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Issues in adopting inflation targeting in Albania revisited

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1. Introduction

As far as monetary aggregates do not contain all the necessary information to predict future inflation, relying on a monetary targeting regime could be suboptimal. For this reason, the central bank of Albania (BoA) has been considering switching to an inflation targeting regime in the medium term. This follows the rationale that the best intermediate target for a monetary policy aiming at controlling inflation is the forecast of inflation (Cukierman and Liviatan, 1992; Svensson, 1997). An inflation forecast, in contrast to monetary aggregates, is unrestricted in its coverage of information. Any information that could be relevant for the future inflation can be taken into account.

In the last decade there has been a large body of literature exploring the benefits of an IT regime compared to the other regimes, summarised in a series of papers by Mishkin et al. (1997, 2000, 2002). Some of the major benefits of IT are: the broader information base it utilises, its relatively higher flexibility with regard to supply shocks, the fact that it is easily understood by the public, improved accountability etc. However, the adoption of an IT regime also poses several problems. Some of these problems are related to internal central bank factors and some others are related to external factors. This paper looks at how BoA has been trying to tackle these issues on the road to formally adopting inflation targeting.

We deem that the problems related to adopting IT in Albania are mostly technical and to a lesser extent institutional. BoA enjoys a relatively high level

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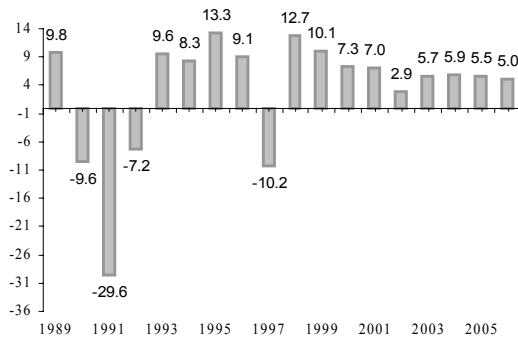
³ The views expressed in this paper are those of the authors and do not necessarily reflect those of the World Bank or Bank of Albania.

of independence and by law has price stability as its main objective. Adopting an IT regime may require some further amendments to the actual law but we do not foresee any particular obstacle in this regard. As far as the technical part is concerned, a successful IT regime requires a good understanding of the monetary policy transmission mechanism, a rather good forecasting model for inflation, and an efficient communication framework with the public. While the bank has been working to improve all these components, a lot remains to be done especially in relation to the first two.

2. The context

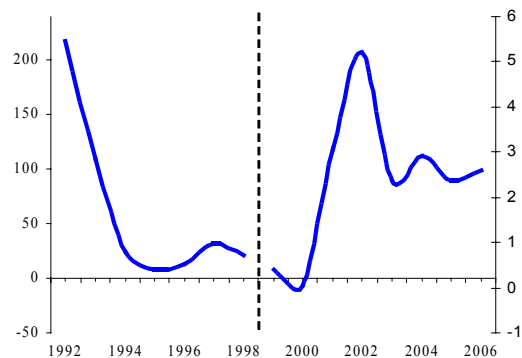
Albania has made substantial progress since the beginning of the transition in 1991. Unlike some Former Soviet Union and CEE countries that started the liberalization of the economy in the 1980s, Albania did not undertake any pre-transition reform before 1991. During 1991-1992 the economy experienced a sharp decline in output and high levels of unemployment and inflation. The adverse economic situation led to a mass migration of the work force abroad, especially to Italy and Greece. From the beginning of the stabilization program in 1992 output grew rapidly until 1997 when it was abruptly interrupted by the collapse of the pyramid schemes. Recovering from the crisis of 1997, Albanian economy continued to experience high positive growth rates, owing to the policies of economic stabilization and a period of political stability. Between 1998 and 2006 real GDP has averaged almost 7% annually. Inflation record has also been impressive, varying not far from 3 percent target of the central bank in more than 8 years now (Fig. 2). The vigorous growth led to an estimated GDP per capita of almost US\$3,000 in 2006 upgrading Albania to the group of middle income countries.

Fig. 1: Real GDP growth, 1992-2006 (%)



Source: INSTAT.

Fig. 2: Inflation, Annual Average, 1992-2006 (%)
(1999-2006 scaled on the right axis)



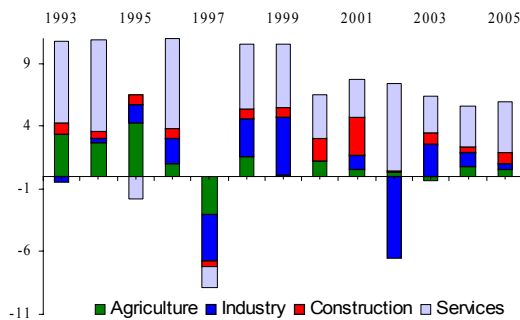
Source: INSTAT

The initial rapid pace of growth was mainly observed in those sectors of the economy where market liberalization proceeded quickly like agriculture and services. Later on construction emerged as a key sector in sustaining growth, compensating for the agriculture slowdown and industry oscillation. Despite the initial revival of agriculture, lack of investments, land fragmentation and

absence of proper land market, poor infrastructure tightening market access, and weak processing capacity, led to a slowdown in agricultural growth to about 3% per annum. As a result its share to GDP narrowed to 21% from its high of 35% in 1995 (Figure 3). However, it still remains the main source of income for nearly 40% of the population. In the last ten years, ‘non-tradable’ sectors such as construction and services have been major contributors to Albanian growth. Together they now count for more than 2/3 of the GDP.

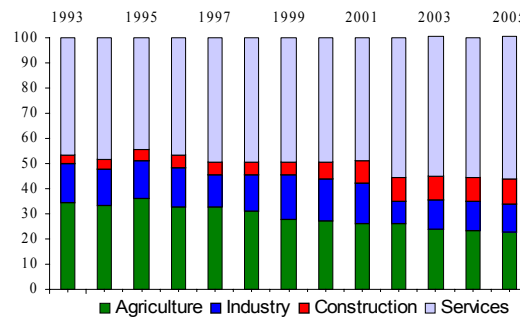
Strong domestic demand supported by total factor productivity improvements and remittances has sustained high growth rates during this transition phase. According to Country Economic Memorandum (WB, 2005) growth accounting analysis in the period 1993-2003 TFP growth accounted for virtually all the economic growth. This was mainly the result of resource reallocation from low productivity sectors (agriculture, industry) to high productivity ones (services, construction). However, according to the same report, TFP growth is fading out and Albania therefore, needs to identify other sources of growth to sustain the high rates of growth experienced thus far, such as enhancing capital accumulation and/or boosting exports.

Fig. 3: Sectoral Decomposition of growth, 1993-2005 (%)



Source: INSTAT

Fig. 4: Composition of GDP, 1993-2005 (%)



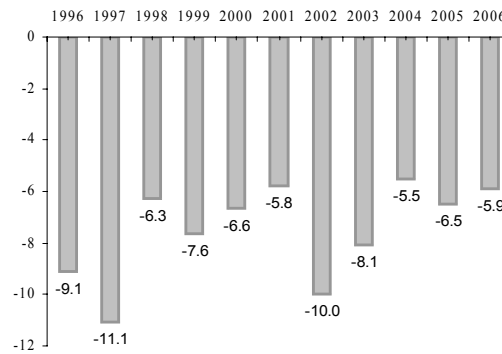
Source: INSTAT

Macro-economic stabilization has catalyzed economic growth. The fiscal stance has continuously improved, owing to significant fiscal adjustments in the recent years. In 2006, the size of budget deficit (including grants) was reduced to 3.2 percent of GDP from above 10% before 1999. Ongoing reforms to enhance the efficiency of tax administration combined with a concerted effort to reduce the size of the informal economy, which is estimated to be one of the highest in the region, is expected to increase tax revenues further. The consolidation efforts have also reduced debt-to-GDP ratios to just below 55% of GDP. But the debt, which is largely domestic, has a short maturity profile and a narrow investor holder base, creating rollover risks.

Large inflows of current transfers and positive service balances in recent years have helped dampen the rising trade deficits with a slight improvement of balance of payments position. Albania has been characterized by large current account deficits throughout the transition period (Fig. 5). Imports have steadily grown reaching 47% of GDP in 2007 with exports lagging behind at 23% of GDP leaving Albania with a trade deficit of 24%. Large remittances at

around 14% of GDP have been a critical in counterbalancing high trade deficits. Foreign direct investments remain low at 3-4% of GDP to fill the remaining current account gap which so far has been largely covered with grants and soft loans. While not yet a matter of concern, long run sustainability issues of current account may occur if certain measures that boost the competitiveness of Albanian exports and attract more FDI are not undertaken.

Fig. 5: Current Account Balance, 1996-2006 (% of GDP)



3. What pushed Albania considering inflation targeting

The inflation record of Albania has been outstanding compared to other peer countries. After bringing inflation down from 237 percent in 1992 to just 6 percent in 1996 inflation has fluctuated around 3-4% with the exception of the limited period after the collapse of pyramid schemes. McNeilly, et al. (1998) attribute the success of Albania in achieving low inflation to the early price liberalisation associated with supporting policies for fostering competition and an early aggregate supply increase in goods and services alongside a restrictive monetary policy implemented by the Bank of Albania (BoA).

Albania has been one of the few countries to have endorsed a monetary targeting regime, which typically consists in announcing targets of monetary aggregates at levels retained to be consistent with high domestic production growth rates at low and stable inflation. Initially, central bank relied on direct instruments in conducting monetary policy. The supply of broad money was controlled by ceilings imposed on the level of credit extended by commercial banks. Later on in 1995, the interest rates of SOBs' deposits were also managed in a first move to switch to indirect instruments. In 1999 credit ceilings were removed and from 2000 the central bank tries to influence interest rates only through open market operations in T-bills (Repos).

Although the regime has been rather successful in terms of price stability, the bank did not take it for granted. For one thing, it would not be entirely correct to attribute the success solely to this regime and what is more important, there was no guaranty it was going to remain successful in the future. According to Estrella and Mishkin (1997), as inflation is brought under control the informative role of monetary aggregates diminishes because the velocity shocks' relative noise increases. This, according to them, could be an

important reason why industrial countries and many emerging market economies do not rely on monetary targeting in the era of price stability. The velocity shocks could be attributed mainly to the instability of money demand which increases as structural changes of the financial system advance.

Albania does not make an exception from this rule. Table 1 shows the targeted and actual growth rates of the broad money and inflation. It is clear the actual growth rates of M3 until 2000 have diverged widely from the targets. In contrast, inflation objective during the same period has been most of the time undershot. Even after 2000 when M3 growth rates have been fairly close to the announced targets, they have varied widely, from 5 to 13 percent, compared to the relatively stable inflation rates. This raises doubts about the relative significance of the nominal anchor used in achieving low levels of inflation and makes it very difficult to clearly transmit the intentions of the central bank by simply announcing M3 growth targets.

Table 1: Planned vs. actual monetary aggregates and inflation (end year, % change)

| Year | Broad Money (M3) | | Inflation | |
|------|------------------|--------|-----------|--------|
| | Objective | Actual | Objective | Actual |
| 1993 | 44.1 | 74.4 | - | 30.9 |
| 1994 | 29.0 | 41.0 | 24 | 15.8 |
| 1995 | 23.0 | 51.8 | 10 | 6.1 |
| 1996 | 22.0 | 43.8 | 10-12 | 17.4 |
| 1997 | - | 28.5 | 53 | 44.6 |
| 1998 | 23.0 | 20.6 | 10 | 8.7 |
| 1999 | 15.0 | 22.2 | 7 | -1.0 |
| 2000 | 12.1 | 12.8 | 2-4 | 4.2 |
| 2001 | 15.4 | 19.9 | 2-4 | 3.5 |
| 2002 | 6.2 | 5.1 | 3±1 | 1.7 |
| 2003 | 9.5 | 8.3 | 3±1 | 3.3 |
| 2004 | 10.6 | 13.5 | 3±1 | 2.2 |
| 2005 | 8.3 | 15.0 | 3±1 | 3.0 |
| 2006 | 14.5 | 16.7 | 3±1 | 2.4 |
| 2007 | .. | .. | 3±1 | 4.0 |

Source: Bank of Albania, Various Annual Reports (1993-2006). IMF (1993-2006)

The central bank has been aware of this divergence and in practice decisions on changing the monetary policy stance have been taken based on a wider range of information besides the M3 growth, such as: inflationary pressures coming from exchange rate movements, price changes in different markets, including foreign markets, supply shocks, and so on. This way of running monetary policy to some extent resembles that of inflation targeting (See also Box 1). BoA also makes public also the end year level of inflation aimed, which has led Stone (2003) to classify Albania as an inflation targeting lite country as compared to a full fledged IT country. However, there are two important elements that distinguish Albania from full fledged IT regimes. These are the communication of monetary policy strategy including the publication and explanation of its inflation forecast and a formal mechanism that makes BoA accountable to the announced inflation target.

Box. 1: Alternative regimes

The other alternatives to IT and monetary targeting are exchange rate pegging and the so called just do it policy applied by FED (Mishkin, 2002). Exchange rate pass-through in Albania is thought to be high, though asymmetric, given the large proportion of imported goods in consumer basket (approx. 70%). This would make this regime an effective way of conducting monetary policy. However, exchange rate pegging so far has been rejected as a suitable strategy to Albania for different reasons. Initially due to insufficient international reserves and later on the bases of real exchange rate appreciation risks, especially when the fundamentals of RER remain still largely unknown. While we believe that to leave the exchange rate being decided by market forces is the best strategy to follow, under certain circumstances intervention may prove an effective way to curb inflation, especially when spirals between exchange rate depreciation and unfounded inflation expectation are observed (see also Section 4). However, in cases when the source of inflationary pressure is of structural nature such strategy could cause more harm than good.

Most of exchange rate discussion, however, refers to scenarios of controlling depreciation to curb higher inflation. From some time Albania, like several other transition countries has experienced appreciation of its currency instead. While this has helped easing inflationary pressures, concerns about external competitiveness are raising. This has pushed BoA to occasionally intervene in the market and to reduce the local currency interest rates to prevent the lek from appreciating too strongly in nominal terms against the euro. However, it remains unclear whether this appreciation is a return to some kind of long term equilibrium supported by fundamental changes. This shows that exchange rate developments cannot be ignored that easily in monetary policy decision even if committed to the free floating regime.

The other 'just do it' strategy might characterize the actual Albanian monetary policy case rather well. Although there is an explicit monetary target and an implicit inflation target, as mentioned earlier, the way the monetary policy operates has a lot of discretion elements in it to achieve the main objective of low inflation, while allowing for some sort of supply shocks adjustments. The advocates of this regime oppose the US switching to a formal IT regime by simply saying 'if ain't broke don't fix it'. However, in the case of Albania maintaining the effectiveness of this strategy for a long time may not be viable considering that BoA does not enjoy the same degree of reputation as FED. According to Stone (2003) this kind of regime should come after a full fledged IT, and it is very difficult and risky for an emerging market country to switch directly to this strategy.

4. The transition experience to inflation targeting

Although Albania has been operating under a lite form of IT, from some years it has been approaching more systematically the adoption of a formal IT regime. Initially a process of identifying the gaps in the preconditions of IT

took place through a series of internal discussions and round tables. Following these barnstorming some of the areas needing particular attention were:

- the central bank's relationship with the government, and within the central bank itself to facilitate policy formulation and effective decision making;
- development needs in the areas of forecasting and current analysis, and associated data requirements;
- a process for developing projections and feeding the results into the decision-making process;
- identification of elements of the policy implementation process that may require modification;
- improvements needed in the central bank's transparency, policy communication and public accountability process.

We will explore some of these issues in more detail.

4.1 Central bank relationship with the government

Several authors (Masson et al., 1997; Stone, 2003) have pointed out the importance of fiscal discipline to the success of the IT regime. Although the fiscal discipline has been a crucial factor in bringing inflation down in Albania several future events, especially certain structural reforms, may force the government to relax its discipline. Among these events an important one is related to the method the new law on compensation is going to take place. If the government is going to cover most of the compensation expenses through its budget this would really put a lot of pressures on inflation.

The coordination between monetary and fiscal policy in Albania during the transition period has been satisfactory with the international factor playing a critical supportive role in this regard. Since 1992 Albania has gone under several IMF supported programs. The Memorandum of Economic and Financial Policies (MEFP) signed by both government and the central bank in the course of these programs has been an effective device to steer both fiscal and monetary policies in a consistent way with the objective of a sustainable growth at low rates of inflation. Preferably this experience should be extended in the future even in absence of third parties intermediation. For this purpose a reduced form of MEFP named Memorandum of Macroeconomic Stability (MMS) is being considered to be prepared under a different institutional arrangement to guarantee the consistency between fiscal and monetary policies.

4.2 Modeling and forecasting

Achieving a reasonable accuracy of the inflation forecast which serves as an intermediate target is crucial for the successful implementation of the IT regime. The central bank has compiled a list of technical problems that need to be tackled, aiming at improving not only the understanding of inflation sources but also of monetary policy transmission mechanism and of the functioning of the Albanian economy as a whole in order to come up with appropriate responses to different shocks that might hit the economy and prices. This list consist in: (1) Building up forecasting models for inflation; (2)

evaluating and further developing the inflation forecasts models; (3) initiating a macro-economic model for Albania. Structural *vs.* more simple models of inflation. Other models that could be used alternatively or complementary to forecast inflation, like VAR etc.; (4) improving the statistical framework, particularly the short term real sector data.

The work on some of these issues has been going on long before the IT proposals was put forth. However, the consistency in pursuing them systematically and capitalizing by adapting the outcomes into policymaking inputs has been less satisfactory. One of the IT advantages on top of those found in academic journals, has been the consistency it brought in for the work pursued by different departments of a central bank to meet its main target of price stability. Besides introducing a mechanism of building up on the previous work, two other critical problems needed to be tackled sooner rather than later for accelerating the progress. These were: the inadequate technical expertise to build up the necessary tools for IT implementation, and the poor state of economic data. The former has been addressed through technical expertise from international institution like IMF. However, to make technical progress sustainable over time, a strategy for developing in-house human capital has also been developed. Regarding statistical data drawbacks, several steps are being taken to improve data sources such as: carrying out surveys, interviews, and assisting INSTAT (the Albanian Statistical Office) to improve national account statistics frequency and quality.

4.3 Policy implementation

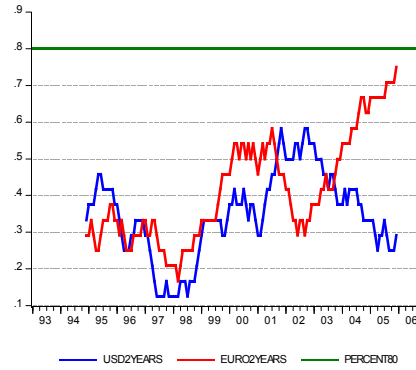
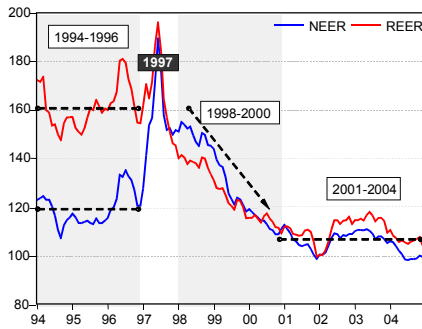
Having a clear understanding of transmission mechanisms of monetary policy it is not an easy task for an emerging market economy characterised by shallow financial markets and subject to frequent structural shocks. Investigating all the possible channels through which monetary policy could affect inflation – interest rates channel-money view; exchange rate channel; bank lending channel-credit view; inflation expectations channel – proved a very useful exercise to get some good clues on what are the most appropriate instruments to achieve the inflation targeting in Albania: money supply, short-term interest rates, exchange rate etc., or a combination of them.

IT and exchange rate

In terms of exchange rate policy, Albania could be better defined under floating regime with occasional interventions in the forex market to maintain a certain level of international reserves. Although the ER pass-through is quite high especially during depreciation periods, BoA so far has been reluctant to rely on direct forex interventions to meet its inflation targets. This is partly because of changes in fundamentals in periods of strong depreciations (1997) and the inadequate level of IR. From 2001 ER has shown noticeable stability (Fig. 6). The ER pass through effects have also dropped (Fig. 7).

Fig. 6: NEER and REER of Lek vs. 80% Euro and 20% USD in Albania

Fig. 7: % of ER fluctuations of less than 1% within 2 year period



Running a flexible monetary policy like MT or IT, does not mean that monetary policy disregards the exchange rate. Monetary policy under IT regime affects exchange rate channels in several ways. There are two main reasons why exchange rate channel should be closely watched. (1) Fear of pass through: While direct interventions have been avoided so far, monetary policy has been particularly attentive to interest rate differentials between Lek and Euro/USD to avoid currency (deposit) substitution which in turn could trigger an inflation-depreciation spiral (97' shock: BoA increased interest rates by more than 10 percentage points). One issue which requires further attention is interest rate misalignments – can monetary policy keep its interest rate over the ‘natural rate of interest’ for unlimited time. (2) Fear of floating: Although euroisation in Albania can be classified as moderate compared to other countries in the region (like Croatia), it still remains significant enough to be disregarded for its inherent risks and implications on economy. In this environment central bank becomes rather sensitive to exchange rate volatility even under a free float.

A high degree of foreign currency substitution (euroisation, dollarisation) can cause serious problems for IT (Mishkin, 2000). Partial dollarisation has the potential to make inflation targeting regime, which requires some degree of exchange rate flexibility, vulnerable to financial instability (Mishkin and Sevastano, 2002). In Albania the level of dollarisation in terms of foreign deposits to total banking assets is around 20-36%. The problems related to dollarisation need to be treated with caution in the prospect of the declining foreign remittances that so far has cushioned the impact of deterioration of current account deficit and have ensured a relatively stable exchange rate. Unilateral euroisation in countries like Albania is already taking place not simply because of monetary policy (or several other) differences as much as due to the tight links these economies have with EU (70 percent of Alb. exp/imp with Italy and Greece, 30 percent of labour force is estimated to be working abroad). To ensure some flexibility these countries have let open the option of euroisation (holding FX deposits/loans, and/or carrying out transitions in euros). Therefore a partial euroisation unintentionally is already taking place. Measures to ‘stop’ euroisation may not be that different from measures to reduce cash economy. Here one could mention the enforcement of transactions in domestic currency especially of durable goods and long term contracts and of loans. Still the question remains: how feasible is this and is it worth pursuing? If yes, could exchange rate serve as an extra instrument to CB beside interest rates particularly concerning the forthcoming capital inflows?

New Zealand experience may be useful in this regard. During the initial period of inflation targeting NZ put more attention on direct price effect of the exchange rate. The uncertainties about monetary policy transmission mechanism make it difficult to foresee the long term indirect effect of interest rates and exchange rates on inflation (Orr et al. 98). In face of growing FDI or other foreign inflows (e.g. remittances), interest rate differentials may run out of steam. Exchange rate intervention may prove quite effective to avoid an excessive appreciation and a possible deflation. The stance of monetary policy could be adjusted by the degree of sterilisation.

However, overdoing exchange rate intervention under IT runs several risks. Mixing up interest rates and exchange rate tools makes it more difficult to clearly communicate the stance of monetary policy. Sterilisation also may prove to be very costly for the bank and the government. While exchange rates and interest rates could be complementary tools in short run it is less likely so in the long run, especially when the relative importance of real shocks is greater.

IT and interest and banking channels

A sound financial system is important to the success of IT for several reasons. A sound financial system could better sustain the negative impact of eventual exchange rate volatility related to the high dollarisation. Also, considering the several objectives BoA is pursuing, it might be important to examine whether Albania has missed or could miss the inflation target if it conflicts with reaching other objectives such as financial stability. A sound financial system would put BoA under less pressure to trade off between its objectives.

The development of the financial system is an important factor also for the conduct of monetary policy. The actual level of financial development in Albania is far from being adequate for an effective monetary policy. The level of competition among banks at the moment is still low while the money and stock markets are virtually nonexistent.

A turning point was marked by the successful privatization of the Savings Bank of Albania, by far the largest bank of the system, which until the end of 2003 was state-owned. This privatization sparked a series of positive changes in the banking sector. The most remarkable one was the strong credit growth. In 2005 the growth of credit reached an outstanding pace of almost 82 percent, albeit from a low base. Credit to households has grown proportionally with total credit growth with small advances against credit to businesses (Fig. 8). But the latter constitute the lion share of total credit. A considerable share of credit is extended in foreign currency. Credit in local currency has gained some grounds recently mainly due to the exhaustion of funds (deposits) in foreign currency, but the preferences of banks and businesses remain biased toward foreign exchange credit. To a certain this fast credit growth reflects a catching-up process. The long period of macroeconomic stability has created benign monetary conditions, reflected in low or declining interest rates and a stable or appreciating exchange rate. The creditworthiness of private companies improved constantly even before the privatisation of the Savings Bank.

Fig. 8: Household credit against total volume of credit (in millions of Lek)

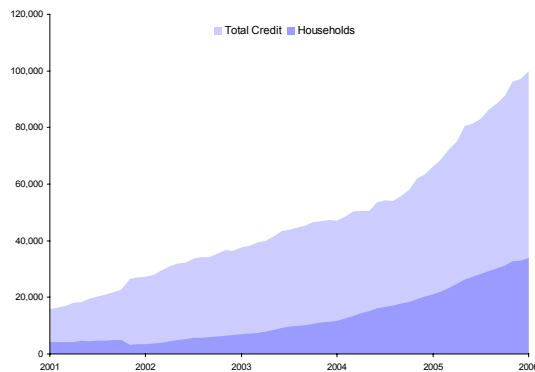
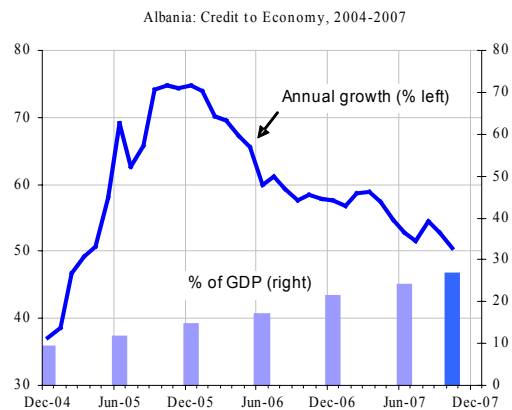


Fig. 9



However, monetary policy transmission mechanism becomes more uncertain as financial markets get deeper. The main concern relates to the interest rate channel effectiveness. Previously this channel has been adequate to influence the exchange rate by affecting prices of traded goods. However, as price pressures from the rapid credit growth mount, interest rates channel becomes weaker. The growth rate of credit is relatively unresponsive to interest rate changes, given the fact that loans are largely extended in foreign currency. Tightening of monetary policy would simply lead to appreciation with little impact on credit volume. Forex intervention to avoid excessive appreciation needs sterilisation to maintain monetary policy tightness.

The recent experience though, has shown that credit channel may not be completely lost. Although, local interest rates play little role in influencing the demand of foreign currency loans it may restrict their supply through deposits' rates differentials. If central bank increases local interest rates, besides restricting demand for domestic currency loans, reduces also the incentives of savers to put their money in foreign exchange deposits which should reduce banks' funds for extending foreign currency loans. There are two loopholes with the above transmission channel. First, foreign banks may force their own interest rate differential that would override central bank interest rate policy. Second, even if private banks follow central bank interests they may borrow some foreign exchange resources from abroad, which would be a typical case of credit boom.

If the above transmission channel fails, then central bank is left with direct instruments such as credit ceilings. However, some other supervisory measures have been introduced as an alternative to slow down growth before recurring to credit ceilings, which at the same time will aim to contain deterioration of banks' loan portfolio. Some of these measures are: increasing reserve requirements on foreign currency deposits above 10 percent; capital adequacy will be amended to allow risk weights up to 150 percent to apply to high risk loans or portions of loans; impose higher than 12 percent minimum capital adequacy requirements on individual, relatively high-risk, banks; and introducing stricter requirements for collateral/loan value ratios.

4.3 The communication with the public: the importance of defining the target

Improved accountability and enhanced transparency and communication with the public are among the added values vested to the IT regimes. While there are several questions currently being addressed with regard to the communication with the public such as: how receptive is the public to the signals of central bank and inflation? how to shape the actual framework of communication between the central and the public to be more adequate and effective? how the quarterly inflation report should be structured, and technical parts written so that they are easily understood? etc., we will focus on a rather more technical but critical aspect of the communication related particularly to the implementation of IT, which is the definition of the target.

From the start of the transition process the Bank of Albania was given the task of reducing and keeping inflation at low levels. However, as in many other independent central banks' laws, the Bank of Albania Law does not specify precisely what low inflation is. Albeit the ongoing debate on the right degree of flexibility in defining the exact level of the target, a consensus has been emerging among academics and central bankers that low inflation should be close to zero but positive.⁴ Some central banks in particular those applying inflation targeting like ECB, have clearly defined the inflation level they target while others like FED have been more reluctant to make public a precise number.

While this regime does not necessarily require announcing an explicit inflation target, in the case of Albania there has been a visible objective for inflation too. Thus, from the first ESAF (Enhance Structural Adjustment Facility) program signed with IMF in 1993 it was clearly stated: "*Following the near-slide into hyperinflation in 1991-92, the reduction of inflation to about 15 percent by 1996 is a key program objective*" (IMF, 1993; Para. 12). Inflation objectives were revised each year and were regularly mentioned in Bank of Albania Annual Reports, alongside monetary targets, which has not been a common practice in a pure monetary targeting regime (e.g. Bundesbank).

The way monetary program was designed, dictated to a large extent the definition of inflation objective. Monetary programming usually consists in projecting end year target growth rates for monetary aggregates and their subcomponents consistent with economic growth and low inflation. Being end year projections means that all the assumptions, including inflation projections/objectives, are defined on an end-year basis.

If we consider the long and variable lags and uncertain magnitude of the effects of money supply on inflation, there seems to be a clear time

⁴ Inflation rates slightly higher than zero are usually sustained on the bases of: first, once inflation gets negative, which is very likely in a strict zero inflation target, it may be very difficult to get out of deflationary cycle; second, at inflation rates close to zero, rigidities could make it costly to sustain further inflation reductions; and third, possible measurement biases in Consumer Price Index asks for some allowances when targeting zero inflation.

inconsistency problem with this framework if both monetary and inflation targets are simultaneously set. One justification for this approach is that monetary program is designed with a medium to long term objective in mind. The above citation gives some support to this argument. Another often mentioned argument is the relatively short lags of transmission mechanism in developing countries. Some previous work (Domac and Elbirt, 1998) has shown that causality from M3 to prices in Albania could be as quick as 6 months. However, lags' length of monetary policy transmission mechanism tend to get longer as financial market gets deeper,⁵ making impossible controlling inflation through the management of monetary aggregates within one year horizon, or even worse, within a calendar year. Setting aside the possible time inconsistency, announcing both monetary and inflation targets simultaneously suffers the signalling problem at low levels of inflation as pointed out earlier.

The above concerns call for some adjustments in the way the monetary policy is conceived in Albania. It may appear this is the same problem as the twin pillars dichotomy ECB gets often criticised for. But in Albanian case we should recognize two important differences. First, ECB clearly points out that the second pillar of monetary targeting, is regarded as a very long term anchor on the basis of widely accepted perception that inflation is a monetary phenomenon. In case of Albania though, this is not clearly publicly expressed as far as there are only end-year figures being referred at, not to mention the huge difficulty of explaining the long term relationship to the public in the first place.

Second, ECB first pillar, inflation target has a mid-term horizon, while in Albania it is an end-year horizon. Besides, the decreasing space of controlling inflation as December gets closer has several other drawbacks. End year inflation could be subject to speculative price movements as it has been often the case in Albania. While these end year price hikes are short lived (no longer than a week), therefore supposedly not a major issue for monetary policy to react, since they coincide with the time central bank inflation performance gets established, endangers its reputation by increasing significantly the chance of missing the target. It may also push the bank to tighten monetary policy excessively or take unnecessarily hasty measures like foreign exchange interventions. Another problem with this type of definition is that it does not say anything about the following year inflation. In other words it lacks continuity.

Whether the twin-pillar approach creates problems for Albania it is an issue that needs further attention. However, the way inflation objective is announced or defined has been adjusted to take into account the above problem. The definition of meeting end-year inflation (Dec. to Dec.) of 2 to 4 percent has been replaced in bank's reports with meeting annual inflation of 2-4 percent in mid-term. Mid-term horizon at the moment is defined at around one year. The exact length of the horizon could be extended depending on many factors which are being analysed continuously ranging from

⁵ Tanner (1979) has shown that there is a long term tendency for lags to increase because of growth in money substitutes and financial innovation which increases the velocity of money

monetary policy transmission mechanism time length to the confidence with which Bank of Albania assesses future inflationary pressures.

For purely transparency reasons inflation definition has remained headline inflation despite the recent decision to introduce a core inflation definition by INSTAT. Switching to core inflation which excludes food and energy items - subject to strong seasonal and weather changes largely beyond monetary policy range of influence - would simply disconnect the bank from the public. To account for the imperfect control of these factors the horizon and the band should be adjusted accordingly supported by a proper explanation. To that extent achieving and maintaining a target of 2 to 4 percent for a mid-term period is still an appropriate objective for Albania for several reasons: (1) Large share of food in the consumer basket; (2) Historical reasons; (3) Balassa-Samuelson effects; (4) Imported inflation.

(1) Large food weight

As mentioned above the large weight of food consumption in Albania increases the volatility of prices. One way of getting rid of seasonal volatility is to target average inflation. Other types of non-seasonal volatilities should be addressed by widening the band. The 2 to 4 band in the last 5 years have proved to be reasonably appropriate to account for agriculture price volatility in spite of the changeable weather during this period. This brings us to the historical reasons.

(2) Historical reasons

Albania has shown remarkable results in terms of price stability. Inflation has been distinguished generally by lower rates relative to other transition economies and not far from inflation seen across EU countries. After the initial period of transition 1991-1992 that saw inflation levels as high as 200 percent, single digit inflation rates prevailed until second half of 1996 when it started picking up over 20%, largely due to fiscal dominance that characterized that year. In 1997 the pyramidal schemes events triggered an economic and social chaos bringing the economy to a standstill and boosting inflation up to 50%. After the turmoil of 1997, inflation has been brought again under control to about 2-4 percent in 1999, where it has stabilised ever since. Both disinflation periods at the beginning of transition and after 1997 have been short, without any obvious real production and employment costs. The actual band of 2 to 4 where inflation seems to stabilise when the economy is not subject to major shocks could be interpreted as equilibrium that for a mid term period appears to be sustainable. However, this is a dynamic and fragile equilibrium. Albania is a developing economy subject to many structural changes. The catching up process of the economy may have several implications for inflation. An often mention implication takes place through Balassa-Samuelson effect which we investigate next.

(3) Balassa-Samuelson effect

Productivity convergence constitutes important adjustment that may have significant implications for inflation in emerging markets. So far BS effect does not appear to have been a significant inflationary source in Albania. Whether this will change in the future will very much depend on the intensity of the forthcoming structural changes the economy will undergo. If any of

these developments occurs most probably it will require upward revisions of the band to accommodate for these necessary real adjustments.

(4) Imported inflation

Inflation can be divided into two components, one that reflects domestically generated inflation and one that reflects imported inflation:

$$\text{Total inflation} = \text{weight} \times \text{domestic inflation} + (1 - \text{weight}) \times \text{imported inflation}$$

where: weight is domestic inflation's share of total inflation and in Albanian is estimated to be 56 percent, which means that the weight of imported inflation component is 44 percent. (INSTAT)

The above three points were mostly related to domestic inflation. However, Albania is a small and open economy with a large share of imports (42% of GDP). This means that imported inflation could be quite significant. Unlike previous factors imported inflation is a component that most likely pushes inflation down toward 2 percent level bearing in mind that Albania's two main trade partners are Italy (with 32% of total imports) and Greece (16%) both Eurozone members that targets below 2 percent inflation rate.

Some rough calculations indicate that imported inflation has been mostly affected by exchange rates movements rather than trading partners' inflation rates that has been fairly constant around 3 percent. Leaving aside the exchange rate noise Albanian inflation seems to eventually converge toward this 3 percent level. To some extent also the early choice of 3 (+/-1) percent inflation objective was supported under the argument that it was the inflation rate of Albania's main trading partners, while allowing the band that would have been consistent with a viable medium-term current account balance as well as macroeconomic equilibrium.

A final argument, which is more reassuring than compelling, is the experience of other countries in targeting inflation. As Table 2 shows inflation targets across these countries vary from 1 to 6 per cent, with point targets on average 2 per cent for industrial countries and about 3 per cent for emerging countries. The target range is set about 1.0 to 1.5 percentage points around the point target for most Inflation Targeters. Apart from the countries that at the time of IT implementation have had high inflation, the range of the inflation target is on average 2 percentage points. Many of countries that apply wider bands tend to narrow them as inflation gets closer to their long-term inflation objectives.

Table 2: Target objective of Inflation Targeting Countries

| <i>Emerging Markets</i> | | | <i>Industrial Countries</i> | | |
|-------------------------|------------|------------------|-----------------------------|------------|----------------|
| | Target | Band | | Target | Band |
| <u>Israel</u> | <u>2.0</u> | <u>1 - 3</u> | <u>New Zealand</u> | <u>2.0</u> | <u>1 - 3</u> |
| <u>Czech Republic</u> | <u>3.0</u> | <u>+/- 1.0</u> | <u>Canada</u> | <u>2.0</u> | <u>1 - 3</u> |
| <u>Korea</u> | <u>3.0</u> | <u>2.5 - 3.5</u> | <u>UK</u> | <u>2.0</u> | |
| <u>Poland</u> | <u>2.5</u> | <u>+/- 1.0</u> | <u>Australia</u> | <u>2.5</u> | <u>2 - 3</u> |
| <u>Brazil</u> | <u>4.5</u> | <u>+/- 2.5</u> | <u>Sweden</u> | <u>2.0</u> | <u>+/- 1.0</u> |

| | | | | | |
|---------------------|------------|----------------|--------------------|------------|-----------------|
| <u>Chile</u> | <u>3.0</u> | <u>2 – 4</u> | <u>Switzerland</u> | <u>2.0</u> | <u>< 2.0</u> |
| <u>Colombia</u> | <u>5.0</u> | <u>+/- 0.5</u> | <u>Iceland</u> | <u>2.5</u> | |
| <u>South Africa</u> | <u>4.5</u> | <u>3 – 6</u> | <u>Norway</u> | <u>2.5</u> | |
| <u>Thailand</u> | <u>1.7</u> | <u>0 - 3.5</u> | | | |
| <u>Mexico</u> | <u>3.0</u> | <u>+/- 1.0</u> | | | |
| <u>Hungary</u> | <u>3.5</u> | <u>+/- 1.0</u> | | | |
| <u>Peru</u> | <u>2.5</u> | <u>+/- 1.0</u> | | | |
| <u>Philippines</u> | <u>4.5</u> | <u>3 - 6</u> | | | |

A final point, should it be 3 ±1% or simply a range of 2 to 4%. Again this depends very much on the confidence with which Bank of Albania controls inflation. The former type of definition helps anchoring inflation expectations better. However, it may also put more pressure on central bank to explain inflation being below or above the centre target even if it is within the ±1% range. In other words it may behave and have the same implications as a point target. Bank of Albania from 2001 has been announcing the 3 ±1% type of objective rather than 2 to 4 range. So far it seems it has been a rewarding move. However, it could make more difficult broadening the band asymmetrically, especially from above, in case real economic adjustments will require higher inflation rates.

5. Conclusions

The nominal anchor used by the Bank of Albania in the last decade to control inflation has been money supply. Although not regarded as an orthodox regime nowadays as it used to be some twenty years ago, monetary targeting has served Albania well judging from the low inflation record. But the instability of money demand increases as advances and structural changes of the financial systems take place. The recent wake up of banking sector in Albania has urged BoA to reconsider the actual regime, as it may become inappropriate in anchoring inflation expectations effectively in the future.

Inflation Targeting was considered as the most appropriate alternative. Although some doubts have been raised about its applicability in developing countries it is a good framework for at least making clearer CB's intentions to maintain low inflation, while allowing for some flexibility to real shocks (a major advantage over exchange rate regimes). Several prerequisites of IT are already present in Albania: independent CB targeting inflation, instrument independence, free floating ER. Explicit inflation targets have been announced since 1993 besides the monetary targets. Some others elements are being developed further: forecast models, monetary policy (inflation) report. However, other preconditions like well understood and effective interest rate transmission mechanism, fiscal dominance (potentially) prove to be more challenging to tackle. Most of these IT preconditions, however, are indispensable for the success of any other regime too, including the actual MT. Therefore, IT adoption cannot be simply judged based on a standard compliance to these criteria.

In the short run, exchange rate could be an indispensable tool under IT to control the ER pass through effects in case of strong depreciation, and avoid deflationary pressures in case of capital inflows. In a longer horizon, however, exchange rate may have more adverse indirect effects. A recent 'peg or not to peg' exercise, looking at several other factors affected by ER like trade integration, financial integration, real vs. nominal shocks, business cycles synchronization etc, generates mixed results about the most appropriate exchange rate regime for Albania. The ineffectiveness and uncertainties about interest rates transmission mechanism severely restrict monetary policy role as shock absorber and therefore the scope of keeping fully flexible exchange rates. Unless the (long term) interest rates mechanism is somehow 'activated' a 'hybrid' instead of a 'fully-fledged' IT may be inevitable.

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