

2. ACTIVITY OF THE BANK OF ALBANIA DURING 2017

2.1 MONETARY POLICY

The main objective of the monetary policy is to achieve and maintain price stability. A stable price economic environment: (i) provides to households and enterprises the possibility to take well-informed decisions on consumption, savings and investments; (ii) helps maintaining the purchasing power and prevents the unforeseen distribution of income; (iii) facilitates the efficient allocation of resources in the economy; and, (iv) promotes financial stability in Albania. Hence, monetary policy supports the stable and long-term growth of Albania, providing an important contribution to the economic and social welfare.

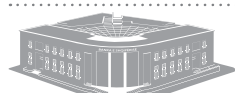
The target of the Bank of Albania's monetary policy is to keep inflation around 3% in the medium term. To hit this target, the Bank of Albania operates an inflation targeting regime, while the exchange rate is freely determined by the demand and supply for foreign currency in the market. On the operational aspect, the monetary policy is fulfilled through the intervention with indirect instruments in the financial markets.

Albania's economy and financial system were characterized by improving trends during 2017

The available economic and financial data of 2017 represents a positive picture, overall. Economic growth strengthened further, growth sources appeared more balanced, and the economic activity in Albania approached its potential level.

According to INSTAT data, the volume of economic activity registered 3.9% annual growth during the first nine months of the year. Indirect data suggest that the Albanian economy has continued to grow in 2017 Q4 as well, although with a somewhat lower intensity compared with the previous quarters. Economic growth was generated by the expansion of domestic demand, in the form of increasing consumption and investments, and by the expansion of foreign demand, in the form of increasing exports. Both the services and the production sectors have benefited from this expansion of aggregate demand.

The expansion of economic activity increased production capacities, as illustrated by the increase of employment, the decrease of unemployment, and the improvement of the financial situation of enterprises. The annual growth of employment averaged 2.9% during the first nine months of the year, while



the unemployment rate decreased at 13.6% at the end of 2017 Q3. Also, enterprises report a capacity utilisation near the average level of the previous year, while the improvement of their financial situation was reflected by the decrease of the non-performing loans ratio and the further increase of unused liquidity, deposited in commercial banks.

The main economic and financial balances of Albania tended toward strengthening

The current account deficit and the level of public debt declined during 2017, while financial markets were overall quiet and the main financial soundness indicators improved.

The current account deficit decreased at an average of 6% of GDP during the first nine months of the year, against the 8% registered in the previous year. The current deficit was financed mainly with non-debt-creating flows, helping control liquidity risk and foreign debt stability.

Fiscal indicators registered a consolidation during 2017, reflecting a low level of budget deficit and a decrease of public debt to GDP ratio. The continuation of fiscal consolidation has enabled a better transmission of the monetary stimulus to the economy, has helped reducing fiscal weaknesses, and has increased the resilience of the public sector against future challenges.

Financial markets were quiet and characterised by low interest rates and contained risk premiums. The banking sector appeared sound, with good liquidity, capitalisation and profitability indicators. The balances of this sector improved, but its lending policies continue to be conservative.

Despite the cyclical improvement, the economic activity remained below the potential and inflation below the 3% target.

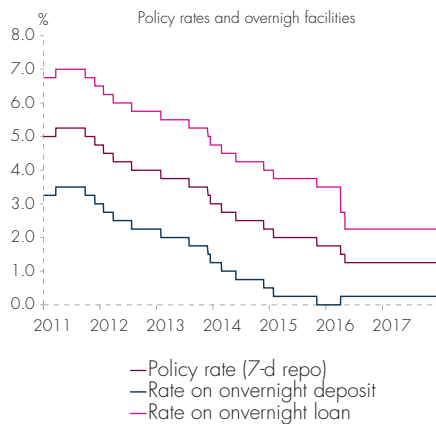
Average inflation for 2017 resulted at 2.0%, up from the 1.3% in 2016. The upward inflation reflected the improving trend of economic activity, but its undershooting continues to reflect the operation of the economy below the potential, the low inflation in trading partner countries, as well as the appreciation of the exchange rate. In particular, inadequate production capacity utilisation implies that the level of employment, the wage growth rate and the business profit margins continue to lag below their medium and long-term equilibriums.

The Bank of Albania maintained unchanged the size and intensity of the monetary stimulus during 2017

Despite the positive development trends, the weakness of general inflationary pressures, the still incomplete utilization of production capacities, the medium-term orientation towards fiscal policy consolidation, and the downward concentration of risks' balance have dictated maintaining the direction and intensity of the monetary stimulus unchanged.



Chart 1 Key interest rates

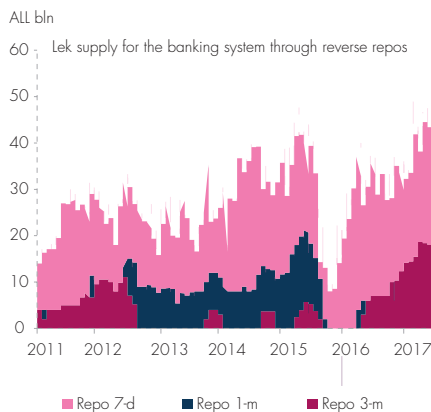


Source: Bank of Albania.

The monetary stimulus was transmitted through three main instruments:

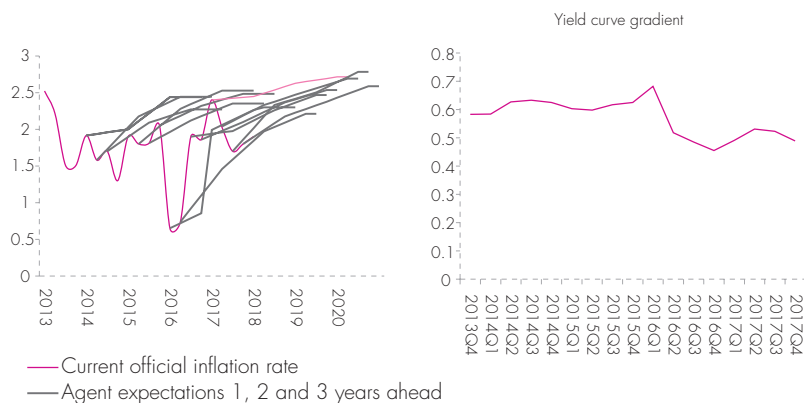
- **The policy rate**, which maintained its lowest historical level, 1.25%. The low refinancing cost of the banking sector has created the premises for an overall decrease of financing costs in the real sector of the economy.
- **The injection of liquidity into the interbank market**, which simultaneously increased its volume and average duration. Liquidity injection contributes to the normal functioning of the interbank market and facilitates the fulfilment of its role as an intermediary of funds in the economy. The Bank of Albania injected on average about ALL 34 billion per week in the interbank market, while a year earlier this indicator marked the level of ALL 24 billion. In addition to the one-week operations, the Bank of Albania increased its three-month liquidity injection, aiming for better control over medium and long-term interest rates.
- **Monetary policy forward guidance**; the Bank of Albania has used it to suggest the strength and intensity of the monetary stimulus will be maintained in the next quarters. This instrument has been successful in anchoring medium-term inflation expectations and reducing long-term interest rates, as shown by the flattening of the yield curve in recent years.

Chart 2 Volume and structure of the liquidity injected in the intermediary market

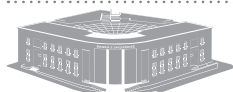


Source: Bank of Albania.

Chart 3 Inflation expectations and the government securities yield curve*



*The gradient is derived from the yield curve regression coefficients in the primary market, obtained by using the least squares method.
Source: Bank of Albania.

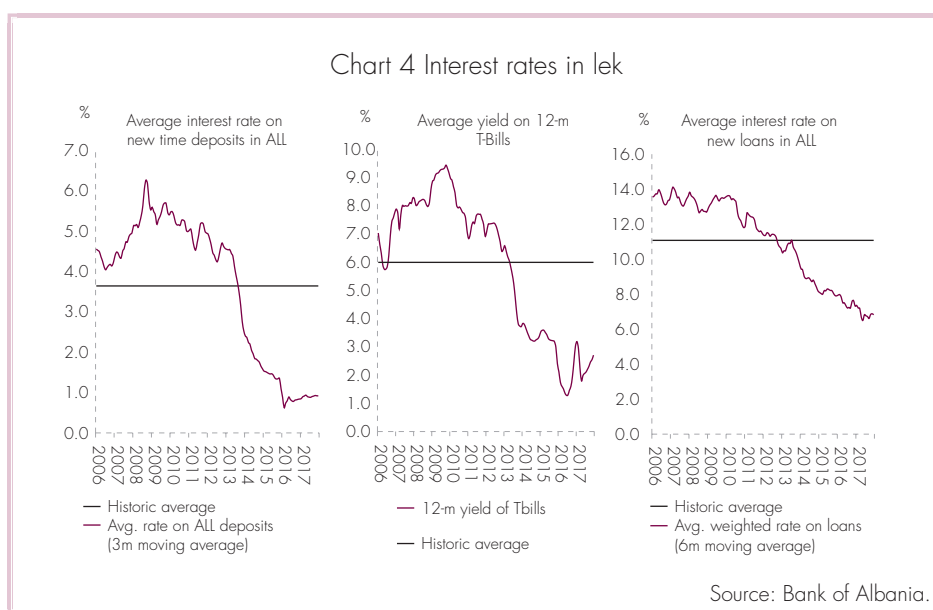


The accommodative monetary policy provided the main contribution to the improvement of the economic indicators.

The accommodative monetary policy has aimed and has managed to boost aggregate demand and economic growth, creating the necessary premises for the return of inflation to target.

The monetary stimulus was transmitted to the economy through a series of channels.

First, the accommodative stance of the monetary policy has boosted the growth of consumption and investments by reducing the cost of their financing and by improving the liquidity situation of the borrowers. The monetary stimulus has enabled the creation of a financial environment characterized by low interest rates, ample liquidity, and low risk premiums. The policy rate has decreased by 5.0 percentage points since the beginning of 2009, which has enabled the decrease of credit interest rates, 12-months T-bills and deposits in lek at 6.9, 4.5 and 6.6 percentage points, respectively (Chart 4).

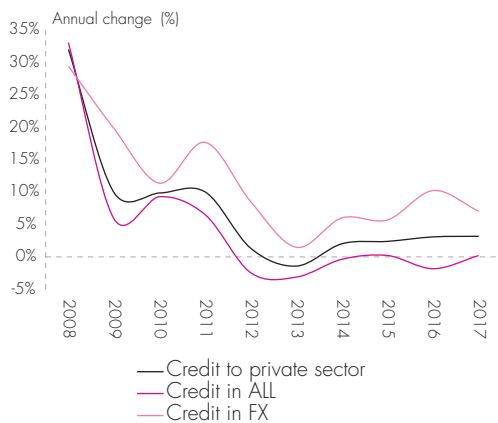


Low interest rates have increased demand for new loans and have decreased the servicing cost of existing loans. In response to them:

- **The volume of lek loans to the private sector increased by 7.2% in 2017**, being the main contributor to total credit growth. The new bank credit to enterprises is mainly used to finance investment projects, whereas those for households mainly to finance consumption.
- **The servicing cost of existing loans declined**, as a consequence of the decrease of the 12-months T-bills yields, whose price is used as reference rate for lek loans. According to a approximate estimation,



Chart 5 Credit performance in years (annual change, in %)



Source: Bank of Albania.

in the absence of an accommodative stance of the monetary policy, the servicing cost of this credit to the private sector would have been around ALL 11.5 billion higher during 2017. This financial saving creates spaces for higher consumption and investments, through the use of its own funds.

Second, the monetary policy has boosted domestic demand, through the reduction of uncertainties in the economy. The monetary policy forward guidance has helped reducing private sector uncertainties, which has promoted a greater orientation towards consumption and investment.

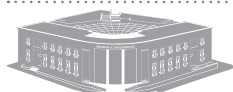
Third, the accommodative stance of the monetary policy has helped improve the balance of trade, through curbing appreciating pressures of the

exchange rate and boosting the competitiveness of Albanian exports. Improving the positive balance of trade has led to further growth in aggregate demand and economic activity.

Finally, the accommodative monetary policy has supported the strengthening of Albania's financial stability. The financial environment with low interest rates has improved the financial balances of borrowers, by bolstering aggregate demand, by easing the servicing cost of debt, as well as encouraging the restructuring of existing loans. In this way, the monetary stimulus has helped improve the quality of banking sector assets, which is also the main systemic financial risk in Albania.

Through the above transmission channels, the accommodative monetary policy has helped increasing aggregate demand and enabled the further expansion of economic activity. Our assessments suggest that the monetary policy has contributed positively, by around 0.7 percentage point, to the economic growth rate of 2017 (for more information, see Box 1).

Growth in aggregate demand has led to higher employment and improved capacity utilization rates, boosting medium-term inflationary pressures. However, inflation remains below our target. This performance reflects the presence of spare production capacities, various short-term shocks as well as other structural factors that have impeded the stable return of inflation to target. Also, this illustrates the need to continue the accommodative stance of the monetary policy in the medium-term as well.



BOX 1: MONETARY POLICY IN ALBANIA AND ITS CONTRIBUTION TO ECONOMIC GROWTH

This box aims to provide an assessment on the impact of monetary policy on economic growth. The first section addresses the theoretical aspect of the impact of monetary policy transmission channels on the economy. The second section addresses the methodology applied to assess the impact of monetary policy on Albania's economic growth. The last section discusses the outcomes of the assessment.

Monetary Policy Transmission Channels

Monetary policy affects the interest rates in the financial market, the expectations of the economic agents, as well as the behaviour of the exchange rate, through the spread between the interest rates in lek and those in foreign currency.

Through the impact of the interest rates channel, the monetary policy has a significant role in defining financial incentives and the availability of liquidity for consumption and investments. Through the expectations channel, the monetary policy affects the decision of economic agents for consumption and investments. Finally, through the exchange rate channel, the monetary policy affects the exchange rate performance and - in the short and medium term - the competitiveness level of Albanian exports. In euroized economies, like Albania, the exchange rate also affects the financial situation of borrowers in foreign currency, unhedged against exchange rate changes. These two exchange rate impact channels have opposite effects in the economy.

The monetary policy is accommodative when the policy rate remains below its equilibrium level and the real interest rates in financial markets are lower than their long-term trend. Such policy is undertaken when inflation is below its target and when the volume of economic activity is below its potential. The monetary policy is tightening when the policy rate is above its equilibrium level and the real interest rates in financial markets are above their long-term trend. Such policy is undertaken when inflation is above its target and when the volume of economic activity is above its potential. Finally, the monetary policy is neutral when the policy rate is at its equilibrium level and the real interest rate is similar to its long-term trend. The size of the gap between the policy rate and its equilibrium level defines the accommodative or tightening intensity of monetary policy.

An accommodative monetary policy stance:

- *promotes the increase of consumption and investments, through the decrease of financing costs; the increase of liquidity in the market; and expectations for growth of demand in the future;*
- *tries to temporarily depreciate the real exchange rate and improve, also temporarily, the foreign competitive position of the economy;*
- *attempts to deteriorate the financial situation of borrowers in foreign currency, unhedged against exchange rate changes, by decreasing their purchasing power. This last channel is viable for euroized economies and its impact is the opposite of the two other channels.*



A tightening monetary policy operates in the opposite direction in all the channels listed above.

In all cases, the monetary policy serves as an instrument for the return of the economy to equilibrium, which serves the stable and long-term growth of Albania. The macroeconomic equilibrium is a prerequisite for medium and long-term price stability.

Assessment methodology of the monetary policy impact on economic growth

The assessment of the contribution of the monetary policy to economic growth implies the measurement of the impact of the interest rates on the market and the real exchange rate in the real economy, which derive only as a result of the monetary policy stance. Two parallel exercises were conducted to obtain this assessment.

- In the first exercise, the impact of monetary policy on the real economy has been obtained through the interest rate channel. The impact of all the components that define the cyclical position of the economy is decomposed and the impact of real interest rates on economic growth is singled out.*
- In the second exercise, the impact of monetary policy on the nominal exchange rate has been obtained through the condition of covered interest parity. The estimated impact is subtracted from the actual exchange rate, to generate an alternative exchange rate without the impact of monetary policy. Through this alternative exchange rate, Albania's economic growth has been re-evaluated without the impact of monetary policy.*

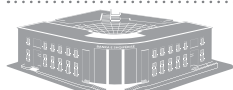
These assessments were carried out through the macro-econometric model used by the Bank of Albania for medium-term projections.

Estimation results

The pint estimation of the monetary policy impact on the performance of the economy has been conducted since 2011. After this year, the monetary policy has consistently maintained its accommodative stance. The results are presented in a chart at the end of this Box.

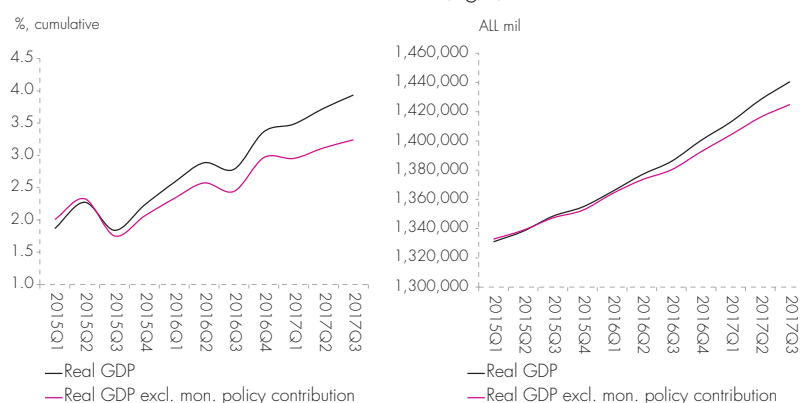
In summary, our conclusions are as follows:

- The positive impact of monetary policy on economic growth has picked up significantly since 2014. The contribution of monetary policy to economic growth for 2015, 2016, and the annualized growth up to 2017 Q3 is around 0.17 p.p., 0.4 p.p., and 0.69 p.p., respectively. The economic growth at 2.23%, 3.37% and 3.93% for 2015 and 2016 and up to 2017 Q3 would be 2.06%, 2.97% and 3.24%, respectively, in the absence of the contribution of monetary policy (see chart 6 on the left).*
- Beyond the impact on growth rates, the positive contribution of monetary policy has a cumulative impact on the economic activity level as well, measured by the real GDP. For 2017, real economic activity in Albania is about 1.26 p.p. higher, as a contribution of the accommodative monetary policy pursued by the Bank of Albania (see Chart 6 on the right).*
- The main impact on economic growth by the accommodative monetary*



policy has been through the interest rates channel. The impact of monetary policy through the exchange rate channel also is positive, but its size is smaller. This comes as a result of the opposite impact that the change of competitive position and the financial situation of unhedged borrowers.

Chart 6 Cumulative economic growth, real and excluding monetary policy contribution (left); cumulative annual GDP, real and excluding monetary policy contribution (right)



Source: Bank of Albania.

In institutional terms, the Bank of Albania has continued to work on meeting the strategic development objectives of monetary policy

To achieve the objectives set out in the Medium-term Strategy¹, the Bank of Albania has worked meticulously to improve the drafting and implementation process of monetary policy. During 2017, progress has been made in the following aspects.

- Further improvement on the analytic, forecasting, and assessing process of the impact of monetary policy. The integration of the various aspects of the process in a unified policy-making framework enables the: (i) forward guidance monetary policy decisions; (ii) generation of macroeconomic forecasts, with regular frequency and according to a standardized process; (iii) consistency of monetary policy decisions with the actual trends in economic development and our projections.

The macro-econometric models², which are used to generate macroeconomic forecasts and to analyse the monetary policy impact, are the main elements of

¹ These objectives are set out in Bank of Albania's Medium-term Strategy 2016-2018.

² Macroeconomic models describe the long-term structural relation between various economic variables, where the relations are assessed by contemporary econometric methods or calibrated according to the historical behaviour of the variables in models.



this framework. During 2017, we worked towards: (i) overall improvement of the existing models; (ii) achieving a more complete inclusion of the financial sector in their existing structure; as well as, (iii) enriching models with diagnostic and analytical functions. In this aspect, we benefited from the technical assistance of the IMF, the Swiss State Secretariat for Economic Affairs (SECO), and the Geneva Institute in the framework of the cooperation agreements.

The results of this work have served to establish a complete and more advanced set for analysing and forecasting macroeconomic variables, as well as for assessing the monetary policy response.

- **Deepening research on the structure of functioning of the economy and on the monetary policy transmission channels.** In the field of monetary policy, during this year, attention was paid to the: (i) study of the determining factors of low inflation in Albania; (ii) reassessment of the determining factors of long-term growth and the identification of the potential growth rate; (iii) analysis of the appreciating behaviour of the exchange rate and the assessment of its impact on inflation; (iv) impact of demand and supply factors on credit performance; (v) structural analysis of the economy, etc. Research findings are reflected in Boxes in the Quarterly Monetary Policy Reports, as well as in the research materials published on the website.

Research results have supported the decision-making and communication of the monetary policy, and have enabled a more comprehensive macroeconomic forecasting framework.

- **Improvement of the quality, structure and clarity of the main monetary policy communication instruments,** in order to increase transparency and its effectiveness. In this regard, our work focused on simplifying the communication language, increasing the emphasis on future developments, as well as enriching the reports with boxes to address specific phenomena affecting the economy and finance of Albania.
- **Increasing the efficiency of monetary policy instruments.** In this regard, the framework of forecasting the needs of the banking sector for liquidity has improved, aiming to enhance the efficiency of the programming and implementation of our interventions for its management. At the beginning of 2018, the short-term liquidity forecast was published, increasing transparency and helping to improve the liquidity management by the market agents themselves.
- **Increasing the efficiency of operational decisions.** For the second year, the new assessment framework of the international reserve adequacy level was implemented, supported by the optimisation approach. The assessment of the optimal level of the international reserve takes into account a number of factors, balancing the sources of risk in an



economy - against which the international reserve serves as a hedge - with the opportunity costs associated with maintaining a certain level of the international reserve. Such an approach prevents large operational fluctuations and decreases the reputational costs from unforeseen shocks.

- **Coordination of monetary and fiscal policies, in support of strengthening macroeconomic stability.** The government's commitment in pursuing a consolidating fiscal policy in the medium-term is factorized in the forecasts of the Bank of Albania and has enabled pursuing a more accommodative monetary policy stance.

The monetary and fiscal policies mix is assessed to be adequate. On one hand, it preserves an accommodative result of main economic policies; on the other hand, it addresses the weaknesses deriving by the relatively high level of public debt.

INFLATION AND ITS DETERMINING FACTORS

The overall inflationary pressures increased during 2017, confirming the forecasts of the Bank of Albania.

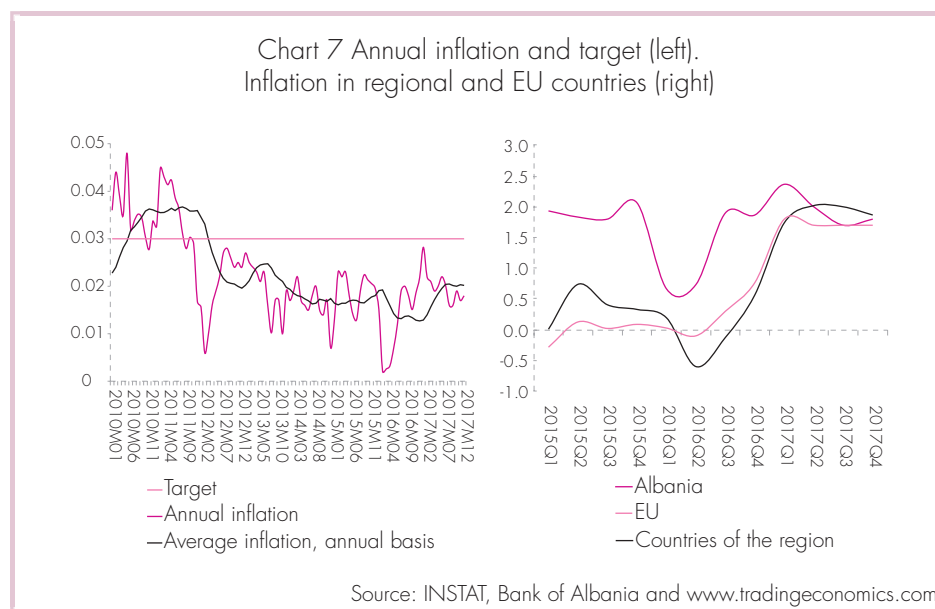
However, owing to the still incomplete utilisation of production capacities, the low inflation in trading partner countries and the exchange rate appreciation, the intensity of these pressures was insufficient for the return of inflation to target.

Annual inflation in 2017 averaged at 2.0%, up against the 1.3% in the previous year and confirming our expectations for its performance. The inflation profile during the year was characterized by a fast growth in 2017 Q1, a decelerating trend in Q2 and Q3, and a slight increase in 2017 Q4. In 2017 H1 and H2, inflation averaged 2.2% and 1.8%, respectively.

In macroeconomic terms, the upward trend of average inflation reflected the strengthening of domestic inflationary pressures, due to the improvement of the economic activity and increased utilisation of production capacities. On the other hand, inflation fluctuations throughout the year reflected supply-side shocks. In particular, the increase of inflation in 2017 Q1 was driven by increasing inflation in unprocessed food prices, as a result of adverse weather conditions, fuel and services prices related with it, as well as the effect of the low comparative base of the same period in the previous year. The mitigation of the above-mentioned effects was reflected in a slowdown of inflation in the following quarters. Also, the decrease of inflation in 2017 H2 was largely driven by curbing foreign inflationary pressures, as result of the combined impact of slow price growth abroad and the exchange rate appreciation.



On a broader context, the performance of inflation in Albania continues to have a similar profile to the performance in the countries of the region and our main trading partner, the European Union. Also, in 2017, a convergence tendency was observed for the level of inflation in Albania with the level of inflation in our trading partner countries.



The level and fluctuations of inflation continued to reflect mainly the performance of unprocessed food prices

Goods in the category of “Unprocessed food”, which are continuously subject of short-term shocks, had the main share in the formation of inflation during 2017 (in average around 60%). These shocks are related mainly with specific weather conditions, fluctuation of the exports’ demand, as well as various shocks in the chain of production and trading of agricultural products. On the other hand, the inflation of the “Processed food” category showed a different behaviour during 2017. Its contribution to headline inflation registered a significant decrease during the year³. The inflation of this category is affected by both the lek appreciation and the slower increase of food prices, especially of grains, in foreign markets. These developments have reduced the contribution of the imported component of this category to headline inflation.

³ The contribution of this category to headline inflation decreased from 0.6 percentage point in 2017 Q1 to almost zero at the end of the year.

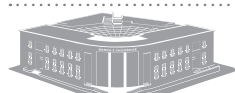


Table 1. Contribution of key items to annual inflation (p.p.)

	Q4:15	Q1:16	Q2:16	Q3:16	Q4:16	Q1:17	Q2:17	Q3:17	Q4:17
Processed foods (p.p.)	0.0	-0.4	0.1	0.4	0.6	0.6	0.5	0.2	0.0
Bread and grains (p.p.)	-0.1	-0.2	-0.1	0.0	0.1	0.1	0.0	0.0	0.0
Alcohol and tobacco (p.p.)	0.2	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0
Unprocessed food (p.p.)	2.6	1.5	0.9	1.2	0.9	1.3	1.1	1.2	1.3
Fruits (p.p.)	0.9	0.7	0.6	0.4	0.2	0.3	0.3	0.5	0.6
Vegetables (p.p.)	1.7	0.8	0.3	0.8	0.6	0.9	0.7	0.7	0.6
Services (p.p.)	0.0	-0.1	0.0	0.2	0.2	0.2	0.2	0.1	0.1
Goods with regulated prices (p.p.)	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Fuels and energy (p.p.)	-0.1	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Housing (p.p.)	-0.2	-0.2	0.0	0.0	0.0	0.0	0.1	0.1	0.2
Non-food consumer goods	-0.3	-0.3	-0.3	-0.1	0.1	0.3	0.2	0.2	0.2
Durable goods (p.p.)	0.0	0.1	0.1	0.1	0.1	0.0	-0.1	-0.1	0.0
Consumer Price Index (annual change, %)	2.1	0.7	0.7	1.9	1.9	2.4	2.0	1.7	1.8

Source: INSTAT and Bank of Albania.

*The table shows some of the main groups of categories.

Other basket items have given a higher contribution to average inflation in 2017, which has been overall consistent during the year.

The category "Non-food consumer goods" had the highest average contribution to 2017 headline inflation, although this indicator had a slight downward trend during the year, driven mainly by the performance of fuel prices in foreign and domestic markets. The inflation of "Services" has also shown the same performance and profile. After a long negative period, the performance of "Housing-rent" prices returned to positive contributions, although low, to headline inflation in 2017 H2. The categories "Goods and services with regulated prices" and "Durable goods" maintained low contributions to headline inflation; the second category often times provided negative values.

The improvement of the cyclical position of the economy is reflected in the increase of domestic inflationary pressures.

Our analyses suggest that the expansion of aggregate demand is accompanied by a gradual, but still incomplete, movement of the economy towards potential. The increase of the production capacity utilisation strengthens the increase of wages, production costs and profit margins, in line with our inflation target.

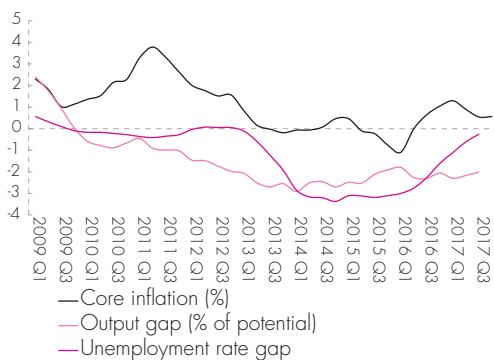
This chain of phenomena has been present throughout 2017. This year's core inflation resulted at 0.8%, significantly higher than the previous year (0.2%).

However, our analyses suggest that the strengthening of domestic inflationary pressures has not yet reflected completely the improvement of the cyclical position of Albania. This transmission has been curbed by the appreciation of the exchange rate, the structural improvements in the employment market, as well as the high inertia showed by the complete return of inflationary expectations to target.⁴ Core inflation contributed more consistently to the formation of headline

⁴ For an assessment of the factors that have contributed to keeping inflation low, see the Box on "Cyclical and structural factors leading to low inflation in Albania", Monetary Policy Report 2018/1, February 2018.



Chart 8 Output gap (%), unemployment rate gap (pp)*, and core inflation (%)**



*Unemployment rate gap is calculated as the difference between the natural rate of unemployment and the factual one published by INSTAT, to simplify the interpretation of the direction with the output gap which is calculated in % of potential output. **The indicators in terms of gaps are flattened through 4 terms moving averages. For the core inflation is given the annual average. Source: INSTAT and BoA's calculations.

inflation during 2017 H2. Its stabilisation suggests a more complete materialisation of the impact of medium-term factors in the formation of inflationary pressures in the economy, despite short-term shocks.

The foreign environment continued to generate low inflationary pressures during 2017, which weakened even further because of the appreciation of the exchange rate

The imported inflationary pressures index (IIP⁵) registered an average annual decrease of 0.3%, while in the previous year this decrease was at 1.7%. This development reflected the increase of the foreign prices (4.2%) and the average annual appreciation of the nominal effective exchange rate (4.5%).

ECONOMIC ACTIVITY

Chart 9 IIP⁵ and contributions of its components



Source: INSTAT and BoA's calculations.

The economic activity continued to grow during the first nine months of 2017, mainly supported by the improved performance of the services and construction sectors.

Domestic demand was the main driver of growth, with positive contribution from both of its components, consumption and investments.

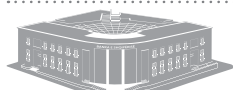
According to available INSTAT data, the economy grew by 3.9% during the first nine months of the year.⁶ This growth rate reflected the same contribution, by 1.7 percentage points, of the services⁷ and the production sectors.

In the services sector, the highest contributions to economic growth are assessed to be from the "Trade, hotels and restaurants, transport" and "Public administration, education and health", at 0.7 and 0.6 percentage point, respectively. Meanwhile, the improved dynamic of the production sector reflected positive contributions from all its main activities. Among them, construction continued to generate the highest contribution to GDP growth, at

⁵ The annual change in the IIP⁵ is the algebraic sum of annual changes in the import price index and the NEER index.

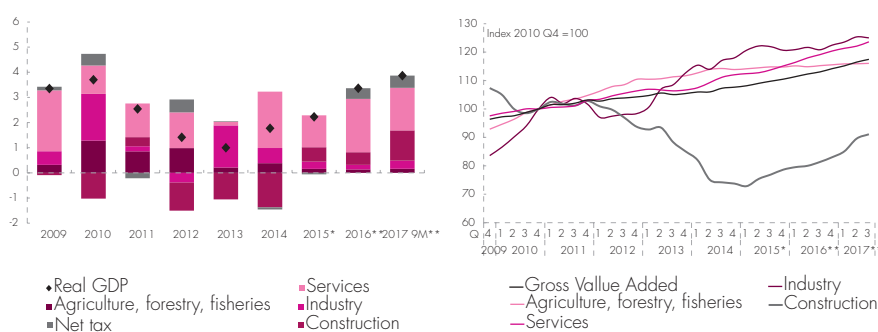
⁶ Until 14 March 2018, the latest GDP data published by INSTAT by production and expenditures cover developments until 2017 Q3. In the three first quarters of the year, economic growth resulted at 4.0%, 4.1% and 3.5%, respectively.

⁷ The main branches of services are: "Trade, hotels and restaurants, transport", "Information and communication", "Financial and insurance activities", "Real estate activities", "Professional activities and administrative services", "Public administration, education and health", "Arts, entertainment, recreation, goods production activities of families for own use and other services".



around 1.2 percentage points, driven by the growth of public investments, the continuation of work in major energy projects (where foreign direct investments dominate) as well as the realisation of new constructions⁸. Meanwhile, the industrial⁹ and the agricultural activity supported the economic growth of the first nine months of the year at 0.3 and 0.2 percentage point, respectively.

Chart 10 Annual growth of real GDP (in %) and contribution of production-side components (in p.p.). Trend of real GVA in economy and sectors^o



^o Indices of the real GVA for the economy and its sectors reflect the trend of the relevant value added, calculated as the moving sum of quarterly values for four quarters, based on 2010 Q4.
Source: INSTAT and Bank of Albania.

Developments in the labour market resulted positive during the first nine months of 2017¹⁰

Employment in the economy registered an average annual growth of 2.9% during the first three quarters of 2017. Notwithstanding the positive performance, this growth was slower than the 6.8% growth registered in the same period in the previous year.¹¹ Employment grew largely determined by the increase of employees in the services sector. This growth has led to a further decline of the unemployment rate. The unemployment rate remained at around 13.6% in 2017 Q3, or around 1.1 percentage points lower than the rate registered in the same period the previous year.

⁸ Referring to the volume index in construction, disaggregated in: new constructions, restructuring and engineering works.

⁹ Among the branches included in the industry sector, to the processing industry is attributed the highest contribution to the GDP annual growth during the period under review, at around 0.4 percentage point.

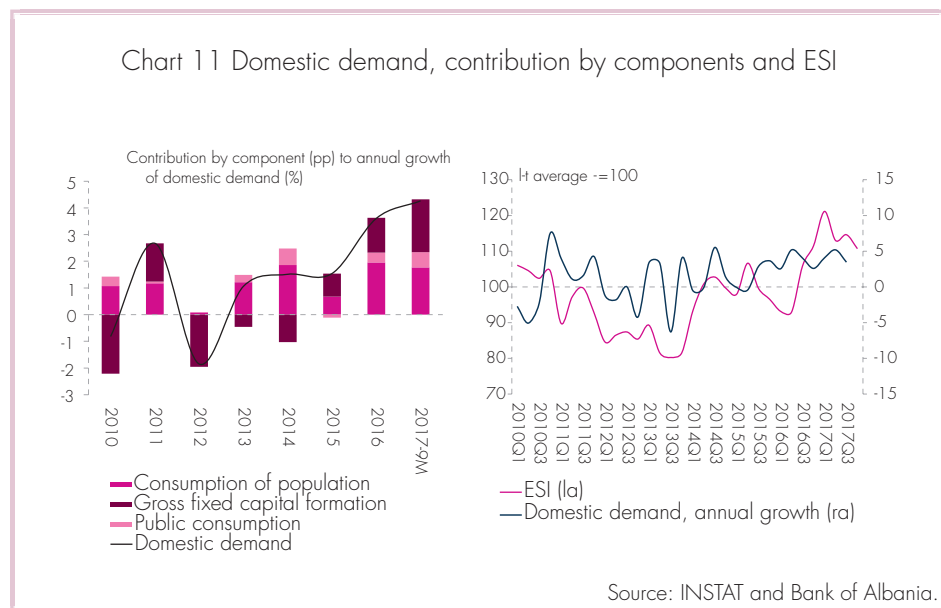
¹⁰ Analysis of employment and unemployment is based on the data of the Labour Force Quarterly Survey, and refers to the indicators for those 15 of years and older.

¹¹ The expansion of employment during 2016 is assessed to have also reflected, to some extent, the effects of the formalization process undertaken by the government starting from 2015 Q3.



The expansion of domestic demand and economic activity during 2017 is supported by the increase of investments and private consumption

Domestic demand increased by 4.3% during the first nine months of 2017.¹² Investments and consumption of the population provided the main contribution. In the case of investments, the main increasing contribution is assessed to have come from the public sector, while the contribution of the private sector has slowed down. At the same time, the contribution of public consumption has increased compared with 2016.



Information from indirect indicators suggests a positive performance of domestic demand during 2017 Q4, formed by downward contribution of investments and upward contribution of consumption of the population.

Private consumption continued its upward cycle during the first nine months of 2017

Private consumption grew 2.5%, on average, during the first three quarters of the year. The increase of consumer spending was slower in 2017 H1 (+2.2%), but accelerated in 2017 Q3 (+3.3%). The growth of long-term durable goods and services expenditures is assessed to have contributed to the expansion of private consumption¹³. The growth of employment and wages, the improvement of consumer confidence, and the favourable financial conditions were the main factors that supported the growth of consumer expenditures.

¹² Domestic demand components are final consumption (including final consumption of the population, of the public administration and of non-profit institutions) and gross fixed capital formation. In terms of national accounts, private consumption in this report refers to final consumption of the population, whereas investments are equivalent to gross fixed capital formation

¹³ Based on indirect indicators, except those published by national accounts, which do not give a disaggregated measurement of private consumption.

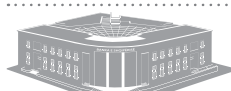
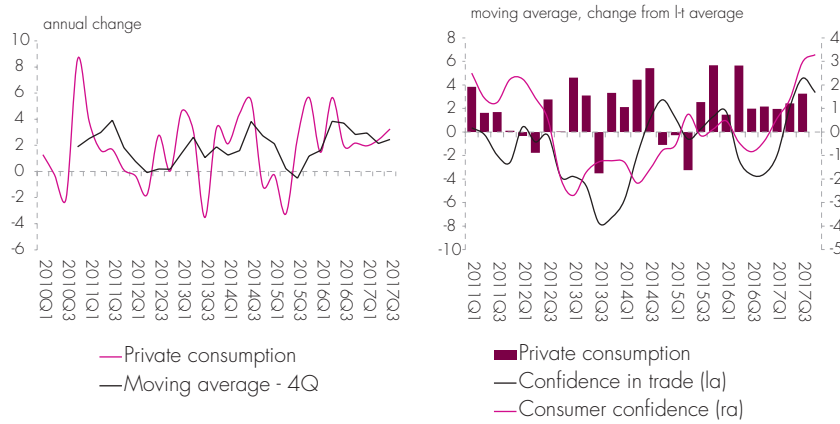


Chart 12 Private consumption and confidence in trade and consumer confidence



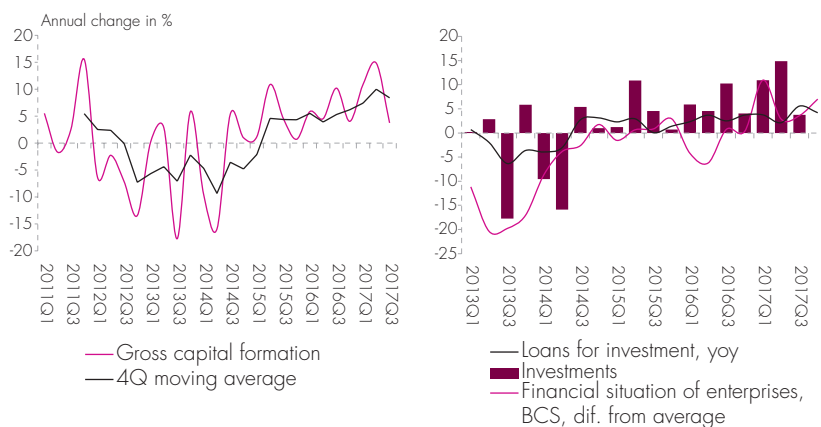
Source: INSTAT and Bank of Albania.

Investments continued to grow during 2017

Investments in the economy grew by 9.8% during the first nine months of 2017. In the last three years, this component has contributed significantly to the expansion of aggregate demand. Investments in construction and, to a lesser extent, also investments in machinery and equipment contributed positively to its growth during the year.

The main factors that supported the growth of private investments are the improvement of confidence and the financial situation of enterprises, the gradual recovery of consumer demand, as well as low financing costs in the banking sector. Confidence indicators in the sectors of trade and construction remained very close to the historical average during 2017, and above the historical average in the sectors of industry and services.

Chart 13 Annual performance of investments in the economy



Source: INSTAT and Bank of Albania.



Fiscal indicators improved, but the intensity of fiscal consolidation decreased during 2017

The budget deficit of 2017 was assessed at around 2% of GDP, slightly upward from the 1.8% registered in 2016. In absolute terms, the budget deficit of 2017 registered ALL 31 billion¹⁴. The deficit growth led to the 2017 fiscal policy shifting towards easing and giving a direct positive contribution to increasing aggregate demand during this period (see Box 2). The higher deficit ratio from the previous year was dictated by almost in the same measure developments in revenue and expenditures. The growth of the share of budget expenditures reflected mainly the increase of public investments, while the decrease of revenues reflected mainly the slowdown of non-tax revenues.

Budget expenditure for 2017 amounted to around ALL 461.4 billion, increasing 6.4% in annual terms. The increase of capital expenditures formed 32% of the expansion of budget expenditures. Except for foreign and domestic debt interest expenditures and operational expenditures, all the other items of current expenditures contributed positively to the increase of expenditure. Measured by the volume of budget expenditures, the share of the public sector was assessed at around 29.5% of GDP, from 29.4% in the previous year. The slight increase of this ratio was driven by the expansion of the components related directly to aggregate demand (public consumption and investments), while the share of interest expenditures declined.

Budget revenues increased by around 5.7%, in annual terms, remaining around 27.5% of the GDP. This ratio registered a very slight decrease compared with the previous year. To a large extent, the increase of revenues was formed by VAT (around 35%), social insurance (32%) and local government (15%) revenues. In addition, national tax revenues also contributed to the increase of total revenues.¹⁵ In view of minimal changes in the tax policy, the growth profile of tax revenues during 2017 reflects the recovery of economic activity and the improved dynamics of labour market indicators.

During 2017, the government had privatisation revenues of ALL 0.4 billion and increased the domestic and foreign net borrowing by ALL 45.4 billion. Available funds, ALL 31 billion, were used to finance the 2017 deficit, and the remainder, ALL 14.8 billion, to improve the situation of the deposit.

Borrowing increased in the domestic market consisted only in long-term debt instruments, whose issue also compensated the decrease of short-term issues. This borrowing strategy resulted in the extension of the domestic debt maturity to 780 days at the end of 2017, from 753 days of the previous year.

¹⁴ Data on fiscal indicators of 2017 come from the MFE publication of 5 March 2018.

¹⁵ This was due to the increase in revenues from the Law on real estate reassessment which temporarily enabled (until May) the reassessment of assets by natural and legal persons at 2% and 3%, respectively, of the taxable base, from 15% defined by the current law.

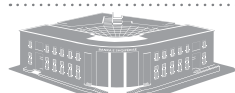
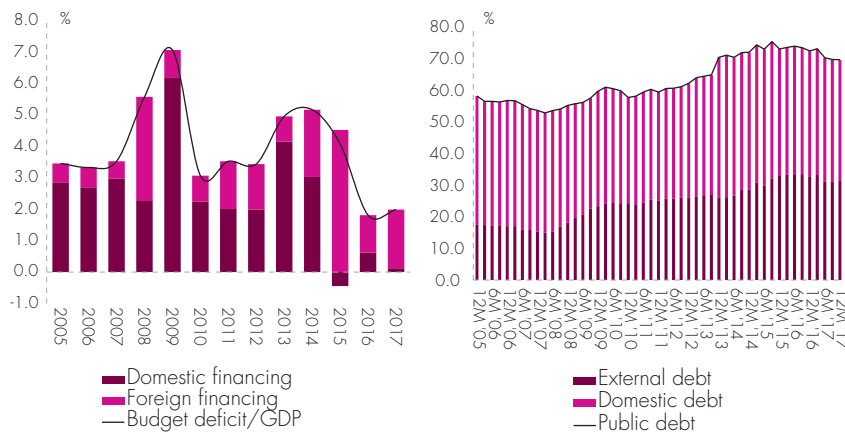


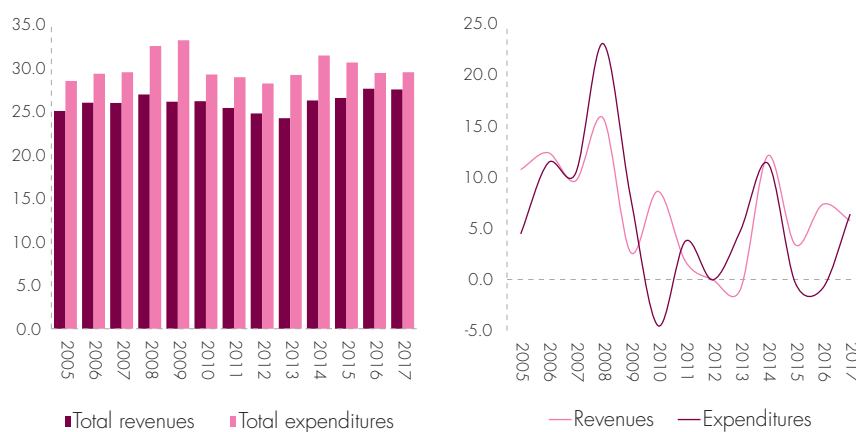
Chart 14 Budget deficit and financing (left) and public debt (right) to GDP



Source: MFE, INSTAT and Bank of Albania's staff calculations.

The public debt stock is assessed to have decreased at 69.6% of GDP in 2017, from 72.4% in 2016¹⁶. The decrease of public debt in 2017 is explained by the positive values of the primary balance, the higher rate of nominal economic growth against the average cost of public debt, the appreciation of the national currency, as well as the decrease of the guaranteed debt stock. Divided by residency, the public debt is dominated at 55% by domestic creditors, almost the same ratio as in the previous year.

Chart 15 Revenues and expenditures to GDP (left) and their annual changes, in % (right)



Source: MFE, INSTAT and Bank of Albania's staff calculations.

¹⁶ The GDP used in the construction of fiscal indicator ratios refers to BoA's assessment after the publication of GDP for 2017 Q3 by INSTAT. The data of debt stock is referred to the publication of MFE for 2017 Q4.



BOX 2. THE NATURE OF FISCAL POLICY IN ALBANIA

This box aims to give an overall assessment on the nature of fiscal policy pursued in Albania during the last 15 years. For this purpose, we first address the theoretical aspects of fiscal policy and their usefulness. Then we briefly explain the methodology and the identification of the fiscal policy direction in Albania during the period.

Fiscal policy: and business cycles

The economic literature offers three definitions on the nature of fiscal policy. Depending on the direction of the change of the budget balance and the cyclical position of the economy, the fiscal policy may be pro-cyclical, counter-cyclical and neutral.

- *Fiscal policy is called pro-cyclical when the economy is below potential and the budget deficit/surplus is contracting/expanding (tightening pro-cyclical policy), or when the economy is above potential and the budget deficit/surplus is expanding/contracting (easing pro-cyclical policy).*
- *Fiscal policy is called counter-cyclical when the economy is below potential and the budget deficit/surplus is expanding/contracting (easing counter-cyclical policy), or when the economy is above potential and the budget deficit/surplus is contracting/expanding (tightening counter-cyclical policy).*
- *Fiscal policy is called neutral when the budget deficit or surplus remains unchanged, while the automatic stabilizers act freely in the economy (EC, 2009 “Public Finances in EMU”).*

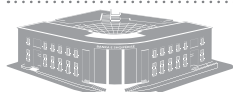
When seen exclusively from the point of view of the stabilising function of an economic policy, the desired nature of the fiscal policy is counter-cyclical. Its counter-cyclicity: (i) complements the impact of monetary policy, (ii) helps mitigating the economic fluctuations; and (iii) tends to be associated with more stable levels of public debt.

However, in practice, fiscal policy may depart temporarily from its counter-cyclical nature if: (i) the fiscal incentive is non-ineffective or impossible; and if (ii) the lack of fiscal incentives may be offset by the increase of the monetary incentive. Counter-cyclical easing fiscal policy may be: (i) non-effective, in the event the further expansion of public debt increases the risk premiums and the financing costs of the private sector, leading to a decline in private expenditures; or, (ii) impossible, in the event of liquidity shortfall in the market (Gavin and Perotti, 1997).

The consolidating trend of fiscal policy in Albania during the last years has been formed by the above-mentioned considerations. Even though aggregate demand has not been able to ensure a full utilisation of production capacities, fiscal consolidation has been assessed as desirable, as long as it lowers risk premiums in financial markets, helps financing the private sector, and enables the pursuit of a more accommodative monetary policy.

Methodological notes

The assessments on the nature of fiscal policy during the business cycles overall are based on the direction and the measure of change of the primary balance, corrected for the impact of automatic stabilizers¹ and the impact of temporary measures¹¹.

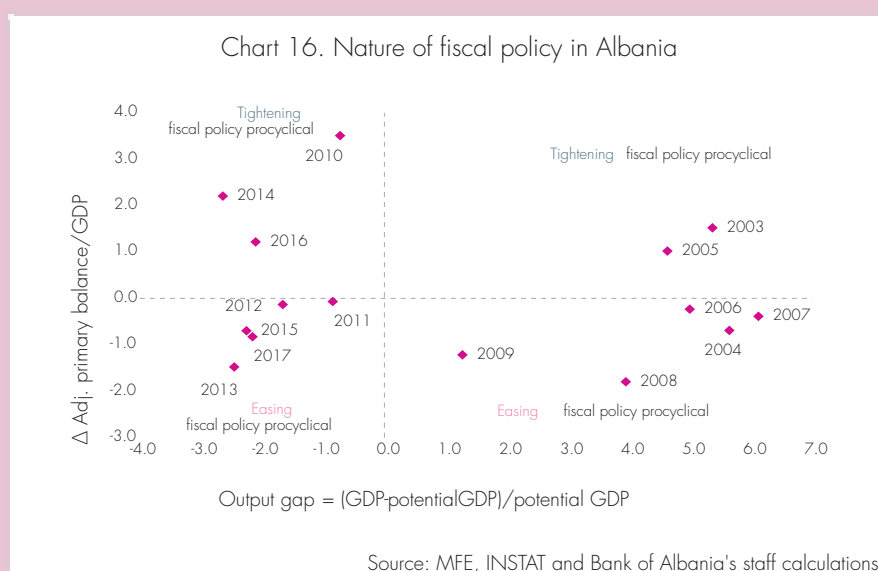


However, to identify the nature of fiscal policy in Albania, we have referred to the primary balance corrected only for the factors that affect it temporarily. This choice is motivated by two reasons. First, it is in line with the previous assessments made in the case of Albania, which evidence a relatively low share of automatic stabilizers in Albania^{III}. Second, it avoids the discussion and construction of technical suppositions on the cyclical components of the primary balance.

Given the above, the following discussion should be interpreted only as an approximation of the true nature of fiscal policy in Albania.

The nature of fiscal policy in Albania

The results of the application of the above methodology in the case of Albania are shown in the Chart below.



During the analysed period, 2003-2017, fiscal policy in Albania has taken all three possible features: pro-cyclical, counter-cyclical, and neutral. In terms of balance, the pro-cyclical feature has a slight dominance, followed almost equally by the counter-cyclical and neutral features.

For 2017, fiscal policy had counter-cyclical features, generating a fiscal impulse of 0.8 percentage point. For 2017, the easing nature of fiscal policy in support of economic growth was shaped by growth in public investments and in wages policies.

^I The automatic stabilizers are those fiscal indicators that react automatically to the business cycle, without the need of a change in the economic policies of the country for that time period (Macroeconomics, 5th edition, p 382, Mankiw, G.)

^{II} Temporary measures are those that have no impact on *over-time* budget position and as such are accounted during the assessments on the nature of discretionary fiscal policy. These measures have been evidenced in the case of Albania both in terms of revenue (as e.g. revenue from the reassessment of assets) and of expenditures (as e.g. expenditures on arrears). For more details, see "Public Finances in EMU, 2006" pp.112-113.

^{III} Gazidede A., 2013 "An alternative method of assessing the fiscal position in Albania: The budget balance corrected for business cycles"

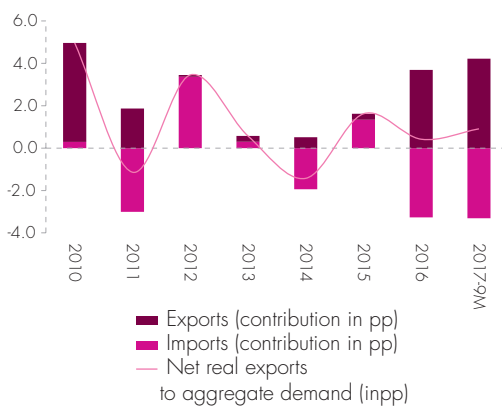


The foreign exchange balance improved significantly during 2017, contributing positively to economic growth in the first nine months of the year

During the first nine months of 2017, net exports provided a positive contribution to aggregate demand growth. The determining factor in this regard has been the good performance of exports, which contributed to the narrowing of the trade deficit in real terms, amid increased demand for imports.

General import expanded by around 13.7% in annual terms, with the main contribution from the growth in services import by around 15.1%. Additional positive contributions from other service groups have also been added to the positive performance of tourist services. In parallel, the performance of the export of goods has also resulted in positive growth (8.9% in annual terms) and with a broad base. Favourable international pricing conditions, coupled with several positive domestic supply developments (particularly in the fields of oil, metals and unprocessed food) have fuelled a high growth in export of goods, concentrated during 2017 H1. On the other hand, imports' recovery continued throughout 2017 as well. The real growth of imports resulted at 7.6%, mainly driven by the import of goods. Import growth intensified especially during 2017 Q3, due to the rapid expansion of electricity and fuel imports.

Chart 17 Contribution of net real exports (in p.p. to GDP)



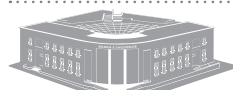
*For 2017, data apply for the first three quarters.
Source: Bank of Albania.

Data for 2017 Q4 evidence a different picture, at least in terms of goods trade. The growth of exports has reduced significantly, affected by a base effect created in the last months of 2016 as well. This perspective is expected to continue during 2018 H1 as well, mainly related with the impact of processed fuel exports. On the other hand, imports continued to show growth. This behaviour is expected to continue during 2018 H1 as well.

In terms of structure by sector, exports remain relatively concentrated in some categories despite the high growth rates during 2017. "Textiles and clothes" accounted for 43% of the total export of goods, unchanged from 2016. Other important categories are "Minerals, fuel and electricity" and "Construction materials and metals". Also, "Food, beverages,

tobacco" contributed significantly to export growth, due to the continuous increase of respective exports in the last two years.

In terms of structure by destination, the European Union countries and specifically Italy, remain Albania's main trade partners. During 2017, the share of neighbouring countries such as Kosovo, Serbia, Macedonia and Montenegro saw relative growth, due to high exports of "Food" and "Construction materials and metals" towards these destinations. Concerning farther destinations, the shares of Sweden and Estonia increased related to the higher export of some categories of processed food towards them.



The sectorial structure of imports remains more diversified. With the exception of "Machinery, equipment and spare parts", whose share resulted relatively high during 2017 (around 21% of total imports), the other categories show similar contributions, such as "Foods, beverages, tobacco," "Construction materials and metals", "Chemical and plastic products". Imports of "Textile and clothes" (around 14% of the total imports) were also important, due to the raw materials imported for products that were then re-exported. As far as import partners are concerned, the European Union countries, in particular Italy and Greece, maintained the main shares. Significant contributions also came from other partners like Turkey and China. During 2017, the shares of Serbia and Russia saw relative increase. This is related to increased imports of fuel, electricity and grains, especially during 2017 H2.

Financing of the current account deficit is based on non-debt creating flows.

The contraction of net exports deficit also contributed to the contraction of the current account deficit during the first nine months of 2017. The positive developments are mainly related with the services account. On the other hand, the trade in goods deficit expanded mainly due to the impact of imports. Regarding income sub-accounts, net surpluses declined, in the case of both primary and secondary income.

The profile of financing the current account deficit continues to be based on non-debt creating foreign currency flows, in the form of foreign direct investments and capital account inflows. Financing by debt-creating flows resulted somewhat lower compared to the previous year. At the end of 2017, the stock of foreign currency reserve assets was sufficient to cover 6.9 months of imports of goods and services and 166% of the short-term external debt.

Foreign debt stability indicators have improved

Foreign debt stock registered EUR 7.85 billion in 2017 Q3, down by 0.4% compared with the previous year and was assessed at 68.6% of the nominal GDP. In structural terms, government debt dominates with around 43.7% of the total, followed by debt related to direct investments at 22%. In maturity terms, long-term debt dominates at around 79.7%. Regarding instruments, loans and investments in foreign currency and deposits constitute around 70.6%. The share of portfolio investments is somewhat low.

In terms of stability, the long-term repayment ability indicators improved during 2017. The ratio of debt stock to the exports of goods and services was around 174.5% at the end of 2017 Q3, while in the previous year, this ratio stood at 212.1%. At the same time, the ratio of debt stock to fiscal revenue marked 246.9%, compared with 272.9% registered in the previous year.

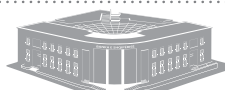


Table 2 The main macroeconomic and financial indicators

	2013	2014	2015	2016	2017*
Annual average inflation					
Headline inflation (in %)	1.9	1.6	1.9	1.3	2.0
Core inflation (in %)	0.2	0.1	-0.2	0.2	0.8
Economic growth					
Real GDP growth (annual, in %)	1.0	1.8	2.2	3.4	3.9
GDP pro capita (EUR)	3,323	3,443	3,556	4,043	
Labour Market¹					
Participation rate in the labour force (15-64 years)	59.6	61.5	64.2	66.2	66.6
Unemployment rate (15-64 years)	15.9	17.5	17.1	15.2	13.9
Fiscal sector					
Budget balance (including grants, in % of GDP)	-5.0	-5.2	-4.1	-1.8	-2.0
Budget revenues (in % of GDP)	24.2	26.3	26.6	27.5	27.5
Budget expenditure (in % of GDP)	29.2	31.4	30.6	29.3	29.5
Public debt (in % of GDP)	70.4	72.0	73.1	72.4	69.6
Domestic (only central government)	44.3	43.3	39.9	39.6	38.3
Foreign (only central government)	26.1	28.6	33.1	32.8	31.3
External sector					
Current account (official transfers exempted in % of GDP)	-9.3	-10.8	-8.6	-7.5	-6.4
Imports of goods (fob, in % of GDP)	31.5	31.6	29.9	30.8	31.6
Exports of goods (fob, in % of GDP)	11.1	9.4	7.5	6.6	7.1
FDI inflows (in % of GDP)	9.8	8.7	8.7	8.7	8.3
International reserve (in EUR million, end of period)	2,015	2,192	2,880	2,945	2,994
Monetary and financial sector					
Repo rate (end of period)	3.0	2.3	1.8	1.25	1.25
M3 aggregate (annual growth, end of period)	2.3	4.0	1.8	3.9	0.3
Credit to the private sector (annual growth, end of period) ²	-1.4	2.0	2.4	3.1	3.2
Deposit/GDP ³	72.4	73.0	72.9	74.2	70.9
Credit/GDP ³	38.0	37.5	37.5	37.5	36.5
12-month average yield	5.2	3.4	3.3	1.8	2.4
ALL/USD average exchange rate	105.7	105.5	126.0	126.0	119.1
ALL/EUR average exchange rate	140.3	140.0	139.7	136.1	134.2
NEER	113.7	112.1	113.8	110.2	105.0
Banking Sector					
Non-performing loans ratio/total loans (%)	23.5	22.8	18.2	18.2	13.2

Source: INSTAT, Bank of Albania, Ministry of Finance and Economy.

*Data on economic growth for labour market and the external sector are from 2017 Q3.

1/ "Labour force survey results", published by INSTAT.

2/ The data is adjusted for written off loans.

3/ GDP assessment for 2017.

FINANCIAL MARKETS AND MONETARY INDICATORS

Financial markets were characterised by low interest rates, downward risk premiums, and low volatility during 2017. The accommodative monetary policy was transmitted to reduced financing costs for the private sector. In the foreign exchange market, the national currency continued to appreciate, reflecting the decrease of risk premiums and the improvement of foreign currency inflows and outflows balance.

Despite low financing costs, banks' credit to the private sector maintained moderate growth rates, due to the still low demand of economic agents for financing as well as the conservative lending policies by the banking sector.



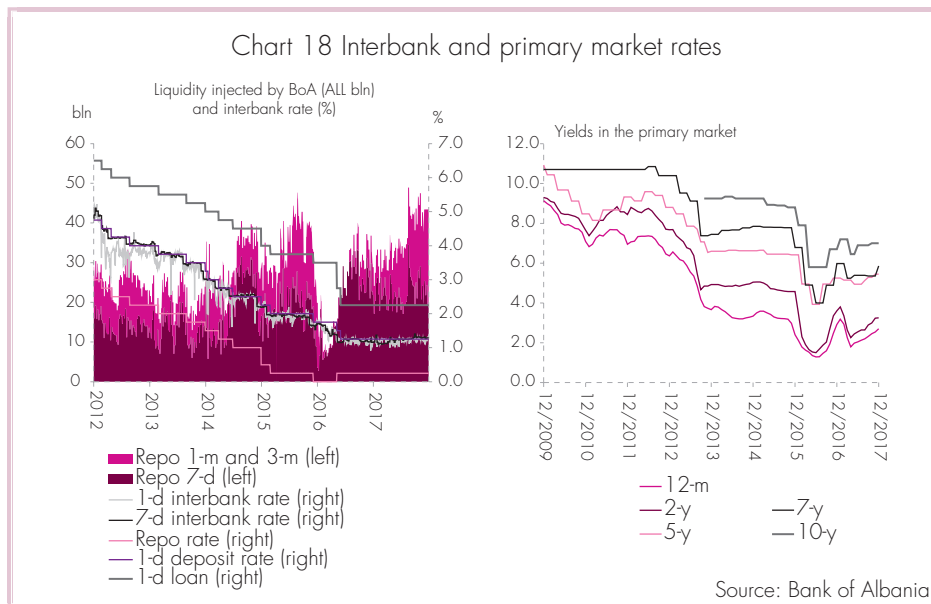
On the other hand, the low interest rates for households' savings has not affected the growth of deposits in banks, but has been reflected in the shift of their structure towards extreme maturities.

Interbank rates ranged close to the policy rate, in accordance with the operational target of the monetary policy

Liquidity management by the Bank of Albania has been successful. The increase of demand for financing by the banking sector is accompanied with the increase of the volume of liquidity injected by the Bank of Albania and the extension of its average maturity term. The interbank rates ranged closer to the policy rate and showed lower volatility compared with the previous year. The trade volumes in this market remained unchanged from the previous year.

Yields on Government securities increased slightly in 2017

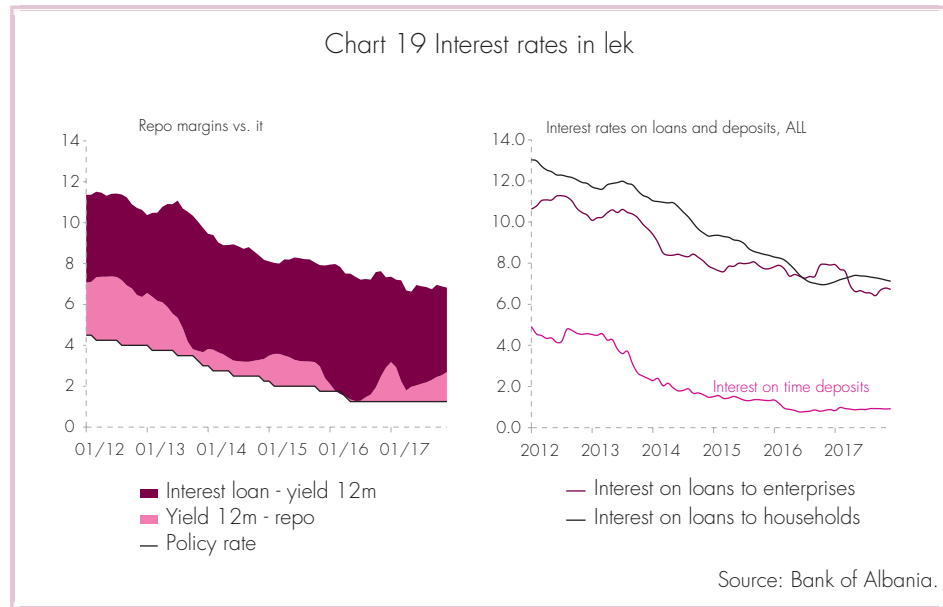
Yields on Government debt securities, T-bill and bonds, showed a more stable performance in the primary market, following significant fluctuations in late 2015 and in 2016. After decreasing in the first months of the year, they started to increase moderately, reflecting a prudent borrowing policy by the government. The 12-month yield resulted 2.4% in average during the year, from 1.8% in the previous year. The yields increased almost uniformly for all maturities, while the yield curve gradient remained unchanged compared with the previous year, thus showing unchanged risk premiums related with the monetary and fiscal policy orientation.



Interest rates on loans in lek decreased for private enterprises

The accommodative monetary policy has been reflected in the reduction of banks' financing costs in the last years, which has enabled the transmission of the monetary stimulus to credit interest rates. Along with this factor, the reduction of credit risk and the improvement of banks' balance sheets have allowed banks to lower interest margins, balancing yields growth over this period.

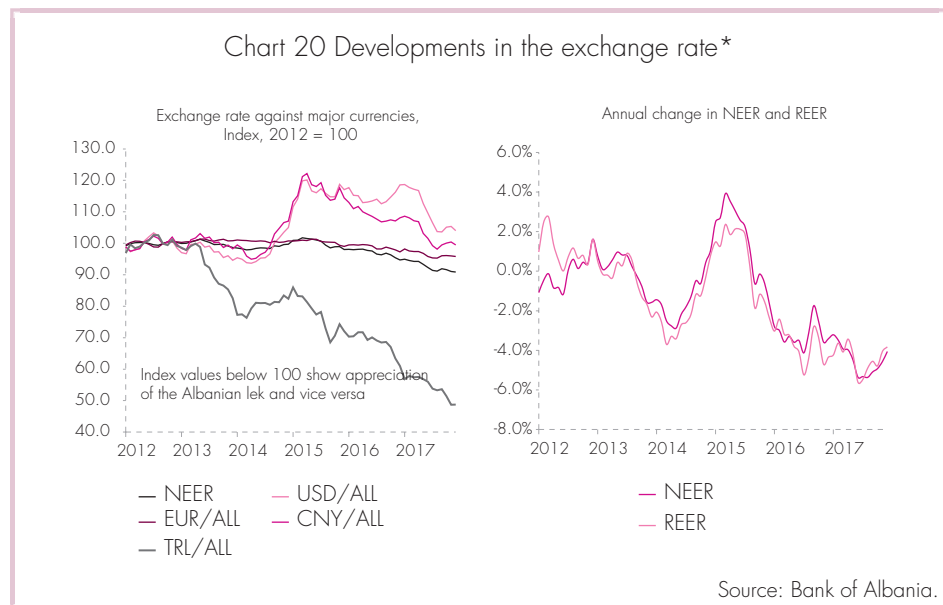




The reduction of interest rates has been present in the credit to enterprises, whose average interest rate decreased from 7.6% in 2016 at 6.7% in 2017. The interest rate on credit to households resulted at 7.3% this year, remaining close to the average levels of 2016.

The Albanian lek appreciated further during 2017

The national currency continued to strengthen against the currencies of the main trade partners during 2017. The appreciating trend of the lek, started at the end of 2015, has reflected the decrease of risk premiums in domestic financial markets, the acceleration of real economic growth, the decrease of the current account deficit and the high foreign currency inflows from foreign direct investments. The appreciation intensified during 2017 H1, due to the plentiful foreign currency supply in the market, as a result of the rapid increase of exports and higher flows of foreign direct investments (for more information, see Box 3).



During 2017, one euro was traded at ALL 134.2 on average, or 2.3% less than in the previous year. The appreciation of the lek against the euro accelerated in 2017 Q2 and Q3, while the EUR/ALL rate appeared stable in Q4. The USD/ALL rate continued to follow the EUR/USD rate in international markets. The positive developments in the euro area economy in 2017 H2 rapidly strengthened the euro and of lek against the US dollar. From June to the end of the year, the US dollar was traded around 12% cheaper than in the previous year. The lek also appreciated against the other two main currencies, the Turkish lira, and the Chinese renminbi. In effective nominal terms¹⁷, the annual appreciation of the lek resulted at 4.5% on average in 2017, from 3.2% in 2016. Real appreciation resulted close to the nominal one, due to approximation of inflation in Albania with the average inflation of trade partner countries.

BOX 3. THE EXCHANGE RATE APPRECIATION - DETERMINING FACTORS AND IMPLICATIONS

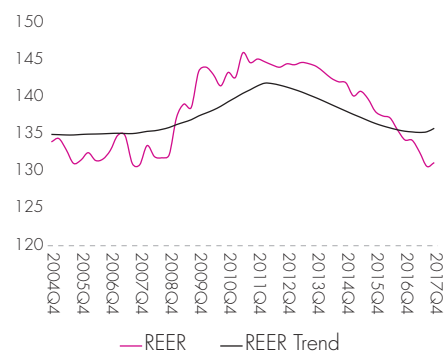
After almost five years of stability, the lek has appreciated during the last two years. This appreciation peaked in 2017 Q3. Although the Bank of Albania follows an inflation targeting monetary policy and a free regime of the exchange rate, it dedicates particular attention to the analysis of the exchange rate, due to its important role in the economy.

Our analyses show that the exchange rate appreciation reflects both the impact of long-term factors and the temporary impact of short-term factors.

In the long run, based on the available models and empirical studies of the Bank of Albania, the value of lek is assessed as being overall in line with the performance of its determining macroeconomic factors.¹ Thus, the long-term exchange rate appreciation trend reflects the difference of the marginal productivity of the Albanian economy compared with our trade partners and the reduction of structural risk premiums in the Albanian economy.

On the other hand, the appreciating exchange rate resulted from short-term shocks as well, which have led to faster appreciation of the currency than that dictated by fundamental long-term factors. These short-term shocks derive from the rapid improvement of the external balance of the economy - or, in other

Chart 21 EUR/ALL exchange rate in real terms and its long-term trend*



*The real exchange rate trend represent the exchange rate level that is determined by the ratio of demand and supply derived by structural or long-term factors such as competitiveness between countries, difference in return on capital, structural risk premiums, etc.

Source: Bank of Albania.

¹⁷ The nominal effective exchange rate (NEER) is calculated against the currencies of the five major trading partners (Italy, Greece, Germany, Turkey and China), using the relevant market shares. For the purpose of calculating the lira/lek and the renminbi/lek rates, the official reference rates remain those of the Turkish lira and the Chinese renminbi against the US dollar. The real effective exchange rate (REER) is calculated similarly to the nominal, but it considers the domestic inflation and those in the trading partners, as well.



words, the rapid contraction of trade and current account deficits at the end of 2016 and the first three quarters of 2017 - and, in parallel with it, the increase of inflows in the financial account, which have corresponded with the peak of foreign direct investments.

As shown in the Chart 21, our analyses suggest that the exchange rate has performed overall in line with its fundamental factors. However, although to a small extent, deviation from this trend were noted during 2009-2016, when the real exchange rate was weaker than that dictated by fundamentals, and in 2016-2017, when this rate was stronger than the theoretical level defined by fundamentals. (In any case, given the sensitivity of the results to the econometric analysis, the conclusions derived by such assessments should be treated with caution.)

The appreciation of the exchange rate is assessed to have produced a downward impact on inflation, due to the decrease of the price of imported goods, whether they are for consumption or intermediate use purposes.

On the other hand, the assessment of the impact of this appreciation on economic activity is more complex. As long as the long-term appreciation trend of the exchange rate reflects the effect of real fundamental factors and not unexpected shifts of financial portfolios, it does not cause adverse consequences for the Albanian economy. This appreciation is a characteristic feature of emerging economies during the convergence stage with more developed trade partners. Also, temporary deviances from long-term equilibrium do not have significant or durable consequences. By contrast, great and long-term deviances from equilibrium tend to produce more serious impact on the economic activity.

In any event, fluctuations of the value of the national currency are inevitable in a free exchange rate regime. For this reason, the Bank of Albania has continuously brought this to the attention of the economic operators, to avoid open and unhedged foreign exchange positions and to increase the use of the national currency.

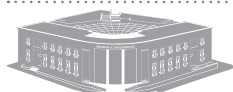
* The balance rate and deviations against it are studied by Hoda, B., (2012), "The balance exchange rate in a developing economy" Bank of Albania, Paper 04(54) and Vika, I., Luçi, E., (2011), "The balance rate of lek against euro: How deviated it is" Bank of Albania, Paper 07(30)

Lending improved slightly during the year, supported by loans in lek

Credit to the private sector¹⁸ expanded moderately in 2017. Excluding the impact of loan write off, the credit portfolio increased by 3.3% during 2017, compared with 3.1% in the previous year.

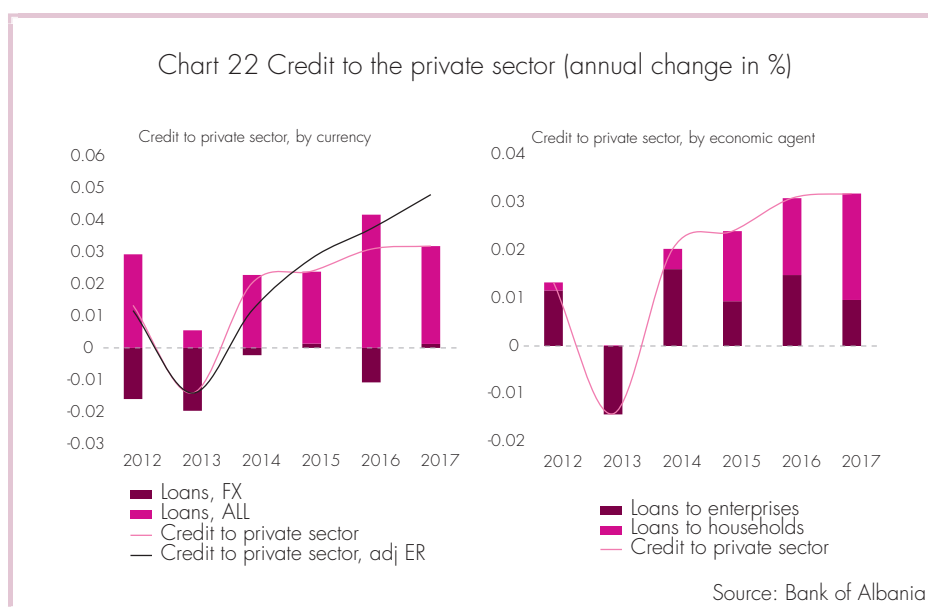
At the end of the year, the banking credit portfolio reached 36.5% of GDP, or 1 percentage point lower than the previous year. The contraction of this ratio is affected mainly by settlements and restructuring of banks' credit portfolio, in accordance with the plan of measures for reducing non-performing loans, as

¹⁸ Credit data are adjusted for written off loans and refers to monetary data that include credit to residents. Written off loans registered ALL 16.7 billion in 2017.



well as by the appreciation of the exchange rate, which has decreased the value of the credit portfolio in foreign currency.¹⁹

Low interest rates supported the growth of credit in lek during 2017, whose annual growth at 7.2% is the main contributor to the expansion of credit to the private sector. Unlike in the previous year, the expansion of loans in lek served mostly for households' financing. Credit to households improved its annual growth pace, registering 7.1% in December. Meanwhile, the annual expansion of 1.4% of credit to enterprises is lower than in 2016, driven by the weak performance of loans for liquidity and the slowdown of growth of loans for investments. The dynamic of credit to enterprises continues to reflect both the sluggish demand for financing and the banks' reluctance to ease lending standards.



BOX 4. CHANGES TO THE CREDIT STRUCTURE OVER THE YEARS

Banks' credit portfolio grew rapidly before the crisis and slowed down significantly after it. This behaviour reflected the performance of the Albanian economy, the credit demand, as well as the fluctuations of banks' credit supply. In particular, the contraction of the post-crisis credit supply reflected the decline in their risk appetite, as well as the policies applied by parent banks on the activities in the region.¹

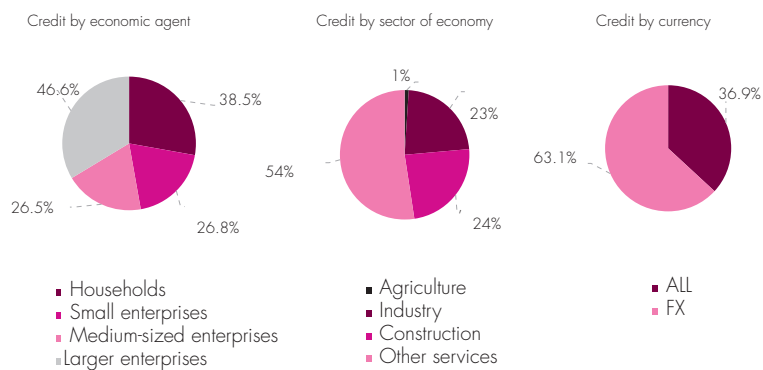
Beyond the growth profile of the total portfolio, credit performance also showed important structural changes. These changes conditioned the structure of bank credit and, potentially, also affected the pace of its expansion.

¹⁹ Adjusted for the appreciation of lek against other currencies, the annual growth of credit to the private sector is around 5%, improving from 2016.



The bank credit portfolio was characterised by three distinct features in 2004-2008: it had a significant concentration in the enterprises' segment (61%), in foreign currency lending (71%), and in construction and services sectors' lending (78%). The expansion and concentration of credit portfolio in these sectors was dictated by their high demand for credit, as well as by the favourable policies applied by the banks.

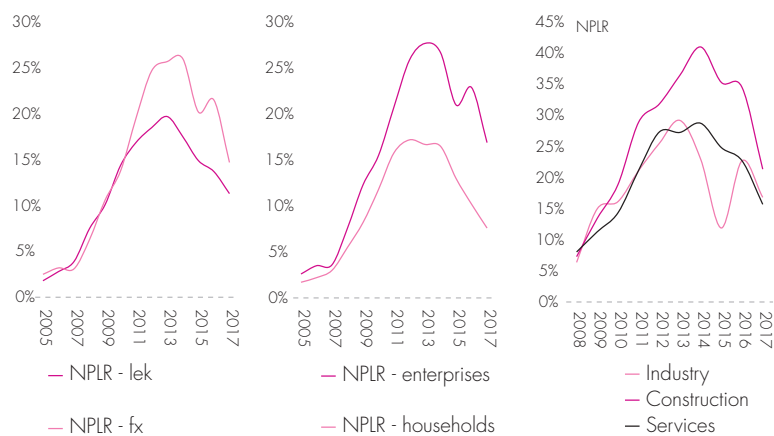
Chart 23 Structure of pre-crisis banks' credit portfolio (data refers to 2008).



Source: Bank of Albania.

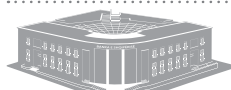
The slowdown of economic activity in Albania and the pre-crisis depreciation of lek against foreign currencies were reflected in the overall increase of non-performing loans. However, the underestimation of business and financial risks associated with exchange rate fluctuations, as well as the relatively high exposure of these segments to bank credit, resulted in a proportionally faster increase in non-performing loans in the above-mentioned segments. The non-performing loans ratio peaked in 2014 with 26% for foreign currency credit, 28% for credit to enterprises, and 41% for credit to the construction sector.

Chart 24 Non-performing loans ratio by main categories



Source: Bank of Albania.

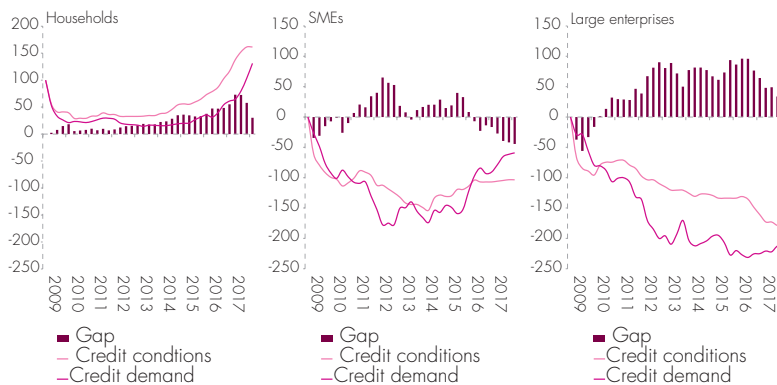
These developments had two significant consequences.



First, the lessons learned from the post-crisis period have re-oriented banks' policies on the distribution of bank credit towards:

- Credit in the national currency. This shift is driven by the awareness of economic agents on the exchange rate risk as well as by the decrease of interest rates in lek. In the credit portfolio sub-segments, long-term credit for investments, for both enterprises and households, has shifted most towards lek. The high increase of loans in lek has contributed to the shift of the credit portfolio towards a more balanced currency structure.
- Credit to households, as well as to small and medium-sized enterprises. In the framework of banks' conservative approach towards credit to enterprises, credit standards have been more favourable for small and medium-sized enterprises. Also, banks have preferred to expand the portfolio of credit to households, perceived by them as a lower risk and under-credited segment. This credit is assessed also as favoured by the measures taken to increase formalisation in the labour market.
- Credit to the industrial sector. The preference for lending to this sector reflects the growth in demand, as well as the low level of the use of by them.

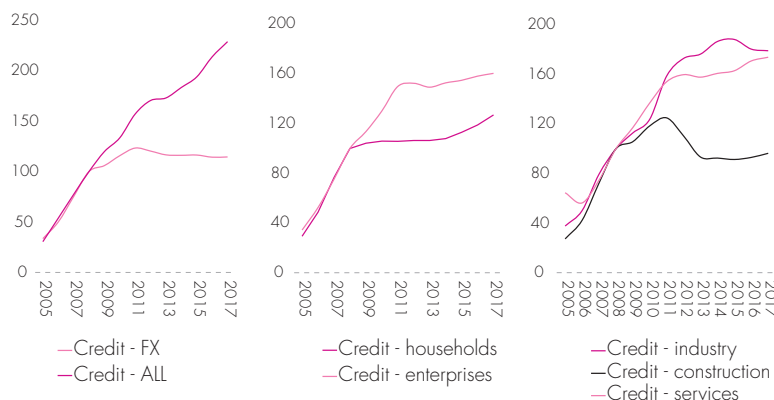
Chart 25 Credit standards, credit demand and the spread, responses' balance, p.p.*



*Credit standards and demand are cumulative since 2009 Q1.
Source: Bank Lending Survey, Bank of Albania.

The dynamics of the credit portfolio pre- and post-crisis are presented in Chart 26.

Chart 26 Credit portfolio by main segments (2008=100 index)



Source: Bank of Albania.



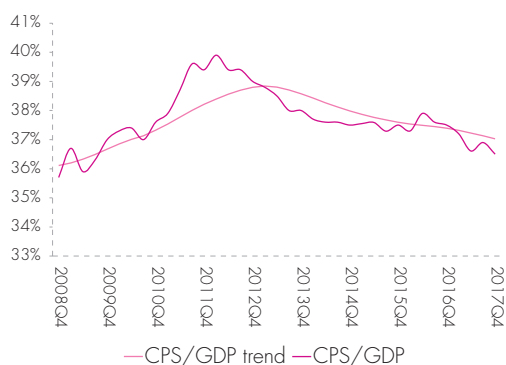
Second, they have curbed the speed of post-crisis credit improvement. On one hand, the need for restructuring the existing credit portfolio, the development of internal analytical capacities, as well as the deterioration of banks' financial balance in response to the high level of non-performing loans, have led to a decrease of bank credit supply. On the other, the need for improving balances and restructuring the business model of the Albanian economy has curbed the expansion of bank credit demand.

Given the above, the completion of the restructuring process of credit will help increase the speed and improve credit stability in Albania.

¹ For more see Box 5: "The impact of demand and supply in credit performance".

BOX 5. THE IMPACT OF DEMAND AND SUPPLY ON CREDIT PERFORMANCE

Chart 27 Credit/GDP ratio and its trend (in %)



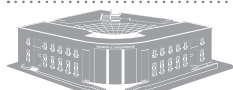
*Trend calculated with the Hodrick-Prescott filter.
Source: Bank of Albania.

The growth of credit to the private sector continued to record low rates during 2017. Our periodic analyses and empirical studies have sought to explain the factors determining this phenomenon. Analyses suggest that credit performance reflects both the sluggish expansion of credit demand and the slow recovery of bank credit.

The decline of demand immediately after the crisis reflected the overall economic slowdown, as well as the over indebtedness of some sectors of the economy. On the other hand, the tightening of supply reflected, initially, the liquidity problems of parent banks and, later, the increased credit risk in response to the overall slowdown of the economic activity. These two indicators have improved during the last years, although credit demand seems to have improved faster than supply.¹ These developments are reflected in a negative gap of credit to the economy, which suggests that, in the presence of a more elastic credit supply, lending in Albania would be slightly higher.

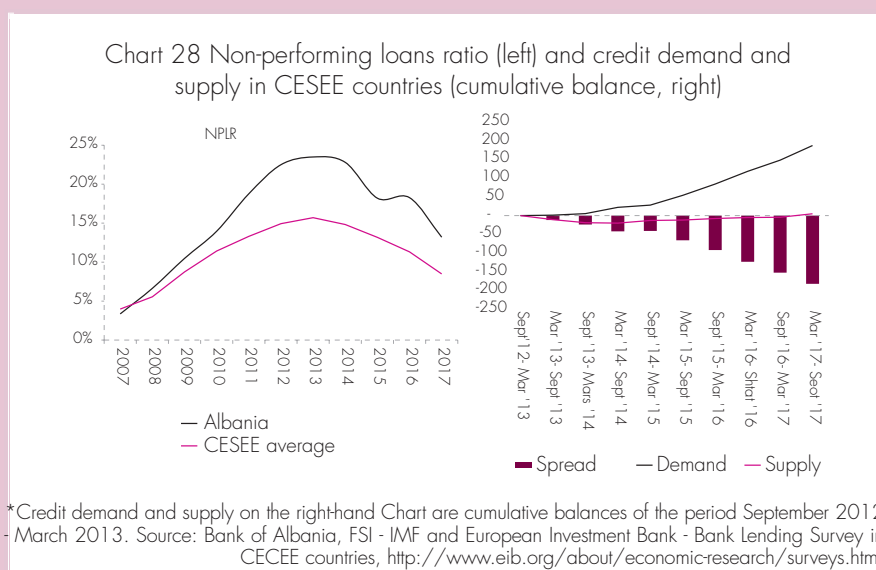
The slowdown of bank credit supply is explained through three factors:

- First, the growth of non-performing loans. The rapid expansion of the portfolio of these loans and the issues the banks faced with collateral execution affected the two dimension of credit risk: the perceived probability on non-repayment of the loan and potential loss of the bank in such an event. This factor reduced the banks willingness to lend. At the same time, the orientation of banks' attention to address existing non-performing loans further reduced their credit supply.
- Second, the overall deleveraging of foreign banking groups and the increase of their risk aversion after the Greek crisis further contributed to the reduction of the bank credit supply¹. The parent bank's tightening policies are not necessarily linked to Albania's specific risk, but reflect more the parent's risk profiling and readiness for exposure to certain regions (group of countries).



- Third, the changes made in the European regulatory framework of banking supervision in 2013ⁱⁱⁱ strengthened the requirements for liquidity and capital of parent banks, limiting their space to increase the exposure in the region, even dictating the need to partially withdraw from region.

Chart 28 illustrates graphically the performance of the above factors over time. While the level of non-performing loans and credit risk in Albania continues to decline, the other two factors - of foreign origin - continue to affect the tightening of credit supply, mainly among European banks operating in Albania.



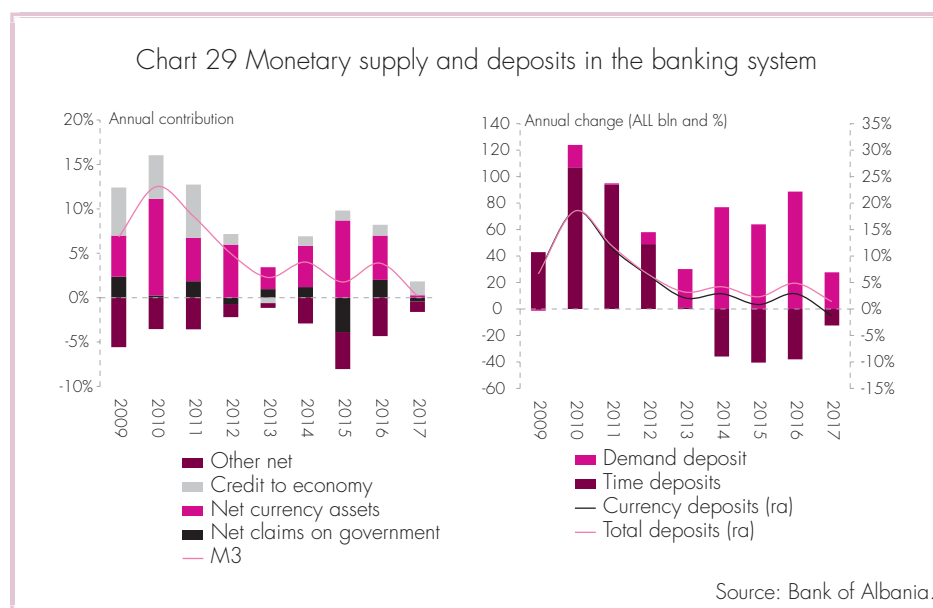
- ⁱ See for example "Box 4: Lending - an assessment of the impact of credit demand and supply" in the Annual Report of the Bank of Albania, 2016.
- ⁱⁱ Note, S. and E. Suljoti, 2017, "Evaluation of bank credit definers in Central and South East Europe countries" Paper of the Bank of Albania, 24 (83).
- ⁱⁱⁱ The so-called CRD IV package contains the Directive 2013/36 / EU and Regulation (EU) No. 575/2013, which lay down higher bank liquidity and capital requirements in order to create adequate reserves of European banks to cope with crisis situations.

The supply of money in the economy showed moderate growth, reflecting, on one hand, the weak demand of economic agents for financing and, on the other, the structural changes in currency holdings

The supply of money in the economy registered moderate annual growth rates, particularly in 2017 H2. Broad money continues to be conditioned by the still sluggish financing of the private sector and by the structural changes on the liabilities side, dictated by the shift of deposits towards above two years maturity and government securities.²⁰ The time structure of money has shifted towards the liquid component, due to the rapid expansion of demand deposits.

²⁰ Both these components are not included in the calculation of monetary aggregates.





Deposits at the end of the year resulted 1.5% higher than the previous year.²¹ Their stock was assessed at around 71% of GDP. Deposits in foreign currency expanded faster, driven by inflows from abroad throughout the year. Deposits in lek registered a moderate growth, reflecting the low creation of money in lek. Alternative instruments outside the banking system have also attracted part of households savings, partially affecting the performance of deposits from households (for more, see Box 4). Households deposits overall registered a positive performance during the year.

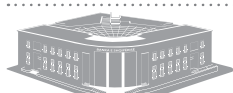
BOX 6. STRUCTURAL CHANGES OF MONEY IN THE ECONOMY

The pursuit of an accommodative monetary policy by the Bank of Albania has lowered interest rates across all financial market instruments. In parallel, the interest rates of financial instruments in foreign currency are also at very low levels due to the aggressive monetary policy pursued by the European Central Bank and the Federal Reserve. In addition to the positive impact of this development on bolstering economic activity, it was accompanied by structural changes in money holding in the economy.

The economic agents have reacted in two different ways to this environment with low interest rates.

- First, a part of savers have preferred to shift their financial savings from time deposits to current accounts and demand deposits. This category of savers has preferred the added liquidity introduced by these instruments, while the opportune cost of this shift is at low levels. Current accounts and demand deposits constitute around 42% of the total deposits stock in the banking system¹ at the end of 2017, or around 2 percentage points higher than the previous year.

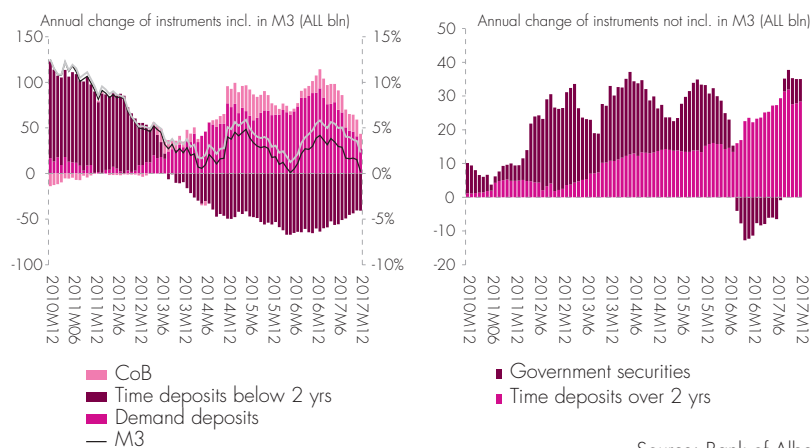
²¹ Regulated for the impact of the exchange rate, they registered a 2.4% growth.



- Second, a part of savers have preferred to shift their savings in time deposits with over two year maturity. In search for higher profit margins, this category has accepted the decrease of liquidity of their savings. Time deposits with over two year maturity constitute around 10% of the total deposits stock, registering 2.5 percentage points growth in 2017.

These developments have affected directly the structure of money. The expansion of demand deposits has had an impact on the growth of liquid components of broad money, while the shift towards deposits with over two years maturity, which statistically are not included in the calculation of the M3 aggregate¹, has affected its decrease. As a consequence the M3 monetary aggregate registered an average annual growth of 2.6% during 2017. Adjusted for deposits with over two years maturity, this indicator registered an average rate of 4.6%, but overall preserving the downwards trend of its growth pace.

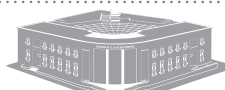
Chart 30 Annual changes in instruments included/not-included in the calculation of the M3 aggregate



At the same time as these developments, some of the deposits of households have been shifted to financial instruments outside the banking system, namely in public debt securities. During 2017, yields on securities have increased and has stirred the interest to invest in them. Also, offering long maturity instruments and attractive rates serves as an additional incentive for shifting deposits to these instruments. Households' investments in securities increased by around ALL 6.6 billion during 2017. The decrease of time deposits under two years maturity in the banking system and their shift in these instruments has further affected the decrease of the growth pace of broad money.

¹ In the deposits' analysis are also included time deposits with over two years maturity.

² The Bank of Albania follows the methodology set by the IMF for the statistical construction of monetary indicators. Broad money in the economy is measured by the M3 aggregate, which excludes time deposits with over two years of maturity. For more on compiling monetary statistics, please refer to the following address:
https://www.bankofalbania.org/web/pub/Metodika_e_SMF_Banka_e_Shqiperise_Korrik_2003_902_1.pdf



2.2 MONETARY OPERATIONS IN THE MONEY MARKET

The Bank of Albania implements its monetary policy by using indirect market instruments. They include open market operations, standing facilities and the required reserve. The main market operations are the repurchase and the reverse repurchase agreement of seven-day maturity, whose interest rate represents the policy rate.

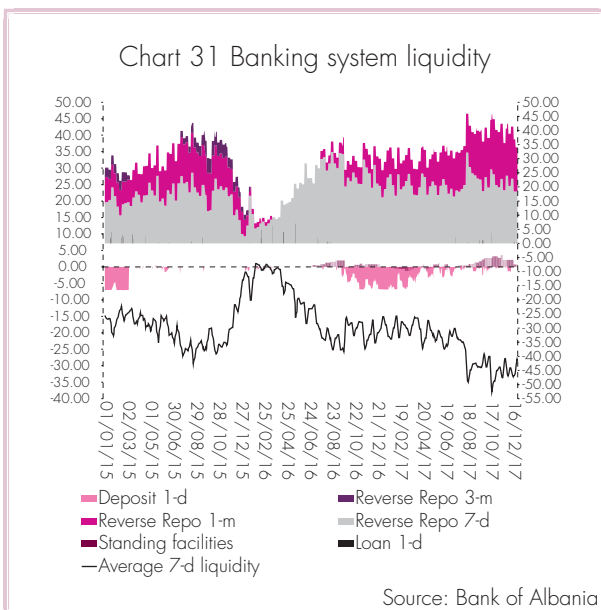
OPEN MARKET OPERATIONS

Open market operations consist in three sub-items: main operations; fine-tuning operations; and structural operations. They are used for managing the short-term liquidity in the money market, aiming at achieving Bank of Albania's operational objective - orienting short-term interbank interest rates close to Bank of Albania's policy rate and limiting their fluctuations.

During 2017, the overnight interbank rate was rather close to the policy rate, at 1.22%, averaging 0.03 percentage point lower than the 0.07 percentage point average, every year in the period 2014-2016. Also, the one-week interbank rate stood close to the policy rate, on average 0.02 percentage point below the policy rate, against 0.06 percentage point in the two previous years. Interests on one-week transactions floated in a relatively broad interval, 1.05% - 1.52%. The last two years trend, when structural surplus of liquidity in a part of the banking system has driven liquidity trading in the interbank market below the policy rate of the Bank of Albania, persisted in 2017, mainly in the

first months of the year. As at end-2017, the overnight and one-week interbank rates averaged 0.02-0.03 percentage point higher than the Bank of Albania's policy rate. Liquidity trading for maturities longer than one week continues to be rather sporadic.

During 2017, the average injected liquidity by the Bank of Albania through temporary liquidity injection operations increased ALL 34.40 billion on average, after an average ALL 25-30 billion in 2014-2016. The need for liquidity by the banking system maintained an upward trend throughout 2017, averaging ALL 38.70 billion in December. The increase of liquidity shortage in the banking system drove the Bank of Albania to gradually increase the share of long-term injections with maturity 7-91 days, on average



39.40% of total injections, against the 19.30% average during 2016, the lowest usage of long-term injections since 2009.

Table 3. Structure of liquidity injection operations by the Bank of Albania

	2009	2010	2011	2012	2013	2014	2015	2016	2017
Main instrument	55%	58%	74%	55%	60%	64%	55%	80.7%	61.6%
Long-term injections	45%	42%	26%	45%	40%	36%	45%	19.3%	39.4%

Source: Bank of Albania.

During 2017, the Bank of Albania has carried out structural operations, purchasing 12-month Treasury bills and maturing 3-month and 6-month T-bills, due to the changes in the structure of issues of the Ministry of Finance and Economy. The total amount of T-bills purchased by the Bank of Albania was ALL 9.3 billion, during 2017, while the holding of the government securities fell by ALL 500 million, compared with the end of 2016.

Standing facilities

Standing facilities – overnight deposits and overnight loans - at the Bank of Albania are instruments available to commercial banks to manage liquidity on a daily basis and to define a corridor in which interest rates fluctuate in the interbank market. This corridor narrowed in 2016, from 3.50 percentage points to 2.50 percentage points and, since the last cut of Bank of Albania's policy rate in May 2016, the overnight deposit stands at 0.25%, and the overnight loan at 2.25%, unchanged during 2017. During 2016, the overnight deposit was used continuously by banks, but at lower amounts, from the average ALL 5.5 billion in 2017 Q1, at less than ALL 1.0 billion in 2017 Q4. The overnight loan was used in 20 cases, over 2017. This figure is similar to that in 2016, 25 cases; meanwhile, the average used amount fell at ALL 1.1 billion, from ALL 1.7 billion in 2016.

Required reserve

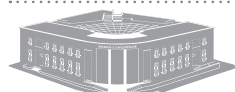
The level of the required reserve is applied to the amount corresponding to 10% of deposits up to two years of the commercial banks, denominated in lek, euro and US dollar. The required reserve in lek is a monetary policy instrument that aims to adjust liquidity in the banking system and stabilise the interest rates. The Bank of Albania allows banks to use up to 40% of the required reserve in lek on daily basis, while observing the obligation to keep the monthly average level of the required reserve not lower than its defined level. The performance of the required reserve has been in line with the performance of the deposits that are subject to this instrument.

The remuneration ratio on the lek required reserve reflected the performance of the Bank of Albania's policy rate (70% of the policy rate). Starting from September 2016, the banks pay for the required reserve in euro an interest rate equal to the deposits rate of the European Central Bank. This interest rate remained unchanged during 2017, and was negative at -0.40%. The



remuneration rate on the required reserves in US dollars has been 0%, since 2011.

The remuneration rate on the surplus reserves in lek and US dollars remained 0% during 2017, unchanged from the previous year. On the other hand, the remuneration rate on the surplus reserves in euro has changed since 2016. It was determined at 0.25 percentage point lower than the deposits' interest rate of the European Central Bank.



2.3 FINANCIAL STABILITY

Financial stability is crucial for sustainable growth. The Bank of Albania has the exclusive right to implement the monetary policy, to supervise the banking sector and the authority to apply the resolution tools and to exercise the resolution powers. The Bank of Albania has a crucial role in safeguarding financial stability in Albania, in collaboration with other authorities.

For the purposes of exercising its function to safeguard financial stability, the Bank of Albania defines the financial stability as a situation in which: a) the financial system exercises financial intermediation and risk management by assisting the public and economic entities in conducting financial operations related with savings, borrowing and payments; and b) financial institutions are resilient to unfavourable financial shocks in their activity.

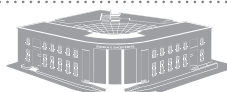
The spectrum of Bank of Albania operations for its contribution to financial stability includes also the compilation and implementation of a macro-prudential policy. The purpose of this policy is, through macro-prudential instruments (mainly regulatory and prudential ones) to act for preventing and mitigating systemic risks, and to strengthen financial system capacities to prevent or cope with these risks.

To assess systemic risks, definite objectives are laid down and financial indicators of financial system (banking sector) and real economy are monitored. The performance of these indicators is analysed regularly, through statistical techniques and experts' opinion, to note the trends and levels of risk.

The Bank of Albania regularly informs the public, every six months, on the financial situation and the risks to banks and financial institutions it supervises, through the Financial Stability Report and the Financial Stability Statement. The Financial Stability Report assesses the risks arising from the developments within the financial system and from its interaction with the internal and external real economy. The financial system's resilience against risks is tested through the stress test.

FINANCIAL STABILITY HIGHLIGHTS DURING 2017

The Bank of Albania considers that, overall, the activity of the banking sector and of the financial system has been stable during 2017. Stress-test results show that the banking sector's resilience to operational risks is good. The domestic and external developments in the real economy have contributed to the positive performance of banking sector indicators.



Global and regional economic developments were positive during 2017. Economic growth was faster in both emerging and advanced economies. Overall, inflationary pressures remain subdued, although in advanced economies they showed recovery. Also, in Albania, economic growth till 2017 Q3 affirmed the positive trend of the recent years. Maintaining of favourable financing conditions and continuation of accommodative monetary policies supported economic growth both in Albania and abroad.

The Albanian banking sector continues to dominate the financial system, but its share to GDP fell slightly in 2017 H2, due to the difference in the growth rates in the GDP and the banking sector's balance sheet. Banking sector's assets recorded a modest growth, with the growth rate slowing down throughout 2017, due to the slowdown in the increase of both customer and securities transactions.

The net financial result of the banking sector improved considerably during 2017, driving profitability indicators up. The main positive contribution to the financial sector's performance has come from the decline in credit risk provisions. Meanwhile, although remaining the main item in the total income from the activity, net interest income continued to drop. The reduction in provisions for credit risk reflects the considerable fall of non-performing loans. The fall in net interest income shows that intermediation is carried out amid low interest rates, where the decline in interest expenditures (with positive effect) did not offset the fall in interest income (with negative effect). The capital adequacy ratio stood at 16.6% at the end of 2017, up by around 0.2 percentage point from a year earlier.

The indicators employed by the Bank of Albania to monitor the performance and accumulation of systemic risks, overall, have reflected decrease of risks to financial stability over 2017. From the macroeconomic aspect, the improvement is attributable to the economic growth recovery, the positive developments in the labour market, the improvement in current account deficit, fiscal performance and the improved debtor position of enterprises. In banking sector activity, the improvement of indicators reflects the fall of non-performing loans, the improvement of the financial result and the good levels of capitalisation and liquidity.

Credit risk continues to be significant for the activity of banking sector

During 2017, the level of non-performing loans fell considerably as a result of banks' actions to collect, restructure and write off lost loans from banks' balance sheets. During 2017, the outstanding non-performing loans shrank by 27% and their ratio stood at 13.2% at end-2017, against 18.2% at end 2016. Credit quality improved across all maturities. Meanwhile, currently, the lowest quality in non-performing loans is noted in the foreign currency credit, credit to enterprises and credit with longer-term maturity. The reduction of non-performing loans is



accompanied by the improvement of their coverage with capital, while the coverage with provisions, overall, remained stable. These developments are expected to positively affect credit supply, through the improvement of banking sectors' perception of lending, and the release of banks' resources previously engaged in the management of non-performing loans. The commitment of banks to early restructuring supports the further reduction of the outstanding non-performing loans, and a better control of their new flows. Regardless of the significant improvement against the average level of the last 3-4 years, the level of non-performing loans in the banking sector is estimated as still high. In addition, the non-performing loans unhedged against exchange rate volatility, notwithstanding the slight fall during 2017, still account for 25% of total credit.

The risk of the banking sector from exposure to exchange rate and interest rates volatility remains present.

The size of the direct impact from the exchange rate fluctuations on the banks' balance sheet is directly related with the size of the net open foreign currency position of the banking sector. The higher this position is as a ratio to regulatory capital, the higher is the expected direct impact of exchange rate fluctuations on the banking sector's balance sheet. During 2017, the banking sector's net open position in foreign exchange, driven mainly by the larger banks, maintained the "long" position and ranged within long-term levels. This position was down during 2017 H1, and slightly up during 2017 H2, albeit remaining below the level in the previous year, and below the average of the two previous years. This shows a limited exposure of the sector to the direct exchange rate risk. On the other hand, the indirect exposure against the exchange rate fluctuations has remained at high levels, due to the still high share of unhedged loans against exchange rate fluctuations²² against outstanding credit (25%), and against the total credit in foreign currency (44%). While both ratios fell slightly during 2017, the Bank of Albania deems that banking sector should continue the efforts to reduce exposure steadily.

The banking sector remains exposed to interest rate volatility when the mismatch between interest rate-sensitive assets and liabilities, by repricing periods, is relatively high. Also, a possible increase in interest rates in the future may drive to a pressure for a fall in repayment capacity of borrowers that have variable-rate loans.

The high use of foreign currencies in the banking sector is accompanied with market and liquidity risks

As at end 2017, foreign currency deposits at the banking sector accounted for 53% of total deposits, while foreign currency credit fell at 56% of total credit portfolio. The low interest rates environment affected the performance of the indicators, but the possible change of this environment may re-introduce

²² The credit unhedged against the movements in the exchange rate is the loan granted in a currency different from the borrower's dominated currency income.



channelling resources in foreign currency towards lending in foreign currency. If this were followed by an unfavourable movement in the exchange rate, the borrowers' repayment capacity for unhedged loans in foreign currency would fall; this would drive to a weakening of the financial situation and liquidity of the banking sector. For these reasons, it is necessary that the exposure in foreign currency of both the banking system and customers take place in compliance with prudential requirements, and be limited only for customers that have natural protection against market risks.

Liquidity risk in the banking activity remains low

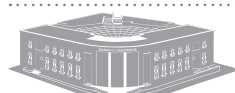
The liquidity ratios, both in lek and in foreign currency, monitored on on-going basis by the Bank of Albania, stand significantly above the minimum regulatory requirements. Deposits are the main source of financing, whose value is almost double higher compared with the outstanding credit granted by the banking sector. The growth of the share of demand deposits and current accounts in the structure of financing sources is a development that requires attention. As at end 2017, demand deposits and current accounts together shared 42% of total deposits, from 40% in the previous year. The considerable share of demand deposits drives banks to maintain high levels of liquid assets, and seek higher return through longer-term investments or be exposed to high-risk products.

THE EFFECT OF MACRO-PRUDENTIAL MEASURES IMPLEMENTED BY THE BANK OF ALBANIA

Given the considerable slowdown of credit growth pace, the fast increase of banking sector investments in non-resident financial entities, and the overall fall of credit quality, the Bank of Albania has undertaken a package of counter-cyclical measures since 2013, which aimed at: a) removing the capital requirements in cases the annual growth of capital stock is within the interval 4-10%; b) increasing the capital requirements on the additional banking sector's investments with non-resident financial entities; and c) changes related to the requirements for standard credit restructuring. Measure (a) was repealed at the end of 2016, while measures (b) and (c) remained in force, as amended, till the end of 2017.

The measure which stipulates an increase of capital requirements when investments with non-resident financial entities increase, during the two-year moving period, resulted with a fall of the annual growth of investments with non-residents, at 1% in 2017, from 25% at the beginning when this measure started to be applied.

Measure (c), stipulates the restructuring of credit since the stage the credit is classified as regular, but the borrower has started to show the first problems in repaying the credit, and the reduction from six months to nine months of the time in which the restructured credits may turn into standard credit, as far as



the borrower has regularly paid three credit instalments (principal and interest). Restructuring aims to maintain the borrower's solvency and the quality of credit. If the restructuring takes place under these conditions, the credit continues to be classified as regular, but is subject of a higher provisioning rate than 10%, compared to the rates of 1% and 5% of standard and sub-standard credits provisioning. A quantitative assessment of the size of this measure's effect shows that the ratio of non-performing loans fell by around 1 percentage point, and excluding the effect of this measure, this ratio would have been 14.2% at the end of 2017.

ACTIVITIES AND NEW PRODUCTS DURING 2017

In 2017, the Bank of Albania was engaged in some important projects for the financial stability. In more concrete terms: the Macro-prudential Policy Strategy was drafted and approved in August 2017; the financial cycle and capital reserves for systemic risks were determined; and the strategy for increasing the use of the national currency in the activity of the financial system and real economy was drafted, consulted and finalised.

The macro-prudential policy is dedicated to the systemic risk analysis, and includes the implementation of measures, mainly prudential measures, aimed at mitigating and minimising the systemic risk. The macro-prudential measures contribute to safeguarding financial stability in two aspects: a) preventing the accumulation of risks in the financial system; and b) strengthening the resilience of the financial system. The Macro-prudential Policy Strategy²³ shall be a guideline of future measures and activities of Bank of Albania. It features the intermediate objectives of macro-prudential policy, a list of instruments for addressing the systemic risks, a set of indicators to signal the risk level and the implementation of a certain instrument, a description of the decision-making at the Bank of Albania and inter-institutional coordination, and the principles of public communication on the macro-prudential policy.

In parallel, the phases of a financial cycle and the concept of capital reserves in the banking sector for systemic risks have been determined. Defining the financial cycle is a difficult, but indispensable process to operationalize some of macro-prudential policy instruments. The global financial crisis in 2008 showed risks accumulate during the boom phase of a financial cycle. In this phase, the financial system should strengthen its positions of capital and of various reserves, in order to withstand the potential losses arising as a result of the change in direction (decreasing) of the financial cycle. Also, in 2017, the indicators of various risks, in particular of credit and liquidity risks, were identified. The determined levels of these indicators, which serve as signals for the implementation of macro-prudential instruments, will be assessed through the statistical methods.

²³ The Macro-prudential Policy was approved with the Decision No. 38, dated 02.08.2017 of the Supervisory Council of the Bank of Albania.



In the Programme of Economic Reforms 2016-2018, the Albanian authorities were committed to preparing a strategy on increasing the use of the national currency (ALL) in the Albanian financial system and economy, known as the de-euroization strategy. This commitment was triggered by the need to improve the effectiveness of the economic and financial policies and to decrease the risks to financial stability. In terms of macroeconomic policies, a high level of euroization, or use of foreign currency, leads to the reduction of the monetary policy effectiveness; limits the role of the free exchange rate as an automatic stabilizer in the case of macroeconomic shocks; and, undermines the fiscal policy effectiveness through the possible increase in the cost of debt service and unwanted change of its structure. In addition, unhedged borrowing in foreign currency and its possibility to contribute to the fall in asset quality, the deterioration of the financial situation and liquidity of the banking sector are important challenges to the financial system stability.

The Bank of Albania collaborated with the Ministry of Finance and Economy and the Financial Supervision Authority to establish the strategy. The three institutions approved the Memorandum of Cooperation on 18 April 2017, which was immediately released²⁴. According to the Memorandum, the signatory parties commit to identifying, in the respective areas of competence and in a harmonized manner, the relevant actions, including communication with the public.

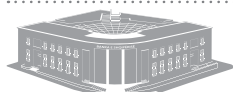
In 2017 H2, the Bank of Albania committed to real steps in the framework of the de-euroisation strategy. It prepared the Policy Document "On increasing the use of the national currency (ALL) in the activity of banks and non-bank financial institutions, subject to the Bank of Albania regulation and supervision"²⁵ and compiled regulatory amendments, to make more costly the activity of the banking sector in foreign currency and strengthen the mechanisms awareness-raising of borrowers, mainly those unhedged against the exchange rate risks, on the risks surrounding the foreign currency borrowing. In addition to the commitment for maximum transparency on every decision and action committed, the Bank of Albania will collaborate with the banking industry and other authorities that supervise the financial markets in Albania.

Notably, this package of measures, part of inter-institutional strategy:

- does not aim to reduce to zero the use of the foreign currency in the activity of banking sector; given the characteristics of the Albanian economy and financial system this is objectively impossible, and in terms of the economy it would be rather costly. It aims at decreasing euroisation at average levels of economies with a similar size and structure;

²⁴ At the signing moment the name of the "Ministry Of Finance and Economy" was the "Ministry of Finance".

²⁵ The Policy was adopted by Decision No. 9, dated 07.02.2018 of the Supervisory Council of the Bank of Albania.



- does not pose administrative restrictions to banks and their clients; it only provides the stimulus for banks to gradually increase the use of national currency in their activity;
- does not have additional costs to banks in the medium term, and does not considerably affect the exchange rate, whose performance is determined by a set of factors of demand and supply;
- after the Memorandum of Cooperation, the package of measures of the Bank of Albania was subject of prior discussions with the banking industry throughout 2017, in a transparent and detailed way. The Governor of the Bank of Albania had public interviews about this package, and it was discussed in the Financial Stability Report 2017 H1;
- other measures may be included in the package, coordinated among the signing authorities of the Memorandum, if they become necessary from the monitoring of certain performance indicators.

BOX 7. MEASURES OF THE BANK OF ALBANIA IN THE FRAMEWORK OF DE-EUROISATION STRATEGY

Research by national and international authors evidences the considerable level of euroisation in the Albanian economy and financial system. These studies analyse the reasons and risks, and highlight that this phenomenon needs to be addressed to control the risks to the financial stability of economic entities, which are exposed to unfavourable shocks in the foreign currency flows and exchange rate, in order to safeguard financial stability and enhance the effectiveness of the economic and financial policies. Taking into account the characteristics of its economy and trade relations, Albania will have an euroisation level higher than zero. The last joint study between the International Monetary Fund and the Bank of Albania, among others, has aimed to quantify the target level of deposits in foreign currency against the broad money indicator for Albania, by comparing the monetary and economic indicators of Albania with those in countries of similar size and structure of the economy¹. After finding that the level of that indicator needs to be reduced, the study evidences that the return of euroisation to "optimal" level may be achieved over time through: (i) maintaining economic and monetary stability; (ii) differentiating the remuneration rates of deposits in foreign currency; and (iii) applying targeted prudential measures to limit the credit to unhedged borrowers against the exchange rate risk.

Referring to the above analysis, and in the framework of inter-institutional strategy to address euroisation, the Bank of Albania adopted some measures that include:

- *Drafting the policy document of the Bank of Albania for increasing the use of the national currency in the activity of banks and other institutions, which are regulated and supervised by it. This document determines the way the Bank of Albania will contribute in this process, and how it will assess the effect of this contribution;*
- *Raising the borrowers' awareness on the risks that accompany the foreign currency borrowing, in particular when it is unhedged against the exchange rate risk; in this framework, banks should be required to provide the potential borrowers with an alternative loan in lek, and*



provide the borrower with an example that shows the way how the loan instalments change in case of a hypothetical strong depreciation of lek exchange rate.

- Increasing the minimum requirement for liquid assets in foreign currency, as a ratio to short-term liabilities in foreign currency, at 20%; for lek, this ratio stood at 15%;
- Increasing the required reserve rate for deposits in foreign currency at 12.5% (from 10%), if the ratio of the deposits in foreign currency to total deposits is not higher than 50%; and at the level 20% for that part of deposits in foreign currency that exceeds the level 50%; lowering the required reserve rate in lek at 7.5% (from 10%) when the maturity term of the deposits is less than 12 months, and at the level 5% when the maturity term of the deposit is higher than 12 months (up to 24 months).

The Supervisory Council of the Bank of Albania approved the package of measures in its meeting on 7 February 2018. The measures shall enter into force, by stages, till June 2018.

¹ Della Valle, G., et al. "Euroization Drivers and Effective Policy Response. An Application to the Case of Albania". IMF Working Paper, WP/18/21.



2.4 SUPERVISION

Bank of Albania's supervision function is based on three pillars: licensing, regulation and supervision. The latter is carried out through off-site surveillance and on-site examinations. The constant supervision and regulation of financial activities in Albania, mainly of banking activities, are at the focus of this function and represent its main activity²⁶.

The supervision function at the Bank of Albania is exercised through: consistent improvement of the regulatory framework, in compliance with the European directives and best practices and market specifics; entry into market of sound financial entities by adding value to enhancing market competition; implementation of a continuous supervision, being materialised from on-site inspections and periodic analyses; implementation of effective corrective measures; and, cooperation with international supervisory and regulatory authorities, or other national authorities responsible for supervising financial entities. The constant supervision and regulation of financial activities in Albania, mainly of banking activities, are at the focus of this function and represent its main activities.

Through the supervisory function, the Bank of Albania aims at: ensuring a sound activity of the financial entities; increasing the contribution to strengthening financial stability; and enhancing the market discipline and fair competitiveness.

In this view, year 2017 marked a range of developments related to supervision and in the financial institutions supervised by the Bank of Albania. The supervisory practice improved regarding the methodology for controlling banks through approximation with Basel principles and efforts to adopt best international practices. These developments are based on the continuous review of the regulatory framework. The self-assessment process of banks on the internal needs for capital is one of the important developments that are expected to improve the management structure of banks. It increases the supervisory responsibility to adopt to these developments through the review of the internal methodology for the assessment of corporate governance. Considerable changes have taken place on anti-money laundering, through the review of the respective regulatory framework and the establishment of internal methodologies for assessing the risk profile of supervised institutions. The increased cooperation with the European Central Bank is expected to support these developments.

In addition, the banking system has improved the risk profile, while the non-performing loans ratio has fallen by around 5 percentage points, over 2017,

²⁶ The Bank of Albania publishes detailed data on the developments in the banking sector and the banking system and banking supervision process in the Supervision Annual Reports.



standing at 13.2%. Liquidity and capital are at adequate levels. Special attention is being paid to the consolidated process with the expected merger of two banks and the strategic plans on the re-positioning in the market, depending on the dominant short and long-term factors.

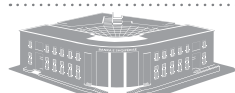
APPROXIMATION OF SUPERVISION PRACTICES

The preparation of the regulatory framework on the Internal Capital Adequacy Assessment Process (ICAAP) was one of the main highlights of supervision in 2017, regarding the approximation of supervisory practices with Basel principles and EU directives. This process is particularly important, as it complements the supervisory perspective with the self-assessment dimension of banks. It contributes qualitatively to establishing an objective risk profile for banks and, consequently, improves the risk-based supervision process.

The document that regulates this process is compiled in the framework of a guideline and in compliance with the Basel II Pillar 2, which sets out the criteria for the establishment of an internal process by banks to assess risks that are not covered by the existing regulation on capital adequacy. The document identifies the core requirements to assess additional risks and calculate additional capital to cover these risks according to the determined methods and those built by banks, based on the risk profile and their strategy. The Bank of Albania shall review the report of this assessment during 2018. The adequacy of control self-assessment environment for risk management and the relevant capital quantitative requirements will be discussed with banks.

In 2017, the project established in collaboration with the European Bank for Reconstruction and Development for the revision of the supervisory methodology in the qualitative assessment of banks' structures was implemented. This project considers the analysing and addressing the supervision of corporate governance elements for the established structures, the functioning and independence of bank committees, structures and functions of internal control structures of risks assessment. The development of this project is in the final stage; the areas that need to be reviewed for improvement are introduced and discussed in principle. A formalised assessment document with concrete recommendations is expected to be presented in the first quarter of 2018, with the purpose to adopt the improvements and render the reviewed framework in 2018 functional.

The Bank of Albania is preparing the regulatory framework for the approximation of Basel-III supervisory practices for the calculation of liquidity. The regulatory framework in compliance with the EU Directive was drafted last year, and, in parallel, the structure for the conduction of a prior exercise with banks on the calculation of the LCR (Liquidity Coverage Ratio) was established. This exercise aims the early identification of problems in its interpretation and the prior assessment of banks' position against this indicator. This process shall take place over 2018.



MONITORING AND ADDRESSING NON-PERFORMING LOANS

Non-performing pursued the downward trend of the last four years. In 2017, the absolute value of non-performing loans decreased more than a quarter, at 27%, lowering the relevant indicator at 13.23%, down by 5 percentage points in annual terms. The value of these loans remained in the balance sheet is provisioned at higher than 70%. The fall by around ALL 30 billion of non-performing loans in 2017, was driven by the writing off from the balance sheet of these loans, at ALL 16.7 billion, solution of large borrowers, the payment of arrears by the borrowers and the restructuring, by improving the classifications. Bank of Albania assesses that the non-performing loans ratio is still high and needs attention to further improve the falling trend, though the maintenance of the regular existing portfolio and the rather efficient solution of non-performing portfolio.

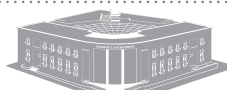
In this context, the fulfilment of the annual objectives of banks related with the performance of non-performing loans and the preparing of Recovery and Resolution Plans of large borrowers are specially monitored through the regular reports required to banks in 2017. The submitted information aimed at clarifying the level of the relationships with every borrower, as well as the exceptions and plans on future developments. They used to be subject of discussion with banks to find space for sustainable solutions and to expand this spirit throughout the system. This reporting will continue in 2018, through standardised reports and will serve as a base to start the regulatory framework for common borrowers.

With assistance of the World Bank and the International Monetary Fund, a regulatory framework, aiming to encourage the collaboration and coordination of banks for addressing common borrowers starting at an early stage of problems appearance, is being compiled. This framework determines encouraging elements to bring banks into a common denominator in their decision-making and the coordinated solution of the occurred problems, by providing the cooperation agreements among them and with the borrowers with the purpose the definition of the criteria and the way of collaboration. Currently, this regulatory framework is drafted and following the discussion with the banking industry, is expected to be approved in the first part of 2018.

The analysis quality of credit performance is improved through the detailing of the received data regarding the shift among classes by which the credits are classified, the factors that affect the performance of credit and by the main currencies where it is concentrated the lending activity. This way of analysing is tested and put in function in the last year and will continue on quarterly basis.

COOPERATION WITH FOREIGN INSTITUTIONS

The cooperation with the international supervisory authorities is considerably intensified, notably, the cooperation agreement between the Bank of Albania



and the European Central Bank. This agreement paves the way towards a stable collaboration through the share of common-interest information, of professional experiences and the decision-making coordination, an important step in the integration process of the Albanian institutions in the European Union structures. Meanwhile, Bank of Albania was invited to participate as observer in two supervisory colleges organised for Greek banking groups of international presence (including the Albanian presence) and in a targeted-inspection in one bank of EU origin. The shared information and the meetings with the homologue authorities in other countries contributed in the coordination of actions and supervisory measures, and in the establishment of a more clear profile for banks in Albania and in the relevant group. This collaboration is expected to continue in 2018 and further.

BANKING SYSTEM CONSOLIDATION

The consolidating trends of banking system being identified in the previous years, materialised in 2017, with the decision on the merging of Intesa SanPaolo Bank with Veneto Bank, mainly driven by the international developments and by the decision of the Bank of Italy and the European Central Bank in coordination with Intesa SanPaolo group in Italy, following the announcement on the bankruptcy of Vento Banking group. The merger by absorption of Veneto Bank is expected to end in 2018, while the banking system will have a lower number of banks. The Bank of Albania deems that there is still scope for further consolidation, expected to be materialised and is carefully monitoring all developments in this regard. This assessment is based on the interest stated by some banks to expand and shrinkage of some other banks due to the revision of presence banks in Balkans by the parent banks.

EVALUATION OF ANTI-MONEY LAUNDERING MEASURES AND THE FINANCING OF TERRORISM PROCESS BY MONEYVAL

In 2017, important amendments were made to the regulation of the Bank of Albania for all institutions subject to its jurisdiction (banks, non-bank financial institutions, savings and loan associations, and foreign exchange bureaus) regarding anti-money laundering and financing of terrorism. The amendments consist in additional requirements for reporting by financial institutions of qualitative and quantitative data, according to a standardised form, on annual basis (including a questionnaire). The amendments, in addition to the problems identified in the implementation of the applicable legal and regulatory framework, aimed to address the implementation of international standards and the recommendations provided in the fourth round of Albania's evaluation by Moneyval's experts.

These amendments drove to the need to improve the supervisory framework for the above-stated institutions. The framework is completed with the compilation and approval of a methodology for off-site evaluation dedicated to the risk on



anti-money laundering and combating the financing of terrorism (AML/CFT) accompanied with a matrix of risk evaluation in this field. The off-site evaluation of AML/CFT risk is a crucial tool in supporting the supervisory process in accordance with a risk-based approach. Based on data reports for 2016, the Bank of Albania, for the first time, performed the evaluation of this risk exposure of the institutions, and currently is carrying out the second analysis based on the data reported by institutions for 2017. The results of this evaluation shall serve to the supervisory process focusing on institutions and activities that pose high risk in terms of AML/CFT.

In 2017 Q4, the Committee of Experts on the evaluation of anti-money laundering measures and the financing of terrorism (MONEYVAL) carried out the fifth round of Albania's evaluation. The Bank of Albania was an important part of this process as the supervisory authority of the financial system, and was very active in completing the necessary information requested through both template forms and direct meetings. The CoE Moneyval Committee Experts evaluated positively the above-stated developments. Currently, the fifth evaluation round for Albania is in the drafting stage of the evaluation report by the experts and the final report with the respective recommendations is expected to be approved by this Committee within 2018 H1.

ON-SITE EXAMINATIONS

In 2017, 14 full-scope and partial examinations were performed in banks, non-bank financial institutions and savings and loan associations. In view of orienting the resources from activities that expose the entities more to risks, and in view of risk-based supervision purposes, the Bank of Albania visited three systemic banks, in 2017. Also, a large number of partial examinations were carried out in banks, while the attention was paid to the examination of non-bank institutions, whose number and share in the financial system has been increasing. The main objective of the examinations remains defining a complete risk profile for the licensed institutions.

In light of the above developments and factors, the main fields at the focus of 2017 examinations are summarised as follows:

In the **banking sector**, improvements are finalised regarding the internal framework, the compliance with the supervisory regulatory framework (in particular the reflection of the classification and establishment of provisions for the borrowers' exposure), the recovery of non-performing loans, the compliance with the regulatory indicators (capital and liquidity), etc. At the same time, the improvement of governance systems, the strengthening of the oversight role of the management bodies, and the increase of independence, effectiveness and preventive ability of audit systems remain important issues of supervision. In addition to the prudential increase of lending, the efforts to solve and recover the non-performing loans are assessed as well. The assessment of strategic



plans of banks, in terms of identifying the market expectations, the orientation of sources and the adoption of structures with these expectations, as well as the acceptability of the shareholder/parent bank's philosophy have been considered attentively. The careful addressing of bank activity expansion and the selected forms of investments with their complexity was part of this assessment. Also, the transparency with customers is always an important part of assessment and verifications throughout the on-site examinations.

Regarding the **non-bank financial institutions**, the audit systems in these institutions still have room to ensure effectiveness, independence and the required authority. The improvement of information systems support would contribute in this regard. These factors are materialised in a higher level of deficiencies regarding the correct reflection of classification and provision funds to the exposures of borrowers, transparency issues with customers, etc. On the other hand, non-bank institutions are rather active, not only in increasing or combining the activities, but also in expanding the use of loan instruments (in addition to their capital) to finance the activity (debt securities, participation in national financing programs/development, borrowing from banks or international institutions, etc.). This trend is considered as a normal developing phase for these institutions, and the increase of stakeholders, investors, that analyse and monitor the activity of non-bank financial institutions are expected to contribute positively to the strengthening of governance systems and their control.

Some of the **savings and loan associations** were subject to examinations for the first time, after the conclusion of the consolidating process and separation from the Unions. Overall, the separation process has been carefully managed by the governing bodies of the associations, maintaining the positive pace of both the activity and financial results. On the other hand, they need to improve the internal framework of these institutions, the completion of operational units, the increase of the professional capacities of management bodies, the clear separation of tasks and responsibilities, etc. The response to the examination recommendations was positive, and within the established deadline.

At the conclusion of the examinations, recommendations on the necessary improvements were provided, and their implementation was monitored closely. Also, supervisory measures are applied on some institutions, for which recurring breaches of the regulatory requirements had been identified.

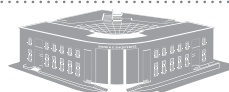
REVIEW OF THE LEGAL AND METHODOLOGY FRAMEWORKS

The drafting and the review of the supervision regulatory framework was aimed at supplementing and improving it, in order to ensure compliance with the applicable legal requirements and alignment with the directives and the regulations of the European Union (EU) and the standards of the Basel Committee, by continuously considering the identified problems and the suggestions of the



supervised institutions, provided through an on-going communication with them. The main regulatory changes are as follows:

- The Bank of Albania, with the purpose to complete the regulation on the supervision of banking groups that operate in Albania, realised the complete review of the Regulation "On consolidated supervision". This initiative considered all the provisions stipulated in the Law "On banks in the Republic of Albania" on consolidated supervision, as well as the requirements and principles laid down in the directives and the regulations of the European Union (EU), and the standards of the Basel Committee. This Regulation lays down the conditions, rules and regulatory requirements of conducting consolidated supervision, for the purposes of risk management deriving from a banking group and a financial group.
- The Regulation "On capital adequacy ratio" was partially reviewed, with the aim to continue the implementation of the measures that penalises (in terms of capital requirement) the placements of the banking sector with non-residents.
- To fulfil the recommendations of the Moneyval Experts Committee, provided in the last evaluation for Albania, and to resolve some issues concluded in the on-site supervision regarding the implementation of the requirements of the supervisory authority on the prevention of money laundering, the requirements set out in the Regulation "On the prevention of money laundering and terrorism financing" were reviewed and fulfilled.
- The Regulation "On the transparency for banking and financial products and services" was partially reviewed aimed at further strengthening transparency, addressing some problems manifested in banks regarding the transparency to customers, and further aligning it with the European Directive on consumer protection.
- The Regulation "On establishing the decision-making level in the supervision of banking and financial activities" was partially reviewed, with the aim to ensure the compliance with the decision-making process and its delegation, in particular the reflection of processes set out in the new supervision regulations on the savings and loan associations and their unions.
- The Regulation "On granting the license to non-bank financial institutions" and the Regulation "On risk management in the activity of savings and loan associations and their Unions", were simultaneously and inter-dependently reviewed. The amendments mainly consist in addressing some problems identified in the supervision process, also aiming some facilities for the institutions while carrying out their financial activity.
- In compliance with the requirements laid down in the Law 133/2016 "On the recovery and resolution of banks in the Republic of Albania", to complete the regulatory framework with regulatory acts, the existing guideline "On recovery plans" was completely reviewed. The new regulation "On recovery plans of banks", which replaces the applicable



guideline, sets out the supervisory requirements on the recovery plans of banks and banking groups, mainly the content of these plans the way and term to present these plans and their updating, the inclusion of a list of qualitative and quantitative indicators, as a very important integral part, as well as the criteria stipulated by the supervisory authority to assess them.

- The important process of the effective governance of banks and the approval criteria of banks' administrators were strengthened through the new requirements set out in the partially reviewed Regulation "On the core management principles of banks and branches of foreign banks and the criteria on the approval of their administrators". The reviewed Regulation aims to align it with the recent requirements of the European Union regulatory acts on the good-governance and ensure compliance with the European Bank for Reconstruction and Development recommendations provided in the project on the assessment of the relevant legal and regulatory framework and supervisory practices applicable at the Bank of Albania. The amendments mainly consist in the new requirements of the supervisory authority regarding: the definition of risk appetite/tolerance and the capacity of banks' risk and the obligation to publish the appetite/tolerance statement as part of their annual report; the compilation of a special policy on the appointment of the Steering Council members of the bank; some additional requirements on the risk management unit/structure and the compliance structure/unit; the requirements to realise an analysis and self-assessment of the bank for the administrators proposed for approval, on the adequacy of professional knowledge with the proposed position; as well as the regular re-assessment process of administrators and, whenever deemed necessary depending on the circumstances, throughout the conduct of their function in the bank, etc.
- The Regulation "On internal audit system" was partially reviewed, to be adapted to the amendments in the Regulation "On the core management principles of banks and branches of foreign banks and the criteria on the approval of their administrators", and aligned with the best practices on internal audit.



BOX 8. GUIDELINE “ ON THE INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS ”

The Bank of Albania Supervisory Council with the Decision No. 26, dated 3.5.2017 approved the guideline “On the Internal Capital Adequacy Assessment Process”.

This guideline completes the three-pillar framework of the Basel Capital Accord, through the presentation of the detailed requirements for banks, already also for Pillar II - Internal Capital Adequacy Assessment Process (ICAAP). This guideline sets out the requirements for banks on drafting and implementing the ICAAP, as well as the expectations of the supervisor on the structure and content of the report of this process to be submitted at the Bank of Albania. The ICAAP is independently realised by the bank, and ensures the assessment of the current and future levels of capital adequacy, based on its risk profile and strategies.

For the realisation of this process, the bank shall follow two steps: first, it shall determine the level of a specific risk they can undertake, in order to define their risk-bearing capacity and ensure adequate capital to cover this risk; and, second, it shall make a critical analysis of the risk level that is rational to undertake, taking into account all the possibilities and threats that correspond to this risk

The ICAAP process is fully based on the internal processes and systems of the banks that helps to manage and effectively control the risk profile and, consequently, to determine the necessary capital level. This process is oriented toward the quantitative elements of the risk management process - the assessment of internal capital requirements and of the capital for covering the risk, as well as its qualitative elements, created to strengthen the internal rules of management and control of the bank, which enable an effective management and mitigation of this risk.

Banks, in drafting ICAAP, shall consider at least the implementation of the following basic principles:

- a) *Responsibility.* The bank shall be responsible for the implementation and development of ICAAP.
- b) *Proportionality.* Banks shall implement ICAAP, regardless of their size and complexity. Each bank shall use appropriate tools and processes in its ICAAP, and shall prove/argument for the Bank of Albania that ICAAP is complete and appropriate for the risks arising from the activity and the environment in which this activity is conducted.
- c) *Materiality of risks.* ICAAP must be focused on risks that may have a material impact on the current or future capital adequacy situation of the bank.
- d) *Looking forward.* ICAAP shall focus on ensuring the bank’s capital adequacy, taking into account future developments and its activity’s performance.

Bank of Albania, based on the ICAAP carried out by the bank, will establish the Supervisory Review an Evaluation Process with the purpose to establish an overall opinion on the risk profile of the bank and of its needs for capital.



LICENCING AND APPROVALS

The **Albanian banking sector** continues to be dominated by EU-based banking group subsidiaries. Currently, 16 banks exercise their activity in the Republic of Albania

Table 4. Banks' ownership structure (number of banks at period-end)

	2012	2013	2014	2015	2016	2017
Banks in Albania, of which:	16	16	16	16	16	16
Branches of foreign banks	-	-	-	-	-	-
Banks' ownership structure, by capital origin, of which:						
Majority foreign owned ¹	14	14	14	13	13	13
- EU ²	10	10	10	9	9	9
- Turkey ³	1	1	1	1	1	1
- Owned by IFIs (Saudi Arabia) ⁴	1	1	1	1	1	1
- Kuwait ⁵	1	1	1	1	1	1
- Swiss Confederation ⁶	1	1	1	1	1	1
Majority Albanian owned ⁷	2	2	2	3	3	3

¹ "Majority" is in any case the simple majority of 50 per cent plus 1 vote.

² Banks with capital origin from EU countries are from: Italy (Intesa Sanpaolo Albania, Veneto Banka), Austria (Raiffeisen), Germany (Procredit), France (Societe Generale Albania), Greece (Banka Tirana, Alpha Bank Albania, NBG Albania), and Bulgaria (First Investments Bank Albania).

³ National Commercial Bank

⁴ United Bank of Albania

⁵ Credit Bank of Albania

⁶ International Commercial Bank

⁷ Majority Albanian owned banks at the end of 2017 are: Union Bank, Credins Bank, and American Bank of Investments.

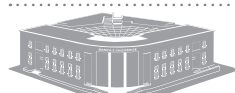
Source: Bank of Albania.

In 2017, the Bank of Albania approved: the transfer of the 100% of the ownership of shareholders' equity of a bank; the transfer of the qualifying holding to the shareholders' equity of a bank; and, three applications by banks for additional financial activities, established in the licensing annex were assessed and approved; the application of a bank to open an affiliate outside the territory of Albania, through the transformation of its branch into an affiliate.

Based on the regulatory and legal framework, 36 managers of banks were approved, by position classification: 16 members of the management board, 6 members of audit committees and 14 executive managers.

In 2017, the banks network was expanded only with two new branches, while banks have informed on the reduction of the number of branches/agencies in Albania (through merger or closure). At the end of 2017, banks carried out their activity through 473 branches/banking agencies, from 494 at the end of 2016.

Based on the submitted applications, the Bank of Albania decided on granting new licences and provided prior approval to **non-bank financial institutions**. Three new institutions were added to the number of non-bank financial institutions, mainly to conduct the activity of: lending (micro credit); financial



leasing; payment services; and money transfer. The number of licensed non-bank financial institutions was 31 at the end of 2017. Meanwhile, approvals to non-bank financial institutions included the prior approvals for two managers, and the approval to conduct additional financial activities for two institutions, and for the transfer of qualifying holding of capital quotes for three institutions. The licences of two non-bank financial institutions were suspended. One of them has turned active, after the ending of the suspension period.

The approval of the managers of **savings and loan associations**, as a requirement of the Law "On savings and loan associations and their Unions" and of the Regulation "On licensing and activity of savings and loan associations and their Unions" was a new development in 2017. Approval was granted for 5 chairs of steering councils of the savings and loan associations, 6 heads of audit committees of the savings and loan association, and 5 managers of savings and loan associations. Based on the legal and regulatory framework, in 2017, the reorganisation of savings and loan associations was finalised. The licence was revoked for one savings and loan association. As at the end of 2017, there were 13 savings and loan associations and 1 union of savings and loan associations

The licencing of **foreign exchange bureaus** continued in 2017: 39 new foreign exchange bureaus were licensed; 41 licenced institutions that exercised foreign exchange activity returned their licenses to the Bank of Albania for termination of activities. At the end of 2017, 426 foreign exchange bureaus conducted their activity in the foreign exchange market.

Table 5. Number of financial institutions licensed by the Bank of Albania (end of period)

	2012	2013	2014	2015	2016	2017
Banks and branches of foreign banks	16	16	16	16	16	16
Non-bank financial institutions	21	21	22	27	28	31
Foreign exchange bureaus	322	333	356	397	428	426
Unions of Savings and Loan Associations	2	2	2	2	2	1
Savings and Loan Associations	126	121	113	111	13	13

Source: Bank of Albania.



2.5 RESOLUTION

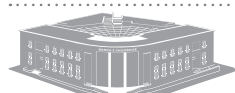
In 2017, the Law No. 133/2016 "On the recovery and resolution of banks in the Republic of Albania" entered into force. This Law designates the Bank of Albania as the Resolution Authority for banks and branches of foreign banks that conduct their activity in Albania.

Banking resolution is the process of restructuring a bank by the Bank of Albania through the resolution tools, in the framework of safeguarding public interests and financial stability. This resolution aims to minimize the impact of a bank, which fails to fulfil its obligations or is facing financial distress, on real economy, financial system and public funds in Albania. The Bank of Albania, as the resolution authority, may employ some tools to implement the structured resolution in a bank.

1. Sale of business implies either the partial or complete sale of a bank's business to a private entity.
2. Asset separation aims to transfer the assets, rights and liabilities of the bank under resolution to an assets management company, which is wholly or partially owned by a public authority.
3. Bridge bank implies the partial or whole transfer of the business of a bank under resolution, to a bank with public capital.
4. Bail-in aims the loss absorption by the shareholders and creditors of the bank, through the write down of shares and/or converting debt instruments in capital.

In March 2017, the Bank of Albania established the Resolution Department, as the responsible unit to accomplish the mandate of the Bank of Albania in this field. During the first year, the Resolution Department was committed in drafting the regulatory base of the legal obligations deriving from the Law No 133/2016 "On the recovery and resolution of banks in the Republic of Albania".

In the capacity of the resolution authority, the Bank of Albania is responsible for: compiling the bylaws for the operationalization of resolution; preparing the resolution plans, which aim to set out the way to intervene structurally in a bank; and the establishment of the resolution fund that will serve for the implementation of resolution tools available to the Bank of Albania. In 2017, the Bank of Albania has worked to fulfil the above-stated elements, as follows:



DRAFTING THE BY-LAWS

In September 2017, the Bank of Albania adopted the Regulation "On the organisation and functioning of the Resolution Department", by setting out the main functions of the department to accomplish the new function. The Regulation "On the Resolution Fund and the procedures for its management" was adopted in October 2017. This Regulation lays down the establishment of this fund and the set of procedures on the contributions and full management of this fund.

RESOLUTION FUND

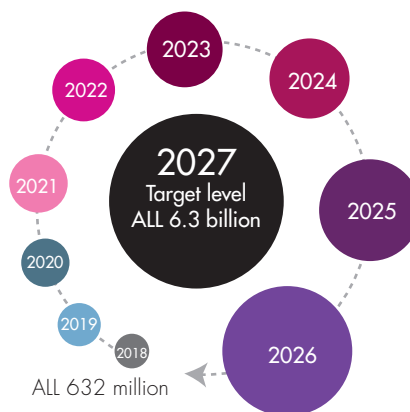
The "Resolution fund" was established for the implementation of the resolution tools by the Bank of Albania. The target funding level, 0.5% of total liabilities, calculated as the difference between assets and capital of all banks licensed in the Republic of Albania, to be reached by 2027. Banks pay regular annual contributions, for the achievement of the target level of the fund, within the term set out in the Law.

During 2017, the Bank of Albania compiled the methodology on the calculation of these contributions and the payment procedure for each bank. The first contribution into the "Resolution fund" was made in January 2018. In total, the target level of the "Resolution fund" stands at ALL 6.3 billion. To meet this level, the banking sector's contribution in the first year was ALL 632 million, which is paid proportionally to the share of each bank in the liabilities of the banking sector. The Bank of Albania calculates and updates the target funding level and the annual contribution the banking sector must pay, to adopt them to the latest developments in the banking sector's balance sheet. In addition to annual contributions, the "Resolution fund" may benefit also from extraordinary contributions of banks, loans, subventions, donations, etc.

The Deposit Insurance Agency manages the "Resolution fund" in compliance with the policy on the management of financial assets approved by the Bank of Albania. This policy sets out the procedures, criteria and limits of concentration and maturity implemented by the Deposit Insurance Agency with the purpose to guarantee the insurance of the fund's financial assets and to maintain a low risk profile and high liquidity.

According to the provisions laid down in the Law No. 133/2016 "On the recovery and resolution of banks in the Republic of Albania", the Resolution Fund may be used to: guarantee the assets or the liabilities of the bank under resolution, a bridge bank or an asset management company; provide with liquidity

Chart 32 "Resolution fund" and its buildup through annual contributions



Source: Bank of Albania



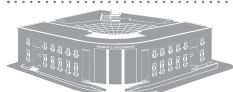
the bank under resolution, the bridge bank or the asset management company; purchase assets of the bank under resolution; contribute to capital and ensure other necessary funds to a bridge bank or an asset management company; compensate the bank under resolution for the uncovered loss arising due to the exclusion of eligible liabilities of certain creditors arising from the application of the bail-in tool; cover the costs for administration of the "Resolution Fund", etc.

PLANNING THE RESOLUTION

The drafting of resolution plans is one of the core functions of the new mandate of the Bank of Albania. The resolution plan is drafted for every bank and banking group operating in the Republic of Albania. The purpose of the resolution plan is to determine the critical functions for every bank; assess if a bank may be subject of resolution or be subject to mandatory liquidation; and prepare the steps to be followed if it is necessary to intervene in a bank.

Throughout 2017, the Bank of Albania has worked to draft the regulation on resolution plan, which lays down the resolution plan and the assessment of the possibility for resolution. This regulation, in compliance with the obligations set out by law, aims to set out all the steps for the resolution planning and to identify the actions to be undertaken and the measures to be implemented in the event a bank meets the conditions for resolution. Also, the resolution plan identifies whether there are any more impediments to the bank's resolution, and, if so, drawing up the necessary actions to remove those impediments.

For the drafting of individual plans of banks, in 2018, the Bank of Albania shall gather information on the governance and management of the bank's main activities, structure of liabilities, placed collaterals, off balance-sheet items, systems used by banks for payments, clearing and settlements, information systems, interconnections and financial dependencies, as well as contractual agreements that may be affected by the resolution actions.



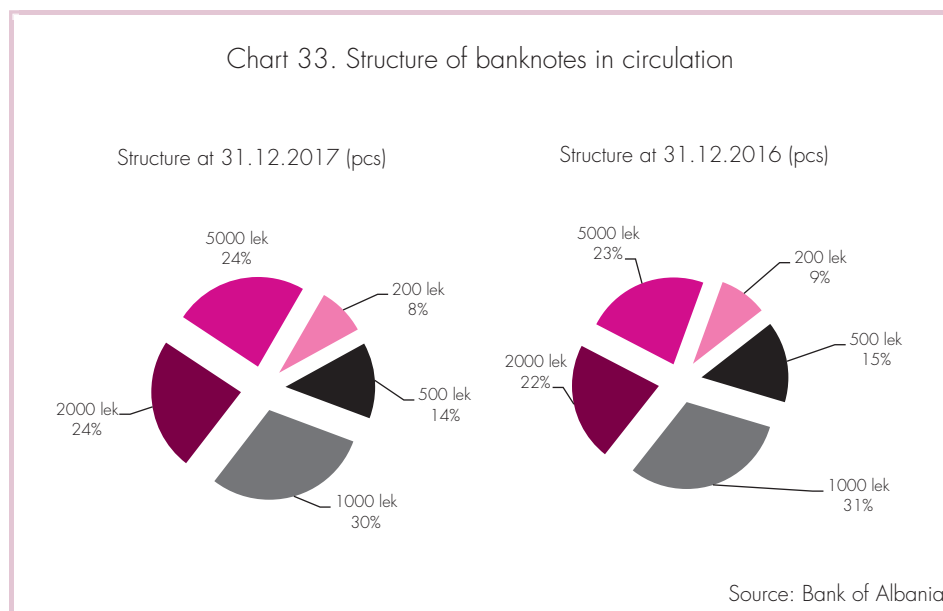
2.6 CURRENCY ISSUE

The Bank of Albania has the exclusive right for the issue and circulation of the national currency – the Albanian lek. The Bank of Albania determines the forms, measures, weights, model, and other characteristics of Albanian banknotes and coins of legal tender in Albania, as well as coins and banknotes for numismatic purposes.

BANKNOTES IN CIRCULATION²⁷

At the end of 2017, there were 134,319,471 banknotes in circulation, worth around ALL 270.248 billion. Compared with 2016, the number of banknotes in circulation increased by around 3.1 million banknotes, whereas their value increased by 5.75%. The change in these indicators is attributable to the continuing change in structure in favour of 5000 Lekë and 2000 Lekë banknotes. The average value of a banknote in circulation at the end of 2017 was ALL 2012, from ALL 1941 at the end of 2016.

Chart 33. Structure of banknotes in circulation



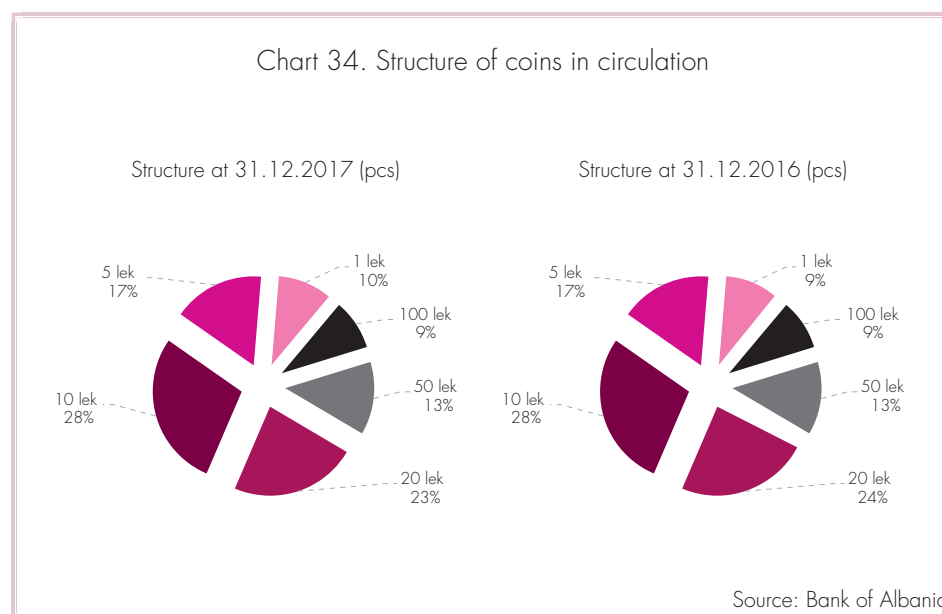
COINS IN CIRCULATION

At the end of 2017, there were 184,060,761 coins in circulation, worth ALL 4.437 billion. Compared with 2017, the number of coins increased by 7.9%

²⁷ It is the number and value of banknotes put in circulation by the Bank of Albania.



and their value increased by 8.2%. At the end of 2017, the overall coin to banknotes ratio was almost unchanged from the previous year.



INDICATORS OF CURRENCY IN CIRCULATION

At the end of 2017, the ratio of currency in circulation to the M2 aggregate was 38%²⁸, from 35% at the end of 2016. The circulation coefficient of the currency²⁹ in the Bank of Albania was 0.432 in 2017, from 0.412 in 2016.

RECIRCULATION AND QUALITY OF BANKNOTES IN CIRCULATION

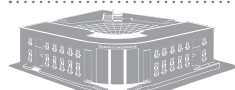
In 2017, around 109 million banknotes were processed, which were checked for authenticity and fitness for recirculation. From the process, around 23.4 million banknotes resulted unfit for use, and were withdrawn from circulation. The sorting rate³⁰ was 21.48%, from 22.16% in 2016. Unfit banknotes were replaced, on a case by case basis, with new banknotes. The banknote circulation coefficient³¹ for 2017 was 0.85, implying that a banknote is returned to the cash desks of the Bank of Albania, on average less than once a year. This rate is higher for 500 Lekë and 1000 Lekë banknotes (around 1.6 and 1.2, respectively) and lower for 5000 Lekë and 2000 Lekë banknotes (around 0.24 and 0.72, respectively), which shows that the latter are returned more rarely to the cash desks of the Bank of Albania.

²⁸ Note: it is the value for aggregate M2 based on preliminary official data for 2017.

²⁹ Ratio of the number of banknotes and coins returned to the Bank of Albania cash desks to the average annual number of banknotes and coins in circulation.

³⁰ Ratio of unfit banknotes and coins to the total number of banknotes and coins sorted in a year

³¹ Ratio of the number of banknotes returned to the Bank of Albania cash desks to the average annual number of banknotes in circulation.



ANALYSING THE STRUCTURE AND THEMES OF CURRENCY IN CIRCULATION

Bank of Albania objectives for banknotes and coins relate to improving the quality of banknotes in circulation, higher engagement with regard to protection against counterfeiting, and reviewing themes, design and security features in legal tender series of Albanian banknotes.

In 2017, the review of the banknotes series was approved, regarding the qualitative improvement of their design, by maintaining the existing theme, and the notable improvement of security features.

Also, in 2017, the theme on the new banknote of 10000 Lekë was determined. The obverse will feature the portrait of Asdreni, and the reverse the "National flag" and some verses from the national anthem.

PROTECTING BANKNOTES AND COINS AGAINST COUNTERFEITING

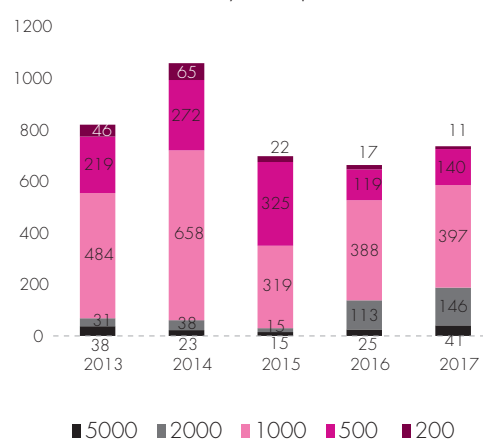
In view of safeguarding the integrity of the national currency, the Bank of Albania continued to work for increasing and upholding the quality of currency in circulation. Thus, the new national series is being prepared and approved for print. In this series, the security level of the existing security features is increased, and new security features are added, to strengthen the resilience of banknotes against counterfeiting.

Addition attention is paid to preventing actions, accompanied with the prudential monitoring of all cases of counterfeit banknotes and coins discovered in circulation, and the increase of capacities to prevent and protect currency from counterfeit, through training and preventive activities in the field of currency protection.

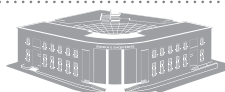
The quantity of counterfeit banknotes and coins discovered in circulation trended slightly up in 2017, compared with 2016. Overall, compared with the number of banknotes and coins in circulation, they remain insignificant. The number of counterfeit banknotes per 1 million banknotes in circulation was 5.7 banknotes, in 2017. Compared with the euro currency, this ratio is considerably lower.

By structure, the 1000 Lekë denomination has the major share in the total counterfeit banknotes and coins, followed by the 500 Lekë and 2000 Lekë denominations. In terms of counterfeit coins, the 50 Lekë coin has the main share, by 134 coins, but with a falling trend in years.

Chart 35. Counterfeit banknotes, over the years (pcs)



Source: Bank of Albania



In terms of techniques, the counterfeit national banknotes are reproduced by the digital colour printing technique, combined with the application of additive methods for the imitation of the security features.



2.7 PAYMENT SYSTEMS

The safe and effective operation of the payment systems, as the basis of the financial markets, is a crucial precondition for the implementation of the monetary policy, the financial stability and the overall economic growth. To achieve the objectives in the field of the payment systems, in 2017, the Bank of Albania has intensified the efforts to: promote their stability; and guarantee the safe and quick money circulation, and at low cost. In this regard, the Bank of Albania has taken measures to regulate and oversee the payment systems and their respective components, as well as take a more proactive role in encouraging initiatives by market actors.

PAYMENT SYSTEM OVERSIGHT

In the framework of further consolidation of payment systems oversight, in 2017, the Bank of Albania has implemented the international oversight standards on payment systems, which guarantee the safety of these systems. Also, it promotes their efficiency by supporting their extensive use by the financial markets and the economic agents, thus encouraging the formalisation of the Albanian economy and financial intermediation.

In more concrete terms, in 2017, the Bank of Albania has worked for the implementation of the Bank for International Settlements Principles For Financial Market Infrastructures³² and the Regulation of the European Central Bank (EU) No. 795/2014 "On oversight requirements for systemically important payment systems³³" with the support of the experts from the central bank of Italy and the World Bank. The assessment of payment systems based on these principles, and the measures for their implementation, support the safety and effectiveness of these systems in Albania, and promote the reliability of these systems internationally, and establish the necessary preconditions for adherence to the common European market.

In compliance with the mid-term development objectives, the Bank of Albania paid special attention also to the development and regulation of small-value payment systems and the instruments used in them. In 2017, the Bank of Albania worked on the adoption of the legal and regulatory framework with the Payment Services Directive. The establishment and implementation of this legal and regulatory framework will contribute to promoting competition in the

³² <https://www.bis.org/cpmi/publ/d101a.pdf>

³³ https://www.ecb.europa.eu/ecb/legal/pdf/oj_jol_2014_217_r_0006_en_txt.pdf



payment systems' market, boosting transparency for the provided services and consolidating consumer protection. Also, the aligning of the practices on the regulation of payments services market with the European ones is a crucial step regarding the integration and implementation of recommendations in the framework of the free capital movement and the adherence to the Single Euro Payments Area (SEPA). Finally, the establishment of the above-stated regulatory and legal base will promote the development of innovative services, always being developed under safe and effective terms.

In addition to the fulfilment of the above medium-term objectives, in 2017, the Bank of Albania has consulted continuously the banking system and the Albanian Association of Banks with the aim to promote the development of the payment instruments and market through discussions on the latest developments and the needs for regulatory amendments, which enhance the effectiveness of these systems and instruments.

THE BANK OF ALBANIA AS A REFORMER IN THE FIELD OF PAYMENT SYSTEMS

The Bank of Albania, as reformer and catalyst, provides a crucial contribution to the development of the financial and payment markets to enhance the efficiency and credibility of these markets and of the relevant infrastructure. To accomplish this goal, the Bank of Albania uses its expertise in the field of payment systems and shares it with the market actors through regular consultations and coordinated meetings with representatives of the private and public sectors. In this regard, the Bank of Albania has continued to work for consolidating the inter-institutional collaboration through the National Payment Systems Committee (NPSC).

Through the Committee, the Bank of Albania has intensified the research activity at inter-institutional level aiming at increasing transparency and public awareness, as an important tool for promoting market development. In more concrete terms, in its meeting, the NPSC initiated a set of projects to research on priority issues in the relevant market, in collaboration with national and international institutions.

Also, in 2017, the Bank of Albania, in collaboration with the World Bank and the Minister of State for Diaspora, engaged in the field of remittances. In this framework, special attention is paid to the assessment of remittances market, and the efforts to increase the effectiveness of this important resource to the economy of Albania.

Finally, in this period, special attention is given to the interaction with various actors of the market and the parties that are interested to be involved in the Albanian market of payment systems and services.



NATIONAL PAYMENT SYSTEM COMMITTEE (NPSC)

To promote the development of payment systems and instruments, the NPSC continued the efforts for the materialisation of the targeted objectives throughout 2017. In the meeting held in May 2017 a set of projects were initiated. These projects will contribute in establishing the necessary preconditions to promote the reformation of small-value payments market, and thus the use of electronic payment instruments.

In concrete terms, the NPSC member institutions were committed to:

- Promoting financial inclusion from the payments point of view. In this framework, the members were committed to the implementation of the recommendations, which aim to address the spaces identified in the report compiled by the World Bank in collaboration with the Bank of Albania for the financial inclusion from the payments point of view. The above Report analyses the market and addresses recommendations based on seven core principles: a) improvement of the applicable legal and regulatory framework; b) development and improvement of financial services infrastructure; c) expansion of payment account holding and of the use of their services; d) expansion of access points of these services; e) increase of financial literacy; f) increase of the volume of transactions processed in the payment systems; and g) the need for inter-institutional engagement from both private and public sectors, that is very important for the implementation of the recommendations.
- Formulating a draft-strategy and implementing it for the reformation of small-value payments market with the support of the World Bank experts. It will serve as medium-term development strategy for the NPSC to promote the development in these systems, through an action-plan for the market actors. The above strategy includes also the monitoring instruments for its implementation and determines the quantitative objectives. Currently the drafting of the strategy is finalised and will be approved in the next meeting of the NPSC.
- Finalising the study on the costs of payment instruments in Albania. The central banks in advanced countries have considered conducting such a study as very efficient, in the framework of the fight against the use of cash in economy, and in identifying the possibilities to reduce costs over the use of payment instruments in the economy. The above-stated study is finalised jointly by the Bank of Albania and the World Bank and will be made public in the early months of 2018.
- Analysing the remittances market in Albania and the implementation of the World Bank Greenback project, in Berat. This project consists in increasing financial inclusion and financial education of emigrants and their families, who receive these funds, and the establishment of rather effective channels in terms of costs for the delivery of these funds.
- Compiling the draft-law on Payment Services. Also, the Bank of Albania considers the payment services and the related instruments as a crucial



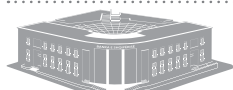
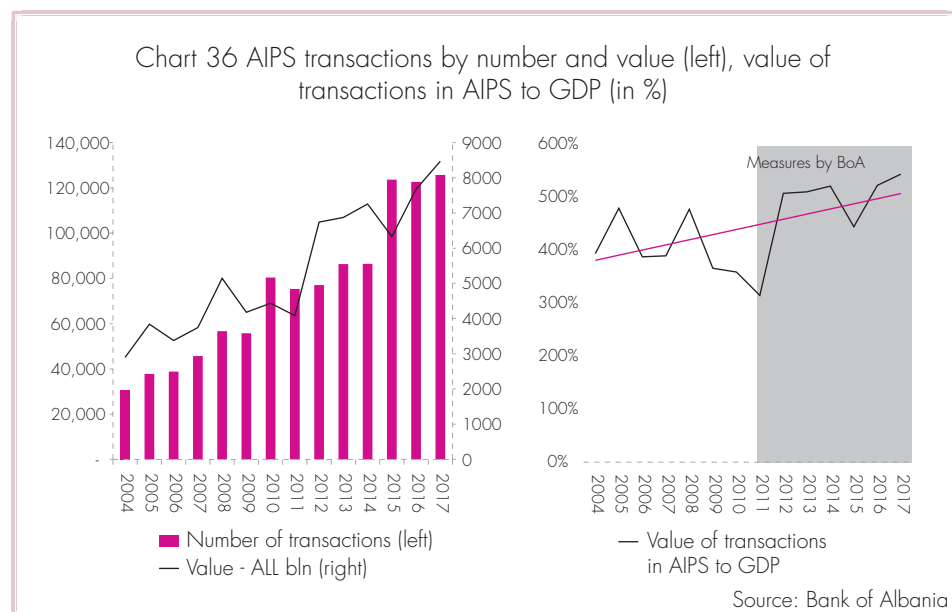
component of payment systems. In this regard, the Bank of Albania has worked for the implementation of the EU Directive 2015/2366 “On payment services in the internal market”. The implementation of this directive in practice is assessed to considerably contribute to the improvement of safety and efficiency of payment services through the promotion of competitiveness, increase of transparency and the clear definition of rights and obligations to both payment service providers and users. Also, the directive provides the conditions for properly addressing the risks arising from the implementation of technology novelties (Fin-Tech) in the payment services. Currently, the Bank of Albania is finalising this draft-law. Nevertheless, by considering the broad effect of this draft-law, consultation with the market actors assumes special importance.

- Finally, the regulatory framework for the organisation and functioning of the NPSC is reviewed, in the light of expanding the participation in the NPSC with representatives from payment and transfer services, electronic money institutions and operators of settlement and clearing systems. This review has taken into account the World Bank recommendations for the implementation of the best international practices.

PERFORMANCE OF AIPS AND AECH SYSTEMS

Albanian Interbank Payment System for large-value payments (AIPS)

In compliance with the objectives of the Bank of Albania, AIPS, the core structure for the settlement of financial markets, reflected safety and efficiency in 2017, preventing incidents and deviations from operating rules. In AIPS, 125,641 transactions were processed, and the total value of the liquidity circulated in the system was ALL 8,472 billion. Compared with the previous year, the volume and value of processed transactions increased by 3% and 10%, respectively. Also, the value of transactions processed in AIPS as a ratio to GDP trended



upward, showing an increasing use of the system and the importance of this system to the Albanian economy.

“Payments for clients” have the highest share in using AIPS in terms of volume³⁴ (53.46% payments generated from individuals, enterprises and public institutions) showing the importance of the system in the economic activity intermediation. On the other hand, in terms of value, “Settlements in AFISAR” have the main share (40.35%) for the settlement of securities transactions, thus showing the importance of the system for the settlement of financial markets and the implementation of the monetary policy.

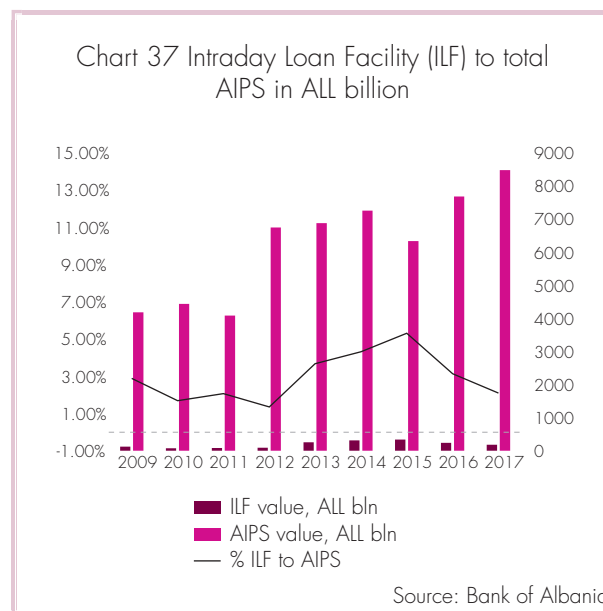
A well-functioning AIPS contributes to the development financial markets, by accommodating the settlement needs of auxiliary structures based on the regulatory spaces for the functioning of the system. In addition, private and public initiatives may employ these spaces to guarantee a rather safe settlement in the books of the Bank of Albania.

Regarding the addressing of risks, the growth of AIPS activity is not accompanied with needs for liquidity support by the Bank of Albania. In more concrete terms, the Intraday Loan Facility (ILF) has decreased in terms of both number and value (by 22% and 26%, respectively), also reflecting a decrease of the average value per transaction. The above-stated development reflects a fall of the exposure of the system to liquidity risk as shown in the Chart 37, where the ILF ratio to the value added in AIPS (ALL billion) fell considerably in 2017.

The downward trend of the need to finance the AIPS activity with ILF, beyond the liquidity conditions in the market, dictates a new way for using this instrument and the collateral management to guarantee it through the AFISAR system.

ALBANIAN ELECTRONIC CLEARING HOUSE FOR SMALL-VALUE PAYMENTS (AECH)

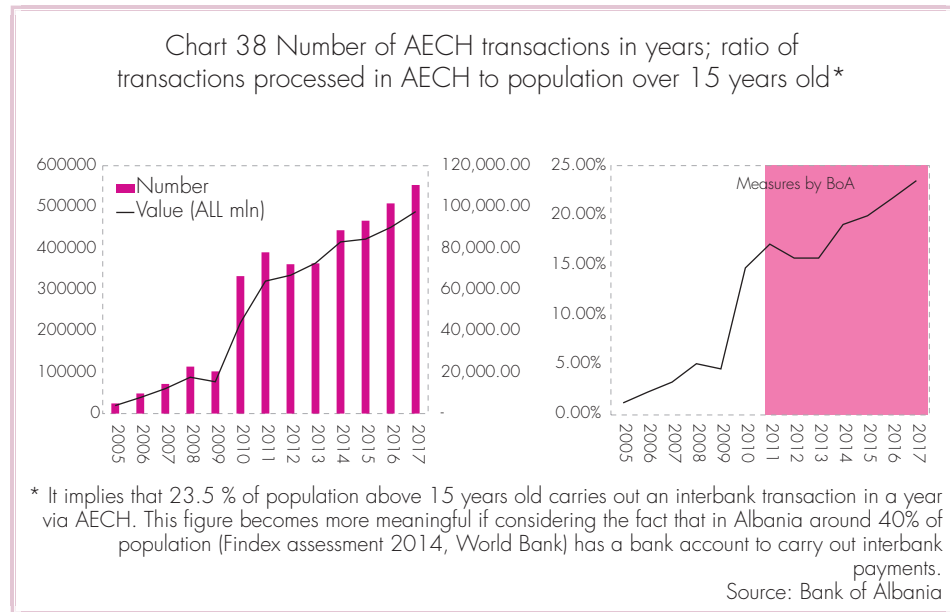
In 2017, the volume of cleared payments in AECH was 553,433 transactions, with an average value per transaction around ALL 180,000. Compared with the previous year, the activity of the AECH system increased in both volume and value of cleared payments, by 9% and 8.5%, respectively.



The allocation of payments by participants shows that the use of AECH by banks, for the payments of their customers, continued to increase. In more concrete terms, regarding the banking activity, both

³⁴ The encouragement of the economic stakeholders to use AIPS after the measures taken by the Bank of Albania in 2011 regarding the commissions applied on the final user.





the number and value of transactions increased by 16.12% and 13.85%, respectively, compared with 2016, reaching a level of using this system for this purpose at 60% against the total activity (40% transactions for the Ministry of Finance). The upward trend in the number of transactions from banks shows the familiarity of the public with payment instruments and their use at interbank level, as well as the transmission of the measures taken by the Bank of Albania in 2011 regarding the commissions applied by banks on the final users.

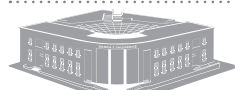
The Bank of Albania, by assessing the contribution of AECH system to encouraging the use of payment instruments, has continued the efforts to promote the expansion of the instruments cleared in the system and the actors who clear payments through this system. The approval and in following the implementation of the Draft-Law "On Payment services" is assessed to have provided a considerable support in this regard.

Also, in terms of risks, the distribution of transactions cleared in AECH system by sessions shows a higher concentration in the first clearing session. This development avoids the overload in the payment flows in the last clearing session by minimising the risks from these overloads.

PAYMENT INSTRUMENTS

The promotion of the use of payment instruments for transactions among economic actors, and mainly in electronic form, which appear more efficient, is rather important to the Albanian economy, when considering the fact that the use of cash in the economy has a cost of around 1.7 % of GDP³⁵ for the Albanian economy. In this framework, market developments are continuously monitored by the Bank of Albania, with the aim to promote the development

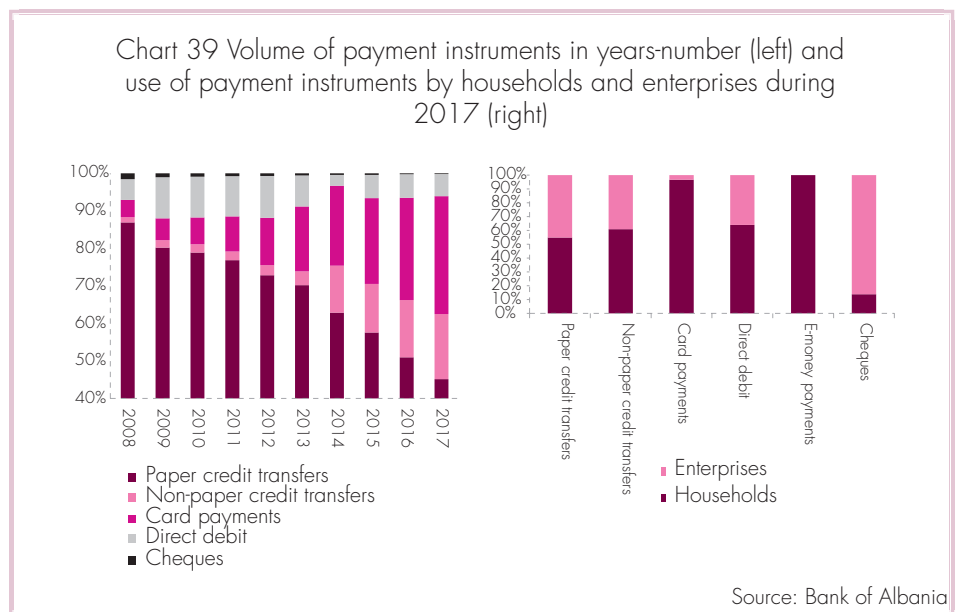
³⁵ The assessment is concluded in the research of the Bank of Albania in collaboration with the World Bank.



through both the regulatory framework and the infrastructure in compliance with the medium-term objective to ensure a safe and fast circulation of the currency in the economy at minimum costs.

Banks' reporting on payment instruments show that around 13.3 million payment transactions by households and enterprises were made in 2017, totalling ALL 4,665 billion. This development shows an increase in the value and number of payment transactions through the payment instruments, 11.18% and 3.41%, respectively, compared with 2016.

From the total number of clients' payments, during this period, a high use of credit transfer is employed (at 61.33%), of which 72.2% are payments in paper form. However, in the last years, we have noted an upward trend in the use of electronic payments, such as non-paper credit transfers (home banking) and card payments.



HOME BANKING

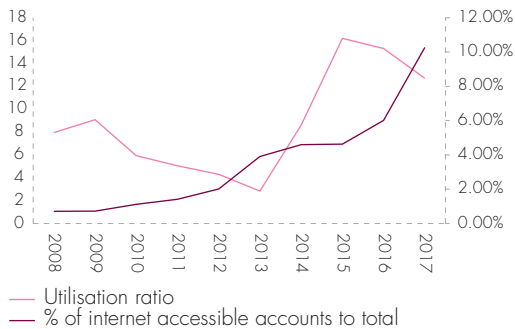
"Home banking³⁶" services have been increasingly used in the Albanian market. The promotion to use this instrument in the Albanian market, as one of the highest efficient instruments in terms of effective productivity and the costs borne from the use, based on the studies of the Bank of Albania on the payment instruments costs, is quite important.

At the end of 2017, of the 16 banks of the system, 14 were offering different home banking products. The establishment of adequate conditions by the supply side (banks) is reflected in an upward trend in the use of these services. In more concrete terms, in 2017, we observed that the volume of home banking

³⁶ These products provide remote access to the bank account, via on-line, telephone or software that the bank makes available to its clients.



Chart 40 Trend of remotely accessible accounts against total accounts and trend of remotely accessible accounts utilisation ratio*



*The utilisation ratio shows how much on average an account is used on-line to carry out transactions. Source: Bank of Albania

payments increased significantly a by 26.32% of and of the value of the transactions by 60.11%, compared with the previous year.

The increasingly upward trend of home banking is closely connected to the presence of infrastructure and the expansion of possibilities to access internet through a smartphone. Also, the policies of banks, in the framework of promoting these payment alternatives, was assessed to have provided a positive role, reflected in the increase of the remotely accessible accounts, from 1% in 2008, to around 11% in 2017 to the total accounts.

Nevertheless, the expansion of the accounts' number is not followed by an increase in the transactions per account. This development shows the need of customers to become familiar with the service, implying the spaces for intervention in the framework of public financial education and the awareness-raising campaigns in this regard.

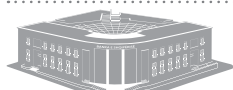
BANK CARDS

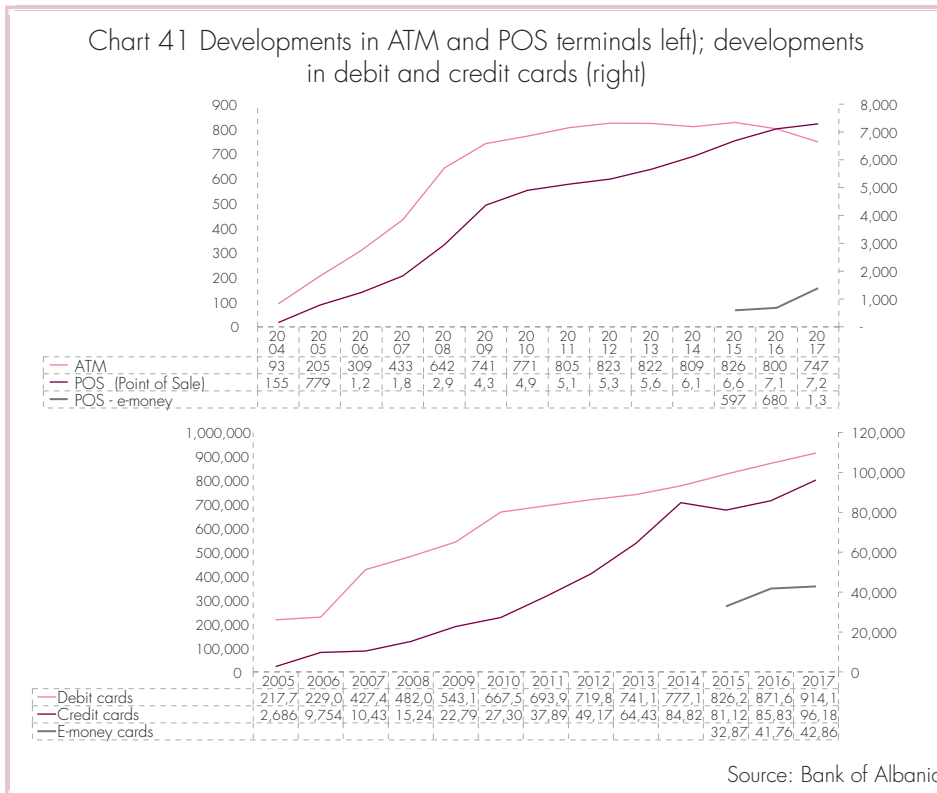
As at the end of 2017, fourteen banks were licenced as card issuers in the Republic of Albania, of which nine were also licenced as card accepters.

In terms of infrastructure provided by banks licenced as card issuers and those licensed as card accepters, at the end of 2017, the number of POS terminals increased by 2.57%, while the number of ATMs decreased by 6.63% compared with 2016. Notwithstanding the positive upward trend in the number of POS terminals, their concentration continues to be high in the region of Tirana,³⁷ 85.95%. Also, the number of POS terminals per 1.000.000 citizens was 2,541, the lowest level compared with the regional countries, followed by Kosovo, 5,982 POS terminals per 1.000.000 citizens.

Terminals for the use of electronic money cards recorded very positive developments. They showed an upward pace at 104.56% compared with the end of 2016. Nevertheless, it should be highlighted that the above-stated growth reflects also the statistical effect of the low comparative base. The encouragement to use of the electronic money instruments is assessed to have affected the financial inclusion of the population, by providing access to bank services (opening an electronic money account and owning a pre-paid card) by categories of population who may not access other services, for example they do not take a wage.

³⁷ Regions are divided according to the branches of the Bank of Albania.





In 2017, the issue of debit and credit cards increased by 4.9% and 12.1%, respectively. Also, the functioning in the market of e-money cards showed a fast increasing pace.

The use of bank cards in ATM and POS terminals shows that cash withdrawals from ATM terminals have the main share in transactions with cards, an indicator of a largely cash-based economy. In 2017, the number and value of card payments in physical and virtual POSs decreased by 7.8 % and 24.9%, respectively. In relative terms, payments carried out with prepaid cards reached up to 8.37% of the payments with debit and credit cards, up 18.47% from the previous year.

The low use of cards as a payment instrument shows the familiarity level of the public, the low level of financial education, and the limited infrastructure of POS terminals offered from enterprises.

Cash transactions

Regarding cash transactions conducted by customers at banks' cash desks, in 2017, their number decreased compared with the previous year. This year has registered a slight decrease of cash desk transactions by 5.48% in terms of number and a slight increase by 0.82% in terms of value, compared with the previous year.



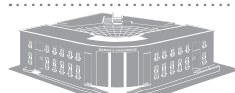
Table 6. Number and value of cash transactions at banks' cash desks

Description	Year 2016		Year 2017		Annual change	
	Number	Value (in ALL mln)	Number	Value (in ALL mln)	Number	Value
Transactions at cash desks	11,388,857	2,572,650	10,765,198	2,593,771	-5,48%	0,82%
1. Deposits at cash desks	7,645,500	1,577,539	7,175,011	1,608,616	-6,15%	1,97%
2. Withdrawals at cash desks	3,743,357	995,111	3,590,187	985,155	-4,09%	-1,00%

Source: Reports submitted by banks according to the "Methodology for reporting payment instruments".

Notwithstanding the decrease in using cash, from the perspective of withdrawals and deposits at banks' cash desks, the use of cash in the Albanian economy in 2017 is dominant³⁸ and has high costs for the various actors and the overall economy. Hence, the coordination of efforts at market level to promote the use of efficient instruments at lower costs is of special importance and one of the priorities of the Bank of Albania.

³⁸ A joint study of the Bank of Albania and the World Bank shows that 99.2% of all payments are accepted in cash by the interviewed enterprises, while they have carried out 66% of payments also in cash. Also, Albanian consumers show a high use of cash (96% of the conducted payments are in cash, meanwhile the payments taken from third parties, 90% are in cash).

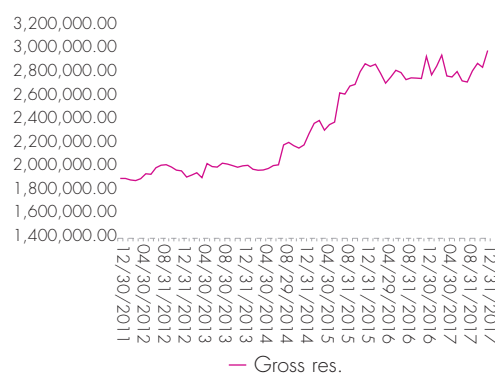


2.8 FOREIGN EXCHANGE RESERVE MANAGEMENT

The Bank of Albania is the national authority responsible for maintaining and managing the foreign exchange reserve of the Republic of Albania. It uses its best opportunities to achieve and maintain a certain level of foreign exchange reserve, which supports Albania's financial stability, and is in accordance with the monetary policy.

The new Regulation "On the policy and management of the foreign exchange reserve", approved by the Supervisory Council in February 2017, lays down the purposes of maintaining the foreign exchange reserve. In compliance with the international practices, the purposes for maintaining the foreign exchange reserve, in addition to the implementation and support to the monetary policy, include safeguarding financial stability. The objectives of the foreign exchange reserve management are subject to the approval by the Supervisory Council. The primary objectives of this process are liquidity and security, whereas ensuring returns from reserve funds management represents the third objective, as long as it does not infringe the objective for liquidity and security. The Investment Committee approves the names of entities where foreign reserves may be invested. These names include the governments of USA, Japan, Great Britain and those in the euro area, as well as government-related agencies or institutions that are generally rated at least AA- (for euro area governments, the accepted minimum rate is BBB³⁹). The names of entities allowed for investment also include multilateral institutions or other institutions rated at least AA-.

Chart 42 FX reserve performance at the Bank of Albania (in EUR million)



At the end of December 2017, the stock of foreign exchange reserve was EUR 2,994.28 million, including the monetary gold, amounting EUR 54.88 million, 1.8% of total.
Source: Bank of Albania

COMPOSITION OF FOREIGN RESERVE PORTFOLIO BY CURRENCY

At the end of December 2017, the composition of the foreign reserve by currency was:

Usd	Eur	Gbp	Jpy	Aud	Sdr	Gold	Rmb
22.0%	63.4%	2.6%	2.2%	1.5%	5.7%	1.8%	08%

³⁹ Entities/ instruments rated up to BBB- are included in "Investment" category (investment grade).

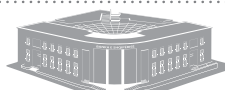
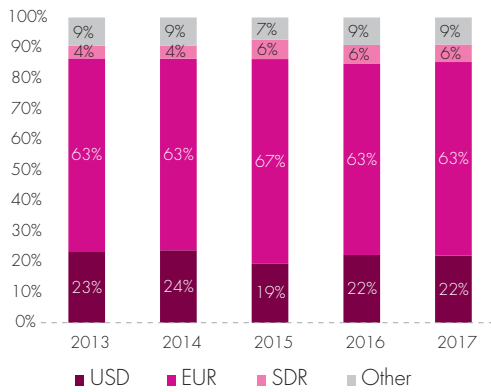


Chart 43. Share of reserve currencies



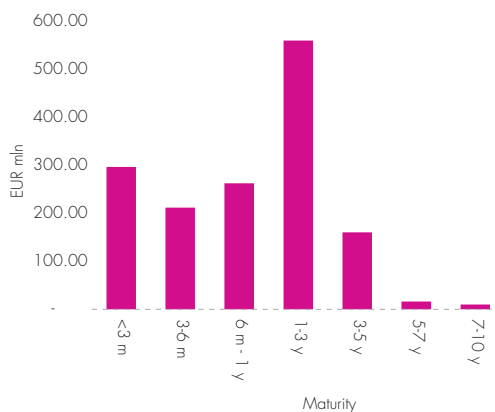
Source: Bank of Albania

The exposure in AUD (Australian dollar) and RMB (Chinese renminbi) shows the decision of the Supervisory Council to invest part of the reserve according to the SDR basket, but the share of the RMB, as part of the SDR basket, is distributed onto two currencies, the Chinese currency (RMB) and Australian dollar (AUD), according to a ratio that is subject to the Investment Committee's revision/ approval.

RESERVE PORTFOLIO BY MATURITY TERM

At the end of 2017, the foreign exchange reserve managed by the Monetary Operations Department is invested into liquid assets, mainly with maturities of 0-3 years. The share of time debt instruments with maturity over 5 years does not exceed 1.7% of the reserve portfolio. The portfolio managed by the external manager (World Bank), is invested against a benchmark portfolio of 0-3 years, mainly in debt instruments issued by the government.

Chart 44. Reserve by instrument maturity (2017)



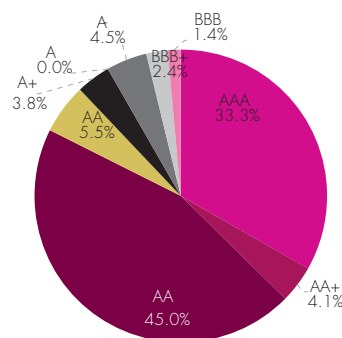
Source: Bank of Albania

RESERVE PORTFOLIO BY RATING AND TYPE OF ISSUER

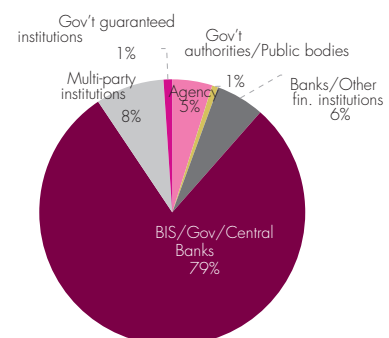
More than 90% of the foreign reserves portfolio is invested in institutions of high quality ratings (classes AAA and AA). The reserve is mostly invested in debt instruments issued by governments / central banks (79%), followed by multiparty institutions (8%), banks

Chart 45. Rating of investment instruments and type of issuer

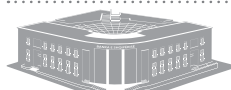
Share by rating at end 2017



Share by type of issuer at end 2017



Source: Bank of Albania

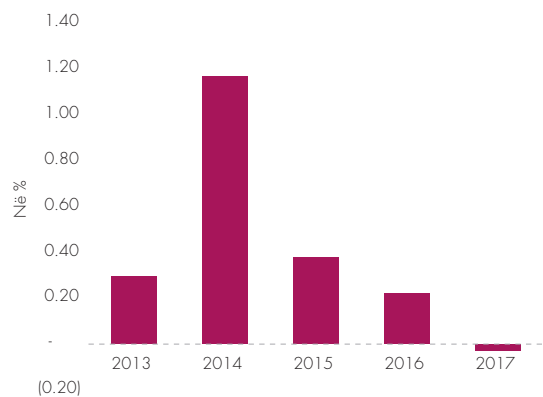


/ other financial institutions (6%), agencies (5%), government-guaranteed institutions (1%) and government authorities /public bodies (1%).

RETURN ON THE INVESTMENT OF RESERVE PORTFOLIO

The absolute return of reserve in total (excluding the part of the reserve in gold, and the fund managed by the World Bank as external administrator), was around -0.029% in 2017, compared with 0.24% in the previous year. The fall in return reflects the challenging international environment, where the interest rates on debt issues in EUR, the main currency of the foreign reserve, are at negative levels, due to the monetary policy implemented by the European Central Bank (ECB deposit rate continues to be -0.40%). In 2017, the interest rates on treasury issues in euro area continued to be at a negative territory. Hence, the investment possibilities with a positive return rate, but by maintaining the accepted credit risk, for the part of portfolio in euro reduced further compared with the previous year. As at end 2017, around 93% of investments in securities in the euro dominated portfolio have a negative interest rate that varies from -0.3 basis point to -85 basis point.

Chart 46 Return of foreign reserve in years



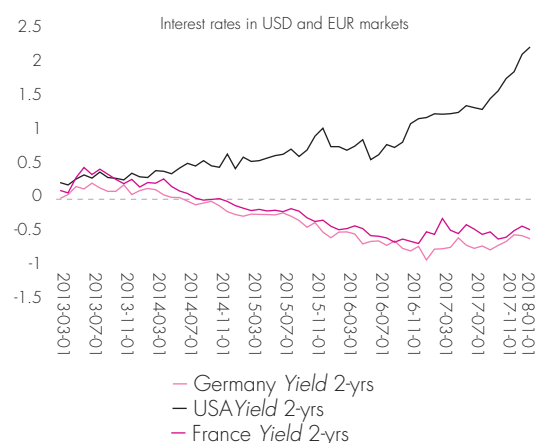
*Both the exchange rate and the return from monetary gold are excluded in the calculation of the return.
Source: Bank of Albania

BOX 9 IMPACT OF EXTERNAL ENVIRONMENT IN THE INVESTMENT OF FOREIGN EXCHANGE RESERVE

Year 2017 was characterised by an improvement in the global sentiment on real economic growth almost across all economies, in whose currencies the international reserve portfolio is held. The economic growth in USA and in Europe was particularly sound, driving the respective central banks to react by increasing the interest rates (Federal Reserve), or reducing the monetary stimulus (European Central Bank). Globally, the treasury yield curve, particularly the US yield curve flattened as at end 2017 (or maintained their historic average levels without sloping as in the euro area), by expressing the increase in interest rates as a result of optimism, mainly in the part below three years of the curve.

The absolute return on foreign reserve at low levels reflects the continuation of an environment with still low interest rates, in the main currencies/ markets where the foreign reserve portfolio is invested.

Chart 47 Two-year rate on government issues, with considerable share in the reserve portfolio



Source: Bloomberg



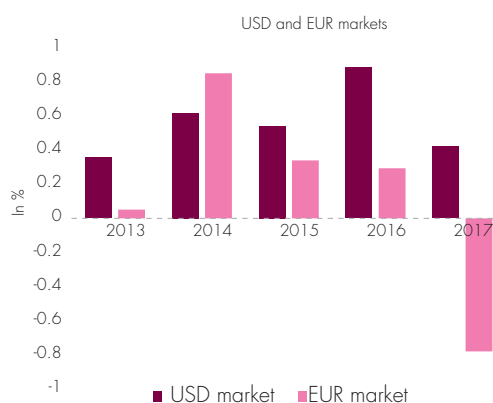
The contribution to the return on investments from the euro, which shares higher than 60% of reserve portfolio, was negative by reflecting the negative interest rates in the euro area.

Table 7 The interest rates on government's issues in euro area at the end of 2017 (in %).

Maturimi	1 muaj	3 muaj	6 muaj	1 vit	2 vjet	3 vjet	4 vjet	5 vjet	6 vjet
Gjermani	(1.34)	(0.85)	(0.77)	(0.70)	(0.64)	(0.55)	(0.39)	(0.20)	(0.10)
Hollandë	-	(0.89)	(0.82)	(0.81)	(0.71)	(0.56)	(0.42)	(0.29)	(0.06)
Finlandë	-	-	-	(0.76)	(0.68)	(0.49)	(0.36)	(0.17)	0.00
Austri	-	-	-	(0.67)	(0.57)	(0.49)	(0.39)	(0.15)	(0.02)
Belgjikë	-	(0.84)	(0.74)	(0.64)	(0.55)	(0.46)	(0.35)	(0.17)	0.04
Francë	(1.10)	(0.79)	(0.73)	(0.65)	(0.49)	(0.31)	(0.15)	(0.01)	0.11
Irlandë	-	-	-	(0.69)	(0.57)	(0.50)	(0.17)	(0.02)	0.04
Slloveni	-	-	-	(0.49)	(0.49)	(0.28)	-	(0.22)	-
Spanjë	-	(0.60)	(0.54)	(0.54)	(0.42)	(0.04)	0.03	0.34	0.58
Itali	-	(0.65)	(0.46)	-	(0.46)	(0.28)	0.02	0.30	0.71

Burimi: Bloomberg.

Chart 48 Return of portfolios in treasury issues rated AAA - AA, the average duration around 1.7 years.



Source: Indices published by Bof AML.

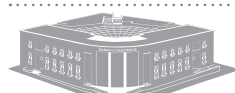
Meanwhile, the contribution to the return from the US dollar and other currencies of the reserve was positive, due to the higher base of the average interest rates in these currencies over 2017.

The return generated from the active management of the reserve portfolio over 2017 was positive. By currency, the euro had the highest share of the contribution to this return. The same situation was reflected on the non-euro currencies, where the relative return was high, but at a lower contribution to the total, due to their low share in the reserve.

Chart 48 shows the performance of markets in the two main currencies in which the foreign reserve is invested, EUR and USD.

OTHER DEVELOPMENTS RELATED TO THE FOREIGN RESERVE MANAGEMENT FUNCTION

Cooperation with the World Bank in the framework of Reserves Advisory Management Program (RAMP) continued in 2017. The World Bank continued to provide specialised training and educational programs, such as CFA (Chartered Financial Analyst), PRM (Professional Risk Manager) and ACCA (Association of Chartered Certified Accountants). These qualifications aimed



at the further consolidation and increase of expertise level of the employees engaged in the process of foreign reserve management, the staff that supports or monitors the performance of this process and of the Bank's staff in general. In 2017, the training of Investment Committee members began, to obtain more experience regarding the responsibility and tasks realised by this decision-making structure in the context of the foreign reserve management.

The regulatory framework for the development of foreign reserve management was amended in December 2017 regarding the investment policy of foreign reserve with the purpose the regulation of the investment into a new instrument class - the covered bonds. This instrument represents a standard investment alternative to the central banks. In the approving process of this instrument, special attention was paid on the accepted credit risk level. The legal risk management was important during the investment in this instrument class; hence, the Bank of Albania was driven and assisted by the Bundesbank in this regard. The continued communication between our institutions will provide updated information, and the Bank of Albania will base its work on this information to establish a rather complete monitoring framework during the realisation of investments in the covered bonds.

In September 2017, the Supervisory Council adopted the amended Regulation "On the functions of the management structures in the decision-making process on the foreign currency reserve management". In the framework of the complete revision of this Regulation, its new content reflects: the competencies of the Governor in the framework of fulfilling the function of foreign reserve management; the supplementing of the competencies of each decision-making unit engaged in fulfilling the foreign currency reserve management function, including the competencies of the Head of the Monetary Operations Department.

BOX 10: FLOWS AFFECTING FOREIGN EXCHANGE RESERVE IN 2017

Gross foreign exchange reserve, estimated and reported in euro, grew around EUR 50.15 million, in 2017, standing at EUR 2,994.28 million, as at end-December. Year 2017 is characterised by a high fluctuation of excess reserves of commercial banks at the Bank of Albania. There was a significant increase in the stock of gross reserves, during the end of December, as a result of shifting of liquidity in currency of commercial banks by non-residents in the form of excess reserves at the Bank of Albania.

A. Transactions with the Ministry of Finance provided a positive impact, estimated at EUR 48.47 million, according to the following items:

- Net inflows from extension of various loans, at EUR 346.83 million;
 - International Monetary Fund (IMF), at EUR 73.60 million;
 - International Bank for Reconstruction and Development (IBRD) etc., at EUR 273.23 million;
- Inflows from the issue of foreign currency debt, at EUR 79.06 million;



- *Transfers (including debt service), at EUR 377.42 million.*

B. Commercial banks and other entities' transactions provided a positive impact, at EUR 28.72 million, according to the following items:

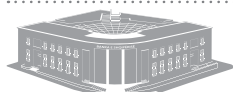
- *Commercial banks' deposits at the Bank of Albania to comply with the required reserve and transactions related to their capital, etc., at EUR 1,459.29 million;*
- *Transfers, at EUR 1,430.67 million;*
- *Net inflows for the account of other entities (DIA, etc.), at EUR 0.10 million.*

C. Bank of Albania's transactions provided a positive impact, estimated at EUR 106.33 million, according to the following items:

- *Purchasing foreign currency from Ministry of Finance and Economy and other institutions, at EUR 72.89 million:*
 - *From commercial banks, at EUR 71.19 million;*
 - *From other institutions, at EUR 0.92 million*
 - *From the Ministry of Finance and Economy, at EUR 0.78 million;*
- *Receipts from interests, coupons, etc. (calculated on cash basis) generated from foreign-exchange reserve investments, estimated around EUR 38.88 million.*
- *Settlement of the Bank of Albania's dues to the IMF is estimated at EUR 2.49 million,*
- *Transfers, around EUR 2.95 million;*

D. Market factors provided a negative impact, estimated at EUR 133.38 million, according to the following items:

- *Foreign-exchange rate volatility of currencies composing the foreign-exchange reserve contributed positively to the gross reserve reported in EUR, registering an effect of about EUR 98.58 million.*
- *The portfolio revaluation effect, as a result of interest rate volatility, is estimated at a negative value of EUR 34.80 million¹³.*



2.9 STATISTICS

Pursuant to the provisions of the Law “On the Bank of Albania”, the Official Statistics Program and the Law on Official Statistics, the statistics of the Bank of Albania aim at compiling impartial, objective and reliable statistics in compliance with the legal objectives of the Bank of Albania as the central bank of the Republic of Albania and a statistical agency within the National Statistical System.

The Bank of Albania uses and compiles statistics relating to financial markets, financial institutions, financial infrastructure and balance of payments. In this context, the development of monetary and financial statistics and the external sector of the economy is a fundamental responsibility of the Bank of Albania and contributes to the decision-making on the monetary policy and financial stability. At the same time, the Bank of Albania carries out statistical functions serving the public as a national statistical agency, an important source of statistics to the Albanian and foreign public.

The Bank of Albania also complies with the reporting obligations to international institutions, the IMF, World Bank, Eurostat and the ECB, within the framework of the European integration process of Albania. The Bank of Albania is a member of the General Data Dissemination System (e-GDDS) and other systems ran by the IMF.

In view of the strategic vision, the Bank of Albania has intensified its work on (i) methodological approximation of statistics with international standards and their alignment the *acquis communautaire*, (ii) expanding and detailing public statistical products, bearing in mind the reporting burden, as well as a faster and easier access of external users to the data and (iii) increasing the quality and integrity of the Bank of Albania statistics.

APPROXIMATION OF METHODOLOGIES WITH INTERNATIONAL STANDARDS

The Bank of Albania intensified its work for aligning the methodology of statistics with the international standards and their harmonization with the *acquis communautaire*. Concrete efforts are undertaken to collect and create new indicators, and to improve the data processing system.

In the field of monetary and financial statistics, in the framework of alignment with international drafting/compilation standards (ECB, IMF), and in line with



the recommendations of the ECB's experts report, progress has been made in the following directions:

- The Regulation "On Bank of Albania reporting on interest rate statistics", which fully approximates the EU Regulation No. 1072/2013 of the ECB, dated 24.9.2013 (ECB / 2013/33).

Statistics on the interest rate are the basis for analysing the monetary transmission mechanism. They also provide for monitoring structural developments in the banking and financial system as well as the analysis of financial stability aspects, such as the interest rate spread of banks and changes in bank profitability. This statistic further enhances our expertise on the analysis of the monetary transmission mechanism and will be offered to the users and the public by the end of 2018, after the completion of the series.

- The methodological approach and the compilation of financial soundness indicators (FSI) have been realized, in line with the standard⁴⁰ and, at the same time, the first FSI publication on the Albanian page at the IMF (<http://fsi.imf.org>).

Since November 2017, this statistic has been offered to the users in a time series starting from December 2010. FSIs include aggregated information on financial institutions as well as respective market indicators.

They are widely used in the definition of national standards on risk assessment, are the source of information for the compilation of financial stability indicators, and represent major quantitative references for the reporting of national, regional and global financial stability.

- The methodology is consolidated and, for the second consecutive year, the statistical book of financial accounts - flow of funds for Albania is fully drafted, in accordance with the most recent standard for the compilation of financial accounts - European Accounting System, ESA 2010.

Financial accounts are an important source of information for monetary policy and financial stability analyses. Regarding monetary policy, it is important to understand the flow of funds and instruments, whereas for financial stability it is important to understand the degree of exposure among the sectors.

The drafting of this statistical book has received positive assessment by the IMF Technical Assistance Mission), which suggested the publication of this statistic.

In the medium term, we will work to extend the time series, a necessity and a

⁴⁰ *FSI Design Methodical Guide (IMF 2006).*



requirement deriving from the obligations under the calculation and reporting of the MIP (Macroeconomic Imbalances Procedure)⁴¹.

- In December, for the first time, the Bank of Albania published statistics of the financial account of the financial corporates since December 2012, in annual and detailed periodicity by sub-sectors. Also, on the official page of the Bank of Albania, a list of institutional units classified under the financial sector was published, according to ESA 2010.

The compilation of the list of institutional units classified in the financial sector is an important aspect for the qualitative compilation of monetary statistics and financial accounts. The institution classification process is also discussed in the inter-institutional working group (BoA, INSTAT and MFE) as well as with foreign experts from EUROSTAT and the IMF.

The publication and updating of the list is an obligation of the Bank of Albania.

- In the framework of full coverage of monetary statistics for the financial sector, for the first time, the monetary conditions of other financial corporations was compiled in accordance with international standards.⁴²

At the end of October, data were successfully transmitted to the Bank of Albania website at the IMF providing users with comprehensive information related to the financial sector's monetary and financial statistics. These statistics are provided on a quarterly basis and will be published at the Bank of Albania's official website in March 2018.

- Work on the calculation of statistics under the EDP, in accordance with methodological standards and best international practices, has continued.

The Excessive Deficit Procedure represents an important statistical book for monitoring public finances soundness in member and candidate countries in terms of compliance with the two criteria of Maastricht. The IMF and SECO-funded regional project (2016-2019) has been supporting the inter-institutional EDP working group for more than a year and has given a positive contribution to the reconciliation of government data compiled by three institutions. Inter-Institutional Responsibilities for Drafting the Excessive Deficit Procedure Tables have been agreed upon in the Memorandum of Understanding⁴³. The Ministry of Finance and Economy is the main institution for the data source. INSTAT has the obligation to draft the methodology and data of non-financial indicators;

⁴¹ For Albania, the completion of MIP is a project supported by the ECB and Eurostat and coordinated by the Bank of Albania. The most numerous indicators in it are those that the BoA drafts, and should be reported in a 10-year timeframe.

⁴² SNA 2008 / ESA 2010, MFSMCG IMF 2016.

⁴³ Signed between the Bank of Albania, INSTAT and the Ministry of Finance (currently the Ministry of Finance and Economy), dated 03.10.2016.



meanwhile, the Bank of Albania has the obligation to draft the methodology and data for the financial indicators.

- In February, the International Reserves and Foreign Currency Liquidity Module was published for the first time.

The liquidity module has been designed by the IMF after the global financial crisis, together with the FSI and external debt statistics, and represents an important statistical product for the financial soundness of economies. This statistic is monthly reported to the IMF, and is offered to the public on a time series from January 2014.

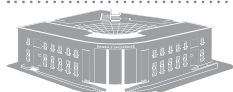
- In accordance with the recommendations given by the IMF's Technical Assistance Mission for external sector statistics, the following indicators have been drafted and submitted to the IMF:
 - Full set of "Co-ordinated Portfolio Investment Survey (CPIS)", together with the relevant methodology;
 - International Investment Position by Currency;
 - Co-ordinated Direct Investment Survey (CDIS), outward.
- The International Transaction Reporting System (ITRS) was finalized.

ITRS enables the expansion of the information base for the compilation of statistics payments statements and the increase of the level of detailing. This reporting is necessary in order to meet the criteria (reporting requirements for the integration) on the geographic breakdown, division by institutional sectors, frequency of compilation for statistics, and publication and dissemination of statistics.

Modern statistics cannot be perceived without the powerful support of the IT, regarding their collection, compilation and dissemination.

Regarding the achievement of international standards related to the reporting, storage and data control infrastructure, during 2017, in the electronic regulator reporting system (ERRS) are included: (i) non-bank financial reporting entities; (ii) Savings and loan associations; (iii) consolidated supervision package for financial groups. Also, full reporting in the framework of payment system oversight and those of the issue function at the Bank of Albania are included.

Also, during 2017, the Bank of Albania initiated the project "Automation of the compilation and dissemination of external sector statistics". The automation of the compilation and dissemination system of external sector statistics constitutes the creation of an important foundation for the statistical book produced by the Bank of Albania, building a solid architecture for the further development of other statistical books.



ENHANCING THE QUALITY AND INTEGRITY OF STATISTICS

In March, the Supervisory Council of the Bank of Albania approved the “Code of Practices for Statistics at the Bank of Albania”. The seven principles of the Code summarize the Bank’s objectives in seven aspects of its practice in the field of statistics. They relate to the importance, integrity, quality, access to the statistical product (availability), confidentiality, burden/obligation of reporting, and cost effectiveness.

The document was drawn up in accordance with the Fundamental Principles of Official Statistics and the United Nations Statistical Commission, as well as the principles set out in the European Statistics Code of Practice. It is similar to the IMF Data Quality Assessment Framework, and in compliance with the principles of transparency, the Bank of Albania objectives and the direction of its long-term strategic development. In addition, the drafting of this document meets the Eurostat’s recommendations in the LPR questionnaire⁴⁴ (The Light Peer Review of the Implementation of the European Statistics Code of Practice in the Republic of Albania). The Code seeks to guarantee the integrity of the statistical process at the Bank of Albania. Its existence further improves the public confidence in the information corroborating decision-making on monetary policy and other economic policies.

For the first time in 2017, the Bank of Albania published the “Policy and Calendar of the Bank of Albania Review of Statistics”. The review is an important aspect of good governance in the field of statistics, as well as the basic requirement / component of the data quality standard. The publication of the review policy provides full transparency to users regarding the review of published statistics.

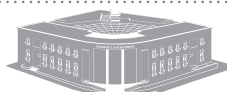
Since June 2017, Albania implements the IMF’s Enhanced General Data Dissemination System (e-GDDS⁴⁵) and has been committed to meeting a number of strict requirements for the production, dissemination, and documentation of statistical data.

The Enhanced General Data Dissemination System was approved by the IMF Executive Board in May 2015. The National Data Summary Page, which is presented on the official INSTAT website, contains links to the published statistics from official statistics producers, namely those of the Bank of Albania, the Institute of Statistics and the Ministry of Finance and Economy. This site aims to serve as a general publication centre for key macroeconomic statistics.

Reliable, timely and internationally comparable statistics serve as a guideline for increasingly globalized and complex economic activities. Adherence to

⁴⁴ LPRs are part of the European Statistical System (ESS) strategy for the implementation of the Code of Practice. Their objective is to increase the integrity, independence and accountability of statistical authorities, which are part of the statistical system.

⁴⁵ Enhanced General Data Dissemination System e-GDDS.



e-GDDS testifies for a higher level of development and transparency of the Albanian national statistical system and contributes, above all, to ensuring that Albania is a right place for doing business and making financial investments.

Without the user's confidence, statistics cannot fulfil its role as a public good. Measures taken by the Bank of Albania in the governance of statistics at the Bank of Albania, coupled with the contribution to the draft law on "Official Statistics", help to further strengthen the reliability of the statistical product of the Bank of Albania.

COOPERATION AT INSTITUTIONAL LEVEL

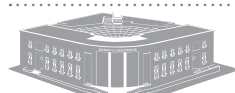
Following the signing of the Memorandum of Cooperation with INSTAT and the Ministry of Finance and Economy in September 2016, these institutions have cooperated in several aspects, most importantly the establishment of two inter-institutional working groups, respectively focusing on (i) national accounts, monetary and balance of payments statistics and (ii) excessive deficit procedure and government financial accounts.

The establishment and functioning of the working groups has led to an adequate exchange of statistical data collected / drafted by relevant institutions, as well as a better methodological harmonization between the three statistical agencies.

With INSTAT, the Bank has worked for drafting the Macroeconomic Imbalance Procedure (MIP). The MIP is a system for monitoring economic policies and detecting potential harms, early on, to the proper functioning of the economy of a Member State or the European Union as a whole. The MIP is part of the six legislative proposals on economic governance adopted by the Parliament and the European Council in November 2011, and as such it is part of the EU acquis to be adapted by candidate countries before the date of accession. In November 2017, the new Activity under MIP "Sources of Data for the Calculation of the MIP Indicators" (PP7.1) was initiated. This activity will be coordinated by the Bank of Albania.

Also, in the framework of inter-institutional cooperation in the field of statistics, in 2017, the Bank of Albania actively participated in the initiative for drafting the Law on Official Statistics.

During 2017, cooperation with AFSA was strengthened to provide statistical information on the non-bank financial system under AFSA's jurisdiction. The benefits that will result from these synergies will be used to eliminate and address some gaps in information related to policy decisions and to improve deadlines and to coverage with relevant information, while enhancing market transparency.



In the international aspect, the Bank of Albania continues to maintain fair and timely reporting of statistics, in accordance with the methodological and transmission standards (platforms) of the IMF, EUROSTAT, ECB. It is also receiving technical assistance from these institutions in the framework of improving the quality of statistics and their approximation to the international standards.



2.10 RESEARCH

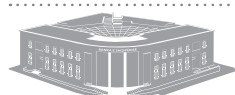
The Bank of Albania aims to base its decision-making process on sound foundation of a body of tested knowledge on the Albanian economy. Investment in creating solid research capacities contributes to improving Bank of Albania's reputation and credibility as an institution with advanced methodologies and the required knowledge for guaranteeing the country's macroeconomic equilibriums. Therefore, the active development of research assumes a primary role in the Bank of Albania's development strategy.

In 2017, research at the Bank of Albania focused mainly on the monetary policy objective, issues related to the preservation of financial stability and banking supervision, and the interaction between these objectives. In line with the mid-term research strategy, research has continued to support the decision-making process for drafting and implementing Bank of Albania's policies, developing new empirical analysis methodologies and enriching the portfolio of econometric models on which decision-making is based.

In the framework of modelling the economy, as a very important aspect of research, two new econometric models have been developed: DSGE and BVAR, which reflect the characteristics of the Albanian economy and aim to support the monetary policy decision-making process. The DSGE model aims to improve the Bank's macroeconomic discussions and analyses by identifying various sources of structural shocks and forecasting and assessing key macroeconomic indicators. Meanwhile, the BVAR model, a relatively easy to use model and less expensive in maintenance, but efficient in forecasting key economic indicators, is intended to serve as a comparative model to assess the forecasting performance of the DSGE model or more complex models of the Bank.

In the area of financial stability, empirical estimates show that banks' behaviour towards increased competition has been essential to boosting banks' stability after the financial crisis. This correlation has been stronger in the case of smaller banks. The results also show that the correlation between the banking concentration and the stability indicator is negative, meaning that the full-fledged competition should be the desired market structure to further boost banks' stability, as a weaker bank power to control the market during crisis periods can simultaneously bring greater stability in the Albanian banking sector.

The development of the banking system is considered to be important for the country's economic development, both in the long and in the short term.



However, it is noticed that bank crediting has not been very efficient and is fragmented, focused only on some sectors of the market. Commercial banks have pursued relatively cautious lending policies, positively affecting the stability of the banking system. On the other hand, empirical estimates suggest that mitigating monetary policy of lowering the key interest rate at record levels may have adversely affected the profitability of banks, especially of smaller banks.

Concerning the external sector of the economy, studies find that the establishment of the prices of Albanian exports is almost equally influenced by domestic and foreign factors. These findings suggest that our exporters, even though only a few in the international market, have a certain impact on price negotiation. Meanwhile, importers of goods are more sensitive, as the international price performance and exchange rate fluctuations affect around 70% of the import price performance.

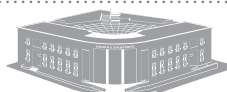
Studies and research projects with micro data are focused on assessing the consumption of Albanian households; assessment of financial and borrowing status of microeconomic enterprises; inclusion and access to finance and banking products; assessment of salary scale flexibility in Albania; they are also engaged in new projects with "large" data, analysis of the "financial inclusion" situation, etc.

Using micro data that cover 17,000 Albanian households from the Living Standards Measurement Survey (LSMS) in 2002-2012, estimates show that consumption of Albanian households responds positively to changes in income and real estate (measured by real value of the real estate they own). However, this response is not homogeneous, as the marginal ratio of consumption to income and the value of real estate varies depending on the age of the head of the family and household fragility.

The survey conducted on the assessment of the financial and borrowing situation of microeconomic enterprises in the agricultural sector states the low level of financial inclusion of this sector, which has a significant share in the gross value added as well as in the number of employees. According to the respondents, access to finance and the cost of providing banking products is ranked as the third most concerning problem after unfair competition and finding a market for their products.

Also, during 2017, the Big Data project was initiated, driven by new developments in research technologies in other central banks. In cooperation with the Bank of Italy, the Research Department undertook the first steps for the recognition and evaluation of "large data" analyses, intended to be used at the Bank of Albania for the evaluation of certain economic and financial indicators.

Another important analytical aspect was the attempt to assess the "financial inclusion" situation in Albania. FINDEX data analysis shows a relatively low level of financial inclusion in Albania. This environment inhibits further financial



development, while improving financial inclusion may require a clear and comprehensive formal strategy, which should provide co-ordinate resources and actions that promote the inclusion of the population in the financial system. These and other studies have become the subject of discussion in the activities and conferences organized by the Bank of Albania or other institutions, where comments and observations have been provided for their further improvement, before being put forward for decision making at the Bank of Albania. In this context, for the 11th consecutive year, the Bank of Albania organized the South-Eastern European Economic Research Workshop on 4-5 December 2017. The Workshop serves as a tool for presenting and discussing research work among researchers, academics and policy-makers to contribute towards deepening economic research as well as to expand knowledge on certain features of economic development and research methodologies. This year, 25 studies were presented by the central banks of the countries of the region, such as Italy, Greece, Kosovo and Macedonia, as well as academic institutions such as LUISS Guido Carli University in Italy, University of Orléans in France, and Rovira of Virgili University in Spain. The important topics were the assessment of various aspects of monetary policy, fiscal policy and central banking, financial stability assessment, various aspects of international trade and analysis of macroeconomic models.

The Bank of Albania's official website, under the category "Publications/ Research", contains more detailed and complete information on all Bank of Albania's research works. Other research works are published in the form of articles in the Economic Review of the Bank of Albania. A half yearly magazine "The Research Newsletter", aims at informing about recently completed or on-going study papers, materials presented in the "Friday Seminars" or other activities organized by the Bank of Albania.

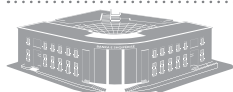
SOME RESEARCH MATERIALS PREPARED THROUGHOUT THE YEAR

During 2017, a series of studies and articles were prepared which aimed to explore the features of the functioning of the country's economy and the banking system. The results of this research work serve to improve economic and financial analysis and to provide a more solid grounding for decision-making. The focus of these studies and empirical analysis was on topics regarding the monetary policy objective, financial stability and supervision, interaction between these objectives, monetary operations, and so on. Below we will briefly present some of the scientific materials prepared during 2017.

Financial Development and Economic Growth - new evidence for Albania

Authors: Gent Sejko, Elona Dushku

The study re-evaluates the long-term relationship between financial development and economic growth in Albania over the period 2002-2016, based on the vector error correction model (VECM) error vector and the Granger tests. Estimates confirm a positive and statistically significant relationship between



financial development and long-term growth. This connection is also confirmed in the short term. Empirical results show that not only macroeconomic developments positively impact banking sector developments but also financial development positively impact economic growth, proving the dual cause relationship between these two indicators.

Banking stability and competitiveness - evidence from the Albanian banking system

Author: Gerti Shijaku

The main purpose of banking prudence regulations to reduce bank risk incentives often coincides with the restriction of competition between banks, although many theoretical and empirical studies argue that in fact the increase in competition leads to lower levels of bank risks. This study analyses the dynamic link between competition and Albanian banking stability over the period 2008-2015. The results strongly support the view of "competitiveness - stability" after global financial crises - that the highest degree of competition improves the stability of banks. Greater concentration also has a negative impact on the stability of banks.

A Model with Autoregressive Vectors for the Albanian Economy

Authors: Ilir Vika, Meri Papavangjeli

This project aims to build a relatively simplified model for the Albanian economy, which is more driven by data than by the transformations resulting from the theoretical views. Such a model is easier to use and less costly in maintenance, and would therefore serve as a comparative benchmark with the projections and analyses generated by other more complex templates currently used. Preliminary evidence provides lasting results. Evaluation according to the Bayesian method improves the predictive power of the model with autoregressive vectors, hence the ongoing work will focus on the use of this technique.

Has the global crisis changed the monetary transmission mechanism in Albania? An application of the probability density evaluation technique

Authors: Altin Tanku, Kliti Ceca

This study analyses the hypothesis that the relationship between interest rate, currency and inflation has changed in the post-crisis period for the case of Albania. The paper uses probability density estimation techniques, based on Tanku and Ceca (2013), as an alternative method of empirical evaluation. Two-dimensional inflation, money and interest rates are estimated for two different periods: before and after the crisis.

An estimate of the marginal trend for consumption of income and real property for Albanian households

Authors: Elona Dushku, Ola Çami

Using micro data that cover 17,000 Albanian households from the LSMS in the period 2002-2012, this study aims to assess the extent to which household consumption responds to changes in income and real wealth. Empirical results suggest a positive relationship between income and consumption change and change in real wealth and consumption.

Price effects according to the market in Albania: how competitive is the foreign sector?

Authors: Ilir Vika, Arlind Rama

This study examines the effects of price according to the-market in the case of Albania and contributes to improving the external sector specification in macroeconomic models for the Albanian economy. The analysis focuses on Albania's trade relationship with the Eurozone, where import and export prices



of goods are directly explained by two factors: the international environment and domestic costs. The econometric results suggest that price-by-market effects are important in determining foreign trade prices in the case of Albania. These findings, in fact, reject the hypothesis or perception that small economies accept market-determined prices without negotiating power.

Potential output and growth, output and unemployment gap in Albania - Comparative Analysis of Recent Estimations- 2015

Authors: Evelina Çeliku, Enian Çela, Iris Metani

This research project aims to re-evaluate the results from the existing and new methods applied in the case of Albania for assessing potential output, natural unemployment rate and relevant gaps. It explains the dynamics in the Albanian economy that have influenced the potential growth and the trend of the natural unemployment rate. Estimates support mid-term projections and monetary policy decision-making. The material has not been published yet.

Evaluation of bank credit determinants in Central and South-eastern Europe

Authors: Sofika Note, Erjona Suljoti

This paper empirically evaluates the factors that have affected banks' lending activity in CESEE before and after the financial crisis. The obtained results show that economic growth, credit quality, financial intermediation rate, and together with foreign and domestic funding sources are the key determinants of credit growth. The credit contraction after the crisis is largely due to the lack of willingness to take risks, as well as the lowering of banks' external financing.

Euroisation drivers and effective policy response: An application to the case of Albania

Authors: Guido della Valle; Vasilika Kota; Romain M Veyrune; Ezequiel Cabezon; Shaoyu Guo

This material proposes a methodology for drafting de-euroization policies based on empirical and theoretical approaches. The material introduces for the first time an empirical assessment of the optimum level of euroization. The results show that euroization in Albania is above the optimal level, so it needs to be dealt with Euroization policies. In the long run, de-euroization requires maintaining a low and stable inflation rate under the terms of exchange rate flexibility. In the short term, policies addressing the risk of financial stability also contribute to de-euroization, making banking intercession in the euro less attractive to the public.

An Alternative to Measure the Clarity of the Monetary Policy Communication at the Bank of Albania: 2005-2016

Author: Evelina Çeliku

The article explores the clarity of Bank of Albania's communication on monetary policy inflation and decision-making during 2005-2016, using the Flesch-Kincaid (FK) grade level indicator. The results show a downward trend of FK, suggesting the development of a clearer monetary policy communication over the years.

Indicators of Early Warning of Systemic Banking Stress in Albania's Case

Author: Odeta Koçillari (Minka)

This material is primarily aimed at finding indicators of early warning of systemic stress in the Albanian banking sector, which may serve to the decision-making for the activation of certain macro prudential policies. The study concludes that the private sector credit gap ratio against GDP against its long-term trend, shows good warning skills accumulation of banking sector imbalances, which may cause future crises.



An assessment of the financial cycle for Albania**Authors: Vasilika Kota and Arisa Goxhaj (Saqe)**

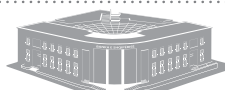
The assessment of the financial cycle and its various phases is important for building appropriate macro prudential policies and instruments aimed at mitigating systemic risk. This material has the main purpose to assess the financial cycle in Albania by creating a synthetic indicator as its potential gauge. The results show that the ratio of credit to GDP ratio, housing price index and credit growth rate are the best choice in building a synthetic index in measuring the financial cycle and that this cycle is positively correlated with periods of financial stress, which should be considered in policies that can be implemented.

The impact of low interest rates on the profitability of the banking system**Authors: Adela Bode, Meri Papavangjeli, Besa Vorpsi**

The decline of the key interest rate on the part of the Bank of Albania in recent years has made it necessary to investigate the impact of monetary policy on the profitability of banks. The material analyses the impact of monetary policy on net interest income through the investigation of a non-linear relationship between the two variables. The results suggest a significant concave link between the key interest rate and the net interest margin only for small banks, while for the bigger banks, the bond appears poorly. The study was presented at the XI European Economic Research Workshop of South Eastern Europe (4-5 December 2017).

The lower limit of the effective interest rate in euroized economies -the case of Albania**Authors: Guido della Valle; Erald Themeli; Romain M Veyrone; Ezequiel Cabezon; Shaoyu Guo**

This material proposes the creation of a framework for the assessment of the lower interest rate in small and euro-denominated economies, based on the experience of the Bank of Albania. It introduces a monitoring tool to identify the negative consequences of low interest rates. A high preference for banknotes encourages economic agents to demand higher deposit rates, raising the lower interest rate limit to zero. Financial euro-adoption brings the lower interest rate increase due to the higher currency substitution trend. Policies aimed at reducing financial euroization contribute to lowering the lowest interest rate limit.



2.11 EUROPEAN INTEGRATION AND INTERNATIONAL CO-OPERATION

European integration is a national objective. On 24 June 2014, Albania received the EU candidate status. On 9 November 2016, the European Commission recommended the conditional opening of accession negotiations. EC periodical reports have commended the contribution of the Bank of Albania towards maintaining macroeconomic stability, financial stability, improving supervisory practices and promoting market development and payment systems in Albania.

EUROPEAN INTEGRATION

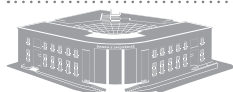
The Bank of Albania continued to contribute to the fulfilment of the obligations deriving from the Stabilization and Association Agreement, the Progress Report of the European Commission, participation in joint EU-Albania subcommittees and the National Plan for European Integration. It coordinates and prepares relevant reports related to Chapter 4, "Free Movement of Capital", and Chapter 17 "Economic and Monetary Policy". On the other hand, it is also contributing to six other chapters of the European Union *acquis*.

Throughout the year, the Bank of Albania has given its contribution for the timely and qualitative preparation of all the relevant documents described above, and has been an active member of all joint meetings between Albania and the European Commission.

The document "EU-Western Balkans Strategy: a credible enlargement perspective" confirms the will of the European Union for the further enlargement of the European family with SEE countries. More concretely, membership of these countries is assessed as an important geo-strategic investment for a stable, strong and united Europe based on common values. In the absence of the Progress Report, the most important document related to the prospects of EU accession was introduced by the European Commission in early 2018.

The document commends the progress achieved insofar and states that: "Albania is making significant progress on its European path and the Commission is ready to prepare recommendations to open accession negotiations, on the basis of fulfilled conditions."

At the same time, it should be noted that deepening economic reforms is vital for rapidly and effectively addressing structural weaknesses, like low competition and high unemployment rates.



In all joint meetings during 2017, Bank of Albania's contribution to preserving and further consolidating the macroeconomic and financial balances has been commended. The monetary policy pursued by the Bank of Albania is considered as adequate for the return of inflation to target and supporting the recovery of economic activity.

The Bank of Albania has continued to regularly follow the implementation of the Stabilization and Association Agreement as well as the National Plan for European Integration. It has participated in the Stabilization and Association Committee meetings, as well as in the meetings of the Subcommittee on Internal Market and Competition, and economic, financial and statistics issues.

In the context of foreign technical assistance, the Bank of Albania has continued its close cooperation with the representatives of the Directorate-General for Neighbourhood and Enlargement Negotiations to benefit under the Technical Assistance for and Information Exchange (TAIEX), a short-term assistance instrument. This instrument is provided by the European Union to assist candidate and potential candidate countries in knowing and approximating the legislation and standards with those of the EU.

For 2017, assistance within TAIEX focused mainly on approximation of the legislation in the fields of banking supervision, human resources, payment systems, document administration and electronic security system.

INTERNATIONAL COOPERATION

Relations with the International Monetary Fund

The Republic of Albania continues to stand in the SDR 139.3 million quotas and owns 2,858 votes or 0.06% of the total sum of the votes of all members of the IMF. It is in the same constituency with Italy, Greece, Portugal, Malta, and San Marino. This constituency has a total of 207,948 votes or around 4.13% of the total amount of votes of all members of the IMF.

In February 2017, the three-year agreement under the Extended Fund Facility (EFF) program for Albania aimed at boosting economic growth and controlling the rapidly rising public debt that had threatened economic stability. On 24 February, the Fund completed two final program reviews, which resulted in a disbursement of SDR 57.28 million (about EUR 73.2 million), bringing total disbursements to SDR 295.42 million (about EUR 377.3 million).

The completion of the three-year agreement closes an intensive co-operation chapter with the IMF. Currently, Albania will have normal monitoring and consultation relations with the IMF, like all other countries, in the context of discussions on Article IV. The latest consultations ended on 4 December 2017. According to the IMF Executive Board's statement, published on 13 December



2017,⁴⁶ "Albania's economy continues to strengthen, benefitting from rising domestic demand, large energy-related FDI, and a recovery in key EU trading partners. Fiscal and financial vulnerabilities have been lowered; however, challenges remain from the high level of public debt and financing needs, non-performing loans (NPLs), and institutional weaknesses that hinder investment. The clear government mandate following election victory in June, the favourable economic outlook, and the prospects for opening negotiation for EU accession provide a window of opportunity to resume implementing the reform agenda. Albania remains under Post-Program Monitoring."

The Bank of Albania has continued to benefit from IMF technical assistance. During 2017, in addition to the two long-term advisors, the Bank of Albania has been visited by several IMF missions to provide technical assistance and expertise in areas such as banking supervision, financial stability, statistics, monetary policy and accounting.

Relations with the World Bank Group

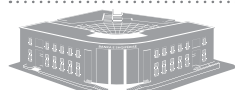
The World Bank Group supports Albania through the Partnership Framework covering the period 2015-2019, which aims to support Albania's aspirations for equal growth and integration into the European Union. Over the years, the World Bank Group has provided over \$ 2.2 billion in assistance to the country. Currently, nine projects amount to a total of USD 544 million under IDA loans and IBRD loans. Albania is in the same constituency as Greece, Italy, Portugal, Malta and Timor Leste.

In the framework of the "Reserves Advisory and Management Program" (RAMP), cooperation with the World Bank has continued for the annual training related to the needs of the Bank of Albania staff in order to maintain, consolidate and further increase professionalism of employees involved in reserve management.

The World Bank has also continued to fund staff participation in specialized education programs such as CFA (Chartered Financial Analyst), CIDA (Certified Investments and Derivatives Auditor) and PRM (Professional Risk Manager).

The Bank of Albania continued its cooperation with the World Bank in the framework of the implementation of the project "On measuring the cost of payment instruments". The project, which is based on the World Bank's methodology, aims to identify and measure all types of costs of various payment instruments used in the economy in order to create a strategy for reform and efficient development of the payments market. Following this cooperation, two other projects have been initiated, also aimed at promoting payment services from the perspective of remittances, as well as fostering public financial inclusion in these services.

⁴⁶ <https://www.imf.org/en/Publications/CR/Issues/2017/12/13/Albania-2017-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-45468>



Following the entry into force of the Law on Recovery and Resolution, the Bank of Albania has obtained WB assistance for the establishment of the Resolution Department and drafting relevant regulatory acts.

Relations with other international institutions

Throughout the past year, the Bank of Albania cooperated with central banks of the European Union, including with the Bank of Italy, in the framework of a bilateral agreement addressing a number of areas of central banking. It has also cooperated intensively with the central banks of France, the Netherlands, Germany and Poland.

Over the past year, cooperation with University of Oxford continued, culminating in the annual conference of the Bank of Albania on "Developments in the banking market and the infrastructure of financial markets. The role of structure, size and market infrastructure in risk mitigation and financial intermediation", 9 November 2017.

The Bank of Albania continued to co-operate with the FSVC, focusing on capacity building in the management of operational risk and of business continuity.

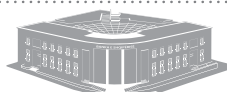
During 2017, cooperation with the Geneva Institute continued, with the support of the Secretariat for Economic Affairs of the Swiss State (SECO). This cooperation focused on research at the Bank of Albania in terms of better modelling and understanding long-term macroeconomic relations and interdependencies.

During the year, the Bank of Albania continued to maintain contacts with the European Bank for Reconstruction and Development (EBRD) in reviewing the regulation on capital adequacy and continued to be an active participant in all the training activities provided by the Centre for Financial Excellence, an institute specialized in economic and financial affairs of the South-east European countries.

PARTICIPATION IN INTERNATIONAL CONFERENCES, SEMINARS AND FORUMS

Following is a summary of international activities, attended by the Administrators of the Bank of Albania:

- On 16 January 2017, Governor Sejko attended a seminar organized by the National Bank of Austria and the World Bank on the presentation of the WB report on "Risks and Returns: Managing Financial Trade-offs for Inclusive Growth in Europe and Central Asia", Vienna, Austria.
- On 17 - 18 January 2017, First Deputy Governor Ms Gjoni attended



the Central and Eastern European Forum, organized by Euromoney Conferences in Vienna, Austria.

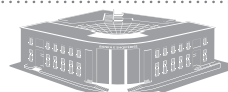
On 8 February 2017, Governor Sejko attended the Constituent Meeting of the International Monetary Fund and the World Bank Group, in Rome. This meeting aimed to discuss the latest developments in the global economy and other respective economies among governors and finance ministers of the member states of this constituency.

- On 6 March 2017, Second Deputy Governor Ms Ahmetaj attended the 9th meeting of the Vienna Initiative Forum, organized at the headquarters of the European Investment Bank in Luxembourg.
- On 9-11 May 2017, Governor Sejko attended the Annual Meeting of the European Bank for Reconstruction and Development (EBRD), "Targeting Green and Inclusive Growth - Meeting Regional and Global Challenges", Cyprus.
- On 23 May 2017, Second Deputy Governor Ms Ahmetaj attended the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey, in Brussels, Belgium.
- On 17-18 May 2017, Governor Sejko attended the Advisory Group Meeting and Annual Meetings of the European Fund for South Eastern Europe (EFSE) in Split, Croatia. This year marked the 10th annual meeting organized by EFSE. On this occasion, the conference focused on "Enabling financial inclusion, start-ups and entrepreneurship", and was attended by central bank governors and senior managers, EFSE representatives, and leading banking and microfinance industry executives, representatives of the business and media organisations.
- On 12 June 2017, Governor Sejko delivered a lecture at the South East European Studies Centre of the University of Oxford, London, on "Economic and financial challenges in South East Europe, and the role of the central bank as guardian of price and financial stability.
- On 16 June 2017, Governor Sejko attended the annual summit of regional countries on "Regional financial stability in a new global environment", Bečići, Montenegro, which was attended by the central bank governors of Montenegro, Macedonia, Bosnia and Herzegovina, Croatia, and the deputy governors of the central banks of Kosovo and Slovenia, as well as finance ministers and tax directors from the countries of the region. This summit addressed the latest developments in the economies of the region and the steps to be taken to ensure sustainable economic growth.
- On 10-11 July 2017, Governor Sejko attended the High Level



Conference "Re-accelerating convergence in Central, Eastern and South-Eastern Europe - The Role of Governance and Institutions" organized by the Croatian National Bank and the International Monetary Fund in Dubrovnik, Croatia.

- On October 5, 2017, Governor Sejko attended the 7th Conference on Central, Eastern and South Eastern European countries (CESEE) on "Institutional Quality and Sustainable Economic Convergence" organized by the European Central Bank (ECB) in Frankfurt, Germany.
- Annual and Spring Meetings of the International Monetary Fund and the World Bank Group, in Washington DC, in April and October 2017, where the Bank of Albania was represented by Governor Sejko, First Deputy Governor Gjoni and other senior officials.
- 37th and 38th Meetings of the Governors' Club of Central Asia, Black Sea region and Balkan countries in April 2017 in Antalya, Turkey and in September 2017 in Moscow, Russia.



2.12 TRANSPARENCY AND COMMUNICATION WITH PUBLIC

Public communication is an important aspect in the Bank of Albania's activity, for fulfilling the obligation to provide maximum transparency of the decision-making and its effectiveness, as well for achieving the permanent objective of increasing confidence in it. In this framework, interactive communication with the public is a primary issue of strategic importance to the Bank of Albania, to transmit its monetary policy directly and comprehensively to the public.

AN OPEN AND TRANSPARENT CENTRAL BANK

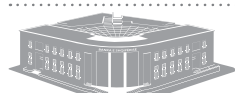
Beyond the legal obligations, the Bank of Albania communicates to the public a variety of information about its role and activity, from the decision-making of the Supervisory Council to its daily operational activity. This transparent communication helps to increase the effectiveness of the policies pursued by the Bank of Albania, enabling the public to understand timely and properly the decisions taken by the Bank and in order to evaluate them fairly.

In this context, the Bank of Albania uses a variety of communication channels, in order to explain the role and its main objective more clearly, to maintain price stability as well as the way of its realisation.

The Monetary Policy strategy is based on a defined decision-making cycle in an annual calendar of 8 meetings of the Supervisory Council. A press conference with the Governor is held after each meeting to explain to the public the decision taken by the Supervisory Council and the analysis used to corroborate this decision. Relevant press conferences were organized in response to this cycle, in 2017, during which the Governor has responded to the media interest on various issues related to the Bank of Albania. In 2017, press conferences were followed by the publication of the Governor's speeches, and the related Q&A in Albanian and in English.

Also, during 2017, after each meeting, a brief summary of key decisions taken by the Supervisory Council of the Bank of Albania was published. All public decisions of the Supervisory Council were fully published in the Official Bulletin of the Bank of Albania, in 9 editions of this publication.

In addition to monetary policy decision-making, the Bank of Albania publishes comprehensive information also in the area of banking supervision and financial stability, notably the Annual Supervision Report and the Financial



Stability Report, which analyse the important developments of the financial system during one half-year period and evidences the factors that represent systemic risk.

The Bank of Albania's communication is complemented continuously and in real time with a series of surveys, analyses, data, and assessments of Bank of Albania's opinions on the country's macroeconomic situation and the role of the Bank in supporting financial stability. During 2017, the activity of the Bank of Albania was communicated to the public mainly through 122 press releases, speeches, interviews and TV shows.

Communication with the public is tailored according to the interest, academic level and professional level of targeted groups by the Bank of Albania, among which, media has an important role. In this framework, the media is continuously informed and sensitized on issues related to BoA and on economic and financial performance of Albania. Also, during 2017, media communication continued through press conferences, speeches, presentations and lectures in activities organized by the Bank of Albania or other domestic and foreign institutions, dedicated interviews or participation in TV shows, expression of positions on specific issues of interest to the Bank of Albania or other public activities of the Governor and other representatives of the Bank. During this year, 7 of its periodic reports were presented "off-the-records" to the media. These meetings aim to guide the media for a correct understanding of the decision-making of the Bank of Albania and are seen as effective means of communication with the public.

In order to increase interaction with the public, in 2017 we have added digital communication through social networks such as Twitter (information), YouTube (video) and Flickr (photo), transmitting the Bank of Albania's general activity to the public, in real time.

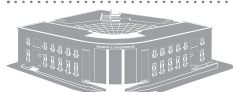
ACTIVITIES IN ALBANIA

- On 2 February 2017, under the auspices of the Second Deputy Governor, Ms Natasha Ahmetaj, the Bank of Albania, in cooperation with the World Bank, organized the workshop on "Financial system in Albania - From 2025 scenarios, to action today". The workshop was conceived as a dynamic discussion platform to exchange views on challenges, identify and manage risks, test different strategies, bringing the future to day-to-day thinking.
- On 15 February 2017, on the initiative and under the auspices of the Governor of the Bank of Albania, Mr Gent Sejko, a discussion meeting was held between the Bank of Albania and the Executive Committee of the Albanian Association of Banks. The main purpose of this meeting was to intensify the dialogue and cooperation between the Bank of



Albania, the Albanian Association of Banks and commercial banks operating in Albania, on issues particularly related to the security of conducting the banking activity, the transport of monetary values, and to discuss the financial, lending and operational activity of the banking system.

- On 4-5 May 2017, the Bank of Albania, in cooperation with the International Monetary Fund, and sponsored by the Swiss State Secretariat for Economic Affairs, Economic Cooperation and Development (SECO), organized the conference "Negative Euro Area Interest Rates and Spillovers on Western Balkan Central Bank Policies and Instruments". Participants attending this conference were senior officials Western Balkan central banks, including the central banks of Bosnia and Herzegovina, Kosovo, the Republic of Macedonia, Serbia; European Central Bank; other European central banks, including Bulgaria, Croatia, Hungary, Romania; the Swiss National Bank, the Bank for International Settlements (BIS) and representatives of the academy.
- The National Payments System Committee held its third meeting on 9 May 2017, chaired by the First Deputy Governor of the Bank of Albania, Ms Elisabeta Gjoni, who also chairs this Committee. The purpose of this Committee is to support and contribute to enhancing the security, stability and efficiency of the national payment system in Albania. Beyond the advisory role, the Committee aims to facilitate the implementation of measures of the relevant authorities by fostering cooperation.
- On 5 September 2017, the Bank of Albania organized the workshop "Factoring in Albania", in cooperation with the European Bank for Reconstruction and Development. The purpose of this workshop was to help banks and financial institutions become aware of the advantages of expanding the factoring service in Albania as an opportunity to finance business, especially small and medium-sized enterprises.
- On 6 November 2017, the Governor of the Bank of Albania, Mr Gent Sejko hosted, in an official visit to the Bank of Albania, the Governor of the Central Bank of the Republic of Turkey, Mr Murat Çetinkaya. During this visit, a Memorandum of Cooperation was signed, which aims to foster cooperation between the two central banks.
- On 9 November 2017, the Bank of Albania, in co-operation with the South East European Studies Centre of the University of Oxford, held its annual conference on "Banking developments and financial market infrastructure." "The role of structure, size and market infrastructure in risks mitigation and financial intermediation" This conference was organized in three sessions, with welcoming addresses by the President of the Republic of Albania, Mr Ilir Meta, the Governor of the Bank of Albania, Mr Gent Sejko, the Minister of Finance and Economy, Mr Arben Ahmetaj and the Director of the South East European Studies Centre at Oxford University, Mr Othon Anastasakis.
- On 4-5 December 2017, the Bank of Albania organized the 11th South-east European Economic Research Workshop. This workshop aims to encourage discussion and promote economic research, as well as regional cooperation in Southeast Europe. The event was attended by representatives of the central banks of the region, academics from



universities and international financial institutions as well as experts from the Bank of Albania.

- On 11 December 2017, a high level meeting was held between the Bank of Albania, the Minister of State for Diaspora, commercial banks and non-bank financial institutions conducting monetary transfer operations. At the end of this meeting, a Memorandum of Understanding between the Bank of Albania, the Minister of State for Diaspora and the Ministry of Finance and Economy was signed. This Memorandum aimed at raising the awareness, facilitating dialogue and fostering effective cooperation between the parties on issues related to the contribution of remittances by Albanian emigrants for the development of the economy.
- On 15 December 2017, Governor Sejko met with the journalists of print and electronic media, economic analysts, managers and other media representatives in Albania. During this activity, the winners of "The Governor's Award for Best Diploma for 2017" were announced. This annual event is dedicated to Albanian students graduated this year in Albania and abroad, for scientific research on issues related to international monetary economics, price and financial stability, economic integration, etc.

A RESPONSIBLE AND ACCOUNTABLE CENTRAL BANK

The Bank of Albania aims to inform citizens, and in particular the Parliament, on all its activities.

Institutional relations with the Parliament are held in several directions. Governor's hearing sessions in the Parliamentary Commission of Economy and Finance are the most significant ones. Like every year, in May 2017, the Governor presented the Annual Report of the Bank of Albania to this Commission, responding to the MPs' interest in specific issues related to it. During 2017, the Governor presented a public hearing in November, dedicated to the Bank of Albania's opinion on the main points of the draft state budget for the following year 2018.

Citizens can find comprehensive and up-to-date information on the economic and financial situation and the country's key macroeconomic developments, as well as the role of the Bank of Albania's contribution in this regard, on the official website www.bankofalbania.org. During 2017, the website had about 960 thousand visitors who checked our page around 2.800.000 times and browsed in total about 5.300.000 sections.

Our website is constantly enriched with a broad statistics system for many sector of the Albanian economy, such as: banking sector, fiscal sector, real sector and external sector, which are published according to a defined schedule



that is updated semi-annually. Bank of Albania's statistics are also found in the monthly statistical reports and in quarterly monetary policy reports.

This site also offers all publications of the Bank of Albania, which summarize updated information on the Albanian and world's economy; on developments in the banking and financial system; financial stability and money; changes and enrichments of banking legislation and its regulatory framework; as well as on other issues, thus consolidating as a source of accurate and reliable information to the public.

As the website is one of the main means of communication with the general public and all interest groups, the Bank of Albania has undertaken the project of redesigning this site during 2017. This project aims to improve quality, visual appearance and facilitate its use, which will help to forward the Bank of Albania's philosophy and communication. The new website will be launched within the first quarter of 2018.

Periodic and non-periodic publications, in 2017, consisted of about 3400 pages of analyses, statistics and research in both Albanian and English. The set of periodic reports was the same as in the previous year: Annual Report, Quarterly Monetary Policy Report, Financial Stability Report (semi-annual) and Annual Supervision Report. In addition to the periodical reports, this range is further enriched with the Official Bulletin (depending on the Supervisory Council meetings), the Economics Magazine (half-yearly), the "Research Newsletter" at the Bank of Albania" (half-yearly), the Annual Conference Book 2016. This year, "Central Banking" magazine has been added to the series of publications, which summarizes all of the activities of the Bank of Albania's through which economic and financial policy decision-making has passed during a six-month period. It also reflects the most important moments related to the supervisory activity, the operational one, the educational role, the social and cultural contribution, and the Bank's activity dedicated to the promotion of national values.

During 2017, the Bank of Albania continued to free distribute of all its publications, taking into account the social responsibility regarding reducing paper publication.

In order to inform the public, the Bank of Albania informs its citizens in writing or in electronic form, depending on how they want to receive this information. During 2017, 177 official requests were sent to the coordinator for the right of information and about 180 e-mails to the general electronic address of the Bank of Albania.



2.13 PUBLIC EDUCATION AND THE MUSEUM OF THE BANK OF ALBANIA

The vast majority of modern central banks pay special attention and resources to the financial and economic education of the public. This is because an informed public is more likely to understand and accept the complex decisions the Central Bank takes. Investing in the financial culture of the general public helps central banks increase the effectiveness of monetary policy, to build and operate through efficient mechanisms of its economic decisions. Such a culture helps consumers, producers and investors make wise financial decisions, and the central bank can achieve its objective more easily.

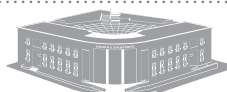
For more than a decade, the Bank of Albania has been engaged in expanding and deepening the financial culture of the public in the country, especially that of the younger generation. Two are the main goals of the programmes, activities and special educational publications prepared by the Bank of Albania: presenting the central bank, its functions and role to the public; and cultivating and strengthening financial literacy in the society. Public education was seen by the Bank of Albania as an opportunity to ensure an adequate environment for the development of its activity; as a necessity to establish the basis for developing an interactive communication with the public; as an irreplaceable tool in view of increasing its reputation and credibility from the public and as an efficient way of increasing the transparency and accountability it intends to transmit.

In order to fulfil the objective of increasing financial literacy in Albania during 2017, the work to educate the public in several directions has continued, such as:

The Museum of the Bank of Albania - The Museum of the Bank of Albania is not only a museum with numismatic information but it also serves for the distribution of financial knowledge to its visitors through educational publications, audio-visual materials and presentations on topics related to central banking and finances for the groups of pupils and students who visit it.

Educational publications - the distribution of educational textbooks: "Personal finance in your hands" continued during 2017 in 10 high schools (in total 1990 textbooks). On the other hand, the distribution of brochures and educational materials prepared in previous years has continued too.

Global Money Week - On 27 March 2017, the Bank of Albania launched the Money Week (March 27 - April 2, 2017), a worldwide holiday celebration



aimed at raising the awareness of the new generation to be future responsible and financially capable citizens.

The Bank of Albania participated for the fourth time in this celebration, in cooperation with the Albanian Association of Banks, with the support of the Ministry of Education and Sports, the Deposit Insurance Agency (ASD), the Junior Achievement (JA) and the National Youth Service (NES), organized educational and awareness activities, including directly around 2200 children and young people.

Educational activities of the Week of Money in Albania include: lectures for university students held by the Governor and Bank of Albania, school and television competitions, visits to the Museum of the Bank of Albania and commercial banks, theatrical performances and educational exhibitions with paintings for children.

The Facebook web page of the Bank of Albania - Created in 2014, with the purpose of promoting and cultivating a financial culture, the Bank of Albania website on Face book has served as another way of approaching the public, mainly the youngest in age. During 2017, about 125 posts were published to acquaint the public with educational material, numismatic curiosities, activities and publications of the Bank, reaching over 11,000 followers

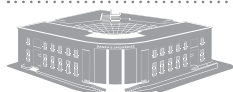
THE MUSEUM OF THE BANK OF ALBANIA

The Bank of Albania Museum was inaugurated on 30 October 2015. It is located within the central bank building in the capital's main square and extends into two floors, each of which is conceived as an independent space from one another.

On the first floor, where the Treasury Room is located or otherwise known as "Rondo", is presented the rich numismatic collection of the Bank of Albania. Visitors can get to know the historical and numismatic values that the coin has, through treasury exhibits, collections of coins and banknotes that have been circulated and used in the country's historic territories, from antiquity to the present day.

The second floor presents the history of the central bank institution in Albania, its role in maintaining price stability and guaranteeing the financial stability of the country, as well as constitutional functions. With a particular focus on public education, its second floor also serves as an information centre where visitors can be interactively informed, as well as develop lessons, lectures or other didactic activities in the field of money and economy.

During 2017, the Bank of Albania Museum was visited by 3248 visitors compared to 2103 visitors during 2016.



HIGHLIGHTS OF THE MUSEUM OF THE BANK OF ALBANIA IN 2017

Each year, the Museum of the Bank of Albania organizes activities to attract new visitors and increase cooperation with scholars, academics, museums and other institutions, as well as specialized institutions in economic, historical and cultural heritage research.

For 2017, the Museum organised the following activities:

1. Treasury curiosities: The Art of the Albanian Banknote”.

On 18 May 2017, within the framework of the International Museum Day, the Museum of the Bank of Albania organized a lecture titled “Treasury curiosities: The Art of the Albanian Banknote”. The activity continued with a temporary exhibition of sketches, drawings and auxiliary materials used for designing Albanian banknotes and sketches and other works by students of the University of Arts related to the banknote.

2. International Conference “Money and banking in Albania, from antiquity to the present day”

The first conference of the Museum of the Bank of Albania was organized on 14-15 June 2017 on “Money and banking in Albania from antiquity to modern times.” The first day of the conference brought together historians, numismatists, archaeologists and researchers of monetary and economic history to present and discuss the findings of their studies in the fields of monetary production and circulation, economic history and banking development in our country, from antiquity to our day. The event was organized in four sessions in which 20 studies were presented. The second day of this conference focused on the educational role of museums of central banks in knowing the history of money, banking and on enhancing financial literacy through exhibitions, education and innovation, bringing together experts from seven museums of central banks in the region.

3. “Museum Nights” lectures

The “Museum Nights” lectures co-ordinate and integrate knowledge about the currency at the exhibition of the Museum of the Bank of Albania with information found in archives, libraries, private collections or exhibited through architecture, sculpture, visual arts and pictures across other museums in the country. Lectures are followed by visits to the Museum.

The first lecture was held by Mr Artan Lame, on “Currency circulation in Albania during the Ottoman Period”, 30 October 2017. The lecture addressed the Ottoman currency, from its introduction in the XIV cent. until the Tanzimat Reforms in XIX cent., characteristics and types of the currencies that circulated in Albanian territories.” The lecture also focused on the circulation of European currencies in Albanian territories before and during the use of the Ottoman currency.

The second lecture of the “Museum Nights” was delivered by Prof. Dr Nevila Nika, UET, on: “Archive: the bank of memory”, 20 November 2017. The lecturer referred to the archives as a unique legacy that passes from one generation to the other, as well as on the essential role they play in developing societies as they preserve and contribute to individual and collective memory.

