

# Monetary policy, exchange rate in Albanian economy

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## *Abstract*

There seems to be a general perception that the exchange rate pass-through is the most important channel in the transmission process of monetary policy in Albania. This perception is questioned here in light of the altering relationships in this developing economy. A discussion on the transmission channels in the Albanian economy is followed by a study of the macro-economic relationships and pragmatic econometrics quantifying the monetary effectiveness. The results indicate that the dollar has become less important in the monetary transmission process at the benefit of the euro. There are moreover strong signs that the exchange rate channel as such is losing its influence at the benefit of the other transmission channels, like the credit channel and most likely the wage channel. However, economists have tested the PPP theory, pursuing criticisms on the accuracy of this paradigm vis-a-vis the long-run behaviour of the real exchange rate. Studies from Froot and Rogoff (1991) and MacDonald (1995) look at it from this perspective. Under continuous scrutiny, both theoretically and empirically, the PPP theory is generally understood to be able to, at best, determine the real exchange equilibrium only in the very long horizon, which typically overcomes relevant timeframes for economic policy and cannot provide an understanding of factors behind short and mid-term deviations from equilibrium.

**Keywords:** Monetary policy, exchange rate, Albanian economy

## *Introduction*

The exchange rate is a very important economic variable, especially for a small, open economy such as Albania, due to the effect that it may have on the country's competitiveness, trade and current account, inflation, wages, domestic economic activity and bank stability. Thus, assessing the equilibrium exchange rate is an important responsibility of macroeconomic policymakers (Isard, (2007)).

The equilibrium exchange rate is usually used as a benchmark for evaluating whether the actual exchange rate is too strong or too weak. Thus, the equilibrium exchange rate can be defined as the real exchange rate level whereby the economy maintains internal and external balances. Internal balance means that factors of production, such as labour and capital, are being fully utilized, so prices and wages are stable and the economy is running at normal capacity. This implies that the output gap is zero and unemployment is at the non-accelerating inflation rate of unemployment (NAIRU). Internal balance is a necessary but not sufficient condition to ensure that the real exchange rate is at equilibrium. The equilibrium exchange rate is achieved when the rest of the world is in equilibrium, so the external balance can be characterized as a state of stable net foreign assets.

### *Albanian economy and monetary policy during 2019*

At the top there is the main instrument of the monetary authority, the monetary policy rate. In many countries this rate is the repo rate. Monetary policy is eased in case this rate decreases, while on the contrary, monetary policy is tightened in case this rate increases. The transmission from movements in the monetary policy rate to movements in inflation flows through different channels. The more effective monetary policy is, the more precise and the more rapidly the monetary authority is able to steer the inflation towards a desired rate by means of the policy rate. The degree of effectiveness depends among others on the speed of the transmission via the channels between the monetary policy rate and inflation.

2019 was a challenging year for the Albanian economy. Economic activity continued to benefit from rising private consumption and the rapid expansion of tourism. However, the foreign environment proved to be unfavorable, while the decline in electricity production, the gradual termination of investments in major energy projects, and the November earthquake had strong negative effects. As a result, the economic growth of 2019 resulted in the level of 2.2%, down from the level of 4.1% recorded in the previous year.

The shocks we suffered slowed down the growth rate, but did not divert the Albanian economy from the positive development trend. This performance was reflected in the reduction of the unemployment rate, in the increase of employment and wages, as well as in the reduction of the foreign debt and the public debt of the country. In parallel, the main indicators of the health of the banking sector remained at satisfactory levels.

The average inflation of 2019 resulted in the level of 1.4%. The performance still below the inflation target, required the maintenance of the stimulative direction of monetary policy during 2019. For this reason, the Bank of Albania kept the key interest rate unchanged at 1.0%, oriented the market on maintaining the easing direction of monetary policy in medium-term horizon, as well as supplied banks with the necessary liquidity.

In response to our monetary policy, financial conditions were stimulating to increase aggregate demand and appropriate for returning inflation to target. The monetary stimulus brought about the reduction of the credit price and stimulated the growth of lending. Under these circumstances, private sector lending experienced a relatively rapid growth and showed a better distribution. Also, the monetary stimulus reduced the cost of debt service for businesses and households, as well as created the premises for a more stable exchange rate.

In addition to supporting price stability, the Bank of Albania has also paid attention to the promotion of financial stability, through the supervision and careful regulation of the banking sector, as well as through the coordination of work with other supervisory authorities of the financial sector.

#### **Banking supervision and financial stability**

The Albanian banking sector continues to remain financially sound and has shown increasing dynamism. This sector has been profitable during 2019, while its liquidity and capitalization indicators are above our regulatory

requirements. Also, resistance testing exercises show that the banking sector exposure to systemic risks is controlled and that the banking sector's ability to withstand risks is strong.

Below I will briefly list some of the main directions of our work to strengthen banking supervision and to support financial stability.

- First, the Bank of Albania successfully administered the banking sector consolidation process. This process reshaped the domestic banking market, bringing in new and motivated actors, as well as increasing domestic capital.
- Second, the Bank of Albania fulfilled all its obligations under the national plan for the reduction of non-performing loans. Thanks to measures taken over the years, the non-performing loan ratio fell from a maximum of almost 25% in 2014 to 8.4% at the end of 2019.
- Third, the Bank of Albania worked to meet the recommendations of the CoE Committee of Experts on the Evaluation of Measures against Money Laundering and Terrorist Financing (MONEYVAL). In the Moneyval valuation report, financial entities were rated at the level of "substantial" or "substantial" effectiveness.
- Fourth, the Bank of Albania has continued to adopt new regulatory acts of the banking activity or to review them in force, with the aim of further approximation with the directives and regulations of the European Union and with the documents of the Basel Committee.
- Finally, the work to promote sound lending to the economy has been accompanied by careful supervision of the banking system, through full and partial examinations.

Carrying out institutional tasks also means a constant attention to other areas of activity of the Bank of Albania. Here I find it appropriate to emphasize the further development of the emergency intervention function, the promotion of the development of the payment system, the increase of the banknote quality, the administration of the foreign exchange reserve, the improvement of statistics, the support of European integration, and the work to educate the public and improving communication with it.

In addition to fiscal easing measures, the Bank of Albania undertook a comprehensive package of measures to provide the necessary liquidity to the banking system, to boost lending and to control debt service costs. This package includes:

- reduction to 0.5% of the key interest rate and unlimited supply of liquidity to the banking system;
- temporary easing of banking regulations, to enable the temporary postponement of the payment of loan installments to customers in difficulty and the consensual restructuring of loans to customers with solid business prospects, helping business finances and increasing their chances of survival;
- elimination of operating costs of the electronic payment system, in response to the increasing demand for this type of activity;
- increase operational capacity to guarantee the supply of the economy with physical money.

The extent of loans in domestic currency in Albania is still limited. So, although credit rates can react to monetary policy changes and the impact on the demand or supply of loans might be strong, the overall impact through this credit channel is expected to be small. This implies that a more tight (loose) monetary policy may lead to higher (lower) credit rates, and even less (more) demand for loans whereas in absolute terms the change in loans is small. The size of the growth in loans is however indicative for inflation. Concerning the wage channel we emphasize the high level of unemployment and weak labour unions in Albania. Wage pressure may for these reasons be low in comparison with developed countries. So, the channel from wages through inflation may be weak. In sum, according to the general observations mentioned above, the exchange rate, credit and deposit channels as well as the wage channel could still be relatively weak. To obtain more solid evidence the next section presents a data analysis of the Albanian economy. We will question in particular the hypothesis that the exchange rate channel is stronger than the other channels. In order to put this hypothesis to the test the effects of the separate channels are quantified. This will give us insights into the relative importance of each of the three main channels along with their improvements in time.

### **Conclusion**

In economic terms, coordinated fiscal, monetary and macroprudential measures have partially mitigated the negative effects of the pandemic. However, the challenges ahead remain serious. In our judgment, the Albanian economy has the premises to successfully withstand this blow. However, this requires that all public actors and private sector operators make the right decisions, in a timely manner and in the most coordinated manner possible.

Coping with the shock is within our means, if each of us will do our best and if we continue to guarantee with priority the monetary and financial stability of the country.

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