

BANK OF ALBANIA: A DECADE LATER

1. INSTEAD OF A PROLOGUE

We are leaving behind the 12th year of transition. Like many other institutions, Bank of Albania, having its numerous responsibilities, has been an active witness and actor of the difficult process of economic, political and social transformation of the country, and so being aware of the achievements and failures of this process. It is not my intention trying to reproduce passages or parts of each event that is related to the Bank of Albania's activity during this decade, for this would take up a lot of your time. Nevertheless, what I would like to focus on, are the key episodes considered to have contributed most to the political and institutional development of Bank of Albania.

2. BANK OF ALBANIA, ITS LEGAL FRAMEWORK AND INSTITUTIONAL DEVELOPMENT

The system of two-tier banks was officially established when the Parliament approved Law no 7559 "On the Bank of Albania" dated April 22, 1992 and Law no 7560 "On the Banking System of Albania".

The law "On the Bank of Albania" acknowledges this bank the authority to formulate and implement the monetary policy, to regulate and supervise the banking system including licensing of new commercial banks, to issue domestic currency, to formulate and regulate the exchange rate policies of the country, etc.

On the other hand, the law cares to vest this new born institution with a certain degree of independence, specifying long office term for the governor, the role of the Supervisory Council, the criteria for the election of its member, etc.

Despite the initial difficulties, which somehow were justified by the low professional level and unsubstantial inheritance in central banking business, as well as in the institutional management in general, the development of Bank of Albania over the last ten years of its existence is tangible in every aspect. Legal and institutional framework of the bank mark special achievements in this respect.

As years have gone by, the legal and regulative grounds have improved significantly. At present, the activity of the Bank of Albania is based on the article 161 of the Constitution of the Republic of Albania, on Law no 8269 dated December 23, 1997 as well as on a wide regulatory package covering specific issues related to supervision of banking system, transparency, licensing of banks and non banks, operational activity, management of

monetary and material resources, etc. Also, Bank of Albania is legally granted the right to independently formulate and implement the monetary policy of the country with the final objective of achieving and maintaining price stability.

As I mentioned before, the institutional aspect of the bank has progressed remarkably. Main attention was given to building a strong central bank with a high degree of political and economic independence. The current law of the Bank of Albania embodies advanced standards in terms of:

- clearly defining the relationship between Bank of Albania and state budget. We claim that over the medium term, direct credit to government from Bank of Albania will be legally prohibited in compliance also with the requirements of our future membership in EU. As of now, the bank finances the budget deficit in limited amounts;
- unambiguously defining the exclusivity that Bank of Albania has on formulating and implementing the monetary policy of the country. In the context of achieving the final objective, the Supervisory Council has the authority to assess and decide independently on the reference interest rates in the economy.
- appointing, setting the office terms, determining cases of probation for members of Supervisory Council, the governor and other administrators of Bank of Albania;

Yet, the last ten year experience has encountered cases when the level of independence legally known to the Bank of Albania was “treaded upon”, thus reducing its real independence to levels far from advanced standards. Also, I believe I am not overdoing it when I say that the professional and intellectual capacity of the bank has increased over the years. Today, many regulations providing arrangements on managing foreign reserves, supervision, foreign debt, transparency, accountability, market operations, financial administration, security, etc. exist in the central bank. Furthermore, deeper analyses of economic and financial development of the country have lead to more decent judgments and decisions, thus increasing public appreciation of Bank of Albania.

The Bank has already constructed a satisfying level of transparency converting itself to an institution open to every interested party. Although of a fragile framework, the level of transparency offered by the Bank of Albania encompasses all aspects of central banking starting from publication of its decisions to their explanation for the public. Furthermore, Bank of Albania has employed a variety of ways to accomplish transparency ranging from classic ones, such as publications of the Bank of Albania, to the most fashionable ones, such as updated information on Internet.

The accountability of Bank of Albania has improved. Recent disputes and discussions in Parliament, as a reaction to the Bank's Annual Reports, are a good indicator of the increasing problems raised and the explanatory power of these reports, hence raising awareness of all members of Parliament to these. However, bank of Albania does not cherish the illusion that every thing is perfect. Moreover she is aware that there is still much more to do with regard to implementing the good international practices and standards. Greater efforts and commitment is required in the future, especially in light of the challenges that the country faces. We have already established that the Central European Bank will be the model for the future institutional framework of Bank of Albania, while other economic and political policy objectives demand for qualitative steps towards professionalism.

3. BANK OF ALBANIA: MONETARY POLICY AND PRICE STABILITY.

The dispute on what the monetary policy can or cannot do is still ongoing. One opinion is that besides price stability, monetary policy should also target employment and economic growth of the country. The alternative view focuses only on price stability. Nevertheless, both views converge on the suggestion that monetary policy serves economic growth and employment only if price stability is maintained. Accordingly, price stability is a necessary condition to maintain growth and therefore the only apposite objective of monetary policy.

In case of Albania, the debate was solved in favour of price stability, which is with no doubt defined as the final objective of Bank of Albania's monetary policy. Monetary policy, being a set of decisions and corrective measures in response to a certain given condition of the economy, aimed at having control on money supply.

Since the very beginning, it was decided on a clear monetary targeting regime. The monetary base was chosen as a nominal anchor and its growth would be supervised by implementing certain performance criteria on Bank of Albania's assets. There were two operational instruments to control money: credit limitations, and interest rate¹ for lek deposits placed with state owned banks.

Following July 1992 a flexible exchange rate regime was adopted and current account transactions were fully liberalized. The critical situation of the foreign exchange reserves did not allow an active participation of the Bank of Albania, and in addition, the adoption of the flexible exchange rate regime was expected to act as an automatic stabilizer of the Balance of Payments accounts, the dollarization level being quite high at the moment.

¹ Interest rate for 12 month lek deposits was increased from 2-3 per cent (annual base) to 28 per cent.

These measures, accompanied by a tight monetary policy and the liberalization of the bulk of consumer prices resulted in a sharp moderation of the prevailing macroeconomic disorder. The very high inflation levels of 1991-1992 started to fall and the output contraction came to a halt. The consolidation of these achievements continued with fast rhythms during the 1993-1995 period.

The raise of the interest rates and the control placed upon the credit for the economy brought to a halt the monetary hemorrhage and caused the consumer price index to be a mere 6% at the end of 1995.

The subsequent period, the low effectiveness of the banking system being a major responsible, corresponds to the development and bankruptcy of the pyramid schemes. The high interest rates offered by them totally replaced the interest rates offered by the banking system causing the ineffectiveness of the monetary policy. This brought a high level deposits to the pyramidal schemes, while their investment in production or valuable assets were minimal. The lack of capacity of the pyramid schemes to manage and invest the deposits, caused their channeling to the commercial banks, and in turn, an increase in banks reserves and the investment of these reserves in government bonds. As a result, at the end of 1996, the inflation turned out to be three times higher than the previous year, reflecting the increase of the banking sector lending to the government.

The consequences of the pyramid schemes bankruptcy to the economy were wide and their economic bill quite a large one. At the end of 1997 the output fall was accompanied by higher inflation, higher unemployment and deterioration of the international position of the country. Nevertheless, the raise of the interest rates to almost 32% started to give its results. The results of the monetary and fiscal policy became more tangible at the end of 1998, time when, as a part of the Emergency Program After the Conflict, certain quantitative restrictions were imposed, namely those regarding the increase of the net foreign exchange reserves, the level of the credit extended by the Bank of Albania to the government and the level of the credit extended by the banking sector to the government.

The 1999-2000 period registered unusual inflation rates for an economy like that of Albania. Although during 1999 Albania hosted the almost biblical exodus from Kosovo, the inflation remained at reasonably low levels. From that period right to the end of 2000 the interest rate fell continuously, although in real terms it remained high. On the other hand, the reaction of the market has been relatively slow and this has been reflected even in the large difference between the minimal deposit interest rates and the yield of treasury bonds. In these conditions, while implementing the abolition of the lower limits for the time deposits, the Bank of Albania entered an unexplored path, that of the monetary control through the market.

Now we can state that we have a two-year experience of controlling money supply through the open market operations. As latest development have demonstrated, the interest rate for the repurchase agreements has assumed a determining role for the other interest rates in the economy, demonstrating a higher effectiveness of the monetary transmission mechanism. This of course illustrates an increase of the capacities of the Bank of Albania in the political decision-making process. Subsequently, as a natural reflection of these developments, the Bank of Albania has adopted an operational program, which includes weekly auctions of repurchasing agreements, accompanied by other facilities, such as one-day deposits or loans. All these developments have caused the increase of the number of transactions as well as that of the participants in the financial market.

The increase in the effectiveness of the monetary policy combined with several other factors, such the fiscal consolidation of the last 2-3 years and the privatization of a couple of large state-owned enterprises, can be said to have played a crucial role in the macroeconomic consolidation of the country, exceptionally in the time span between the last quarters of 1998 and 2001. Throughout this period, the real growth has been at high levels such as 7 - 8 %, while the annual inflation has averaged a successful 1.4 %. The unemployment level as well as the international position of the country has also improved.

Regarding the monetary policy, its contribution has clearly been materialized in the continuous achievement of the three quantitative objectives part of the monetary program of the Bank of Albania.

An important achievement of these years is the revival of the loan-supplying activity of the banking system. As during 2001, the loan to the economy has increased with high rates during the first three quarters of this year. In the first eight months of 2002 the loan to the economy has amounted to 38 billion lek, while the expectation for the end of the year amounts to 58 billion lek, that means 17,5 billion more than the previous year and 8 billion more than the total loan extended throughout the 1993-1999 period.

In addition to the monetary policy, the Bank of Albania is responsible for the design and implementation of the foreign exchange policy. At the time being, the Bank of Albania has adopted a fully flexible rate regime, where the exchange rate is determined by the market forces. Reflecting the positive macroeconomic developments, during the last 5 years the exchange rate has been relatively stable, fluctuating around the level of Lek 140 per US dollar. The foreign exchange reserves have increased to 826 million USD at the end of November 2002, almost three times higher than the 309 million USD of the end of 1997.

Anyway, still it cannot be said that the monetary control is perfect. This fact is related to the state of development of the markets in general, where I can mention the dominating position of the Savings Bank and the existence of the informal market in the economy. This imperfect control, along with different shocks from the supply side such as the energy crisis of the last two years and the new composition of the consumer price basket, has caused an increase of the inflation rate, increasing the concerns for the realization of the objective that the Bank set for 2002. Still, based on the last expectations of the Bank of Albania we believe that in a similar way to the last year it will be possible that the inflation rate at the end of the year result to approximately 4%, near the upper band of the target for 2002.

4. BANK OF ALBANIA: BANKING SYSTEM AND FINANCIAL STABILITY OF THE COUNTRY

The banking system of Albania is relatively young. The notion and existence of the commercial banking first came into being in the spring of 1992, even though before that the National Bank (Bank of State) was carrying out functions similar to those of a commercial bank.

The changes of the financial sector, which at that time was identified as the banking system itself, were an important part of the reforms that started in 1992. At the same time, the authorities were engaged in the creation of a suitable environment for foreign capital investment in the commercial banking activity, which resulted in the creation, after one year, of the first two banks with private capital participation; the Italian – Albanian bank and the Arabian – Albanian Islamic Bank.

Despite the developments mentioned above, until mid-1990s and a bit further, the banking system continued to represent an underdeveloped financial segment, with an absolute domination of the public sector and in the existence of a very poor infrastructure, manifesting in this way inadequate bank services. This period also relates to a rapid increase of the bad credit portfolio, which, under the circumstances of an ineffective and far-from-international-standards supervision, lacking tradition and of course due to incapability and other various subjective reasons, created huge problems in the financial situation for the three state banks.

In this situation, starting from the middle of 1997, the authorities at the time reached to a conclusion that besides decisions in monetary policy, in order to create an efficient and secure banking system, it was necessary to undertake other reforms starting from the liquidation of any 'insolvent' bank, to possible changes in legislation, increase of supervising and licensing capacities and so on.

Some of the first steps were the decision to liquidate the Agrarian Commercial Bank, the establishment of the Bad Assets Resolution Trust, the attempts to privatize the National Commercial Bank and the Savings Bank etc. In the same way, after the new law "On banks in the Republic of Albania" was passed, the licensing package went through some modifications, like the increase of the amount of required capital and the abolition of discriminating foreign investors. In addition to the universal banking certification, Bank of Albania extended the focus of her licensing activities with the Savings & Loan Associations and also with other nonbank financial institutions.

Over the years, with the consolidation of the political stability, the strengthening of the public order and also a quick restoration of the macroeconomic equilibrium, it is believed that the attraction for foreign capital has increased and it is becoming more appealing to the banking business in Albania. Actually, the Albanian banking system consists of 14 commercial banks, which is two times more than the number at the end of 1996. A good reason for that is the fact that our local business has become more interested in the area of commercial banking. Now the Bank of Albania is analyzing the first applications of Albanian businesspersons to be permitted to operate banking activities in Albania with an entire local capital. Furthermore, according to the latest data², assets of the banking system are estimated to be nearly 53 percent of the total production compared to 45 percent at the end of 1998.

In addition to its extension, the banking system in the last years has made progress even in terms of the augmentation of the financial position. To better concrete the achievements, it is sufficient to briefly refer to the data in 2002. The position of the banking system looks good and there is a tendency of improvement almost in all indicators. It is the fourth year that banking system shows positive financial results. Realized profit during the first three quarters amounts to Lek 2.8 billion compared to a loss of Lek 3.2 billion at the end of 1998.

Referring again to year 1998, assets of the banking system increased 59 percent or in absolute value of Lek 122 billion. A significant impact on asset growth had private and joint-venture banks. The growth of these banks' assets, in comparison to year 1998, totals Lek 120 billion which is a result of the increased credibility of these banks, an increasing number of clients coming to them, and also owing to the extension of their activities in other cities.

At the end of September 2002, the balance of non-performing loans (gross) was only 6.4 percent of the total portfolio compared to 32.7 percent in 1999.

² Quarter III, 2002.

The ratio of capital adequacy for the banking system is 28.7 percent, while capitalization is high even in the particular groups of banks. In these high ratios of capital adequacy (minimum required rate is 12 percent), along with high levels of capital, has been significantly affected by the asset structure of the banking system as classified according to its risk. The banking system continues to evidence a high level of zero-risk or low risk investments in assets. Any change in asset structure in favor of high-risk assets would significantly improve the ratio and at the same time affect earnings growth rate – without omitting the impact on the development of different sectors of the economy – via higher lending.

Many indicators that are considered as liquidity measures are shown at satisfying levels. A very low ratio of the net credit balance to total assets (10.6 percent), the ratio of net credit balance to average deposits (12.8 percent), and also the fact that 49.8 percent of total credits are short-term loans, support the above argument.

In conclusion, I should stress that, despite the improvement of the indicators, reforms in the banking system seems not to be taking place at a satisfying pace. This assessment relates to the delay of the privatization process of Savings Bank, and also the need to replace the owner of National Commercial Bank. Both banks represent the largest banks in the banking system and problems that concern their ownership, unfortunately, will affect the performance of reforms in the banking system and the progress in its activities. These issues require a particular attention from the respective authorities. At the same time, the approval of the law on deposit insurance is a further positive step with the view to assure depositors and help increase credibility in the banking system.

5. A FEW WORDS ABOUT CHALLENGES IN THE SECOND DECADE

To be realistic, I have to say that experience of the Bank of Albania increases the security of her orientation in the future. Also, we have to admit that the global environment we are living in makes the perception of future developments somehow easier. However, without trying to go beyond the limits of modesty, which I am kindly allowed by those present here, I should say that Bank of Albania is, however, an institution that deserves to aim from now and on at the perfection of her vision in the future, since it has already one such.

In that context, we remain very much committed to further develop our actual legislative and regulatory framework, and also the other capacities of Bank of Albania that have to do with planning and applying monetary policies, market perfection and making market intervention more efficient, strengthening supervisory standards, etc.

Concretely, the Bank of Albania with her mid-term objective to build a similar model to that of the European Central Bank will bear in mind:

- Financial stability is considered as the principal priority for the Bank of Albania, as long as banking system forms the most important segment in the financial sector. For that reason, the Bank of Albania will continue to increase **her licensing and supervisory capacity** by having a midterm objective to consolidate the banking system, and make it more efficient, competitive, and covering a larger area, etc.
- The Bank of Albania remains affirmed in the necessity of **deepening and moving on the reforms in the financial system in general and in banking in particular**. There is no doubt that the greatest challenge in the coming year is the Savings Bank, while we consider it of a particular importance to find a new owner for the National Commercial Bank.
- With regard to our policies, we have already declared that our strategic objective will be to **adopt an inflation-targeting regime**. In fact we have an experience in declaring the objective inflation, while some other preconditions have to some degree been completed. However, in the coming years, our commitment will continue in other fields as well, which are thought to give a great contribution to a successful adoption of this regime.
- **Further consolidation of legal independence**. It is understandable that, besides coming closer to a juristic definition of independence, attempts to a more rigorous respect of it will increase in daily practices. Perhaps time has come to think right at this moment for a halt for Bank of Albania to lend to the state budget. I would like to bring to mind to those present in this room that an important criterion of legislative convergence for every aspirant country is in fact to compose a law for the central bank that is in line with EU regulations, where independence is particularly outstanding.
- Further strengthening of independence implies increasing the responsibilities of the Bank of Albania, which above all imply **greater transparency and accountability before public**. Although recent progress is tangible, we remain committed to fully apply the code of good practices on transparency in financial and monetary policies.
- Increasing openness of the Bank of Albania in declaring and explaining her policy decisions, and also her ambitious goals to adopt an inflation-targeting regime in the future, highlights the necessity for higher level of professionalism. For that reason, the Bank of Albania will continue to apply **advanced policies of human resource management**, where further staff training is given a particular stress.

Dear invitee, participants, friends and colleges,

I personally have no doubt that presentations, discussions and other intermissions from your side during the conference will be a new value added to the to-date achievements.

Hoping that the contribution you will be giving to the discussions in this conference will be of a particular importance, there is nothing else for me to add, and I wish you enjoy your stay during this conference.

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