

The Monetary Policy of the Central Bank of Albania: Historical Perspective and Future Challenge

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The evolution of monetary policy framework in Albania has reflected its dynamic environment of a transition developing country economy. The Bank of Albania (BOA) has always followed an ultimate goal of price stability and has operated a flexible exchange rate. However, the monetary regime, including its analytical framework strategy, has constantly evolved. Attached in International Monetary Fund (IMF) stabilization programs, the BOA adopted initially a monetary targeting regime. Fiscal discipline and rapid budget consolidation were certified by strict IMF. Together with other structural reforms, it allowed to the prudent monetary policy to quickly disinflate the economy throughout the 1990's. However, the rapid development of the economy and financial markets made a transmission mechanism based on a stable relationship between monetary and prices ever less predictable. Money growth became less reliable as an indicator of medium term price development. This needed profound change in the BOA monetary policy strategy. The BOA modified its monetary policy by broadening the range of information; it included in its decision-making, by continuously refining its monetary operations and by continuously improving its transparency and communication. This transformation and flexibility allowed the BOA to deliver on its mission of price and stability through its second decade of life. This research paper gives a broad overview of monetary policy development during the first two decades. The second section provides a critical review of the overall results of BOA monetary policy and some challenges and conclusions that are expected in the future.

Keywords: monetary policy, BOA, monetary policy regime

The modern history of the Central Bank of Albania (BOA) begins in 1992, as the country's central bank to preserve the internal and external value of the domestic currency. This law was not openly clear on what was the final goal of monetary policy. The new legal acts have endowed the BOA with a considerable amount of instrument independence, granting it almost full de-jure flexibility in achieving its goals. BOA has aimed to achieve the role of an independent policy-maker, by setting its long-term objectives in policy documents.

Albania ranks high in both de-jure and de-facto independence ratings compared to its regional peers. The choice of a monetary policy regime is ultimately guided by macroeconomic motivations.

The choice of a monetary policy regime is based on a specific set of factors. The International Monetary Fund (IMF) programs of monetary policy framework in Albania were instrumental in the initial set-up. Successive revisions and improvements were driven by economic and financial developments in the country but left unchanged the basic assumptions of an independent monetary policy and a flexible exchange rate.

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Throughout the first decade of transition, IMF programs and technical expertise have been an important factor in shaping the policy mix in the country. As in most developing countries transition economies, these programs were built around three objectives:

- (1) Economic liberalization, in particular the liberalization of the exchange rate and price controls;
- (2) Stabilization, through tight fiscal and monetary policies geared to deliver macroeconomic stability, and the formation of the free-market institutions. The implementation of the programs objectives produced a stable economic environment, creating favorable conditions for fast and stable growth;
- (3) Factor relocation, increased productivity, and increased financial intermediation and domestic demand.

Financial programming was designed by the projection of core macroeconomic indicators, such as real gross domestic product (GDP) growth, inflation, the current account, and the balance of payments, against policy instruments, such as the monetary stance and fiscal policy. There was not a strict model to be followed by policy-makers. In practice, policy formulation was based on a variety of simple models and techniques. Financial programming relied heavily on monetary approach to the balance of payments and a theoretical tool developed by the IMF that served to connect external and macroeconomic internal imbalances to interrelation of money supply and demand.

Monetary Policy Regime of the Bank of Albania

IMF financial programming implied a monetary targeting regime which assumed that monetary expansion is the key driver of inflation. Albania adopted a floating exchange rate regime.

The monetary targeting framework was supposed to be in line with the medium-term inflation objective, the GDP growth, and also accounting for changes in money rapidity.

BOA developed various tools and techniques in order to forecast money demand as a function of expected nominal GDP growth and money velocity. The money multiplier concept served to link the expansion of monetary aggregates to the BOA balance sheet.

The conceptual framework developed from the IMF had five performance criteria. These quantitative performance criteria, which ultimately aimed to control the amount of domestically generated liquidity, were:

- (1) The net international reserves of the BOA;
- (2) The net domestic assets of the BOA;
- (3) The net domestic credit to the government;
- (4) The net international reserves;
- (5) The net domestic assets were also considered the operational objectives of bank of Albania.

These quantitative performance criteria, aimed to control the amount of domestically generated liquidity and the frequent revisions indicated a proper understanding of the need for flexibility of the monetary policy required. The monetary policy framework of BOA has been constantly evolving in response to intensive developments in the financial system, structural changes in the economy and rapid integration with our trade and financial partners. The monetary targeting framework provided good results.

The current regime of the monetary policy in Albania is in line with the best practices of inflation targeting. The last IMF arrangement concluded in 2008. In that year, the BOA announced a new monetary strategy to the public; with the inflation target of 3%. This strategy marked an end with the past. Monetary aggregates were preserved as an indicator of inflationary balances in the economy, but their revealing power was clearly exposed to the first pillar of projected inflation. Furthermore, the new monetary strategy explained some of the

theoretical concepts which guided the monetary policy in the future and the aim was to stabilize economic cycles and flexibility.

The last part of this paper deals with some of the future challenges of the monetary policy in Albania. Broadly, these challenges can be gathered in three main areas:

- (1) Preserve and enhance the stabilizing role of monetary policy in a challenging environment of a developing country transition economy;
- (2) Improve coordination with financial stability;
- (3) Improve coordination with the fiscal policy.

BOA has been running an independent monetary policy and has secured an inflation targeting regime and a flexible exchange rate that has played a crucial role and has served as an absorption mechanism to several domestic or external shocks. But the benefits of running an independent monetary policy have its disadvantages for a small and open economy. Countries, like Albania, are forced to run an independent monetary policy within a “partial corridor” of interest rate deviations from the interest rate pursued by an anchor economy. This can be argued that might be a problem originating in the initial phases of transition but the importance of short term capital flows would validate this argument at a later stage of development.

In comparison with the advantages that a fixed exchange rate might bring, such as fostering external trade or internal fiscal discipline, there is clear argument to be made with regard to pursuing a fixed exchange rate regime. This policy has been undertaken by several countries in central and eastern Europe, while others have chosen to adopt inflation targeting. The experience of these countries with such diverging regimes has been mixed.

The most important factor in explaining differences in economic performance among countries is their underlying structural and overall macroeconomic policies. The successful story of Albania in operating an inflation targeting framework is reflected in an improving transmission mechanism and anchored inflation expectations. The improving transmission mechanism increases the effectiveness of the monetary policy in the future, while anchored inflation expectations yield more flexibility in pursuing independent monetary policy.

Inflation targeting and independent monetary policy is a preferred path of convergence to the journey of the Albania for the European Union (EU). Such a path is likely to yield better structural and cyclical convergence. But again, several issues remain to be discussed and solved in the future like what will be the role of the exchange rate in inflation targeting framework or whether the central bank can use the foreign exchange rate as an intervention in order to affect liquidity conditions in the economy. This issue has both theoretical and practical considerations, but it is also addresses the problem of monetary policy communication with the public.

Conclusions

The lessons from the past instructed monetary authorities and policy-makers to pay more attention to variables, such as leverage and liquidity ratios in the financial system, capital adequacy under several stress-test assumptions, and real estate and asset prices in the capital markets. While the building of adequate risks metrics is, at most, a work in progress. The general aim would be to avoid risk miss-pricing at a systemic level. BOA has been one of the pioneering institutions to establish both an advisory committee on monetary policy and an advisory committee on financial stability. The aim of these committees is to facilitate the exchange of information between these two areas and to discuss on specific measures. Monetary policy should take the lead in stabilizing the economy and inflation, while fiscal policy should concentrate on preserving sound fiscal

balances and provide assistance at low levels of interest rates (zero lower bound) where monetary policy loses its effectiveness. The recent crisis confirmed the importance that fiscal position has for macroeconomic stability and allows for more countercyclical policies. We have to mention that a low level of public debt is also beneficial for financial stability as it gives credibility to all the system.

Albania has always been characterized by high public debt levels and recent debt dynamics do not appear to be favorable. BOA has argued the need of a fiscal rule which would both discipline short to medium trends of fiscal policy and ensure long-term debt sustainability. This can make possible to low the risk premia in the economy and should be an urgent priority by the fiscal authorities. Beyond this issue which would enhance the overall architecture of macroeconomic policies in the country, still work could be done in order to facilitate the flow of information and to coordinate fiscal policy with monetary policy. This coordination should start from a common understanding of the cyclical stance of the economy and overall macroeconomic equilibria.

In its first two decades of life, the monetary policy of the bank of Albania has constantly evolved to adapt to a changing legal, economic, and financial environment. The policy framework has evolved from a monetary targeting regime to an inflation targeting one. The operational framework has adopted the best international practices and the institutional procedures and communication strategy has improved considerably. BOA has an admirable record in delivering price stability and smoothing economic volatility in the country. This flexibility in monetary policy explains the success in delivering price stability to the Albanian economy. BOA faced several challenges in its third decade of life that include: a better understanding of the role and limits of monetary policy in a small and open economy, a rapidly evolving transmission mechanism, and developing better coordination tools and mechanisms with macroprudential and fiscal policy. But the institutional flexibility can serve as a valuable lesson for the future.

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