

BANK OF ALBANIA

MONETARY POLICY  
DOCUMENT FOR 2008



# MONETARY POLICY DOCUMENT FOR 2008

## INTRODUCTION

The Bank of Albania, the monetary authority of the Republic of Albania, has the exclusive right to design, approve and implement the monetary policy. The monetary policy is designed and implemented in view of achieving the primary objective: achieving and maintaining price stability.

Each year, the Bank of Albania publicly explains its objective and its definition in quantitative terms, and the instruments it will use in achieving the primary objective. This process increases the Bank of Albania transparency on monetary policy issues, as a prerequisite for attaining a high level of accountability in carrying out its mission as a central bank. At the same time, this document serves to the orientation of economic agents' public expectations towards inflation targeting, as key element in conducting monetary policy.

Monetary Policy Document for 2008 was designed as a follow-up of the medium-term strategy "Bank of Albania Development Plan over 2006-2008", the Monetary Policy Documents for 2004-2007 and it is in line with Albania's medium-term development strategy. The basic strategy of the monetary policy for 2008 and its operational framework will maintain the key principles and forms pursued over the previous year. In this document, the Bank of Albania details all the concrete elements of monetary policy for 2008, in particular in the field of monetary policy objectives and its operational framework. The publication of this document explores in concrete terms the commitment of the Bank of Albania to be a transparent institution.

Over 2008, the Bank of Albania will aim at improving its analytical abilities; expanding the range of information used in the decision-making process; enhancing the transmission channels efficiency; and enhancing the quality and quantity of public communication. The Bank of Albania will aim to further increase transparency in designing and communicating the monetary policy. This process has further intensified in the last years. Apart from the improved communication of the monetary policy strategy and decisions the Bank of Albania will aim to intensify the educational programmes for different segments of the public at large.

## I. LEGAL GROUNDS

Pursuant to Article 161 of the Constitution of the Republic of Albania, the Bank of Albania "... is granted the exclusive right to independently implement the monetary policy".

Pursuant to Article 3, paragraph 4a1 of the Law No. 8269, dated 23 December 1997 "On the Bank of Albania", the main task of this institution is "to independently design, approve and implement the monetary policy of the Republic of Albania, in accord with its primary objective".

Pursuant to Article 3 of the Law No. 8269, dated 23 December 1997 "On the Bank of Albania", the primary objective of the Bank of Albania is "to achieve and maintain price stability".

Pursuant to Article 43, paragraph a of the Law No. 8269, dated 23 December 1997 "On the Bank of Albania", the Supervisory Council of the Bank of Albania has the following competences: "To approve the monetary policy of the Republic of Albania, defining the limits of the Bank of Albania operations in the open market, the interest rates for deposits held with the Bank of Albania and for the discounts and loans or credits of the Bank of Albania, and the reserves and level of reserves banks are required to maintain with the Bank of Albania".

## II. INFLATION TARGET FOR 2008

Achieving and maintaining price stability implies achieving low positive inflation rates and maintaining them for relatively long periods of time. In quantitative terms, the Bank of Albania has translated the price stability objective into the maintenance of inflation at 3 per cent, with a fluctuation band of  $\pm 1$  per cent. The annual change of consumer price index, measured and published by the INSTAT will remain the measure of inflation. The inflation target covers the forecasting period which currently is 12 months.

The abovementioned quantitative definition of price stability reflects the reality of the Albanian economy as a developing one. These economies are characterized by large fluctuations of relative prices towards finding the proper balances of market economy. The target to have lower inflation rates may impose high cost to the Albanian economy. On the other hand, the maintenance of inflation target at the same rate as the seven preceding years will provide a positive contribution to the further consolidation of public expectations of inflation around the objective announced by the Bank of Albania.

The Bank of Albania will continue to maintain a free floating exchange rate regime. The value of lek against foreign currencies will be freely determined in the foreign exchange market by demand and supply. However, in certain cases, the Bank of Albania may intervene in the foreign exchange market in order to observe the net international reserve objective of the Bank of Albania (see item III) and/or to smooth the short-term risky fluctuations of the lek exchange rate.

## TARGET LEVEL

The Bank of Albania believes that the monetary policy will continue to provide a positive contribution to the development of the Albanian economy by maintaining low inflation rates.

- First, since it is a positive inflation rate, it takes into account the technological evolution of products and their qualitative improvement. In addition, many studies have proved that inflation has an internal statistical tendency to record positive rates. In fact, an inflation rate close to 0 may correspond to a deflationary situation.
- Second, a low inflation rate helps to maintain positive real interest rates. Positive real interest rates help to absorb the public savings in the banking system, contributing to the stability of the latter, and to maintain its ability to meet the economy and the Government demand for money.
- Third, such an inflation rate corresponds to the needs of the development of the Albanian economy as a transition economy. It facilitates the relative prices mobility, providing a positive contribution to the instructive role this mechanism has on the allocation of funds in economy. Most developed countries define price stability as an inflation rate of about 2 per cent. Since Albania is a transition country, a higher inflation rate reflects a higher structural risk in the Albanian economy and a larger mobility of relative prices in it.
- Fourth, being at the same level with the inflation target of the last five years it will have a positive impact on the stabilization of inflationary expectations in economy, as well as on the growth of confidence in the economic decision-making process. On the other hand such an inflation rate and the monetary policy designed for its achievement provide a positive contribution to the economic growth rates as the last years have indicated.
- Finally, the inflation target of 3 per cent is also consistent with Albania's objective to join the European Union in the early future. The objective of controlling the price rise to a close level but higher than the European Central Bank target<sup>2</sup>, allows the Albanian economy for a real convergence providing at the same time the required extent to carry out the necessary structural changes.

## TARGET FORM

The inflation target for 2008 will remain 3 per cent with a tolerance band of  $\pm 1$  per cent. This specification does not only serve at its best to the orientation of public expectations of inflation but also reinforces the Bank of Albania commitment to achieve this target. On the other hand since inflation is often subject to the influence of supply-side factors or rises in the administered

prices the fluctuation of consumer prices may not always be a consequence of monetary conditions and subject to the influence of monetary policy. Monetary policy is attentive to these factors as well but it does not necessarily react. The decision whether to react depends on the transitory nature of these shocks on inflation considering at the same time the need to maintain a stable monetary and financial market. At any case, the Bank of Albania communicates the balance of risk factors to the public.

Taking into account the risk of possible shocks on inflation and the need to establish a stable medium-term monetary policy the Bank of Albania will allow the inflation rate to fluctuate by  $\pm 1$  per cent around the key rate, considering them to be in line with the price stability objective.

#### OTHER INFLATION MEASURES

Apart from the measure of inflation as the annual change of consumer prices index the Bank of Albania employs other inflation measures such as core and average inflation with a view to enhance the monetary policy decision-making process. These measures provide a more comprehensive basis for making more realistic decisions.

Core inflation represents the stable and long-term part of total inflation and it is measured by excluding certain items of the basket of goods which face volatile price movements as a result of temporary shocks out of the monetary policy scope. During 2007 the methodology which measures this inflation improved serving as a useful input in the monetary policy decision-making process and as key element in the inflation forecasting process used by the Bank of Albania. The method of core inflation measure, considered as the most appropriate for the case of Albania, is that of permanent exclusion. According to this method, four measures of core inflation are currently being computed, which exclude: a) goods and services with high seasonality, which cause high and temporary fluctuation of prices (usually unprocessed foodstuffs); b) goods with administered prices (energy and water); c) goods whose prices are subject to fiscal policy (excise goods); and d) goods, whose prices are closely related with external factors (oil).

Beside the periodical application of the abovementioned measures, during 2008 the Bank of Albania will further intensify the research work in order to find and apply other measure methods of core inflation.

Average annual inflation represents the average annual inflation for the last twelve months and it provides useful information related with the development trends in consumer prices. As such, average annual inflation will be a key point of orientation in the monetary policy decision-making process.

During 2007 the Bank of Albania has paid great attention to building the time series on the economic agents' expectations, such as Business Confidence Index, Consumer Confidence Index, surveys on commercial banks' expectations

of inflation, the exchange rate and the interest rate, and to the Real Estates Index. Major steps have been made in terms of analyzing and using these series to improve the monetary policy decision-making process. This remains a priority for 2008 as well.

### III. INTERMEDIATE AND OPERATIONAL OBJECTIVES

Consumer price stability is based on the control of other indicators, which, on one hand, are strongly related to the inflation target and on the other, are under a more direct control of the Bank of Albania. These are the intermediate and operational (quantitative) objectives. Intermediate objectives are orienting (indicators), whereas the operational objectives are strictly attended. Along with the primary objective of the Bank of Albania, these objectives make up the framework of its objectives.

The annual growth of money supply (M3) is the intermediate objective for 2008. The definition of M3 annual growth as an intermediate objective is based on the argument that inflation, being a monetary phenomenon, is influenced by the money supply growth. For this reason, the Bank of Albania aims at controlling the increase of monetary assets in economy, so that the money supply corresponds to the need of economy for real monetary assets. Based on the economic growth projection for 2008, on the Bank of Albania objective for the inflation rate, and on the monetary developments trends, the Bank of Albania will aim at maintaining the money supply growth at the level of 14.2 for 2008.

The framework of monetary policy objectives is completed by the identification of the monetary policy operational objectives. They establish a closer relation between the monetary policy operations, its intermediate and primary objective, which is to achieve and maintain price stability. Net domestic assets and the net international reserves of the Bank of Albania constitute the operational objectives for 2008 as in 2007. A quantitative level is set for each objective, so as to control the efforts for their achievement. Moreover, the Bank of Albania pursues and monitors the net domestic credit to the Government, although this is not part of its operational objective.

- Net domestic assets of the Bank of Albania represent the amount of the Bank of Albania claims, excluding its foreign currency claims on non-residents. More concretely, here are included the Bank of Albania (net) claims on the Government, and its claims on commercial banks. An upper limit is set on these claims, which implies that the Bank of Albania cannot increase the position of net domestic assets beyond the set limit. For 2008 the upper limit for net domestic assets of the Bank of Albania is ALL 17.2 billion.
- Net international reserves of the Bank of Albania represent the Bank of Albania net foreign assets, minus all foreign currency assets of commercial banks held with the Bank of Albania (required reserve in foreign currency

plus excess reserve in foreign currency). A lower limit is set on them and the accruals are based on the exchange rate as of end December 2006. For 2008 the lower limit on the net international reserve of the Bank of Albania is USD 270.9 million.

- Net domestic credit to the Government represents total claims of the banking system on the Government, minus the deposits of the latter held with the Bank of Albania and the commercial banks. The setting of an upper limit level aims at putting under control the crediting of budget deficit by the banking system, within the pre-defined levels. For 2008 the upper limit of budget deficit domestic financing is ALL 25.2 billion.

These quantitative levels are reviewed over the year, based on the performance of monetary developments and on the corrective measures proposed by the Bank of Albania in the monetary programme.

In line with the expansion and the enhancement of competition in the Albanian banking market, the Bank of Albania will pay an increasing attention to the control of interest rates in the interbank market. Although they do not serve as an operational objective of the Bank of Albania, the interbank market interest rates are an important indicator of the monetary situation in economy and a key indication of the economy development.

#### IV. MONETARY POLICY INSTRUMENTS

With a view to achieving its objectives, the Bank of Albania employs market instruments. Monetary policy instruments will be oriented towards the accomplishment of the Bank of Albania operational objectives. In compliance with the monetary policy principles for 2008, as defined above in the present document, the Bank of Albania does not have any definite commitments related to the foreign exchange market interventions, except for cases when the Bank of Albania may intervene in the foreign exchange market in order to observe the net international reserve objective of the Bank of Albania and/or to smooth the short-term risky fluctuations of the lek exchange rate.

##### OPEN MARKET OPERATIONS<sup>4</sup>

Open market operations aim to manage the interest rates in economy, to administer the liquidity situation in the market and to signal the monetary policy.

Open market operations include:

- Repurchase agreements and reverse repurchase agreements;
- Outright transactions;
- Foreign exchange market operations.

The main instrument used to transmit the monetary policy signals is the interest rate applied on the repurchase agreements and reverse repurchase agreements of one-week maturity<sup>5</sup>. The core interest rate is set by the Supervisory Council of the Bank of Albania and it is employed by the Bank of Albania in the weekly auctions of repurchase agreements (repos). This rate also sets the overnight deposits and loans interest rate of the Bank of Albania.

It also influences on the interbank market interest rate, on the lek deposits rate held with commercial banks and on the Treasury bills and credit in lek extended to the economy.

## STANDING FACILITIES

Standing facilities influence on the situation of liquidity in the banking system and they avoid large fluctuations in the interest rates. They are always and exclusively initiated by commercial banks. The latter are the sole counterparty of the Bank of Albania in these operations.

Standing facilities provided by the Bank of Albania include:

- Overnight deposits;
- Overnight loans;
- Lombard loan.

## REQUIRED RESERVE

Through the required reserve instrument, the Bank of Albania obliges commercial banks to keep a minimum reserve in lek and in foreign currency with the Bank. The required reserve aims to stabilize money supply, the liquidity and the interest rate in the banking system, and to foster the banking system security.

Dependent on the Albanian financial market conditions and on the needs of the monetary policy, the Bank of Albania will continue to review its monetary policy instruments. These reviews will aim at enhancing the efficiency of their use.

## V. COMMUNICATION OF MONETARY POLICY DECISIONS

The monetary policy and its decisions are communicated to the public through the following documents:

- Monetary policy document, which describes the main principles of the monetary policy adopted for a year.
- Quarterly assessment of the economy, which describes the quarterly

economic and monetary developments.

- Semi-annual monetary policy statement, which describes the monetary developments during the first and the second half of the year.
- Publication of the Bank of Albania Supervisory Council's decisions on the interest rates, within the day the decision has been made.
- Frequent press conferences of the Governor of the Bank of Albania which communicate and explain the monetary policy decisions in case of a change in the interest rate by the Supervisory Council.

The communication of monetary policy will be also carried out through the publication of all regulations and other acts, which regulate the instruments used in the implementation of the monetary policy.

## GLOSSARY

- Repurchase agreements/reverse repurchase agreements

The Bank of Albania employs these agreements to temporarily withdraw or inject liquidity in the banking system. Repurchase agreements are used to temporarily reduce the liquidity in the banking system. Reverse repurchase agreements are used to temporarily increase the liquidity in the banking system or the banks' ability to increase lending or currency in circulation. Repurchase agreements and reverse repurchase agreements of one-week maturity are executed through standard auctions. While agreements of one-day, one-month and three-month maturity are executed through quick auctions.

- Outright transactions

The Bank of Albania reduces the liquidity in the market through outright sale transactions and increases it through outright purchase transactions. These transactions are executed through the purchase or sale of Treasury bills of up to one year maturity or of debt securities with high credibility.

- Foreign exchange market operations

Foreign exchange market operations are carried out by the Bank of Albania through the purchase or sale of foreign currency in the market. These operations are executed in order to pursue the policy defined in the present Document.

- Overnight deposits

Overnight deposit assists commercial banks in operating with the excess liquidity, by depositing it for one day with the Bank of Albania. Overnight deposit also helps to withdraw the excess liquidity from the banking system and to mitigate large short-term interest rate fluctuations. The overnight deposit interest rate represents the lowest interest rate in the market provided by the Bank of Albania.

- Overnight loan

Overnight loan is a fully collateralized loan provided to commercial banks to satisfy their overnight liquidity needs. It also helps in mitigating short-term interest rates fluctuations. Overnight loan interest rate is higher than the core interest rate.

- Lombard loan

Lombard loan is used to help commercial banks satisfy their temporary liquidity needs. It is a fully collateralized loan of up to three-month maturity term. Lombard loan interest rate represents the highest interest rate set by the Bank of Albania.

NOTES

<sup>1</sup> According to the amendment made upon Law No. 8893, dated 25 July 2002.

<sup>2</sup> The European Central Bank aims to maintain inflation close to, but not higher than 2 per cent in the medium term.

<sup>3</sup> This objective may be subject to change over the year in response to new economic and monetary conditions.

<sup>4</sup> The attached glossary provides a detailed description of the functioning of monetary instruments.

<sup>5</sup> Operations of repurchase agreements and of reverse repurchase agreements are known as repo and reverse repo.