsible institutions and centres interested in these three elements is necessary.

The issues dealing with the role of surveillance, and the ensuring of financial stability are the goals of this panel.

To treat these issues, I invite the panellists:

Mr. Sean Craig - Senior Economist at the IMF Monetary and Capital Market Department;
Mr. Boshtjan Jazbec - Member of the Governing Board of the Bank of Slovenia;
Mr. Valentin Lazea – from the National Bank of Romania;
Mr. Klodian Shehu – from the Bank of Albania

INSTITUTIONS INVOLVED IN ENSURING FINANCIAL STABILITY

The financial stability issues have become a regional and international problem, due to:

- regional integration processes and globalization of the economy;
- operation of companies in a regional context;
- broad impacts provided by possible shocks in the financial markets.

The regional and international institutions are needed for ensuring this stability.

Institutions cooperating and coordinating the financial market surveillance:

- The IMF, through the agreement on Article IV and FSAP, monitoring the economy in general and the financial market in particular;

- The World Bank, through its assistance in the implementation of reforms for strengthening the financial system (legal assistance to the FSA, banks, capital market);
- A number of international organizations (OECD), or even EU in the framework of approximation;
- A number of professional organizations and associations or committees, which draft the standards on supervision, accounting and estimates of the field indicators, etc.

In the fall of 1998 the Finance Ministers and central bank governors of the G-7, the most industrialized countries, requested from the IMF to draft options on surveillance of financial markets in different countries, in consultation with the other above-mentioned stakeholders.

Since then, a number of instruments have been elaborated and developed to ensure an effective surveillance for certain countries.

This surveillance is carried out:

- firstly through supervision, objectives and parameters established in the framework of negotiations about the Article IV or the FSAP, early identification of vulnerabilities and risks that various countries may face;
- secondly, by providing information and debating on the experiences of various countries and by enhancing the financial supervision standards;
- thirdly, by extending loans that help in overcoming crises and current difficulties, conditioning them to the undertaking of a number of reforms;
- Fourthly, by providing technical assistance to the countries that need it.

Now I'll give the floor to Mr. Craig to present his intervention on possible risks that financial market surveillance and supervision should take into consideration.

* Ridvan Bode, Minister of Finance, Republic of Albania

THE EXPANSION OF FOREIGN-OWNED BANKS IN EMERGING EUROPE: IMPLICATIONS FOR SURVEILLANCE

*R. Sean Craig**

I. THE CHANGING NATURE OF RISKS TO FINANCIAL STABILITY

A key feature of the development of financial systems in many emerging European countries is rapid expansion in foreign ownerships of banks. This has brought substantial economic benefits by expanding financial intermediation and lowering the cost of financial services. It has also reduced the risk of a banking solvency crisis as the foreign owners are generally large, reputable European banks that are well managed and supervised with a strong regulatory capital base. Concern about reputation risk and relatively centralized management mean that these banks are very likely to support their subsidiaries in emerging European countries that are at risk of insolvency or a bank run with capital or liquidity injections.

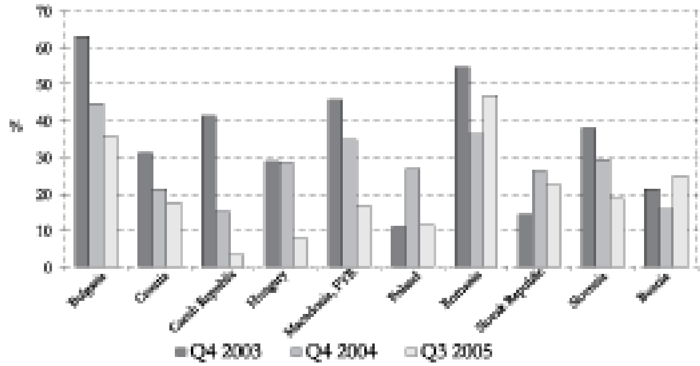
The large foreign bank presence in a number of emerging European countries has altered the nature of risks to financial stability. While the risk of a solvency crisis is lower, the relative importance of risks related to the potential for capital flow volatility has increased. The rapid credit growth and potential build up credit risk in many countries (Chart 1) can still pose a risk to financial stability but through different channels than a traditional solvency crisis. Specifically, rapid credit growth increases vulnerability by widening current account deficits while at the same time posing a risk to the sustainability of capital inflows and foreign exchange (FX) reserves.

A key feature of this credit growth is that it has been financed by bank-intermediated capital inflows in many emerging European countries. While this has been beneficial so far in that it has contributed to rising FX reserves, it is important to recognize this process can work in the opposite direction. By virtue of the link between credit growth and capital inflows, a sudden stop in the expansion of credit by foreign banks poses a risk to the sustainability of capital inflows and FX reserves. For countries with a pegged or managed exchange rate, the bank intermediated capital inflows financing the current account deficit would typically have to be replaced by a drawdown in FX reserves. The extent of the drawdown depends on the size of current account deficit, highlighting the relatively greater contribution of external imbalances to risks to financial stability in foreign bank dominated financial systems.

To assess risks to the sustainability of capital inflows and FX reserves, surveillance needs to focus on the factors that could trigger a sharp slowing of credit growth. In this regard, the build up of credit risk is of primary concern still since even though the risk of bank insolvency is much lower. Specifically, the recognition or materialization of this risk will reduce banks' projected return on equity (ROE) and therefore their decision on how rapidly to expand credit. In sum, in largely foreign owned banking systems surveillance needs to continue to focus on credit risk but must pay closer attention to the sources of financing of credit and external imbalances.

Moreover, in such systems, they could be greater potential for contagion arising from the potential for the materialization of credit risk in one country to influence banks' decision to expand credit in other countries. These different considerations are reviewed in depth and below the implications for surveillance are presented.

Chart 1 Credit Growth Rates for Countries in the Region, 2003–05



Sources: International Financial Statistics (IMF)

II. REVALUATING THE ROLE OF CREDIT RISK IN FINANCIAL STABILITY

A build up in credit risk is unlikely to lead to a banking solvency crisis in banking systems dominated by foreign owned banks but can pose a risk through other channels. The recognition or materialization of a build-up of credit risk could trigger a sudden slowing of credit growth. This would have a direct macroeconomic effect (i.e. a credit crunch) but also could have an indirect effect through the impact on capital inflows and FX reserves.

The rapid credit growth in many emerging European countries can contribute to an unrecognized build-up in credit risk. The increased volume of loans from rapid credit growth can overstretch banks' credit assessment capacity. Moreover, the resulting deterioration in quality of disbursed credit is often not adequately recognized, owing partly to the diminution in assessment capacity. Rapid credit growth can also conceal deterioration in credit quality because the increase in the share of new loans temporarily depresses reported nonperforming loans since credit quality problems typically emerge with a delay.

Institutional weaknesses can contribute to the underestimation of the build up in credit risk. They include a lack of adequate credit monitoring tools reflected in weak accounting, auditing, financial reporting and disclosure, the lack of an adequate credit bureau or register and opaque ownership structures. The poor quality of data on credit risk means that foreign owned banks' risk management and measurement systems designed for developed countries do not work well in many emerging European countries. This make it difficult for parent banks to reliably estimate credit risk or risk adjusted ROE in their subsidiaries, forcing them to rely largely on the judgment of local managers. This information asymmetry, where parent banks cannot independently assess credit risk in their subsidiaries, creates scope for local managers to report estimates of credit risk that are too low so as to make lower provisions and report higher ROE. This lack of adequate data has led banks to rely more heavily on collateral to mitigate risk but weaknesses in the legal system make it difficult to recover collateral, which can result in underestimation of loss given default.

Underestimation of credit risk may also result from foreign currency denominated or indexed lending when local borrowers lack a hedge against FX risk (Table 1). This can result from moral hazard arising from a perception that an exchange rate peg will not be allowed to fail, resulting in an under-pricing and/or under-provisioning for this risk. This could result, for example, from an expectation that a country will join the EU and then EMU. Banks often lend in foreign currency because the parent bank or their supervisors want to limit exchange rate risk. However, this risk is not eliminated but merely transformed into indirect credit risk that will materialize when a country is forced to devalue by domestic macroeconomic or international financial developments.

Table 1 Real Credit Growth and Foreign Currency Lending in Emerging Europe

Country	Percentage point change in the credit to GDP ratio 2004/05	Foreign currency loans to total loans
Bosnia &Herzegovina	6.4	56.0
Bulgaria	8.8	47.3
Croatia	4.4	77.7
Czech Republic	2.7	13.7
Estonia	14.9	80.4
Hungary	4.3	42.3
Latvia	14.5	65.9
Lithuania	7.7	62.2

Poland	-0.1	26.3
Romania	1.1	60.8
Russia	2.5	35.8
Serbia and Montenegro	5.4	73.1
Slovak Republic	2.2	21.8
Slovenia	5.7	25.3
Turkey	5.2	35.7
Ukraine	4.6	38.4

Source: National authorities, WEO, and staff estimates.

III. RISKS TO THE SUSTAINABILITY OF CAPITAL FLOWS

While there are a number of sources of risk to the sustainability of capital inflows, the focus here is on those originating in the banking sector. They are related to the extent, to which foreign owned banks rely on funding of credit from abroad, as well as their strategic objectives and capacity to assess credit risk. Different features of banks' operations and risk management influence the strength of the linkage between credit growth and capital inflows and how they are likely to cut credit growth in response to shocks, such as the materialization of credit risk in the country or abroad.

Foreign banks' expansion in the region reflects a strategy of raising overall ROE by offsetting the relatively low ROE earned by parent banks in their home markets with higher ROEs in emerging European countries. This strategy exploits banks' competitive advantage arising from their strong reputation, their technical and operational capabilities and relatively low funding costs. It appears to be successful, with these banks earning a disproportionately large share of group profits in the CEE region. For example, in June 2005, Austrian bank groups earned 43 percent of their profits in the CEE region, although only 23 percent of their assets were invested there.[1]

The potential for a reassessment of the ambitious ROE targets set by parent banks for their subsidiaries owing to a materialization of credit risk could precipitate a slowing of credit growth and capital inflows. Foreign owned banks in emerging European countries generally tend to set high ROE targets of between 20 to 25 percent before tax. These ambitious ROE targets, however, often assume relatively low provisioning rates, which could reflect an underestimation of credit risk (or, equivalently, overestimation of risk-adjusted ROE). When the extent of underestimation of credit risk is recognized (either before or when the risk materializes), banks have to increase their provisioning rate in line with their upward reassessment of credit risk, forcing them to reduce ROE projections. This could lead management of large foreign bank groups to conclude that their ambitious ROE targets cannot be met and curtail lending growth. The size of this adjustment is likely to depend on how they reassess risk adjusted rates of return in the context of their long term strategic objectives in the region.

The impact on capital inflows depends on the extent to which credit is funded from abroad. This is likely to reflect the cost of this funding relative to local funding and prudential maturity and currency matching requirements, which sometimes can only be met by foreign funding. The cost of medium and long term local funding varies significantly across countries, but is often higher than the funding that subsidiaries of foreign-owned banks can obtain from their parents. Specifically, a number of foreign-owned banks indicated that their cost of funding from their parents was around EURIBOR plus 150-250 basis points. Even when rates on demand and time deposit are low in a country, their maturity may be too short to allow the subsidiaries to satisfy the maturity matching requirements of supervisors or their parent bank's risk management system. In contrast, parent bank treasury operations typically can tailor the maturity of the funding to allow their subsidiaries to meet the matching requirements. Parent banks may also prefer to fund lending by their subsidiaries who can earn margins that tend to be wider than those available in their home market.

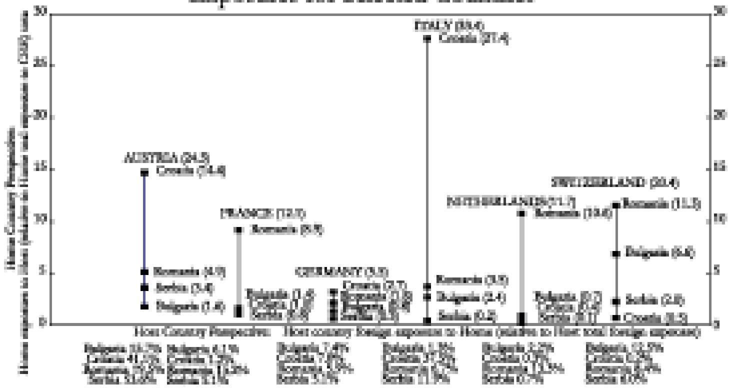
IV. POTENTIAL FOR CONTAGION THROUGH FOREIGN OWNED BANKS

The expansion of individual foreign-owned banks in a number of emerging European countries is beneficial but at the same time creates linkages between countries that can serve as channels for contagion. Contagion can occur when the recognition or materialization of risk in one of several of these countries triggers a broader reassessment or risk where banks view similar exposures in other countries as more risky. This can lead banks to slow, or reverse, lending growth in these other countries, which will impact their capital inflows. This potential for contagion would be increased if banks pursue common strategies across the region since this tends to result in similar types of exposures across countries. When this is the case, rapid credit growth is more likely to contribute to a build up of credit exposure concentrations in the region.

The potential for contagion reflects the centralization of risk management and treasury operations in foreign-owned bank groups. Most large international banks operating in emerging Europe typically monitor risk on a group wide basis and take strategic decisions in the head office. They delegate day-to-day operational decisions to local management in their branches and subsidiaries to varying degrees depending on the bank and country. This centralization helps allocate capital to the most productive investment projects. However, it can also strengthen channels of contagion by making it more likely that foreign owned bank groups will reduce exposures in one country in response to losses elsewhere in the region. This effect will be mitigated, however, to the extent that centralization improves the quality of risk management since this reduces the likelihood of unrecognized credit risk materializing.

A final contributing factor may be the large asymmetry in the importance of bilateral credit exposures to individual countries and to banks. The banks' exposure to a country is typically a much smaller share of its loan portfolio than the share in the country's total borrowing, and to foreign-owned banks means that changes in parent bank lending policies that are modest from the perspective of the bank can have a big impact on the county. For example, Austrian banks' exposure to individual countries never exceeds 13 percent of their total regional exposure but can represent well over half of borrowing from foreign banks for individual countries (Chart 2). This asymmetry could have implications for contagion because it may make it less likely that foreign banks groups will internalize the impact of a reduction in their exposures on capital inflows and credit growth and moderate the reduction to lessen the impact.

Chart 2 Relative Size of Home and Host Country Exposures for Selected Countries



V. REFOCUSING SURVEILLANCE AND POLICY ON RISKS FROM FOREIGN OWNED BANKS

The above analysis implies that in foreign owned banking systems when the risk of a traditional banking solvency crisis is very low, surveillance and policy should focus more on risks related to potential volatility in bank-intermediated capital inflows. They can arise from foreign funding of most credit growth and the potential underestimation of the build-up of risks. To monitor these risks, surveillance needs to be broadened to focus on banks' funding structure on the liabilities side of their balance sheets as well as credit and market risk on the asset side. It also need to have a stronger macroeconomic orientation owing to the influence of external imbalances on the severity of these risks where, for example, a bigger current account deficit is likely to be associated with larger FX reserve losses when risks materialize.

An important dimension of surveillance remains the identification of build ups in credit and market risk. In this context, measures to improve the quality of creditor information can help strengthen this aspect of surveillance. Moreover, this should facilitate a more accurate assessment of credit risk by banks and reduce the potential for an unexpected build up in credit risk. A related benefit could be that the improvement in big international banks' risk measurement system would reduce the scope for their subsidiaries to underestimate credit risk so as to make lower provision and report higher ROE.

Policy could be reoriented towards reducing risks from volatile bank-intermediated capital inflows. While foreign financing is generally beneficial for countries, it also creates transmission channels through which shocks to the banking sector can impact capital flows, increasing the risk of a capital account crisis. Policy can weaken these linkages and mitigate this source of risk by encourage banks to diversify funding sources by fostering a shift from foreign to local financing of credit growth. They can be justified by the failure of foreign bank groups to fully internalize risks associated with reliance on foreign funding of euro lending owing to: (i) moral hazard arising from a perceived guarantee of the exchange rate peg; and, (ii) the fact that foreign banks' exposure represents a small share of their overall exposure, which may limit the attention paid to this risk.

Supervisors' cooperation with the home supervisors of foreign owned banks needs to be strengthened. This should help ensure more effective oversight of foreign owned subsidiaries. Home supervisors can provide information on the potential for contagion through these banks and help ensure that parent banks are adequately managing risks in their subsidiaries.

Finally, consideration could be given to adapting restriction on maturity and currency mismatches. This could involve, for example, allowing more flexibility by relaxing the restriction a bit and relying more on a capital charge for market and other risks that arise from such mismatches. This would provide banks with more flexibility to rely on shorter maturity local funding while the capital charge would provide a buffer against these risks and an incentive to limit them. Another possible step would be to allow banks to treat a proportion of sight and savings deposits that are statistically very stable as "core deposits" (a widely used practice known in the banking industry as "mapping" used in the home countries of many foreign owned banks). These deposits could be used to fund medium and long term loans and would be an attractive funding source as the interest rates on these deposits are lower and comparable to those on foreign funding.

* R. Sean Craig, Monetary and Exchange Affairs Department, International Monetary Fund

These remarks should not be reported as representing the views of the IMF.
The views expressed are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. The presentation describes research in progress by the author(s) and is provided to elicit comments and to further debate.

[1] Oesterreichische Nationalbank (2005), Financial Stability Report, No. 10, December.

WHO SUPERVISES WHOM? THE ROLE OF NATIONAL FINANCIAL REGULATORS

*Boštjan Jazbec**

ABSTRACT

The quest for new financial architecture of single European market is most likely to intensify at the time of an outburst of potential financial crisis. The role of national financial supervisors is most likely to be questioned as banking and provision of other financial services have become highly integrated. While commercial banks easily cross national borders, national central banks and corresponding financial regulators find it difficult to establish necessary power and responsibility to ensure national financial stability. This is especially true in new EU member states and EU accession economies where most of the financial sector is foreign owned. There is a pressing question who shares a burden in a financial crisis?

I would like to thank Minister Bode for his kind introduction. Special thanks go to the Bank of Albania and Governor Fullani for inviting me to this distinguished event in Tirana.

In my short presentation, I would like to address a question: Who supervises whom? And Who pays what? In trying to answer these questions it should be rather clear who supervises whom, while the answer to the other question is still rather uncertain. Most of this uncertainty stems from the fact that we – the region in general –

have not experienced serious financial crises yet. For that reason, we do not know how our financial systems and their regulators would behave in the wake of a crisis. The problem is further complicated by the fact that commercial banks rather easily cross national borders, while national financial authorities, which are dominated by the central banks still find it difficult to exercises necessary power and responsibility with regard to the stability of the corresponding financial systems.

It seems that there are many definitions of what is financial stability and the one I am using in my presentation is just one of them. The problem with all these definitions is that they usually depict good times when everything is in order. However, what we all try to prevent in case of financial system irregularities are unnecessary costs during financial crises. And that is the main reason why we all talk about financial stability. Because if everything were so fine and perfect, we would deal with economic optimum situation where nobody would benefit on the account of somebody else. As we are all bankers – no matter whether we are commercial or central bankers – we usually trade with promises. On this particular issue, we constantly promise each other that everything will be fine when the crisis really occurs and starts damaging our economies. To my opinion, stakes are rather different and for that reason I do not really believe that we would all fight for the same reason in turbulent times.

Looking at the current development in the region, we observe rather large economic growth. However, this growth development does not distinguish South East Europe from other emerging markets. Also, looking at inflation figures, our region is doing relatively well. Where I see the difference is the behavior of balance of payments for pretty much all countries in the region. There are substantial differences between national savings and investment which are mainly financed by bank credits. However, most of the commercial banks in the regions are foreign owned. And here comes a series of question: Who controls whom? Who defines the rules of the game in the region? And if I elaborate a little bit further: Do we have a problem of financial stability in the region? Do we find a rapid credit growth as a threat for the stability in the region?

As long as we all benefit from the high economic growth rates, we are all glad for this to happen. However, in good times we have to resolve issues regarding the responsibilities for financial stability in our countries. As we all probably know, the issues of supervision and prudential measures are pretty much national responsibility as the European Central Bank is mainly responsible for the monetary policy. Knowing that it seems that there might be problems in coordination actions among different financial authorities – including national central banks – in cases when commercial banks operate beyond their national borders. As foreign banks are of systemic importance for the region, the issue of their supervision is of the paramount importance. This is even more important in cases when commercial banks generate most of their income abroad. The solution for this problem could be unified supervisory institution on European level, which would be responsible for the European financial stability issues. As we are all playing the same game in terms of common European monetary policy, this would probably be the best solution for the soundness of the European – still – national financial sectors. But that would also mean that we would have to consolidate – at least to some extend – national fiscal accounts. And there is a problem. A political one.

Until we solve this problem we have to deal with reality which is broadly depicted in Article 129 in European new Capital Adequacy Directive which gives rather patronizing power to home supervisory institutions over corresponding host institutions. Reading carefully the whole Directive gives us the answer to the first question of who supervises whom. To some readers the answer is straight forward: home institutions supervise national financial sectors in cases when they are foreign owned. But why should this be so problematic? Because there is something, which is called national deposit insurance scheme. It would be perfectly fine if control and responsibility for supervision would also bear the responsibility of sharing the burden in cases when something goes wrong. This means that those who supervise should also bear costs for deposit insurance scheme. You might say, fine, but foreign banks are also part of the national deposit insurance schemes. This is true, however, in extreme cases we have already observed foreign banks quickly withdrawing from ailing economies. The best examples are

Argentina and Croatia not so long ago where foreign banks where first to flee from the economies.

To maintain long-run financial stability in our economies these questions should be seriously addressed. One solution could be unified European financial regulator. On the other hand, one might link responsibility for supervision with all the costs occurring in bad times. In between, we should all enjoy good times.

Thank you for listening this short presentation.

* Boštjan Jazbec, Member of the Governing Board, Bank of Slovenia
The views expressed herein are those of the author and not necessarily those of the Bank of Slovenia.

ENHANCING FINANCIAL STABILITY THROUGH BANKING SUPERVISION: THE CASE OF ROMANIA

*Valentin Lazea**

Ladies and Gentlemen,

First of all, let me thank the Bank of Albania and Governor Fullani for inviting me to this outstanding conference. We have all heard some interesting speeches which approach the issue of financial stability from a theoretical point of view. Let me present you a case-study, that of Romania, which in many ways confirms those theoretical arguments by empirical findings.

I. GENERAL FEATURES OF THE ROMANIAN BANKING SYSTEM

One may refer to the financial system in a broad sense (including the capital markets, insurance companies, pension funds etc.) or in a narrow sense (banking sector only). In my speech, it is the latter approach that I will use, and for a good reason, given the banks' preeminence.

Let me stress from the beginning that the financial markets in Romania are regulated by different entities: the banking market by the NBR, the capital market by the National Securities Commission, and the insurance market by the Insurance Supervision Commission.

These three institutions closely co-operate and there is no intention to eventually merge them into a single supervisory body.

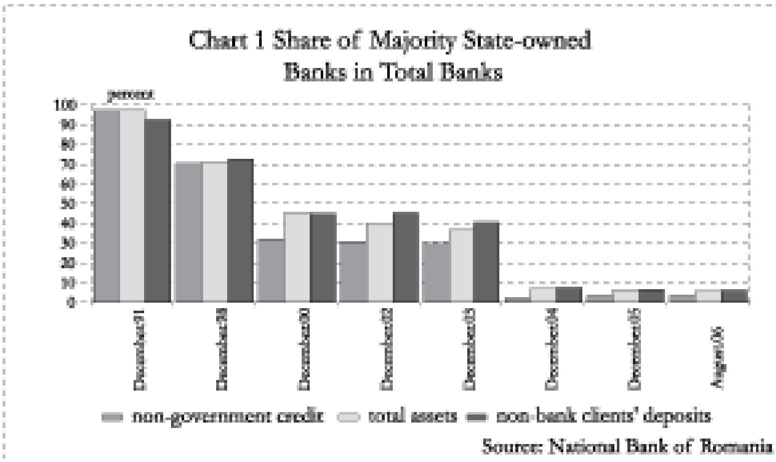
Banks are dominant in the Romanian financial system, accounting for 83.72% of the market share in terms of assets. The other types of financial institutions, although growing fast, have still modest shares of the market (e.g. 6.79% for leasing companies, 4.12% for insurance companies etc.). However, Nonbank Financial Institutions (NFIs) have recently entered under the regulation and supervision of the National Bank of Romania (NBR).

Financial Institutions	Assets' Share in GDP (%)		Market share as of Dec. 2005
	2002	2005	
- Commercial banks	31.19	44.76	83.72
- Leasing companies	1.48	3.63	6.79
- Insurance companies	1.51	2.21	4.12
- Financial Investment companies (SIF)	1.45	1.76	3.30
- Other non-bank credit institutions	0.41	0.93	1.75
- Investment funds	0.09	0.17	0.32
Subtotal	36.13	53.46	100.00
- Bucharest Stock Exchange	6.05	19.52	
- RASDAQ	4.03	2.86	

After a decade of restructuring and bankruptcies, that cost the state around 10% of GDP in the period 1990-2003, the commercial banks started to expand rapidly credit to non-government. At this moment in time, the majority of the banks are privately owned (with the bulk being held by foreigners).

Commercial banks	Dec. 1999	Dec. 2002	Dec. 2005
Total number (including CREDITCOOP)	41	39	40
Privately owned	37	36	38
Foreign owned	26	32	30
Share of private banks' assets in total assets (%)	53.2	59.6	94
Share of foreign capital banks' assets in total assets (%)	47.5	56.4	62.2
Top 5 banks' asset share (%)	66.7	62.8	58.8

Foreign banks' involvement (through privatizations or through greenfield investments) brought about easier access to external financing, a more efficient risk administration, better corporate governance and an enhanced stability of the overall banking sector. Thus, supervision has a relatively easier task to perform in this context.



share in total banks (%); August 2006			
	Total assets	Non-govt. credit	Non-bank clients'deposits
Banks with majority foreign capital*	87.9	89.0	85.8
Banks with majority domestic private capital	6.7	7.5	7.9
Banks with majority domestic state-owned capital	5.4	3.4	6.3
*) including BCR			

But, foreign banks bring not only solutions, but also problems, as Mr. Sean Craig's study has aptly shown. This can happen especially when host market risk is not properly assessed by home country banks, thereby leading to imprudent behavior by their local subsidiaries.

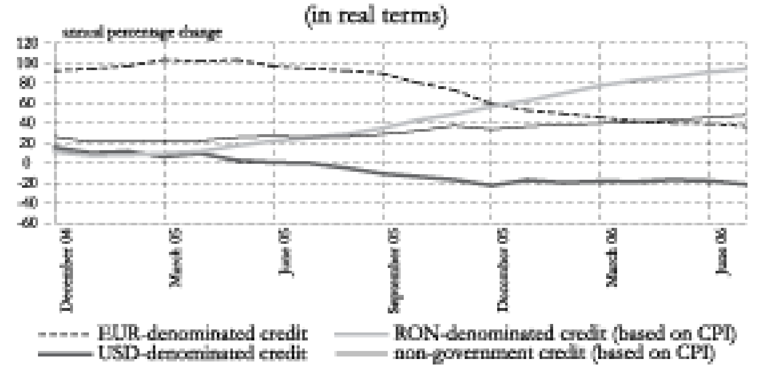
	2001	2003	2005
Total commercial banks, domestic assets (% of total assets)	71.6	83.1	88.5

Receivables from the banking sector, of which: − receivables from NBR	27.2 23.4	29.3 26.3	36.5 28.5
Receivables from the non-bank sector, of which: − receivables from govt. sector − receivables from firms − receivables from households	44.4 10.8 31.3 2.3	53.8 4.7 36.9 12.2	48.5 1.9 30.2 16.4
External assets	14.5	5.7	3.5
Other assets	13.9	11.2	8.0

One can interpret the heavy involvement of the NBR in attracting banks' liquidity as a prudential measure to put a brake on the rapid expansion of non-government credit (and also to compensate for the gradual diminishing of T-bills and bonds, in line with reduced budget deficits)

Until December 2005, the Euro – denominated credit growth was much faster than that of the Leu-denominated credit growth. After some measures were taken by the NBR, the two tendencies inversed themselves, with the RON credit growing at 93.2% in real terms (!) as of August 2006, while the EUR credit growth was 37% in real terms in the same month, year-on-year.

Chart 2 Non-Government Credit
(in real terms)



Source: National Bank of Romania, National Institute of Statistics

percent							
	Total (annual change)	EUR		USD		RON	
		annual change	% in total	annual change	% in total	annual change	% in total
Dec.04	26.2	92.8	43.3	15.9	17.5	11.1	39.2
Mar.05	22.6	104.0	44.5	6.1	16.0	9.7	39.5
Jun.05	27.0	96.9	46.1	0.8	14.0	21.9	39.9
Sep.05	28.9	89.8	47.4	-10.6	11.6	35.0	41.0
Dec.05	33.8	59.3	44.0	-22.3	10.0	56.8	46.0
Mar.06	39.9	45.9	40.9	-18.1	8.8	77.8	50.3
Jun. 06	45.8	39.4	40.7	-17.8	6.9	91.3	52.4
Aug.06	48.0	37.0	41.2	-23.8	5.8	93.2	53.0

What is also important to stress is that the overall pace of credit growth accelerated to 48% in real terms. The issue then arises: when does a rapid increase become a problem? Or, in other words, when does a credit growth translate into a potential boom and bust? Several quantitative methods can be used to answer this question:

1° The ratio of overdue loans to total loans. This indicator shows no problem for Romania, because the ratio is actually falling. But, as Mr. Bini – Smaghi showed in his speech, this might be deceiving, as in periods of rapid credit growth, non-performing loans can easily be hidden.

2° Some leading indications as the ratios of M2/GDP (stable in the case of Romania), M2/M1 (rising) or currency outside banks/deposits (stable).

3° The leverage (ratio of debt to equity by private firms), especially in the non-tradables sector, which is thought to be the first hit when things turn bad. In the case of Romania, the leverage of the services sectors has actually decreased (with the exception of construction).

II. MEASURES TAKEN BY THE NATIONAL BANK OF ROMANIA

In an environment of total capital mobility, there is only limited scope for a Central Bank in using its prudential supervision measures. But it can supplement them through monetary instruments (which have a prudential effect) and with administrative measures. The National Bank of Romania has extensively used both of these.

1) Monetary measures

The NBR attracts liquidity via open market operations, its own Certificates of Deposit, as well as the overnight deposit facility. However, due to the high costs involved by these absorptions, the NBR had to rely heavily also on some other instruments such as:

Minimum Reserve Requirements (MRR)

− the MRR was gradually increased for forex deposits from 30% to 35% (in January 2006) and then to 40% (in March 2006)
− for RON deposits, the MRR was raised from 16% to 20% (in June 2006).

2) Administrative Measures

- in order to decelerate the rate of growth of non-government credit, a set of measures was taken in February 2004, asking for:

a) limiting the monthly installments to 30% of the borrower's net income,
b) limiting, for the housing credit, the value of credit to 75% of the house's value and requesting collateral of 133% of the credit amount, while monthly installments should not exceed 35% of the borrower's family net income.

- overall credit servicing (consumption, housing, etc.) for households is limited to 40% of the borrower's net income since August 2005,
- commercial banks are prohibited to lend in excess of 300% of their own funds to unhedged borrowers since September 2005,
- starting October 2006, lending based on the ID card alone is prohibited.

One must bear in mind that commercial banks' behaviour doesn't have only microeconomic effects, but also macroeconomic effects.

One particular problem might arise from the fact that, in attracting foreign financing resources (a process that is commendable in itself), commercial banks might be less inclined to stimulate domestic deposit-taking and, therefore, contribute to a fall in the domestic savings rate.

	2001	2003	2005
Total commercial banks' domestic liabilities (% of total liabilities)	74.1	71.2	63.5
Interbank deposits	3.7	2.9	2.5
Deposits attracted from non-bank sector, of which: − payables to the govt. sector − payables to firms and households	70.4 3.7 66.7	68.3 3.0 65.3	61.0 3.5 57.5
Capital and reserves	14.4	13.1	12.2
External liabilities	5.9	11.7	20.9
Other liabilities	5.6	4.0	3.4

III. ASSESSING THE FINANCIAL STABILITY

Given the importance of the financial stability issues, the National Bank of Romania decided to set up, in December 2004, a new Department for Financial Stability, which has four divisions:

- Financial Institutions
- Financial Market and Infrastructure
- Macro Prudential Risk
- Banking Risk

The main output of the Department consists of the Annual Financial Stability report, from which most of the following information is extracted.

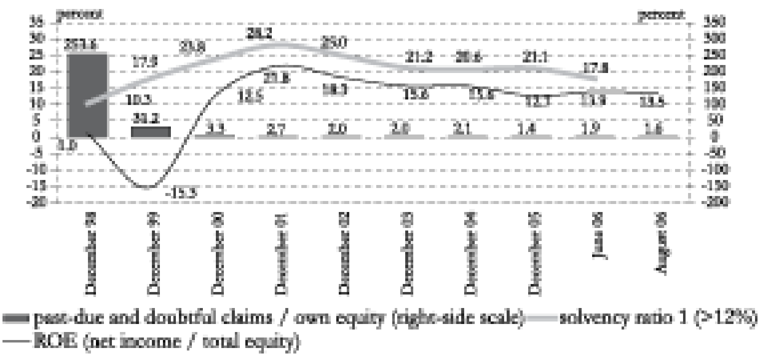
IV. PRUDENTIAL INDICATORS

Capital adequacy of the Romanian banking sector remains significantly above international standards, although it showed a tendency of very gradual decline in the last few years, related to the very rapid (and, sometimes, risky) expansion of non-government credit.

Thus, the solvency ratio (>12%), expressed as own funds divided by risk-weighted assets, declined from 21.09% in December 2003 to 20.21% in December 2005 and to 19.72% in March 2006, whereas the ratio of own capital to risk-weighted assets (>8%) decreased, in the same period, from 18.11% to 15.59% to 15.30%.

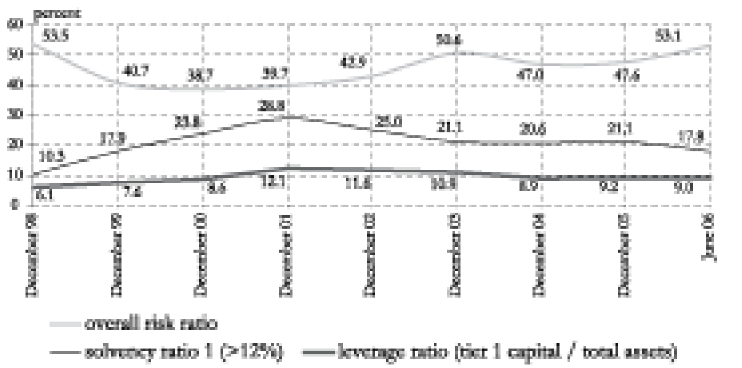
A minor shift could be detected in the composition of own funds, from own capital (Tier 1) to supplementary capital (Tier 2). Out of the 40 banks operating in Romania at end-2005, 28 banks have increased their share capital in that year, while 5 other banks followed suit in the first quarter of 2006.

Chart 3 Analysis Ratios for the Banking System



Source: National Bank of Romania

Chart 4 Analysis Ratios for the Banking System



Source: National Bank of Romania

A stress-test performed by the NBR in June 2005 found that, even under severe shocks (a depreciation of 18.6% of the national currency, coupled with a reduction of 6.7% of the interest rate), the solvency ratio of the banks would be affected only marginally (falling by 1.6%, from 18.3% to 16.7%), remaining above the internationally required levels. The brunt of the shock would be accommodated by a reduction of the own funds of 9.5%, unevenly distributed between banks (privatized banks would suffer most, with a reduction in own funds of 15.2%).

As a conclusion, one may infer that capital adequacy of the Romanian banking system is good, allowing it to withstand even severe shocks and providing a solid basis for future credit growth.

V. RISK ANALYSIS

A more detailed analysis should take into consideration different types of risk to which commercial banks are subject:

- credit risk
- liquidity risk
- market risk

Credit risk, albeit on an ascending path, is well contained. One aspect is related to the currency mismatch, given that forex credits might be related to unhedged borrowers.

The measures taken by the NBR (increasing the capital requested for loans to unhedged borrowers, increasing the minimum reserve requirements more for foreign currency than for the RON, etc.) have succeeded in bringing, in March 2006, the share of RON credit above the share of forex credit for the first time in many years, thus mitigating the currency mismatch.

Another facet of credit risk is represented by the maturity mismatch, given that an increased share of the credit is granted for medium and long-term, while the deposits are predominantly short-term. This risk is being mitigated by foreign banks' increased reliance on parent undertakings, as well as through issuance of long-term bonds that would match the term structure of loans.

Credit risk may also be assessed in terms of the evolution of Non-Performing Loans (NPLs), which have fallen significantly compared to the levels of 2000 (when they represented 15.7% of the total attracted and borrowed sources) to 3.7% by March 2006. In 2003, a new criterion for classifying credits was introduced, namely the financial performance of companies (leading to a temporary worsening of the NPLs). The coverage of risk-weighted assets by reserves and provisions has kept increasing, from around 125% in 2000 to 170% in March 2006.

Liquidity risk, although rising in recent years, is also well under control. The share of liquid assets in total assets has fallen from 33.1% at end 2003 to 28.8% at end 2005, before reaching again 35% in March 2006, as a result of increased interest rates set by the NBR (offering the most liquid placement for commercial banks' assets). The ST assets/ST liabilities ratio has increased between 2003 and 2005, from 210.5% to 245.7%, as did the credits/deposits ratio (from 71.7% to 74.9%), showing an acceptable exposure to the liquidity risk. As already mentioned, banks started issuing bonds on the capital market, the volume of funds attracted increasing nine-fold in 2005 compared to 2004.

The net result was a smoothening of asset maturities, as well as a reduction of the mismatch between assets' and liabilities' maturities.

% of total

	< 1 m	1 to 3 m	3 to 6 m	6 m to 1 y	> 1 y
Maturities of assets (Dec. 2005)	56.1	5.7	6.4	9.1	22.7
Maturities of liabilities (Dec. 2005)	55.5	9.7	4.1	4.6	26.1

Market risk can also be divided into interest rate risk (moderate in the case of Romania), exchange rate risk (small) and asset price risk (negligible). The interest rate risk is falling, since the net income of the commercial banks from interest declined from almost 8% in 2001 to less than 4% in 2005.

Other factors mitigating this risk are:
- the continuous transfer of interest costs to other (fee-related) costs by the commercial banks
- the continuation of the practice of variable interest rates on long-term contracts

The exchange rate risk is low, because banks rely heavily on their parent undertakings.

The asset price risk is negligible, since banks have little or no shares in their investment portfolio.

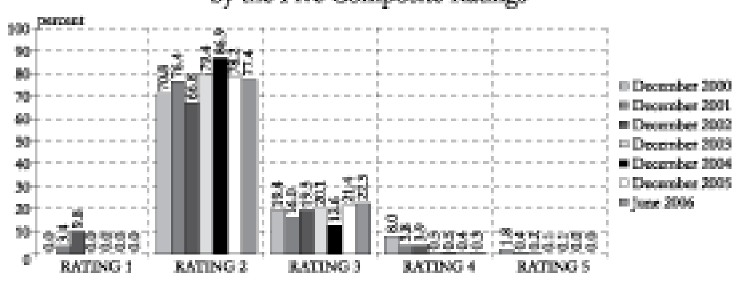
VI. SUPERVISORY MEASURES

The supervision of the NBR has helped enhance the banking sector's financial stability through a wide array of measures:

- implementing a uniform rating system
- implementing early warning systems
- reducing to one year the frequency of on-site inspections for every bank
- using more forcefully the penalties for the banks in breach of regulations
- more selective criteria for the shareholders and managers of banks
- cooperation with domestic and foreign supervisory authorities

Concerning the uniform rating system, a CAMEL system was developed (Capital, Assets, Management, Equity, Liquidity), according to which the Romanian banks were clarified. As it can be seen from the graph, the vast majority of the banks (more than 75% of them) come under the Rating 2 (which is "good"), none of then being either exceptional (Rating 1) or very bad. (Rating 5)

Chart 5 Weight of Banks in Total Bank Assets by the Five Composite Ratings



* According to CAMEL, the components (capital adequacy, shareholders' quality, assets quality, management, profitability, liquidity) are rated from 1 to 5. Top rating: 1; lowest rating: 5.

Source: National Bank of Romania

With regard to the use of penalties for the banks in breach of regulations, only in the first half of 2006, the NBR has applied 5 fines, has issued 1 warning and 3 requests for remedy of the situation.

The criteria for shareholders and managers of banks include, inter alia: a proven experience of at bust 7 years in the financial sector, the lack of criminal record, proofs that the shareholders have enough own funds (without counting borrowed money) etc.

As to the cooperation with foreign supervisory authorities, Memoranda have been signed with 10 countries (8 from the EU and 2 non – EU members): Germany, France, Italy, Netherlands, Austria, Hungary, Greece, Cyprus, Turkey and Moldova. Of course, as already mentioned by several speakers, there is continuous need to enforce these MoUs, lest they fall into oblivion and become useless pieces of paper.

VII. FUTURE DEVELOPMENTS

The implementation of Basel II in Romania is in an incipient stage, and in 2007 most banks will continue to use the Basel I methodology. Explanations for this may include:

– the relatively high degree of banks' capitalization
– the small size of the Romanian market, which would not warrant a sustained effort of modification of procedures
– the insufficient quality of statistical data

The NBR has initiated a multi-stage approach, designed as follows:

– exchange of information with the relevant domestic and foreign authorities
– modifying internal regulations, adopting guides for validating banks' internal models and assessing the latter's compliance with the new regulations
– validating the banks' internal models
– verifying the implementation of Basel II by commercial banks

So far, in the process of consultations, few commercial banks have expressed their readiness. Thus, concerning credit risk (first part of the first pillar, dealing with minimum capital requirements), only two banks have opted for the internal ratings based approach, while the others prefer the standardized approach. As concerns operational risk (the third part of the first pillar) only 13 banks have opted for the standardized approach, while 20 banks prefer sticking to the basic indicator approach.

As a conclusion, one may say that the good opportunity offered for reassessing risk by Basel 2 will probably be lost, because of the particularity of the small market. This will only make clearer the need for the National Bank to enhance its supervisory capacities, in order to foresee and counteract any potential threat to the stability of the system, which is one of its statutory tasks.

Thank you very much for your attention!

* Valentin Lazea, Chief Economist, National Bank of Romania

RECENT DEVELOPMENTS IN THE ALBANIAN BANKING SECTOR AND CHALLENGES FOR THE FUTURE

*Klodion Shehu**

Dear participants,

In my speech, I will give you an overview of the banking system performance in Albania, trying also to share with you some of the challenges that the banking industry and we supervisors face at this time. I will also share with you the experience we have had to date, with the international cooperation as we perform our supervisory work.

Currently, the Bank of Albania, as the supervisory authority and through its Supervision Department, monitors the business performance of 17 commercial banks, 7 non-bank financial institutions specialized in lending and money transfer services, 2 unions of savings and credit associations (and their member association) and 58 foreign exchange bureaus. The supervision of the rest of the financial market that mainly is represented by insurance companies, pension funds and securities companies is the responsibility of the recently established institution, called Financial Supervision Authority. Albanian Government debt securities in national currency are the sole representative of the "capital" market, while no company is listed in the formally existing Stock Exchange. Bank's assets make up to 90 percent of the financial market assets, and around 60 percent of the Albanian Gross Domestic Product. Hence, banks represent the focus of the supervisory work of the

Bank of Albania, and their performance is critical to the financial stability of the country.

To provide for smooth clearance of the banking transactions, the Bank of Albania is operating a Real Time Gross Settlement system, combined with an additional one dedicated to small amounts, retail transactions. In addition, the Bank of Albania operates through indirect instruments to provide liquidity in the inter-bank market, and its monetary operations framework is complete.

The form of bank establishment includes subsidiaries and branches of foreign banks (3), as well as banks that are locally owned. Currently, there is no distinction in the prudential norms and supervisory practices that are applied to subsidiaries or branches of foreign banks. To enter the Albanian banking market, among others, a minimum amount of capital of 1 billion lek (a little more than 8 million euros) is needed, which is paid in either lek, euro or usd. All the banks can perform universal banking activities, but for some of those activities which are considered as non-traditional and sophisticated, a higher amount of capital is required.

The opening of the banking market was an early development of the past decade, which went along with the efforts to restructure and privatize the state-owned banks. The privatization process was finalized in the end of 2003, and since than the banking system is fully privately controlled. With time, as their number increased and as the competition environment was tightened, banks started to expand their network (including cross-border branch establishments), introduce new products, improve service quality and also engage more in high return activities in an effort to protect the market share and assure financial performance stability. This has led to a more efficient use of their financial resources, including their capital. In their search for efficiency, some of the banks, not always those that have been established earlier have been more active than the others. As a result, their capital adequacy ratios are closer to the minimum required level of 12 percent.

The financial performance of the banking system as a whole is satisfactory. Last year, the annual after tax profit was around 54 million euro. The return on assets was around 1.4 percent, while the return on equity was a decent 22 percent. The banking system remains capitalized and liquid. On June 2006, the average capital adequacy ratio was 18.4 percent, while liquid assets of the banking system counted for 60 percent of the total assets. Credit to the economy is picking up relatively quickly, after the privatization of the banking system. Currently, outstanding loans represent around 30 percent of the banking assets. Credit annual growth was around 80 percent last year, and on August 2006, was approximately 54 percent.

UNCERTAINTIES AND RISKS

In spite of the generally good performance of the banking sector, the tightening of competition environment will objectively expose it to increasing risks, from the combination of exogenous and endogenous factors. Exogenous risks will mainly come from the interaction of the banking system with the real economy, and their magnitude will be affected by the banks ability to operate steadily, in a potentially changing business environment. Such changes could come from events in the local market, which may be generated also from developments that occur in our region and beyond. The endogenous risks will arise from strains in the banks internal capacities, as they try to participate in the profit opportunities that lie ahead. One should also notice that single banks' position toward such risks, will be affected by factors related to their size, their access to international financial markets and their ability to generate and use professional expertise. In fact, particular challenges are now in front of the low end of our banking system. The small banks and the ones that do not have a foreign financial support, should be quick in understanding their new position and react accordingly. These are challenges that could be overcome through measures that will aim at adopting high standards in providing impeccable quality for their banking services, upgrade the useable technology in search for innovation, and create and maintain some market niche through specialization. Such measures will be successful if they are endorsed fully by the shareholders, knowing that in such way they have contributed to increasing the value of the bank and present it with new opportunities for business development in the future.

A stable macro environment, with generally low inflation and interest rates level, not only in the local market but also in the region, has supported the good performance of the Albanian economy. Banks are contributing and are benefiting from such performance, through their exposure to different developing economic sectors. However, banks have to pay attention to different financial imbalances that might be arising in particular sectors of the economy, and try to assess and incorporate their effect in the banking business. This indispensable task is not an easy one, particularly when the general local infrastructure for collecting information and verifying its accuracy, especially for exposures, is not developed. In addition, banks have to monitor carefully exposures to potential risks from their interaction with the rest of the financial institutions as they grow, knowing that there might be regulatory loopholes that allow for detrimental regulatory arbitrage.

When it comes to endogenous risks, the situation requires particular attention. Good governance and tight monitoring is the fundamental requirement, to enable the establishment of a solid bank internal framework of controls and procedures. Such controls and procedures should adequately cover all the areas of the banking activity, require the continuous assessment of risks that are generated in the main business directions and enable the set up of the supportive infrastructure, define clearly the responsibility and the reporting lines, and also provide for the establishment and the maintenance of a motivated staff, particularly important for a changing environment. A consistent decision making process based on thorough analysis, different aspects of the banks activities with the related persons, professional management of staff relationships are some of the areas where the Albanian banks have experienced deficiencies. In addition, asymmetries related not only to the size of the banks but also to their asset composition and exposure toward particular business sectors, have occasionally affected the behavior in the market of some of the banks. Despite a continuous improvement in the banking services, there are still instances that show deficiency in the transparency of the banks to the clients for the bank products. Such issue is more exacerbated by the relatively low financial culture of the general public. The entrance in our market of foreign banks with a long banking tradition and good international reputation is a key factor in soliciting the adoption of better standards in good governance, and such banks should be aware of this role.

Risk identification and assessment is another area where our banks have a long way to go. They should set up and strengthen these internal structures, while the needed expertise is proportionate to their business sophistication and relevant exposures. As the efficiency of the market will improve with time and the nature of risks will change, banks will have to put in place a process that will allow them to adopt their business characteristics to such changes. Again, more is expected from the most active banks in our market, that should take a leading role in further developing their risk management capacities, and promote the discussion within the industry.

THE SUPERVISORY RESPONSE

Many of the challenges that are faced by the banking system represent challenges for the Bank of Albania as the supervisory authority. We are in a process of finding the right equilibrium among compliance-based and risk-based supervision, appropriate to the development of our market. To this purpose, we are requesting banks to improve the quality of their reported data and shorten the time lag of periodical reports sent to the Bank of Albania. At the same time, more attention is being given to the analysis of the data, including the running of different stress-test scenarios. We have begun sharing the stress-test results with each of the banks, with the purpose of soliciting them to perform similar tests and improving the quality of the analysis through a discussion process. On-site examinations and their follow-up are being tailored to the risk characteristics of the bank. We have started to apply supervisory rules and practices that support consolidated supervision. The content of the examinations report is enriched with forward looking recommendations, in an effort to prevent unwelcome developments and put the bank in a position to engage in timely and proper actions.

We strongly believe that we can better deliver our supervisory responsibilities, if we “bring in the table” the banking industry. This is critical, because effective supervision is not possible without and is not a substitution for good bank governance. Indeed, if the latter is missing, the supervisory authority would suffer to understand and identify in time, the risks which are material to the bank business. As a result, we are going to have costly supervisory approaches and extreme supervisory decisions that are unavoidably going to disrupt the performance of the banking system in the short term, and of the financial system as a whole. For this reason, in our regulatory framework and in our supervisory practise, we are stressing the role of the adequate bank management structure oversight in the bank business, identifying their responsibilities to act according to generally accepted governance standards. On the other side, the communication is serving to bring our concerns to their attention, avoiding misinterpretation, the creation of financial imbalances, and also assuring better support for strong supervisory actions when needed. Furthermore, the supervisory authority can use this enhanced communication, to avoid "overshooting" in the regulating process, when the market discipline can act. To increase the role of market discipline, we have initiated a process of preparing changes to the regulatory framework that would contain stronger requirements for banks activity public disclosure. From such communication, we expect bank representatives to understand that sometimes it is important to sacrifice short term profit interests, in order to assure long term resilience and sound performance.

An important challenge to our banking system and to us, is related with the adoption of appropriate Basel II requirements and the implementation of IAS/IFRS. For the first, we shall reorganize the internal approach in order to increase effectiveness. At the same time, some changes in the regulatory framework will introduce requirements that belong to the Standardized Approach for Credit and Operational Risk. Furthermore, requirements that are related with the disclosure requirements of the New Accord have been initiated. Our current general position to this issue is to follow a pragmatic approach and to approve only the adoption of well understood (from each side) elements of Basel II that can be implemented in a safe way. We are aware that this process is going much faster for European Union banks and will be pushed also by such banks that operate in Albania. In order not to impede the sound implementation of sound Basel II practices, particularly those that will enhance risk assessments capacities in banks we shall require maximum coordination with other home country supervisory authorities, being also mindful of the differences that will exist in respective approaches. The full implementation of IAS/IFRS in 2008 is a legally binding requirement. Most of the banks are audited in compliance with the IAS/IFRS, but the expertise in the financial sector for this issue appears to be limited. However, banks will be required to perform an assessment on the changes and effects that the full adoption of the IAS/IFRS is going to bring for their business performance and infrastructure. On the other side, due changes should be prepared for the Bank Accounting Manual. For the process, we are committed to require the assistance of audit companies, for raising the awareness and understanding of this issue. We expect them to come forward with concrete proposals on how to better approach the issue in such a short time. Everything will be coordinated with the National Accounting Board, the entity that directs the process on a national level.

In a period of increasing interactions among financial institutions within the local financial markets and their increasing cross-border operations, communication to other supervisory authorities in the country and abroad, is paramount. Within the country, such established communication is expected to be enhanced with the newly established Financial Supervision Authority. The main goal is to assure adequate supervision coverage, for all the financial institutions that operate in the market. More attention is going to be paid to the dialogue with the external audit companies, given their role in spotting material risks in the data quality of the financial institutions. When it comes to cooperation with foreign supervisory authorities, the experience of the Bank of Albania is generally good. With time, through the signing of bilateral Memoranda of Understanding, we have established formal cooperation with National Bank of Bulgaria, Bank of Greece, the supervisory authorities in Turkey and the Authority of Banking Payments in Kosovo. This was to assure better supervision of banks that operate in Albania, whose capital is originating from their countries. In spite of the absence of formal Memoranda of Understanding, we also have established practical cooperation with the Financial Market Authority in Austria and with Banca D'Italia. In all the instances, the cooperation has proven to be effective when dealing with particular issues of banks and when performing the analysis of foreign bank applications to enter the Albanian market, or vice-versa. Joint on-site examinations have been organized with the Austrian Financial Market Authority supervisors, and local on-site assistance has been provided to the examiners of the Bank of Greece, as both these supervisory institutions have examined the respective countries banks that operate in Albania. Ad-hoc meetings have been organized to discuss the situation of particular banks. We have established Memoranda of Understanding with other supervisory authorities in the region like the National Bank of Macedonia and the Central Bank of Montenegro. At this stage, cooperation with them is confined to the exchange of general banking market information. With these latter supervisory authorities, we can exchange information also in the framework of the organization of Banking Supervisors of Central and Eastern Europe, where our respective supervisory authorities participate. Our belief is that there is an unexploited area of cooperation among supervisory authorities in the region, particularly regarding the explanation and the supervisory response to the market behavior of same financial institutions with systemic importance, that operate in our countries. In addition we can also discuss and coordinate supervisory measures that aim at reducing business activity imbalances (like high credit growth) of our financial institutions that operate in a similar situation. This is a topic that can be explored further during this conference, and beyond.

In the process of strengthening the supervisory capacities, we have been supported by the expertise of the World Bank, the International Monetary Fund the Bank for International Settlements, and from other organizations like USAID, FSVC, GTZ etc. Expressing our deep appreciation, we look forward to future development and assistance projects that will help us in confronting successfully our challenges.

In conclusion, we believe that the financial situation of the banking sector is healthy, but further improvements are needed, particularly in fully adopting the international standards of good governance. Risk assessment capacities need to be strengthened, in face of risks arising from market openness and increasing competition.

Consistent communication with the financial market industry will create better incentives for confronting successfully the common challenges. Increasing cooperation with other local and foreign supervisory authorities is important to ensure adequate supervisory response to many financial market developments in our countries and in the whole region. We count on the support of international financial institutions and other organizations, to further strengthen our supervisory capacities.

Thank you.

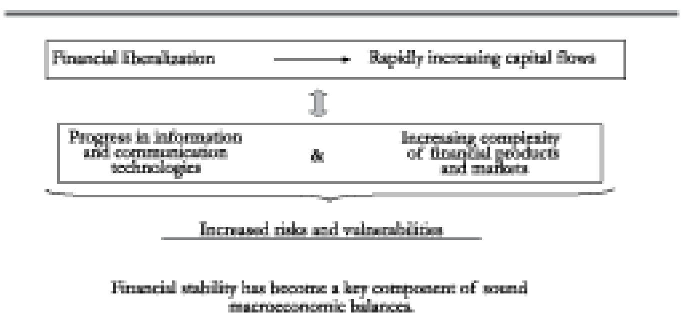
* Klodion Shehu, Director of Supervision Department, Bank of Albania

THE ROLE OF FINANCIAL STABILITY FOR THE CONDUCT OF MONETARY POLICY

*Mehmet Yörükoğlu**

We are living in a new era of globalization principally in the financial markets. This is mainly due to progress in technology, especially information technology, and overall economic liberalization wave in the world (Chart 1).

Chart 1 Why has financial stability become a very important issue in many countries?



Before this liberalization wave and the information technology enabled the globalization process in the world financial markets, there was strong home bias between savings and investment in a typical country. Most of a country's savings were invested in that country. In an ideal frictionless classical world economy, capital should flow to the location where it will have the maximum return, as a result equalizing marginal returns to capital across locations globally. This insight supports the Solow's neoclassical growth mechanism, in which capital flows from initially rich countries where marginal return to capital is low to initially poorer countries where the marginal return to capital is higher. This enables the so-called convergence process across countries where initially poorer countries grow faster and eventually catch up the initially rich ones. Growth economists have tested this strong result of the neoclassical growth model extensively, and until recently the result was negative. Actually, until recently, without any significant exceptions studies found that in practice capital does not flow from rich to poor in a regular way, and even if there is some regularity it is capital flowing from poor to the rich. As a result the gap between poor and rich countries was actually increasing, implying a divergence not a convergence of per capita output across countries. Nobel laureate macroeconomist Robert Lucas wrote his seminal paper simply titled "Why does not capital flow from rich countries to poorer ones?"

Of course there were few countries making miracles as again Robert Lucas named them, which actually achieved to catch up like Japan, Singapore and Hong Kong, but these were exceptional countries with high domestic savings rates, not needing significant capital inflows for rapid growth.

However, recently capital started to flow towards emerging countries, which have high growth potentials. For these countries financial reform and financial stability became much more important for overall macroeconomic stability and growth compared to other countries due to two important reasons;

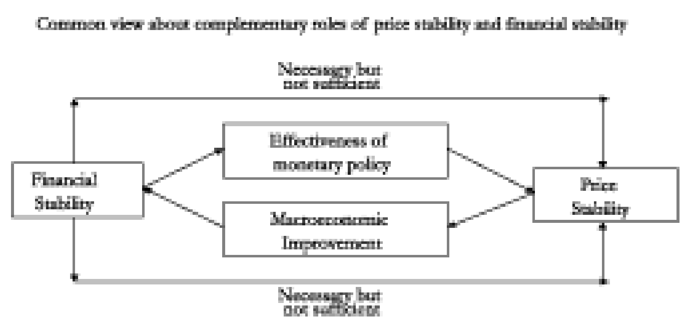
1) Capital does not flow to an economy, which is under significant financial instability risk. Even if it flows it will require significant risk premium.
2) Capital inflow in such a country may create significant current account deficit which makes the country much more vulnerable to external shocks, especially to changes in risk perceptions of global investors.

Therefore in this era of significant capital inflows to emerging economies, in order to make best use of this opportunity, emerging economies should try to achieve the best practice in financial stability.

This will not only determine the extent of success and the speed of the economic convergence but also the probability and the magnitude of the economic turbulences that the economy will experience on the convergence path.

As the world financial market truly globalizes, the interaction between financial stability and macroeconomic and monetary stability is becoming more and more of prerequisites of each other. Central bankers are responsible for providing a stable economic environment. Both price stability and financial stability, which are complementary to each other, are prerequisites for a stable economic environment. Strong financial system increases the efficiency of monetary policy. The other hand it is hard to achieve financial stability in the long run without maintaining price stability. (Chart 2)

Chart 2 Importance of Financial Stability for Monetary Policy

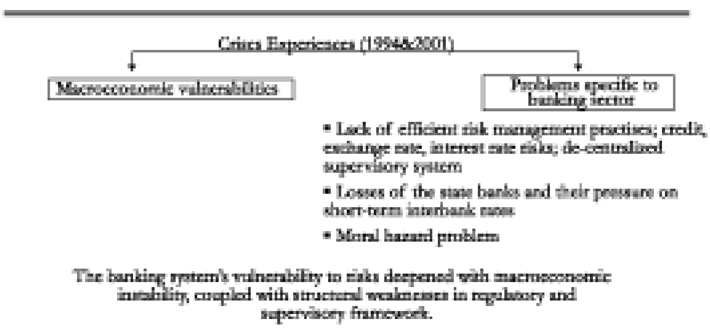


Turkish experience about the interaction between monetary policy and financial stability has been shaped by deep financial crises. 1994 and 2001 financial crises stemming from macroeconomic vulnerabilities such as high and volatile inflation coupled with large amount of budget deficits and problems specific to the banking sector in Turkey, underlined the fact that financial stability issue must be given utmost importance.

Weaknesses in macroeconomic fundamentals together with high public sector borrowing requirement resulted in banks taking excessive risks, especially foreign exchange and interest rate risks in order to get higher returns. In addition to these risks, connected lending which is a sign of weak corporate governance practises, led to an unsustainable period ended by crises.

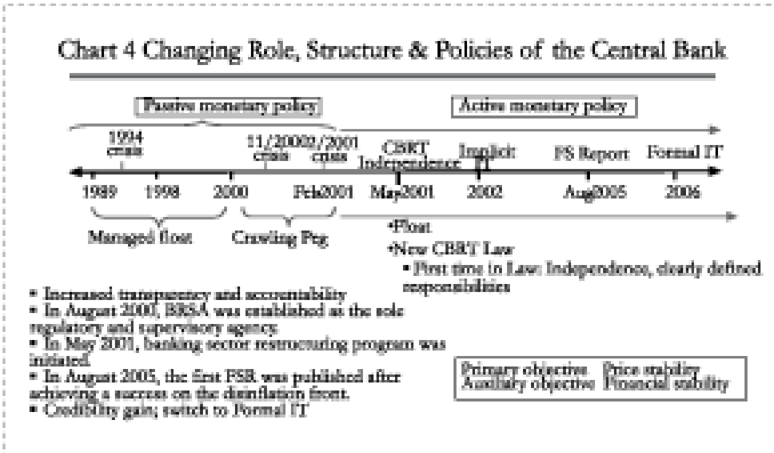
The duty losses of the state banks and their worsening financial position forced those banks to borrow from the markets with high overnight rates resulting in a pressure on short-term funding rates. The deposit insurance scheme which caused moral hazard in the banking sector was also a factor affecting the unsound practises in the sector (Chart 3).

Chart 3 Why has financial stability become a very important issue in Turkey?



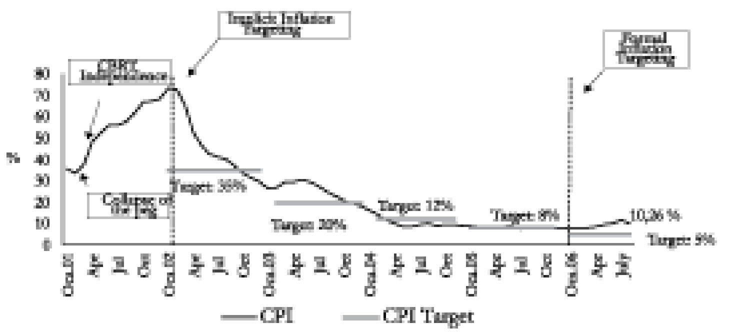
Within that context, 2001 crisis became a milestone for the Turkish economy and the Turkish financial system. A new economic program and many institutional arrangements have been introduced. The Central Bank switched to floating exchange rate regime, abandoning the exchange rate peg and the Central Bank Law was amended. By the new Law, the CBRT acquired tool independence and primary objective of the Central Bank was defined as achieving and maintaining price stability for the first time in its history, whereas the importance of the financial stability for the Bank was underscored by defining it as an auxiliary objective.

In early 2002, following the achievement of relative stability in financial markets, the CBRT announced its new monetary policy strategy as implicit inflation targeting regime. Finally, in line with price stability objective, CBRT introduced formal inflation targeting regime as the monetary policy strategy at the beginning of 2006 after a "credibility gain period" of four years (Chart 4).



Along with the institutional changes at the CBRT, the stabilization program that was launched in May 2001 has led to a great progress in decreasing the inflation rate and dismantling the imbalances in the economy. The Turkish economy lived through 30 years of high and volatile inflation rates, which had been one of the primary sources of macroeconomic imbalances in the economy. The CPI inflation declined to single digit Charts from 73,2 percent and inflation targets were attained successfully in the last four years. However, in the light of information currently available, the inflation will be above the target for end-2006 due to high oil prices, increases in unprocessed food prices, stickiness in services prices and the unexpected domestic currency weakness during the turmoil in May- June. Therefore, the recent trend in inflation could be treated as a temporary shock, stemmed essentially from both supply side and cost-push factors. In that context; the CBRT was cautious on the outlook for inflation for the year-end but the Bank forecasts that the inflation would converge to target by the end of first quarter of 2008 (Chart 5).

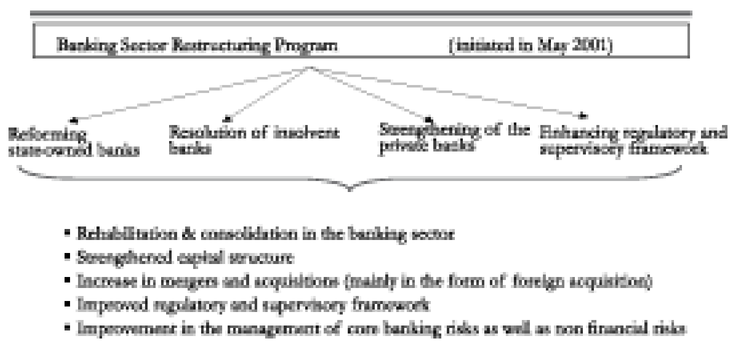
Chart 5 Successful Disinflationary Process...



Source: Turkstat

The achievement on the inflation front has significantly improved the macroeconomic environment and eliminated the vulnerabilities that put burden on the proper functioning of the financial system. On the other side, the Banking Sector Restructuring Program which was initiated in May 2001, has eliminated the distortions in the financial sector to a great extent and brought the regulatory environment in line with best international standards. The restructuring program had four main pillars (Chart 6):

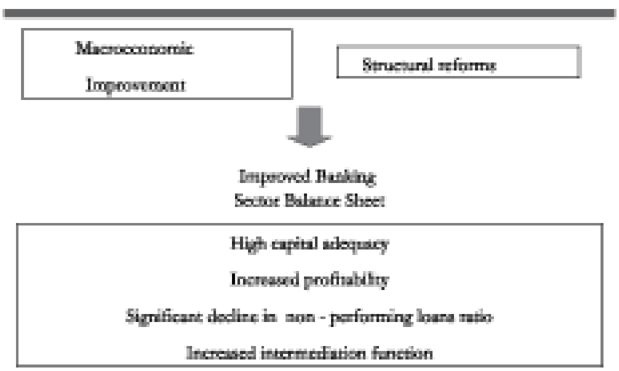
Chart 6 Structural Reforms in the Banking Sector



- Financial-operational restructuring and privatization of state banks
- Resolution of insolvent banks
- Strengthening the private banks
- Enhancing regulatory and supervisory framework

The results of the structural reform process in the financial sector were impressive. The number of banks which was 79 as of end-2000, decreased to 46 as of October 2006 after a consolidation process, due to resolution of insolvent banks together with mergers & acquisitions. The banking sector profits have considerably increased since 2002 after making a huge loss in 2001 because of the financial crisis. Capital adequacy ratios of banks have increased significantly bringing the capital adequacy ratio of the sector to 20.5%, well above the minimum legal requirement of 8%, as of August 2006. Credits/ Deposits ratio increased to 71% from 30.5% in 2001, leading to a better-diversified asset portfolio. In line with these developments in the sector, foreign direct investment to Turkish banking system reached to around USD 13 billion in 2005&2006 which corresponds to 4.2 % of the sector's total assets as of August 2006 and this process is expected to go further in 2007 (Chart 7).

Chart 7 Sound Financial Sector Evolved...



It is obvious that Turkish banks are managing their risks far better now compared to the pre-crises periods. Banks have nearly square net foreign currency positions. Non- performing loans ratio, which could be a proxy for credit risk, is at historically low levels (3.8% as of August 2006). Banks, which used to have assets mainly consisting of government securities previously, have diversified their asset portfolio by increasing the weight of credits in their balance sheets. (Chart 8)

Chart 8 Managing Risks Better Now

- Exchange Rate Risk

Turkish banking sector has a balanced net fx position.

- Credit Risk

Non performing loans ratio is at historically low levels. Rapid credit growth is continuously monitored by the CBRT.

- Liquidity Risk

Maturity mismatch still exists but deposit base is very stable.

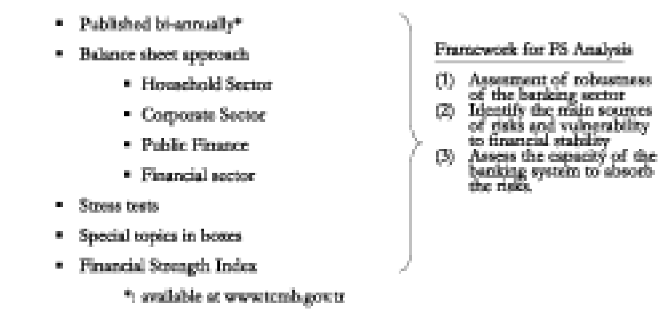
- Interest Rate Risk

Relatively better diversification of asset portfolio.

The most important contribution of the CBRT to above mentioned progress in the banking sector has been the efforts of the bank for providing a low-inflation environment. Moreover, the CBRT, as the institution that is responsible for operating the country's payment system and carrying out the lender of last resort function, has continued to assess the developments in the banking sector by closely monitoring the system.

The main tool of the CBRT for assessing the soundness of financial sector as a whole is the Financial Stability Report, which the Bank shares with the public semi annually. Household sector, corporate sector, financial sector and public sector are evaluated using a balance sheet approach, i.e. investigating the interactions between these sectors and the impact of developments in other sectors on the financial sector. The report also includes stress tests for the financial sector and special boxes, which mostly cover recent debates and issues regarding the financial sector. Financial strength index, which takes place in the report, is a useful tool for monitoring the vulnerabilities in the system (Chart 9).

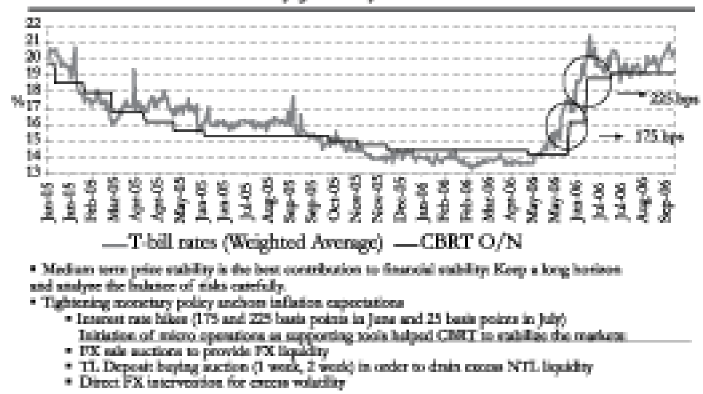
Chart 9 Financial Stability Report



After touching on the CBRT's perspective on financial stability, the monetary policy reaction for sustaining price and financial stability simultaneously could be streamlined as follows. In May – June turbulence, the process of monetary tightening and interest rate hikes in developed countries prompted an increase in risk aversion, which caused a disposal of financial assets in emerging markets including Turkey. This triggered the depreciation of domestic currency which then led to a worsening in inflation expectations. Inflation expectations for the next 12-months increased by almost 2.5 percentage points from April to July and the 24-month ahead expectations deteriorated by around 1,5 percentage points during the same period. As a response to these developments, CBRT increased policy rates by 175 bp and 225 bp respectively in June and by 25 bp in July. Besides the adjustments in policy rates, CBRT took some measures on the operational side; such as withdrawing the excess domestic liquidity by one and two week deposit buying auctions, providing FX liquidity through FX sale auctions and smoothing out the increased volatility in the market by direct FX interventions. All of these measures yielded fruitful results and the markets stabilized (Chart 10).

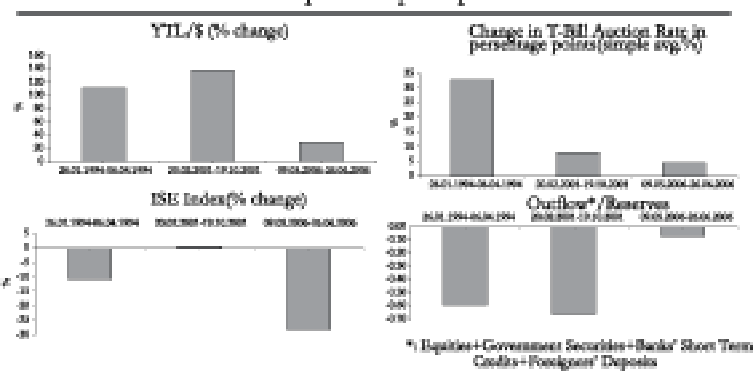
On the back of the favourable developments in the economy during the last five years, the vulnerability of the Turkish economy to both internal and external shocks has significantly decreased. Recent market turbulence experience proves this case. Although Turkey was

Chart 10 Rapid Policy Response to the Turmoil in May-June by the CBRT...



among the countries that had been adversely affected by the market turbulence during May-June of this year, the scope and size of recent turbulence in Turkey is somewhat less severe compared to previous episodes of increased financial distress, thanks to the strong economic fundamentals as well as sound banking system (Chart 11).

Chart 11 Reactions in financial markets were less severe compared to past episodes...



Despite the positive developments in the financial sector, there are still some challenges to be tackled. Asset price bubbles are still a major concern for many developed and developing country policy makers. Are asset price bubbles something a central bank should be concerned about to a degree that policy strategies have to be amended? Should a central bank react to asset prices? These are important questions and the uncertainty related with the answers poses a risk not only on inflation but also on the stability of the financial sector. Central banks need to be very careful about the probable impacts of policy decisions on asset prices and the financial sector while trying to maintain or reach to price stability.

Furthermore, increasing number and use of complex financial products have contributed to the development of a far more flexible and efficient financial systems and are generally regarded as a challenge for supervisory authorities. At the same time, central banks should also be in a position to effectively analyze the mechanisms behind those new financial products carefully and assess their probable effects on financial stability.

Uncertainties about monetary transmission mechanism especially in emerging market countries due to reasons like weak institutional infrastructure, high level of dollarization, fiscal dominance etc., make decision making process in central banks more complicated. A thorough analysis of the relationship between the instrument and objectives is a large task, because of the many transmission channels through which monetary policy influences the economy. As a result, central banks have to monitor financial system continuously to assess the changing dynamics of transmission mechanism in order to increase the effectiveness of its policy making (Chart 12).

Chart 12 Main Challenges Ahead

- Dealing with asset price bubbles
- Increasing use of complex financial products
- Learning process in transmission mechanism (credit channel) continues.

* Mehmet Yörükoğlu,Vice Governor, Central Bank of the Republic of Turkey

MONETARY POLICY AND FINANCIAL STABILITY

*George D. Demopoulos**

I. INTRODUCTION[1]

Ladies and gentlemen,

It is a great pleasure for me to be invited to the 6th International Conference on "Regional Financial Market and Financial Stability", organized with great success by the Bank of Albania, and to have the opportunity to address such a distinguished audience. My intervention today will be about the role of monetary policy and, in particular, of central banks in preserving and promoting financial stability.

The main issues I will discuss are the present financial environment and its characteristics, the interaction between monetary stability and financial stability and if these two goals are mutually reinforcing or conflicting and the role of central banks in promoting financial stability: How do central banks manage risk and uncertainty and what are the alternative policy options and instruments they have at their disposal for dealing with financial imbalances?

II. THE PRESENT FINANCIAL ENVIRONMENT AND ITS CHARACTERISTICS

One of the main features of the global economy in the last few decades has been the *process of globalization* and integration of financial markets, driven mainly by financial deregulation and technological innovation. This development has brought about improved macroeconomic efficiency in the form of enhanced competition in the financial markets, more efficient allocation of capital and less inflationary financing of the economy, as the share of bank credit has gradually reduced in favour of more transparent and direct market-based financing. The result of the capital flows' liberalisation and enhanced competition was that capital markets, money markets and the banking sector have become *deeper, more liquid and interconnected* at an international scale, while new complex and sophisticated products have been developed.

Despite these positive developments and the fact that *business cycles have stabilised* [2] in terms of inflation and GDP growth, experience over the last three decades suggests that *financial shocks have been amplified*, as demonstrated by a number of financial crises in the '80s, the '90s and early 2000[3]. Safeguarding financial stability requires primarily identifying the main sources of risk and vulnerability:

On a macroeconomic basis, what we observe is that asset price cycles and credit cycles have become more pronounced than in the past, while stock markets and foreign exchange markets have suffered from persistent disequilibria. The high, by historical standards, asset prices, such as the housing prices, along with the continuing surge in household borrowing have raised concerns over potential boom and bust events in the future. These concerns have been exacerbated by the fact that global financial market volatility has, also, significantly increased to levels higher than these justified by cyclical factors. On top, financial cycles and systemic shocks have become more synchronised internationally, as a result of contagion phenomena cross-border and co-movements of market prices internationally. This development implies that should an unwinding of global imbalances (like high oil prices, or current account deficits) take place in a disorderly fashion and should monetary policy tightens simultaneously in several major countries, as has been the case recently, then a period of financial instability is highly likely, as a result of inevitable rebalancing of portfolios worldwide.

On a microeconomic basis, the main risks can be found in market participants' (i.e. borrowers and lenders) behaviour (Trichet, 2001). Banks, on one hand, have tended to increase their return on equity through higher leverage or low provisioning during upswings. Consequently, they have become more vulnerable to economic fluctuations and more fragile to sharp corrections. Market participants, on the other hand, have become more inclined to engage in short-term profit-seeking activities and, thus, to undertake higher and sometimes not sufficiently hedged risks. Herd behaviour and trend following tend to further amplify financial imbalances.

The *costs* of financial instability can be high. The IMF[4] has estimated that the direct costs of banking crises have amounted to more than 10% of GDP in over a dozen countries in the past fifteen years.

What seems interesting, however, is that despite the amplification of the financial cycles, the global economy appears to be more *shock-resilient* than in the past. This can, in brief, be explained by structural flexibility, improved funding possibilities for households and firms, better risk-management capabilities for banks, and successful and credible monetary policy.

III. INTERACTION BETWEEN MONETARY STABILITY AND FINANCIAL STABILITY

The next question that arises is how monetary policy interacts with financial stability and if the twin goals of financial stability and monetary stability are mutually reinforcing or conflicting.

Defining financial stability is difficult. Financial stability can be distinguished in the concepts of 'micro-stability', which involves the health of individual financial institutions, and 'macro-stability', which focuses on the health of the financial system as a whole. In a more intuitive sense, financial stability means the avoidance of financial shocks that are large enough to cause economic damage to the real economy (Macfarlane, 2004).

The *relation* between monetary policy and financial stability has been long debated in the literature, but there is still no clear consensus on how exactly one affects the other and, in particular, whether there are *trade-offs or synergies* between them (Herrero and Del Rio, 2004).

Broadly speaking, monetary policy is propagated to the real economy through financial markets. In this respect, a *well-functioning financial system that is robust to shocks is crucial for the effectiveness of monetary policy*. Financial globalization has naturally led to new developments in monetary policy instruments and to the way monetary policy is conducted. As market-based financing has expanded during the last decade (e.g. the continuing expansion of corporate bond markets) asset prices have gradually gained in importance (Issing, 2002) and monetary policy transmission mechanisms have become more diversified and complex. As a result, a change in asset prices might have a huge impact on financial system stability and economic activity in general and hinder the effectiveness of monetary policy.

This situation has prompted the authorities to separate the different goals and instruments of economic policy. In this context, monetary policy has been clearly assigned the objective of maintaining price stability through inflation targeting and the use of policy interest rates.

*How do the objectives of price stability and financial stability fit togethe*r? One important lesson of the '70s and '80s has been that price stability contributes to financial stability. Low and stable inflation rates reduce uncertainty and promote sound economic decisions. By helping to remove market distortions in price signals and by anchoring inflation expectations, risk premia in interest rates are reduced, along with the likelihood of misperceptions about future asset returns (Papademos, 2006). The more predictable the monetary policy response, the greater its contribution to financial stability is.

However, *the issue is more complex*. Indeed, the '90s taught us that price stability is necessary but not sufficient condition to safeguard financial stability. Prior to the Asian crisis, large imbalances were built up in the real estate and other asset markets in Southeast Asia, although inflation was relatively low. This showed that confidence based on sound economic performance tends to drive up credit and asset prices[5].

This is the heart of the *potential conflict* between price stability and financial stability. A credible monetary policy may succeed in achieving its primary objective of price stability, yet it still might facilitate the conditions for financial imbalances to develop, as it creates low inflationary expectations, reducing firms' costs and uncertainty. As a result profits accelerate, as do stock prices, building up financial imbalances. Greenspan (2004) said that 'perhaps the greatest irony of the past decade is that the gradually unfolding success against inflation may well have contributed to the stock price bubble of the later part of the '90s.

The reverse is also true: *financial instability may reduce the effectiveness of monetary policy*. A reduction, for example, of policy rates may have weaker effects than under normal conditions if the financial system is unstable, because increasing risk premia prevent lending rates from falling, or because of credit rationing arising from a general unwillingness on the part of banks to lend (Papademos, 2006). A striking example of this sort has been the asset price bubble in Japan in the late '80s. Plummeting asset prices and rising non-performing loans have undermined the solvency position of banks, making them unwilling to lend. The extremely accommodating policy stance, with interest rates close to zero percent, could not reopen the bank lending channel (Bakker, 2002).

From the above, it is apparent that an adequate monetary policy is a fundamental prerequisite for the smooth functioning of the financial cycles and can act as a stabiliser. The reverse is also true. Nevertheless, monetary policy alone cannot guarantee the stability of financial systems.

IV. THE ROLE OF CENTRAL BANKS IN GLOBAL AND REGIONAL FINANCIAL STABILITY: DESIGNING AN APPROPRIATE STRATEGY FOR MONETARY POLICY

This leads me to the following question: How do central banks manage risk and uncertainty and what are the alternative policy options and instruments they have at their disposal for dealing with financial imbalances? Let me pick up this question and briefly analyze it.

Looking at: Monetary policy objectives

The design of monetary policy is particularly important since central banks have an undoubtedly special responsibility due to their position at the heart of the financial systems, by supplying liquidity, supervising and ensuring that payment systems operate smoothly.

Central banks are given the *task of achieving an inflation target*. In essence, monetary policy has one instrument; it can set the path of short-term interest rates. More than one objective would inevitably cause a decision-making conflict, unstable results and considerable uncertainty in expectations about the changing objectives of monetary policy. Attributing other objectives than price stability to the monetary policy would extend beyond what a central bank could credibly deliver and be accountable for. There is a limit to what monetary policy can be expected to perform.

For example, the ECB has at its disposal the key instruments and powers needed to maintain price stability over the medium term and therefore fulfil its mandate; it does not have though the instruments and powers necessary to ensure financial stability and efficiency on its own.

It is the responsibility and the objective of *regulatory and supervisory authorities* to safeguard financial stability. These regulatory and supervisory powers could, in principle, be assigned to the central bank and handled in-house.

Looking at: Risk-management approach of monetary policy

However, a recently expressed view supported by BIS (2004) is that a too narrow focus of monetary policy on price stability in the short-term might pose risks to price stability in the longer term, as the potential consequences of financial instability may be overlooked.

Thus, a *"risk-management approach" to monetary policy* is essential. This conceptual approach emphasizes understanding the many sources of risk and uncertainty that policymakers face, quantifying those risks when possible, and assessing the costs associated with each of these risks.

A characteristic example of a risk-management approach is the ECB's monetary policy strategy. The first pillar assigns a prominent role to money and in this context monetary aggregates are carefully monitored to reveal any imminent threats. Under the second pillar, other macroeconomic and financial variables that contain information about future price developments are analysed. Monetary analysis (second pillar) helps to identify distortions and imbalances in the financial system and the implied potential risks to long-term price stability in a timely and structured manner.

Looking at: Asset prices and monetary policy

Most prominent is the appropriate *role of asset prices* in policy. As Governor Greenspan (2004) once noted, asset prices will remain high on the research agenda of central banks for years to come.

But most central banks have chosen, at least to date, not to view asset prices' level as an explicit goal or target for monetary policy, but as economic variables to be considered as informational input to forecast future inflation and growth. This is because asset prices are mainly affected by real economic, structural and other factors, which are outside any monetary policy control and are difficult to rightly assess whether their level is sustainable and in line with the fundamentals.

Looking at: Practical ways used by central banks to support financial stability

Given these trends, the question that emerges is what practical role is there for central banks to play with regard to financial stability?

Besides the use of the interest rate, central banks can *support financial stability and complement the activities of the competent supervisory and* *regulatory authorities* in various ways: a) identify potential vulnerabilities, tensions and disruptions in the financial system as a whole, b) analyse the transmission of shocks in the financial system (e.g. contagion channels) and c) develop and implement policies to make the financial system better equipped to absorb shocks, like accounting, reporting and provisioning standards, prudent bank supervision and lender-of-last resort activities. These will help improve the functioning of the financial cycles and smooth their interaction with the business cycles.

Having said that, it is important to note that, central banks' efforts in promoting financial stability and timely signalling out the potential risks does not mean that the occurrence of the financial cycles can be avoided altogether[6]. Central banks can only *mitigate* the impact of financial cycles on the real economy.

Looking at: The role of international/regional co-operation

Close contacts and continuous exchange of information between central banks at international and regional levels have improved their readiness to react promptly in a crisis. The most recent example has been the cooperation after the events of September 11th, when the FED and the ECB moved forward with simultaneous liquidity injections in the global system and cut of the policy rates by 50 basis points, avoiding thus a systemic crisis (Bakker, 2002). The fact that modern financial markets are international and information- and technology-based, also suggests that supervision organised at national level might have become outdated.

V. CONCLUSION AND FUTURE CHALLENGES

To conclude, I would like to summarize the key elements that a monetary policy strategy should possess in order to accomplish its task with efficiency and success, in an *environment characterized by fast change, risk and uncertainty*.

Monetary policy should be *forward-looking* and be conducted in such a way that it grasps the potential aggregate risks to the economy as early as possible. Perhaps monetary policy alone cannot prevent a bubble from emerging. However, it can mitigate the impact of financial cycles on the real economy. Monetary policy should *not target the level of asset prices*, but only take them into account as additional information to forecast future inflation and growth. For financial systems to be stable, monetary policy must go hand-in-hand with other aspects of economic policy, that is, fiscal policy and structural programmes. The *policy mix* must be well-balanced at the international, as well as the regional and national levels.

Ladies and gentlemen,

As it becomes evident from this presentation, in a changing and complex environment a *risk-management monetary policy appears a good choic*e. In implementing a risk-management approach, however, we must confront the fact that only a limited number of risks can be quantified with any confidence. Ultimately, an appropriate monetary policy involves a *significant amount of subjective judgement* on behalf of central bankers (Greenspan, 2003).The fact that the risks have not materialised to any significant extent does not mean that these risks have diminished. *Continuing vigilance* is required to constrain financial fragility, safeguard financial stability and avoid financial shocks from occurring and diffusing cross-sector and cross-border.

Thank you very much for your attention.

REFERENCES

Bakker, A.F.P. 'Promoting Financial Stability: the role of Central Banks', Central Bank of Malta, Quarterly Review, June 2002.

Bank for International Settlements (BIS) (2004), 74th Annual Report, June, Basel.

Borio, C. and Lowe, P. (2002), 'Asset prices, financial stability and monetary stability: exploring the nexus', BIS Working Papers no 114.

Borio, C. and White, W. (2004), 'Whither monetary policy and financial stability? The implications of evolving nature of policy regimes', BIS Working Papers no 147.

ECB (2006), Financial Stability Review, Frankfurt am Main.

Ferguson, R.W. (2006) 'Thoughts on Financial Stability and Central Banking', Remarks at the Conference on Modern Financial Institutions, Financial markets and Systemic Risk, Federal Reserve Bank of Atlanta, Georgia.

Fisher, C. and Gai, P. (2005), 'Financial stability, monetary stability and public policy', Winter Quarterly Bulletin, Bank of England.

Goodfriend, M. (2003), 'Interest rate policy should not react directly to asset prices', in Hunter, W., Kaufman, G. and Pomerleano, M. (eds), Asset price bubbles: the implications for monetary, regulatory and international policies, MIT Press.

Greenspan A. (2003), 'Monetary Policy under Uncertainty', Remarks at a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming.

Greenspan A. (2004), 'Risks and Uncertainty in Monetary Policy', Remarks at the Meetings of the American Economic Association, San Diego, California.

Hamalainen, S. (2002), 'The role of monetary policy and the central banks in global financial stability', 8th European Forum, BMW Stiftung Herbert Quandt, Berlin

Hayford, M.D. and Malliaris, A.G. (2006), 'Recent Monetary Policy in the US: Risk Management of Asset Bubbles', forthcoming in the Journal of Economic Asymmetries.

Herrero, A.G. and del Rio, P. (2003), 'Financial Stability and the design of monetary policy (1)', Working Paper no 0315, Bank of Spain.

Issing, O. (2002), 'Monetary policy in an environment of global financial markets', launching workshop of the ECB-CFS Research Network on 'Capital Markets and Financial Integration in Europe', Frankfurt am Main

Macfarlane, I.J. (2004), 'Monetary policy and Financial Stability', speech at CEDA, annual dinner, Melbourne

Okina et al (2001)' The Asset Price Bubble and Monetary Policy: Japan's Experience in the Late 1980s and the Lessons, Monetary and Economic Studies (special edition)

Papademos, L. (2006) 'Price Stability, financial stability and efficiency and monetary policy' speech at the Third Conference of the Monetary Stability Foundation on 'Challenges to the financial system-ageing and low growth', Frankfurt am Main.

Raab (2003), 'Fostering Financial Stability: The Role for Ministries of Finance', in Teunissen J.J. and Teunissen M (eds), Financial Stability and Growth in Emerging Economies: The Role of the Financial Sector, pp. 276-278, FONDAD The Hague.

Trichet, J.C. (2001), 'Preserving monetary and financial stability in an increasingly globalised world', Speech at the OECD Forum 2001 on Sustainable Development and the New Economy.

* George D. Demopoulos, Professor of Economics and European Chair Jean Monnet. Member of the Monetary Policy Council, Bank of Greece

[1] Ms Melina Vasardani of the Economic Research Department of the Bank of Greece has greatly contributed to the preparation of the paper.

[2] It is interesting to note that, since 1985 the volatility of real growth in GDP has been only about half of what it was during the preceding twenty-five years (Ferguson, 2006).

[3] Long-term analyses show that the frequency of crises doubled in the period 1973-1998 compared to 1945-1973 (Bakker, 2002).

[4] See Bakker (2002).

[5] See Borio and Lowe (2002), Borio and White (2004) and Goodfriend (2003) for the so-called 'paradox of credibility'.

[6] In addition, preventing the emergence of the bubble by timely tightening monetary policy is not always an easy task. In the case of Japan in the late '80s, for example, Okina et al. (2001) argue that 'even if Bank of Japan had known ex ante the target interest rate that would have prevented the bubble from emerging, one wonders whether it could have raised the short-tern interest rate from 4% to 8% in one go at a time when inflation was very low. It could not succeed in persuading the public. Plus it was not sufficiently sure about the existence of the bubble. If interest rates had been raised early but only by a small degree, asset prices would have continued to rise, as expectations would have remained unchanged'.

INTERACTIONS BETWEEN MONETARY POLICY AND FINANCIAL STABILITY: THE CZECH EXPERIENCE

*Vít Bárta**

1. INTRODUCTION

In the paper, I deal with two interrelated areas: banking sector development on one side and macroeconomic and monetary development on the other. More specifically, I introduce the basic facts in both areas in the pre-crisis period (1990-1996), and then I elaborate on the main interactions during currency- and banking sector crises (1997-1999) and list policy responses taken by policy-makers. I illuminate the consequences of the twin crisis and the costs incurred and finally I draw some lessons. It is worth to mention that the Czech Republic represents an almost text-book example of the twin crisis and it provides useful lessons how to avoid some policy mistakes.

2. MACROECONOMIC, MONETARY AND BANKING SECTOR DEVELOPMENTS IN THE PRE-CRISIS PERIOD DURING 1990-1996

2.1 Banking sector development

Splitting of the "monobank" and creation of big state-owned banks

The building of a banking sector started virtually from scratch.

The first step was the splitting of the former socialist "monobank", State Bank of Czechoslovakia (SBCS), and the creation of a two-tier banking system. From the ashes of the monobank, four large state-owned banks were established.

However, at the very beginning of the 1990s the banking sector was suffering from all conceivable deficiencies inherited from the former central planning system: undercapitalisation, a burden of bad loans, a shortage of the long-term funds necessary to support banks' development plans, inexperienced staff, non-existent risk management, legal loopholes, etc. (see for example Dědek (2001)). These features had far-reaching consequences: the banking sector was very weak and various forms of government assistance turned out to be practically inevitable.

Consolidation Programme I

The rather difficult starting position of the newly formed banks led to the implementation of "Consolidation Programme I". In 1991, Konsolidační Banka (KoB) was established as a major vehicle for the takeover of bad loans. The Consolidation Programme involved operations associated with the removal of bad loans extended before 1990 from the balance sheets of Komerční Banka (KB), Česká spořitelna (ČS), Investiční banka (IB) and SBCS, operations to strengthen the capital of the state-owned banks (KB, ČS and IB), and the clean-up of the balance sheets of other banks in the periods both before and after the division of Czechoslovakia. These operations were as follows:

(a) the transfer of assets to KoB;
(b) the write-off of loss loans from National Property Fund (NPF)[1] funds;
(c) increases in the equity of banks with NPF bonds and in the capital of the banks split off from SBCS;
(d) a capital increase in Československá obchodní banka (ČSOB);
(e) the transfer of credits and guarantees from ČSOB to Česká inkasní (ČI)[2].

The overall costs of Consolidation Programme I are estimated to have reached more than CZK 100 billion (which is about 7% of 1995 GDP).

Entry of small private banks

Shortly after the economic transformation began, new banks started to operate in the Czech economy. Licensing policy was quite benign at that time. This was a reflection of the rather liberal approach towards new start-ups in any industry in general and in the banking sector in particular. The principal motivation was to increase the competition of the four large banks (created from the monobank), which were considered too inertial and ineffective. The number of newly entering ("truly" private) banks in the Czech economy was impressive: 13 new banks were established in 1990, another 13 in 1991, 17 in 1992, 10 in 1993, and four in 1994.[3] However, this huge expansion in new banks later caused serious problems for the Czech financial system.

Crisis of small banks

Right from the outset, the small new private banks were operating under difficult conditions. They were typically undercapitalised and faced types of risk that had not been common earlier. Their strategies were focused on increasing their market shares at the expense of the relatively established big banks, which often drove them beyond prudent thresholds. The above-mentioned benevolent licensing policy, combined with inexperienced and still weak banking supervision and the specific process of small- and large-scale privatisation, caused the small banks to take on rather unsound development strategies. Banks assisted the rapid pace of transformation but, at the same time, took on risks comparable with those usually assumed by venture capitalists, risks which even the relatively high margins they enjoyed could not cover. The absence of effective legal and institutional supervision also invited fraudulent behaviour by the managements of these banks. Thus, the new small banks started getting into trouble shortly after the beginning of the economic transformation.[4]

During 1995, problems became apparent in some small banks with mostly Czech capital. Although these banks accounted for only a small part of the banking sector (about 4% of its total assets), the situation had to be addressed in order to ensure the consolidation and creditworthiness of the banking sector as a whole. The banking supervisory authority focused on those banks where the problems were most serious, forcing individual consolidation programmes on them. Despite all these efforts and remedial measures, the unfavourable trend was not prevented in most cases. This was chiefly because bank owners were often unwilling or financially unable to take radical action to solve their banks' problems, and also because the problems originating from when the banks started were just too big to solve. A lack of supervisory experience and motivation also contributed to the failure of the consolidation programmes.

Consolidation of small banks

The Czech National Bank (CNB) prepared at the end of 1995 and initiated at the beginning of 1996 a comprehensive programme of small bank consolidation to prevent a domino effect within the small bank sub-sector, which could have undermined public confidence in the banking sector as a whole. Consolidation Programme II clarified the negative financial situation facing a number of small domestic banks. The banking supervisory authority reacted with the uncompromising interventions allowed to it by law in cases where banks' shareholders rejected or were not able to accept an appropriate solution and/or where prolonging those banks' negative financial situation was unjustifiable. Of the total of 18 small banks, 15 were treated under Consolidation Programme II, with nine of them undergoing a radical solution consisting in the revocation of their licences or the introduction of conservatorship following a reduction in capital. In other cases there was co-operation with the existing shareholders, or new investors were found to cover the banks' potential losses.

The outcome of the greater pressure on the supervisory authority to remedy banks' shortcomings was a painful but ultimately purgative process, the postponing of which would only have harmed the economy further. It is estimated that the costs of Consolidation Programme II were comparable to those of Consolidation Programme I, i.e. more than CZK 100 billion.

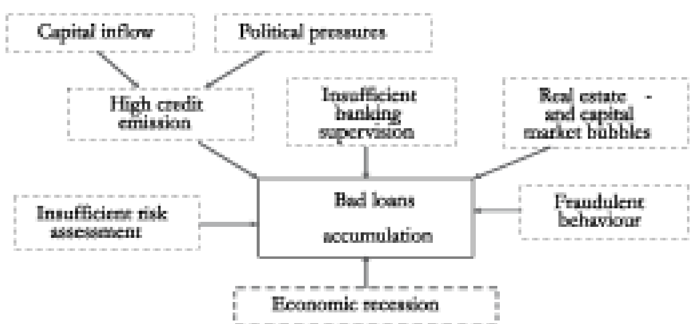
Stabilisation Programme

The implementation of Consolidation Programme II had negative side-effects. The public's confidence in the banking sector was falling and the risk of a run on small banks was increasing. To reduce the risk of a liquidity crisis for small banks and to promote the overall stabilisation of the banking sector, a Stabilisation Programme was adopted in 1996. The programme was intended for the 13 small banks existing at the time. It entailed Česká finanční (ČF)[5] purchasing insolvent receivables from banks at their nominal value, up to a maximum of 110% of the banks' capital. This was done on the basis of, return on assets with the banks obliged to gradually create a reserve to repay their dues to Česká finanční after seven years.

The Stabilisation Programme turned out to be unsuccessful. Although six banks joined the programme, five of them were later excluded, closed and liquidated after failing to comply with its criteria. Only one bank emerged from the programme successfully. The costs of the Stabilisation Programme are estimated at about CZK 15 billion, still a fraction of the costs of the earlier programmes.

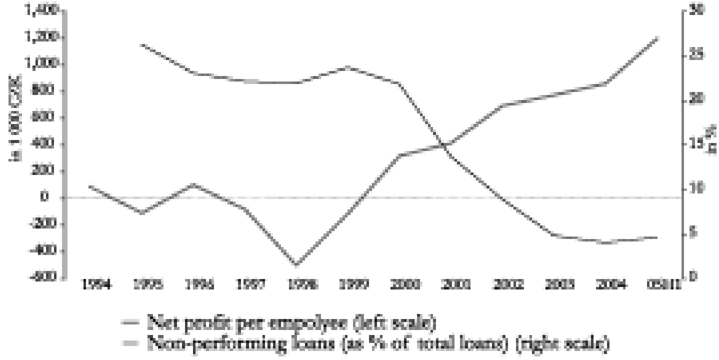
To sum up, the Czech banking sector in 1996 was far from being consolidated. It accumulated sizable losses (both explicit and implicit) which exacerbated the overall fragility of the macroeconomic performance. In other words, banks became an Achilles heel of the economy. The above described problems that implied an accumulation of bad loans are summarized and illustrated on *Chart 1*.

Chart 1 Anatomy of banking sector crisis



A quantitative view on the banking sector performance is provided by *Chart 2*. It shows that the share of non-performing loans in total loans was about 23% during 1996-97 and the net profit per employee was virtually zero during the same period.

Chart 2 Banking sector performance: net profits and non-performing loans

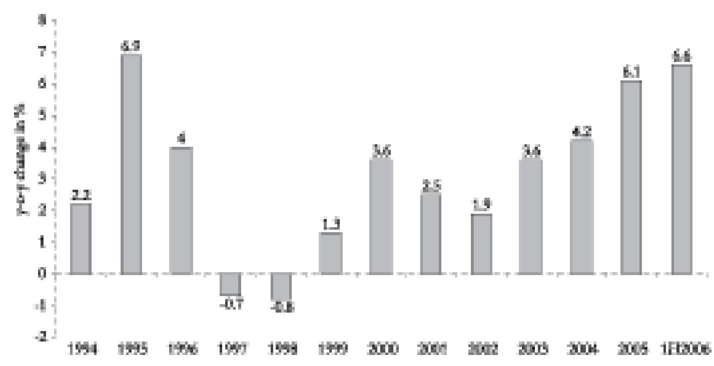


2.2. Macroeconomic development

Overheating and emergence of external imbalance

At first sight, the Czech economy was reasonably healthy in the mid-1990s. Economic growth reached almost 7% in 1995 (see *Chart 3*), unemployment was around 4% and inflation was close to 9% and stable.

Chart 3 GDP in the Czech Republic (1994-1H2006)



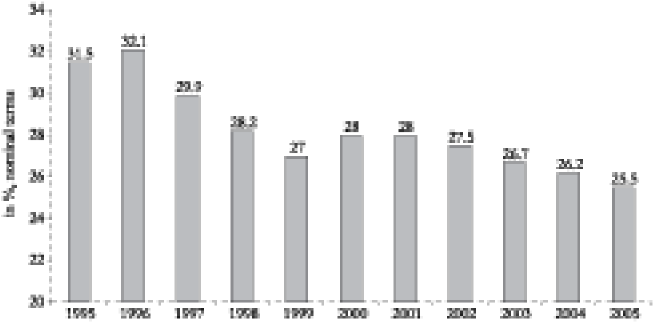
The exchange rate was fixed with the aid of a currency peg, which had provided a crucial nominal anchor since the very beginning of the economic transformation. This spectacular performance was accompanied by ongoing privatisation and a general overhauling of property rights. The overall prospects were considered quite promising.

However, a closer look showed worrying signs of overheating. Growth in real wages was exceeding the growth of productivity and the gap between both variables reached almost 12 p.p. in 1995 and was still substantial in 1996 (*Chart 4*).

Chart 4 Real wages and labour productivity in the Czech Republic (1995-2004)

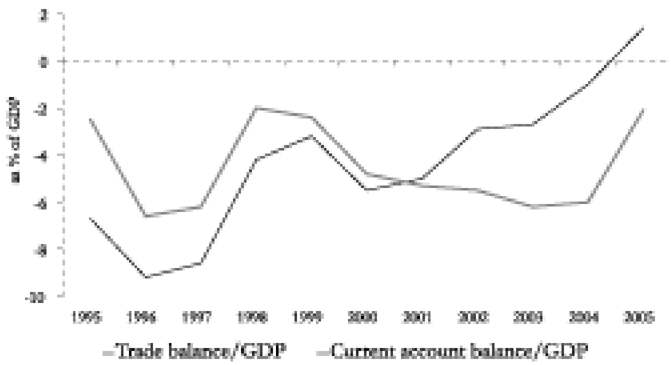
A similar unfavourable message emerges when one looks at the relationship between domestic demand and supply. Stimulated by the fast growth of wages, household demand started to boom and loans to the newly-fledged private sector expanded robustly, partly as a consequence of what has been called "banking socialism". Government expenditures were directed towards large infrastructure projects (many of them took place in the area of environmental protection) with typically low returns. Also, private investments recovered after the decline during the transformation recession. *Chart 5* shows the investment boom in 1995-6 with an exceptionally high ratio of gross fixed capital formation to GDP (in nominal terms).

Chart 5 Gross fixed capital formation to GDP (in %, nominal terms)



The resulting mismatch between domestic demand and supply implied the emergence of an external imbalance: current account deficits reached -6.6% of GDP in 1996 and -6.2% of GDP in 1997 (*Chart 6*), thus exceeding the level generally considered to be critical (5% of GDP).

Chart 6 Trade- and current account balance/GDP (1995-2005)



Unfortunately, policymakers at the time underestimated the threat of external imbalances and neglected the possible consequences. Instead of accepting that the economy was overheated, they perceived its performance as reflecting the strengths of the newly-formed market economy and any kind of policy tightening was rejected. Similarly, the external imbalance was thought to reflect the natural propensity of a transformation economy to invest (and to consume) with a belief that all investment spending would be converted to future productivity gains.

As a consequence, the policy response was insufficient. Although the Czech National Bank increased interest rates several times during 1996, overall monetary tightening was sober. At the end of February 1996, the CNB widened the fluctuation band of the Czech koruna to ±7.5% (from ± 0.5%) to impede the inflow of speculative capital which was attracted by the combination of a high interest rate differential and a fixed exchange rate. However, these measures were only partial, and overall fiscal-monetary mix remained too loose (or not restrictive enough) especially at the beginning of 1997.

Capital account liberalisation and the "Impossible Trinity"

The progressing economic transformation was accompanied by the step-by-step liberalisation of the capital account, which became a crucial component of the story of the loss of macroeconomic stability. This process was partly driven by the politically-driven entry into the OECD (which occurred in October 1995) but it was also to a large extent spontaneous. It thus started to undermine the consistency of the existing macroeconomic framework, which was based on a fixed exchange rate regime and monetary targeting.

The completion of capital account liberalisation and the maintenance of the fixed exchange rate led to the emergence of the "Impossible Trinity" (or the open economy trilemma). This term refers to the extremely problematic parallel existence of: a) free capital flows, b) a fixed exchange rate and c) an independent monetary policy. The mechanics of the "Impossible Trinity" worked ruthlessly: a high interest rate differential (due to a high inflation differential) in combination with the stable exchange rate was the best invitation for a sizeable capital inflow. Maintaining the currency peg required the interventions on the forex market (purchase of forex) which led to an increase in the monetary base and monetary aggregates. The resulting sterilisation by the central bank led to the steady accumulation of foreign exchange reserves and again pushed interest rates upwards, implying further stimuli for capital inflow and thus completing the vicious circle (see *Chart 7* for the visualisation).

Chart 7 Vicious circle of monetary policy

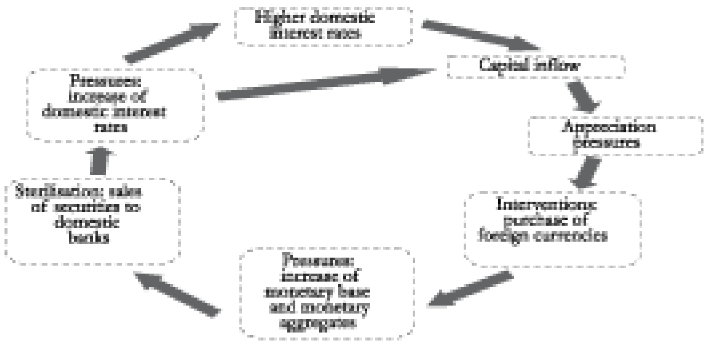
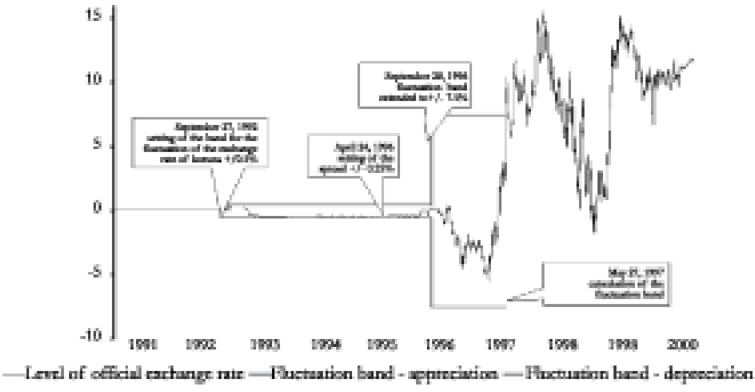


Chart 8 shows that after the widening of the band in February 1996 the Czech koruna started to appreciate (vis-à-vis the basket of USD and DEM which was valid until May 1997).

Chart 8 Exchange rate of Czech koruna vis-à-vis basket of currencies



The monetary development had negative side effects on the real economy. The appreciation of the koruna undermined the country's competitiveness, thus leading to the highest trade deficit (in terms of GDP) during the whole transformation period (see *Chart 6* above). Although this appreciation helped to diminish inflation temporarily, the situation was fragile and the economy became vulnerable.

3. MAIN INTERACTIONS DURING CURRENCY- AND BANKING SECTOR CRISES DURING 1997-99 AND SUBSEQUENT POLICY RESPONSES

3.1. Currency crisis: speculative attack and stabilisation packages

In early spring 1997, the sentiment on the foreign exchange markets started to reverse. In February, the koruna reached its appreciation peak and the inability of policy-makers to adopt the necessary corrective measures pushed it towards depreciation. The economic prospects undermined the sudden worsening of public finances in April. Although the government adopted stabilisation package it was found to be insufficiently credible.

The koruna came under pressure on the foreign exchange markets during May and was exposed to a speculative attack (partly motivated by the uncertainties in East Asia). The attack was not sustained, despite sizeable interventions to defend the fluctuation band. On May 27, the CNB abandoned the currency peg and switched to a managed float. During June, the koruna depreciated by about 12% against the former parity.

To reverse the capital outflow the CNB increased interest rates dramatically for a short period of time. Although this helped to prevent the koruna from further depreciation it dented the economic performance through sharpening problems in the banking sector (bad loans) and also the enterprise sector (inter-enterprise arrears) in subsequent months.

In June, the government adopted the second stabilisation package. It addressed two areas: in the macroeconomic area it implemented a fiscal tightening, a wage freeze in the public sector and the adoption of an import surcharge to restrict imports. In addition to this short-term stabilisation effort the package addressed the legal, institutional and microeconomic bottlenecks of the economy with the aim of boosting supply side performance over the long run.

The macroeconomic restriction (both fiscal and monetary) was rather robust, and the economy slipped inevitably into recession in 1997 and 1998.

The anatomy of currency crisis in a simplified form is shown on Chart 9.

Chart 9a Anatomy of currency crisis I

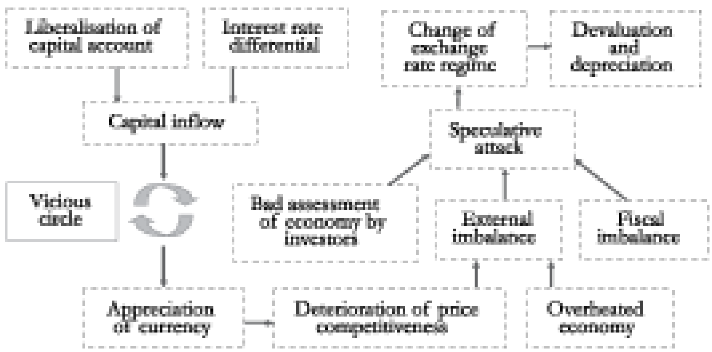
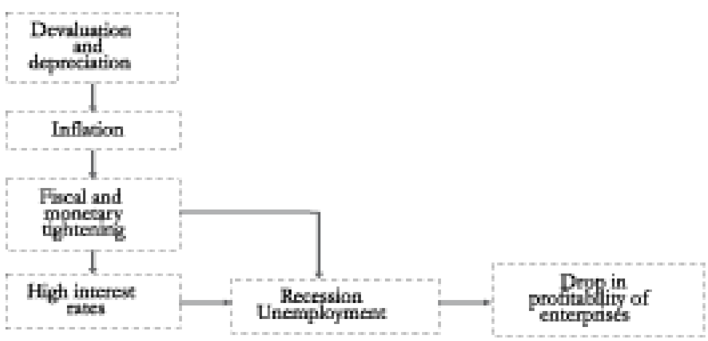


Chart 9b Anatomy of currency crisis II



3.2. Banking sector problems during economic recession

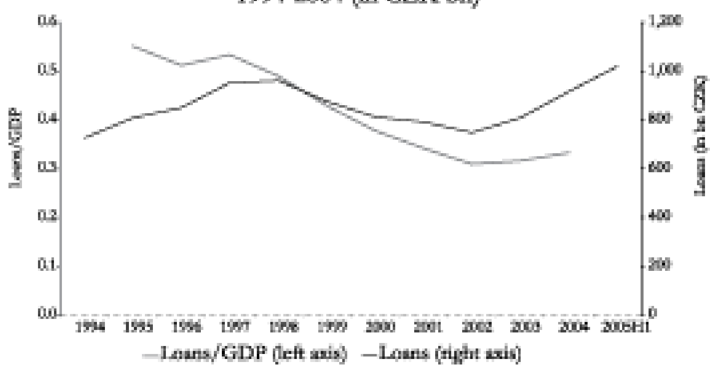
The negative economic developments and the related worsening in the economic situation of debtors continued to adversely affect even the large banks' financial results and the quality of their assets. Persistent shortcomings in the legal environment preventing banks from recovering receivables from debtors, together with the diminishing creditworthiness of the business sector and very high ex ante real interest rates, fostered a decline in lending and the maintenance of a relatively high ratio of classified loans to total loans. *Chart 10* illustrates the situation, showing that the profitability of banks per employee started to worsen in 1997 and remained negative for three consecutive years, bottoming in 1998.

Chart 10 Net profit per employee (in CZK '000s)

Source: CNB

The end of the 1990s was thus characterised by increased fragility of this vital component of the economy. *Chart 11* shows the decline in loans (in both absolute and relative terms) during the period 1998-2002. In popular terms, the decline in bank lending was termed a "frozen credit channel". Needless to say, the observed credit contraction impeded and slowed down the economic recovery and at the same time substantially weakened the efficiency of the

Chart 11 Bank loans and ratio of loans to GDP, 1994-2004 (in CZK bn)



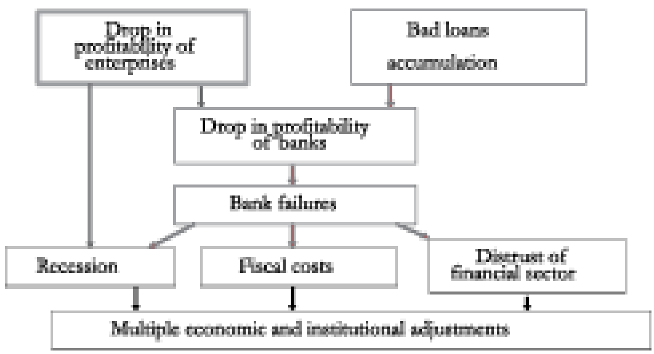
transmission mechanism of CNB monetary policy. The situation of credit contraction was sometimes labelled a "credit crunch" (see Hampl & Matoušek (2000) for more details).

The negative macroeconomic trends and bank losses at the end of the 1990s hit the large banks hard. The state, as the main shareholder, contributed to strengthening ČS and KB's capital and cleaning up their balance sheets. The cost of the clean-up amounted to about CZK 76 billion for these two banks during the period 1998-2000. These operations temporarily rescued the big banks and preceded their privatisation; strictly speaking, they were a necessary condition for it.

3.3. Interaction between the currency- and banking sector crises

Chart 12 illustrates how the currency crisis coincided with the banking sector crisis and how these worked together towards multiple economic and institutional adjustment.

Chart 12 Anatomy of twin crisis



4. CONSEQUENCES OF THE TWIN CRISIS AND COSTS

4.1. Banking sector development

Privatisation of big banks

The privatisation of the big state-owned banks was an ever-present issue during the Czech economic transformation process.

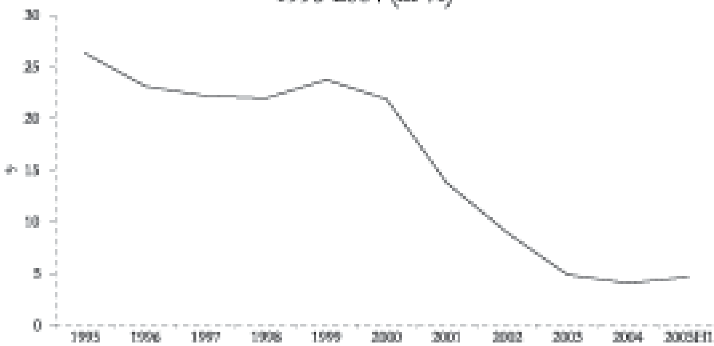
It was often discussed by governments, but the decisive steps were repeatedly postponed in the first half of the 1990s, typically due to pressures from smaller parties in the coalition government and to very vocal leftwing opposition on this issue, despite clear interest from potential investors. In addition, the privatisation of the minority or majority equity stakes in large banks via the voucher method in the first half of the 1990s did not bring the desired results in terms of a strengthening of their management and corporate governance. Ownership was untransparent and excessively diluted, and control by the state inefficient. As a consequence, the efficiency, profitability and competitiveness of the big banks were, in line with the general macroeconomic picture, relatively poor and worsening in the second half of the 1990s.[6] Considering the unfavourable developments in the latter half of the last decade, finding a strong strategic investor became an imperative and a precondition for their stabilisation and further growth.

The privatisation of banks resumed in 1998. In January, the state's minority 36% stake in Investiční a Poštovní Banka was sold to Nomura International. In June, General Electric Capital Services acquired substantial parts of Agrobanka, then the largest private bank, which had been effectively state-managed for the previous two years. In 1999, the state's almost 66% stake in ČSOB was sold to Belgium's Kredietbank. In 2000, the 52% stake in ČS was sold to Erste Bank Sparkassen, and finally, in 2001 the remaining state stake in KB was sold to Société Générale. By 2001, the privatisation of the banking sector had basically been completed, and further restructuring followed an evolutionary pattern without any active government involvement.[7] The costs related to the privatisation of the big banks are estimated by Havel (2004) at about CZK 100 billion.

Banking sector recovery

The economic recovery, which started in 1999 and accelerated in 2000, the rescue operations carried out by the state (most notably the capital strengthening and takeover of bad loans by KoB) and the completion of the privatisation of the big banks had profound consequences for the performance of the banking sector. The burden of bad loans persisting throughout the 1990s started to decrease rapidly after 2000. *Chart 13*shows the plummeting share of non-performing loans in total loans.

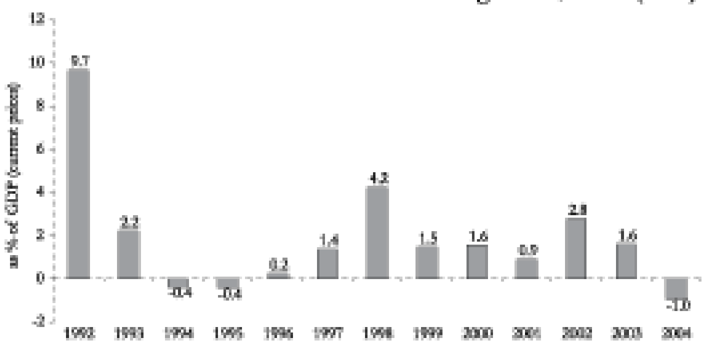
Chart 13 Share of non-performing loans in total loans, 1995-2004 (in %)



Costs of the banking sector restructuring: volume, structure and time patterns

Below we summarise the costs related to the banking sector restructuring process from the beginning of the 1990s until 2004.[8] The estimated costs in terms of GDP each year are shown in *Chart 14*.

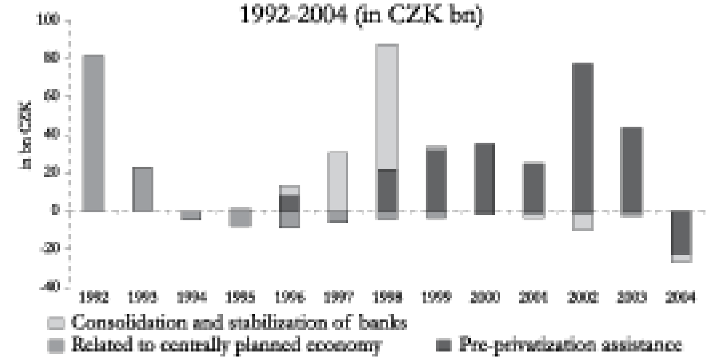
Chart 14 Transformation costs of the banking sector/GDP (in %)



Note: The costs incurred each year are divided by nominal GDP (i.e. at current prices) in that year.
Source: Ministry of Finance and CNB (2005), CZSO and own computations

It is useful to discriminate between the different reasons for the transformation costs. *Chart 15* shows three kinds of costs associated with the restructuring of the banking sector, namely those inherited from the centrally planned economy, those incurred by the consolidation and stabilisation of banks, and those stemming from pre-privatisation assistance.

Chart 15 Structure of the costs of banking sector restructuring, 1992-2004 (in CZK bn)



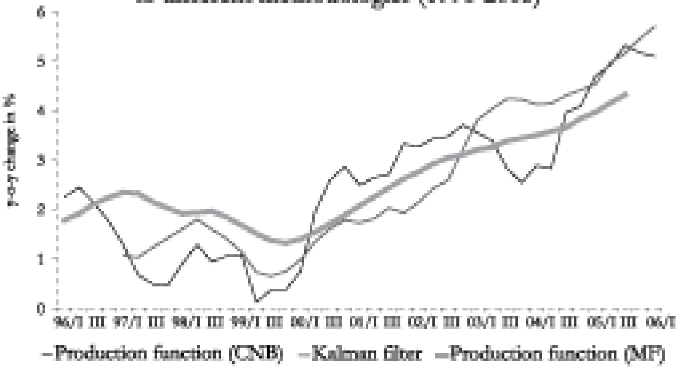
Note: Positive values denote costs, while negative values denote revenues
Source: Ministry of Finance and CNB (2005)

The structure and time pattern of the transformation costs are intuitive. In the initial period the costs inherited from the centrally planned economy dominated (reaching about CZK 62 billion over the years), but in 1997-98 the consolidation and stabilisation costs (amounting to about CZK 88 billion) took the lead. With the onset of the privatisation of the big banks, pre-privatisation assistance clearly dominated and persisted until 2003, amounting to approximately CZK 220 billion.[9] The overall costs in money terms were about CZK 370 billion, which is equivalent to 24% of GDP accumulated on annualised basis over the period.

4.2. Macroeconomic and monetary development

The subsequent period brought a mixture of bad news and good news. On the positive side, the external imbalance was brought under control during 1998 and 1999, reaching substantially lower levels than before 1997. The supply side performance (due to intensified competition and progress in the institutional and legal environment) has been improving over time, implying an acceleration of potential output growth since 2000 (see *Chart 16*).

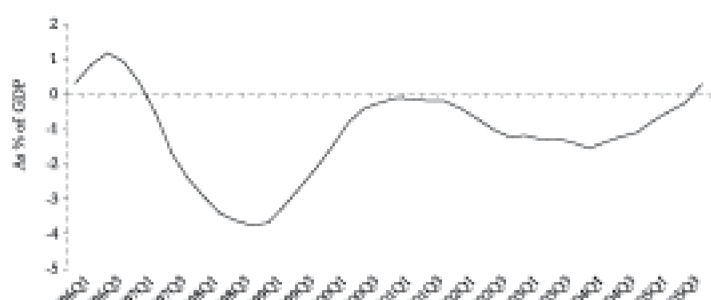
Chart 16 Growth of potential output according to different methodologies (1996-2005)



In the policy area one good achievement consisted of the adoption of inflation targeting from the beginning of 1998. The rather untidy monetary discretion which took place in the aftermath of a speculative attack was thus transformed into a consolidated monetary framework with transparent and well-defined decision-making. In other words, the earlier currency anchor was replaced by an inflation anchor which corresponded much better to the almost fully-liberalised economy.

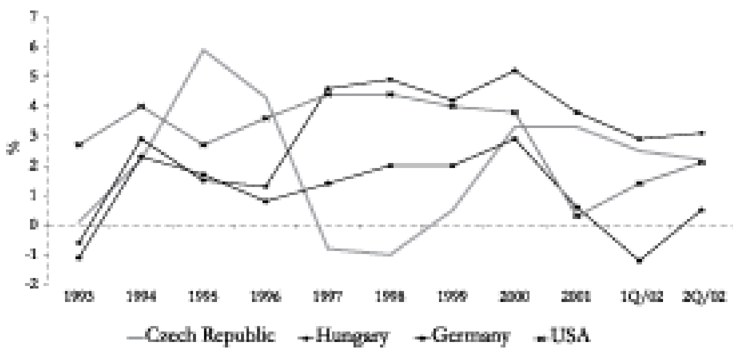
On the negative side, the emergence of the output gap played a dominant role. *Chart 17* shows the output gap which reached about 4% of GDP in 1999.

Chart 17 Output gap (as % of GDP)



The size of the output gap indicates that the income adjustment of the (preceding) disequilibria was rather costly. The recessionary pattern of the Czech economy was even more striking because no similar development had occurred in the neighbouring transformation economies (see *Chart 18*).

Chart 18 GDP in selected countries



Also, unemployment started to increase to a new level of around 8%. Although it was not favourable for those who became unemployed, the macroeconomic development benefited from the fact that a higher level of unemployment helped to keep wages in check later on.

Chart 19 Exchange rate of koruna vis-à-vis euro (the data before 1999 was obtained from the conversion rate between DEM and EUR)

The macroeconomic stabilisation had a negative impact on exchange rate volatility. As can be seen in *Chart 19*, after depreciating throughout 1997 the koruna appreciated quite strongly due to the high interest rate differential during 1998 but depreciated again (due to the low interest rate differential) in early spring 1999. The relatively fast and robust pass-through was thus transformed into more volatile inflation complicating the formation of inflation expectations and implementation of stabilisation policy based on inflation targeting.

5. LESSONS

The macroeconomic, monetary and banking sector developments in the Czech Republic over past 15 years yield the following lessons.

Lesson 1: We suggest that Czech policy-makers underestimated the trends towards overheating and the external imbalance during 1996 and 1997 and the threat represented by the "Impossible Trinity". They mistakenly considered the growth performance in 1995 to be sustainable and did not respond adequately to the progressing capital account liberalisation. We believe that an earlier exit from the exchange rate peg and a better coordination of economic policies between the government and central bank would have been the right responses which could have saved the economy from hardship during 1998 and 1999 (or would at least have limited it substantially). In other words, instead of being the leaders of events during 1996 and 1997, policy-makers followed events and typically opted for second-best solutions. Monetary policy gained a pre-emptive approach only with the advent of inflation targeting at the beginning of 1998.

Lesson 2: The negative consequences of overheating in the middle of the 1990s were partly attributable to the inflexibility of the supply side of the economy, which did not respond to increased domestic demand. With a dose of simplification, neither macro nor micro worlds were in a good shape at that time. Since 1998, a remarkable progress has been made on both fronts. Macroeconomic tightening restored the macroeconomic balances and the many different measures adopted on the micro level enhanced the flexibility and profitability of the supply side of the economy. It is beyond any doubt that a flexible and competitive economy is substantially less vulnerable to macroeconomic imbalances and more resilient to possible external and/or policy shocks. The causality thus runs both ways: a strong economy implies a better macroeconomic balance and at the same time good stabilisation policies are supportive of the supply-side build-up.

Lesson 3: (Highly) competitive markets are very instrumental for establishing the low level of inflation. If wages in public sector remain under control (which was typically the case in the Czech Republic during 1998 -2006) the wage setting in overwhelming private sector basically prevents from overheating the economy and emerging any demand-pull inflation. Moreover a trend nominal appreciation of currency is potent enough (via import prices) to keep tradable sector prices in check, i.e. on the level which is systematically below level which prevails in economies relying on fixed exchange rates (such as currency boards in Baltic countries).

Lesson 4: Very high initial costs related to the socialist legacy probably were largely unavoidable. The economic transformation started quite soon after the collapse of the centrally planned economy, and there were no ready-made blueprints for a smooth regime change. The toll had to be paid.

The period after 1992 or so is more questionable. Exaggerating slightly, we can say that the banking sector partially substituted for (or mimicked) the former system of central redistribution of resources. The relative inefficiency of enterprises was transformed into banking sector losses. This process was driven by "transformation requirements" and facilitated by underperforming banking supervision, a malfunctioning legal framework, and an underestimation of the risks. Initially, these losses were implicit and hidden, but over time they became explicit. The costs were dispersed over numerous agencies, and unfortunately there was a tendency to neglect them and postpone remedial solutions. We believe that a large proportion of the costs incurred due to the consolidation and stabilization of the banking sector could have been avoided, and the corresponding risks shifted onto the private sector.

The timing of the privatization of the big banks was discussed intensively throughout the 1990s. The postponement of the large banks' privatizations in the early 1990s was due to purely political motives, based on the belief that some control of this crucial sector is advisable in a generally uncertain (rapidly changing) environment. However, the big state-owned banks extended (at least partially) the previously existing soft budget constraint and did not seem to foster any hardening. Moreover, the government did not prove to be a good owner, which implied operational inefficiency and managerial under-performance.

We believe that earlier privatization of the big banks would have yielded higher revenues (the market shares of the big banks were initially very high) and that the transformation costs incurred by the public sector during the stabilization recession would have been much smaller, because the majority of the potential costs would have been covered by new private owners. This is suggested by the substantially improved performance of the banking sector after the completion of the privatization of the big banks. With the benefit of hindsight, the hesitation in privatizing all state-owned banks sooner rather than later seems to have been unjustified. And the postponement of the privatization turned out to be unnecessarily costly.

To sum up: banking sector should be private as soon as possible and as healthy and competitive as possible. Such a sector is a necessary (though not sufficient) condition for a flexible market economy and sustainable economic growth. Sales of still existing state owned banks and/or state owned shares in banks are highly advisable.

Lesson 5*:* The interaction between banking sector problems and economic downturn should be avoided. The consequences of twin crisis are usually serious and the costs incurred rather high. Disorderly banking sector typically sharpens the economic recession and makes the recovery more protracted and painful.

Lesson 6: In order to avoid inflation volatility it is advisable to mitigate the exchange rate volatility with all possible means that stay at disposal. In any case, it would be useful to bring inflation down with a purpose to reach low interest rate differentials. Low differentials are less likely to stimulate either outflow or inflow of capital which (if in a large scale) have disruptive consequences. By the same token, it would be highly useful to sterilise capital inflows related to non-systemic developments, such as privatisation of big state-owned companies or banks. Adoption of sterilisation schemes with an appropriate involvement of central bank proved to be very effective in the Czech Republic in the first half of this decade. In other words, special circumstances justify adoption of special measures.

By maintaining that the low volatility of the exchange rate should be one of the focuses of policy-makers we do not mean that currency floating should be restricted or even replaced by any kind of fixed exchange rate regime. Real exchange rate appreciation materialising via nominal appreciation proved to be a useful adjustment mechanism of relative prices levels (at least in the Czech case) and the channel through which both real and nominal convergence occur.

The overall macroeconomic and monetary framework can be fully consistent if based on simultaneous existence of: floating exchange rate regime, inflation targeting, liberalised capital account, and well performing supply side (competitive banking sector, dominant private sector, flexible labour market, balanced public finance). Under such circumstances a sustainable catching-up in real terms should be relatively easy to materialise.

REFERENCES

Bárta, V., and Singer, M. 2006. "The Banking Sector after 15 Years of Restructuring: Czech Experience and Lessons." In *The Banking System in Emerging Economies: How Much Progress has been Made?* BIS Paper 28. Bank for International Settlements, Monetary and Economic Department, Basel, Switzerland.

Czech National Bank (2000, 2001, 2002, 2003, 2004), Banking Supervision.

Czech National Bank (2000), Transformation Costs of the Recovery and Consolidation of the Banking Sector, www.cnb.cz.

Czech National Bank (2004), Financial Stability Report.

Dědek, O. (2001), Bank Consolidation in the Czech Republic. In: The Banking Industry in the Emerging Market Economies: Competition, Consolidation and Systemic Stability, BIS Papers, No. 4, BIS.

Hampl, M., and Matoušek, R. (2000), Úvěrová kontrakce v ČR - její příčiny a důsledky, VP č. 19, CNB (in Czech).

Havel, J. (2004), Bank privatisation – Critical view of the Czech deal, Politická ekonomie, 2004 č. 1 (in Czech).

Ihnát, P., and Procházka, P. (2002), The Financial Sector in the Czech Republic: An Assessment of its Current State of Development and Functioning. In: Financial Sectors in EU Accession Countries, (Ed. Thimann, C.), ECB.

Ministry of Finance and Czech National Bank (2005), Analýza transformačních nákladů v letech 1991-2004, mimeo (in Czech).

* Vít Bárta, Advisor to First Vice Governor, Czech National Bank.

[1] National Property Fund of the Czech Republic was founded in 1991 for the purpose of providing for the technical implementation of individual privatisation decisions and the temporary management of state ownership interests intended for gradual privatisation, in accordance with act on the powers of bodies of the Czech Republic in the transfer of state property to other persons and the act issued by the Czech National Council on the National Property Fund No. 171/1991 Coll.

[2] Česká inkasní (ČI) was a single-purpose financial institution controlled by the Ministry of Finance. It was established in 1993 and was authorised to clean up the portfolio of the state-owned ČSOB during the latter's transformation (particularly of inherited old receivables from state-owned companies having trading partners in countries with a high political risk). Agreements were concluded between the Ministry of Finance, the Czech National Bank and ČSOB. Česká inkasní for this purpose obtained a loan of CZK 29 billion from ČSOB guaranteed by the National Property Fund.

[3] The total number of banks peaked at 55 in the mid-1990s. Of these, 32 were Czech-owned, 15 were foreign-owned and eight were foreign bank branches.

[4] Kreditní a průmyslová banka ran into problems in 1993, Banka Bohemia and AB Banka in 1994 and Česká banka in 1995, to mention just a few.

[5] Česká finanční was given the task of technically implementing a programme to enhance the stability of the Czech banking sector. This "stabilisation programme", declared under Czech Government Resolution No. 539 of 16 October 1996, was designed for small and medium-sized banks. ČF was also tasked with implementing a so-called "consolidation programme" which had been announced earlier by the CNB in connection with the consolidation of the banking sector/mergers of small banks. ČF's objective is to manage bad debt purchased from small banks in accordance with the law with the maximum return in the shortest possible time and at the lowest possible cost.

[6] The engagement of the state-owned banks in very generous lending in the mid-1990s was sometimes labelled "banking socialism". This term reflected the fact that state-controlled banks responded to politicians' calls to "support" the economic transformation at the expense of the soundness of their balance sheets.

[7] Many insights into the procedures, transparency and fairness of the privatisation of the three big banks have been offered by Havel (2004).

[8] We draw here from Ministry of Finance and CNB (2005).

[9] The rather high costs in 2002 and 2003 refer, among other things, to the above-mentioned tranches of "black" and "grey" assets, i.e. bad loans and similar assets, transferred from the former Investiční a Poštovní banka to the balance sheets of KoB/Česká konsolidační agentura.

HOST SUPERVISION ISSUES IN SOUTH EASTERN EUROPEAN COUNTRIES: WHY IS HOST-HOST COOPERATION DESIRABLE AND HOW TO MAKE IT HAPPEN?

**Luigi Passamonti*
***Franco Bruni*
****Peter Nicholl*

From the research we have conducted with all Central Bank Supervisory Authorities in the Region on existing supervisory and regulatory practices, as far as multi-national banks and cooperation with home countries are concerned, a number of areas of common interest have been identified. It has been underlined how, in terms of host supervision work, it is important to harmonize an issue that is very simple but also very powerful. The important requirement between host-home supervisors and bank head office is that the template and the financial performance data be the same, because if the data is not consistent in terms of issues, format and frequency of reporting, it would be difficult to exchange views, and have a common risk management and supervisory strategy. We have a sample document about Romania, distributed yesterday which has been discussed today, dealing with policy issues that were considered to be important by the host supervisors.

In this connection, a meeting on this issue which was held in Vienna last September showed a concrete approach to activities that can be executed in a relatively short time. We can analyze results and build further momentum in order to expand the cooperation and reach more ambitious results, and, as mentioned by Professor Franco Bruni, to obtain support, from the other two members of the chain that is, from host supervisors and multinational banks. I believe an agreement could be reached based on regional collaboration through regular working meetings. The priority policy issues that emerged in the Vienna meeting and here again are evidenced in the minutes of the meeting.

The first issue is governance and the branch-subsidiary management arrangements. There was a lot of discussion about Board composition, with increased awareness of the need for host supervisors to pay attention to the quality of the Board appointments. Recently Serbia and Macedonia adopted new laws to improve the quality of Board governance. Concern was expressed by your colleagues about outsourcing operational activities from the subsidiaries to head office, and how to ensure that there are sufficient plans to allow the continued operations in host countries.

The second issue is competition and its assessment: by product, by region, by segment, and how policy could address these issues.

Other "traditional" issues emerged in this scenario, such as consumer protection and consumer education. In this regard, I am pleased to inform you that we will discuss consumer protection issues in our next regional meeting. It is interesting to see that we are getting out of the risk assessment, moving towards building a strong infrastructure to protect the banks and its clients. The issue of information sharing is also connected to the standardization of reporting templates. Cooperation could help with instrument choice through analysis of nature and implications and benchmarking with international and regional experiences -- i.e. regional supervisors in one country could collaborate and examine how issues faced in country "A" could be seen from the perspective of country "B" or "C", to ensure comparability and mutual learning.

Implementation challenges were also mentioned, such as coordination with other domestic institutions, antitrust, contract enforcement, and role of certain regulations, banking industry codes of conduct and how to achieve influence over bank, headquarters and support from home supervisors.

We have the next meeting planned in a month time, with the same participants and two more countries that are planning to attend, so we have almost a full house. There was a sense from some of the participants that this group could undertake joint working visits, for example to Basle or to Brussels, to foster better understanding of issues faced by supervisors in the region. The same group could prepare these visits, so that it could discuss issues of common interest before meeting with international counterparts. The benefits of this enhanced Regional host supervision cooperation could be the theme of a conference on Regional Financial Stability, through a more meaningful host supervisor dialogue.

As referred by Professor Franco Bruni, it is better when Albania, Bosnia and Bulgaria have developed together a language on a set of issues before discussing with, for example, Austria and Italy. In this way there are fewer differences in points of view, reflected in the possibility to have more standardised products, services to the clients for the benefit of cost and efficiency, paving the way for the phase of integration with EU procedures.

This also means calibrating the work of this regional working group towards the standards discussed, so we can have a phased progression towards the best standards. This can not be done by this group by itself, there should be some encouragement by home supervisors to the host supervisor. International organizations, such as the World Bank, the International Monetary Fund, and Basle, could contribute by sharing collaboration templates, therefore enhancing partnership among institutions. The Convergence Program supports this initiative, and should be seen as catalyst at the beginning to help and bring people to the table, prepare agendas and provide technical support.

We should support a regional coordination that could emerge from this process and may be able to alter this shape, their interface with home supervisors.

Thank you very much.

*Luigi Passamonti, Senior Advisor to the Financial Sector Vice President, World Bank,
**Franco Bruni, Professor of International Monetary Economics, Bocconi University, Italy and World Bank Convergence Program,
***Peter Nicholl, Member of the Governing Board, Central Bank of Bosnia and Herzegovina.

NON-TRADITIONAL MORTGAGE LOANS

*Allen Frankel**

INTRODUCTION[1]

Until only a few years ago, most high-income countries sought to preserve distinctive national housing finance mechanisms.[2] They did so through the maintenance of "special circuits" that channelled funds into housing finance, and by allowing insolvent specialised housing finance firms to continue to operate. In the 1990s, the high cost of these actions came to be acknowledged and addressed. Subsequently, a bias toward deregulatory initiatives was established. In a number of countries, these initiatives have resulted in the integration of housing finance markets with government bond markets. This was accomplished through the application of technology, as well as the development of secondary markets in mortgage-related risk exposures.

In Southeast Europe, we have now witnessed the first stage of introducing households to market-based financial processes. Even at this early stage of financial deepening, sophisticated housing finance arrangements are being explored both by domestic firms and foreign-based firms. An underlying rationale exists for policymakers to oversee these efforts even when the financial sector is of limited relevance. It is the abundance of evidence supporting the thesis that financial sector development is crucial to economic growth.

One prominent strand of this argument emphasises the importance of financing mechanisms that encourage credit intermediation based on the collateral value of houses. That is, mechanisms that can accommodate household's interests in making equity investments in risky projects such as start-up businesses.

The collateral value of housing wealth is subject to enormous variation across countries. Behind these variations lie differences in financial infrastructures, legal systems and supervisory guidelines. That being said, the following stylised fact has emerged. In those countries where housing is regarded as low-haircut (high quality) collateral, its collateral value has much more significance for the overall performance of the macro economy.

Some economists have had a less positive take on the benefits of collateral-supported credit booms. Their views are captured by economic models that incorporate some form of financial accelerator based on the role of collateral requirements. Typically, in such models, an exogenous shock, such as expectations of more rapid real economic growth, increases the value of the asset employed for loan collateralisation. This leads to a rise in credit, as borrowers' new wealth relaxes their credit constraints. More credit, in turn, leads to further increases in asset demand and prices, further relaxing borrowers' credit constraints, and so on.

The whole process can be reversed. Borrowers unable to repay their debt see their collateral seized and sold to benefit their creditors. Asset prices decline, depleting the value of collateral and triggering compensation requests by creditors. The situation could give rise to a credit crunch: less credit leads to decreases in demand and asset prices, further tightening of borrowers' credit constraints, and so on.

In implementing economic growth strategies, emerging economies have often chosen to quickly catch up by adopting latest technologies. The choice of mobile phones (wireless telecommunication) rather than fixed-line phones is the most frequently cited example of this kind. The upside of a strategy of skipping over soon-to-be-obsolete technologies accommodates policymakers' interests in speeding up the rate of convergence of standards of living with advanced countries. The downside is failure: bad investments with systemically disruptive consequences.

BENCHMARKING: US HOUSING LOAN PRODUCTS

My benchmark for the most advanced housing loan system is that of the United States. The US mortgage provides many more options than are common anywhere else. US households can choose whether to pay risk adjusted fixed or floating interest rates; they can choose the time at which the mortgage resets; they can choose the term and the amortisation rate; they can prepay freely, and they can engage in home equity withdrawal. Finally, households need not make down payments to qualify for a home mortgage. In such cases, households pay a risk-adjusted mortgage rate that compensates the lender for the heightened risks of default. The US home financing system has changed dramatically over the last decade. The change is a product of the applications of technologies. First, the new capacity to price various mortgage contract possibilities for borrowers is based on investment in computer hardware and distributed network capacities. Second, it is also a product of more intensive trading of US dollar-based interest rate risk exposures via over-the-counter (OTC) derivatives contracts. Third, it is the product of improvements in data capture and modelling of household behaviour. The latter is important for the development of risk-based pricing to higher risk households, for example, those households without the financial means to make a down payment (an equity investment) on a house.

I now turn to how the changes in technology were reflected in the industrial organisation of US mortgage finance in the 1990s. When one looks at the changes that occurred, one is struck with the role played by changes in technology. That being said, one should acknowledge the liberal US regulatory policies that govern mortgage-related businesses. Liberal regulatory policies are a necessary, but not a sufficient, condition for changes in the industrial organisation of finance to be driven by technological innovations.

CHARACTER OF US MORTGAGE FINANCE IN THE EARLY TO MID-1990S

Standard mortgages loans, for only prime credits, were originated by banks and other financial institutions. The underwriting standards employed were those of the US housing agencies which, among other things, limited mortgage loans to 80% of house values.[3] The agencies stood ready to purchase qualifying loans. Loans purchased were bundled into mortgage-backed securities. The securities not retained by the agencies were distributed to banks and institutional investors, such as insurance companies.

The housing agencies were (and continue to be) barred from originating mortgage loans for retail customers, and, therefore, they operated through a network of delegated agents: commercial banks, mortgage banks and mortgage brokers. To address various issues, the agencies moved to adopt automated underwriting processes. Such processes were attractive because they could be implemented in a standardised manner by the various mortgage originators. Applications from low-risk borrowers could be safely vetted by validated statistical models.

CHARACTER OF US MORTGAGE FINANCE IN 2006

The share of standard mortgage loans to prime borrowers has been greatly reduced over time. A majority of loans currently originated are underwritten by non-bank financial companies, known as mortgage banks. Most loans are originated by brokers who served as commissioned agents. A multiplicity of loan products is offered. Pricing is calibrated to credit scores that have been validated as robust predictors of default behaviour.

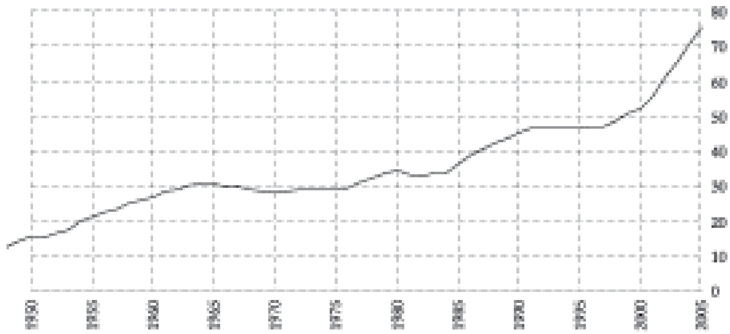
Standard and non-standard loan pricing is set in the secondary market trading. Loan pricing is insensitive to loan-to-value ratios below 80%. Recent loan innovations require to borrowers to make interest-only payments for an initial period and offer the option of even lower payments which, if chosen, result in negative amortisation of principal amounts owed. Exceptionally, in response in part to public expressions of concern by banking supervisors and by the credit rating agencies, such loans are not offered to the least creditworthy group of borrowers. That is, at the margin, non-priced credit rationing continues to play a meaningful role in the US housing finance market.

INTERPRETATION OF TRENDS

Long-term trends

Home mortgages have loomed continually larger in the financial situation of US households. Chart 1 below shows that mortgage debt as a percentage of GDP increased from about 15% in 1950 to nearly 75% at the end of 2005.[4] The high end of the current ratios for countries in central Europe is somewhat below the 1950 US level. Overall, the rapid growth in US mortgage debt has closely tracked the mortgage's market growing reliance on securitisation. Large-scale mortgage securitisation remains an exceptional market practice outside of the United States.[5]

Chart 1 US Mortgage Debt
As percentage of GDP



Source: Green and Wachter.

Medium-term trend

US home-ownership rates were stagnant for more than two decade, from the mid-1970s through the late-1990s.[6] The increase over the last few years has been heavily among young households. One interpretation of this phenomenon is that the upsurge reflects the effective lowering of the required downpayment, a reflection of the proliferation of "affordability" mortgages in the marketplace.[7]

House prices

Over the last few years, the prices of houses in California most likely to be financed by subprime loans appreciated more strongly in percentage terms than those of other houses.[8,9] This is surprising, since these houses have not been purchased by households that have experienced relatively large income increases. It is also not likely that the homes are located in up-scale neighbourhoods where motivated homeowners have successfully blocked new housing developments. One explanation that fits the data is that the houses were purchased by subprime borrowers who would not have qualified for mortgage credit if the underwriting standards in place prior to the turn of the century had continued to be employed.

ILLUSTRATION OF THE ARGUMENT

At this point, I think it would be useful to employ some abstraction to highlight the potential relevance of what has happened in the United States for what might happen, over time, in Southeast Europe.[10]

The fundamental asset in our discussion is the representative house, with a mark-to-market price equal to h.

We have a financial system with three groups of investors – young households, old households and financial institutions that have balance sheets.

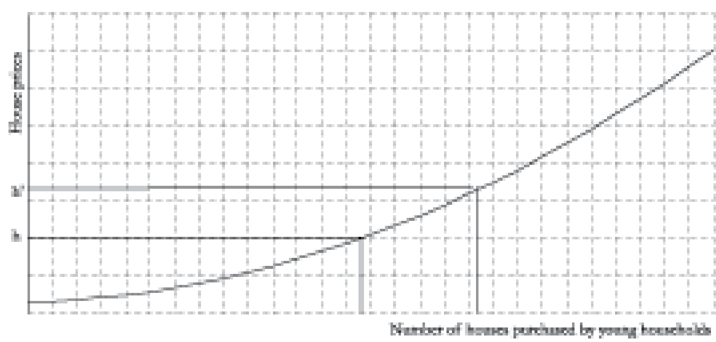
The three groups have the following characteristics:

- Young households start with no housing assets. Each household has a documented credit history. The future earnings potential of each household are also documented.

- The old households are unleveraged investors in housing. At the initiation of illustration, these households own the entire housing stock.
- Young households will have higher lifetime incomes than old households. This is reflected in the higher private valuations assigned to houses by young as compared to old households. However, at any point in time, it is uncertain what will be the magnitude.
- Financial firms incur liabilities to old households and then make mortgage loans to young households. House prices are an increasing function of the proportion of the housing stock backed by mortgages to young households.

The last point is illustrated by Chart 2 below. The marginal purchase price of a house is an increasing function of house purchases by young households. The higher house price, h’, might be realised when house purchases by young households can take place with lower downpayments.

Chart 2 House Prices – Role of Property Transactions Between Generations



What might be drawn from the above from a financial system systemic point of view?

- Loan origination processes matter even though regulated loan originators, such as banks, do not retain loans.
- Home ownership rates of young households are likely to be

particularly sensitive to changes in non-priced underwriting standards, such as minimum downpayment required.

- Changes in the marked-to-market value of housing can reflect changes in the financial technology that will be not being reflected in liquidation of houses in a housing bust.

Some policy issues

A key role of financial supervision is to oversee a credit system in which supervised institutions maintain high underwriting standards despite competitive pressures. Supervisory mandates are implemented by policies which encourage institutional behaviour to ensure levels remain manageable. In recent years, it has come to be appreciated that regulatory arbitrage of inconsistent mandates can be a source of financial sector risk. One unanticipated consequence of this scrutiny has been a more intensive focus by financial firms on what risks they can profitably manage. In an aggregate sense, the scrutiny has encouraged the dispersion of transferable risks away from financial sector firms. That is, financial risk management responsibilities are now more widely dispersed among all economic agents.

Foremost among the underlying forces that have actually led to a shift of risk bearing has been technology. Technology, such as applied to housing finance in the United States, has allowed risks to be unbundled and rebundled and then sold separately. Added to the new products (such as mortgage-backed securities), technological change has also provided new and cheaper means for delivering products and for widely disseminating information.

Meeting the preconditions for the successful application of the new technologies cannot be taken for granted. To function well, market-based financial systems require an information infrastructure that is costly both to construct and to maintain. Furthermore, households need to be financially literate to responsibly employ sophisticated financial products whether as borrowers or as investors.

Researchers have begun to appreciate the policy relevance of financial literacy issues. Mortgages have become increasingly complex contracts. If large numbers of borrowers do not know their mortgage terms, they may be surprised by contractual changes in payments and subsequently experience financial distress.

The Federal Reserve Board staff research published in 2006 raised some questions.[11] One finding was that borrowers with less income or education were more likely not to know the terms of their mortgages. In turn, this led them to flag the policy concern that borrowers who are unable to describe accurately the terms of their mortgages are also likely not to understand the inherent risks.

US financial supervisors have now acted to discourage the offering of products designed for high income borrowers to a broad array of consumers.[12] Over time, financial sector supervisors in Southeast Europe might also conclude that it is appropriate to distinguish among households in terms of what financial products can be made available.

Greater reliance on market forces in economies, such as those of Southeast Europe, have encouraged interested parties to treat risks in those economies as increasingly comparable to those in advanced economies. Home country supervisors and managements of bank increasingly rely on group-wide frameworks using globally standard risk assessment techniques. This enhanced capacity to quantify the value of operations has spurred the integration of financial institutions into the global market for corporate control.

In his 2006 Presidential Address to the American Finance Association, John Campbell discussed issues involved in the study of household finance. He spoke about evidence that many households make good financial decisions but that a minority makes significant mistakes. He discussed the existence of financial products that involve a cross-subsidy from naïve to sophisticated households, and how they can inhibit welfare-improving financial innovation.[13] Campbell's assessment is likely to be even more relevant for the situations of transition economies. And, if it is, would it not be of more relevance to host-country supervisors?

The policies, in question, are concerned with the systemic aspects of consumer protection. They include disclosures to consumers, better advice on financial planning, encouraging the availability of simple financial products, selective access to new financial product markets (for example, innovative housing mortgages) and the setting out of collateral requirements (downpayments) for household loans.

* Allen Frankel, Adviser, Monetary and Economic Department, Bank for International Settlements, CH-Basel.

[1] The views expressed in this paper are my own, and do not necessarily reflect those of the Bank for International Settlements.

[2] "Housing and personal wealth in a global context", John Muelbauer; a paper prepared for a United Nations WIDER Project Meeting, April 2006.

[3] Although now privately owned, Fannie Mae and Freddie Mac (the housing agencies), are subject to special governmental restrictions on how they conduct their businesses. For example, they are not permitted to underwrite mortgage loans above an amount reset annually. A similar restriction does not apply to mortgage underwriting activities of other firms.

[4] "The American mortgage in historical and international context", Richard K Green and Susan M Wachter, Journal of Economic Perspectives, Fall 2005.

[5] Denmark and Australia are two other countries with high ratios of mortgage debt to GDP. Typical fixed-rate mortgage loans are securitised in Denmark and typical floating-rate Australian mortgages are not.

[6] "The great turn-of-the century housing boom", Jonas D M Fisher and Saad Quayyum, Economic Perspectives, Federal Reserve Bank of Chicago, 3Q/2006.

[7] As compared with standard mortgage loans, affordable mortgages involve lower borrower payments in the first few years of loan and higher payment later on. All other things being equal, the availability of such loans allowed households with good income potential to purchase houses consistent with their long-term incomes at an earlier age.

[8] Subprime mortgages are loans to borrowers who are unable qualify for agency underwritten loans.

[9] "Home price appreciation and subprime mortgage performance", Eugene Xu, Deutsche Bank Securities, presentation materials, July 2006.

[10] The illustration draws on a paper by Hyun Song Shin entitled "Risk and liquidity in a system context", December 2005. The paper

is available on the BIS website.

[11] "Do homeowners know their home values and mortgage term?", Brian Bucks and Karen Pence, Working Paper, Federal Reserve Board, January 2006.

[12] "A US supervisor's perspective on current banking issues", Remarks by Federal Reserve Board Governor Susan Bies at the British Bankers Association Supervision Conference, 11 October 2006.

[13] "Household Finance", John Y Campbell, Journal of Finance, August 2006.

AUSTRIA'S PERSPECTIVE AS A HOME AND HOST COUNTRY

*Michael Würz**

Ladies and Gentlemen,

Let me start with a short story: Once at a school-exam, a student asked his teacher: "Aren't these the same questions you asked us last year?" And the teacher answered: "You are right, but in the meantime the answers have become different." Well, that's a pity for the student if he prepared on basis of the old answers. However, for banking supervisors the situation is even more complicated: We are not only required to adapt our answers to new developments, but we are also confronted with new and additional questions. Supervision is therefore a living topic, with supervisory rules and approaches today being state of the art and tomorrow potentially being claimed as inadequate. A good example for these developments is the move from Basel I to Basel II, with the latter being implemented in the EU as of 1 January 2007.

However, there are also a number of further examples on the EU-agenda: own funds requirements, liquidity supervision, large exposure requirements, etc. In order to address all these questions in depth, even devoting the whole conference to these subjects would not be sufficient. Thus, in my intervention I will select one of these issues: cross-border banking supervision. Against the background of rapidly changing markets, market participants' efforts to invent new products, centralisation tendencies of large banking groups and increased cross-border activities, supervisors' efforts to ensure adequate supervision are challenged. A number of questions have arisen in this respect, and as regards possible solutions enhanced supervisory cooperation seems to be a key.

I will therefore first provide you with a basic overview of the supervisory cooperation as experienced by the Oesterreichische Nationalbank (OeNB), and then briefly touch upon some open questions in this respect.

Before going into medias res, I would like to take this opportunity to briefly explain the role of the OeNB in banking supervision. The OeNB is not "the competent banking supervisory authority" of Austria – this task has been entrusted to the Austrian Financial Market Authority (FMA), which has been established as an integrated supervisory authority in 2002.

However, besides fulfilling its macroprudential and financial stability tasks, the OeNB is also closely involved in micro-prudential banking supervision, basically by two means:

- Institutional involvement (e.g. representation in the Supervisory Board of the FMA, right to name a member for the Management Board);
- Operational involvement (e.g. conduct of on-site inspections regarding credit and market risk, processing and analysing of the banks' reporting, right be heard before the FMA issues regulation and before MoUs are concluded).

In order to provide a comprehensive picture, I would also like to mention the Financial Market Committee. This Committee has been established at the Ministry of Finance (MoF) as a common platform for the three institutions jointly responsible for financial markets stability: the OeNB, the FMA and the MoF. Its objective is to promote co-operation and exchange of opinions, and it may also issue recommendations on issues related to the financial market. Therefore, you can see that in Austria, co-operation among authorities is also required on the national level, in day-to-day supervision as well as in crisis situations.

However, as regards the cross-border dimension of supervisory cooperation, Austria serves as a good example of why cooperation actually matters. The importance of CEECs for the Austrian banking market is continuously increasing, which in turn requires specific solutions in the supervisory process and particularly cross-border cooperation.

- On a consolidated basis, aggregated total assets in the CEE segment increased by one-third to approximately EUR 136 bn at year-end 2005. This accounts for a share of 16 % of the total assets of the Austrian banking system (year-end 2004: 14 %).
- Profits before taxes in the CEE segment increased in 2005 by 54,7 % to EUR 2.2 bn. This sharp increase in profits, which is driven by subsidiaries in CEECs (incl. new acquisitions) as well as an increasing volume of direct loans, led to a share of 35 % of the total aggregated profits of the Austrian banking system (year-end 2004: 27 %).

Looking at the other side of the coin, namely at the share of Austrian banking assets held by foreign owners, among the old EU Member States Austria is one of those with the highest share of foreign ownership. On a consolidated level, in 2004 21,65% of the total assets of the Austrian banking system were in the hands of foreigners, which puts Austria in the fourth place after Finland, Ireland and Portugal. Nevertheless, as regards the new EU Member States, i.e. the Member States which acceded in 2004, the share of foreign owned banking assets is generally much higher; in some Member States it is even beyond 90%!

What are the conclusions to be drawn from these figures?

- First, banks themselves are faced with new challenges, particularly as regards the development of their risk management and their competition strategies.
- Second, due to the increasing integration of the EU financial services market, supervisory cooperation becomes sine-qua-non for effective banking supervision. And this need for supervisory cooperation does not stop at the EU frontiers. For example, as regards Austrian banks a 50% share of subsidiaries (in terms of

total assets and profitability) is licensed in non-EU countries of the CEE region. Moreover, the growth in terms of both total assets and end-of-period results as well as with a view to direct loans is much more dynamic in non-EU MS. Austria therefore considers it extremely important to establish good cooperation with non-EU supervisors from the CEE region as well.

- Third, while the cross-border banking activities may lead to further diversification of the banks' portfolios, at the same time they imply enhanced contagion risks, at least in case of major events. Comprehensive financial stability analyses, including from regional perspectives, are therefore required.

As proven by the previous figures, in Austria we have experience with both roles, the role of the home and the one of the host supervisor. Personally, I think that this experience is quite useful, because seeing cooperation from both sides ensures awareness of the respective needs of your counterpart, which helps in shaping cooperation arrangements.

In this context it is notable that due to the Basel II implementation process the need for supervisory cooperation is further increasing, for instance due to the high number of options/discretions, qualitative requirements of Pillar 2, etc. Similarly to the publications of the Basel Committee on the cross-border implementation of the New Accord and home-host information sharing, the so-called Capital Requirements Directive that transposes Basel II into Community law recognises this need and contains specific cooperation provisions. In addition, it strengthens the role of the home – "consolidating" – supervisor. The consolidating supervisor has to coordinate the gathering and dissemination of relevant or essential information, to plan and coordinate the supervisory activities in going concern and in emergency situations and finally, he has a decisive role in the process of cross-border risk management model approval if the involved supervisors can not agree on a joint determination within six months. Particularly the latter requires specific cooperation arrangements.

However, there are also structural tendencies that have impact on the cross-border supervisory process. For example, banking groups tend to centralise certain business functions on a group-wide basis. So-called "centers of excellence" provide horizontal services to different parts of the banking group and cut across different jurisdictions. Again, cooperation is a key word!

In principle, two forms of co-operation can be distinguished:

- Multilateral cooperation within specific committees: Committee of European Banking Supervisors – CEBS, Banking Supervision Committee – BSC;
- Bilateral cooperation between supervisors of two countries or of a specific banking group.

You may be aware of the saying that "in order to get something done, a committee should consist of no more than three men, two of whom are absent". Well, I think that for multilateral supervisory cooperation on the EU level the last decades and particularly the last years have proven this statement as being wrong. In fact, I would argue that cooperation already has a quite successful track record that dates back to the 1970ies when the so-called Groupe de Contact was established. This group still exists, but it has now become the main sub-group of CEBS, which commenced its activities in January 2004. CEBS is located in London, comprises the banking supervisors and central banks, including the ECB, from the EEA-countries and has been extremely productive for the last two years.

Within the European System of Central Banks, a second committee of EU banking supervisors and central banks exists – the BSC. Both CEBS and the BSC have a more or less identical composition, but their tasks are different and complement each other: The BSC has a macro-prudential and financial stability perspective, while CEBS' focus is more on micro-prudential, regulatory and convergence issues in the banking field.

- For example, the BSC regularly analyses financial stability issues, looks at the overall impact of regulatory measures and monitors the developments of banking structures. Recently, the BSC has also conducted work in order to better cover regional stability issues besides the overall EU developments.

- In contrast, CEBS' main area of work is currently the implementation of Basel II, with a specific focus of achieving consistent rules and convergent supervisory practices across the EU. For this purpose, CEBS developed a number of guidelines on critical Basel II issues. These guidelines cover, for example, the model approval process and the recognition of external credit assessment institutions, the pillar 2 process and home-host cooperation, disclosure of supervisors and the Basel II solvency reporting. They are expected to effectively contribute to efficient cross-border banking supervision in the EU and to a common supervisory approach based on best practices. For the supervised banks, these guidelines should result in reduced compliance burden due to consistent national approaches.

In this context, I would like to particularly highlight the CEBS guidelines for cooperation between home and host supervisors, which have been developed in order to avoid duplicative tasks for both supervisors and institutions and to reinforce the efficiency of banking supervision. More precisely, CEBS has looked into the provisions for home-host cooperation laid down in the CRD and tried to specify, in practical terms, the role of the respective involved authorities.

This specification is based on a number of general considerations, e.g. that cooperation should be conducted within a risk-based approach to supervision, that supervision should be proportionate and that it should take into account the degree of significance of subsidiaries/systemic importance of branches.

Another key element is information exchange in the supervisory colleges set up between the relevant consolidating supervisors and host supervisors. Here it is taken into account that supervisory cooperation and information exchange are in the interest of both home and host supervisors, and that they have to serve the interests of both. For example, it is stressed that exchange of information is a two-way process, i.e. that the flow of information has to be in both directions from the host to the home and from the home to the host supervisor. This is particularly important in cases where the subsidiary is systemically important or at least counts for a large share in the local market. In Austria, this is the case with BA-CA, which is a subsidiary of the Italian UniCredit, but at the same time Austria's largest bank.

Besides these overarching elements, a specific framework has been developed for the (1) general cooperation between supervisors when they carry out the Supervisory Review and Evaluation Process (SREP) and (2) for the model approval process. For example, as regards the SREP the risk assessments process has been divided into five steps (risk identification, risk assessment, planning, supervisory action and evaluation) and for each of these five steps, the cross-border implications and the respective tasks and necessary actions in order to effectively address these implications are highlighted. The coordination of this process lies – according to the CRD – in the hands of the consolidating supervisor. The concrete arrangements among the involved supervisors (who is going to do what?) should be agreed in advance, which has the advantage of providing certainty of expectations.

The guidelines allow for great flexibility in allocating tasks within a commonly agreed framework and can be adapted on a case-by-case basis according to the concrete needs of cooperation between the parties. For example, a particular task may sometimes be better addressed by the consolidating supervisor, in other groups by one of the host supervisors. However, it is important to note that the Guidelines can and do not change the respective responsibilities laid down in the CRD. For example, a supervisor may act on behalf of another supervisor in carrying out specific supervisory tasks, but this does not mean that the other supervisor is no longer responsible (i.e. delegation of tasks, but no delegation of responsibilities).

In addition to these Guidelines, CEBS has now established a Subgroup on operational networking. The tasks of this group are to facilitate the dialogue between the so-called colleges of supervisors (i.e. home and host supervisors) of the different banking groups and to help in identifying relevant issues that would benefit from further consideration. In this way, consistency of approaches for different banking groups should be fostered, which contributes to achieving a level-playing field for banks. For a test phase, CEBS has started with a sample of large banking groups, but this work may be extended in the future.

However, multilateral cooperation can only be complementary to bilateral cooperation. Let me give you now a few examples of what bilateral cooperation means for Austria in practice.

In the specific Basel II context, two aspects have to be mentioned:

- Co-operation meetings: Austria has participated in respectively organised so-called co-operation meetings, where the supervisors of a particular group meet to discuss the roll-out process and the respective tasks related to model validation. In this process, supervisors may for instance agree that the host supervisors validate the locally developed components of a model whereas the home supervisor assesses the centrally developed model features. This should ensure that the most suited supervisor performs the respective supervisory function. Supervisors from EU and non-EU countries participated in these meetings.
- Information Exchange: The CRD contains specific requirements that will further foster information exchange among EU supervisors: It is specified that supervisors have to provide one another with any information which is essential on own initiative (e.g. adverse developments in banks), and that relevant information has to be provided on request. As noted, this flow of information has to be in both directions and should inter alia ensure awareness of risks related to a specific banking group. We will see how these provisions will work in a couple of weeks, when Basel II enters into force.

As regards cooperation more generally, Austria has also concluded a number of traditional MoUs, namely with Bulgaria, Czech Republic, Croatia, France, Germany, Hungary, Italy, Netherlands, Romania, Slovakia, Slovenia and UK; further MoUs are envisaged with Poland, Malta and Cyprus, and discussions with regard to the possible future conclusion of MoUs are also being held with Ukraine, Russia, Albania and Serbia. These MoUs are considered as being very beneficial in facilitating cross-border co-operation, particularly in relation to countries that are not (yet) members of the EU. They are not only a useful basis for information exchange, but also allow detailing the respective tasks and duties against the background of the specific situation and relationship.

In addition, bilateral meetings are organised irrespective of whether there has been concluded a MoU or not.

Finally, Austria considers it important to cooperate also on working level. For example, recently a seminar on banking analysis has been organized in Vienna with off-site analysts from CEECs, which will also help to gain new contacts, to enhance understanding among each other and to foster information exchange on working level. Another seminar will be organized regarding reporting.

For us, bilateral cooperation is a key element for getting a real under-standing of the framework and the conditions under which Austrian banks' subsidiaries operate. And this understanding again on one hand facilitates the bilateral cooperation process, but on the other hand enables us to analyse the risks related to these operations and possible repercussions on the Austrian financial market and thus for financial stability.

We have developed some further tools which help us in analysing the exposures of our banking groups. They are not directly related to supervisory cooperation, but I think it may nevertheless be useful to briefly touch upon them:

- The FMA, together with the OeNB, regularly holds so-called management meetings with the management of Austrian banks. In these meetings issues related to the banks' subsidiaries in CEECs are also tackled.
- However, access to information is not limited to such specific meetings. According to the Austrian Banking Act, the FMA has the right to ask the Austrian (parent) banks each and everything related to their business activities at any time.
- The Austrian reporting requirements also demand regular information about Austrian banks' (fully consolidated)

subsidiaries. From the beginning of 2007, this information will be further extended, e.g. with a view to the subsidiaries' credit risks (amount of credits, specific loan loss provisions, defaults, collateral, etc).
- Finally, we currently attempt to develop a risk-based analysis approach of the Austrian banks in CEECs and to combine these analyses with the information available from local market developments.

So far as regards the current home-host issues and the Austrian experience in this respect. There is broad agreement that over the next years, in the EU the primary focus will be on further cooperation and convergence of supervisory practices between authorities. CEBS is the main addressee in this respect, and substantial efforts are underway to achieve something like a European Supervisory Culture. The tools for this purpose are the guidelines and the operational networks I already mentioned, but also other initiatives like joint training of supervisors and staff exchanges. These initiatives reflect that convergence can not be developed simply on the paper, but has to be built up in practical day-to-day supervision.

However, there are also discussions on the long term supervisory arrangements. Particularly the largest EU banking groups ask for a system where they only have to interact with a single supervisor – be it a so-called lead supervisor or a European Banking Supervisory Authority – and where they only have to comply with a single set of rules. In this respect, the European Commission has recently noted that work on any longer term agenda will need to commence at a reasonably early stage, and that the following areas will need to be considered: liquidity arrangements, crisis management, LoLR-arrangements, deposit guarantee and bankruptcy/winding-up proceedings. The Commission explained that in the absence of considering and addressing these important points, any discussion on amending and expanding the present supervisory arrangements in the EU would be premature. Further, there would be the risk to produce conceptual arrangements that present a dichotomy between practical roles and ultimate legal responsibilities and thus supervisory arrangements that may fail in times of stress when robust systems are of critical importance.

From the OeNB's perspective, we are of the view that maybe some day a decentralised model of a European supervisory authority could be feasible. However, this would not only require proper solutions as regards the issues identified by the Commission, but also further financial market and political integration. In contrast, we do not support any form of the lead supervisor model, since this would not only raise serious legal questions, but also imply that banks are operating on one and the same market while being subject to different supervisory regimes; thus, there would be no level-playing field.

Let me conclude:

- In the EU, we have developed quite extensive cooperation arrangements. Particularly in the last two years, there has been a major step forward. The established principles will likely influence cooperation between EU and non-EU supervisors as well.
- Since Austria is home as well as host country, we see cooperation from both perspectives – something, we consider as real benefit and which helps us to understand the respective position of our supervisory colleagues.
- From the Austrian point of view, it is particularly important to establish close cooperation also with non EU-supervisors from the CEE region. This should be for the benefit of both sides, including for the supervised banking groups.
- In the next years, the efforts to further enhance supervisory cooperation and convergence will continue – on the EU-level but also globally.
- The question of whether one day there will be a single European Banking Supervisor has to be left to the future. In any case, the discussion of how to shape supervision in an optimal way will certainly continue.

*Michael Würz, Head, Financial Markets Analysis and Surveillance Division, Oesterreichische Nationalbank.

HOW TO WORK TOGETHER EVEN BETTER IN THE FUTURE?

*Radovan Jelasić **

In my opinion, one of the good proofs for good cooperation is that half of these people sitting here round this table I have seen or met for the third time during this month, so I have seen some of them more often than some of my immediate colleagues.

Let me just go back to the old basics: the banking sector restructuring in Serbia started in 2000, and, we all thought once the ownership was changing, we could basically lay back, press the two buttons and everything would be solved. And again and again, I am asking myself what is the reason why certain banks act completely different in Milan, in Vienna, in one of these countries, compared to Albania, Serbia, or some other ones. I mean, we are talking of the same banks. Was it realistic to expect that all of them are going to act exactly the same way abroad, as they are acting at home? Or… are we missing something here? It is not important only to change the ownership structure. That is a necessary, but not a sufficient precondition for having a successful transition. Our role is to build up an efficient financial sector, and for that, of course, ownership transition is very important, but not sufficient – definitely.

The second thing I think is also very important: After sitting here for two days, you know, one question always comes up to my mind – what business are we, supervisors, in? Are we in a business of creating additional supervisory jobs in Albania, Romania, Serbia and many other countries, or are we in a business of making sure that Serbian, Albanian and Romanian depositors' money is in safe and sound banks? There is a lot of vested interest here. If you see your bank's balance sheet doubling or tripling in the countries of Eastern and Central Europe, which means also doubling and tripling the number of supervisors, would you follow up with that development, or you just consider it like a normal practice? So, once more, what is our job? And once more (and I am sure that all of my colleagues agree) our job is to make sure that our citizens' money is in the safe and sound banks.

Compared to many other people, we can definitely not complain, because we are the decision-makers, and although we cannot make sure that there is a direct flight from Bucharest to Tirana, I think we can know many other things. This conference also proves that the difference between success and lack of success is not that one knows what needs to be done. The only difference is that one is doing and the other one is not doing, and of course the big challenge is on our side. Are we going to do that or not? I put here a lot of different reasons why and why not, and what is the reason for even a stronger cooperation, but let me just pick up two or three of them.

BIS, Basle meeting, it was January. Mr. Josef Ackermann, CEO of Deutsche Bank, came to central bankers' dinner and said: "We approach our customers and tell them: What service do you want? Where, and from which country?" Then, we listen to that person, and ask ourselves: Is he making fun of us, supervisors? Or is he serious? Yes, he is serious, yes. And I honestly think that a lot of supervisors did not enter into the 21st century with the attitude 'this is my country, this is my banking, this is my voluntary pension fund'. Definitely a lot of people need to switch their mind to what is the interest of supervisors and why they are here.

As Mr. Fullani just mentioned, there is definitely much more need for exchange of experience, and I am sure that if any of us changes reserve requirement, makes a new decision regarding credit, etc. etc., you know, he could just call up: Hey, did you guys in Bulgaria, in Albania, in Serbia, did you see something like that? Trust me, there is not a single change in our central bank regulation for which they (commercial banks) do not have an appropriate answer – from changing reserve requirement ratio to consumer credit limits. I think it's really an issue more and more, so to say, of credibility, because, I mean, it's a kind of Mickey-mouse game at the end of the day. They really don't think that you know, you are using the expertise, and once more they firstly call Washington, and then IMF, then the IMF is calling somebody else and they really think that you should use these experiences much more actively. Definitely, maybe it's a little provocative, but I think that the central banks of the European Union are not showing enough clear leadership. You know, when you go to this conference, and you all hear that even among EU members there are some unresolved issues. You are just wondering how and when they will get to us to solve our problems.

I think the best example is really Austria. I am surprised to see there are only twelve MoUs, although the stake of some Austrian banks in the banking sector goes up to 30, 40, 50 %. Why don't we condition MoUs before entrance of banks from certain countries? I am confident that such an action could contribute to the speed and efficiency of implementing MoUs.

And last but not the least, as I have already mentioned – lack of capacity, because, you know, I would assume, if some of these home supervisors see banks' stakes booming in the regional countries, they would exert effort to check on it. Let me give one great example, it happened to us, 2-3 months ago, that's an Austrian home supervisor, invited us and said: "In two months, we propose to everybody who is host supervisor to go to exactly the same bank and leasing and other related companies using the same formula, using the same ratios as we do. We are going to coordinate it." This is something, but you expect, I would expect from a home supervisor, I mean, that he coordinates, and it's not only something that we give but also something that we get. Especially if some of us try to sign these MoUs after negotiations even of 2-3 years, you know, it just somehow doesn't get to an end, and even if you signed it, I expected the home supervisor would come and tell me "Based on these MoUs, this is the information you will get from me, daily, weekly, monthly, this is the contact person, etc, etc. And this is what I request from you, when you go locally, I'll send somebody". Basically a lot of these countries say: "Well, you know, it was a nice visit to your country, it was a great dinner, and if you have a problem, you just give me a call." It was the first MoU from our side and, you know, I expected definitely much more variety of concrete steps that the home supervisor is going to offer us. But going back once more, if concrete steps are concerned, all of these issues that we have, especially regarding credit boom, regarding Euroization, regarding leasing, etc, I think it would be really wise to put together data and say: "If you do this one, then that's what is going to happen". Definitely, policy coordination among the supervisors is necessary. Once more: the same problems I am facing today, were probably faced by Mr. Isarescu two or three years ago, and may be will be faced by somebody else in a couple of months…Cooperation means a lot to all of us.

Thank you very much for your attention.

* Radovan Jelasić, Governor, National Bank of Serbia

HOW TO WORK TOGETHER EVEN BETTER IN THE FUTURE?

Kemal Kozarić *

Ladies and Gentlemen,
Dear Colleagues,

It is a great pleasure to be here to work together toward better common future.

Our common long-term goal is a full membership in the European Economic and Monetary Union. All the countries presented here are heading the same way to the Europe: some move faster and are much ahead, while others are just to enter the complex process of fulfilling criteria and reaching European standards.

Central banks, as sole monetary authorities having primer task in maintaining price and financial stability in their country, are also playing important role in European integration processes and regional cooperation.

Our region shares common goals and common trends, so it is natural to share and exchange experiences. Countries such as Greece, or Romania and Bulgaria expressed readiness to help to the potential candidate countries to avoid mistake and achieve goals. Central banks in the region are ready to cooperate in many projects that are of great importance for the economy - within the country and within the region. We can point out some issues and trends in the region that are of common interest and where we can and should establish closer cooperation:

1. Monetary policy - how to choose the best model for managing monetary policy in the country?

As we are all aware there is no universal model of monetary policy in contemporary world. We had discussed earlier whether there is a "right" model and agreed that there is no permanent solution and each country is building its own way of monetary policy depending on specific economic and social environment. Here we have different models: targeted inflation, free floating, and currency board. We see that Serbia and Albania are planning to introduce new models. For the future monetary policies in our countries it is, therefore, very helpful to exchange experience on each new model introduced and new practice.

2. Banking supervision - is the second issue of great importance for the region. Financial systems are developing. Financial institutions are operating across borders integrating markets but also posing new risks. This requires stronger cooperation between supervisory authorities and cross-border supervision. It is even more important for this region, since banking systems went through similar transition processes and currently most of the same foreign banks that took large share of banking sectors in our countries are operating throughout the region.

3. This takes us to next important subject of our cooperation - Credit growth. We are all faced with the same trends. We can discuss if there is an optimum credit growth, is it too high or too low, how is it affecting economy in our countries and what role central banks can play to control credit growth? Since it is an important issue, some future regional conference could have special topic on credit growth in the region and how to deal with it.

4. Payment systems in the region are also a topic for cooperation, especially for countries that share common payment transactions. Therefore the idea of the regional payment system initiated by the

National Bank of Serbia is very good one and should be supported by central banks here.

Central bank of Bosnia and Herzegovina has reformed payment system, established registers for legal entities and private persons. It is successfully operating the RTGS and the Gyro Clearing, and the payment system is fully in compliance with the Basel Core principles for systematically important payment systems. We are ready to share the knowledge on our experience with payment system reforms and improvements.

5. The relationship with international financial institutions and the European Central bank is in the focus of our regional cooperation. Having on mind our common European goal in recent years, it becomes very important for our central banks to establish in early phase of integration closer links with the European Central Bank and the National Central banks from the Euro system.

The Central Bank of Bosnia and Herzegovina will start a "need assessment project" with the European Central Bank next year. This will be long-term cooperation, aimed to improve standards of our Central Bank to the level of central banks from the European system of central banks. The Central Bank of Bosnia and Herzegovina is ready to assist other central banks of the region in their process of cooperation with the European Central Bank.

6. And finally education is the key element of our cooperation. Exchange of experience and knowledge is the best way to work together. However, it has to be more frequent and on a regular basis if we want to have real effects.

The Central Bank of Bosnia and Herzegovina is open to discuss and establish cooperation over those listed and all other issues that are of common interest for the central banks in the region.

I believe we already have basis for good cooperation: there is a willingness and readiness to work together! Now it is necessary to establish more permanent ways through which we can establish such cooperation:

1. One possibility is to have Regional annual conferences hosted each time by other central bank, covering one specific subject that is of major regional interest. Such conference would provide space for academics and central bankers to exchange working papers, ideas and open different aspects of the issue within round tables. The Central Bank of Bosnia and Herzegovina is already planning to host a similar conference next year.

2. The other possibility is to establish such cooperation though Governor's Club of Central Banks from Central Asia, Black Sea and Balkan countries, where our region is included. As I will be deputy president next two years, I will give my efforts to put on the agenda all topics that are of special interest for our regional central banks.

It is clear that stability and prosperity is what this region needs in order to enter the European Union, and only strong mutual cooperation can help to achieve it.

* Kemal Kozarić, Governor, Central Bank of Bosnia and Herzegovina

HOW TO WORK TOGETHER EVEN BETTER IN THE FUTURE?

*Ljubisa Krgović **

Ladies and gentlemen, distinguished participants, dear colleagues. First of all, I wish to thank the Bank of Albania and Governor Fullani for the opportunity to participate in such a well organized and meaningful conference.

In the last few decades, the financial markets and institutions have experienced a radical transformation and sudden expansion, which was induced by a general trend of deregulation, liberalization, globalization, and by the progress in computer technologies.

And what is especially important for us, the so called four Cs (4C): concentration, conglomeration, competitiveness and complexity.

International capital flows have intensified, markets have developed new and sophisticated instruments, while the velocity of performing financial transaction has drastically accelerated, significantly reducing financial transaction costs.

The level of the mutual dependence of financial institutions from different countries has increased drastically. The development of the financial sector, in the last decade was much faster than the development of the real sector, and financial assets grew faster than GDP of the developed countries. These trends led to a set of positive effects, in particular to a better allocation of capital, and a reduction in expenses. However, they were also followed by occasional and very severe financial crises, which were often caused by the movements of short-term speculative capital. These crises were not only a threat to individual economies, but also represented a threat to the global economy.

Such trends led to real challenges and also caused significant costs to the economic policy makers, for they needed to, in a timely manner, identify them and assess properly all of the risks that they bore. They also left significant trails on both the national and international banking system. Simultaneously, the above mentioned structural changes occurred much faster than any changes in the supervisory and regulatory framework.

It is inevitable that these trends will continue in the future, and that the South East European countries, as yet still small, cannot make a large influence on such trends, but can only adjust to them, and try to make use of their advantages by minimizing the disadvantages at the same time. The question now is how we can better cooperate in the future, in order to use these advantages for our mutual benefit.

The first excellent example of our joint cooperation is a conference of this type, which should be held more frequently in the future, and which should enable us to discuss the challenges of globalization on financial stability, and to find the answers as to how we can work together to prevent the crises from appearing. The problems that we are facing are similar; different strategies may have different level of effectiveness, while suggestions from countries that are more advanced in the process of transition may be particularly beneficial.

The foreign exchange rate policy is an excellent example of how most countries in this region have applied completely different strategies with different results. Bosnia and Bulgaria applied a Currency Board regime, Greece is a member of the European Monetary Union, Romania and Serbia have the policy of managed fluctuation, Albania applied the policy of free fluctuation of FX rate, while Montenegro and Kosovo applied a unilateral euroization.

Supervisory processes will face a great number of challenges in the near future. Some of the most important are related to the dynamic growth in banking activity, the increase in foreign investments in the banking sector, and the higher level of globalization and financial markets integration. The cross-border activities of banks are becoming more important, as well as the supervision of banks on a consolidated basis. Therefore, the exchange of supervisory information on individual banks is becoming extremely important since the banks, which are members of the same banking groups, perform their operations in many countries of this region.

Capital markets in many countries of this region are undeveloped and superficial, and without having any real impact on real sector financing, without adequate control mechanisms, and with current trade often based on "insider" information. The starting of the project of the connection of exchanges in this region should be continued, and more intensified in the future, in order to become connected to the European capital market, while at the same time changing the regulatory framework to remove deficiencies and strengthen the institutional infrastructure.

The establishment of a free trade zone in South East Europe is of great importance for both the intensification of mutual exchange and EU integration. The EU message to the countries from this region is clear: if we cannot trade mutually using the principles of free trade on which the EU economy is based, we do not have anything to look for in the EU. A unified approach from this region- with the active assistance of Greece as an EU member, and Romania and Bulgaria who will become members next year -may bring this region closer to the EU. The harmonization of financial systems and legislation with the rules of the EU, on which we should mutually work, is essential.

Concretely, I would like to suggest some areas, which I think are particularly interesting for the development of regional cooperation, whereas its forms and shapes are various and additional ones that may be developed through the process of actual cooperation.

Firstly, as has been mentioned many times before
- Promotion of the host regulator position -

Home-host relationships of supervisory bodies are becoming an increasingly important factor of the efficient regulation of the worlds' financial sector. The interests of home and host regulator are sometimes burdened with short term views, producing a particular conflict of interest. Clearly, the interest of the home supervisor in some cases may be viewed as a desire to strengthen risk management concentration at the level of the parent bank while the interest of the host supervisor is to strengthen local management in order to manage risks efficiently. Another example of different perceptions is the exchange of data, which is often viewed as a one-way exchange by a home supervisor. I could also add to this a different perception with regard to the systemic importance of banks, etc.

Since our countries are host regulators in relation to the same home countries, the mutual cooperation and development of a joint opinion in relation to home supervisors leads to a decrease in differences in interests, and contributes to the strengthening of home and host relationships, the quality of supervision, and finally to stability in the region.

Secondly,
- Unification of financial system supervision -

The concentration of supervisory activities in one regulatory body is a noted trend which provides for numerous advantages in small countries in transition, in particular from a consolidated supervision standpoint. If we advance more in this area in a short period of time, we will be able to unify and more efficiently use our capacities in supervision of particular areas where we all face a deficit of resources (supervision of IT, supervision of market risk, granting of approvals for IRB approaches, etc.).

Thirdly,
- Unification of database and analytical and methodological framework and horizons -

Risk transfers between our banks are becoming more frequent, in order to present a better risk profile. Individual groups of borrowers that act regionally have a higher concentration of risk, and cross border lending becomes more evident. These are challenges that all supervisors of the financial system in the region face, while looking for a common response. It may be provided through a more intensive exchange of information or the unification of databases.

Methodologies of stress testing and macro economic modeling would gain in quality if they would include any real and potential change in the region in overall economic movements, as well as the analysis of changes in the financial sector of each country individually.

Fourthly,
- Regulation and supervision of capital markets -

There have been more and more companies stock listed, and there has been interest from neighboring countries in their shares. External trade exchange in the region has become more intensified, requiring the creation of a large number of standardized stock exchange products. The protection of investors requires mutual efforts in the standardization of regulation and supervision of capital markets.

Each of these markets is individually not deep and is insufficiently liquid, but brought together, they all may create much more and more interesting material that will additionally promote external trade exchange (for example, securitization, etc).

Fifth,
- Common forms of attracting investors -

The cooperation in the area of the creation and development of investment, mutual and other funds, rating agencies and other forms that may lead to attracting investments throughout the region, seems to be a particularly interesting area of common cooperation.

Finally, in both the recent and distant past this region was often characterized by hostilities, and by numerous episodes of political instability. A clear downtrend in political risk means a greater inflow of foreign investments and faster economic growth, and Central Banks should give an example on how collaboration and cooperation are essential in this era of globalization.

Maybe, I have mentioned some ideas that have been heard before but to me that means we are thinking in the same way and that real regional cooperation has a good chance of success.

Thank you!

* Ljubisa Krgović, Governor, Central Bank of Montenegro

HOW TO WORK TOGETHER EVEN BETTER IN THE FUTURE?

*Michel Svetchine**

Thank you very much Mr. Governor!

I will not elaborate long, since a lot of clever statements have already been made. If you allow me, I will just provide you with some personal and very practical comments about regional cooperation.

What could be the structure of the banking sector in our region at the end of this decade?

First, we will certainly have some large European international banks operating in the Balkan area. As we already discussed together during this conference, such situation raises the issue of the asymmetric relationships between home and host supervisors. As we all know, host supervisors could consider being in a weak situation compared to most of the home supervisors. No doubt that it is a difficult issue to address. Nevertheless, allow me to make one suggestion. Why, from time to time, all the host supervisors of a large EU bank operating in the Balkan region could not visit together the home supervisor and address him their common issues. Without doing so, and meeting home supervisors on an individual basis, the host supervisors will always be in a weak situation.

Second, aside from these large EU international banks, we will still have some local banks operating in the different countries of the region. At least, I hope so.

Of course, every national supervisor could state: “Oh, I keep this task for my own and perform my job alone, since I am the domestic supervisor and the only Authority responsible for”. That is true, but since the main problems faced by domestic banks are of the same kind among the region, why not having more operational exchange of personnel? We as Central Banking Authority of Kosovo have experienced such cooperation with Supervisors from Albania. It has been very fruitful for both parties to benefit from the experience of its neighbour’s examiners.

Third, and last, we will have also regional banks. I hope the banking sector in the Balkan will include more and more regional banks. By regional banks, I have in mind institutions in hands of shareholders coming from the region (that is from former Yugoslavia, from Italy, from Turkey, from Greece), but institutions which are not at the same size as the main players in the EU area.

To supervise successfully these different categories of institutions, and apart from the important recommendations which have been made during this interesting conference – in particular to sign memoranda, to set up regional meetings- all proposals which are more than useful, I would like to make an additional suggestion based on one of our recent experience.

Last month, with the support of the Slovenian Banker Association, the CBAK organised in Pristina a training session for its banking examiners on the topic: “How to assess credit risk?” Usually, in such training sessions, the trainers belong to international financial institutions; they are coming with an extensive experience acquired in large financial centres. Their study cases are mostly based on complex and sophisticated operations and on internal proceedings in use in these large international financial centres. Nevertheless, we all know that the way banking activities are performed in New York, Paris, Frankfurt or London is not exactly the same as in most of the countries of the Balkans. As a result, we have asked to our Slovene trainers to come with actual and real study cases based on their local banking experiences. No need to emphasize that our examiners fully benefited from examples very closed to the cases there are dealing with in the course of the on-site inspections performed in banks operating in Kosovo. No need also to mention that communication is easy with regional trainers.

What about developing more these kinds of training sessions?

Before giving the floor to my colleague from Bosnia and Herzegovina, I would like to thank once more Governor Fullani and Bank of Albania for their very kind, very effective and very professional welcoming.

Thank you very much all of you.

* Michel Svetchine, Managing Director, Central Banking Authority of Kosovo

HOW TO WORK TOGETHER EVEN BETTER IN THE FUTURE?

*Petar Goshev**

Dear governors,
Dear participants,
Dear ladies and gentleman,

Let me express my gratitude for the invitation to give this speech. In addition, I would like to congratulate Governor Fullani for the excellent organization of the conference.

In these two days we had an opportunity to hear very interesting discussions, including those regarding financial stability, role of financial supervision in maintaining and improving financial stability, and interactions between the monetary policy and financial stability. As the topic of the last Panel discussion is " How to work together even better in the future?", I would like to provoke discussions regarding the challenges that our financial systems are facing nowadays, and of course, how to better cooperate and why we actually need cooperation in this region.

I think, all of us agree that financial and banking systems in the countries of our region have undergone a similar, if not the same, process of numerous reforms. I believe that the banking systems have very similar structure, characteristics, and therefore, to a great extent, we are all facing similar challenges and policy issues. Furthermore, there is a consensus in all of our countries with respect to the EU orientation and integration.

What are the main issues and challenges of the financial system of the Republic of Macedonia today, which I believe are very similar to those in other countries in the region?

1. Relatively simple structure of the financial systems and relatively high concentration in the financial and banking system. In the Republic of Macedonia, for example, the financial system has a very simple structure, where deposit-taking institutions dominate, covering almost 91% of the whole financial sector's assets. The rest of the financial sector's assets belongs to the insurance sector with a share of 8.7 percent, and leasing companies and brokerage houses with a share of only 0.3 percent.

2. The development of the financial markets in the Republic of Macedonia is determined by interaction of two groups of factors:

- Internal factors, including completion of the privatization process and consolidation of companies ownership structure, reform and opening of the financial system, macroeconomic stability as well as expectations connected to the future convergence to the EU, having in mind the achieved candidate country status for accession in EU.
- External factors, such as the financial deregulation and low domicile yields that encourage European banks to expand their business in transition countries.

Financial markets in the Republic of Macedonia are on the track of fast development. For example, in the first half of 2006 the turnover on the Macedonian Stock Exchange increased by 46 percent compared to the same period of 2005. The share of foreign investors on the demand side was 36 percent. At the same time, the value of the stock exchange index increased by 58 percent. In addition, government securities market continued to develop, both regarding the outstanding amount and increasing bond maturity.

Strategy to develop local financial markets must revolve around mitigating risks injected in financial system as the market develops and becomes more sophisticated. The liberalization of financial transactions and capital flows aimed at deepening capital markets, inevitably increase risks that often result in financial distress and crisis.

3. The banking sector is characterized by certain concentration and relatively high foreign presence. In the Republic of Macedonia, the three largest banks have a share in the total assets and in the total deposits of 65 percent, and 72 percent, respectively. In spite of the concentration on the market, bank profitability and efficiency have improved in the recent years. Two of the largest banks that are of systemic importance for the country are subsidiaries of foreign banks from our region, and slightly more than half of the banking sector is in foreign ownership. Most of these foreign banks are also present in the banking sectors of the other countries in the region through branches and subsidiaries. Therefore, access to information about the performance of the foreign banks is crucial for the stability of our banking systems.

4. The level of financial intermediation, as the key indicator of banks' relative importance to the total economic activity in the country, although improving, is still low. For the Macedonian banking sector this indicator, measured as the ratio of banks' overall assets, gross-credits and deposits to GDP equals 52.8 percent, 28.0 percent and 37.5 percent, respectively.

5. Fast credit growth has been recorded in the recent years. It was encouraged by the economic growth, increase in banks' deposits and the trend of interest rates decline. However, unlike other countries in the region, the credit growth in the Republic of Macedonia of approximately 20-25% is still moderate and does not raise serious concerns about macroeconomic and financial stability. At the same time credit risk, as a dominant risk in the overall risk profile of the Macedonian banks is continuing to decrease.

The common nature of these issues in our countries guides us towards having increased cooperation. I believe there are at least two practical issues for which we could start building a regional perspective:

1. Host-host supervisory cooperation and
2. Financial stability analysis.

1. Currently there is relatively well-established information sharing and cooperation between the home country supervisors of the parent bank and the different host country supervisors of the subsidiaries, particularly if there is a formal Memoranda of Understanding signed between the home and host supervisors. So far, the National Bank of the Republic of Macedonia has signed such Memoranda with the central banks of Albania, Slovenia, Bulgaria and Russia, and intends to do it with other countries as well. However, it is my observation that there is little or no information sharing and cooperation among host country supervisors.

Why host-host cooperation?

One of the greatest challenges in the cooperation among supervisors is in the field of information-sharing, supervisory control and undertaking corrective measures with respect to subsidiaries and branches of foreign banks. Are subsidiaries and especially branches of foreign banks of the same relevance for the banking sector of the home and of the host country? The issue of effective cooperation arises even with a greater importance in small host countries with small banking sectors, like ours, where the undertakings of foreign banks are relatively small compared to their parent bank and therefore they are considered to have no significant effect on the parent banks, overall banking group or financial conglomerate. Consequently, the interest of the home country supervisors for these undertakings may be minor, which makes cooperation between home and host supervisors more difficult, especially the access of host supervisors to adequate information on the parent bank. On the other hand, poor performance of the subsidiary may pose a threat to the safety and soundness of the host country's banking sector.

In many of our countries, undertakings of the same foreign parent banks are present. In many of the countries, these undertakings account for a major part of the overall banking sector's assets, but at the same time they account for an insignificant share of the parent bank's assets. One should agree that there is no doubt about the importance of host-host cooperation in respect to these banks.

2. Financial stability analysis is a relatively new function for many central banks, as well as for the National Bank of the Republic of Macedonia. Although this activity is not explicitly stated as a central bank function in a number of central bank laws, recently many central banks have started conducting detailed financial stability analysis. There are several aspects in which financial stability, especially stability of the banking system, is important for the conduct of the monetary policy in the Republic of Macedonia. I will mention few of them:

- The sound banking system could limit the needs for liquidity injection under lender of last resort. So, there would be no risk for having extra liquidity in the system that could endanger the exchange rate stability and price stability in the economy, as a final monetary policy objective;
- Highly concentrated banking system could induce potential risks for financial instability and consequently may require a reaction by the Central bank, related to the potential "moral hazard" behaviour of the big banks and their attitude of "too big to fail". This may put the central bank in a position to choose between achieving monetary policy objectives and financial stability objectives;
- The sound banking system, with a credit portfolio of good quality, is usually more responsive to monetary policy changes and therefore it contributes directly to the achievement of the monetary policy goals. In this view, we are registering positive developments in the Macedonian banking system – a gradual decline of the share of non-performing loans (now falling bellow 10 percent) is accompanied by some improvements in the interest rates transmission channel.

Successful performance with respect to the financial stability issues implies data and information accessibility for all financial system segments, as well as opportunity to compile data from several institutions in the country with competencies in financial stability. In this context, the National Bank of the Republic of Macedonia is initiating formal establishment of an inter-institutional body in the country, consisted of representatives of each regulatory and financial supervisory body, which will on a regular base discuss the developments in the different segments of the financial systems and will discuss and initiate changes in the regulation. The idea is to create more consistent and efficient regulatory and institutional framework. Furthermore, since financial systems are becoming to a greater extent complex and inter-connected (both among sectors and internationally), they are much more vulnerable to shocks that reduce the effectiveness of their operation and that may cause financial instability. In this view, cooperation with institutions from abroad in order to share knowledge and practical experience in the field of financial stability analysis is vital.

What may the actual mode of cooperation in the field of financial stability analysis be?

One of the main products of the financial stability analysis is publishing of an annual Report on the financial stability that the central banks especially from EU countries issue on a regular base. The National Bank of the Republic of Macedonia will start with issuing such report in 2007. It will be a source of relevant information on the degree of stability of the banking and the financial system in the Republic of Macedonia. The Report will rely primarily on the financial soundness indicators calculated in accordance to the relevant IMF Compilation Guide. What is important, from a regional point of view, is that we prepare and publish such a report using the same methodology. This would provide comparable data on the functioning, the stability and the risk degree of the banking and financial systems in the countries of the region. At the same time, it will promote the banking and financial systems transparency and contribute to the strengthening of the discipline of the market participants. Improved financial stability in the region will make our banking and financial sector more appealing to foreign investors.

Regarding the cooperation on the financial markets, I would like to point out that the Macedonian stock exchange is a member of FEAS (federation of European Asian Stock Exchanges). It has signed Memorandum of Cooperation with the stock exchanges in

Ljubljana, Athens, Belgrade, Sofia, Zagreb and Vienna. In general, the cooperation with the other stock exchanges should facilitate access to capital for those who need it in the region. In addition, the cooperation with the stock exchange in Vienna is also expected to accelerate the process of harmonization of the Macedonian legislation in this area with the European standards.

Ladies and Gentlemen,

Financial sector issues are of great complexity and the room for cooperation is huge. The issues I mentioned are only some of the many that we have to discuss on a regular basis.

Thank you very much for your attention.

* Petar Goshev, Governor, National Bank of the Republic of Macedonia

Published by:
Bank of Albania
Sheshi "Skënderbej", Nr.1, Tirana.
Tel : 355-4-222230; 235568; 235569;
Fax : 355-4-223558
public@bankofalbania.org

Printed by: Printing House of the Bank of Albania
Printed in: 1000 copies