



THE EFFECTIVENESS OF MONETARY POLICY IN ALBANIA AND THE NEED FOR FURTHER REFORM

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ABSTRACT

A key test of whether a central bank has been conducting successful monetary policy is the extent to which people ‘trust’ their money. In this paper we assess the Bank of Albania’s effectiveness by analysing conventional monetary policy transmission mechanisms and by analysing evidence of inflation expectations. The low level of financial intermediation and rampant unofficial dollarisation and euroisation represent serious constraints to the transmission process. Furthermore, we take differences in long-term interest rates between hard currencies and the Albanian Lek as tentative evidence that inflation expectations have not yet stabilised at a low level, despite the fact that inflation has been low and stable in recent years. Exogenous events, such as the steady inflow of remittances, contributed to the steady inflation record, because they supported the exchange rate and limited inflationary pressures from the demand side.

Confidence in the conduct of monetary policy and the stability of the banking system should create low and stable inflation expectations. If these are achieved, steps could be taken towards inflation targeting. In our view, further reform should address four points: (i) Reducing the amount of dollarisation, because real economic linkages are overwhelmingly with Europe. (ii) The financial intermediation level should be fostered, while taking care to avoid an unsustainable lending boom. (iii) The cash economy should be transferred into a bank-based economy; and (iv) the quality of institutions must be improved.

JEL: E52, E58, G21

Keywords: Albanian economy, monetary policy, inflation targeting, financial development

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1 Monetary stability and monetary policy: The Albanian record

Monetary stability is one of the major cornerstones of the recent success of Albanian economic development. Measured by inflation rates as well as by the volatility of exchange rates, the Albanian record has proved remarkably successful:

- Consumer price inflation dropped from more than 40 % to around 3 % in the aftermath of the 1997 burst of the pyramid scheme. This is even more remarkable when one considers that fast growing transition countries normally experience some intrinsic tendency for inflation due to the Balassa-Samuelson effect (Kovács et al, 2002).
- The exchange rate is stable; if anything, the Lek has appreciated against the Euro, and this trend has been even more pronounced against the USD.

In searching for an explanation for this extraordinary record, attention is attracted immediately to the contribution of the Bank of Albania's skilful, determined and cautious monetary policy, oriented toward inflation reduction objectives. The BoA evaluates and controls the progress of monetary indicators clearly developed in an adaptive monetary program. With a clear ambition to switch to formal inflation targeting in the medium term (Hadëri/Kolasi, 2003), the BoA already publishes a target band for inflation rates, currently between 2 - 4 %. Monetary Repurchase agreement rates and open market operations are the key instruments of the BoA's monetary policy. The Central Bank's cautious policy was evident between 2002 and 2003 when repo rates were raised to between 7 % and 8.5 % and then lowered again to 6.5 % in response to monetary developments. The monetary program for 2003 was adopted in light of the ratio of currency outside of banks to money supply and a stronger engagement in deposits of longer term maturities.

With regard to the foreign exchange rate, the Central Bank operates within a managed floating exchange rate regime. The Albanian exchange rate is classified as independently floating, and is affected by interventions of the BoA—when necessary—to smooth fluctuations of the Lek versus the US-Dollar and the Euro. Between January and August 2003, the Bank of Albania intervened in purchasing currency amounting to \$ 46 million to tame appreciation pressure. Consequently, the Lek remained fairly stable compared to the Euro in 2003. This was different from the experiences of other central and eastern European countries whose real exchange rates often appreciated, but whose nominal exchange rates typically depreciated modestly.

The Bank of Albania takes the notion of monetary stability seriously in regard to low inflation and stable exchange rates. When it intervenes, it does so with care, determination and with good reason. These interventions have even received the praise of the International Monetary Fund, an institution more often known for criticism of intervention than for appraisal. The IMF country report for Albania (IMF, 2004) states: "The BoA has managed liquidity skilfully and the prudent easing of monetary policy

has been appropriate ... the BoA should continue its gradual approach, carefully monitoring domestic supply conditions, and international energy prices and interest rate differentials". There is no doubt that the BoA has to be credited for sound monetary performance because it has contributed to stability with a "transparent, systematic, and market based" monetary stance (Samiei, 2003).

We are not alone and the good Lord gave us two eyes: one for policy and one for markets. The BoA's monetary policy has been supported by fiscal policy oriented towards regaining macroeconomic stability. After some episodes of stress, the Albanian government has started to re-strengthen the country's prudential fiscal framework. The annual fiscal deficit came down from 12.1 % of GDP in 1999 to 5.6 % in 2003, while overall indebtedness dropped from 71.6 % of GDP in 2000 to 60.3 % in 2003 (EBRD, 2004). This is even more remarkable as the fight against poverty and unemployment require considerable financial resources.

And there have been favourable markets. As Government policy has supported the strong commitment of the BoA towards monetary stability, so have some key market patterns. GDP growth was high and robust, and with a favourable structure of employment and moderate wage increases to smoothen the Balassa-Samuelson effect, the appreciation of the Lek tamed cost impulses without having an overly negative impact on exports.

There are certainly other factors which may have contributed to the convincing performance of Albania's inflation and exchange rates. For example, one might think of the influx of capital from official transfers and remittances which supported the exchange rate (Samiei, 2003; Muço et al., 2003), as well as exogenous events such as the timing and quantity of domestic food production which also had helpful effects (BoA, 2004).

One can conclude that the excellent monetary performance of the economy as measured by standard indicators has resulted from policy expertise and some favourable market patterns. Good luck and good management had a role in this process. Circumstances have been kind to Albania recently, and the Bank of Albania was indeed smart enough to take advantage of this. But there may be future times in which Albania must again sail stormy weathers, and in which monetary policy may again become more complicated.

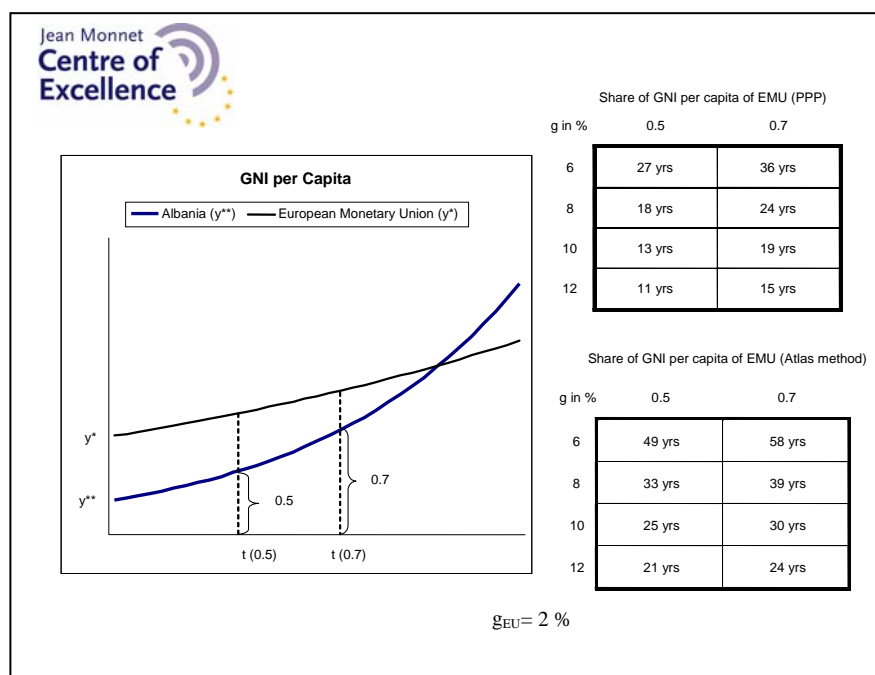
Albanian monetary policy already operates in a difficult macroeconomic environment. Unemployment is unbearably high and poverty a constant major concern. The informal sector is hard to integrate into the formal economy. Energy problems still exist. The quality of Albania's institutions is worse than in neighbouring countries: risk indicators with respect to the rule of law, efficiency of administration, corruption and organised crime regularly come up with unfavourable results. Given these major challenges one may ask whether monetary policy is well prepared for more difficult times, should Albania again be forced to master uncharted waters. And one may look at the design of the monetary framework if a risk assessment reveals scope for further reforms.

2 Real convergence and monetary fundamentals: A complex interplay

Standard indicators of economic wealth reveal that Albania is still a poor country, especially in comparison to the European Union. Albanian GNI per capita is estimated at around \$ 1.765 (EBRD, 2004), some 18 % of the average GNP of the European Monetary Union. Purchasing power parity (PPP) figures look somewhat similar. In 2003 and calculated on the basis of PPP, GNI per capita in Albania was about \$ 4.700, in the range of 7 to 8 % of the EMU average (WDI, 2004). Evidently, real GNP growth is badly needed to increase the welfare of the nation, fight the war against poverty and to combat unemployment.

Growth is strong in Albania: after a slowdown in 2002, economic growth picked up to 6 %. This amount is robust and substantial, but not spectacular, given that Albania started transition from a comparably low base. However a rate of 6 % does not seem to be enough: a simple back-of-the-envelope calculation reveals that 6 % growth would require some 20 to 30 years for Albania to converge to between 50 and 70 % of the average GNI per capita of the current European Monetary Union. We calculated the time period needed for a catch up to 50 or 70 % of average GNI per capita of the EMU given an average growth rate of the EMU of 2 % and assuming growth rates for Albania between 6 to 12 % (see Figure 1). Even with a growth rate of 12 % and calculated on the basis of the Atlas method (WDI, 2004) calculations in reveal that the catch up process would take some almost a generation to approach a 70 % average per capita of the European Union.

Figure 1: Catch up – Time Periods

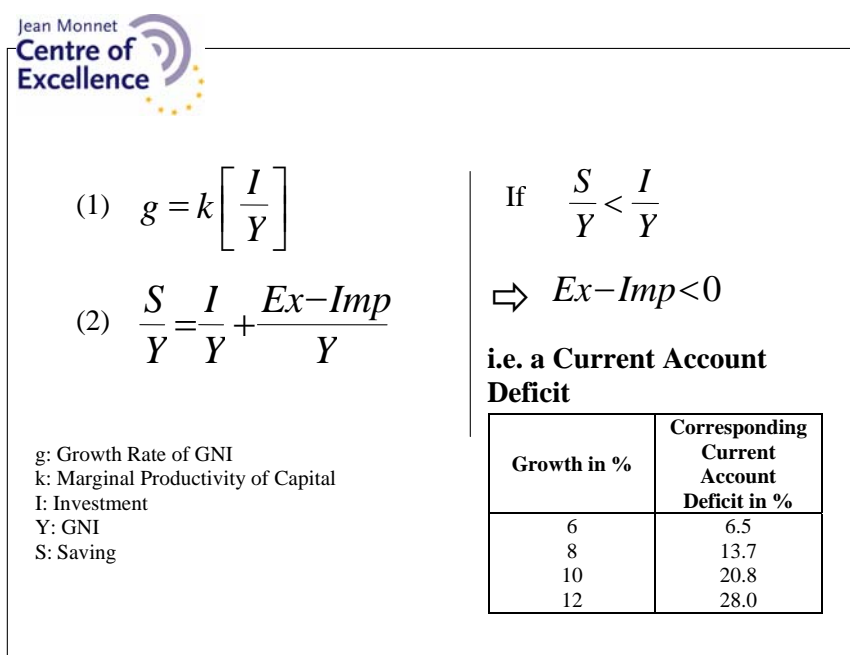


Source: Own calculations based on data by World Development Indicators, 2004

A convergence process taking 20 to 30 years with high growth rates but slow progress in consumption is probably longer than most people are prepared to wait. Perhaps too much patience and determination would be required given that richer regions are just across the border, or over the sea for that matter. Moreover, countries, such as Ireland, have shown that it is possible to sustain higher rates of growth over a prolonged period of time and to achieve real convergence in less than a generation.

Higher growth means higher investment in real and human capital needed to speed technical progress. Equation 1 in Figure 2 refers to the very fundamentals of the growth process: growth rates depend on the investment ration I/Y and the efficiency of investment k . In a simple Harrod-Domar model of economic growth, both variables are taken as being independent from each other, in a Solow-type model both variables are interlinked via the production function and markets. To make things easier—the Solow model accounts for well-functioning (neoclassical) markets at least in the very long run—we refer to the simple, but not simplistic, view, that growth depends on investment in real capital, human capital, and some kind of autonomous technical progress.

Figure 2: Some Fundamentals



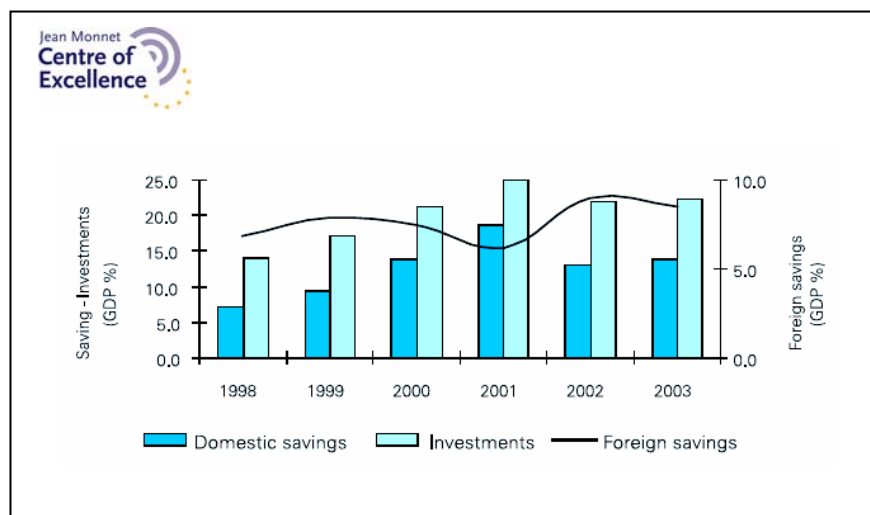
The problems faced by growth-men—and the lessons to be learned—can easily be seen. A growth-oriented convergence strategy requires a high share of investment to GNI. The problem is that a comparatively poor country like Albania with a low level of consumption can hardly afford to devote its scarce resources towards increasing investment. In terms of monetary aggregates this reads as follows: in the short run a comparable low income country such as Albania cannot increase savings to a level necessary to finance high investment without risking monetary equilibrium or, even worse, political instability. To ensure an equilibrium between overall demand and

overall supply, higher savings are needed for higher investment. Otherwise, demand driven inflation places monetary stability is at risk.

There is only one exception: if a country imports foreign resources via its current account deficit, the gap may be closed between necessary high investment and income-restricted low savings. From the point of view of welfare economics, a current account deficit can be interpreted as an import of foreign resources financed by a steady inflow of foreign capital into the country. Thus the domestic savings ratio may still be low. But if the scarcity of domestic resources is closed via a current account deficit, thus enabling high investment, and the corresponding domestic savings-gap is fuelled by an inflow of foreign capital, internal macroeconomic stability can be guaranteed, as well as external stability expressed by a market equilibrium of the balance of payments. These links are expressed in equation 2 of Figure 2. Equation 2 can be interpreted as a tautology because of definitions of saving, investment and current account deficits or as a necessary condition for macroeconomic – especially monetary – stability. In this paper we refer to the second interpretation thereby interpreting the current account deficit as an import of foreign resources to the country, badly needed by poor countries to equilibrate investment requirements for high growth and the saving ability of a poor country trying to make living.

This is exactly the situation in Albania. Figure 3 drafts the development of savings and investments as a percentage of GDP in Albania. It is easy to see that the domestic savings ratio against GDP is much lower than the investment ratio, resulting in a current account deficit.

Figure 3: Savings and Investments as percentage of GDP

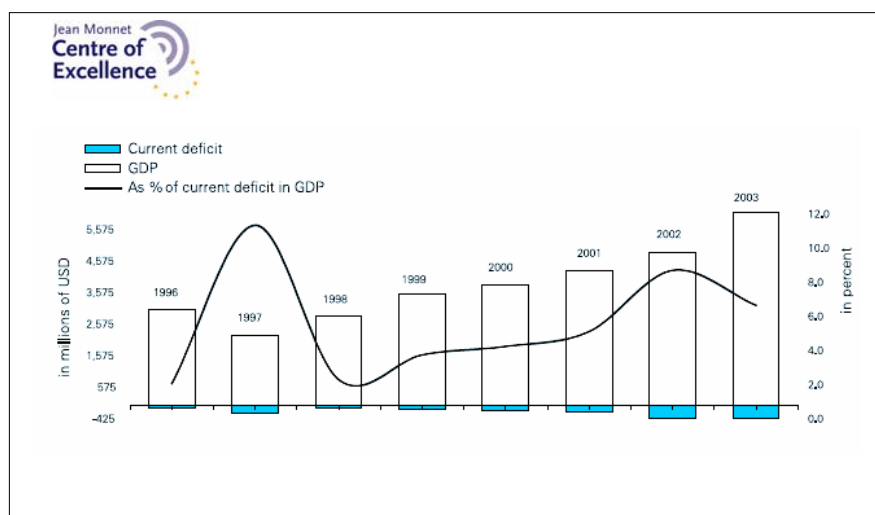


Source: Own calculations based on data by World Development Indicators, 2004

A current account deficit which corresponds to saving and investment differences is sketched in Figure 4. As calculated by the BoA, the current account deficit was estimated at 6.7 % of GDP at the end of 2003 and has narrowed considerably compared to 2002 when the ratio stood at 8.7 %. (Note: the current account deficit as calculated by the EU amounts to 8.5 % in 2003 and to 9.1 % in 2002; COMM, 2004). These

figures correspond to our own calculations in Figure 2. A growth rate of 6 % corresponds to a 6.5 % current account deficit. If savings and investment ratios would remain unchanged, a catch-up process with higher rates of growth would require a higher current account deficit. Calculations show that the current account deficit has measured against GDP almost doubles if the growth rate increases from 6 to 8 %.

Figure 4: Current deficit as percentage of GDP



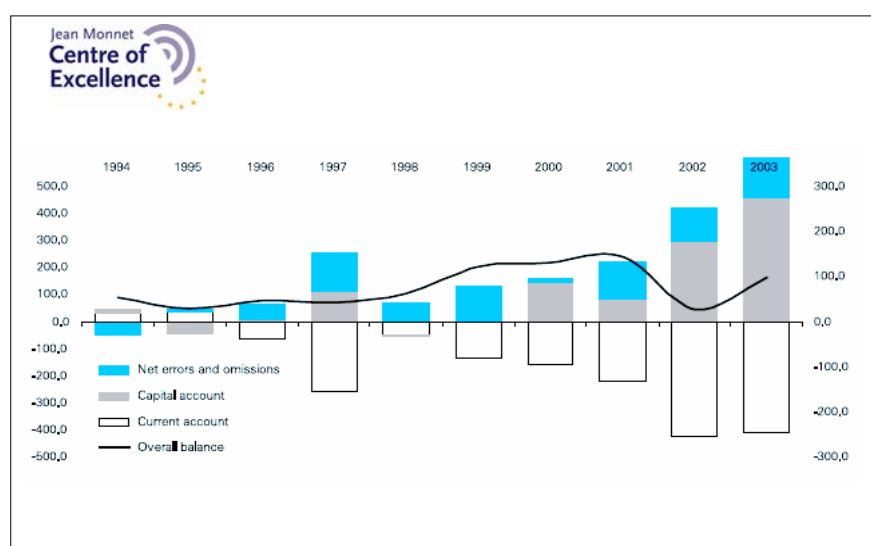
Source: Bank of Albania, Annual Report 2003

This is no more than may be expected: given unchanged decisions on savings and the political determination to foster monetary stability, higher growth means higher current account deficits needed to feed foreign resources into the domestic economy. Despite the fact that the current account deficit is used mostly for consumption in Albania (through imports of consumption goods) it should not be forgotten that this is linked to investment via opportunity costs. Consumption goods import patterns save resources needed for private and public investment given the low level of domestic savings in Albania. Unfortunately, at least from an economic point of view, we are not talking about the United States. The US could afford current account deficits over the years because of the role of the US dollar. This was due in the post-World War II period to favourable institutions (the Bretton-Woods international architecture), and more recently has been due to well-functioning capital-markets. The Lek does not serve as an international reserve currency and Albania cannot be said to feature a deep and wide capital market. For smaller and poorer countries like Albania, high current account deficits can easily prove to be unsustainable. A steady and reliable inflow of foreign capital is needed to finance the deficit and to support the currency.

Albania is lucky in this respect: its current account deficit is financed mostly by remittances from Albanians working abroad, by moderate foreign investment inflows and by foreign financial assistance (Figure 5). These inflows maintain the Lek's strength, and served to strengthen Albania's overall external position during 2003. The Lek has appreciated slightly relative to the Euro, and was even stronger relative to the USD. Moreover, the reasonably steady inflow of foreign capital has meant that the Lek

has not been extremely volatile. Of course, relying on favourable conditions is a decidedly risky business. As long as savings and investment decisions (private and public) are based on correct perceptions of future economic conditions – especially on the sustainability of growth rates and the steady inflow of capital into the country – monetary conditions will remain stable enough to make the convergence process work. But if there are exogenous shocks or somebody cries wolf in the hope of a speculative attack, the somewhat overvalued currency—as measured by the current account deficit—may come under pressure. The Lek has remained steady because of the special characteristics of the inflow of foreign capital. Remittances are not overly sensitive to speculation, foreign direct investments are still among the lowest in the region in pro capita terms, export growth and relatively low inflation has helped to ensure the stability of the local currency, thereby enabling badly needed financing of the current account deficit.

Figure 5: Balance of payments structure



Source: Bank of Albania, Annual Report 2003

It does not seem advisable to run a stress-test by pursuing an overt policy to increase the current account deficit to a level too high to be trusted by markets, or by giving up financial or monetary discipline. External equilibrium is rather unstable and foreign exchange rates may turn out to be more volatile than expected. There is always the possibility of a currency crisis with all of the well-known characteristics: depreciation, a banking crisis and contagion. To ensure a self-sustained catch-up process policy must enable higher domestic savings—i.e. slow increase of consumption!—and high investment ratios. Thus, the growth strategy sketched above has to be linked to increasing the export-base and to reducing the trade deficit, thereby also diminishing the current account deficit. The process has to be gradual, but determined. Risks are around the corner: there is a fine line between overshoot and economic crisis, characterised by short term needs and long run goals. Most importantly, Albania needs to maintain a reliable monetary policy designed to ensure low inflation rates based on sound, long-term market confidence in the functioning of the convergence process.

3 Risks and consequences for monetary policy

3.1 Risks: Long-term inflation expectations

A key challenge for Albania over the next few years will be to advance real convergence without putting macroeconomic stability at risk. An average medium-term growth rate of between 6 % and 8 % seems achievable provided that structural reforms proceed and economic policy remains stability-oriented.

If convergence is to be based on a higher growth rate than the median of the last few years, this process will necessarily be accompanied by a higher current account deficit than before. This deficit is the consequence of growth fuelled by higher import volumes needed to fill the gap between private consumption and private savings. However, this somewhat risky catch-up strategy will only work if it is supported by a monetary and fiscal policies aimed to increase domestic saving and the export base in the medium and long run. In other words, Albania must gradually, but determinedly, turn the current account deficit into a reliable surplus.

The sustainability of Albania's external position may come under pressure in the long run if the widening of the current account deficit does not reflect savings and investment decisions based on correct perceptions of economic conditions. Potential risks to current account sustainability relate to possible future changes in the financing pattern as well as an overestimation of output growth. The characteristics of the process imply increased output volatility as well as challenges to managing volatile capital flows.

Monetary and exchange rate strategies contribute significantly to macroeconomic stabilisation by providing credibility for inflation expectations. Economic indicators such as low and stable inflation rates, exchange rate stability and shock absorption are just that—credibility indicators. The reputation of a central bank can be gauged by the degree to which people trust their money. The success of a central bank is ultimately judged by the level of trust people have in the currency. Stable monetary regimes help in foster credibility and acceptance.

If people have faith in the domestic currency, they may even accept temporarily higher inflation or volatile exchange rates, because they are convinced that the currency will be stable in the medium and long run. On the other hand, when people are wary about their own currency, they might amplify short-term imbalances by reacting procyclically to minor shocks. A small depreciation, for instance, might trigger a large-scale reshuffling towards foreign currencies (safe havens) because people lack confidence in their own money. The fear of large-scale depreciation may then become self-fulfilling.

Despite successfully fighting inflation, we find some evidence that Albanian monetary policy has a less than convincing record in delivering confidence in the long-run

stability of the Lek and the sustainability of the growth process, i.e. the speed and the quality of real convergence of the economy. We base our judgement on theoretical and empirical observations which are linked to expected inflation.

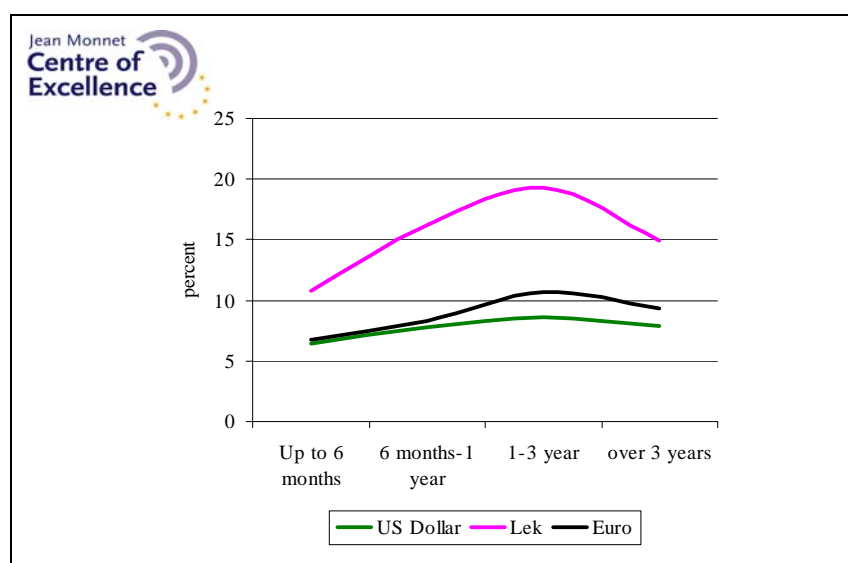
If inflation expectations are not favourable and are not kept low and stable they will channel into medium and long-term interest rates, as well as into expectations on the future development of the exchange rate. Therefore, they have a grip on the real economy and prices, because most investments have a medium to long-term horizon and firms ideally seek to finance them in a corresponding maturity, hence, avoiding a maturity-mismatch between investment and financing. Medium and long-term contracts usually take into account expected inflation rates. High uncertainty on future inflation may not only result in substantial premiums on long-term positions, but also discourage business parties from committing themselves to long-term contracts (in Lek denomination) altogether. This in turn may reduce the amount of specialisation and division of labour in the economy, because business parties are unable to contract specific relations, with adverse effects on economic growth.

It is only recently that economic theory discovered the importance of expectations—especially on inflation rates—in determining patterns of growth and employment. Prominent examples are debates connected to the stability of the Phillips-curve, the non-accelerating inflation rate of unemployment (NAIRU) and the assessment of non-Keynesian impacts of deficit-spending policies due to the Ricardo-effect. Linked to the theory of exchange rates the special role of expectations in speculative attacks is well-known. Economic theories worked on how expectations are built and came up with rational-choice arguments as well as ideas of adapted expectations. Economic theory agrees, however, that there is no doubt that inflation expectations are closely linked to past inflation rates and the credibility of Central Bank monetary policies. And there is no doubt, either, that inflation rate expectations also include an assessment of the characteristics of future growth patterns of the economy and risks linked to an efficient functioning of the complex interplay between monetary variables and economic fundamentals.

The theory of building inflation expectations is somewhat complex. With regard to pure and simple empirics, things are easier. However, it still is hard to find appropriate indicators to measure expectations on future inflation. As a proxy, we use interest rates on new credit for different maturities, obtained from INSTAT, as our preliminary indicator. A glance at the yield curve across maturities provides some insights on expected inflation. The yield curve has typically a non-linear form –i.e., interest rates rise with maturity for maturities between less than 6 months to 1-3 years, but the interest rate for maturities for more than 3 years is typically lower than the interest rate for maturities of 1-3 years. Hence, the non-linear yield curve (see Figure 6). However, the yield curve is affected by many factors other than inflation expectations. Insecurity about the future path of financial institutions may result in substantial premiums on long-term commitments, which appear as if inflation expectations were high, but in fact reflect the low confidence in the financial system – i.e., a high liquidity premium. We address this difficulty by comparing interest rates for different maturities across currencies—i.e., Lek, USD, and Euro—thus assuming that the liquidity premium is

based on the desire for financial flexibility and confidence in the financial institutions, but is less sensitive to the currency in which credit is denominated. Longer term maturities include a liquidity premium, because the lender forgoes some degree of flexibility in case of shocks if he commits himself to a longer-term loan. Moreover, the type of collateral usually needed to obtain a loan might vary across maturity, and hence, explain part of the yield curve. The remaining part of the yield curve can be explained by a mixture of inflation expectations and liquidity premium.

Figure 6: Average yield curve 2004: Interest rates for new credit according to maturity



Source: INSTAT, 2004

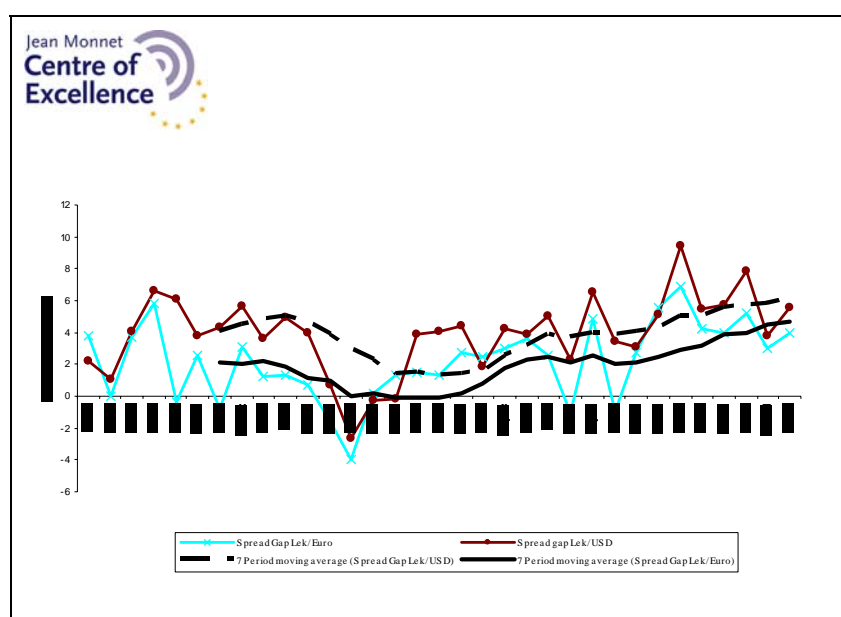
The described yield curve looks similar for new credit in Lek as well as in USD and Euro. All share the typical non-linear development. However, the magnitudes of differences between short-term interest rates and long-term interest rates are much higher for Lek denominations than for either USD or Euro denominations. To illustrate the point, Figure 7 draws the difference in spreads between Lek and Euro and Lek and USD denominated credit. The spreads are calculated as the difference between credit rates for new credit with maturities of less than 6 months and credit rates for maturities of 1-3 years. The spread gap describes the difference between maturity spreads for Lek denominations and Euro as well as USD denominations. Hence, a spread gap of 4 percentage points between Euro and Lek indicates that the difference between long (1-3 years) and short-term (< 6 months) credit rates is 4 percentage points higher in Lek than it is in Euro.

Furthermore, we have included a 7 period moving average trend line in order to smooth short-term variations. For instance, the 2002 run on deposits at Savings Bank shows up in plunging spread gaps during that time, because short-term interest rates for Lek denominations have been soaring, thus, reducing the spread to longer maturities. In the following, the analysis concentrates on the trend lines.

Figure 7 offers a number of insights. First, spread gaps have almost always been positive since October 2001, indicating that the premium on longer maturities is much

higher in Lek than it is in USD or Euro. Second, the spread gap between Lek and USD has been persistently above the spread gap between Lek and Euro. By inspection of Figure 7, one can estimate the gap in spread gaps at around 2 percentage points. Third, spread gaps have been increasing since January 2003. However, this would be much less pronounced (if existent at all) were it not for the 2002 run on deposits and the concomitant squeeze in Lek spreads. Thus, fourth, excluding the 2002 turmoil in spreads, spread gaps have been remarkably stable over the last years; only since the last year spread gaps have been raising above the levels of mid 2002 by two to three percentage points.

Figure 7: Spread gaps



Source: Own calculations, based on data by INSTAT, 2004.

Looking at the spread gaps allows separating the effect of inflation expectations and the liquidity premium on the yield curve. It seems plausible assuming that the liquidity premium is independent from the currency of denomination, because it reflects the price of real economic and financial flexibility. If there are frequent shocks, which would increase the need for flexible financial planning, then this should affect loans in Lek as well as in other currencies. Monetary shocks, which would affect only one currency, are conceptually included in inflation expectation. Hence, comparing the spreads gives an idea of the expected inflation differentials in the Albanian economy. The persistently positive spread gap between Lek and USD as well as Euro suggests that most economic agents expect inflation in Albania to be higher than in the United States or in the European Monetary Union (EMU). And the spread gaps are not negligible: As of June 2004, the gap between new Lek and Euro credit was 4 percentage points, while between new Lek and USD credit this gap was even wider, at 5.6 percentage points. Evidently, Lek denominated credit includes a much higher premium on longer maturities, which can be interpreted as a lack of trust and faith in the stability of the Lek. Consequently, people add a substantial surcharge on long-term commitments in Lek.

The interest rate premiums for Lek denominated credit and the gaps in maturity spreads suggest that, despite of the recent inflation record, long-term confidence in the Lek and the sustainability of growth is not very high. One may conclude that, even in light of the tentative evidence we have assembled here, inflation expectations are not favourable enough to proclaim victory in the fight against inflation in Albania. Inflation expectations are not that sound to serve as a reliable basis for low inflation in the long run, exchange rate stability and sustainable high growth.

3.2 Risks: *Financial intermediation*

As the catch-up process to higher income levels proceeds, monetary policy has to contribute to four important tasks to solve the problems of monetary stability and resource allocation:

- 1) The increase of private investment according to desired growth,
- 2) the equilibration of domestic saving to the corresponding level to enable for macroeconomic demand-supply-conditions necessary for low inflation rates,
- 3) the setting of an interest rate appropriate to ensure a steady inflow of private capital necessary to finance the current account deficit and
- 4) the need for an efficient intertemporal allocation of funds according to sustainable rates-of-return and risk.

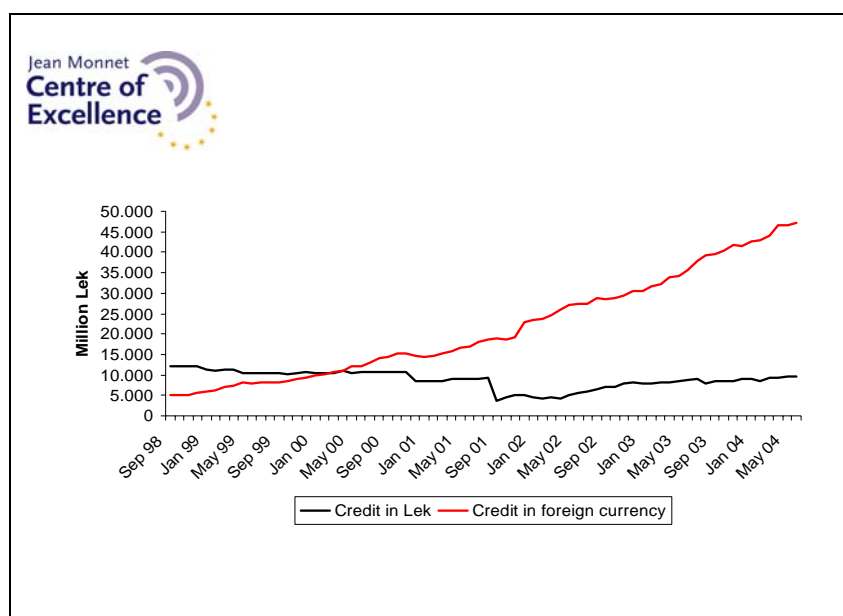
The BoA is aware of the challenges for monetary policy. The bank's annual report stated: "channelling the savings to actual investments must be one of the main ... priorities" (BoA, 2004, p.27). Tasks are of a Herculean dimensions for monetary policy and may be solved properly only if financial markets work efficiently. The BoA has been somewhat optimistic: "The level of the real interest rates encouraged the investment of a part of ... (private) savings as bank deposits." (BoA, 2004). Cautious as it is, this statement does reflect a realistic view of the financial system and its functioning in allocating investment and saving.

Albanian financial markets are shallow, although this is not unusual and is also the case in many other emerging economies. Theoretical and empirical evidence suggest that financial markets are not developed sufficiently to ensure an efficient temporal and intertemporal allocation of resources:

- a) The Albanian economy still is a cash economy. This is proven by the structure of the country's financial asset portfolio. In 2000, speculative deposit withdrawals revealed low public confidence in the Albanian currency, and triggered a substantial increase of currency vis-à-vis money supply. At the end of 2003, the ratio of currency outside banks to money supply was 27 %, close to the historically high, 29.4 % average level of the last 4 years (BoA, 2004).
- b) The majority of credit is denominated in foreign currencies. We base our judgement on empirical evidence on the usage of USD and Euro. In Albania (see Figure 8) credit growth in foreign currencies outpaces credit growth in Lek.

This finding is somewhat at odds with the notion of monetary stability, for low inflation and a stable exchange rate should increase the attractiveness of the Lek. On the other hand, it is perfectly compatible with the interest charged for credits. The interest rate on Lek denominated credit is much higher compared to interest rates on Euro denominated credit. A weighted average of credit rates for new credit has been persistently higher for Lek denominations as compared to Euro denominations. In 2004, the spread was between 3.2 and 5.7 percentage points (see Figure 9). This difference is a good argument for seeking credit in Euro rather than in Lek. Apparently, and despite of the success of monetary policy, the monetary track record does not convince people to switch to their domestic currency.

Figure 8: Credit to the Albanian Economy (excluding credit to central government)

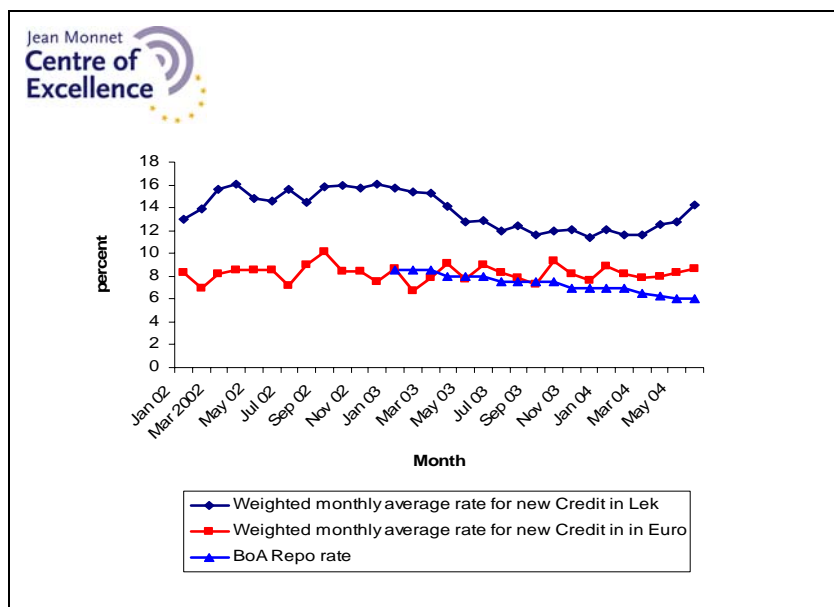


Source: INSTAT, 2004

The strong role of the USD in Albania is a puzzle on its own, since the amount of trade is much higher with European countries. Part of the explanation for the strong position of the USD could be high remittances denominated in USD by expatriate Albanians, as well as an already high stock of USD in circulation, probably from the early days of transition. In fact, banks have been collecting more deposits in USD than in Euro; it is only during the last couple of months that this ordering has been toppled. After the 1997 shock, nobody resents Albanians for not putting their faith and money into their own banking system. In fact, the stability which the USD must have provided during that rough period is probably the best explanation for its current favourable treatment. The USD is still an important unit of account, medium of exchange, and denomination for financial products. Nevertheless, trade between Albania and the US is a hundred times smaller than trade with the EU. The lack of trade relations leads to a pass through of exchange rate variations primarily by

balance sheet effects. Hence, it may result in delayed adjustments and counter-intuitive effects.

Figure 9: Nominal interest rates



Source: Own calculations based on data by INSTAT, 2004.

- c) The poor state of financial markets is characterized by low use of credit of banks to the public and collateral to secure transactions which is hardly developed in the private sector. Credit to the private sector is only 6.8 percent of GDP (2002), though it showed remarkable growth since 1999, when it was only 3.8 % (WDI, 2004). Overall credit to the economy provided by the banking sector has declined since 1997, which reflects less lending to the central government. However, claims on the central government still account for more than 85 percent of all domestic credit in 2003, down from 92 percent in 1998 (INSTAT, 2004).
- d) While financial markets in Albania are dominated by the banking sector, the degree of financial intermediation (the role of banks as intermediaries in channelling funds from depositors to borrowers) is still rather low. The degree of financial intermediation is even lower than in comparable emerging market economies. The foreign-currency exposure of the enterprise sector seems to be comparatively high. If the domestic currency were to weaken substantially, credit risks for the banking sector could emerge, which could in turn have implications for the conduct of monetary and exchange rate policies.

A rapid deepening of financial intermediation and the expansion of financial sector balance sheets may entail higher volatility in financial performance both in individual financial institutions and the sector as a whole. For example, it is likely that domestic enterprises will rely increasingly on external sources of finance, rather than on internal

funds. Likewise households, with improving income prospects and creditworthiness, may increasingly engage in intertemporal consumption.

In Albania reforms of the financial framework continue in anticipation of a take-off in credit and banking intermediation. Again, the authorities are aware of the challenges. The privatisation of the Savings Bank was intended to boost the dynamics of the domestic banking system. Significant progress has been made in implementing a supervisory developing plan. The effort to move away from the cash economy is reflected in the “Beyond Cash” programme by the BoA and the Albanian government efforts to use bank transfers to pay their employees. With IMF and World Bank technical support in areas such as prudential supervision and combating money laundering, provisions to improve the quality of the financial system and financial intermediation have already been made. However, the day-to-day prevailing characteristics of the financial system still have severe consequences for the functioning of monetary policy due to weak transmission channels. The main challenge for policy-makers will be to manage the deepening of financial intermediation and a dynamic expansion of financial institutions’ activities without risking the stability of the economy. At this stage financial markets in Albania are not prepared to operate efficiently enough to secure further fast and sustainable economic development.

3.3 Consequences: Weak transmission channels

The efficiency of financial markets is decisive in determining macroeconomic stability by equilibrating private (and possibly public) savings and investment. According to the simple text-book view, by influencing interest rates and credit restrictions a central bank may be able to control the process of adjusting overall demand to supply, thereby stabilising demand driven inflation at a given level of employment. The process works like this: higher interest rates and credit restrictions render investments more expensive and savings more attractive. Economic demand therefore slows down, because firms may decide to invest less, and households to consume less. Moreover, balance sheets of firms (and households) might be adversely affected, because they have to refinance existing loans at higher interest rates. In reference to some aspects of modern economic theory, one may also be inclined to accept the notion of a significant influence on wage-costs and expectation-driven rates of accelerating inflation. By analysing the transmission channels of monetary policy in Albania via interest, credit and exchange rate channels, some insights may be gained to assess Albanian monetary policy instruments.

The credit channel works via credit restrictions. If commercial banks are unable or reluctant to pass through repo rates changes to customers in a timely fashion, they may adjust volumes nonetheless. Thus, an increase in repo rates could lead to lower volumes of credit, even if interest rates remain unchanged. In Albania, the banking sector provides little credit to the private sector economy while most of the credit is denominated in foreign currencies. Hence, the credit channel might provide little leverage over domestic prices.

For a smooth functioning of the interest-rate channel, the pass-through of interest rate variations of the BoA to financial decisions in the private sector is decisive. In a situation of low financial development, interest rates in the banking sector do not necessarily reflect equilibrium between investments and savings, but are rather driven by credit rationing and fear of adverse selection. A higher interest rate, if passed on to customers, could worsen the quality of the credit portfolio and result in actually lower profits. In fact, short-term interest rates on new credit issued in Lek increased during 2004 by 1.5 percentage points, while the BoA reduced its repo rate at the same time from 7 to 6 % in June (INSTAT, 2004). This tentative evidence at least suggests that the BoA does have to deal with substantial time lags, until interest-rate variations are passed through. Moreover, the low volumes of credit to the private sector, and the generally high amount of currency in circulation—Albania is often considered a “cash-economy”—suggest that even if interest-rate variations would be passed through quickly, the real effect on demand and prices might be somewhat limited. The central government is the dominant lender by volumes (85 %), and it may be doubted that a government’s spending delight could be decelerated by moderate interest rate increase, for it does not have a hard budget constraint. The incentives set by moderate interest-rate changes might not be sufficient for substantial price adjustments in a foreseeable period of time, say within the usual time-lags of monetary policy.

The delicacy of the exchange-rate channel is that it may affect different features of the economy at different speeds. Prices of imported goods react swiftly to exchange rate variations. However, the impact of exchange rate variations on competitiveness may translate to slower changes in aggregate domestic demand. This lag discrepancy can produce a whiplash effect on the economy if the central bank diligently targets contemporary inflation rather than long-run inflation (Ball, 1999, Svensson, 2000).

In small open economies like Albania the functioning of the exchange-rate channel is rather sensitive to the amount of transactions, assets, and liabilities denominated in foreign currencies. High official transfers and remittances from expatriate Albanians represent the major share of capital inflows. They can be considered less sensitive to economic fundamentals; if anything, they are supposed to react counter-cyclically, because “members and friends of the family” abroad (including the IMF) may be more generous in dire economic circumstances. However, the pressure on the Lek following the run on deposits in 2002 is a reminder that this relation is probably shallower than it appears.

Moreover, the balance-sheet effect—i.e., the impact of exchange-rate variations on the net value of companies with foreign currency liabilities (and assets)—may produce an opposite effect on demand. If foreign currency liabilities are not hedged, by either foreign currency revenues or financial instruments, company balance sheets may suffer from a devaluation, and firms may be forced to cut investments. A currency devaluation can therefore depress domestic demand despite its otherwise expansionary effects (Kasa, 2001). The strong position of USD and Euro in the Albanian economy amplifies the exchange rate channel.

4 Scope for reforms: A tentative approach

The aforementioned risks and the apparent weakness of transmission channels are poor conditions for an efficient monetary policy. This is especially true if empirical evidence points to unfavourable inflation expectations. The solid inflation record of the past few years may not have been sufficient to create forward-looking credibility in the sustainability of growth and the robustness of the financial system. This must be concluded from theoretical considerations and the tentative empirical evidence collected here. The comparably small stock of private credits and the remarkably high ratio of foreign currency denominated credit point to the fact that the financial sector is too shallow to support economic development sufficiently. Financial and monetary fragility is underlined by expectations of future inflation rates which are expressed by substantial gaps in maturity spreads between Lek and the two major foreign currencies. There is an apparent lack of long-term trust by market participants in the sustainability of real convergence and the efficiency of monetary fundamentals which may add to the fragility of the present situation. Minor shocks can trigger substantial adjustment, because people tend to react in a capricious manner when they lack sound long-term faith in the credibility and sustainability of the currency. Destabilising expectations may become self-fulfilling.

Fortunately, conditions are not that bad in Albania in 2004. Empirical evidence signifies a significant growth of confidence in the sustainability of the growth patterns and in the potential for the future stability of the Albanian currency. It should be noted also that these signals are evidence of the trust people have in the firm commitment of the BoA to pursue the stability oriented monetary policy of the past. Some positive signals should be highlighted:

- a) A shift towards bank deposits away from cash holdings as well as an increase of the proportion of Lek deposits in total deposits reflects increasing confidence. Moreover, confidence in the banking sector appears to have improved with local and foreign deposits both growing in 2003. (BoA, 2004).
- b) At the end of 2003, the structure of the portfolio of Albanian financial assets as measured by the ratio of currency outside banks to money supply was close to the level of the last four years (averaging 29.4%), (BoA, 2004, p. 52). After the deposit withdrawal of 2002 this is an encouraging development.
- c) The development of the portfolio structure towards medium and long term loans are positive signs. Commercial banks are becoming more inclined towards financing longer term projects. This speaks for more confidence in long-term stability in the domestic currency and in the prospects for further economic growth.
- d) Some empirical evidence can be found which speaks for a more balanced development of the structure of the money supply with regard to foreign currency structure. The expected increase of credit due to the involvement of the savings bank will contribute to an increased role of Lek denominated

credits. Interest-rates differentials between the Lek and foreign currency loans seen are declining, boosting the appeal of Lek denominated loans.

Low levels of financial development, made more pronounced by a lack of adequate financial intermediation, are serious impediments to long-term economic growth, the internal and external stability of the financial system and the smooth functioning of transmission channels. Additional efforts are necessary to increase the amount of financial intermediation without compromising the quality of allocation to prevent an unsustainable lending boom. The financial sector still needs to strengthen its structures, including banking, focusing on the development of products and facilities operating in other countries. Financial intermediation and prudent supervision will play a central role in providing for turning the economy from its orientation on cash-financing to a leverage-based financial system. A considerable number of steps in the right direction have already been made.

There is no doubt that the quality of Albania's institutions needs to be improved. Given the characteristics of past economic and political patterns, one may be inclined to agree on statements which highlight insufficient reforms. During recent negotiations on the Stabilisation and Association Agreement (SAA), EU officials expressed the view that "Albania should accelerate the pace of its reforms in order to ensure that, by the end of the negotiating process, it is in a position to properly implement the Agreement." (COMM, 2004). The EU report mentions areas linked to corruption and organized crime, the judicial system and public administration, proper functioning of democracy, human and minority rights and further formalisation of the economy. It is obvious that the report hardly mentions the BoA.

Poor quality institutions are a serious obstacle to growth and development. It may be true that only slow progress has been made in institution building such as enforcement of the rule of law and property rights protection. Reforms like privatisation and the removal of administrative barriers to business creation have gained momentum again (EBRD, 2004). And the European Commission states correctly that an outstanding political commitment and determination is necessary in order to address the many pending issues (COMM, 2004).

The BoA has proved already its commitment to transparent and stability-oriented monetary policy and institutional reforms. The list of recent reforms as listed by the BoA in its annual report for 2003 (BoA, 2004) is impressive indeed: modernising the financial sector, fostering bank intermediation, approving accounting standards and supervisory capacity. Convincing examples for work on a safe and efficient market infrastructure can be seen in the completion of a real time gross settlement system and the establishment of a complementary intraday collateralised credit facility. Expertise and the legal framework have been improved with technical assistance from the World Bank, the IMF, EU, EBRD and other donors to the BoA.

There still is a lot of work to be done around the construction area "Albanian financial sector". The liberalisation of capital movements may serve as a prominent example. This task mostly concerns outward capital transfers, to a much lesser extent inward

capital transfers and the legal framework for protection of investment property rights and the repatriation of profits. According to a statement by the EBRD (EBRD, 2004), Albanian authorities are determined to ensure full liberalisation by 2010. And there seems to be agreement that continued reform of the Albanian financial sector, improvements in monetary policy instruments, and in banking supervision, remain crucial to Albania's progress towards a more sound capital market.

The BoA seems to have the clear intention to advance towards formal inflation targeting in the medium term (Hadëri and Kolasi, 2003). According to the Supplementary Memorandum on Economic and Financial Policies (MEFP) for Albania, the BoA has recently repeated its determination to continue to strengthen its capacity for eventual adoption of inflation targeting (IMF, 2004). It may be advisable not to proceed too fast. The switch to a new monetary policy regime should not come too early. In face of the evidence presented here - low financial intermediation, credit mainly in foreign currencies and unfavourable inflation expectations as expressed by substantial gaps in maturity spreads between Lek and foreign currencies - a cautious introduction, interpretation and handling of a regime of formal inflation targeting may be appropriate. This should serve to enable room and time for improvements in long-term confidence and the further development of financial market institutions.

Economic theory lists a number of conditions which should be met before inflation targeting becomes a successful strategy, including a clear mandate for price stability of the central bank, flexible exchange rates, low current inflation and inflation expectations, transparent conduct of monetary policy and a widespread understanding of the underlying mechanisms among the general public.

Most of these conditions are fulfilled already in Albania: a clear mandate for price stability of the central bank, flexible exchange rates and low current inflation rate do exist in Albania. The conduct of monetary policy is transparent. Up to now, however, inflation expectations seem not to be based on long-term confidence in the sustainability of high and stable growth, low inflation rates in the long run and the efficiency of the foreign exchange rate regime. There might also be some room for the improvement of the public understanding of mechanisms of monetary policy. The BoA is working on the communication issue via a public campaign to reduce speculations with price peaks during holidays. This campaign is running for the second consecutive year (BoA, 2004).

The appeal of inflation targeting consists in allowing for the provision of an anchor for expectation building. This requires an ability to react flexibly to all kinds of financial, monetary, and real economic shocks, increasing the capacity for effective control. But if the target is missed too often due to frequent external shocks the credibility of a central bank may come under pressure. The Albanian economy, like other small open economies, may experience that inflation is driven by exogenous shocks like exchange-rate and capital movements more often than by domestic factors (Mishkin, 2000, Masson et al, 1997). Moreover, there may be some practical problems. Due to the low degree of financial intermediation and frequent structural breaks of past time series, it may be hard to assemble reliable forecasts.

The solid inflation record of the past years may not have been sufficient to create sound forward-looking credibility. Instead of attempting to introduce a new monetary policy regime too quickly, the BoA could aim at creating sound long-term confidence in the capacity of the currency to serve as a trustworthy asset in the real convergence process. Long-term confidence in the currency is the ultimate yardstick for the success of monetary policy which will allow for the right investment and saving decisions, which are necessary for the sustainability of economic growth. In this case markets may accept some volatility in exchange-rates or minor deviations from proclaimed inflation targets.

The adoption of a formal regime of inflation targeting could wait until an increase in market confidence in the economy and the Lek has materialised. As long as expectations on future inflation rates do not signal increasing long-term confidence, an inflation target may even add to insecurity in the future conduct of monetary policy. Empirical evidence may be found in observing maturity spreads of loans denominated in Lek, Euro and USD as suggested here.

There should be an anchor to develop confidence in the domestic currency beyond the stance of pure and complex monetary policy. The IMF suggests that the BoA should continue its gradual approach aimed at maintaining low inflation, monitoring domestic supply conditions, and observing interest rate differentials (IMF, 2004). This will work within a system of flexible exchange-rates if markets learn to trust their domestic currency, and inflation expectations begin to express the solidification of long-term confidence. Countries have developed several different strategies to anchor their currency to contribute to building long-term confidence, such as exchange-rate pegs, currency boards or (alas) inflation-targeting. Albania does not need a monetary peg to succeed in building confidence because it already has a peg, still unknown to economic theory but easy to discover through careful assessment of the conduct of the BoA's monetary policy, which is well developed and serves the purpose for which it is intended. We like to call it the institutional peg.

In Albania this peg is based on the firm and proven commitment to institutional reforms needed for convergence to the European System of Central Banks. In recent years, the Bank of Albania has expressed its ambition to approximate its central banking model to that of the European Central Bank. This anchor may be considered a reliable benchmark based on an easy to follow commitment. Institutional quality is usually not the domain of a central bank. However, given the importance of institutions to the conduct of Albanian monetary policy and the development of the economy as well as civil society, the BoA has evidently accepted its leading role in institution building in Albania

The BoA has proved to be reliable in its commitment to this goal as well. During 2003 the BoA has improved its operational framework and its banking supervision regulatory system in line with requirements of harmonisation with the European Union (BoA, 2004).

And the commitment itself is indeed clear: "The Bank of Albania has clearly presented its strategic approach to the European Union representatives towards reaching a

convergence with the European Central Bank. This important objective found reflection in one of the articles of the bilateral agreement between the Republic of Germany and the Republic of Albania according to which German experts will assist the Bank of Albania in the convergence process”(BoA, 2004).

We are happy and honoured to be on board.

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