

MONETARY POLICY : ANALYTICAL
OVERVIEW OF THE PAST AND VISION
TOWARD THE FUTURE

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ALBANIAN ECONOMY IN THE LAST DECADE

END OF '80s, YEARS OF ECONOMIC DETERIORATION

The anniversary of Albania's membership in International Monetary Fund and World Bank, more or less coincides with that of first political decisions taken by Albanian authorities to control main economic indicators, which at the time we are referring to were completely distorted.

As most of the participants here might have witnessed, for many decades Albania was cut off from other European countries, including the Central and Eastern European ones because of its extreme centralization and adherence with the principle of self-

support. Consequently, Albania found itself totally unprepared to move into a market economy. This led to the devastation of most of the economy and a considerable decline in living standards.

Given these circumstances, Albania was caught up in a deep financial and economic crisis. Years 1985-1992 were the years of a rapid and significant decrease in production, of deep domestic and foreign macroeconomic imbalances, of a general disorder in management and infrastructure, of the waste of foreign reserves and generation of foreign debt of the country.

In 1989 overall production of the country was reduced by half, while both industrial and agricultural production went through a severe decline. Production of grain fell by fifty per cent compared to that of the '80s. Thus, Albania was transformed from a country exporting agricultural and livestock products to one that was at a large extent dependent on emergency aid from abroad.

The situation was immediately reflected on unemployment indicators that increased considerably, specially with regard to industrial sector. As a result, many Albanians started to emigrate mostly in neighboring countries.

The financial situation deteriorated at a fast pace as well. This was associated with increases in nominal wage and large payments to support insolvent enterprises. Tax revenues fell from 42 per cent of GDP in 1990 to 28 per cent in 1991 and 16 per cent during the first half of 1992.

The continuous increase of budget deficit and lack of a suitable monetary policy led to incapability to control liquidity, inflation, and savings as well as to a deeply negative level of real interest rates. During 1990-1992 inflation rose considerably to over 100 per cent and during the beginning of 1992 it grew at a monthly rate of 15-20 per cent, thus reflecting all the above mentioned problems, lack of supply of consumption products and price liberalization process during 1990-1991. Given that the official exchange rate was far from that applied by parallel market, international reserves fell substantially and trade balance worsened. Balance of payments indicated a deep deficit, which had many consequences for the economy.

Table 1. Main Macroeconomic Indicators⁶⁹

| | 1980-85 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 |
|---------------------------|-----------|-------|-------|-------|-------|--------|--------|--------|
| | 1/ | | | | | | | |
| GDP 2/ | 16376 | 17390 | 17254 | 17008 | 18681 | 16811 | 12156 | 10974 |
| Change | 2.0 | 5.6 | -0.8 | -1.4 | 9.8 | -10.0 | -27.7 | -9.7 |
| Change in Per Cent | | | | | | | | |
| General Industrial | 2.6 | 5.0 | 1.5 | 2.1 | 5.0 | -19.6 | -36.9 | -60.0 |
| Production | | | | | | | | |
| General | 3.0 | 4.0 | 0.5 | -6.2 | 10.6 | -4.4 | -20.9 | 18.0 |
| Agricultural | | | | | | | | |
| Production | | | | | | | | |
| Population Growth | 2.1 | 2.0 | 2.0 | 2.0 | 1.9 | 1.8 | -0.9 | -1.1 |
| Employment | 3.0 | 3.3 | 3.0 | 1.7 | 1.9 | 0.2 | -19.2 | -17.4 |
| Growth | | | | | | | | |
| Unemployment | 4.3 | 5.4 | 5.2 | 6.0 | 6.7 | 8.5 | 11.4 | 23.9 |
| Rate | | | | | | | | |
| Annual Change of | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 104.1 | 236.6 |
| CPI 3/ | | | | | | | | |
| In Per Cent of GDP | | | | | | | | |
| Budget Revenue | 50.9 | 48.7 | 49.2 | 53.2 | 48.2 | 47.0 | 32.0 | 23.3 |
| Budget | 53.5 | 48.8 | 50.9 | 54.4 | 56.8 | 63.6 | 64.0 | 40.7 |
| Expenditure | | | | | | | | |
| Fiscal Balance | -2.6 | -0.1 | -1.7 | -1.2 | -8.6 | -16.6 | -34.0 | -17.4 |
| Change in Per Cent | | | | | | | | |
| Total Domestic | 7.5 | 3.5 | 12.8 | -0.7 | 21.5 | 21.9 | 80.0 | 59.0 |
| Credit | | | | | | | | |
| Broad Money (M3) | 3.5 | 7.3 | 7.2 | 7.8 | 14.8 | 21.0 | 110.0 | 152.7 |
| Money in | 6.6 | 7.0 | 12.3 | 6.2 | 0.6 | 36.5 | 169.0 | 123.0 |
| Circulation | | | | | | | | |
| In millions of USD | | | | | | | | |
| Current Account | -27.6 | 0.5 | 7.8 | -23.5 | -70.4 | -95.1 | -250.0 | -31.6 |
| Balance | | | | | | | | |
| Trade Balance | -33.2 | -0.6 | 1.0 | -34.8 | -90.9 | -109.6 | -209.0 | -453.0 |
| Exports | 116.6 | 95.5 | 100.3 | 106.6 | 132.7 | 123.0 | 72.0 | 70.0 |
| Imports | 149.8 | 96.1 | 99.3 | 141.4 | 223.6 | 232.6 | 281.0 | 523.0 |

2/ Prices as of 1990.

3/ End of period.

FIRST THERAPIES AND THE “VIRUS” OF FRAUDULENT SCHEMES

The overall political and economic collapse of end of 1991 intensified further during the first half of 1992. However, March 1992 elections marked a turning point that was reflected in the adaptation of an emergency program whose aim was to restrain further macroeconomic imbalancing of the country within a period of six months (June-December 1992). For the first time since the foundation of Breton Woods institutions, Albanian authorities signed a supporting agreement with IMF where Albania was granted financial support as foreseen in the Stand-by facilities.

⁶⁹ Source: “Albania: From Isolation Toward Reform”, International Monetary Fund, September 1992 and Bank of Albania.

The Shock Therapy implemented during the second half of 1992 soon displayed its results by providing a macroeconomic environment suitable for actions and reforms of a larger scale over a medium term period.

Galloping inflation of 1990 – 92 began to fall in tandem with the cessation of further decrease in production, etc. Meanwhile, taking some quick measures such as, giving up the subsidies for insolvent state owned enterprises, liberalization of a substantial majority of consumption prices, initiation of privatization process, especially privatization of land, reforms in the inflated state administration, etc. provided the necessary space to walk rapidly towards the path of macroeconomic consolidation during the following period, 1993-1995.

End of 1995 presents an optimistic picture in which the production rate of 13.4 per cent and a single digit inflation rate of 6 per cent stand aside. That year also made evident the increase of international reserves, improvements in unemployment rate, domestic currency stability, liberalization of foreign capital inflows as a result of fixing foreign debt problem, etc. The following two-year period corresponds with the “rise” and “fall” of pyramid schemes. High interest rates offered by the firms “replaced” the interest rates offered by the banking system and **consequently, the effectiveness of monetary policy was reduced.** High interest rates led to large inflows of deposits at these schemes’ cash desks, while their investment in production and securities was minimal compared to the total amount collected. Moreover, it was noticed that not only the principal but also the interests were rolled over in these firms. Thus the “virus” infected the economy, finances, but also the minds of Albanians. In order to increase their wealth without having to work, they sold their cattle, houses and put their savings in these fraudulent foundations. Unable to administer the flow of deposits the schemes deposited them in demand deposits in commercial banks causing a high level excess reserves that were used to purchase treasury bills. In conclusion, by the end of 1996 inflation rate was three times higher than that of the previous year reflecting an increase in government finance by banking system. The effects of the collapse of pyramid schemes were widespread and thus they charged our economy with a large bill. At the end of 1997, the fall in production was associated with a fast increase in inflation, aggravation of international position of the country, and rising unemployment rate. Bank of Albania’s attempts to reduce inflation and absorb liquidity by increasing the interest rate to around 32 per cent, started to show their results.

1998 - 2000: THE COURSE TOWARD MACROECONOMIC CONSOLIDATION

Like in 1992, also this time the first signs of re-establishing control on overall main economic indicators were evident since the second half of the year (1997). This was indicated by achieving better results than those projected for the year-end. In fact, Albanian economy acceded to another emergency program⁷⁰, which, same as in 1992, enjoyed the IMF support, but this time the agreement was named "For the Support of the Emergency Program after the Conflict". The results of implemented policies became more tangible by the end of 1998. The high two-digit inflation rate of end of 1997 fell to 8.7 per cent. The increase of public and investors confidence and the several attempts to ease monetary conditions helped expanding domestic demand. Because of this, domestic production returned to the levels before the crisis. Stabilization policies, which by default assume the establishment of tight monetary and financial restrictions in the economy, generated their social cost, which was reflected in further increase of unemployment rate and spread of poverty over wider segments of population. In spite of the uncertainty that characterized Albanian economy in the beginning of Kosovo tragedy during 1999, it was possible that in cooperation with the international factor, the effects of this tragedy on our country be measured at a large extend. Macroeconomic developments remained within the forecasted values. The further economic growth at a level of 8 per cent and the fall of inflation to unknown levels during the last decade speak for themselves. For the first time, gdp per capital was estimated above 1,000 US dollars.

Both policies, fiscal and monetary, were in line with the overall approach and thus, their effects had a positive impact on the inflation growth. On the other hand, the flow of goods and foreign currency that Albania absorbed during 1999 have directly affected the exchange rate and contributing to price stability. However, maintaing this stability over longer time periods remained a challenge for the future.

Table 2. Main Macroeconomic Indicators⁷¹.

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|--------|-------|-------|-------|-------|-------|-------|-------|-------|
| GDP 1/ | 12309 | 13331 | 15107 | 16478 | 15325 | 16556 | 17880 | 19275 |

⁷⁰ September 1997 – March 1998.

⁷¹ Source: Bank of Albania, Ministry of Finance and INSTAT.

| | | | | | | | | |
|---------------------------|--------|--------|--------|--------|--------|--------|--------|---------|
| Change | 9.6 | 8.3 | 13.3 | 9.1 | -7.0 | 8.0 | 7.3 | 7.8 |
| Change in Per Cent | | | | | | | | |
| General | -10.0 | -2.0 | 6.0 | 13.6 | -5.6 | 4.1 | 6.4 | 5.0 |
| Industrial | | | | | | | | |
| Production | | | | | | | | |
| General | 10.4 | 8.3 | 13.2 | 3.0 | 1.0 | 5.0 | 5.0 | 4.5 |
| Agricultural | | | | | | | | |
| Production | | | | | | | | |
| Population | 1.1 | 1.5 | 1.1 | 1.3 | 0.9 | 0.6 | 0.8 | 0.8 |
| Growth | | | | | | | | |
| Employment | 1046.0 | 1161.0 | 1138.0 | 1116.0 | 1107.0 | 1103.0 | 1081 | 1068.0 |
| Growth | | | | | | | | |
| Unemployment | 22.3 | 18.4 | 13.1 | 12.4 | 14.9 | 17.8 | 18.0 | 17.3 |
| Rate | | | | | | | | |
| Annual Change | 30.9 | 15.8 | 6.0 | 17.4 | 42.1 | 8.7 | -1.0 | 4.2 |
| of CPI 2/ | | | | | | | | |
| In Per Cent of GDP | | | | | | | | |
| Budget | 26.7 | 24.1 | 23.4 | 18.4 | 16.6 | 20.3 | 21.2 | 22.4 |
| Revenues | | | | | | | | |
| Budget | 40.4 | 33.1 | 33.6 | 31.2 | 29.5 | 30.7 | 32.7 | 31.6 |
| Expenditures | | | | | | | | |
| Fiscal Balance | -9.1 | -8.6 | -6.5 | -10.2 | -11.2 | -6.6 | -5.5 | -4.9 |
| (Domestic | | | | | | | | |
| Finance) | | | | | | | | |
| Change in Per Cent | | | | | | | | |
| Total Domestic | 352.3 | 27.4 | 28.0 | 48.1 | 43.0 | 17.8 | 10.6 | 6.5 |
| Credit | | | | | | | | |
| Broad Money | 75.2 | 40.6 | 51.8 | 43.8 | 28.5 | 20.7 | 22.3 | 12.0 |
| (M3) | | | | | | | | |
| Money in | 74.3 | 55.8 | 49.9 | 17.7 | 47.6 | -6.4 | 27.4 | 22.3 |
| Circulation | | | | | | | | |
| In millions of USD | | | | | | | | |
| Current Account | 18.8 | 71.4 | 36.6 | -62.3 | -253.7 | -65.0 | -132.9 | -163.1 |
| Balance | | | | | | | | |
| Trade Balance | -508.9 | -459.6 | -475.0 | -678.3 | -534.9 | -603.6 | -662.8 | -821.0 |
| Exports | 111.6 | 141.4 | 204.8 | 243.7 | 158.6 | 208.0 | 275.1 | 255.4 |
| Imports | -620.5 | -601.0 | -679.8 | -922.0 | -693.5 | -811.7 | -937.9 | -1076.4 |

1/ Prices as of 1990.

2/ End of period.

The last two years, 2000-2001 seem to have added to the further consolidation of overall macroeconomic equilibrium. This is indicated by developments within the limits set in the program for year 2000, while it is believed that end of this year will record same values as those projected for the year-end. Perhaps, it is time to emphasize that the attention of authorities, apart from the concern to maintain price stability, should also focus toward a greater concern, that of finishing in time and at all costs the reforms and structural adjustments that have started in compliance with medium-term programs for our country's development.

I believe that operation of these "medicaments" of a vital importance for us will be the key to our success in the further macroeconomic consolidation and fulfillment of government's long-term engagement to reduce poverty in the country.

MONETARY POLICY – AN OVERVIEW OF THE PAST DECADE

Two basic policies that have sustained the economic stabilization process by smoothing inflation pressures during the last ten years, were the monetary policy and the fiscal policy. During this period, there were moments when one of them was apparently more dominant than the other as well as there were moments (actually this has been the prevailing tendency) when both these policies were developed in harmony with each other, thus providing a vital factor to achieve the success.

Yet, today, ten years later, we can say that the lessons we learned during this hard period of challenges and successes, in a way, impose an understanding of the importance to reach the conditions that will really reduce the influence of momentary decisions and objectives of fiscal authorities on monetary policy in the country. Having in mind that this argument will find room again in the following presentations, I would like to express the confidence of the institution I direct, that concrete actions will be taken in this regard in the near and medium future.

By midyear 1992, monetary policy in Albania was designed and implemented and some decisions were introduced as a part of the support agreement with IMF for the first time. The purpose of these decisions was to control money supply through the adoption of direct instruments of monetary management. The first law “On Bank of Albania” mentions that “maintaining the domestic and foreign value of national currency”⁷² will lead to the achievement of price stability.

Over the years, the final objective of monetary policy of Bank of Albania was specified further by developing a definition that makes price stability the final objective of monetary policy. More specifically, the existing law, which regulates Bank of Albania’s activity states that “achieving and maintaining price stability”⁷³ is the main objective of Bank of Albania while all the other objectives derive from it.

It seems that this way Bank of Albania has solved the dilemma of choosing the key objective of monetary policy in favor of price stability with the belief that this solution serves also to the

⁷² Law no. 7559, dated 22.04.1992, “On Bank of Albania”, article 3, paragraph 1.

⁷³ Law no. 8269, dated 23.12.1997, “On Bank of Albania”, article 3, note 1.

achievement of production and employment rates at the best possible way over long term period.

Going back to year 1992, reserve money was chosen then as the intermediary objective, while there would be two main instruments to control money: restrictions on lending and decision of interest rates⁷⁴ of time deposits in Lek placed in state owned banks⁷⁵ by administrative means. The “floating rate” regime (which is still in existence) was adopted since July 1992, while transactions in current account were liberalized completely.

As it can be imagined, since 1992 and on, Bank of Albania chose a clear regime that determines monetary objectives, keeping itself away from picking any specific regime that would determine exchange rate objectives. Meanwhile, in no occasion the possibility of adopting *currency board* was taken into consideration.

Among the first actions adopted by monetary policy, the most distinct one is the immediate increase of interest rates for Lek deposits placed in state owned banks from 2-3 percentage points before July 1992 to 28 percentage points. Meanwhile all of the banks were subject to restrictions on lending growth.

The critical situation of international reserves⁷⁶ of the country did not allow an active participation of Bank of Albania in the market. Moreover, it was believed that the implementation of free floating exchange rate regime would serve as an automatic regulator of the balance of payments position given that the dollarization of the country was at high levels.

In absence of other alternatives⁷⁷, it was decided that domestically financed budget deficit would be covered 100 per cent by direct credit from Bank of Albania. This phenomenon is still present nowadays, though in another form and at a smaller size.

The monetary policy framework implemented in mid 1992 as described above remained unchanged for a three-year period. It should be noted that though this seems relatively easy, considering the time frame, its implementation met with various difficulties,

⁷⁴ Lower limit.

⁷⁵ In 1992 and some years after that, banking system in Albania was composed of state owned banks only.

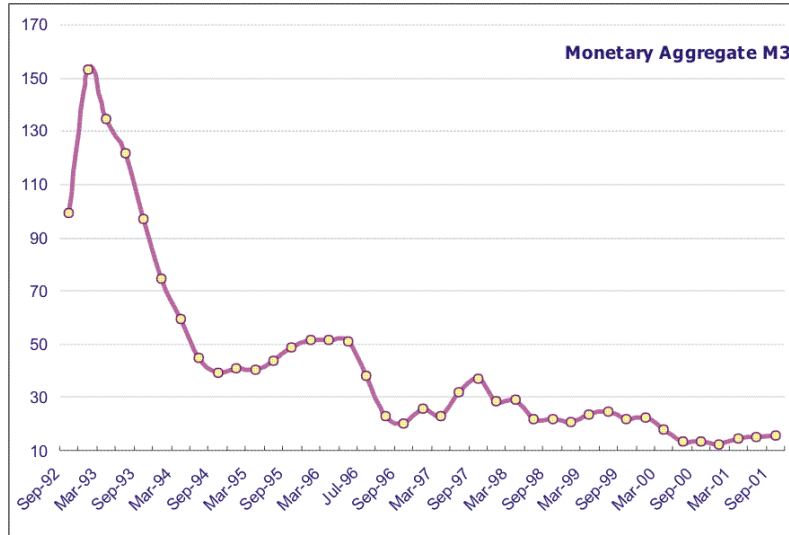
⁷⁶ At this moment, a high degree of dollarization of the economy was noticeable.

⁷⁷ In May 1995, the treasury bills were used as means to finance budget deficit for the first time.

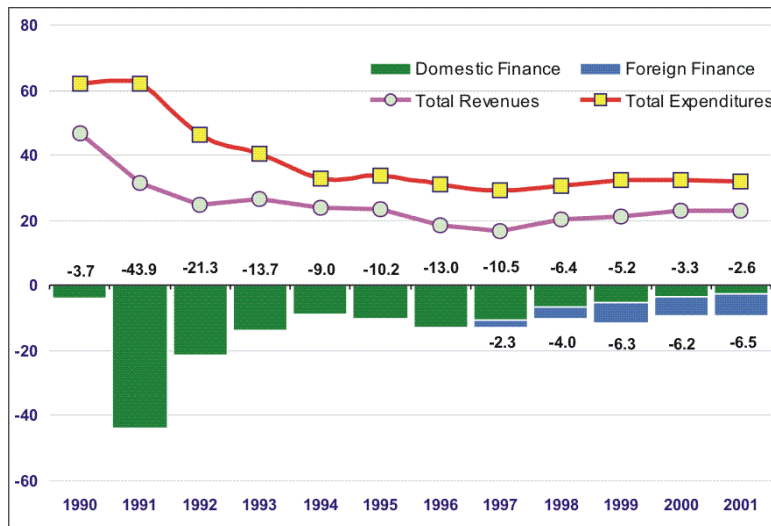
which on one hand reflected the low level of Bank of Albania's perception and implementation of it and on the other hand, the low level of understanding and responsibility by second tier banks. It is important the fact that this period marks a satisfying harmonization between two basic policies, monetary and fiscal thus eliminating the influence of fiscal policy on monetary policy at greatest.

Referring to the figures, the period 1992-1994 reflects an admiring stoppage of the hemorrhage of money in circulation. This was a result of high interest rates for deposits and BoA's attempts to impose lending restrictions on second-tier banks. More specifically, by the end of 1994 money in circulation increased to 41 per cent annual rate compared to 74.4 per cent that was at the end of 1993 and 153 per cent at the end of 1992. These accomplishments were reflected also on the inflation rate, which by the end of 1994 was around 15.8 or 15 times lower than that of end of 1992.

Though by the end of 1995 annual inflation rate was only 6 per cent, its development at this time carried the first signals preceding the events of 1997. Mid 1995 coincides with the first moves to invest money in pyramid schemes (keep in mind that for two years in a row deposit interest rates were declining continuously). The expected results were efficient in changing the trend of money supply, which since April 1995 started to increase at higher rates than before (see graph 1. Money supply and money in circulation: 1992-2000)



**Graph 1. Money Supply
(Annual change; end of period)**



**Graph 2. Fiscal Deficit
(Percentage of GDP)**

The circumstances of 1995 strengthened during 1996 and turned into “decision-making” factors with regard to economic development of the country and its short-term perspectives. Interest rates offered by informal lending market “pushed out of the game” those offered by banking system and consequently, monetary policy became nonexistent. As if this was not enough, year 1996 was rich in political events (two electoral campaigns) that in a way or another affected an increase in budget expenditures. Financing the deficit would jeopardize the achievement of final objectives for inflation (see graph 2. Fiscal deficit: 1992-2000). In short, the last month of 1996 provided the frames for the main features of that political and economical turmoil that followed in the next months.

Maybe it is inappropriate to reproduce once more what our country experienced during the first months of 1997. A number of reasons, obstinacy and rancor, initiated a chaos not seen before, which resulted in a total economic and political collapse. Undoubtedly, the most expensive charge belonged to the economy, which was very fragile even before the collapse.

The effects of 1997 were widespread, ranging from the devastation of production capacity (real GDP fell by 7.3 per cent) to the return of galloping inflation rates. The inflation rate in December reached a maximum level of 42.1 per cent. However, the kicks given to Bank of Albania and its monetary policy were even stronger as they were related to:

- Loss of public confidence in banking system, which led to an uninterrupted hemorrhage of money, while it was impossible to avoid the decrease of demand deposits and foreign currency deposits;
- Monetary policy implications by the nonexistence of public finance. Budget deficit was financed by liquidities offered by Bank of Albania and this led to considerable increase of reserve money and became a certain source of inflation.
- Decrease of the confidence in domestic currency, which by mid 1997 had lost more than half of its value.

Finding itself in such situation, Bank of Albania had to react by increasing⁷⁸ interest rate⁷⁹ immediately. By the end of May 1997 interest rate reached its highest level of 28.9 per cent. This was

⁷⁸ In fact, Bank of Albania started to increase interest rates since mid 1996 but unfortunately they were not effective. The informal market offered almost the same rates but at a monthly return.

⁷⁹ Weighted interest rate for new deposits in Lek placed in the banking system.

one of the main reasons that the results of year-end 1997 were better than expected. The reparation of negative effects of 1997, especially of the short term ones, continued rapidly during 1998 and mostly in the following period. By the end of 1998 inflation rate was only 8.7 per cent, while the recovery of general domestic production was impressively at a level of 8 per cent.

The period 1999-2000 marked rates of inflation unusual for economies like Albania. Even though during 1999 Albania had to face the "Bible-style" evacuation of Kosovars, inflation remained at low levels due to reasons explained above. Starting from that period till end of 2000 interest rate fell, but yet it remained very high in real terms. On the other hand, market reaction has not been instantaneous and this thing, apart from other things, was reflected in the large difference between minimum interest rates for deposits and Treasury Bill *yield*. In these circumstances, Bank of Albania deemed it reasonable to void minimum limits for time deposits in Lek in the state owned banks, thus walking on a new path, that of monetary control through market instruments.

MONETARY POLICY: CHARACTERISTICS AND OTHER ASPECTS

Throughout the above two introductions, we tried to recall to this audience what could be justly considered as achievements and failures of economic policy and more specifically of monetary policies in Albania during the transition.

However, speaking about the latter one, I would emphasize that type of monetary policy and an analysis of its decisions involve a whole process, which includes the institutional aspect, market developments, political, social, economic environment, professional skills, etc. In order to make a well-rounded analysis, which I think would also add to the perspectives of dealing with this problem, it would be better to examine the process in its all components.

First, I would underline certain prerequisites that should be met and that are considered key factors in achieving success.

INSTITUTIONAL PILLAR OF MONETARY POLICY

It is clear to all of us that the task of monetary policy is delegated to central bank, because in the long term there is no conflict between the objective of price stability on one hand and economic growth and decrease of unemployment on the other. Delegation to central

bank implies that: in order that monetary policy be successful, it should be supported by institutions. In other words, monetary policy should be a feature of an independent, responsible and transparent institution.

These three elements are important items to support a real monetary policy, which ensures considerable gains for the country in the long term, even though it might conflict with political interests in the short term. This theory holds true in the case of Albania. Moreover, we are aware of the role of monetary authority in exerting appropriate pressure whenever there are attempts to forego long-term interests.

Bank of Albania, initially a state owned bank dependent on the Ministry of finance and with a not very long tradition, had a very important task in the beginning: establishing the image of a central bank and its credibility. In order to understand how difficult this task was, it is sufficient to mention that Bank of Albania needed to make its name known to the public first.

On the other hand, a very good tradition was created within the central bank, that of adding new values to the ones created year after year. This has led to the consolidation of central bank structure and that of the institution. It is exactly this, which provides the possibility and conditions to talk about more independence, responsibility and transparency today. In the minds of employees of central bank, all these three elements help fulfil our main task: achieving and maintaining price stability through formulation and adoption of a realistic and wise monetary policy.

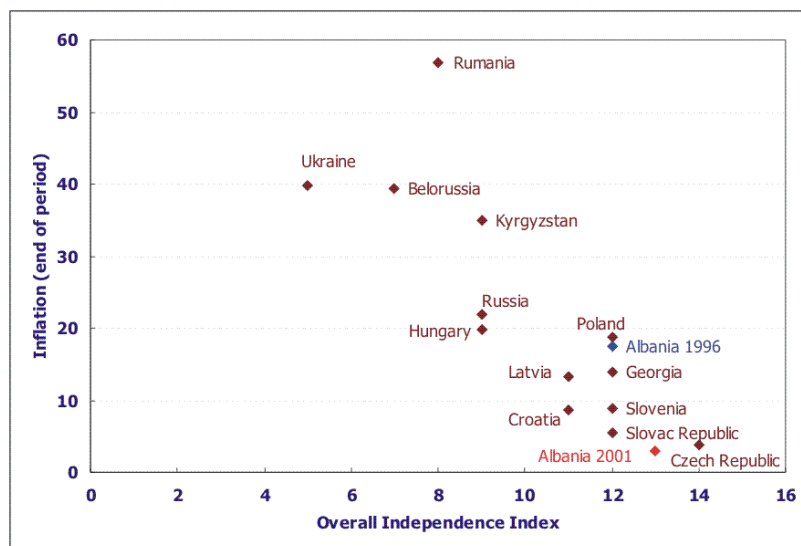
FIRST PILLAR – BANK OF ALBANIA INDEPENDENCE

The independence provides central bank with the space to follow the objectives as defined by the law and free from political pressures and daily interests. For this reason, it is considered that achieving a high degree of central bank independence is necessary to ensure the desired results from the adopted monetary policy. Like any other bank, Bank of Albania should be considered from two aspects of independence: legal independence and real independence. Without wanting to analyse the elements of independence in detail, I need to stress out a few facts:

- The law on central bank provides a high degree of independence for Bank of Albania given that it was designed after international standards. This is an advantage since it means that there are legal bases to build an independent

institution, as well as there is legal room where this institution can function independently. Furthermore, improvements in the law on central bank during this decade have led to an increase of its legal independence.

- Central bank real independence is much lower than its legal independence. This is related first of all with the poor institutional tradition in Albania and that of honouring institutional authorities, as well as with the rich tradition, in a negative meaning, in disregarding the laws.
- A number of other factors present in the Albanian environment have mostly damaged real central bank independence, despite



Graph 3. Independence Index & Inflation (Year 1996; inflation as of end of period)

central bank attempts to avoid this. I would group these factors considering country’s mentality and tradition on one hand, and financial and economic aspects on the other. In the first group, I would first mention the political instability in Albania (illustrated by two early elections during the decade), which has been a factor that has not helped in increasing central bank independence, since the rights of this institution were not attended. Moreover, central bank had to “keep silent” during aggravated political situations in order to prevent being a toy in the hands of politicians. In other cases, central bank found itself at the centre of political debates over financial issues that have spurred out of momentary political interests. I would also

add the lack of public opposition to inflation to this irrational political behaviour. I am not implying that Albanians should oppose inflation same as Germans do, however it is hard to find public support whenever the voice is risen against the increase in prices. It seems that public protests are driven by other events. On the other hand, lack of legal initiative and bank self-containment due to the lack of communication with the public for years, have “eroded” bank’s real independence. In the second group, I would include the low development of financial market. In Albania, this market is dominated by banks, which for reasons that are not subject of this presentation, perform a low intermediation, thus reducing the importance of central bank authority and their support for its independence. It is enough that I mention the ratio of credit to government and credit to private sector by banking system in this context. During the last decade, this ration was at levels of 80-90 per cent on average. Thus, central bank was in the position of “accommodating” budget deficit. **On the other hand, domestic credit⁸⁰ makes for 41.5 per cent of GDP.** Given the lack of capital markets, this credit is served by central banks and other second-tier banks. So, in order co-ordinate the monetary policy with economic-financial one, Bank of Albania has to credit Government directly. Savings Bank, being the only state owned bank, is in a “semi-fiscal” position. Considering Savings Bank share in the banking market, central bank has limited possibilities to act independently while adopting its monetary policy. This is better illustrated by another fact. In most of the cases, open market operations imply a Bank of Albania – Savings Bank relationship and thus the reaction is not in fact that of the market.

SECOND PILLAR – BANK OF ALBANIA’S ACCOUNTABILITY

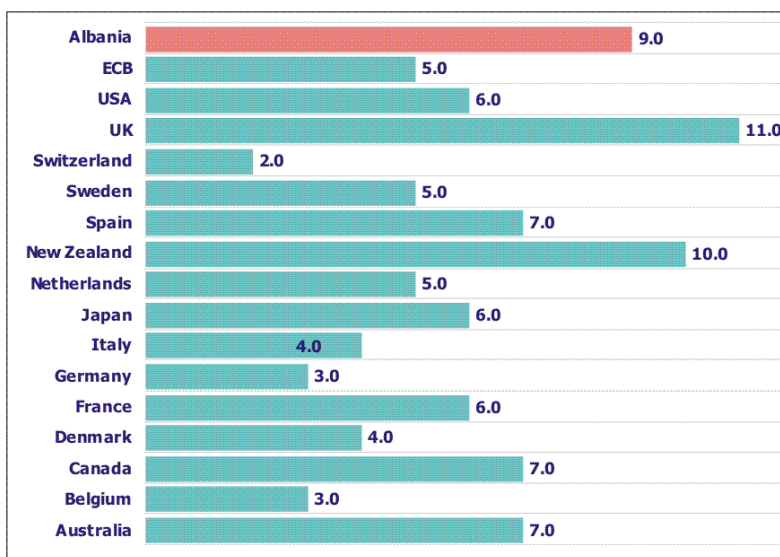
Obviously, real independence cannot be grasped completely as a concept in an environment uncertain of what a central bank is and which are its functions. In order to ensure its understanding central bank needs to be credible to the public. Credibility is attained through achieving the main objective. During the last ten years it has been possible to keep inflation under control and with the exception of few cases, in general inflation was at low levels. The developments of inflation rates have surely affected the increase of central bank credibility.

⁸⁰ Memorandum on Economic and Financial Policies of the Government of Republic of Albania for 2002 Under a Three-Year Arrangement Under the “Poverty Reduction and Growth Facility”.

However, given that transition countries' economies are exposed to *shock* factors, structural changes and liberalization process, inflation is affected by other factors apart from being a monetary phenomenon. Bank of Albania has defined a second pillar, that of increasing accountability in order to increase its monetary policy successfulness. In our case, central bank accountability could be increased through improvements in reporting by making clear the mission, functions, available instruments and their efficiency as used by central bank.

Yet, a period about one-decade long was needed for the central bank to come at present point. This period was mostly dominated by the self-containment of the institution and its habit to keep distant from the media. We should let others assess central bank performance in order to increase our independence. Even in this aspect, I would distinguish between two measures of central bank accountability: legal and real accountability.

Like legal independence, also legal accountability of Bank of Albania is very high. Referring to legal accountability index measured by Haan et Al⁸¹, Bank of Albania is assigned a value of 9 out of 13. Besides, according to this index, Bank of Albania holds a highly regarded position compared to other banks considered by these authors (see graph 4: Accountability Index).



**Graph 4. Accountability Index
(End of '90s)**

However, legal and real accountability are not at same levels. Like real independence is much lower than legal independence, so is real accountability much lower than legal one. Increasing real accountability requires time, a higher level of emancipation of central bank employees and management, as well as of the environment which central bank addresses and reports to. Main deficiencies in being accountable are related to the quality of the report and explanations on Bank's activity as well as to its transparency.

THIRD PILLAR – BANK OF ALBANIA'S TRANSPARENCY

Central bank has lacked the quality of being transparent hence, adding to the low support for its real independence and independent decision-making. On the other hand, the low transparency has had an impact on the unsuccessfulness of monetary policy. Transparency makes monetary policy easier to predict and as a result its efficiency and influence on economy increases. Otherwise, one cannot understand what central bank is trying to achieve. It is believed that transparency ensures the transmission of Bank of Albania's opinions and views to the public and accordingly allows for a better understanding of monetary policy improving the reaction of economic players. In this context, transparency can be looked at from two points of view: as communication and educational means. A high level of transparency used in an environment uneducated or unfamiliar with financial and economic issues could turn against the institution itself as a boomerang. For this reason, Bank of Albania has undertaken an instructional program, mostly with media, in order to gain greatest possible benefits from transparency. In general, Bank of Albania's transparency is related to:

- Explaining its main objective and other tasks.
- Explaining and making known the quantitative objectives, the attainment of their actual levels and factors that have influenced it.
- Explaining the instrument used to adopt monetary policy.
- Explaining points of view on interest rates and how they can change in light of certain variables.
- Explaining the legal framework, which regulates and supports the implementation of an independent monetary policy.

FINANCIAL MARKETS

Monetary efficiency depends at a large extent on the level of markets' development in general and financial market in particular. Looking back at history, it should be noted that Albania inherited nothing of markets in 1990. Also, the experience gathered over the years and the reforms in financial system have been of a small scale. Today, financial system is characterized by a set of banking system and small number of insurance companies as well as by a network of financial corporations (mainly credit institutions).

As you may already know, Albanian banking system is made of 13 banks, one of which is state owned and yet, accounts for 62 per cent of total banking assets as of the end of second quarter 2001 (for more details see table 3. Banking System in Albania). This kind of dominance is characteristic for all segments⁸² of financial market especially for money market, interbank market, primary market for treasury bills, etc.

It seems that insurance system is slowly taking shape. Today, there are four companies operating in the insurance market. All of them are with Albanian capital, however, like in the case of banking market, insurance market is also dominated by a large state owned company, INSIG.

The establishment of an organized and flexible pension funds market has not been achieved yet. Only the Social Insurance Institute is functioning as such and that one is subsidized by the state. Still, it is not clear whether a project that would provide the adequate incentives for the establishment of such markets exists and thus, it seems that Albania will be lacking pension fund markets for another while.

⁸² Still, a lot more is expected from these markets with regards to the number and volume of transactions.

Table 3. Banking System in Albania

| | 1 st Q-00 | 2 nd Q-00 | 3 rd Q-00 | 4 th Q-00 | 1 st Q-01 | 2 nd Q-01 |
|---|----------------------|----------------------|----------------------|----------------------|----------------------|----------------------|
| Share of each bank in total assets | | | | | | |
| Savings Bank | 64.4 | 63.6 | 61.0 | 64.8 | 63.3 | 61.6 |
| National Commercial Bank | 13.7 | 13.1 | 12.7 | 9.4 | 9.4 | 9.7 |
| Italian-Albanian Bank | 5.8 | 5.9 | 6.0 | 5.4 | 5.4 | 5.3 |
| Arabic-Albanian Islamic Bank | 1.0 | 1.0 | 0.9 | 0.8 | 0.8 | 0.8 |
| Dardania Bank | 1.1 | 0.8 | 0.8 | 0.7 | 0.7 | 0.6 |
| Tirana Bank | 3.8 | 4.1 | 5.1 | 5.1 | 5.5 | 5.9 |
| National Bank of Greece | 2.5 | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 |
| National Commercial Bank | 0.5 | 0.6 | 0.5 | 0.6 | 0.6 | 0.7 |
| Alpha Bank | 2.1 | 2.3 | 2.9 | 3.0 | 3.1 | 3.3 |
| American Bank of Albania | 3.1 | 3.5 | 4.6 | 4.3 | 5.1 | 5.6 |
| Fefad Bank | 1.1 | 1.4 | 1.6 | 1.7 | 1.9 | 2.0 |
| First Investments Bank | 0.5 | 0.6 | 0.7 | 0.8 | 0.9 | 1.1 |
| Intercommercial Bank | 0.4 | 0.5 | 0.6 | 0.7 | 0.7 | 0.9 |
| Share of each bank in total deposits | | | | | | |
| Savings Bank | 71.5 | 71.3 | 69.1 | 69.3 | 67.6 | 66.0 |
| National Commercial Bank | 10.4 | 9.9 | 9.8 | 9.7 | 9.6 | 10.1 |
| Italian-Albanian Bank | 4.8 | 4.7 | 4.6 | 4.2 | 4.3 | 4.4 |
| Arabic-Albanian Islamic Bank | 0.5 | 0.4 | 0.3 | 0.3 | 0.3 | 0.3 |
| Dardania Bank | 1.0 | 0.7 | 0.7 | 0.6 | 0.5 | 0.4 |
| Tirana Bank | 3.2 | 3.4 | 4.0 | 4.1 | 4.8 | 5.1 |
| National Bank of Greece | 2.3 | 2.4 | 2.5 | 2.5 | 2.4 | 2.4 |
| National Commercial Bank | 0.3 | 0.3 | 0.3 | 0.4 | 0.5 | 0.5 |
| Alpha Bank | 1.7 | 1.8 | 2.2 | 2.4 | 2.4 | 2.6 |
| American Bank of Albania | 3.1 | 3.7 | 4.8 | 4.6 | 5.5 | 5.9 |
| Fefad Bank | 1.0 | 1.2 | 1.4 | 1.5 | 1.7 | 1.9 |
| First Investments Bank | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Intercommercial Bank | 0.1 | 0.1 | 0.2 | 0.3 | 0.3 | 0.5 |
| Share of each bank in total credit | | | | | | |
| Savings Bank | 21.8 | 20.3 | 18.2 | 43.1 | 41.9 | 37.2 |
| National Commercial Bank | 41.4 | 39.6 | 36.5 | 0.0 | 0.0 | 0.0 |
| Italian-Albanian Bank | 18.5 | 20.2 | 21.8 | 25.8 | 25.6 | 25.0 |
| Arabic-Albanian Islamic Bank | 0.0 | 0.0 | 0.1 | 0.0 | 0.2 | 0.2 |
| Dardania Bank | 0.0 | -0.1 | -0.1 | 0.6 | 0.6 | 0.6 |
| Tirana Bank | 6.4 | 6.4 | 7.3 | 8.9 | 9.5 | 10.5 |
| National Bank of Greece | 0.1 | 0.2 | 0.5 | 0.6 | 0.7 | 0.7 |
| National Commercial Bank | 2.2 | 2.0 | 1.9 | 2.0 | 2.0 | 1.8 |
| Alpha Bank | 2.7 | 2.7 | 4.0 | 6.3 | 7.1 | 7.7 |
| American Bank of Albania | 2.4 | 3.1 | 4.2 | 5.3 | 5.3 | 6.2 |
| Fefad Bank | 4.6 | 5.5 | 5.5 | 7.1 | 6.9 | 6.8 |
| First Investments Bank | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Intercommercial Bank | 0.0 | 0.1 | 0.1 | 0.3 | 0.3 | 3.3 |

A vital element of financial systems in developed countries comprises intermediary financial instruments. Unfortunately, this element is almost nonexistent in our economy and it seems that the instruments development will come naturally with the development of stock market, security market, derivatives market, etc. as it usually happened in foreign economies.

The scarcity of financial institutions as well as the unconsolidated situation of production units has led to the same scarcity of financial instruments. The first innovation was in 1995 when a new instrument to finance budget deficit was launched, treasury bills. Since then progress for introducing new instruments has been slow and it mainly consists in practicing new short-term instruments such as repurchase agreements which Bank of Albania is using to ensure monetary control in the economy.

Actually, the market lacks instruments like: obligations, commercial papers, tradable certificates of deposits, commercial credit, option and future contracts, mortgages, bonds, government obligations, derivatives, stocks, credit from direct foreign investments for their branches in Albania, etc. Even when some balance sheets include, here and there, items such as "shares and other capital", these cases are exceptions and do not represent any general tendency.

However, even though that group of economic agents which regulate and manipulate the flow of free funds and savings is not present, it seems that Albanian economy is still managing the process, albeit in a risky manner. Despite the progress, considerable amounts of capital and current transactions are performed informally keeping the informal market participation in the total amount of transactions performed by the economy over a given period of time considerably high. Making no further analysis of the markets, their "players" and the rules by which they accept to play, I would like to underline another important factor, monetary policy's incapability to be efficient in an environment as described above. It is sufficient to mention that the solution of 1992 with regard to administrative measures was totally conditioned by markets atrophy at that time. By the same token, during the crisis of 1997 monetary policy was driven by interest rates applied by Pyramid schemes. Now, as a result of some positive developments in money market, Bank of Albania is trying to curb its policy⁸³ using only market instruments. The abovementioned explanation and

⁸³ We will get back to this argument later when we speak about transmission mechanism of monetary policy in Albania.

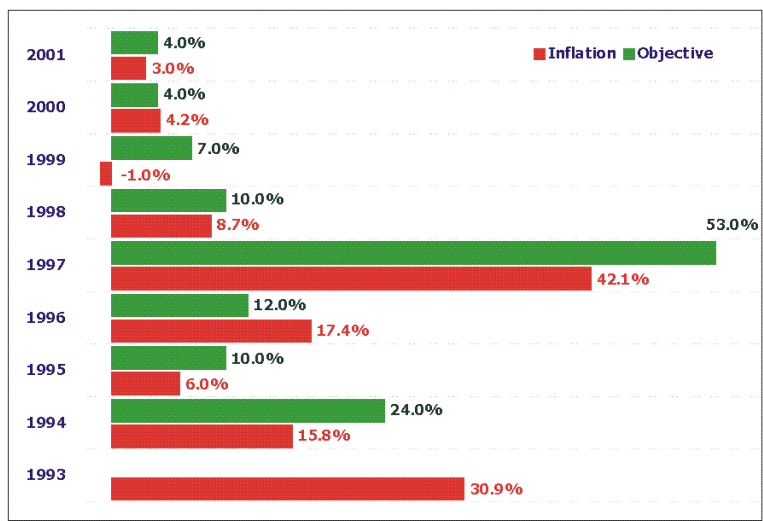
description of prerequisites that should be met and of the necessity of a developed market, will help us better understand the specific aspects, causes and imposed solutions regarding monetary policy in the last decade.

Final Objective of Monetary Policy.

Since July 1992 till now, in no occasion there was doubt that the advantage of all advantages stays in achieving and maintaining price stability. Going back to the big debate of which objectives monetary policy targets, Bank of Albania chose to control price stability with considerations that all other objectives of monetary policy serve the main objective.

It never happened that the final objective of Bank of Albania's monetary policy was other than the one mentioned above, even though sometimes, specially during the first years (period 1992-1994) some reports of Bank of Albania mention that the objectives of bank's monetary policy include price stability, production growth and foreign economy equilibrium.

Unlike first years, during the last two years Bank of Albania has made a step ahead (surely a brave one) when in the beginning of 1999 it made public the value of final objective of monetary policy. More specifically, it set an interval for annual inflation objective.



Graph 5. Meeting inflation targets (End of period; change Y/Y)

Same thing has happened during the current year⁸⁴, 2001 when Bank of Albania has set the final objective of annual inflation rate within the interval 2-4 per cent at the end of the year.

However it should be acknowledged that during the transition period actual inflation rates have varied from the projected ones set as objectives. In the beginning the shifts from projected to actual rates have been large, but with time they have become smaller. Nevertheless, it should be noted that with the exception of two years, 1996 and 2000, actual inflation rate was below the targets. Maybe 2001 will mark for the first time an annual inflation rate which matches⁸⁵ the projected values for it (see graph 5. Meeting inflation targets)

MONETARY POLICY REGIME

In defining its monetary policy regime, Bank of Albania has been first of all conditioned by the economic environment and the nature of transmission mechanism that was characteristic for our economy in the early '90s. However, it should be emphasised that this regime did not change over the period of time under consideration, despite new developments. Even though the first law on Bank of Albania in 1992 acknowledges it the right to design and adopt country's foreign exchange policy, the existing circumstances favoured the selection of a clear monetary regime. Since then, the intermediary objective of this regime has been M3 aggregate, or so called money supply.

The choice between two alternatives, money and exchange rate regimes, in favour of the former is conditioned above all by the incapability to support a fixed exchange rate regime. The desired results would be quicker in case a fixed exchange rate regime was adopted (moreover it is easier to adopt this regime) however, at that time the level of international reserves of Bank of Albania was very low and the balance of payments deficit was increasing considerably.

At that time it was hard to predict problems that could arise, nevertheless, it could be said that the choice that was made and the attitude towards it were optimal. Keep in mind that many developing and transition countries were trapped into their incapability to escape exchange rate regime. According to Mr.

⁸⁴ Second year in a row.

⁸⁵ This means that actual inflation rate should vary within 2-4 per cent.

Crockett⁸⁶ “While the system is working well, the political authorities usually see very little reason to replace it. And when the currency comes under pressure, the authorities are unwilling to accept a policy defeat by abandoning the peg.”

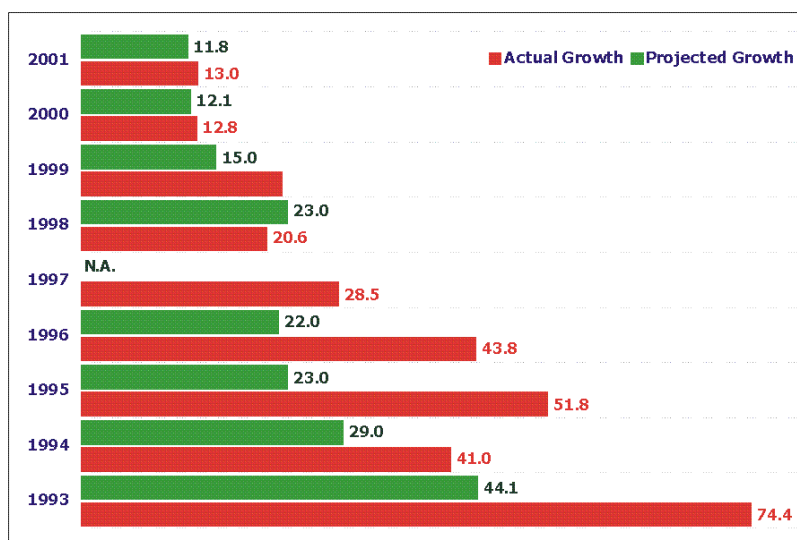
Nonetheless, it should be mentioned that adopting money regime as a nominal anchor has limitations present in the case of Albania as well, especially in the last years. More specifically, I would like to illustrate that despite the few empirical analysis, the relationship between money and inflation is not important. This provides us with a strong reason to consider our attitude with regards to broad money in the future. Talking about developments in money supply, it should be noted that the objectives for M3 have reflected the developments in inflation, production, fiscal policy, foreign sector, etc. Yet, alike inflation, the actual values for money supply have been different from the projected ones and in most cases they have exceeded them (see graph 6. Meeting money supply targets).

PERFORMANCE CRITERIA

For as long as Albanian authorities are willing and accept to sign contracts with IMF, they are obliged to meet some quantitative restrictions whose purpose is to control domestic assets of banking system and central bank assets. In this context, these restrictions are vested with the quality of monetary quantitative objectives similar to the intermediary objective for broad money.

As aforementioned, Albania signed the first agreement with IMF in the second half of 1992 and since then it started to apply quantitative restrictions for the first time. The aim of these restrictions was to set upper and lower limits for indicators such as: net foreign assets of Bank of Albania (floor), net domestic assets of banking system (ceiling) divided in net claims on government and claims on economy. The so-called the criteria to achieve success are still used today, though somehow differently from the way used in the first years of transition. Not going into much technical detail about the method to determine the level of these objectives, I would like to explain briefly the reasons and logic behind them. Net foreign assets of Bank of Albania, or as they are differently called net international reserves, are related to developments in balance of payments and they reflect the stability of foreign exchange position of a country.

⁸⁶ Andrew Crockett, “Monetary policy objectives in light of Asian crises”, Monetary Policy Frameworks in a Global Context, p. 224.

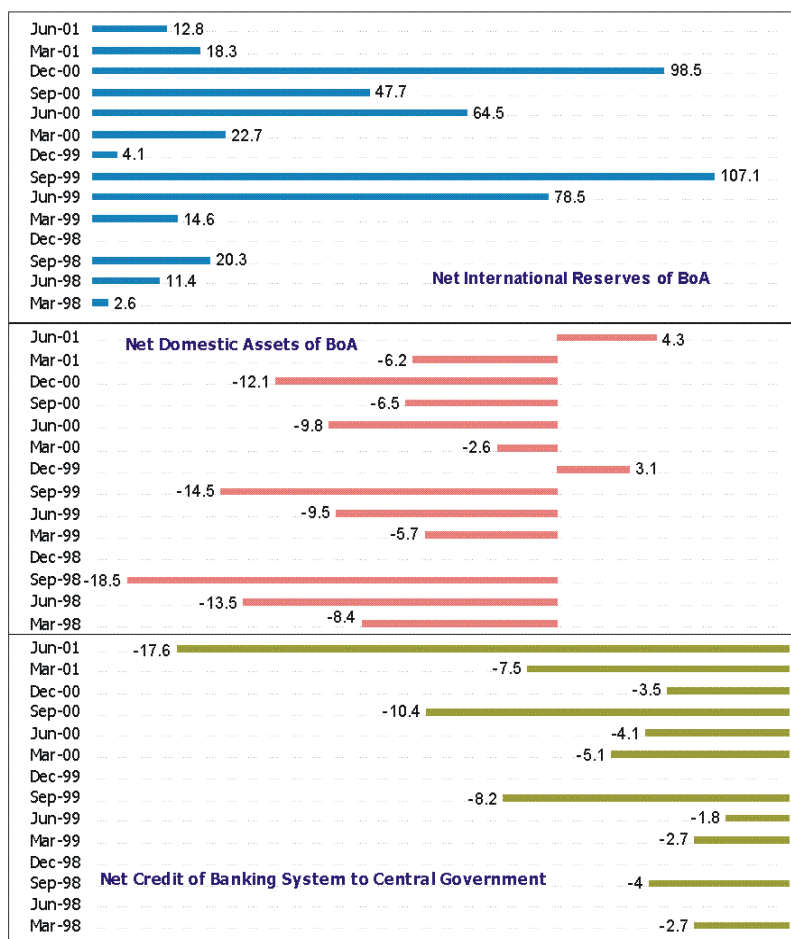


**Graph 6. Meeting money supply targets
(End of period; change Y/Y)**

These reserves provide a guarantee to defend the exchange rate for Lek when as a result of speculations and negative short-term developments Bank of Albania thinks it is necessary to intervene in exchange market. International reserves are also considered as the last resort to finance expenditures or consumption of an economy in extraordinary cases; for this reason they are measured in months of imports and their objective is based on this logic. Restrictions on credit to government by banking system serves as another tool to control budget expenditures. Bank of Albania engages in controlling the level of credit to government by banking system by being a partner in controlling public domestic credit, and indirectly also government expenditures, which bring inflationary pressures on the economy. Given that this objective includes the contribution of three actors, Ministry of Finance, commercial banks and Bank of Albania, we cannot control it completely. However, we exert our control through indirect instruments of monetary policy.

Net domestic assets of Bank of Albania reflect a part of liquidity generated by Bank of Albania into the system. Changes in net domestic assets mainly come from relationships of Bank of Albania with commercial banks and government. The level of this part of liquidity determines at a great extend the overall liquidity in economy and thus it affects inflation.

Graph 7 indicates the performance of this objective during 1998 – June 2001. This was the period during which Albania signed supporting agreements with IMF.



Graph 7. Deviations from targeted values

OPERATIONAL INSTRUMENTS

Since the time (third quarter of 2000, see figure 1) when the application of direct instruments for monetary control was abandoned once and for all, monetary policy of Bank of Albania has entered a new and interesting phase of its development now. For a relatively long time, around 8 years, monetary policy was based on the application of two main instruments, which in fact

were two administrative decisions of Bank of Albania. These decisions were related to the restrictions on credit growth by commercial banks and the obligation of state owned banks to maintain the minimum interest rate settled by Bank of Albania for Lek deposits.

Credit Limitations

Considering the underdevelopment of banking system and the lack of a developed formal credit market, starting from mid 1992 Bank of Albania had to control the amount of credit accredited to non-government sector through applying credit limits specific for each bank in the banking system. In order to establish a kind of flexibility and to encourage banks to engage into simple forms of interbank transactions, it seemed reasonable that these limits be negotiable.

However, many problems arose, especially with regard to reporting and supervising lending limitations. New credit for private sector⁸⁷ started to increase rapidly and by the end of 1993, its accounted for 11 per cent of total credit as compared with 4 per cent that was the previous year. Because of many objective and subjective reasons, in most cases, it became impossible to comply with these limits and their efficiency reduced accordingly. Nevertheless, increased borrowings from informal market reduced the demand for credit from banking sector. Meanwhile, starting from May 1995, banking sector was made available another investment alternative, treasury bills. Consequently, the importance of credit restrictions fell considerably specially after the 1997 crisis when for reasons related to banking supervising criteria and disbelief of banking system towards private business this instrument lost its purpose and in 1999 it was completely abandoned.

Interest Rate

Looking at history, before 1992 interest rate did not affect allocation in economy. During the '80s, interest rate for deposits was stable within the interval 0.5 – 3 per cent, while there was no difference between lending and deposits rates. Although in November 1991, interest rates increased in general, still they could not “compete” with galloping inflation rates that economy was going through in that period.

⁸⁷ However, it should be noted that starting point was very low.

When the attempts to stabilize the economy in mid 1992 started, it was believed that establishing a real return rate would provide the key to success, especially with regard to employment of financial investments and sources. The first move was to increase the minimum interest rate for Lek deposits from 4 – 8 per cent to 22⁸⁸ – 32⁸⁹ per cent. In response, lending rates increased significantly reaching the highest point of 39 per cent for one-year loans.

The effects were clear in the first two-three years of transition. The end of money hemorrhage coincided with an increase of deposits in the system, while inflation was refrained considerably and continued falling till it reached a one-digit figure by the end of 1995. Not mentioning lending schemes phenomenon again, during 1996-1997, or maybe a bit earlier, interest rates collapsed and consequently also the monetary policy at that time. The collapse continued till another period of high increases in interest rates for Lek deposits comes.

The actual inflation developments during 1999 - 2000 were unusual and they led to smoother monetary conditions during all this period. This way, we come to the third quarter 2000 when banks' reaction was not in line with the reductions in administrative rates by Bank of Albania. In these circumstances, the reconstruction of the whole operational framework was taken into consideration and it was decided that monetary policy of Bank of Albania be based on the application of market instruments only. More specifically, it was decided that Repo rates would serve as the basic interest rate in economy. These transactions would be performed through weekly⁹⁰ auctions held by Bank of Albania

As diagram 1. indicates, the primary instrument of monetary policy of Bank of Albania is fixed Repo rate, which depending on the signals that Bank of Albania wants to convey to the market, is offered either through auctions with unlimited⁹¹ amounts for fixed prices or auctions with fixed amount⁹² for prices within a limit. Despite the type, their only purpose is to control liquidity in the

⁸⁸ Interest rate for 3-month deposits.

⁸⁹ Interest rate for 12-month deposits. .

⁹⁰ Depending of Bank of Albania's intentions, auctions could be: (i) Repo agreements – to absorb liquidity – or (ii) reverse Repo agreements – to inject liquidity in the market.

⁹¹ In this case, the signals showed imply a neutral monetary policy, as it is actually happening since last spring.

⁹² Initially, Repo auctions consisted in accepting predetermined amounts for a ceiling price predetermined as well. In this case, the market gets a clear signal to further decrease interest rates.

system trying to keep it in optimal levels and ensuring maximum efficiency of transmission mechanism.

On the other hand, fixed Repo rate provides a reference for other discount rates, mainly with regard to credit facilities offered by Bank of Albania to the banking system.

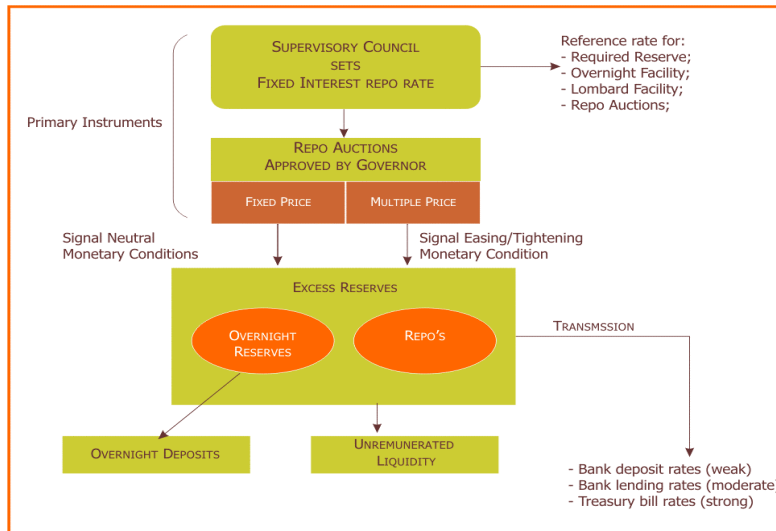


Diagram 1. Current Monetary Policy Framework

Other Instruments

Utilisation of indirect monetary control instruments, despite recent developments, dates earlier and to prove this I would like to recall the application of reserve requirements, credit facilities offered by Bank of Albania, etc. However, last years have marked considerable changes with regard to operational framework of Bank of Albania. I would like to present briefly the types, status, purpose, etc. of monetary instruments available to Bank of Albania today.

Outright Agreements

Outright agreements can be utilized in cases that require stable sterilization of the market. At present, the instrument used for these transactions includes treasury bills with one-year maturity or with remaining maturity of no less than fourteen days.

During 2001, there were two cases when treasury bills were permanently sold for a total amount of 8 billion Lek and in both cases, they were purchased by Savings Bank.

Interventions in Foreign Exchange Market

Although Bank of Albania has adopted a flexible exchange rate regime, it has still been present in the market, mostly to avoid speculations with Lek. In case of trading foreign currency, transactions can be with full rights or temporary rights (swaps).

Credit Facilities

Lombard Credit

Lombard credit facility was introduced relatively early, but it was used in extreme cases⁹³ only. Obviously, it has a classic purpose, i.e. it offers assistance to the banks with temporary liquidity problems⁹⁴ and it is considered as lending of last resort. It also implies the highest lending rate offered by Bank of Albania to the system.

Lombard Credit rate⁹⁵ is determined as the sum of Repo rates and a penalty of six per cent.

Overnight Credit

This facility was offered to the banking system since last year and its purpose is to supply overnight liquidity to specific banks that need it. The name implies that this credit should be paid back the following day and its price⁹⁶, like Lombard credit, is based on Repo rate plus a penalty of 2.5 per cent. Overnight credit⁹⁷ is used very rarely.

Required Reserves

Required reserves is one of the few instruments of indirect control on money used since July 1992 and maintaining the same rate of 10 per cent.

⁹³ It is never used during 2000 – 2001.

⁹⁴ It can have maturity up to three months and can be granted only once during a three-month period.

⁹⁵ At present, its rate is 13 per cent.

⁹⁶ At present, its rate is 9.5 per cent.

⁹⁷ Till October 31, 2001.

Required reserve is calculated considering all deposits⁹⁸ (commercial bank liabilities to third operates) in Lek and foreign currency. A recent innovation happened in October 2000 when Bank of Albania offered a level of remuneration of 1/3 of market rates⁹⁹ in order to lower the intermediary cost of banking system. Given the urge to see faster results, since the first quarter of 2001, the level of remuneration increased to 1/2 of market rates.

AMBIGUITY AND LOW EFFICIENCY OF MONETARY TRANSITION MECHANISM

For reasons mentioned above, transmission mechanism in Albania is different from the one typical of a small open market economy. At present, specialists opinions, including those of IMF experts, have converged to the conclusion that monetary policy outcome fades in the light of factors such as: (i) Savings Bank monopoly in Lek deposits market; (ii) limited role of credits in Lek; (iii) relatively large differences between lending and deposits interest rates; (iv) limited activity of interbank market, which mainly focuses on short term instruments; (v) remittances from emigrants; (vi) large amounts of cash in Lek and foreign currency held by Albanian public. As you might imagine, diagram 2. illustrates a possible version¹⁰⁰ of transmission of monetary policy decisions into economy and also the role of other macroeconomic indicators and policies on inflation.

From this point of view, it is right to ask: Is Repo rate capable to convey Bank of Albania's decisions to economy? The figure indicates that at present, Repo rate affects lending and deposits rates, while it affects nominal exchange rate only slightly. On the other hand, according to the figure¹⁰¹, it is fiscal policy, nominal exchange rate, remittances from emigrants, etc. that have a greater impact on aggregate demand and consequently on inflation.

⁹⁸ With the exception of interbank deposits.

⁹⁹ 1/3 of the rate for 3-month treasury bills for Lek reserves and 1/3 of the rate for monthly deposits in USD and EURO for USD reserves and Euro reserves respectively.

¹⁰⁰ Up to now, this is considered as the most plausible approach. Given that there are still uncertainties with regard to monetary policy effects on certain variables or markets, the figure presents two lines. The interrupted red lines represent not well argued relationships, while the green lines represent efficient transmission channels.

¹⁰¹ This diagram, apart from other things, shows once more the necessity to focus the attention to the development of financial markets in the country. Markets such as stock market, securities market, real estate market, etc. are potential channels of vital importance for transmission of monetary decisions to the economy.

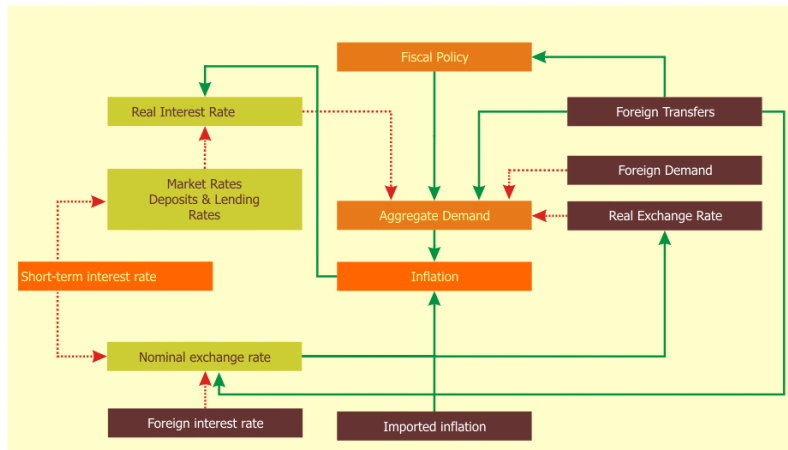


Diagram 2. Transmission Mechanism

Based on the above diagram, in cooperation with IMF experts it was possible to design a small macroeconomic model¹⁰² that is a set of equations, which try to identify the main relationships on an aggregate level. Improving this model in the short term is considered a priority for Bank of Albania since comprehending it is in tune with medium term objective of the bank, that of possibly adopting *inflation targeting* regime.

THE FUTURE: INFLATION TARGETING OR ...

The explanations given above as well as the logic of this conference lay down an important question: Which is the vision of Bank of Albania for the future, especially for the more distant one? Will monetary policy of Bank of Albania continue to dwell in the existing framework, where, as aforementioned, there are many uncertainties, or will there be attempts to complete its efficacy on economy and, why not, even to measure it?

Answering these questions, I would emphasize that at present, Bank of Albania has taken a decision that above all implies adopting a monetary policy regime, which focuses again on price stability. Unlike present regime, in the new one even the intermediary objective will be the same macroeconomic variable, inflation. I believe you already understand that we are talking about that monetary regime that has found a wide spread recently and

¹⁰² For more details, please contact Department of Research, Economy Division.

that due to difficulties of finding an accurate and concise translation in Albanian, I will call it *Inflation Targeting Regime* (IT). Actually, it can be said that IT can be a successful strategy if, on one hand it finds a sound macroeconomic and institutional environment and on the other it faces an audience (economic agents, individuals, general public) that understands and welcomes it.

Going into details about each of these aspects, I would start with:

Macroeconomic Aspect

Inflation

In general, literature recommends that a period of two-three years of low inflation¹⁰³ should proceed to application of *inflation targeting* regime. Low rate is considered an inflation rate within 1-3 per cent. In general, during the last years, the trend was towards low rates and for almost a year, since last December, inflation has varied close to the upper level for the objective.

In different years, *shock* factors have been present when there was high inflation as well as when there was low inflation. On average, annual inflation rate from January 1998 to September 2001 has been 24.6 per cent, while during the last four years, January 1998 – September 2001, it has been 6.5 per cent. If we look at each of the last years, annual inflation rates have been 21.6 per cent, 0.4 per cent, 0.0 per cent and 3.3 per cent for 1998, 1999, 2000 and 2001 respectively. Based on inflation developments up to now, even though the current year implies that inflation is higher compared to that of the two previous years, it is believed that the preconditions to apply IT regime already exist. It should be noted that inflation performance during 1999-2000 reflects many *shock* events, which have affected its unusual development.

Exchange Rate

Exchange rate regime is one of the other strong points for adopting IT. In the case of Albania, it is a fortune that Bank of Albania has the exclusive rights to take decisions that choose and administer the type of exchange policy in Albania. Also, since 1992, Bank of Albania has chosen a free floating exchange rate regime whose main feature is that currency price is determined by supply –

¹⁰³ Yet, countries like Czech Republic, Poland and other have adopted this regime in circumstances when inflation rate varied from 6 to 10 per cent.

demand relationship. The existence of this regime, is one of the criteria for adopting inflation targeting, and thus this indicator provides a strong point in its support. This becomes more plausible considering the stability of domestic currency, Lek, compared to US dollar and European currency, EURO. For the fourth year in a row, Lek has been stable putting Bank of Albania in the position of a “simple spectator” of the developments in foreign exchange market.

Fiscal Consolidation

The last years have marked important developments with regard to fiscal consolidation. It is a fact that during the last years, budget deficit enjoyed the “fortune” of earning considerable revenues in foreign currency (financial assistance and privatization revenues). These revenues have smoothed out fiscal pressure on monetary policy and thus, banking system has not faced liquidity problems, while Bank of Albania has met the limits of financing budget deficit as defined by the law.

However, it cannot be talked about fiscal stability and consolidation yet. To say this, we consider the structure of budget revenues (a considerable part of it comes from custom office), fiscal evasion and somehow arbitrary practices in collecting taxes and deciding on reference prices. On the other hand, fiscal authority has not adopted the necessary transparency. This means that it is not completely clear the efficiency of budget revenue utilization. Also, the low level of well-being in Albania (it is ranked the fourth poorest country in Europe), high unemployment rate and the not so good practices of administering budget revenue are factors which exert strong pressure on authorities to expand budget deficit and weaken the position of fiscal stability. From this point of view, and keeping in mind the difficulty of separating that part of inflation which is caused by budget policy, it can be stated that for as long as treasury bills market will be the only securities market in Albania, for as long as Bank of Albania lending to government will not be prohibited by law, for as long as there will be no credible engagement from political forces to administer fiscal revenues rigorously and with transparency, etc. the successful adoption of IT will be difficult.

Financial Stability

If we look at financial system crises, it seems that Albania has not gone through any of them. This holds true for that part of the

economy which is called "formal". In Albania, despite the establishment of three new insurance institutions, *de facto* financial system can be identified with the banking one. On the other hand, we should not forget that 1997 crisis, though it was caused by banking system, still it was a typical financial phenomena, whose outcome on main macroeconomic indicators, production, inflation, unemployment, balance of payment, etc. was unmeasurable.

In this context, the question arises: Which can be Albanian immunity system from financial crisis?

Despite the continuous attempts to strengthen banking supervision, yet our banking system is underdeveloped and offers a low level of intermediation. It shows large concentration and it operates in conditions where the risk is high (the whole spectrum from political to operational one), regulations are incomplete and there are problems with implementing the rules, etc.

On the other hand, markets and other financial institutions are newborn and the level of exposure is high. Informal economy is still present and, despite the bitter experience, there are hints that borrowing activity still continues at a less extend.

As it might be noticed, defensive mechanism of Albania towards financial crises suffers from many problems and although they are known for quite a while, it is not possible to eliminate them. The weak immunity system causes Albanian economy to have a high degree of exposure and consequently an important condition of IT regime is not met.

Institutional Aspect

While in the macroeconomic aspect there are factors which favor the choice of IT regime as a monetary policy regime, it is believed that in the institutional aspect there are more disadvantageous points which weaken this choice.

Central Bank Independence

The law offers an independent position for central bank, but in reality central bank independence is far from the legal independence and under threat. It seems that other authorities have no intention to respect central bank independence. On the other hand, there is not sufficient guarantee that independence as granted by the existing law (all of it or specific aspects of it) will not be subject to later changes.

Central Bank Transparency

Also, it is assessed that central bank transparency is far from the standards set for it. The bank is not transparent about its core meaning: explaining decision-making process, especially with regard to monetary policy.

Central Bank Credibility

It cannot be mentioned that Bank of Albania enjoys credibility in the public. It should be understood that Albanian public initially needed to know that there is a central bank called Bank of Albania. On the other hand, adopting IT regime weakens central bank credibility in the view that it is highly possible to shift away from the objective since inflation is affected by *shock* factors.

Central Bank Accountability

It is estimated that real accountability should increase. Bank of Albania has taken on to respect all the reporting requirements, but the quality of this report is subject to further improvements that are expected to increase Bank of Albania's accountability.

Not So Good Relationships with Fiscal Authority.

The coordination between fiscal and monetary authority is not at levels required by IT regime. In practice, this lack of coordination hinders Bank of Albania to implement efficiently the instruments to complete monetary policy.

Overall, institutional aspect is considered a weak point in adopting *targeting inflation*.

The Level of Understanding from the Public

Albanians took the first practical lectures of what inflation is at the beginnings of '90s. As years passed by, everybody understood that more or less, price increases erode their income and savings, however few understand that the difficult mission of keeping stable prices belongs to an institution named Bank of Albania. In fact, Albanians learned one thing; "short-term sacrifices can reap long-term rewards". This statement was called out by both main political forces when each of them came to power. Despite this, they could not understand the mechanism, which can take one from the devastated present to a richer and safer future. An evidence of this

is the unending period of transition and the many failures during this period (mostly for subjective reasons). A limited number of people are able to explain why serious reforms are needed while some remain disappointed and the majority accepts them indifferently.

In this context, it is hard to believe that Bank of Albania will find “suitable” partners on the other side who can rightly understand and perceive its decisions. When the public understands and welcomes central bank policy, then the public and its expectations for inflation (guided by the objective for inflation) turn into a factor that determines future inflation rates.

In fact, public awareness, its familiarity with policies, banking, etc. improvements in institutional framework are today’s tasks and they do not need to wait for the completion of other preliminary conditions. Some of the issues which need to be looked at are as following:

1. Increasing Bank of Albania's transparency. For this reason, central bank has increased the number of publications, specially the explanatory ones, presentations with media, contacts with public, meetings and seminars and has also approved a strategy and regulation on transparency.
2. Improving relationships with other state institutions. For this reason, Bank of Albania has adopted an intensive approach towards all international organizations (integration in EU, Stability Pact, and discussions of documents such as development strategies for SMEs). The most notable is the participation in debt committee.
3. Increasing accountability. Bank of Albania has increased its contacts and reports with and to the Parliament trying to expand on explanations about decision-making.
4. Increasing credibility. Apart from achieving the objectives and making these known, Bank of Albania is trying to win the public and establish regular communications with it. The bank is organizing campaigns (on lending); it is approaching businesses to understand the latter’s expectations, etc.
5. Achieving education. The process of education involves Bank of Albania itself, other authorities and the public. Bank of Albania has also offered financial support for this.
6. Increasing central bank independence.
7. Getting involved in other issues which are not Bank of Albania’s direct concerns, but which affect the existence of required conditions to adopt IT. An example of this is the involvement in the project for improvement of statistics.

On these grounds, Bank of Albania can build models to analyze and predict inflation as well as improve transmission mechanism. In order to comply with or improve each of the above-mentioned preconditions, a period of 2-3 years or more is needed. This time interval is based above all on Bank of Albanian uncertainty about the commitment of other authorities to adopt this regime, about public reaction; in the need to build a macroeconomic model (including a trial period); in the increase of financial market efficiency with regard to absorbing informal assets, strengthening banking supervision, etc.; in improving money market so that an efficient instrument to control money, etc. becomes available.