Bank of Albania

BANKING DEVELOPMENTS AND FINANCIAL MARKET INFRASTRUCTURE

THE ROLE OF STRUCTURE, SIZE AND MARKET INFRASTRUCTURE IN RISK MITIGATION AND FINANCIAL INTERMEDIATION

Conference jointly organized by the Bank of Albania and South East European Studies at Oxford (SEESOX), University of Oxford
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Responsibility for the information and views set out in these presentations lies entirely with the authors.

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WELCOME ADDRESS

*Gent Sejko**

Your Excellency Mr President,
Your Excellency Minister Ahmetaj,
Dear Prof. Anastasakis,
Honourable Governors,
Your Excellencies Ambassadors, dear guests and participants,

I would like to warmly welcome you to the Annual Conference of the Bank of Albania. For almost two decades, the Conference has become a prevalent event in the research and professional activity of the bank. Our analyses and conclusions, over the years, have endeavoured to respond to many challenges and dilemmas for our national economy and beyond. Thanks to the cooperation with the University of Oxford, more specifically with St. Anthony's College, this conference has aimed, and I believe it has succeeded in doing so, at exploring and providing answers for a number of issues, which, given their nature, effect and interconnection, are present across the region of South East Europe.

The theme of this year focuses on similar issues. During the day, national and international experts on economy and finance, as well as academics, will analyse the latest trends and developments in the

* *Gent Sejko, Governor of the Bank of Albania*

financial sector in the region, focusing on potential implications on the macroeconomic equilibrium and financial stability of each economy. The theme of the conference is relevant to both current and future developments. From the international perspective, it seems that the overall situation is increasingly more supportive. Advanced economies, together with large emerging economies are in a phase of full recovery, underpinned mainly by the boost in aggregate demand. Interestingly, the euro area, which includes most of our trading partners, is experiencing an overall positive momentum concerning economic growth, and forecasts are optimistic.

There is a broad consensus that the economies of the South East Europe region, in the first half of 2017, registered a satisfactory performance in terms of recovery; in the meantime, according to key indicators, such performance is expected to strengthen further in the third quarter of this year. Albania is no exception to the regional context.

In the previous quarter, the economic and financial situation in Albania was set on a path of constant improvement. Growth and employment indicators followed an upward curve and expectations for 2018 remain positive. Consumption and foreign investments have contributed positively to economic activity and are expected to generate a further increase in productivity and competitiveness. At the same time, income from the export of goods, and especially of services contributed to the reduction of the current deficit and the strengthening of the external position of the economy. The effects of the monetary policy have maintained a stimulating trend, aiming at closing the negative gaps of prices and output.

Financial stability is also characterised by a positive situation. The notable decline in non-performing loans in the balance sheet of the banking system is the most prominent achievement in this aspect. The measures taken in mid-2016 have produced a substantial effect, materialised in the reduction of non-performing loans by around 10 percentage points, below the maximum level registered in 2015. It is always a pleasure to note that credit growth has been positive. In particular, lek credit has grown rapidly compared to foreign currency credit, which makes the banking system and the private sector healthier, and enhances the effectiveness of the Bank of

Albania's monetary policy. Positive developments in the banking sector and the economy have supported the further improvement of capitalisation, liquidity and profitability indicators. Two months from the end of the year, in our assessment, the banking industry in Albania enjoys full financial soundness, against the backdrop of an optimal liquidity and capitalisation situation, a key prerequisite for financially supporting the economic developments of the country.

We have also paid particular attention to legal, institutional, regulatory and supervisory developments, notably the drafting and implementation of the resolution law.

Dear participants,

This year marked 25 years since the establishment of a two-tier system in Albania, which stipulates the banking system as the provider of financial and banking services in the economy, and the central bank as the administrator of the monetary policy and regulator and supervisor of the banking system. This first step was followed by other steps related to other segments of the financial market, such as the securities and capital markets, including the establishment of the relevant supervisory and regulatory institutions.

Initiatives in these aspects have promoted a constant expansion of the financial market, in terms of both diverse institutions and number of financial products and trading volumes. Yet, despite these developments, the financial system remains dominated by the banking system and relevant developments in it. The last financial stability report of the Bank of Albania states that banks account for around 90% of total financial system assets, equivalent to 92% of the GDP, whereas the rest of the financial sector shares only 10% of the financial system total assets.

Assessments and studies of the Bank of Albania, as well as comparative studies by third parties, particularly by the International Monetary Fund, show that the financial distribution and expansion in the Albanian financial market is close to the equilibrium, dictated by the Albanian economy and consumers. Moreover, financial intermediation indicators, as a percentage of the Gross Domestic

Product, are at similar levels to those in other countries of the region. The dominance of the banking segment has naturally led to a higher level of concentration of financial products and services in its favour. More than 80% of resident investments in the financial system are in the form of deposits and current accounts in banks. Only little more than 12% are in the form of government securities, whereas the rest, around 6.5%, are invested in investment or private pension funds, accounting for only 0.1% of total financial system assets. Statistics show that only a small number of companies operate in other segments of the financial sector, and their activity in terms of domestic product or of the financial market remains insignificant.

Regarding the above, we may logically conclude that the financial market architecture may not be considered complete yet. Financial instruments with long-term maturities are rare, whereas the short-term ones outside the banking system are apathetic and fragmented, in terms of both products and markets. An outcome of such a financial architecture is a kind of added pressure on the banking system, depriving the economy of other financing alternatives, beyond what the banks offer.

This vacuum may not be filled with strained efforts by the banking system. It has been broadly accepted that each segment of the financial market plays a complementary rather than substituting role. I could mention a number of examples to illustrate my point, but for the moment I would rather not, as in the upcoming panels these issues will be discussed in greater detail by other colleagues and academics today.

Overall, the above elaboration regards investment-related financial institutions and financial instruments. However, it must be noted that similar problems characterise the other extreme of the financial market, the corporate - or enterprises sector - as we call it in Albania. Bank of Albania surveys show that micro units face a shortage of financial resources and have limited access to credit. Thus, more than 1/3 of respondent enterprises consider the low level of access to finance and the cost related to it as the main cause for not expanding their activity. These micro units, which are basically family-run businesses, have a greater need to cooperate with non-bank financial institutions, due to the difficulties they experience in fulfilling the requirements for collateral or detailed financial documentation -

criteria that banks require. This is another argument that leads to the logical conclusion that, in addition to their own capital and bank credit, these enterprises would benefit greatly from other segments of the financial market.

The low level of financial inclusion of the population is another element that prevents the deepening and expansion of the financial market in Albania. The latest data from the World Development Indicators show that only 38% of adults have an account with a financial institution, while only 6% and 22% of adults have a credit card and a debit card, respectively. Financial inclusion may not only be increased through the banking system. The financial system, especially the capital market and the corporate securities market, should play a significant role in increasing financial inclusion.

I take this opportunity to emphasise that, in addition to the need for expanding and deepening the financial market, it is necessary to increasingly pay attention to the management of risk that accompanies any financial investment. We are witnesses of a rapid technological evolution, which has practically eliminated physical boundaries, has eased access to electronic investment platforms, and has rendered very difficult the supervision and regulation of many innovative financial instruments that are traded in these platforms. The phenomenon of informality coupled with the speed of innovation in the field of financial instruments represents a real risk for every investor that is naively driven by profit, and does not stop to analyse the magnitude and nature of risk to which he is exposed. Anyhow, inclusion should take place carefully, relying on specialised financial intermediaries and auxiliaries, whose activity is regulated and supervised by a legitimate authority in Albania or abroad.

Dear participants,

The depth and expansion of the financial markets determines the set of financial instruments eligible for trading in a broad spectrum, from the maturity perspective. These instruments are nothing more than consecutive steps in the monetary policy decisions pass-through mechanism. The whole process of instrument trading serves to determine the value of assets, the price of risk and savings,

and, eventually, the propensity toward consumption, savings or investments. In this sense, the existence, completeness, and effectiveness of the financial market play a significant role in the monetary policy pass-through. This is the reason why the central bank places its focus on these markets and on their proper functioning.
Based on these specific reasons, the Bank of Albania initiated, time ago, a series of actions for creating a more dynamic financial market. The macro-prudential measures taken with regard to liquidity and capitalisation; limitations placed on positions with non-resident banks, provisions and collateral; and the package of measures for reducing non-performing loans were all steps taken to remedy problems related to the shallowness and narrowness of the market, the low financial inclusion, and the inadequate financial education.

Studies and analyses of the Bank of Albania support the logical conclusion that the development of the financial market is an important factor for boosting economic activity and enhancing welfare in general. At the Bank of Albania, we believe that the current structure of the banking market promotes competition in relation to banking products and services. However, the further expansion and deepening of the market is a present challenge for all the relevant actors involved. The banking industry, the Bank of Albania, other segments of the financial market as both as actors and as regulators, the government, academia and experts of the field, should be all involved in this effort. Our ambitions should aim at developing a dynamic and liquid financial market, with upward trading volumes, and a widening spectrum of instruments, including a prolongation of maturity horizons and prudent risk management. This framework should be accompanied by added transparency in all the phases of trading, with financial education assuming a special place. Only in this way would we be able to deepen and expand, in real terms, the financial market, and through it attain a higher efficiency in implementing economic and financial policies, in mobilising and using national savings, in financial inclusion, in economic activity growth, and in enhancing the welfare of the population in the long run.

In the hope that the proceedings of this conference will be characterised by a fruitful exchange of ideas and views by the participants in this room, I thank you for your attention!

WELCOME ADDRESS

*Othon Anastasakis**

Dear Governor,
Dear friends,

Every year, our partnership between SEESOX and the Bank of Albania grows stronger and stronger. Through the years, we have developed the right mechanisms of cooperation, which are second to none, including consistency in the goals and the objectives of the partnership, important milestones marked by annual conferences, workshops, panels and exchange visits, and high quality deliverables in the publication of books, opinion pieces and conference and workshop reports. The chemistry between our two institutions and our people and the friendship on personal level are unique.

Throughout our engagement, we have aimed at identifying yearly themes to give substance, purpose and energy to our partnership. The themes have varied, always keeping in mind the benefits of the banks' financial and monetary priorities, and SEESOX's political economy programme. So far, we have discussed the following issues through the years: the nature of the financial and Eurozone crisis and their impact in our region; the strategy for exit from crisis; the notion of reform including the agents of reform and the notion of resistance to

* *Othon Anastasakis, Director of South East European Studies at Oxford (SEESOX)*

reform; the concept of regional cooperation in South East Europe; the idea of the banking union and how this affects central banking; the impact of Brexit and the financial and monetary implications in the European environment; and this year, opportunities and risks in the post-crisis environment.

Our conferences have been consistent in their structure, composition and monitoring of yearly developments. Like today, we always aim for three sessions. The first session looks at the diagnosis of the contemporary situation and we always start with the current state of affairs given that every year brings new, interesting, and, at times, surprising developments. The second session tackles the banking and financial sectors head on, by discussing pertinent issues and ways to move forward. These two first sessions are composed by academics, scholars, policy-makers and bankers, and they give an interesting multidimensional and diverse look at issues and trends. The third session is always a session of central bankers from the region and beyond, and refers to the governors' perspectives but also on what is to be done. We always aim to end our conference with some final memorable points, which reflect our conference proceedings.

Each conference is always followed by a conference report, which comes roughly two months after the conference, and is a brief summary of presentations. The longer version of the conference comes out in a volume, which reproduces the edited versions of the conference presentations, with chapters and graphs.

So, as customary, this year we are happy to introduce, not just the start of the conference for today, but also the publication of two edited volumes from last year's conference. One from the Bank of Albania, which entails the conference proceedings in two languages, English and Albanian; and the SEESOX publication, which is part of our SEESOX series on current affairs and is available in electronic form, apart from hard copies.

The title of the book, "Aligning monetary policy with financial stability in uncertain times", is based on our conference, held at the same time last year, which took part in the aftermath of the Brexit vote, and which in my opinion is one of the most original points in the book, in that we were among the first to discuss here the impact of such an important development for Europe: the exodus of Britain from the EU.

This year, we are discussing risks and opportunities in the context of what we term as post-crisis, a more hopeful and optimistic environment, but where complacency, we believe, should be absent. This is why we are focusing on this in order to show that despite the more hopeful economic environment in Europe, with a stronger euro and a more encouraging Eurozone, there are significant risks that need to be taken into consideration, not only in drafting financial and monetary policies, but when thinking on the future, the banking union, the euro zone, and the EU in general.

I would like to thank, at this opportunity, the Governor of the Bank of Albania for his support and commitment to our partnership. We had the enormous pleasure of hosting him in Oxford last May for a really well-received keynote lecture, preceded by a tour of some of the city's and University's landmarks. I would like to thank Altin Tanku for his friendship, solidarity and warmth as a person through all these years from the beginning of our common journey. Also, Enri Herri for organizing this conference so diligently on behalf of the Bank of Albania and all those not mentioned who worked for the success of this conference here in Tirana, in order to make this conference really constructive.

I would like to thank, from Oxford, Adam Bennett, the coordinator of our political economy programme and Deputy Director of PEFM, with whom we have worked tirelessly all these years to bring about the Oxford contribution to this partnership. He will be chairing the next session. I would also like to thank Charles Enoch, who is a director of PEFM, the programme of financial markets in Oxford, and who could not be with us due to IMF commitments in Brazil, but sends his apologies and is, in a way, present as one of the editors of this volume. My thanks go to Jens Bastian, who has been a fellow and a visiting scholar at SEESOX in Oxford and with whom we have continuously worked on our political economy programme. I am very glad he is here with us today to deliver a talk and to chair the Governors' panel. I would like to thank Julie Adams with the

SEESOX administrators, she is in Oxford at the moment, but she is one of the pivotal persons to have this cooperation through. And also, I would like to thank the participants of the conference, all of them friends of SEESOX and the Bank of Albania, who have enthusiastically agreed to participate in today's event.

Such partnerships and events are not just opportunities at the private/public academic policy-making, country to country, inter-institutional, university/banks synergies. They are also opportunities to bring people together in a region which needs it, and most importantly, to make personal friendships that endure through time. I wish you all a fruitful conference in the tradition of excellence that we have established.

Thank you for your attention.

GREETING SPEECH

*Arben Ahmetaj**

Your Excellency Mr President,
Dear Mr Governor,
Dear ladies and gentlemen,

I would like to thank the Bank of Albania for this annual initiative and I notice with pleasure that a good part of this audience has been at this table in previous years as well, which makes it easy to share the experience of these years, all of us bearing witness to what happened, or what was prevented from happening, because governments, but also authorities, are judged the same in both cases.

I will not go back in time, but surely at this table we together shared the concern for the recovery of a collapsing economy in 2013. Each of you remembers that autumn of 2013, when the Greek scenario was not virtual at all for Albania, with all respect and no preconceptions for what the Greek citizens and governments did to prevent the crisis or mitigate it in time.

Beyond the public debt, which was concerning enough by itself, there was a mountain of undeclared debts to third parties, and a high level of non-performing loans, which in 2013 was around 25% of GDP (from 6.5 in 2008).

* *Arben Ahmetaj, Minister of Finance and Economy*

We stopped this infamous scenario from happening, which I repeat, many people said more than once was the most probable scenario for Albania at the time.

And we did not stop there.

It was a coordination of all forces, and of course, I must say that the Bank of Albania played its key role. So it was the coordination of all these forces and stakeholders that gave us the opportunity to undertake with success a difficult and ambitious programme of reforms aimed at macroeconomic stabilisation and fiscal consolidation.Since then, many of you have been following this process with us. Today we may also assess together the results of this continuous effort by all stakeholders to put the economy in the context of positive and tangible progress.

Today the Albanian economy is growing around 4 times more in relation to four years ago. We have forecasted an average growth of 4.5% during the second mandate, to reach 5.5% - 6% at the end of the mandate, a growth that is not simply quantitative, but becomes concrete, and tangible for citizens and Albanian enterprise.

We are optimistic and many may even accuse me excessive optimism, but after a very quick read of the presentation that Mr Bakker will make later, it turns out I am not the only optimist here. The International Monetary Fund is too, one of the rare cases when the Fund expresses direct optimism.

Thus, we are optimists not only because of our forecasts; we are optimistic first of all because of what we have done, reform after reform, which has proven to function and has rewarded the economy and citizens, and second, because a series of concrete projects in the primary sector will have an increased impact on the economy. The accelerating trend of the growth rate, already established since the Government took the reform agenda, is the best guarantee for the right path that the economy of the country is following.

Here I definitively want to emphasize a sentiment that we also share with Mr Bakker, with the International Monetary Fund; that the continuation of reforms is essential. Any slowdown of reforms will bring “reverse” processes that will return us to where we started 5 year ago.

The economic growth, as the Governor said as well, is supported by the growth of consumption and private investments. Both these to items have performed in very positive territory for several quarters. In 2016, Foreign Direct Investments reached the historical record of USD 1.1 billion. Moreover, we express the belief that our incentive policies and initiatives have to bring the economic activity closer to its potential level, and this will be reflected in the maintaining of the high level of investments in the economy in the medium-term as well.

And this, I must say, is a challenge for the government and the Albanian economic landscape, also because two major projects, TAP and Devoll, are in the final stage of investments and are entering into their operational phase.

One of the most positive aspects of the economic development of the last 4 years is also the answer of the employment market to economic growth. The participation of labour forces has increased to 66.8% while unemployment has decreased to 13.9% in 2017 Q2. There have been more than sixty-five thousand new jobs in 2016 alone. These are sixty-five thousand new jobs referring not only to the Institute of Statistics, but also to the balance sheet of the General Directorate of Taxes, i.e. payrolls.

All these economic developments have also been already reflected in enterprise and consumer confidence in the economy. ESI in 2016 Q4 reached its highest level in 10 years, standing 18.6 points above the long-term historical average. The fluctuation over 2017 Q2, reflecting the political situation at the time as well, draws our attention towards the accountability and appraisal we recieve for what we do, but also for what we prevent from happening.

Public debt continues in a downward trajectory for the second consecutive year, and is consolidating year after year. The government has expressed its stance very clearly, which is also thanks to the very careful intervention we made with the Budget Organic Law in 2016, one year before the election, forcing ourselves, and hence all subsequent governments, to be accountable and consolidate the debt. It is the first time that the Organic Budget Law has established what we refer to as the golden rule of debt: No government has the right to increase public debt, but on the contrary, every government is forced to continuously reduce public debt.

Today, public debt is at 71.7% and in 2018 will decrease by 2.5%, reaching 68.6%. Here I want to share with you a moment of scepticism towards the authorities, not simply the Albanian government but towards the Albanian authorities, namely "what will happen now that the IMF is going away?".

I have two comments. The IMF has not gone away, simply it has a monitoring relationship based on Article 4, even if Jens wanted to go away, we would not let him. Second, here we are, even without a binding agreement with the International Monetary Fund, and the fiscal consolidation is continuing.

This year we had a positive primary balance in an election year, which has never happened in 27 years, and for 2018 a considerable positive primary balance is again forecasted. Again we are not forced by the agreement with the International Monetary Fund, but by our political responsibility towards our citizens.

I would remind you that 2017 was the first year in the 25 year of history of Albania that in a parliamentary election year, the budget resulted with a primary surplus. The budget deficit for 2018 is forecasted to be at 2.0% of GDP. For the third consecutive year, the primary balance is forecasted to be positive at 0.6%, aiming to keep the debt on a downwards trajectory.

The global financial crisis, although did not touch directly the financial markets of our region, clearly had its impact through indirect channels. In the context of Albania, the constant slowdown of the growth rates that peaked in 2013, the economic crisis that hit Greece, and the EU's growth apathy (particularly Italy's - our main trade partner) created significant challenges for our financial market.

Meanwhile, during 2014-2017 numerous measures were taken in favour of the modernization of the financial system, also supported by the Financial System Modernization Program (FSM-DPL 2014). In this framework, the Bank of Albania reviewed the supervisory and regulatory measures, and the Deposit Insurance Agency was significantly strengthened both in its hedging capabilities and in its operations, bringing it closer to the Basic Principles of Effective Deposit Insurance Systems. The Albanian Financial Supervision Authority has already expanded its authority, while nearly all legal bases of the non-banking financial system, pension system and insurance have been improved. Very soon we will present improvements to this legislation, further improvements in cooperation with all the stakeholders.

Today, thanks to very good work and intensive cooperation between the Albanian Government and the Bank of Albania - and I would like to again thank the Bank of Albania and Governor Sejko, as well as with the ongoing assistance of our international partners (IMF and WB) - we have financial system regulatory infrastructure much more capable of detecting risks that emerge in the system, as well as a more complete set of protective measures to deal with them.

So, in terms of modernizing the infrastructure system, we may say the government has done its part. We refer to the annual, meticulous attempt to pass the autumn reform of 2016. Meanwhile, along with the Bank of Albania, we have worked towards that action and reform undertaken by the bank to reduce non-performing loans.

The issue of non-performing loans was largely dealt with during our first mandate in 2014-2017. For your information we have a joint working group between the Bank of Albania and the Albanian government, in this specific case signed by the Prime Minister and the Governor, and represented at the technical level by the Ministry of Finance on the government's side.

Despite a decrease by around 15.2% (almost 10% lower than 2013) we are fully aware that the phenomenon of NPLs requires even deeper treatment to address systemic issues. And believe me, the system can often recieve different treatment as well, as in the case of dealing with the process of collateral execution, a case that commercial banks are discussing with the government and the Bank of Albania in relation to private bailiffs. As the Prime Minister has promised, this issue will be solved very soon. I am convinced that you are aware of it and will mention it as well.

Regarding lending, I would to say that performance is modest from my point of view. Often we question, and of course we have technical answers, but also logical and emotional ones. Why have consumer credit, and loans to households or mortgage credit performed so well, while corporate credit is at a modest level? However, I believe that lending remains maybe the main aspect that has not reflected the same positive performance as the other indicators I mentioned above, and in fact we have not grown in this area.

I believe that the continuation of consolidation, and advancement of the measures above-mentioned to decrease of NPLs will enable short-term and medium-term lending to reflect those rates and optimism reflected by consumers as well as by the other economic stakeholders of the Albanian economy.

Finally, I would like to thank you for your attention and I believe that the thoughts we share together today at this table will serve as a small contribution from each individual to what comes next, in favour of the sector you represent and undoubtedly in favour of the economy and the citizens of this country.

I would like to thank again the Governor of the Bank of Albania for the attentive work and the coordination between all stakeholders.

Thank you!

GREETING SPEECH

*H.E.Mr. Ilir Meta**

Honourable Governor Sejko,
Honourable Mr Anastasakis,
Honourable Mr Minister,
Honourable attendees!

The world financial crisis reminded us of some basic lessons that everyday political interest tends often to overlook by creating market structural deficiencies, as well as making us very vulnerable to such crises that have a strong and time-extended impact.

Naturally, for a relatively new economic organisation like the euro area, coping with the effects of the crisis was a testing moment that required rapid decision-making to assess the impact of existing defence mechanisms, as well as the creation of new mechanisms to adapt to the new situation.

The impact of the crisis on the real economy and the financial segment was accompanied by high levels of public debt, low tolerance to investment risk, the low pace of expansion of global trade, as well as the repatriation of foreign direct investments.

* *President of the Republic of Albania, H.E.Mr. Ilir Meta.*

Although somewhat delayed, the impact of the crisis was also felt in our economy, coupled with a clearly slower growth pace trend. This slowdown highlighted many structural deficiencies affecting directly the growth of public debt, unemployment, and non-performing loans in the banking system, as well as financial difficulties for enterprises and households.

I take this opportunity to compliment the Bank of Albania for its proactive role in mitigating and managing the impact of this crisis.

The accommodative monetary policy pursued by the bank has contributed to the economic growth of Albania and to the easing of the financial burden on private borrowers, through the easing of lending standards and the expansion of lek loans.

This monetary policy had a positive impact in several areas: by contributing to the decrease in interest rates on all the products of the financial markets, by reducing their risk premiums, as well as by maintaining a stable liquidity situation.

The latest available economic data confirms the upwards trend of the Albanian economy, supported mainly by the expansion of domestic demand by the public and the private sectors, as well as the increase of foreign demand.

The positive economic developments of the euro area countries, but also elsewhere, have helped in the expansion of exports and tourism activity.

However, although the upwards trend of the Albanian economy is expected to continue in 2017-2019, the challenges we face are numerous and various in nature.

First, the European post-crisis regulatory environment and the policies of European banks to reduce their exposure to non-EU countries remain constraining and inhibitory factors for development. Second, returning the economy to equilibrium, meaning a long-term and medium-term economic growth of 3.5-4%, is still insufficient to guarantee a tangible impact on the welfare of broad layers of society, as well as to converge faster with the standards of European Union countries.

Third, the model of growth of our economy continues to be characterized by market deficiencies, which must be addressed as soon as possible: Thus, the degree of sectorial diversification remains low with services that constitute around 45% of the Gross Domestic Product, while the share of domestic demand remains high and diversification in terms of exports remains low. Meanwhile, the qualifications and education of the workforce in the labour market remain far from the requirements of the time.

And fourth, the Albanian financial sector is characterized by low sectorial diversification where the banking sector represents the most active and developed sector of the financial system constituting around 90% of its assets.

In this framework, the progress of structural reforms is vital to support the rapid economic and institutional convergence with the countries of the European Union.

The reforms undertaken should affect changes in the structure of the economy, as well as the improvement of the legal and institutional environment that determines the level and composition of investments in the country.

Immediate measures are necessary to seriously improve the business climate, reduce informality and corruption, as well as promote cross-sectorial competitions.

Structural policies must be undertaken to raise the level of human capital, improve the infrastructure of development, and promote the healthy governance of public and private companies.

Also, the creation of the capital market remains a necessity since it impacts directly on the expansion of funds to be used for investments, on the diversification and decrease of the costs on the sources of funding for the companies, as well as increase overall welfare.

In any case, institutional reforms, the strengthening of the legal and regulatory framework, and macroeconomic stability remain the prerequisites for the development of the capital market.

Concluding my address here, I would like to express my special gratitude to the Bank of Albania, which is a very credible institution in our country, to Governor Sejko for the good work done in the framework of guaranteeing the macroeconomic stability of Albania, and for the initiative in carrying out this conference in cooperation with the South East European Studies Centre (SEESOX) at Oxford University.

Good luck with your conference! Thank you.

FIRST SESSION:

THE NATURE OF RISKS AND RISK RESILIENCE IN THE SEE REGION

The session will discuss the nature of current regional and domestic risks, their interlinks and, at the same time, define and assess resilience to these risks. The session will explore the regional dimension.

Chair: Piroska Nagy-Mohacsi, Programme Director, LSE Institute for Global Affairs

EU DEVELOPMENTS AND THEIR IMPACT IN THE REGION OF SOUTH EAST EUROPE: RISKS AND CHALLENGES

*Othon Anastasakis**

In my speech today, I will talk about political risks in the European context, and the regional context. In addition, I will talk about opportunities. I will take stock of gains, so far, but also of challenges ahead.

Going back a year ago, we were here and were much more uncertain about what was going to happen. There were uncertainties surrounding elections ahead of us in France, Germany and the Netherlands; there was the impact of Brexit, and the heavy shadow of Brexit. So, one year on, we are more optimistic about what is happening in the European environment.

First of all, the EU and the region of the European Union are going into action, trying to put together scenarios in order to foresee the future of the EU and what is going to happen. Brexit was a real moment of existential crisis, so there are now scenarios on whether the EU will proceed toward the federal approach for all, or cooperation among those who want and can in particular areas. This is something that remains to be discussed during the upcoming years.

* *Othon Anastasakis, Director of South East European Studies at Oxford (SEESOX), St Antony's College*

There is a reconfiguration of the Franco-German relationship underway, and we all know that France and Germany have always been the engine of the EU. They give the EU its pulse, and its sense of perspective.

With regards to the future of this engine, we see how Macron has come up with particular proposals regarding the future of Europe and cooperation with Germany.

We have also seen electoral victories of the mainstream political forces in Europe over populist parties. This is very significant in big and important European states, serving as a signal that there is a certain direction to be followed. In terms of positive data, we will be talking more about the updated rates of growth rising from next year following unemployment, lowest since 2009 and also with a strong momentum; so that is a more optimistic situation.

Nevertheless, there is no need for complacency and Brexit remains a big problem. However, the most important factor is the UK's loneliness, because, in many ways, it appears as if Britain has become the experiment for the other countries to see what happens if one country really decides to leave.

Let me tell you, coming from the UK, the situation is no clearer than what it was last year. We are still talking about hard Brexit vs soft Brexit and still the Government hasn't pointed to what direction it wants to take Britain in. The main issues before the actual trade discussions start, which are the heart of the matter, relate to the issues of EU citizens in Britain, the Ireland - UK border, and how much Britain has to pay the EU budget before it leaves. These are very important and difficult points that are not fully resolved.

Then we have the Eurosceptic parties in Europe, which are on the rise. They are no longer marginal parties, but profess to be alternatives to the mainstream parties.

In the economic domain unemployment is still high, especially in some countries of the EU. There are social inequalities inside all the countries in Europe, as well as disparities between the different countries of Europe.

Then we have the global risks, some of which are new. For instance, we cannot consider the transatlantic relationship to be what it was during the past decades. We all know there is a discrepancy between the US and the EU. We know of the reluctance of President Trump to continue financing NATO forces as the US used to. We see also disagreements between the US and EU in terms of trade. Then there is geopolitical competition with Russia that has been going on for some years which many compare to a (new) Cold War environment. Tension between the West and Turkey is a new phenomenon because Turkey has always been a Western ally, but right now is not in good terms with the West. It keeps a functioning relationship with most European countries, but skepticism towards Europe and the US is growing inside Turkey. It is also in a frictional relationship with the USA, caused by additional bilateral issues. Lastly, there is also the issue of Islamic fundamentalism and terrorism, and the continuing migration flows from the Mediterranean. This time, more flows are coming from North Africa because the Turkish deal seems to be holding.

Now we come to our region in terms of the kind of regional opportunities we can see here. First of all, we do see some bright signs in terms of more stable governments in the region. There is a pro EU direction, and a consensus in the way the elites of the Western Balkans regard their EU orientation. There are also some recent reassurances that Western Balkan enlargement will proceed and that Serbia and Montenegro will become members of the European Union within the next seven to eight years. There is a lot to be desired in how the enlargement agenda is being built. Moreover, there is the EU's external action service, that is, Foreign Affairs and Security Policy Commissioner Mogherini's office, which really has a focus on the Western Balkans and desires to see successes in the security field in the region. The commitment and attention are in place.

The Berlin Process is a crucial element. I understand that is something that is also treasured in this country. There are anticipated benefits from that process; there are the themes of connectivity, education and infrastructure. There are nine hundred million euros in commitments already. The relevant problems, however, with these regional initiatives have to do with the lack of actual outcomes, which we have yet to see. The first outcomes are expected in 2018. In terms of how the whole thing is organized, you may know that the Berlin Process has been taken around the capitals of several countries. It started in Berlin, then went to Vienna, then to Paris and so on. Next year, it is going to London and that will be a little bit of an awkward moment, because how can we have a country that is exiting the EU professing to the Western Balkans integration to the European Union? A lot of security concerns may be expected to be addressed there. Then there is the presence of China and the Gulf states, which are also viewed as opportunities for investments. Chinese investments in the region actually give rise to geo-economic significance of the Western Balkans region and its connection with Central Europe.

There are certain country risks that are common to all the countries. In the rule of law, there are issues with impunity, corruption and organized crime. There is also democratic backsliding, persistent nationalism, and the alienation of citizens from the elite. These are the main topics that are important when looking at the main political risks.

Furthermore, there are regional risks that need to be taken into consideration in bilateral issues that haunt the region, for example whether Serbia and Kosovo will abide by their normalization agreement, the implementation of which still suffers a lot. Enlargement is a very difficult issue not just for the European Union, but also for a part of the Western Balkan countries. There is also public disillusionment, and the citizens of the Western Balkan states should not be taken for granted forever.

Russia is a very difficult external power in the region, with its politics of opportunism and disruption.

Turkey has a very close relationship and economic partnership with countries in the region; at the same time, it is distancing itself from Europe. So this poses a very difficult and complex situation.

China is a risk as much as an opportunity, because it has a different approach to investment. The difference in approach in terms of

systems, rules and procedures between the EU and China or Russia is an issue that the Western Balkan countries have to address.
Finally the need for a credible commitment from the EU is something which is repeated every year, over and over. But unless this becomes a reality, then we will have problems like we have seen in many countries that turn more authoritarian when the EU diverts its attention.

The enlargement agenda needs to refocus; it cannot exist as it used to. There is kind of new atmosphere now. There is still the understanding that the Western Balkans are unfinished business, but the enlargement agenda needs to focus, and contribute towards economic opportunities that should be created for the local communities and help to prevent the brain drain. South East Europe in general suffers from brain drain, and many bright minds leave the area and settle abroad.

The Berlin Process may provide tangible projects, success stories and connectivity, but not just within the region. Connectivity must be expanded and focus on the broader enlargement agenda. As a final point, the democracy, rule of law and civil society, should be put at the heart of the region's Europeanisation and membership of the EU.

GEO-ECONOMIC DEVELOPMENTS AND REGIONAL TRENDS: CHINA'S EMERGING FOOTPRINT IN SOUTHEAST EUROPE; WHAT ARE THE RISKS AND OPPORTUNITIES?

*Jens Bastian**

First of all, I would like to thank in particular the Governor of the Bank of Albania, Mr Sejko, also Mr Tanku, whom I am very happy to see again after many years, and Mr Herri who has helped me in the organisation of this conference. You just heard from Othon Anastasakis. He is a former colleague and has remained a friend for many years in Greece and in Oxford. We have done much together and he has even helped me now to build a short bridge to my presentation on China.

What I would like to present to you is part of a larger project that I am engaged in with the European Bank for Reconstruction and Development in an advisory capacity. The leading question of this project is how the EBRD should deal with the emerging footprint of China in the regions of Central, Eastern and South Eastern Europe. As I give this presentation, China is very much on the agenda, not only in Europe, but also in the United States. The President of the United States, Mr Donald Trump, and his counterpart, President Xi Jinping, are currently meeting in Beijing on a two-day official visit of the former.

China is a new arrival to the region of South-Eastern Europe. But it is not a new arrival to Albania.

* *Jens Bastian, Independent Economic Consultant*

China's Return to Albania

- ***China Pacific Construction Group (CPCG)* building expressway linking Montenegro and Albania**
  - **3,2 billion USD investment – 280 km long**
- **Oil exploration rights acquired by China's *Geo-Jade Petroleum***
- ***China Everbright* and Friedmann Pacific Asset acquisition of Tirana International Airport SHPK**
- ***PowerChina*, a construction holding, has irrigation projects in Albania**
- ***China State Construction* (CSC) 16-Mile Arber Road project to Macedonia**
- **Investment in Port of Shëngjin**

Albanian parliamentary chairman Ilir Meta in 2016 (Photo Albanian government press office)

Source: Wikipedia, 2017

These activities create across different sectors what I would call "clusters of investments". And these clusters are most advanced in transport, infrastructure, across the region, and in the energy sector. Moreover, in order to organise and advance these activities, China is establishing a financial footprint. I would like to highlight that in my next slide.

Establishing a banking sector footprint

- ***Bank of China* branch opened in Belgrade, January 2017**
- ***Exim Bank* financing motorway construction in Macedonia, Montenegro**
- ***China Development Bank* lending for Stanari thermal power plant in Republika Srpska**
- ***China Development Bank* MoU with Bank of Greece, July 2016**

As seen in Skopje, FYR Macedonia, June 2017

Such a financial footprint in the region is illustrated by what the Bank of China is doing in Belgrade, opening a branch, or what Exim Bank is doing by financing motorway construction across a variety of countries in the region, through bank lending. China Development Bank has also provided lending for thermal power plant construction and modernisation in Bosnia & Herzegovina.

What you are seeing here is establishing a cluster of Chinese, mainly state-owned banks creating a financial footprint in the region. The prevailing modus operandi of that footprint is debt financing of large infrastructure projects through banks, either from mainland China or from subsidiaries in Hong Kong. Equity funding, in terms of outright direct investment and acquisitions is taking place notably in Greece, to a lower degree in Serbia, and is gradually gaining pace in other countries, which I will highlight in a moment.

Creating Chinese-led investment funds

- **China – Central + Eastern European Investment Cooperation Fund**
  - **Established 2012**
  - **Registered in Luxemburg**
  - **Funding: USD 500 million**
  - **Export Import Bank of China**
  - **Exim Bank Hungary**
- **Second Investment Cooperation Fund**
  - **Launched end-2016**
  - **Sino - CEE Financial Holdings Ltd**
  - **Funding: €10 billion**

Cooperation between China and Central and Eastern European Countries
中国—中东欧国家合作

6th Summit in Budapest, Hungary, November 2017

Secretariat located in Beijing

What this development tells you is that the lending that Chinese banks provide to different activities in the region allows countries to diversify their sources of funding from outside Europe.

This outsourcing even goes a step further. This is illustrated by a number of Chinese-led investments funds which have been created in the course of the past years. The first such fund had resources of

USD 435 million under the heading "China - Central Eastern Europe Investment Cooperation Fund". The second such fund – established in 2016, four years later, - has an initial budget of 10 billion euros.

If, from a banking perspective, you look at this second funding instrument with regard to leverage ratios, the financing can go up to dimensions which are unseen from a Southeast European perspective in the past 25 years. That tells you something about the ambition and the outreach activity and the deep financial pockets that Chinese investors are prepared to bring to the regions of Central, Eastern and South-Eastern Europe.

Yet, the financial sector footprint by China even goes a step further. This is reflected in how Hungary - a country not that far away from here and a member of the European Union - is increasingly involved in financial cooperation with China as illustrated by currency swaps; by issuing sovereign debt in the domestic currency of China, the renminbi, not only in Hungary, but increasingly, as happened in July of this year, selling Chinese debt in China itself. Hungary is the first country in Central Eastern Europe to do so. Recently Poland followed with its first issuance. How will this develop? And are these developments always a good thing?

If we look at these recent developments, there is a sense of optimism, a sense of "can do", of success stories emerging. But, I do not think that this is the entire story when we look at China.

Mr Othon Anastasakis already illustrated the importance of looking at opportunities, but also having at hand a risk matrix, risks that can emerge over time while they currently present themselves as opportunities.

Infrastructure opportunities turning into financial risks?

- **Montenegro and China's Exim Bank signed in 2014 an 800 million euro deal to finance a highway linking the port of Bar with Serbia**
  - **Exim Bank provides loan for 85 percent of the total**
  - **Six-year grace period**
  - **Repayment of 20 years**
- **China provides flexible funding if countries use Chinese workers and equipment**
- **World Bank withdrew a $50 million budget support loan to Montenegro**
  - **The highway deal adds to high debt levels of 58 percent of national output**
  - **IMF warns deal threatens fiscal stability**

Construction of the Bar - Boljare highway

I highlight here the case of Montenegro. It is not the dark sheep in that sense. There are risks also in other countries. But in Montenegro there are some interesting consequences to identify. One of them is that you have an extensive network of highway constructions based on Chinese bank lending.

Furthermore, China stipulates that the country to whom it is lending for infrastructure projects has to invest in Chinese workers, services and equipment. Such lending and behaviour has caught the attention of multilateral international organisations, for example, the IMF, who have warned the authorities of Montenegro about their rising debt exposure to China. Equally the World Bank has gone one step further and actually withdrawn budget support for Montenegro because of how Montenegro has exposed itself to China.

The question then rises as to what needs to be done.
In my view, the future holds the following:

What does the future hold?

- **Trade by destination and origin will continue to shift towards China**
- **Southeast Europe will further diversify its sources of capital**
  - **China's FDI to the region will increase**
  - **Chinese loans to Southeast Europe**
  - **Financing public infrastructure projects**
- **The growth potential of Chinese tourism**
- **China's growing footprint in the region presents challenges and opportunities for**
  - **The EU, the IMF, the EBRD, the RCC**
  - **Central banks in Southeast Europe**

I think that trade between China and the region will increase. But this also means that trade imbalances will increase. I am also of the opinion that the countries in South-Eastern Europe will continue to diversify their sources of capital toward China. That brings rising lending exposure and repayment risks.

In my concluding remark I would argue that China is positioning itself in this region, presenting itself as a stable alternative to Europe and a reliable alternative to other financing organisations like the IMF, the World Bank and the European Investment Bank.

I think that China's growing footprint in the region must be managed. I do not think that it can be contained. I think that when regional leaders go to China, and there is a long queue of regional politicians doing that in the course of the past years, they are doing so because they express a determination that the future of these countries lies in doing business with China.

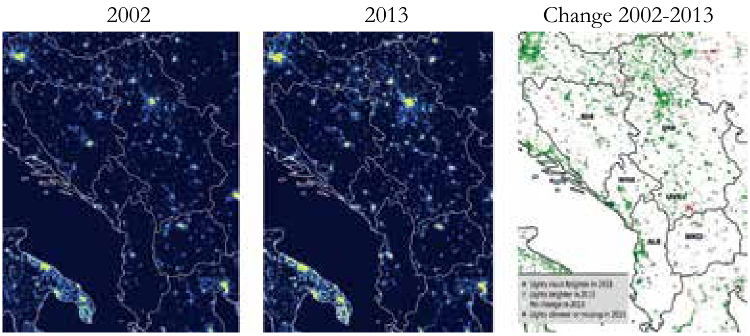
Thank you for your attention!

REGIONAL AND COUNTRY SPECIFIC RISKS: COMPREHENSIVE DISCUSSION OF ECONOMIC, FINANCIAL STABILITY RISK, FISCAL INSTITUTIONAL AND SOVEREIGN RISKS

*Bas B. Bakker**

Life in the Western Balkans has become brighter in the past decade and a half. This is not just visible in economic statistics; it is even visible from satellites! The left panel of chart 1 shows the region at night in 2002; the middle panel in 2013. You can clearly see how much lighter it has become!

Chart 1. Nightlight intensity in Western Balkans

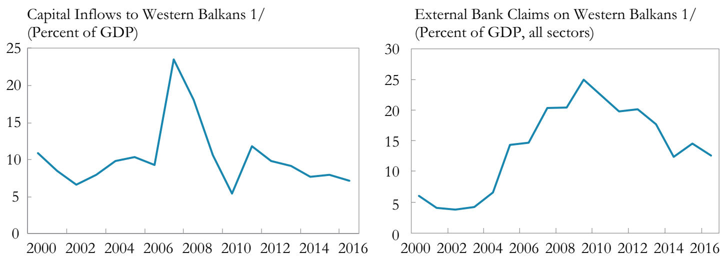


* *Bas B. Bakker, Senior Regional Resident Representative, IMF Regional Office for Central, Eastern, and Southeastern Europe*

Moreover, after recessions in 2009 and 2012, the region is growing again, supported by activity with main trading partners. And unemployment is finally coming down—although it remains too high. Also, the immediate outlook is good.

So, what are the remaining challenges and vulnerabilities? They are two-fold. First, the impact of the 2009-12 crisis, including in the banking system and public finance, needs to be addressed. Second, the economic transition and convergence of per capita economies to those in advanced economies needs to be sped up.

Chart 2. Capital Flows and External Bank Claims – Western Balkans



1/ Does not include Kosovo; includes Serbia and Montenegro from 2007.

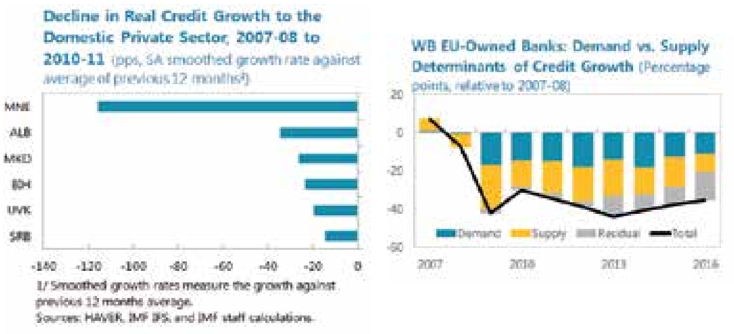
1/ Does not include Kosovo; 2016 uses GDP projections

Sources: BIS, IMF, and IMF Staff estimates.

Let's start with the banking system. As is well known, in the past decade the region has gone through a capital flow boom-bust. The left panel of chart 2 shows how much capital flows increased and then fell back. The right panel of chart 2 shows the stock of external bank claims. Here you can see how much they rose prior to the crisis and dropped thereafter.

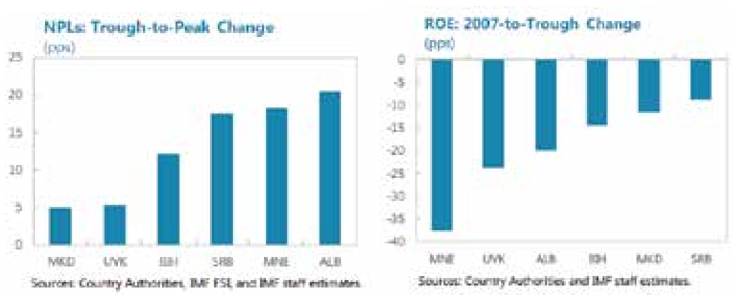
The result of this drop in foreign bank funding was a sharp drop in credit growth. The left panel of chart 3 compares credit growth rates in 2010-2011 with those in 2007-2008. You can clearly see the drop. The right panel tries to disentangle the causes of the dropping credit growth into demand factors (the blue bars), and supply factors (the yellow bar). They both matter, but supply certainly was important.

Chart 3. The fall in credit growth



Because of the sharp drop in credit and the resulting economic crisis, NPLs increased sharply. Chart 4 on the left shows the increase in NPLs from pre-crisis to their peak. The right panel shows what happened with the Return on Equity—it dropped sharply.

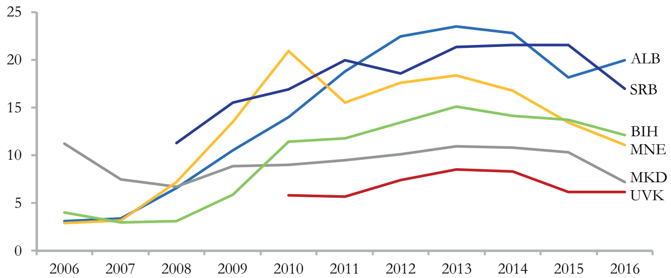
Chart 4. Performance of NPLs and RoE



The good news is that NPLs have come down from their peak. Chart 5 shows their levels for various countries, but they remain high. The data in this chart ends in 2016, but if you extended it to 2017, the NPL situation would look even better for a number of countries.

Chart 5. The decline in NPLs.

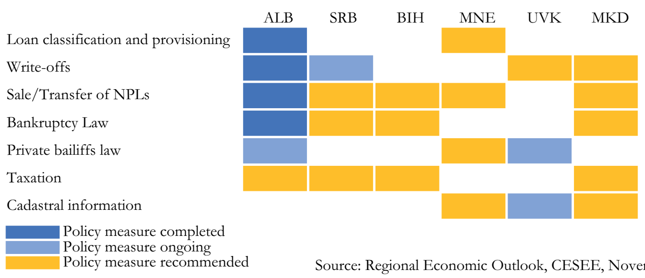
Non-Performing Loans to Total Loans (Percent)



Banks need to address the remaining stock of NPLs. This requires a multi-pronged approach. Much needs to be done. Chart 6 gives a summary. What needs to happen is combination of making it possible for banks to address the NPL problem (for example, by making it easier to sell NPLs or foreclose on collateral) and forcing them to address the issue (rather than let them pretend they will grow out of the problem).

Chart 6. Key policy actions and recommendations fostering bank balance sheet repair

Summary of Key Policy Actions and Recommendations
Fostering Bank Balance Sheet Repair



Source: Regional Economic Outlook, CESEE, November 2017

This chart also gives an indication of what countries have already done. Albania looks fairy blue. It has done a lot!

Another issue is bank funding. As we have discussed, there has been a reduction of foreign funding in the past, but there are risks of further reductions going forward. Foreign funding has often helped improve local economic governance. Therefore it will be helpful in attracting new funding, including from local capital markets. Both new foreign funding and tackling over-banking would help in developing local capital markets.

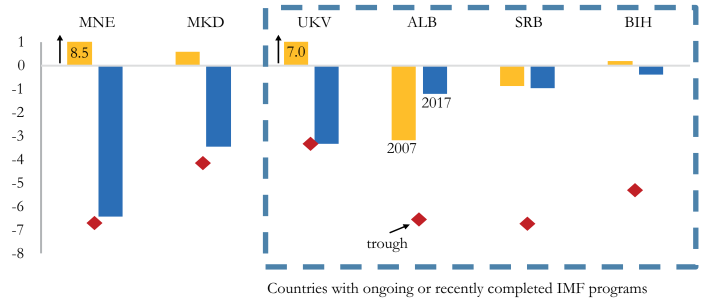
Governments can also help by reducing non-bank obstacles to credit, upgrading solvency frameworks, improving land and property titles, etc.

Moving on, let's now look at public finances.

The good news is that fiscal deficits have come down and particularly so in countries with IMF programs. In Chart 7, the orange bar shows fiscal balances in the pre-crisis period. The red diamond shows the post-crisis peak in the deficits, and the blue bar shows the 2017 deficit. You can see how the deficit has come down in many countries, including in Albania.

Chart 7. General Government Balance

(Percent of GDP)



However, public debt is still far above the pre-crisis levels. Again, in chart 8, orange is pre-crisis, diamond is peak and blue bar is 2017.

Chart 8. Public debt

(Percent of GDP)

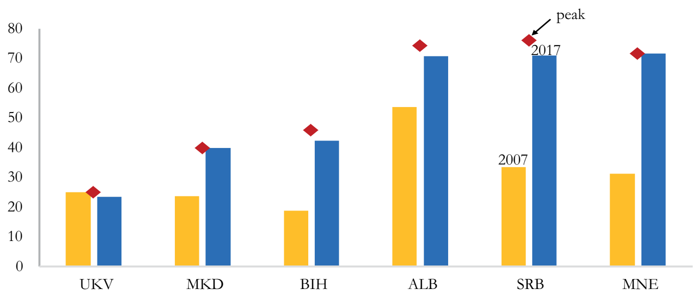
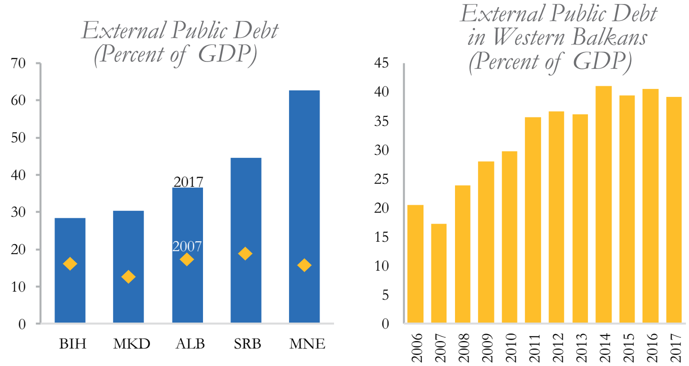


Chart 9. External Public Debt

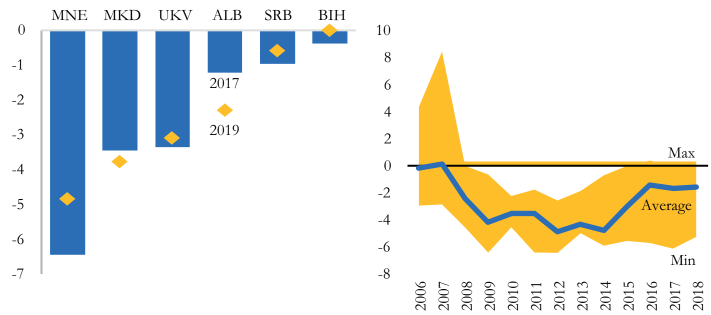


Much of this public debt is financed externally. Chart 9 on the left shows the external public debt, both in 2007 and 2017, for individual countries.

Given the high levels of debt, further consolidation would be helpful. Unfortunately, as you can see in chart 10, little further fiscal consolidation is planned going forward.

Chart 10. Fiscal consolidation

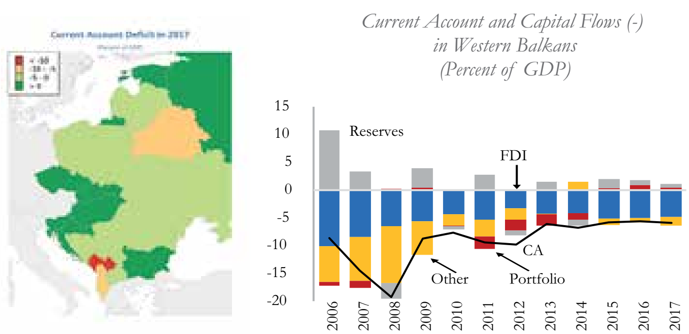
GG Balance in Western Balkans (Percent of GDP)



Let's now look at external vulnerabilities.

Current account deficits have come down, and in most countries they are no longer very high. Even better, and as you can see in chart 11 on the right, they are almost fully-financed by FDIs, which we consider as the most stable funding source.

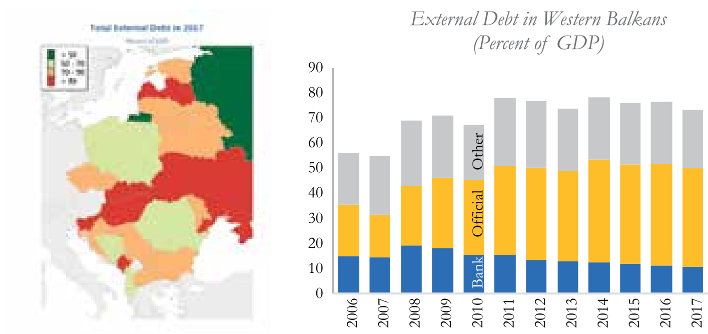
Chart 11. Current account and capital flows



However, external debt remains relatively high. On the left chart 12 shows the external debt to GDP ratios for individual countries, whereas on the right it shows the average for the Western Balkans.

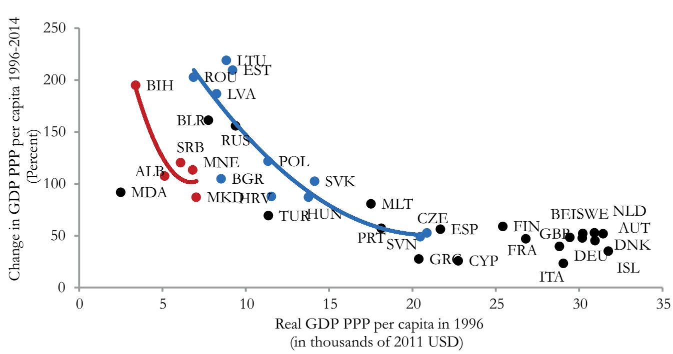
There has been a reduction in debt to foreign banks, as foreign banks have been withdrawing, but this has been offset by an increase in public debt. This helped avoid deeper recession. But now that times are much better, deficits and debt need to be brought down again. Otherwise, governments won't have much flexibility to deal with future shocks.

Chart 12. External debt



Let's now talk about completing transition. In the past two decades poor countries and Europe have grown faster than rich countries. The chart shows on the left axis real GDP per capita in 1996 and on the right axis growth between 1996 and now. You can see clearly that poor countries have grown faster.

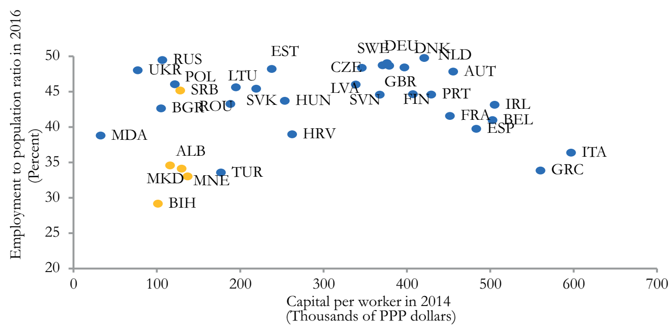
Chart 13. GDP PPP per capita in 1996 v change in 1996-14



However, countries in the western Balkans, the red dots, have not done so well for the same income level in 1996 as countries in the EU new member states.

This raises a broader question. Why are the countries in the Western Balkans so poor? In an accounting sense, one reason is that they have relatively little capital per worker. You see this indicator in chart 13 on the x-axis. The other reason can be that only a small percentage of the population works. You see that indicator on the y-axis.

Chart 14. Capital per worker v. Employment to Population Ratio

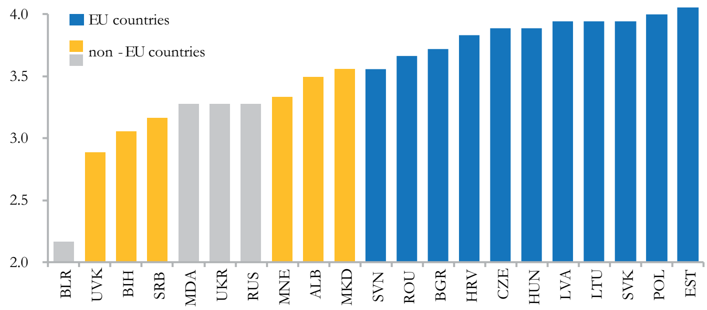


We can see in Chart 14 that in the Western Balkans there is little capital per worker and relatively few people work.

Better institutions would help to get more investment and thereby build capital and employment. Now, the good news is that as countries get ready for EU accession and adopt the Acquis Communautaire, they upgrade their institutions. To see the impact EU membership makes, Chart 15 shows the EBRD transition indicators. They basically show how much progress has been made by moving from a planned economy to a full market economy. The higher the indicator the more progress.

We can see that all the EU countries score much better than the non-EU countries, including the Western Balkans. A key reason is that access to the EU requires major improvements in institutions.

Chart 15. Average of six EBRD transition indicators - 2014

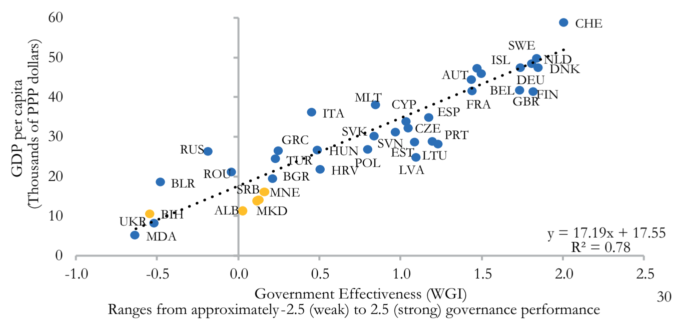


Note: 2007 for Czech Republic.

What can be done to improve institutions? Let me focus on measures in the economic sphere that can boost investment and create jobs. We discussed this in two previous IMF Regional Economic Outlooks. A key challenge is to improve the investment climate. This would make it more attractive to invest. Better protection of property rights, improving legal systems and other government services, and addressing infrastructural gaps would all help. Another challenge is to collect more tax money at existing tax rates (by improving tax collection efficiency) and to make better use of money that is collected, including by addressing efficiency gaps in public investment.

Chart 16. Government effectiveness v GDP per capita

Government Effectiveness vs. GDP per capita in PPP dollars, 2015



Note: Data for UVK not available.

Boosting government effectiveness would also help. Chart 16 shows on the X-axis an indicator of Government effectiveness. This is compiled by the World Bank. On the y-axis you see GDP per capita.

You see a very strong link: rich countries tend to have a more effective government than poorer countries. They have better institutions of government.

To summarise: the outlook is better than it has been in many years, and particularly in the near term it looks good. But, challenges remain and this would be a great time to address them.

EUROISATION, THE EURO AREA MONETARY POLICY, AND ITS CONSEQUENCES FOR BANKING AND FINANCIAL SYSTEM MARKET RISKS IN THE SEE REGION

*Franz Nauschnigg**

First, as usually disclaimed, these are my personal views and not necessarily the Eurosystem's official position, as it gets more interesting for you if I present my personal view.

Let us look a bit into history. The Euro area enlargement, with Slovenia, Slovakia and the Baltics has been a big success. At the Austrian Central Bank we were very much involved; first, with our close neighbours, Slovakia and Slovenia. For us and for both

Chart 1. The euro is the currency of 19 Member States

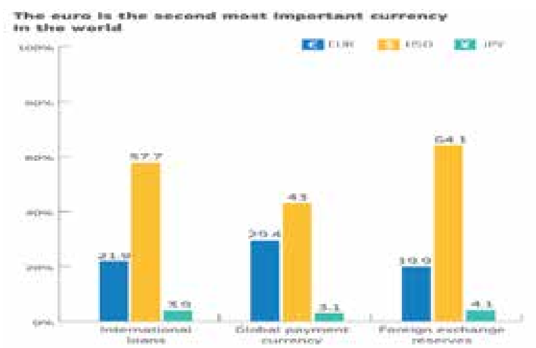
* *Franz Nauschnigg, Head of European Affairs and International Financial Organizations Division, Oesterreichische Nationalbank (OeNB)*

countries, it was a win-win situation, because with this membership in the euro area, the euroisation risk for the banking system disappears.

As we had some banking exposures in the region, we were also in a service process. It was no problem in the region. Croatia has just declared that it is preparing for euro membership. It will be a long-term process and we are in very close contact with the Croatian National Bank as we were with other colleagues who had joined before. Also, what should be kept in mind is that even though the euro has had a big crisis, it has remained the second most important currency after the dollar, catching up as the dollar has slowed down.

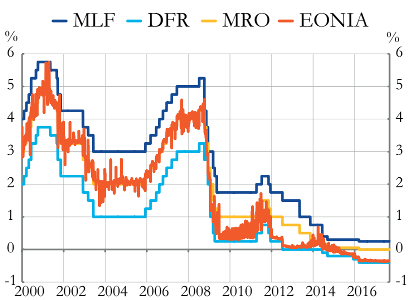
The euro is the second most important currency in the world.

Chart 2. Euro also during crisis second most important reserve currency



We had an evolving view of the euro before 1990. We said it will not happen; then in the run up to the euro we said it will not function; and now we have this fear of it falling apart. This did not happen. When we had a lot of speculation before 2012 on the breakup of the euro area, and a lot of Anglo-Saxon funds were speculating on rising spreads in the euro area periphery and rising serious spreads, when Mario Draghi went to London and told them: “We will do everything to save the euro, and believe me it will be enough”. We lost a lot of money, and since then we have not had speculative attacks on the euro area again. We had some discussions with Austrian funds, which had intervened with EUR 400 billion to keep the very exchange rate that we set. How did we manage? We went to the ELT programme and did not have to spend a single cent. It is very easy. The euro area and the euro system are just too big. You are not speculating against Italy and Spain, but against the euro system, which has unlimited amounts of euros at its disposal and you know that the OMT program is unlimited. So, we can spend and buy all the government bonds we want. So the game was up and now I think that if you look at financial markets, they learn; usually if you are a trader in London or New York, you first learn: never fight the Fed. It is just too big. You cannot win against the Fed. Now we are teaching them: never fight the euro system. It is too big and you should not take on.

Chart 3. Monetary policy expansionary interest rates, APP



APPs:

2009 – 2010: CBPP1 60 bn EUR
2010 – 2012: SMP 218 bn EUR
2011 – 2012: CBPP2 16 bn EUR
2012: OMT announcement sufficient
2015: APP 60 bn €/month, 80 bn, now 60 bn, next year till Sept 30 bn.

Avoided deflation, strengthens growth, spills over into SEE

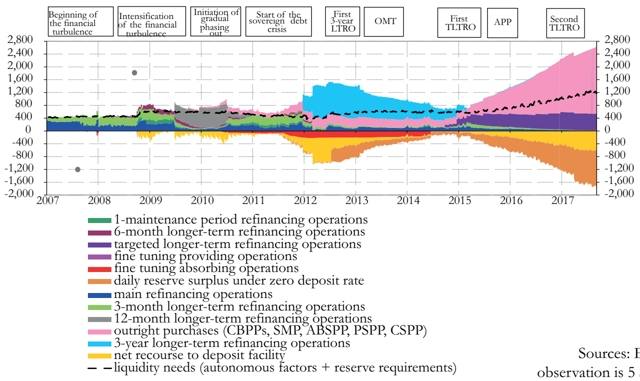
Turning to monetary policy, we had this conventional exchange rate. We also have an unconventional monetary policy. We also call it APPs, Assets Purchasing Programmes. We see it is a different model, for example, to the securities market program, where we bought the Government bonds of the European peripheral countries. It was a really win-win for the euro area, because in the euro system, our profits from 2010 to 2016 are to face the APPs when they are approaching EUR 60 billion. It was also a win for the peripheral countries, because it lowered their interest rates, because we were buying.

In 2012, it was sufficient to just announce the OMT programme. We did not have to spend a single cent and you all know the Asset

Purchasing Program we have now. We started with 60 billion, increased it to 80 billion, and have now 60 billion and next year till September it will be 30 billion. This keeps interest rates low.

If you look at the balance sheet of the Euro system (chart 4), things are going increasingly well, and you should not underestimate what may happen. We have also pledged to re-invest. And the bigger it gets the bigger the investments are.

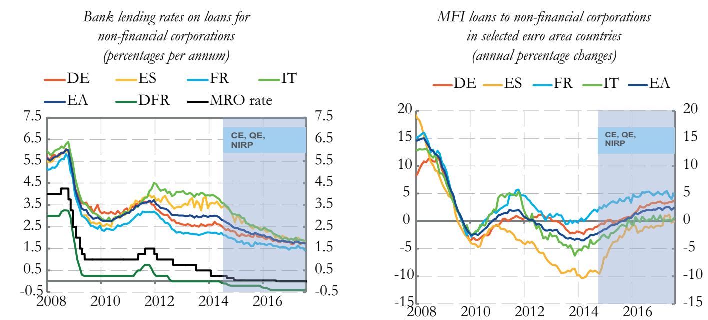
Chart 4. Euro system's balance sheet (EUR billions)



Sources: ECB. Latest observation is 5 September.

Even if we do not add anything, the re-investments are already becoming very large. So, the pass-through has been mostly via the bank lending channel. Bank rates on loans for non-financial corporations have come down (chart 5) quite a lot, especially in

Chart 5. Pass-through via the bank lending channel



Source: ECB.
Notes: The indicator for the total cost of lending is calculated by aggregating short- and long-term rates using a 24-month moving average of new business volumes. Latest observation: July 2017.

Source: ECB.
Notes: Adjusted for loan sales, securitisation and cash pooling activities.
Latest observation: July 2017.

the crisis countries. Loans to non-financial corporations in selected countries have increased substantially, mainly in the countries most affected by the crisis.

So, essentially our monetary policy has brought stable growth for the euro area, and this has helped South-Eastern Europe as well, because the euro area is the largest trading partner of the region, and if the euro area does well this helps the SEE region. It helps the region through the financial channel; the interest rates are coming down. On the other hand, it helps through the trade channel, FDIs channel, and also some other channels (Chart 6).

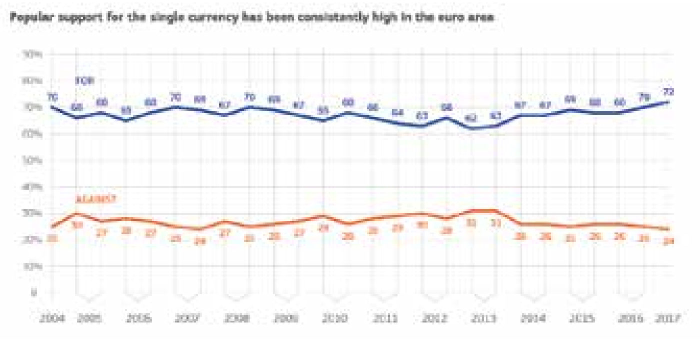
Chart 6. Monetary policy brings stable euro area growth - helps SEE

If you look at this chart, we had the euro area recession in 2011. To be frank, we tightened fiscal policy a bit prematurely. We underestimated the fiscal multipliers, and only after 2016, when the fiscal policy became supportive of the monetary policy again, the growth started to really take off. We are now on very stable growth paths, as one colleague in the ECB said "firing on all cylinders".

Just looking at/comparing to the UK, as mentioned before, the UK was growing faster than the euro area. But now, the euro area is growing much faster than the UK. And we expect this to also last in the upcoming years. We also have the US investment program and I think we should also have it in South-Eastern Europe. For example, we should be far away from the Austrian borders to reach along the Adriatic coast. This would help enormously to improve infrastructure in the region.

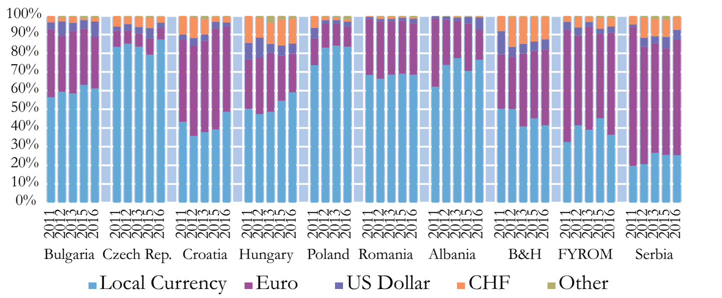
Another thing that is happening is that the euro is becoming more popular (Chart 7). The most eurosceptic part is the one that said we should leave the euro; in Austria, in developing parts, and also in France. For France, it is harder to fight for the euro, because it is the most popular there of all the euro area. So, this eurosceptic part has shifted their policies, because it is a vote loser.

Chart 7. Euro becomes more popular



Now to Euroisation (Chart 8).

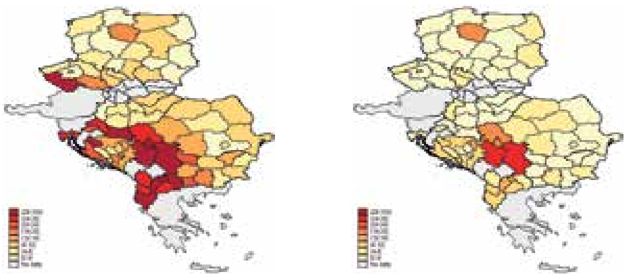
Chart 8. Euroisation popular especially in SEE countries



Source: OeNB Euro Survey.
Note: Respondents answering "Don't know" or "No answer" are excluded.

Chart 9. Measures of network externalities

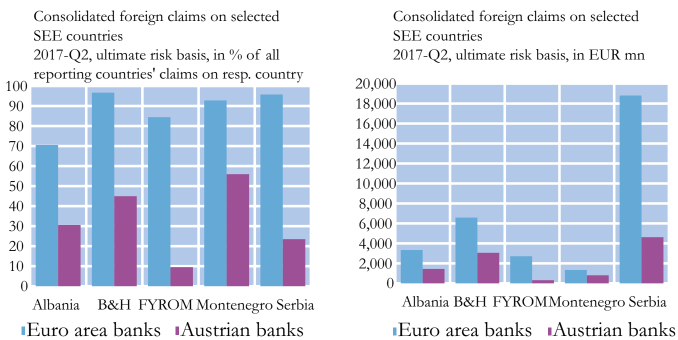
Subjective measure “common to pay in euro” | *Objective measure actual payment behavior of 20 neighbors*



Source: OeNB Euro Survey fall 2014, regional averages calculated by authors.

People say it is common to pay in euro. The objective measure shows it is much less common. However, you have the impression that we use euro very much. Moreover, euro area banks play a very important role in SEE (Chart 10).

Chart 10. Important role of euro area banks in SEE



Source: BIS, OeNB.

It is mostly the euro area banks that are dominating the banking sector in the region. It is also Austrian banks, and we take pride because together with the IMF, at the IBRD we have been very active in this. We have the so-called Vienna Initiative, where we convince banks to keep their exposure in the region. If we had the Vienna Initiative for Greece, things would have gone much better. Also, there are consolidated foreign claims on selected SEE countries, including Albania and Serbia. This represents a lot of money invested in the region (Chart 10).

Thank you very much for your attention!

BANKING AND FINANCIAL SYSTEM MARKET RISKS, COMPREHENSIVE DISCUSSION OF LIQUIDITY RISK & SOLVENCY RISKS, ECONOMIC AND FINANCIAL STABILITY RISK, FISCAL AND SOVEREIGN RISKS

*Periklis Drougkas**

Thank you for inviting me to your annual conference to present my views on the very important topic of "The nature of risks and risk resilience in SEE Region" and specifically to give you an overview of the risks of the Albanian Banking Sector. It is a great pleasure to be here today.

The good, promising I would say, macroeconomic indicators and the developments in the local economy have supported the good performance of the financial system. The banking sector's performance metrics, capitalization, liquidity and profitability have been overall improved and are considered as adequate. However, the need for continuous monitoring over time is suggested by the analysis of the determinant factors and stress test exercises performed by the Bank of Albania. Developments in the banking sector during H1 2017 exhibited a noteworthy upgrading of the credit quality of loan portfolios confirming the significance of the process.

The Albanian Banking sector comprises of 16 banks divided, according to Bank of Albania, into 3 groups:

* *Periklis Drougkas, Chairman, Albanian Association of Banks*

Group 1: Market share up to 2% possessing the 4.7% of banking sector's total assets
Group 2: Market share from 2-7% possessing the 27.1% of banking sector's total assets
Group 3: Market share over 7% possessing the 68.2% of banking sector's total assets

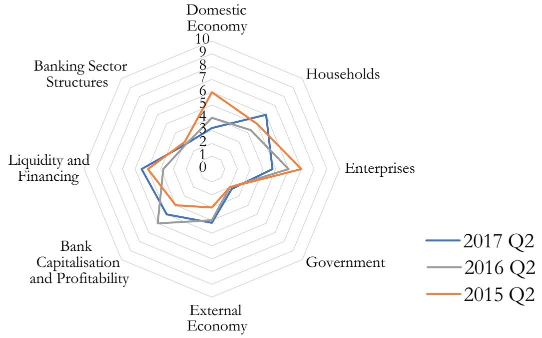
By capital origin, the banks with foreign capital constitute 82.6%, while the banks with Albanian capital constitute 17.4% of the sector's total assets

The banking activity contributed to GDP by 92% approximately.

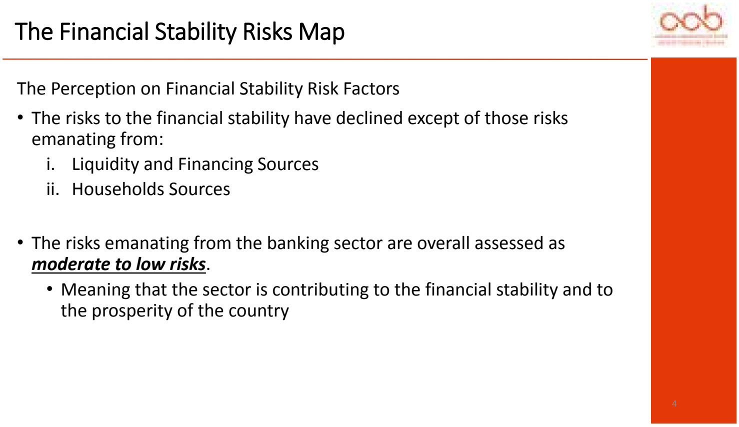
Main risks of financial stability

The financial stability map in chart 1 illustrates the distribution of factors that define the stability of the financial system in the country. It compares the performance of banking sector activity, the external and internal economic environment, and the real economy agents, the government, the enterprises and the households of the second quarters of the years 2015, 2016 and 2017.

Chart 1. Financial stability risks map



Source: Bank of Albania, Financial Stability Reports, 2017, 2016, 2015.



Interpreting the financial stability map of H1 2017 we observe a decrease in risks in the external and domestic economic environment and different developments in the banking sector risks. The decrease of risks in the economic environment derives mainly from the high economic growth rates and macroeconomic stability.

Economic environment

Analysing the economic environment in vertical axis of chart 1 we observe that:

The "domestic economy" risk is calculated as "low", following the progress of the output gap which is narrowed due to the reduction of the external debt. The "external economic environment" risk is evaluated as "low" with a downward trend, largely driven by the positive economic performance of Albanian trading partners and the low financing rates.

Real economy agents

Continuing the analysis of the real economy agents residing in the right side of chart 1 we observe that:

The "households" risk is assessed as "moderate" with an upward trend due to developments in the housing market and lower expectations of households. The “enterprises” risk is considered as “average” with a downward trend, following the improved quality of the loan portfolio, the improvements in the production volume index and the ascending expectations of the private sector; The “government” risk is evaluated as “low” given the stable sovereign risk premia, the lower cost of debt and the good performance of tax revenue streams.

Analysing the left side of chart 1 where the banking sector’s activities reside, we observe that risks of the sector are experiencing a declining trend except the risks emanating from:

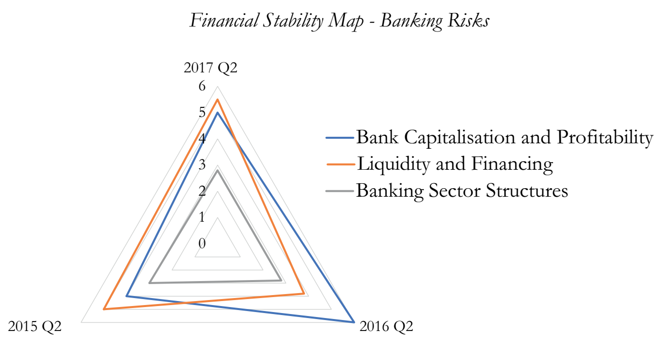
- Liquidity and Financing sources
- Household sources

The risks emanating from the banking sector are overall assessed as moderate to low risk. This means that the sector is contributing to the financial stability and to the prosperity of the country.

Banking sector activity

Taking a closer look at the banking sector risks through the years 2015 to 2017 we observe an overall improvement.

Chart 2. Financial stability risks from banking sector



Financial Stability Risks from Banking Sector

- The banking sector risks in general present a decreasing trend
- The trend reflects:
  - the successful anti-crisis measures taken by the Bank of Albania regarding the lending and investment activities of the banking sector.
  - the wise risk management and cautious control of activities of the banks.

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The continued decline in liquidity ratios indicates the recently improved trend of intermediation by the banking sector in routing unemployed funds towards lending in the economy. It is expected that the banks will more effectively allocate their resources in order to support local economic activity, positively affecting their capitalization as well as their profitability.

The “capitalization and profitability” risk is calculated as “average” with a downward trend due to the improvement of capitalization levels and loan quality.

The “liquidity and financing” risk is evaluated as “moderate” with an upward trend, portraying a) the deepening 3 month period mismatch of banks’ assets and liabilities and b) the lower growth of household deposits.

The “banking sector structure” risk is continuously evaluated as “low”, due to better distribution of financing funds and of credit, slightly counterbalancing the risk from the high credit concentration to “enterprises”.

We may conclude that overall the banking sector risks are experiencing a decreasing trend, therefore the sector is contributing positively to the financial stability and prosperity of the country.

The anti-crisis measures taken by Bank of Albania regarding the lending and investment activities, and the wiser risk management and cautious control of activities by the banks have proven successful. The writing-off of lost loans from the balance sheets of the banks has reduced the upward pace of the non-performing loans, although according to the Bank of Albania the banking sector continues to be exposed to credit risk.

Systemic risk of the banking sector

What are the systemic risks that influence the banking sector?

In general the banking sector is assigned a positive assessment of the systemic risks originating from global and domestic macroeconomic developments.

Globally, this is due to accelerated or balanced economic growth projections, and will continue over the next few years.

Domestically, this is due to economic growth from 3.94 to a higher rate, and the successful fiscal consolidation process (2016 – budget excess).

The Financial Market is showing normal operations with new issues of government securities, and increasing interest rates for securities. The Interbank Market has limited operations with an increasing trend, though the interest rates are not fixed by the market offer and demand.

The FX market is operating normally and smoothly without emergencies. The ALL is appreciating towards foreign currencies.

The payment system is considered secured and efficient.

The banking sector has the following assessment towards systemic risks originating from the:

1. Lending process: high due to high NPL ratio.
2. Execution of collaterals: high due to difficulty of execution,

bailiffs, bankruptcy law, etc.

3. Political risk: sensitive due to temporary uncertainty from past elections.
4. External shock risks: showing a downward trend endorsing the banking sector resilience to external risks.

Let me present to you the main risks which are directly linked with the banking sector activity.

Market risk

The market risk is considered low, mainly due to the following parameters:

1. The banks operating in Albania have "zero" equity market risk since they are not listed.
2. The Albanian Government securities market risk is not significant. The country risk is B+.
3. The Government and Corporate securities market risk is low due to the strict control of the Bank of Albania and parent groups.
4. The exposure of the banking books to foreign currency and interest rates volatility is very low
5. However, the interest rate risk remains high due the mismatch of the residual maturities of assets and liabilities.

Credit risk

Before giving you an overview on credit risk, allow me to make a short reference to the banks' lending activity.

During H1 2017, the outstanding balance of loans was decreasing, mainly due to the decline of loans to enterprises which constitute the 66% of those outstanding, although loans to households increased by 2.8%. The increase in household lending is driven by the growth in consumer and housing loans. The overall currency distribution of loan portfolios favours foreign currency loans amounting to 57%. The lending activity is funded mainly by local deposits which consist the 82% of banking sector total assets.

The overall credit risk is evaluated as moderate with a decreasing trend, considering the sharp decrease of NPLs - approximately 15.2% lower than H2 of 2016. The decrease reflects the bold strategy and solid tactical actions and efforts by the banks to collect the overdue loans, restructure going concerns, and write-off the "lost" loans. According to the latest report of the Bank of Albania, the ratio of non-performing loans decreased to 14.8%, the lowest level since the beginning of 2011, positively supporting the profitability of the banks. The cash coverage for overdue loans has improved, but the risks on law enforcement and collateral execution remain high and unchanged for a long period.

The improved credit quality of the loan portfolios of G3 banks (large banks) has supported the improvement of the overall banking sector's credit quality. The credit quality is lower for foreign currency loans, loans to enterprises and medium term loans. On the other hand, unhedged foreign currency loan credit quality has been improving continuously since early 2015. The quality of loans to non-residents is considered as good, having a NPLR 3.5% impressively lower than the overall NPL ratio.

Let's see how we have improved the credit risk.

Credit Risk

Decreasing

- The NPL ratio: fell significantly
- NPL amounts: decreased
- Cash coverage ratio for the overdue loans: improved, but
- The risk on law enforcement and the difficulties of the execution of collaterals remain high and unchanged

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Credit Risk

The high NPL ratio dictated:

- **BoA** : to issue new regulation and amend the existing ones
- **The Government:** a) to amend the legal framework regarding the debt collection and b) to amend the bailiff office procedure's (not a successful initiative)
- **The banks community**: a) to improve the collections procedures, b) to improve the credit standards and c) to implement new credit control tools,

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The high NPL ratio of the previous years dictated that additional measures needed to be taken. The Bank of Albania issued new regulations and amended the existing ones. The Government amended the legal framework regarding debt collection, and amended the bailiffs' guidelines to improve their performance, but not successfully. The banks improved collections procedures, the credit standards, and employed new credit control tools.

What are the credit risk mitigating factors employed by banks?

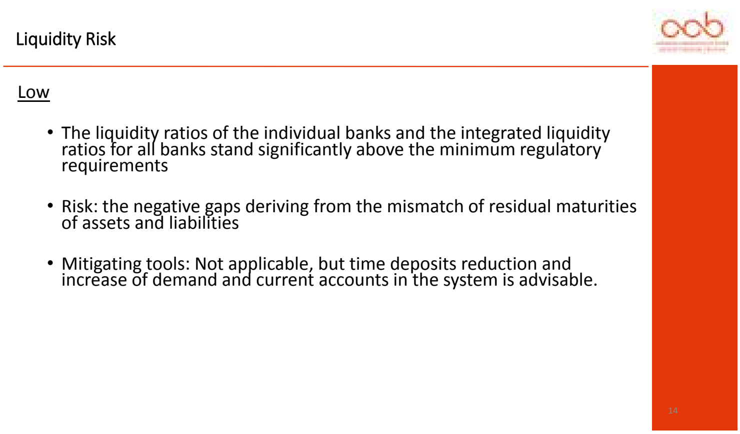
1. Provisions: The value of provisions funds offsetting the credit risk was at the level of 72.5% at the end of H1 2017,

demonstrating the significant efforts of the banks to improve the credit quality of their portfolios.

2. Capital Coverage: The capital coverage has improved due the reduction of the net value of NPLs. The ratio "Net NPLs-to-Regulatory Capital" decreased by 450 basis points from the level of 23.1% at 2016 year-end to 18.6%. It is worth noting that this ratio was 30.2% at the end of 2015.
3. Collaterals: The collateral coverage is high, with real-estate the predominant surety. Cash collateral loans are best performers, with NPLR which stands at 0.8%. The quality of non-collateralized loans, contributing 28% of the total outstandings, has improved, decreasing the NPLR by 430 basis points from 19.8% to 15.5%. The "real-estate, specifically the land" surety has the highest NPL ratio, calculated at 22.5%, showing an increasing trend. The high amount of real estate collateral which secures loans to enterprises and households strongly underlines the significance of transparency, smooth operation and regulation of real estate market. The latter entails strict and efficient implementation of legal obligations during the execution of collaterals.

Liquidity risk

The liquidity position of the banks continues to perform above the regulatory ratios of 15% for LEK and foreign currency. The customers' deposits are the main source of funding which set the Deposits-to-Loans ratio above 191% at the end of H1 2017.



The liquid assets still remain at a high level since lending activity is performing below its potential.

The total value of parent group financing contributes with a low share to banks' financing needs and sources, with local deposits being the main funding source.

The negative gap deriving from the mismatch of the residual maturities of assets and liabilities, which is considered as high, can be mitigated by reducing the time deposits and increase the demand deposits (savings & current).

Operational risk

The operational risk deriving from banking activity is low, the capital coverage of banks for operational risk was considered as satisfactory and stable throughout 2017. The capital requirements covering the operational risk stayed the same. The capital adequacy ratio of the period was not affected due to low operational losses.

Capitalisation

It is worth noting as well that:

The banks' capitalization at the end of H1 2017 was assessed as satisfactory mainly due to the reduction of the capital requirements for investments in non-resident entities. The capital adequacy ratio was at the level of 16.3% at the end of June 2017, higher than 2016, and well above the regulatory ratio of 12%.

The low financial leverage ratio (Assets-to-Equity) of the Albanian banking industry confirms the satisfactory level of capitalization.

The Proposal

Having said that, I would like to propose to bankers, supervisors and regulators to continue working together in order to enhance the transparency of financial stability reporting (which is excellent work by the Bank of Albania) by developing an additional set of indicators that will portray all the risks of the financial system that can be used by all economic agents and the public.

Conclusion

Concluding, I would like to make a quick reference to the technological risks and opportunities the banking sector is facing today.

The path to digitized banking platforms provides much wider opportunities for banks to cut down on fixed costs, thus improving their profitability. The use of external suppliers of digital infrastructure allows banks to contract IT services that are directly linked to customer volumes, without investing in expensive legacy systems. The usage of "cloud computing" will bring down costs further, allowing smaller banks to potentially compete with larger banks on an equal basis as vast, fixed IT infrastructure costs no longer create barriers to entry.

Cyber-crime is a considerable threat to the banking sector, and the banks have to deal with this seriously and prudently. The question is: "How do you place your company in the "Safe List"?" The protection of valuable intellectual property and business information in the digital world against theft and misuse is an increasingly critical management dilemma and a high priority issue. There are other challenges too, like PSD2 with the share ledger, and GDPR, which intends to strengthen and unify data protection for all individuals.

The successful banking models are those that have already understood and embraced the disruptive era and exploited all the opportunities that deliver value-adding innovations to meet customer needs and expectations. The "digital natives" don't recognize and accept the traditional bank branch model of limited banking hours. They call for access to "all-weather" banking services 24/7/365.

I am confident that the present generation of executive bankers in Albania has the energy to succeed exploring profitable methods to meet the changing expectations and needs of customers, within a financially stable environment. I wish to good luck to all executives and all of us in this endeavor.

BANKING SYSTEM AND NEW REGULATORY FRAME - DID WE INTERNALISE THE 2007 LESSON?

*Natasha Ahmetaj**

Dear ladies and gentlemen,

We are gathering again to talk about banking, not because we like banking, or because we are bankers, but because banking is becoming more and more a part of our individual lives. Banking has resumed in Albania after many years. I remember 20 years ago, many of us, including myself, had never entered a bank, because we did not have an account. So what is there to do in a bank without an account? Meanwhile, today, it is indispensable to have banking in our daily lives and in our families.

Having said that, I am happy to see and to say that the Albanian banking sector is well developed, and is increasingly becoming a part of our economy and our life. I am both happy and privileged to share with you some of the indicators, to corroborate this idea.

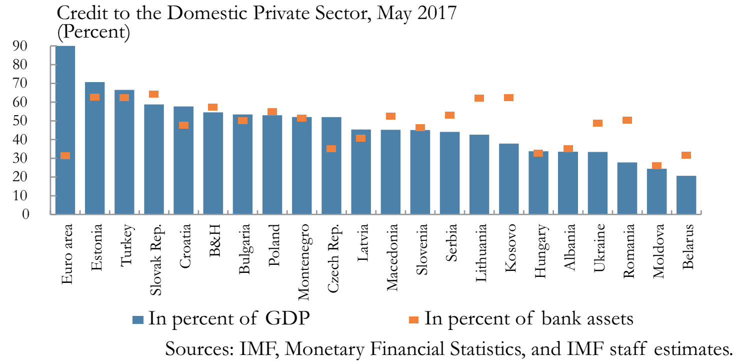
1. BANKING PRESENCE IN ALBANIAN LIFE

Let me show four indicators to support my idea about the increasing presence of the banking system in our lives.

* *Natasha Ahmetaj, Second Deputy Governor, Bank of Albania.*

Looking at Chart 1 you may be able to identify the credit to GDP and credit to bank assets size.

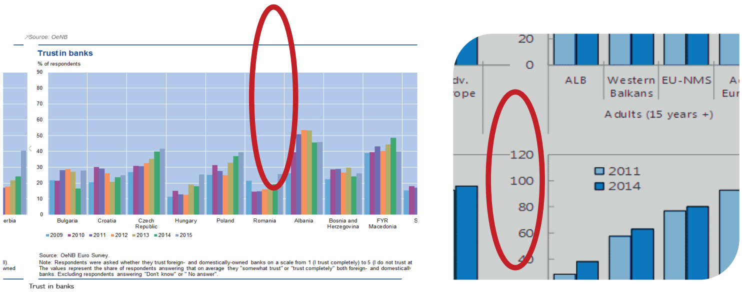
Chart 1. Credit to GDP



For both indicators, Albania is coloured in red, and you can see that indicators for Albania are lower than the rest of the region. This means that the contribution of our system for crediting the economy versus GDP is lower than our neighbouring countries. Also, our share of credit to assets' size is also lower than many other neighbours, showing that the banking system has not carried out all the duties versus the economy, by performing the intermediation role to extend credit from the high deposit levels. We can see that there are other countries that have the same percentage of credit to GDP ratio. However, they do not have the same capacity of lending as Albania, because their credit to assets size is higher - much higher than ours. So, we are doing well, but we are not doing as well as we could.

Now let us turn to another indicator to show the presence of banking in our lives. The first graph in Chart 2 shows that Albania has very high level of trust in the banking system and great respect for banks.

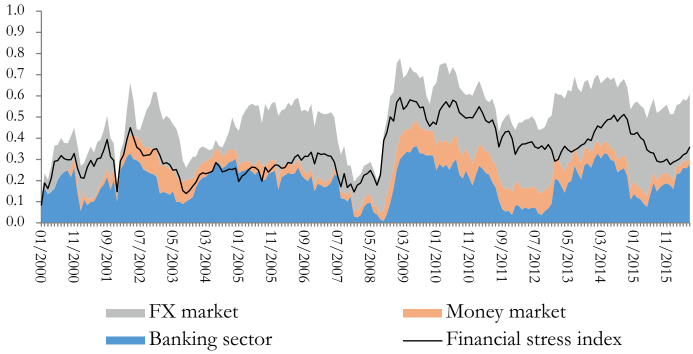
Chart 2. Financial inclusion



Sources: World Bank, Global Financial Inclusion database, and IMF staff estimates.

The chart is based on a recent survey that shows that Albanians trust the Albanian banks much more than the population in other countries trust their banking systems. So, while having this very positive trust and respect for the banking system, we have very low financial inclusion. The graph on the lower-right section of Chart 2 shows that in terms of percentage of participation for the adult population having one account, Albania ranks among the lowest level compared with three other groups presented in that figure.

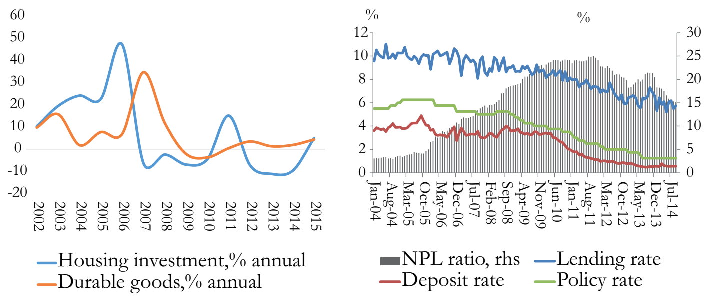
Chart 3. Delivering stability to the financial system



Another indicator shows the effects of the presence of banking in our lives, this time as positive contributors. Chart 3 shows what the banking system is doing for delivering financial stability for the country. In this chart, you see the index that shows that the stress, the blue line, is trending increasingly down in Albania, creating thus a positive environment for the economy, upon which to base its own activity.

While the Albanian banking system may not be doing enough, it is still delivering other positive contributions to the Albanian economy. Here we can see the positive effect of the monetary policy on our banking system's development. In addition, the banking system is more present in Albanian life through credit activity. We can see here how positive the role of monetary policy has been, which is also a kind of attribute of the banking system for borrowing becoming less and less costly in Albania. In the second graph on the right I want to stress two ways how monetary policy is doing that.

Chart 4. Positive role of the monetary policy in lending cost



First of all, the borrowing cost trended down in the previous year. You can see the red line in the second graph, that is, the margin of borrowing is always going down. Also, in the grey bars in the background of the second graph you can see the level of NPLs accompanying all this trend of credit rates. Even in the times when the NPLs peaked, about 25%, again we had a continuous downward trend for the borrowing rate, which shows that the policy rate has also offset the negative high perceived credit rate due to very high NPLs. So, these are two ways the monetary policy has been quite effective and quite productive for improving the overall environment of lending in the Albanian economy.

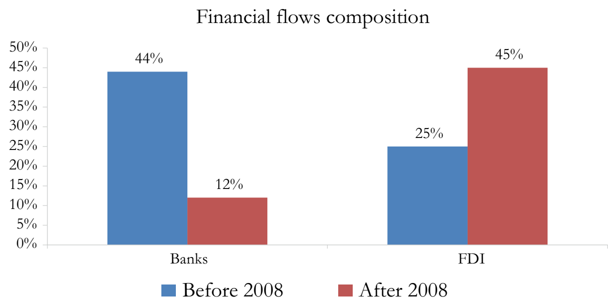
In the first graph on the left we can see that aggregate demand is also responding positively to this monetary policy effect and the low-rate environment, because there are two components of aggregate demand very sensitive to the low rate. We can see that in the Albanian economy both those components - durable consumer goods and investments in housing - have already started recovering after 2014, due to this positive environment.

After showing the increasing presence of the banking system in Albania, and before looking ahead, I would like to highlight the main improvements that we need to lead to the system, for our country as well the as the overall global tendency. I would like to stress two main developments that I think are blurry in the horizon, but soon will be visible and very present in our financial systems.

2. POST CRISIS PARADIGM

In a recent study, two main changes are taking place in the banking system behaviour. First is the behaviour of the banking system in international relations. Up to 2008, the banking system developed internationally via two ways. One, via cross-border lending, and two, via new foreign affiliations, especially in countries like Albania, or developing countries. After 2008, both these developments reversed in the opposite direction. We have now deleveraging and shrinking and, sometimes, developing exit strategy for big EU-based banks. The second very interesting development is in the world financial flow composition. Up to 2008, banking flows stood at the centre of global financial flows, implying banking was the main contributor of international financial flows. This aspect has also changed. If before the crisis, banks accounted for about 45% of total international flows, now they account for just 25%. This means that the trend internationally is shifting from debt to risk sharing properties. Perhaps, this is giving another hint to us that in the near future, after not so many years, this trend of exit strategy will be just a transition.

Chart 5. Changes in cross-border lending behaviour



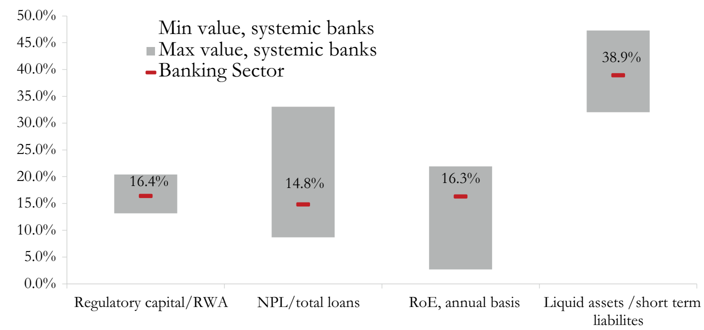
In the long-term, again the strategy of opening new foreign affiliates will return, because of what happens with the excessive funds of international banks, in the absence of lending internationally. Debt is not a preferred instrument any more, and banks will start investing in new foreign affiliations, that is coming back to the country they are leaving right now. Maybe this will be just a transition period.

3. BANKING SYSTEM - MAIN GOALS AHEAD

Having shared with you these main developments in the financial world, not only in Albania and in region, but also globally, let me now move on to next part of my presentation.

Banks have to understand that their position within financial flows will be not any more as central than it was before 2008. But, this does not mean that they have no homework to do and to go further ahead. After the 2008 crisis, as always happens in the aftermath of a crisis, the first reaction was new regulation - especially for the large banks that were the main contributors to the crisis, this new regulation came fast and thick. There were two main goals of this new regulation regime: to increase the resilience of large banks; and, to try to find the equilibrium of competition - not too much competition, not too little competition. Regarding the improvement of resilience, the main focus was on capital. This is not just about more capital, but more high-quality capital. For EU banks, the level has increased from the 7% that it used to be before the crisis for tier 1 capital, up to 13.5% now, and is continuing to rise.

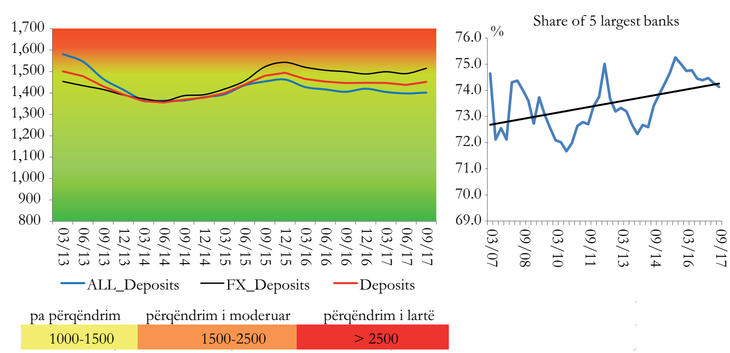
Chart 6. Increasing resilience for large banks



Yet, capital is not the only relevant important consideration regarding resilience. Limiting the banks' dependence on runnable funding sources is another very important consideration, especially for Albania. If we look the last tendency we see more and more the increasing percentage of demand deposits in total deposits. Hence, this is something important to be considered, also for Albania, as a potential risk in very near future.

Regarding competition, we have to find the balance. On the one hand, we need not too much concentration. In Albania we are

Chart 7. Monitoring the level of competition



coming very close to moderated concentration. Not yet, but very close. On the other hand, we need to address the "too big to fail" problems.

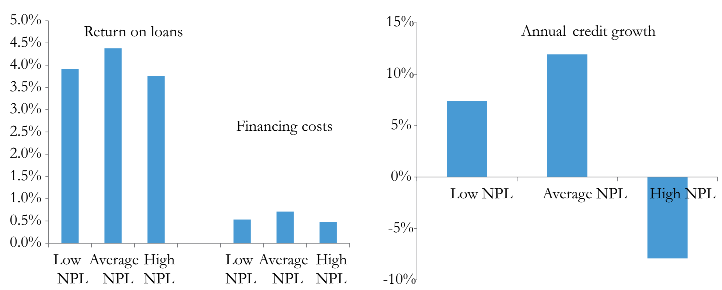
Everywhere, the first reaction in addressing the "too big to fail" problem was implementing the resolution regime. We did the same in Albania and almost the whole framework of that regime is already established. Again, turning to the competition, there are two main things that need to be at the focus of the attention of large banks especially. First, it is optimising the size. The crisis showed that being a small bank is not an advantage, but it is not even an advantage being an over-sized bank or very big bank. There are many studies regarding the optimum size of a bank in order to be operating and manageable. While there is no final figure for that, we have to say here that: big banks must self-find the optimum size in order not to experience what the other larger banks experienced during 2007. The last crisis provided some lessons on this issue.

First of all, regulation was not enough, because while half of 100 largest banks used to always comply with the regulator and all requirements, they still went into bankruptcy. Also, capital is not enough. Capital is the main regulatory requirement, but it is not enough to cover all kinds of risks and because of that, we have to simultaneously check all the risk directions in order to prevent any stressful periods as was the case in 2007. We have some data with this regard as well. For example, four of the big banks that failed during the last crisis had at that time the level of capital adequacy that new Basel III is looking for today, and that still did not help them to resist the shocks. Also last December, it was Banca Popolare that still had 12% Tier I capital, and six months later it also went bankrupt.

As we argued so far, it is not good to have very large banks and, even worse, to have "too big to fail" banks. We should not forget that even very high competition is not a positive asset for the banking system. Competition may damage the banks in two ways. First, by pushing the banks towards lower and lower levels of profitability, which enables banks to create capital buffers, as it is a very necessary source for their resilience; and second, by pushing them to undertake higher risk than they should do otherwise. So, high competition is also not good and it is the duty of the central bank to check and control the level of competition. When we talk about stability, everything is about balance. We should find the balance also in the competition level.

Turning to my last point, another duty for banks today and in the coming years is to manage the crisis legacy, which is mainly the resolution of NPLs.

Chart 8. Managing the legacy of crisis



No need to dwell on the details in this point, because good words have been said by the previous speaker regarding NPL management in Albania. However, I have two or three points about regulation strength and tools, because as we keep hearing, the banks are complaining about the regulation, very tough regulation, which is damaging their efficiency. We know that is a trade-off between efficiency and stability, but we cannot sacrifice stability for efficiency, because a large bank being in difficulty is not a private issue. We know, and the large banks also recognise, the high cost of their failure for the whole economy. We also know that capital is very expensive, but a well-capitalised bank can withstand shocks better than others that have not enough capital, even without resorting to the fair sales, and so continue crediting the economy in tough times. So, the long life of a well-capitalised bank is a kind of pay-off for the expense of capital. Also, the rules are becoming complex, because the financial system is becoming complex, and the rules just mirror that complexity.

I want to finalise what I have said for the way ahead and also for the strength of rule, with the words of George Bernard Shaw: “If history repeats itself, and the unexpected always happens, how incapable must man be of learning from experience?”

So, we have to internalize all the lessons that the crisis of 2007 left behind, in order for us, at the very least, not to make the same mistakes.

Thank you very much for your time and attention!

SECOND SESSION:

ECONOMIC FINANCIAL AND INSTITUTIONAL CHALLENGES AND POLICY SOLUTIONS

The session will discuss challenges and policy options faced by central banks and Supervising Authorities. The session will also keep in focus the role and efficiency of monetary policy, exchange regimes, macro-prudential and regulatory changes and/or other institutional arrangements in the presence of financial market incompleteness and limitations.

Chair: Adam Bennett, Deputy Director of PEFM & Associate of SEESOX, St Antony's College

CREDIT CONDITIONS, THE EFFECTS OF ECONOMIC SHOCKS AND MONETARY POLICY

*Massimiliano Marcellino**

We study the interaction between financial markets and the economy, taking a macroeconomic perspective. We start from the consideration that widening credit spreads lead to a decline in economic activity, see for example Gilchrist and Zakrajsek (2012), Faust, Gilchrist, Wright and Zakrajsek (2013); and Lopez-Salido, Stein and Zakrajsek (2017). Widening credit spreads are also typically associated with credit rationing and the worsening of general financial conditions. All this makes borrowing by consumers and firms more difficult and more expensive, thus lowering aggregate consumption and investment, and therefore GDP growth, employment, earnings, and prices.

There is also empirical evidence that the transmission of structural shocks and the effectiveness of economic policy may change over time. For example, the responses to monetary policy shocks and the size of the fiscal multipliers can depend on whether the economy is in an expansionary or recessionary phase, see for example, respectively, Weise (1999) and Auerback and Goridnichenko (2012).

Hence, the first interesting question is whether the dynamic relationships among economic variables change over time. A

* *Massimiliano Marcellino, Professor, Department of Economics, Bocconi University.*
This article is based on joint research with Andrea Carriero (Queen Mary University of London) and Ana Galvao (University of Warwick).

second, related question, is whether the changes are driven by the business cycle phase, by the stance of monetary policy, or by credit market conditions, as measured by credit spreads. A third question is whether the effects of economic shocks change across the different identified regimes. And a final question is whether monetary policy is differently effective across regimes and whether or not it can be also used to improve credit conditions.

We address these questions using a particular econometric model developed in a paper by Carriero, Galvao and Marcellino (2017), on which this article is based and to whom we refer for additional details. The model is labeled ST-MAI-TV: smooth transition (ST) multivariate autoregressive index (MAI) with time-varying variance (TV). The ST component allows for changing dynamic relationships across the variables, the MAI component allows to model a large number of variables in order to take a more granular view, and the TV component permits the size of the shocks hitting the economy to change over time, as empirically this is an important feature. We apply the model to a set of about monthly 20 macroeconomic and financial variables for the USA, including real, nominal and monetary indicators, together with a set of credit spreads, over the sample 1982-2016.

As a first step, indicators belonging to the same group (activity, prices, monetary, credit) are summarized into indexes, in order to reduce the dimensionality of the problem and get overall measures of real, nominal, monetary and credit developments. The resulting indexes, or factors, are graphed in Figure 1.

Figure 1 shows how the activity factor closely monitors the evolution of the US economy, decreasing during recessionary periods and increasing over expansionary periods. The nominal factor does not vary much, though it dropped significantly since the late '70s, and there is a declining trend at the end of the sample which is common to many developed countries and is associated with a decrease in global inflation. The monetary factor tracks the monetary policy stance, which is expansionary during recessions and contractionary during expansions. Finally, the credit factor has similar behavior to the activity factor, but seems to lead it slightly, with deteriorations in credit conditions (increases in the values of the credit index) followed after some time by a drop in the activity index.

Figure 1. The year on year growth rate in the indexes
(right scale is for the monetary index)

Note: Monetary policy factor in the right axis.

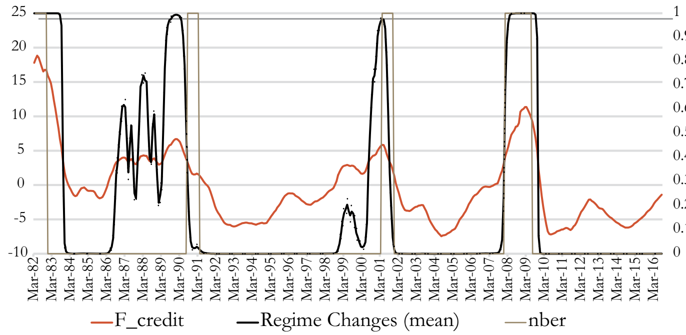
Our estimated factors are substantially correlated with standard measures of the US economy. For example, the correlation between our activity factor and the Philadelphia FED activity index is about 0.86, and between our credit index and the Chicago FED financial conditions index is about 0.78.

Each factor can be used in turn as a driver of parameter time variation in the ST-MAI-SV model. The resulting specifications can be compared in terms of fit, or using information criteria that combine fit with the extent of parameterization. Using both measures, it turns out that the credit factor is more relevant than the other factors to model changes over time in the dynamic relationships among the 20 key economic and financial variables that we are considering.

Figure 2 provides a characterization (endogenously determined by the econometric model) of periods of high and low credit stress. The same figure also reports the credit index and the NBER dated business cycle phases. It turns out that there is a substantial overlap between the NBER dated expansions and recessions and our dating of periods of high and low credit stress. However the overlap is not complete, with the credit stress period anticipating the recessionary period both in the early 1990s and in the early 2000s.

The previous findings suggests that widening or shrinking credit spreads do matter for the dynamic evolution of the economy,

Figure 2. Credit stress regimes as identified by the ST-MAI-TV model and NBER dated recessions



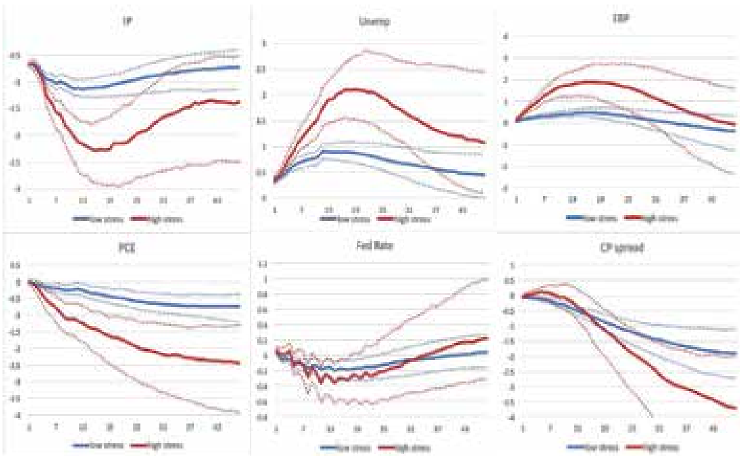
NBER recessions: greyish line.

and therefore in principle they are also relevant in studying the transmission of economic shocks and the reaction to monetary policy. To assess whether and to what extent this is the case, we focus on three common and relevant economic shocks. First, demand shocks, such as unexpected changes in net exports. Second, supply shocks, for example unexpected variations in oil prices. Third, monetary policy shocks, specifically unexpected changes in the policy rate.

We consider negative shocks, namely, shocks that are expected to reduce real activity, and focus on their effects on six key economic variables: Industrial production, unemployment, personal consumption expenditures (PCE), inflation, the Federal Funds rate, and two measures of credit spread, labeled as EBP and CP. In Figures 3 to 5 we report the (cumulated) estimated responses over time of these 6 variables to each of the 3 shocks, together with 68% confidence bands that provide a measure of the uncertainty around the estimated responses. Responses in red assume that the shock hits in the high credit stress regime (regime 2), while responses in blue assume the shock hits in the low stress regime (regime 1).

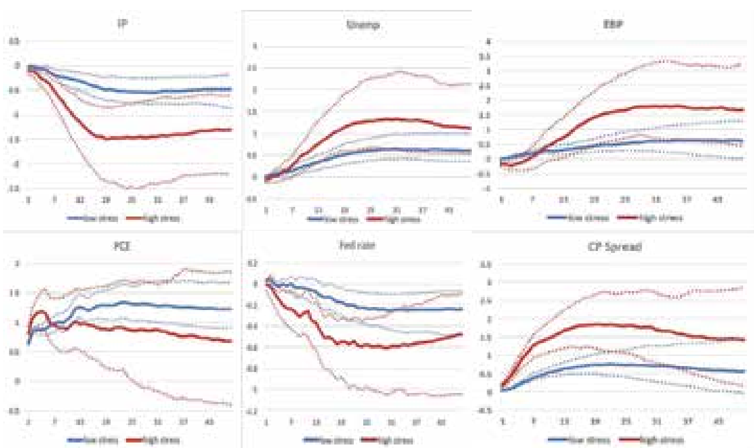
Figure 3, reporting responses for a negative demand shock (an exogenous decline of the activity factor), shows strong amplification effects in the high stress regime in the responses of economic activity variables and prices to demand shocks. Similar sized demand shocks have their effects amplified twofold after two years if they hit in a regime of bad credit conditions. The effect of the demand shock on unemployment is an increase of about 1 percentage point after two years in times of low credit stress, but in times of high stress, this effect is 2 percentage points. An amplification of similar magnitude is also detected in the excess bond premium responses.

Figure 3. Responses to a negative demand shock



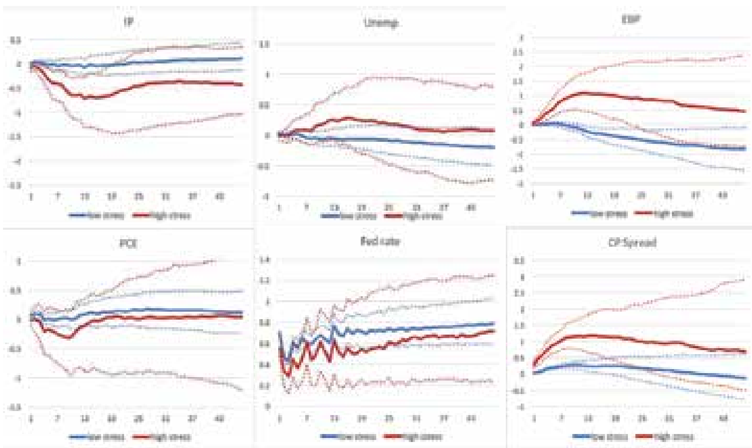
Similar amplification effects are also found in the responses of economic activity variables to supply shocks (Figure 4), except for the PCE deflator.

Figure 4. Responses to a negative supply shock



Amplification effects are smaller for monetary shocks (Figure 5), though still present. In particular, the excess bond premium increases following monetary policy tightening in the high stress regime. However, a shock of a similar size has a negative effect on excess bond premium in the low stress regime. An important side consequence of this result is that expansionary monetary policy during credit stress periods not only has positive effects on activity but can also reduce the extent of the credit stress, by lowering the credit spreads.

Figure 5. Responses to a negative monetary shock



In summary, we have shown that credit conditions drive switching dynamics in a set of 20 key economic and financial variables for the USA. They seem to matter more than business cycles or monetary policy stance. Economic activity responses to demand, supply, monetary and credit shocks are amplified when they hit the economy during periods of credit stress. Price responses to demand and credit shocks are also amplified. Credit spreads shrink with expansionary monetary policy, in particular in the credit stress regime. This amplifies the positive effects of expansionary monetary policy on economic activity and prices during credit stress periods (but also the negative effects of a restrictive policy). Therefore, monetary policy is even more useful in problematic times, if properly used.

NONPERFORMING LOANS AND THE UNFINISHED POST-CRISIS REGULATORY AGENDA

*Piroska Nagy-Mohacsi**

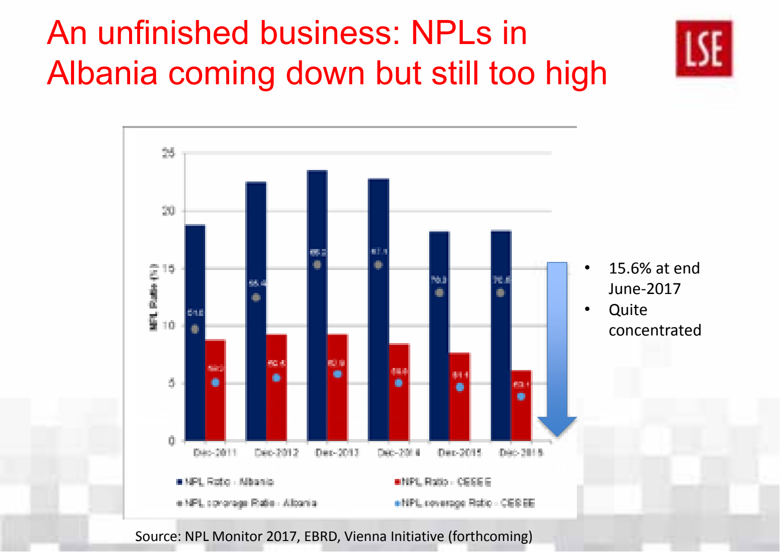
In this short paper I will discuss two points: progress in dealing with the high level of nonperforming loans (NPLs) in the wake of the global financial crisis (GFC) of 2008/9, as well as progress in post GFC regulatory reform that could help avoid the re-occurrence of the crisis and a new wave of NPLs in the future.

Progress in reducing NPLs

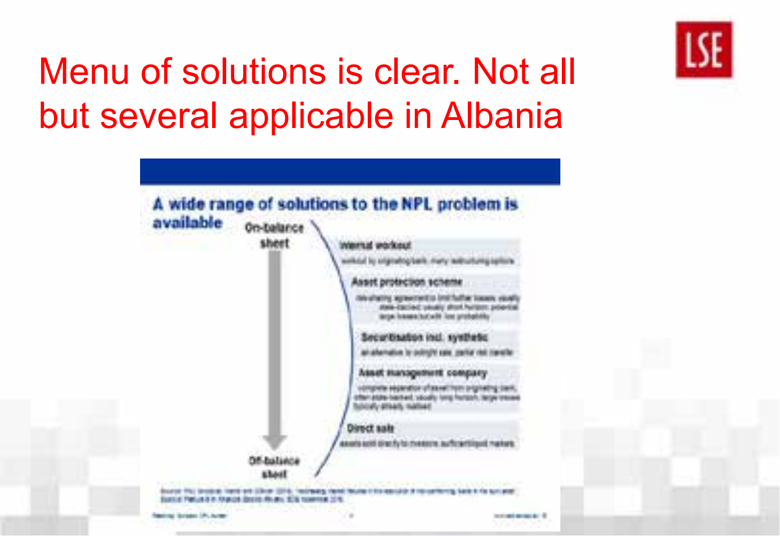
Why are NPLs important? Because an overly high level of NPLs necessitates setting aside bank capital to back them up as well as human capital to manage them. ECB and other studies have persuasively shown significant gains to be made from reducing NPLs. The capital release gained from removing NPLs can spur lending growth, boost confidence, and free up valuable managerial time to focus on the basic business of banks: financing consumers, investment, SMEs and startups, and innovation.

Albania's NPL ratio is currently still high, but it is coming down. Albania has an excellent "report card" in the past 18 months in this area. The economic conditions to carry out this work are there; the legal structures are in place and the leadership knows what to do and

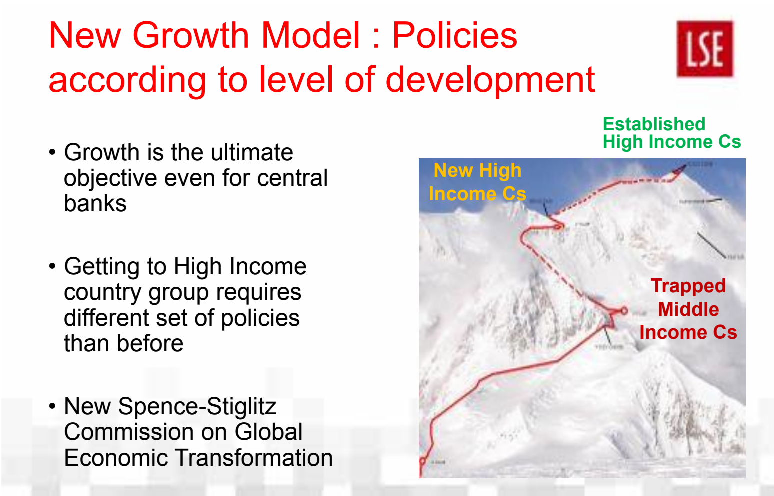
* *Piroska Nagy-Mohacsi, Programme Director, LSE Institute for Global Affairs*



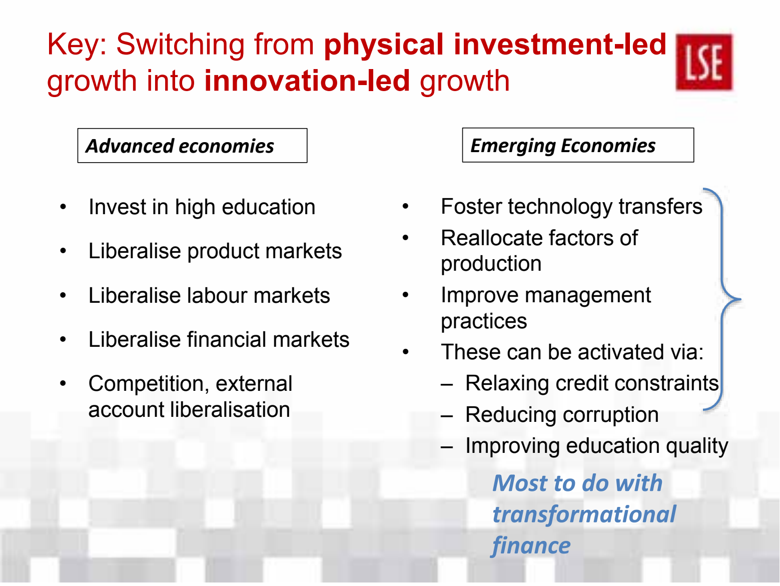
how to do it. So it is now a question of political will. NPL reduction is now recognized as one of the key final "pushes" needed to get post crisis economic recovery truly broad-based. "Just do it", as the saying goes.



Indeed, economic recovery and more broadly sustained growth, income generation and/or employment have become de facto or de jure objectives of central banks. Some central banks still have strict a single mandate of some form of inflation-targeting, but many of them have had a clear de facto focus on growth following the GFC.



This chart of the World Bank from our joint Middle Income Trap project illustrates this point. Getting to the middle income group of countries is relatively straightforward for most developed countries (apart from fragile states). However, very few countries have made it to high-income levels. Since the beginning of the 2000s, only about a dozen economies have managed to do so. The main issue is that this leap requires different sets of policies, shifting the policy focus away from physical investment-focused growth to innovation-led growth. This is not simply about investment. It is not simply about debt versus equity financed investment. It is about innovation enabling investment and associated transformational finance.



Progress in regulatory reform

How much progress has been made in post GFC regulatory reform that should help avoid the re-occurrence of the crisis and related NPLs? A lot has happened. In the area of microprudential regulation, the quality and quantity of capital has increased, there is a new leverage ratio, liquidity coverage ratio, a net stable funding ratio, and some progress has been made in agreeing on ways resolution mechanisms can improve banks' total loss absorbing capacity. Moreover, new macroprudential tools have been added to the regulators' toolkit: countercyclical capital buffers, a heightened regulatory focus on globally and/or domestically systemic banks, lending standards have been improved, and so on. Other measures target pay limits and better governance.

Yet with all the good work that has been done since 2009 with good international collaboration and coordination, some big issues worryingly persist:

1. Too much regulation? There is a serious question whether there now is too much regulation. This mostly comes from the

industry and the US. It is generally recognized that in order to deal with multiple problems - and this is what we have in today's financial sectors – we need multiple instruments. Yet it is fair to say that for small banks and other small financial institutions the current level of regulation is excessive and it toughens entry. There is a need for proportionality. Both the Federal Reserve and the ECB are looking at this issue, because the financial sector needs to have competition to reduce market concentration and the heavy reliance on banks.

Post-Crisis Regulatory Reform: Extensive…

LSE

- **Micro-prudential**
  - Quality and quantity of capital (RW)
  - Leverage ratio (LR)
  - Liquidity coverage ratio (LCR)
  - Net stable funding ratio (NSFR)
  - Resolution mechanism/Total loss absorbing capacity (TLAC)
- **Macro-prudential**
  - Countercyclical cap buffer
  - G-SIBs; D-SIBs capital req
  - Lending standards (LTV, LTI etc)
- **Other**: pay limits, governance…

…. yet big issues persist

LSE

- **Too much regulation?**
  - Multiple problem – multiple instruments
  - Compliance issue for small bank & entry
  - Maybe also MacroConduct not only MacroPru (Kevin James et al 2017)
- **Is regulatory capital sufficient?**
  - "Optimal": Tier 1 ~ 16-19% - Today 2/3 of G-SIBs and D-SIBs have less
  - Does higher capital result in less lending? Good news: No (Cecchetti 2014)
  - Trade-off: capital – credible resolution mechanism TLAC (Holdane 2017)
  - Maybe it is all about leverage by "small" & "large" (Hyuan Song Shin 2017)
- **Is the Too-Big-To-Fail problem solved?**
  - No
  - Big size does not help performance only bank lobby power (Hubert 2017)
- **Complicated political economy of central banks**
  - Deeper into political territory; joint tasks with fiscal authority
  - Central bankers are primary target of populism

2. Macroconduct regulation? This is the idea that in addition to macro-prudential instruments that are by now well-known, maybe one should think of macroconduct instruments to better regulate company behaviour. It may not be enough to regulate only the financial sector; it may also be necessary to regulate corporate behavior, and perhaps develop some principles/ conducts there. Kevin James at LSE is doing pioneering research in this area.

3. Is regulatory capital sufficient? The vast majority of recent studies find that Tier 1 capital should be close to 20% as opposed to where we are today; for example at 13% in the euro area. Two thirds of global systemically-important banks and two thirds of domestic systemically-important banks do not reach 20% for tier 1 capital. So, is regulatory capital sufficient? Academics will tell you "no". There is good news, though. Does higher capital result in less lending? The answer is "no" as a study by Cecchetti shows. Moreover, there is a trade off between capital (the quantity and quality of regulatory captial) and the credibility of the bank resolution mechanism. Andrew Haldane of the Bank of England has found that if you have a credible resolution mechanism with a good level of bank total absorptive capacity, then you can afford to have less bank capital. However, there are not too many countries with a strongly credible resolution mechanism today. Finally, a vast body of literature is coming out now, led by the BIS, that suggests that the regulatory focus should be more on leverage and less on capital.

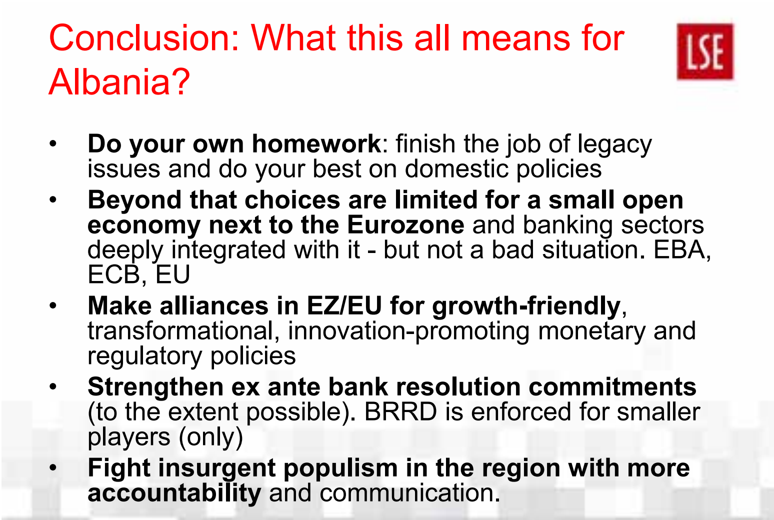
4. Has the "Too-Big-To-Fail problem" been solved? In my view, no. Even with a 20% tier 1 capital, a big shock would lead to a serious financial crisis. Market concentration of banks has increased since the crisis. Bank size is the big issue. In our institute very interesting research about bank size by Kilian Hubert finds that size does not increase bank efficiency but does increase banks' political influence.

If these issues were not enough, central banks need to address these challenges in an increasingly complicated political economy context.

Naturally and rightly, post GFC central banks have moved deeply into political economic territory. They have performed joint tasks with fiscal authorities in a concerted effort to avert a deep recession, and this was a very good thing. Central banks have been also active in other areas that are closer to politics such as financial inclusion. Central bank decisions have significant income distribution effects too. However, central banks' deeper political involvement has not been matched by more accountability. This has made central bankers a primary target of populism in parts of the world. Central bankers need to consider how to engage with the public more effectively and address any accountability issues head-on.

Conclusion

By way of summary, we ask the question, what does this all mean for countries with small, open economies like Albania?



For a small, open economy with deepening ties to European institutions and mechanisms, the main conclusion is that it is critical to do one's "homework" consistently well: deal with legacy issues such as NPLs and then focus on growth-enhancing transformational finance. Beyond that, choices are limited for small, open economies next to the euro area, and for the banking sector whose banks are owned by euro area-based banks. That said, this is not a bad position to be in. The vicinity of the world's biggest single market and the clear prospects of joining it is a very enviable position to be in.

An implication of this is that countries such as Albania would want to make alliances within the euro area and the EU for a more growth-friendly transformational monetary and regulatory policy.

Lastly, it is important for central bankers to face up to the criticism coming from populist circles and tackle the issue of accountability. Central banks are rightly in the political arena. They are rightly working with fiscal authorities. But it means that as they add tasks – as they have done in the wake of the crisis – they also have to commit to more accountability to the public, whatever the right form that might take. This will strengthen rather than undermine their independence.

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MACROPRUDENTIAL POLICIES AND THEIR SPILLOVER EFFECTS

*Pietro Catte**

I will speak about basic rationales, and objectives for macroprudential policies, because this is useful to setup the issue of spillovers. We will go briefly over the implications of having a high degree of international financial integration in the global economy and what this implies for macroprudential policies. Then I will speak about spillover effects and their policy implications.

Now, where are we coming from?

Macroprudential policies have existed for a long time. They have been around for some time, especially in emerging countries, but what really brought them to the attention of everyone, the need to have a specific tool to deal with systemic risk, was the global financial crisis of course, which showed that it is not enough to have macroeconomic and macroprudential policies. To contain systemic risks, you need specific policy tools. This is not to say that macroeconomic policies and macro-surveillance were perfect before the crises - they were far from that. However, even in the presence of perfectly aligned macro-policies and micro-supervision and so on, it is not enough to stem systemic risk. These tools that are identified as macroprudential ones are really microprudential tools, which

* *Pietro Catte, Deputy Head of International Economy and Relations Directorate, Banca d'Italia.*

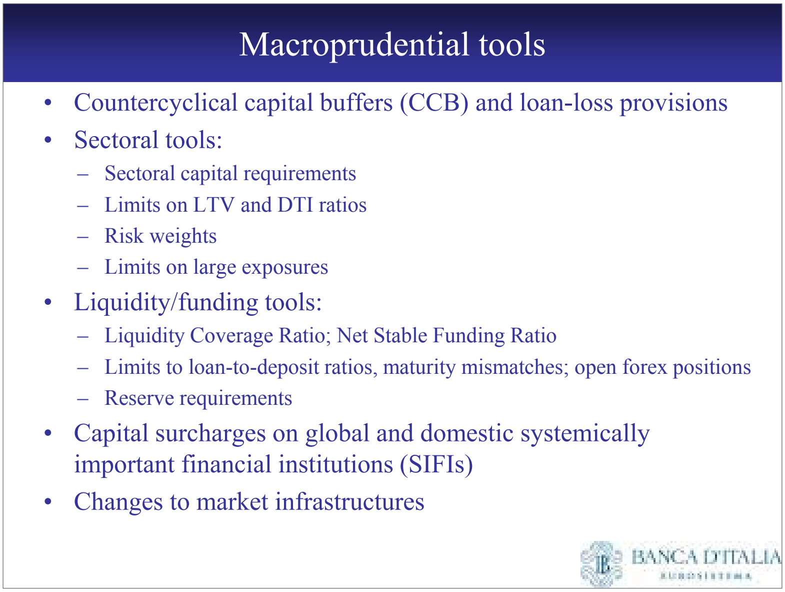
are being used for a broader objective, which is a macro financial objective.

Chart 1. Macroprudential policies: rationale and objectives

Also, the experience of using these tools - which I will go over - will often make use of the same instruments, for different objectives. The other thing that the global financial crisis showed was that risks tend to spill over across borders. So there are externalities to policies aimed at preserving financial stability, and there is an argument for international cooperation. This is why there is so much discussion about the reform of financial regulation and also about macroprudential policies, even though macroprudential policies tend to be national - and they have to be national, because risks are very often specific to the financial system. Yet, there has to be some sort of coordination, some standards, and some communication across countries.

So what are the objectives? The objectives are to make the financial system more resilient against shocks if they occur, to contain the buildup of systemic vulnerabilities over time, to make the system less procyclical, and to contain the vulnerability arising from interlinkages and from the fact that there are very large institutions, or interconnected institutions, that spread risks once they arise.

Chart 2. *Macroprudential policy tools*



I am not going to go through these tools, because you know them, but this is just to show that there is a variety of tools that tend to operate on different elements of banks' balance sheets. Some are broad and some affect the different parameters of banks, depending on the instruments and different transmission mechanisms they have.

Now, what happens when you have high degree of financial integration across countries? One problem that is present from the beginning with macroprudential tools is that the benefits of financial stability are visible in the medium term, while the costs of restraining a credit boom are visible immediately, and generate immediate resistance and opposition. Therefore there may be a bias toward inaction.

This is a well-known problem and this is why there is so much effort to build up a framework from macroprudential policies that tend to counter this inaction bias. Now this inaction bias can be exacerbated in an international context. First of all, assessing systemic risks becomes more complicated, because they come from the interconnection with banks which operate in different systems. National authorities might be reluctant to intervene if this puts their own banks at a competitive disadvantage with others by restricting their actions and their ability to operate in other markets. So, you need international cooperation in this area, and that is why you have procedures for exchanging information, you have the global monitoring of systemic risks in various forums, and you also have international standards being set and a kind of peer pressure for this collective action problem.

Chart 3. Implications of growing international financial integration for macroprudential policies

Implications of growing international financial integration for macroprudential policies

- Domestic inaction bias may be exacerbated
  - Assessment of systemic risks is more complicated (e.g. for global banks)
  - National authorities might be reluctant to put domestic banks at competitive disadvantage, in view of potential regulatory arbitrage ("race to the bottom")

    → Need for international cooperation
    - procedures for the exchange of information (e.g. supervisory colleges)
    - global systemic risk monitoring by FSB, BIS, IMF
    - international standards and peer pressure to address collective action problem (Basel Committee and FSB guidance; IMF surveillance)

- Greater scope for cross-border spillovers from national MPPs
  - Outward spillovers: credit and financial conditions in other countries may be affected
  - Inward spillovers: foreign institutions are able to circumvent MPP measures, via either local branches or direct cross-border lending, partly offsetting their effects.

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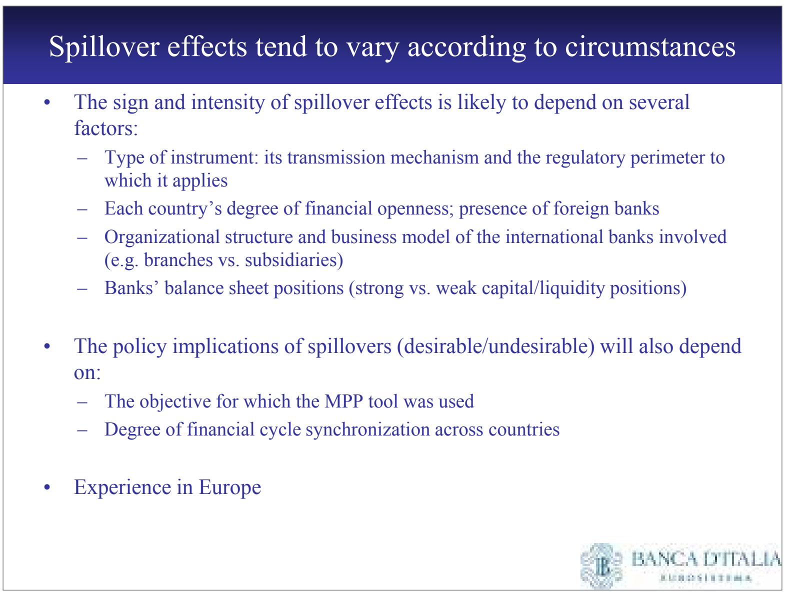
Now, international financial integration also means that there is scope for spillovers from national macroprudential policies, and there can be different types of spillovers. Outward spillover can happen if a country enacts, for example, a tightening of macro-prudential standards. This will aldo affect the credit conditions in other countries through banks from the home country that are present in other systems.

At the same time, there are inward spillovers in the sense that if you tighten policy at home, there might be foreign institutions which are able to circumvent this macroprudential action either through local branches that are not subject to this measure, or via cross-border lending, which tends to weaken and offset the effect of macro-prudential policies. This is, therefore, a very relevant issue.

These spillover effects tend to vary according to the circumstances. Their sign and intensity depends on the type of instrument, because the transmission mechanisms are different; on the degree of openness - of course, the presence of foreign banks; and on the organizational structure and the business model of international banks, because it depends whether they have centralized liquidity management. In addition, it depends on the balance sheet position of the banks, because banks may be more reactive to incentives to moving to other markets if they have a strong balance sheet, and strong capitalization.

Chart 4. Spillover effects tend to vary according to circumstances



Implications of the spillover also depend on a number of circumstances, like the objectives for which the policy was used. This is because you may have a spillover that offsets the effect on credit, but you still have a positive effect on the resilience of the banking system. Thus, you may be able to strengthen your banks, but at the same time, you may not be able to fully control what happens to credit in your country if there is a spillover. The degree of financial cycle synchronization across countries also matters because if you have the outward spillovers, these may be good or bad, depending on whether other countries are in the same phase of the financial cycle. In Europe we have seen this kind of experience, especially in Central and South Eastern Europe and in the Baltic countries. Before the crisis, we saw several situations where macroprudential measures that were introduced to try to stop or to slow the credit boom and to build resilience were partly offset by credit inflows coming from other countries through local branches, or through cross border lending, all included in foreign currency lending. This is a very relevant issue which we have seen in a number of cases.

There have been attempts to assess how empirically important these spillover effects are. There is a very large study that was published this year in the International Journal of Central Banking by 15 central banks, plus the studies of the ECB and the BIS. They have 15 countries studies with macro data and common methodology, making it possible for comparability over the same period. In addition, there is a common data base on macroprudential policy measures developed with the IMF.

Chart 5. Empirical assessments of spillover effects from MPP measures (1)

Empirical assessments of spillover effects from MPP measures (1)

- International Banking Research Network
  - 15 country studies using confidential micro data, common methodology, 2000-2014 period
  - 2 cross-country studies by BIS, ECB
  - Common database of MPP measures, developed with IMF
  - Results published in *International Journal of Central Banking*, March 2017
- Main results:
  - No single dominant pattern; signs of spillover effects vary; spillovers are statistically significant in about one-third of specifications
  - Heterogeneity of results seems to be connected to bank balance sheet positions, banks' business models and liquidity management; cyclical positions do not seem to matter
  - Response of cross-border bank credit to liquidity and sectoral MMP measures more frequently significant than response to capital measures
  - In general, size of spillover effects is not large
  - No systematic difference between AEs and EMEs
- Some limitations of the results / qualifications of their implications:
  - MMPs were not used very frequently in the sample period; relevance of spillovers may increase in the future as MPPs are used more frequently and in a variety of situations
  - Analysis focused on adjustments along the intensive margin, excluding those via entry/exit and M&A (extensive margin). Also, it focused on quantity adjustments, not prices.

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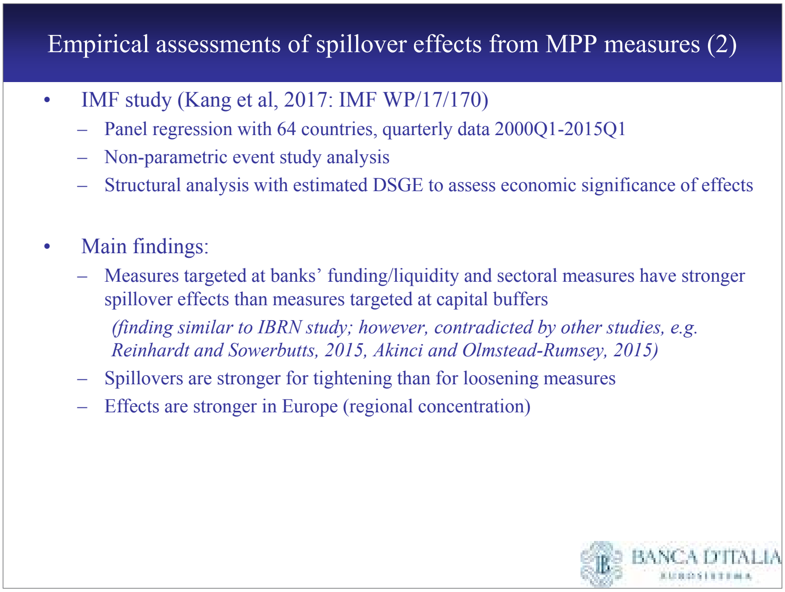
Chart 6. Empirical assessments of spillover effects from MPP measures (2)



The results are not particularly strong, and there is no single dominant pattern: the intensity of the spillovers varies a lot, and it varies from different factors including the one I mentioned before; cyclical positions do not matter a lot. Conversely, the bank balance sheet position matters, and the business model of the banks matters, but in general the size of spillover effects is not large. They seem to be stronger in some cases and there is no systematic difference between advanced and emerging economies, which is somewhat surprising because one would normally think that they are stronger in emerging countries.

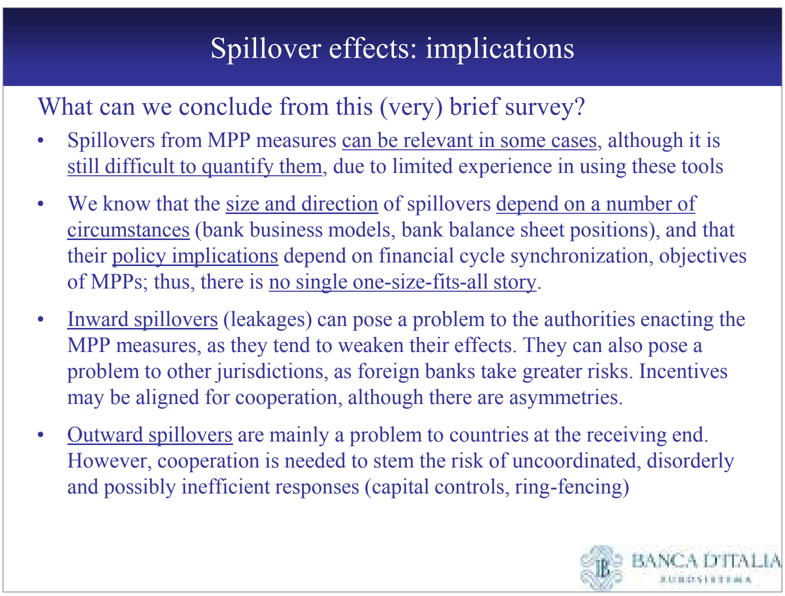
However, it is difficult to draw strong implications from this kind of study, because the period it refers to in which macroprudential is used is not very long. Part of the database covers the use of these instruments but for other reasons; so it is not the same thing as using them for macro-prudential policies. You do not have a variety of situations and ideally you would want a study covering more than one financial cycle, and of course we do not have that yet.

So, there are some limitations, and it is hard to draw strong implications.

There is another important study conducted by the IMF; this is not with macro data but is a panel regression with a large number of countries. Several methodologies were used and, in general, they also find results that banks' funding measures have stronger spillover effects than measures that target capital buffers, and they find stronger effects in Europe.

What we may conclude from this survey is that macroprudential measures can be relevant in some cases, but it is difficult to quantify them. Size, direction and their implications depend on a number of factors. They do pose a problem where they appear, and inward spillovers cause a problem for the authorities enacting the measures as they tend to weaken the effects of macroprudential policies. There might also be some alignment of incentives to counter these spillovers. In particular, this can be done through a reciprocity agreement and this is something that is embodied already in the Basel Agreement in the EU. The ESRB - the European Systemic Risk Board - has put in place a framework for voluntary reciprocity of macroprudential measures, meaning that the country can request the reciprocity from other countries.

Chart 7. Spillover effects: implications



So if you enact a measure, you can ask others to apply the same measure in banks operating in the requested countries, to the exposures in that country. It's a relevant point. Of course, it is easy to apply this if you have a harmonization of toolkits and transparency. For outward spillovers, it's a little bit more difficult to have a systematic solution to address them.

REAL AND FINANCIAL SHOCKS IN ALBANIA: SHOULD MONETARY POLICY BE SUPPLEMENTED WITH ADDITIONAL TOOLS?

*Erald Themeli**

Honorable organizers and dear guests,

I would like to begin by thanking you for the opportunity afforded to share my thoughts on a subject of great interest to the Bank of Albania.

Figure 1. Motivation

* *Erald Themeli, Head of the Monetary Policy Department, Bank of Albania. The author would like to sincerely thank Mr. Eglent Kika and Mr. Olti Mitre, both at the Monetary Policy Department of the Bank of Albania, for their invaluable help in the discussion, quantitative assessment, and graphic presentation of the impact of real and financial shocks in Albania. The author would also like to thank Ms. Erjona Suljoti and Ms. Sofika Note, both at the Monetary Policy Department of the Bank of Albania, for their extensive and much appreciated work on the literature review.*

The starting point for my presentation is twofold. On one hand stands the ongoing debate among central bankers, policy makers and academia, regarding the need – or the scope – of coordinating monetary policy with macro-prudential instruments. This debate investigates both sides of the argument. Should monetary policy tools and instruments be deployed to safeguard financial stability? Alternatively, can the achievement of monetary policy goals be facilitated through the employment of macro-prudential, or probably other, tools? On the other hand stands the recent experience of Albania, where the aftermath of the last Global Financial Crisis (GFC) exposed us to a wide variety of shocks, and where the issue of policy coordination is still open.

The goal of my presentation is, first, to investigate whether – and to what extent – the Albanian economy is subject to financial shocks. Later, I will present some of the corrective measures that the Bank of Albania has undertaken to mitigate the probability and the impact of such shocks.

Before proceeding, allow me to preview some of my conclusions.

1. First, economic literature suggests that small, emerging and financially integrated economies might benefit from supplementing monetary policy with additional instruments. Such coordination should yield superior results, especially in the presence of large financial shocks and the limited effectiveness of conventional monetary policy instruments.
2. Second, an investigation of Albania's past and recent history underscores the presence of both real and financial shocks. While the former are prevalent, the presence of financial shocks appears to be large enough to warrant structural and – potentially – countercyclical corrective action.
3. Third, cognizant of this fact, the Bank of Albania has already employed a multi-faceted action plan aimed at decreasing the probability of liquidity risk premia as well as reducing impact shocks in credit default and exchange rate risk premia.

The remainder of the presentation is structured as follows.

Figure 2. Content

Overview

- Coordination of monetary and macro prudential policies: a brief literature overview
- Real vs financial shocks in Albania
- Some relevant coordination areas
- Concluding remarks

The first section is a brief literature review on the subject. The second section presents and explains the decomposition of shocks in Albania. The third will detail how the Bank of Albania has tried to tackle some of these financial market imperfections. The last section will conclude.

1. LITERATURE REVIEW

The GFC of 2007-2008 forced economists to review most of their tenets on sound economic and financial management. One major point of discussion has centered on the costs and benefits of close coordination between monetary and macro-prudential policies. The topics of dispute seem to be the relative incidence of real and financial shocks, the effectiveness of using monetary policy to mitigate financial imbalances, and the impact of the blurring of lines between monetary and macro-prudential policies on their long-term effectiveness.

Figure 3. Literature review: Pre-crisis consensus

Interaction of Policies | Real vs Financial shocks in Albania | Relevant Coordination Areas | Concluding Remarks

1. Pre-crisis consensus

- Under simplified assumptions, monetary stability was thought of as a sufficient condition for overall economic stability
  - Prevailing frictions in the economy were perceived to be limited to the real sector
  - Under the premise of rational expectations, economic management policies increasingly become rule-based
  - Accounting for the time-inconsistency problem, economic stabilization duties were delegated to 'technocratic', independent and accountable central banks
- Financial markets were assumed to be self-regulating and efficient
  - Financial regulation and supervision did mostly have a micro-prudential perspective
  - Second-guessing asset-prices was deemed to be futile and leaning against the wind undesirable
  - Under a correct system of incentives, financial stability would originate as a result of sound individual institutions & sound individual market segments
- Monetary and macro-prudential policies were thought of as non-overlapping domains
  - Financial crisis: mopping up the effects rather than leaning against the wind

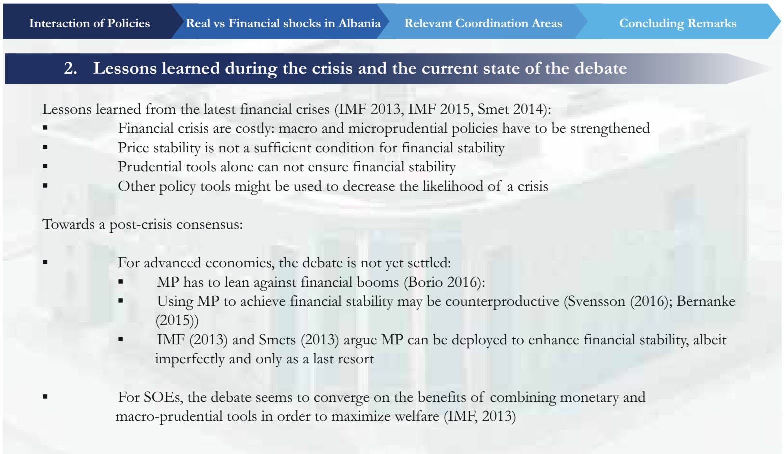
As described, amongst others, in Smets (2014) and Borio (2016), the pre-crisis consensus on economic management policies assumed monetary stability was a sufficient condition for overall economic stability. This belief, established mostly on large economies with well-developed financial systems, relied on a few assumptions. First, economic cycles arise mostly from frictions originating in the real sector. Second, financial markets and financial systems were assumed to be self-regulated and resilient to systemic shocks. Therefore, assuming a sound system of incentives, financial stability was expected to arise as a result of monetary stability and market forces.

Under these assumptions, which were rooted in a long period of stability, three specific tenets of macroeconomic management arose:

1. First, monetary policy was assigned with an almost-unique responsibility for overall economic stability. Furthermore, to account for the time-inconsistency problem inherent in policy-making and for economic agents endowed with rational expectations, monetary policy was delegated to increasingly independent and technocratic central banks, while monetary policy itself became increasingly rule-based.
2. Second, financial regulation and supervision largely employed a micro-prudential perspective, aimed at reducing the probability of default for individual financial institutions or individual market segments. In particular, second-guessing the market valuation of systemically important asset classes, such as house or stock market prices, was thought to be inefficient. Consequently, using policy tools to lean against the wind was believed to be counterproductive. The possibility of a financial crisis was not altogether ignored, but the prevailing consensus assumed it would be better to deal with its aftermath rather than actively try to prevent it.
3. As a corollary, monetary and macro-prudential policies were thought of as non-overlapping domains of economic and financial management.

The GFC made it abundantly clear this consensus was wrong.

Figure 4. Literature review: Lessons learned and the current academic debate



An extensive discussion of its causes and consequences is beyond the scope of this presentation. However, I would like to draw your attention to a few relevant lessons policy-makers learned from this crisis. IMF (2013), IMF (2015) and Smets (2014), amongst others, provide an excellent summary of them. First, they note that financial crises are costly. This should imply that both macro and micro-prudential policies and tools have to be strengthened in order to decrease the likelihood of crises occurring. In particular, Borio (2016) argues in favor of investing central banks with an explicit mandate for safeguarding financial stability. Second, neither price stability nor prudential tools are sufficient, by themselves, to ensure financial stability. Therefore, some degree of coordination amongst them should be required.

Diagnosing the problem is, of course, rather easier than prescribing a solution.

The debate on the benefits of coordinating monetary and macro-prudential tools in advanced economies is still ongoing. On the one hand, what is sometimes referred to as the 'BIS view', argues that monetary policy has to actively lean against financial booms in order to preserve financial stability. This is notably exposed by Borio (2016). On the other hand, Svensson (2016) and Bernanke (2015) refute the notion that monetary policy should be burdened with additional objectives. They note that monetary policy is a rather blunt tool to deal with financial stability issues. Concurrently, assigning a double mandate on monetary policy reduces its effectiveness and, ultimately, risks the loss of its credibility. There is, however, a third view aiming for consensus. IMF (2015) argues that, subject to a cost-benefit analysis, monetary policy can be deployed to support financial crisis. However, they note monetary policy can only be used imperfectly and as a tool of last resort.

On the other hand, for small, open and financially-integrated economies, the debate is converging on the need to combine monetary policy with macro-prudential tools (IMF, 2013). Largely, this stems from their propensity to be exposed to financial crises, especially ones originating from large shifts in financial flows. Concurrently, scholars note that macro-prudential policies can also be used as a tool of last resort, to alleviate the burden on monetary policy and increase its effectiveness.

Starting from this premise, I turn my attention to the origin and impact of shocks in the Albanian economy.

2. ASSESSING THE IMPACT OF REAL VS FINANCIAL SHOCKS IN ALBANIA

We employ the main macro-econometric model, used by the Bank of Albania to generate macroeconomic forecasts and to conduct monetary policy analysis, in order to investigate the role and impact of real and financial shocks in the recent Albanian economic history.[1]

To facilitate the discussion, we focus our attention on shocks to the real economy.[2] Despite its parsimonious nature, the model allows us to distinguish between:

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[1] *GAP is a QPM-type of model developed and employed by the Bank of Albania for forecast and monetary policy analysis. It falls under the semi-structural New-Keynesian type of models, in prevalent use for inflation targeting central banks. A thorough discussion of the original version provided by Dushku and Kota in 'A Bayesian estimation of a small structural model for the Albanian economy', Bank of Albania, 2011, can be found here: www.bankofalbania.org/Publications/All_publications/A_Bayesian_Estimation_of_A_Small_Structural_Model_for_The_Albanian_Economy.html The updated version of the model will be detailed in a forthcoming BoA paper.*

[2] *Because the model is specified in 'gap-form', i.e. deviations from trends, the model output is generated in terms of output gap volatility.*

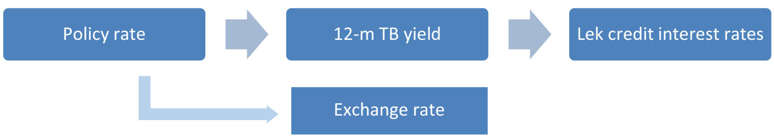
1. Demand shocks, originating from various alterations in behavior of any demand component from its predicted or trend behavior;
2. Supply shocks, originating either from changes in domestic or external prices or from changes in potential growth, such as productivity shocks;
3. Financial shocks, originating from financial market variables.

Because of our interest in financial shocks, let us look in more detail at financial market variables entering the model. The model is specified to account for the small, open economy and financial euroization nature of the Albanian economy and its financial system. Therefore, the model allows for the identification of three special cases of financial shocks:

1. Liquidity risk premia (LRP) shock:
2. Credit-default risk premia (CDRP) shock;
3. Exchange rate risk premia (ERP) shock.

Before we proceed, let me briefly explain each of them.

The transmission mechanism from the policy rate into domestic financial markets, embedded in the model, can be graphically described as below:



The policy rate is endogenously determined by the policy reaction function equation of the model. The policy rate is first transmitted to the 12-month Treasury bill yield and then to the lek credit interest rate. Concurrently, policy rate changes affect the exchange rate through the UIP equation. The behavioral equations capturing these transitions account for both trend and cyclical variations in the relevant relationships.

Defining the LRP shock

In the first step of the financial market transmission mechanism we account for: (i) the steady state structural spread between 12 month TB yield and policy rate, as a proxy for steady state LRP in domestic financial markets; (ii) trends and fluctuations in government borrowing in domestic markets, as a proxy for the demand and supply of the 12-month TB paper; as well as for (iii) model-consistent financial market expectations over the 12 month investment horizon. The model also includes a residual term to account for unexplained deviations in actual and predicted values of the 12 month treasury bill yield. We assume changes in this residual term, which should be historically averaged at 0, capture various positive and negative LRP shocks in the system. We define a positive LRP shock as a negative shock to the residual term. This shock would drive down the 12-month TB yields and – ultimately – the lek credit interest rate. The opposite would happen with a negative LRP.

Defining the CDRP shock

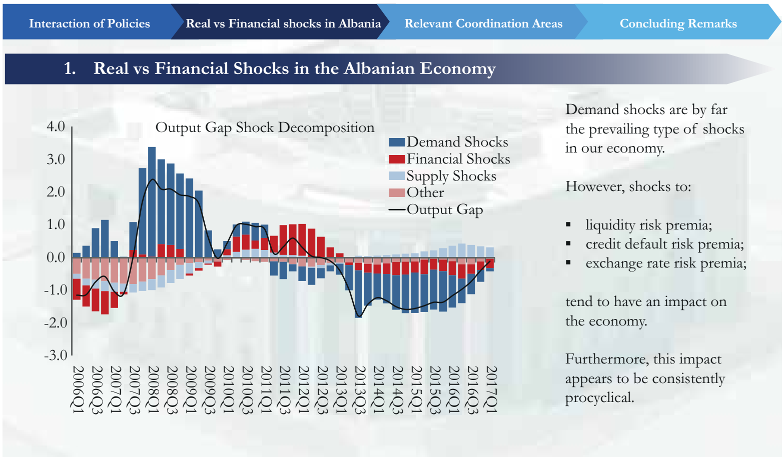
On the second step, i.e. the transmission from the 12 month treasury bill yield to the lek credit interest rates, the model accounts for the credit default risk premia present in the lending activity. This CDRP has: (i) a structural component, which captures profit margins and systemic credit risk. This component is on a secular downward trend, to account for increased competition amongst banks and other improvements in the domestic lending environment; and, (ii) a cyclical component, attempting to capture fluctuations in the default probability throughout the business cycle, the latter proxied by the output gap. Applying the same logic as before, the model contains a residual to account for the unexplained variations in the predicted and observed values of lek credit interest rates. Again, we assume variations in this residual term, which are historically centered at 0, stand for CDRP shocks. We define a positive shock to CDRP as a negative residual in the transition equation linking the 12-month TB bill yield with the lek credit interest rate. Therefore, a positive CDRP shock should lower lek credit interest rates and a negative shock to CDRP (a positive residual) should raise them. The reverse would happen with a negative CDRP shock.

Defining the ERP shock

The exchange rate is determined through a UIP equation. It captures: (i) past and expected values of the exchange rate; (ii) policy rate differentials between Albania and the ECB; and, (iii) exchange rate risk premia. The ERP itself has: (i) a structural component, designed to capture the additional return required to invest in lek assets as a compensation for inherent volatility in the lek exchange rate; (ii) a cyclical component, designed to capture ERP fluctuations throughout the cycle; and (iii) a stochastic residual term. This latter term performs the same function as the residuals we described before. We assume variations in this residual term to be ERP shocks. As before, we define a positive ERP shock as a negative residual in the UIP equation. Therefore, a positive ERP shock means lower ERP risk premia and would cause an appreciation of the nominal exchange rate. A negative ERP shock would cause the opposite.

Using the Kalman Filter algorithm on past historical data to identify shocks that hit the economy, we can decompose the output volatility in Albania over the past 12 years and group structural impulses into demand-side shocks, supply-side shocks and financial shocks. The latter group is an aggregate of all the three previously defined financial shocks, namely the LRP shock, the CDRP shock and the ERP shock.

Figure 5. Real vs financial shocks in the Albanian economy



Let us briefly look into this decomposition and draw a few initial observations.

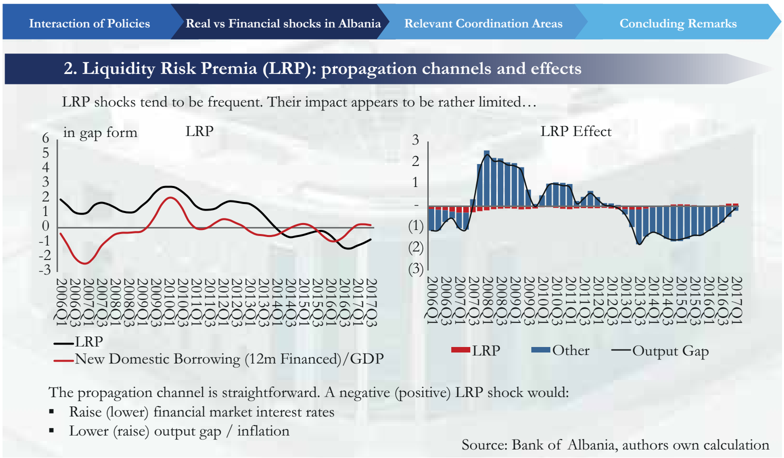
The prevalent shocks in the Albanian economy over this horizon (2006:Q1 – 2017:Q2) are originating from fluctuations in aggregate demand. According to this decomposition, Albania entered into the GFC with an over-heated economy, reflecting to a large extent demand-side shocks of a fiscal origin. These shocks, representing large public infrastructure projects, carried on well into 2009. They cushioned the negative impact of the initial rapid deterioration of external trade and provided some countercyclical fiscal stimulus in this period. Later on, demand shocks turned negative, on account of the subsequent fiscal correction, which accelerated noticeably around the 2014-2015 period. Supply-side shocks appear, by and large, to be a marginal occurrence in the Albanian economy. Probably, as a minor oil producing country, Albania is sheltered from oil price movements in international markets. Concurrently, the economic structure has evolved only gradually and technological progress might have been rather sluggish.

Lastly, financial shocks – which at this point aggregate for the LRP, the CDRP and the ERP shocks – appear to be a consistent feature of our past history. While they do not play a prevalent role in output volatility, they still account for part of it. The following sub-sections will look in more detail at each of them.

2.1 LRP SHOCKS IN ALBANIA

The set of charts presented in Figure 6 depicts the evolution of the LRP in Albania (the black line on the left-hand panel) and its impact on the output gap (the red bars on the right-hand panel).

Figure 6. Liquidity risk premia (LRP): propagation channels and effects



The LRP appears to have been negative (captured by positive values in the residual, depicted here) over the first 8 years under analysis here. Furthermore, there is a noticeable spike in the LRP around the 2009 period, which corresponds to the immediate aftermath of the GFC and its most intense impact on the domestic Albanian financial markets. A rapid credit expansion coupled to high budget deficits initiated a growing liquidity deficit in the banking system over the 2006-2008 period. This deficit was further exacerbated by deposit withdrawals, amounting to almost 10 percent of overall deposits, in the first half of 2009. Given the disproportionate role the banks play in the financial system (around 95% of overall financial assets reside in banks' balance sheets), their growing liquidity deficit pushed up the LRP in the system. On the contrary, starting from 2013, the LRP appear to be on a downward trend and turned positive from around late 2014. This development reflects the intensification of fiscal consolidation efforts, coupled with a higher external financing of public debt. Their net effect was a rapid improvement in the liquidity position of banks' balance sheets and a positive LRP shock.

The transmission of these LRP shocks in the output gap is straightforward. The negative LRP shocks over the first part of the period pushed up 12-month TB bill yields, causing, in turn, an increase in the bank lending rates.[3] As a result, these negative LRP shocks were reflected in lower credit growth and slower economic activity. This situation reversed after 2014, with positive LRP shocks adding to economic growth. However, one important point to note here is that the direct impact of LRP shocks in aggregate demand appears to be rather small.

2.2 CDRP SHOCKS IN ALBANIA

The second type of financial shock is CDRP shock. The CDRP represents the difference between lek lending rates and the yields on 12-m Treasury bills. Their historical evolution is depicted in black in the left-hand side panel of Figure 7. The CDRP shocks themselves are defined as unexplained movements in CDRP, and they are represented by the blue dotted line. The impact of shocks to CDRP on the output gap in Albania is captured by the red bars in the right-hand side panel of Figure 7.

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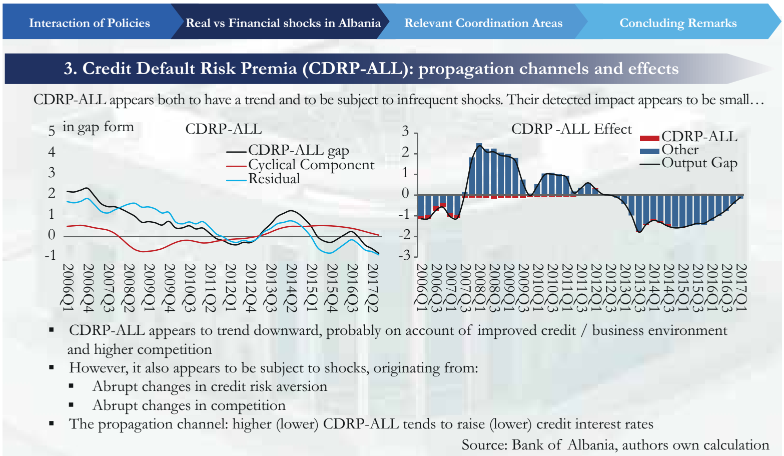
[3] *Around 3/4 of lek lending rates in Albania are indexed to the 12 month TB yield.*

Figure 7. Credit default risk premia (CDRP-ALL): propagation channels and effects



Despite a few noticeable oscillations, the CDRP appear to have a secular downward trend in Albania. We can assume this trend reflects growing competition in the domestic banking sector as well as trend improvements in the credit and business environment. At the same time, we can see that cyclical conditions (presented by the red line in the left-hand panel) do play a role in determining the CDRP in Albania. It is clear that a cyclical downturn is accompanied by higher credit defaults and – therefore – a higher perceived default probability for new loans. The lagged effect of negative cyclical conditions in NPL rates and higher CDRP appear to have peaked around 2015. From there on, cyclical conditions have improved, accompanied with a rapid reduction in NPLs and, in turn, with lower CDRP.

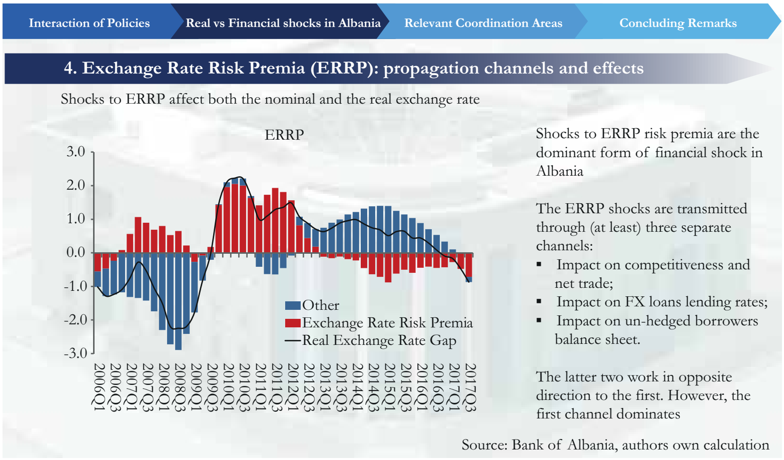
However, the evolution of the CDRP appears to be mostly driven by shocks to CDRP. One episode of note is the CDRP shock at around 2013-2014. This correlates with the imposition of the new Capital Requirement Directive (CRD IV) by the EU authorities. Amongst other measures aligning the EU code on banking activity with the Basel II and Basel III directives, the CRD IV imposed a 100% risk weight to any exposure EU or EU bank branches had to non-EU public entities, including non-EU central banks. As a result, risk-weighted assets on the balance sheets of EU bank branches and EU bank subsidiaries in Albania increased, and lending activity became more capital expensive. With the EU banks withdrawing from lending, competition amongst the remaining non-EU banks went down and credit default risk premia shot up. Later, the CDRP shocks subsided and the CDRP went down.

Finally, the direct effect of shocks to the CDRP on aggregate demand appears to be rather small, even smaller than the impact of the LRP shock.

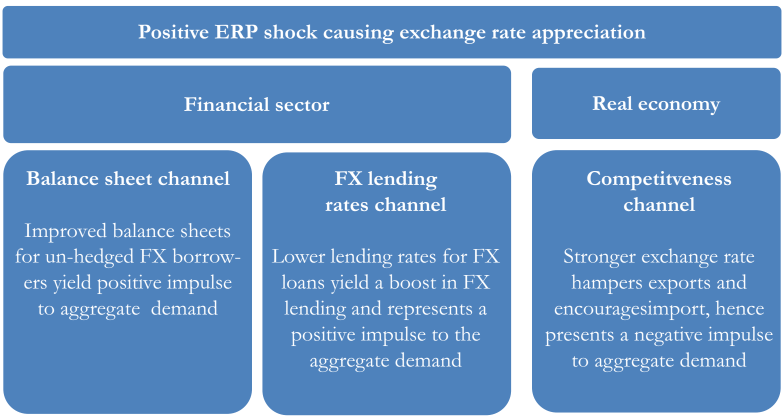
2.3 ERP SHOCKS IN ALBANIA

The third type of financial shock would be the ERP shock. Again, we define the ERP shock as the unexplained part of changes in the exchange rate. These arise because of increased or decreased trust in the value of the national currency. The red bars in Figure 8 indirectly capture the impact of ERP shocks on the exchange rate. (The black line represents the real exchange rate gap. While we defined the ERP shocks as affecting the nominal exchange rate, they do also affect – at least initially – the real exchange rate and its difference from the equilibrium value, i.e. the gap.)

Figure 8. Impact of ERP shocks on the real exchange rate gap



Albania suffered negative ERP shocks in the period 2009-2012, which in turn caused a depreciation of the nominal and real exchange rate (depicted here as a real exchange rate gap of a positive sign). These shocks were the direct effect of the GFC and its impact on the trust that external and domestic investors put on national currencies of small, open and financially euroized economies. Subsequently, the ERP shocks turned positive, on account of the subsiding crisis abroad and improved confidence in the domestic economy and its financial markets. These positive ERP shocks are partly responsible for an appreciation of the nominal and real exchange rate, as we can see from the negative turn on the real exchange rate gap. The propagation mechanism of ERP shocks into the economy is rather more complicated than that of the LRP and CDRP shocks. There are three propagation channels through which these exchange rate shocks are transmitted into the economy, as depicted below.



The competiveness channel stipulates that any positive real exchange rate shock will, in turn, cause a nominal exchange rate appreciation, a real exchange rate appreciation, and a negative real exchange rate gap (an overvalued currency). This will raise the price of our exports and lower the price of imports, resulting in a negative impact on economic activity.

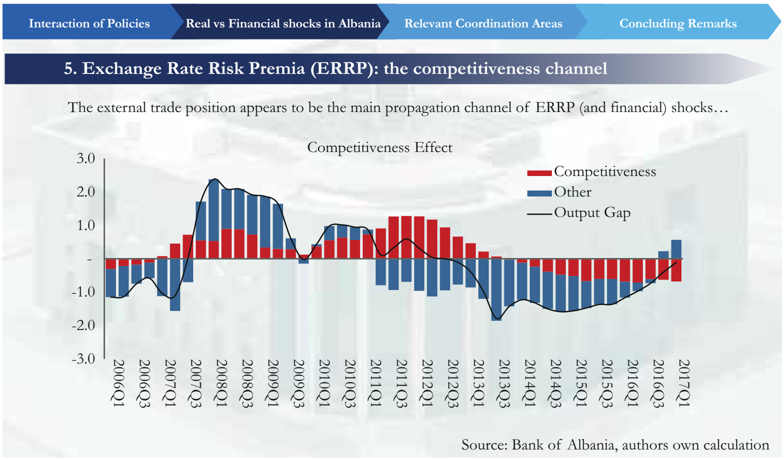
The balance sheet channel stipulates that – under the premise of a positive ERP shock and the attendant appreciation of the nominal and real exchange rate – an un-hedged borrower in foreign currency (i.e. a borrower whose liabilities are in FX but whose income is in lek) will experience an improvement in his financial conditions. In other words, taking everything else as equal, his liabilities will shrink vis-à-vis its revenues and assets. As a result, these un-hedged borrowers can afford to raise consumption and investment, providing a positive boost to aggregate demand and GDP.

The FX lending rate channel captures the impact of the exchange rate appreciation on FX lending rates. As discussed before, a positive ERP shock will improve the balance sheets of un-hedged borrowers. While inducing a spur in their consumption and investment propensity, it also tends to improve their perceived credit-worthiness. As a result, the CDRP for FX loans are empirically found to decrease under a period of appreciation of the exchange rate, and vice versa. In the case of a positive ERP shock, this channel would imply lower DCRP for FX loans, which, in turn, induces a positive boost to aggregate demand and GDP. As we can observe, the first channel, which can be thought of as real economy channel that is at play across all open economies, means a positive ERP shock, has a negative impact on growth. On the contrary, the two subsequent channels are specific to the case of a financially euroized economy, with a large presence of un-hedged borrowers. They also tend to operate on the opposite direction, which means a positive ERP shock has a positive impact on growth.Let us now assess the individual impact of these channels.

The competiveness channel

The impact of the ERP shocks on output gap, propagated through the competiveness channel, is depicted in Figure 9.

Figure 9. ERP shocks and the competitiveness channel



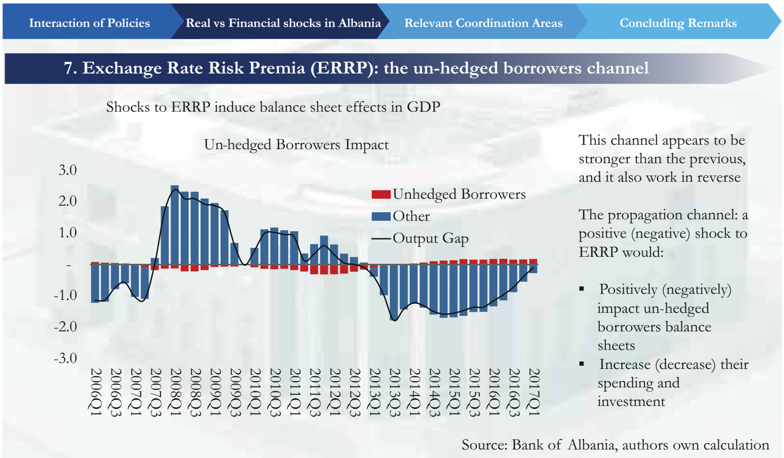
Focusing on the post-crisis period, it is clear to see the depreciation of the exchange rate in the immediate aftermath of the GFC yielded a progressive improvement in external trade balances, with positive effects accumulating over the next two years. Afterwards, the stabilization of the exchange rate and the following appreciation it experienced reversed the situation. Positive shocks on the exchange rate have caused a nominal appreciation of the exchange rate, a positive real exchange rate gap, and a drag on growth as a result of deteriorated external competitiveness.

A last point to make is the competiveness channel, which propagates ERP shocks, appears to have the largest persistence and magnitude amongst all financial shocks and channels under analysis.

The balance sheet channel

The impact of the ERP shocks on the output gap, propagated through the balance sheet channel, is depicted in Figure 10. As a reminder, the balance sheet channel translates ERP shocks into changes in the financial situation of un-hedged borrowers and, subsequently, into changes in their consumption and investment path. This channel operates on the opposite side of the competiveness channel.

Figure 10. ERP shocks and the balance sheet channel



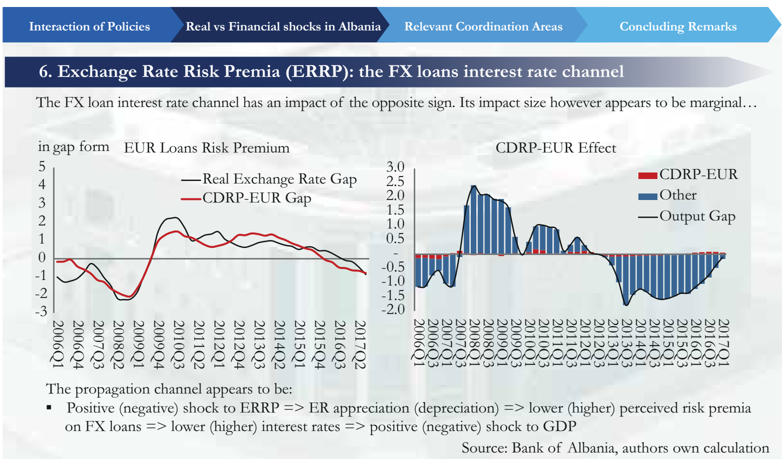
Again, focusing on the time horizon covering the period after the GFC, we can see that the immediate depreciation in the aftermath of the crisis deteriorated the financial situation of un-hedged borrowers and dragged down aggregate demand and the output gap in this period. Subsequently, the positive ERP shock and the attendant appreciation improved their financial balance sheet and had a positive impact on demand and output.

Nevertheless, it is clear this propagation channel is much weaker compared to the first.

The FX lending rates channel

Figure 11 contains a graphical representation of the impact that this propagation channel has on aggregate demand in Albania.

Figure 11. ERP shocks and the FX lending rate channel



The left-hand panel depicts how closely the observed credit default risk premia for loans in foreign currency (expressed as the difference between actual lending rates and the 3-month Euribor rate for loans in euro[4]) track the real exchange rate gap. As a result, any ERP shock that affects the nominal and real exchange rate is bound to affect the CDRP for euro loans. As we discussed before, this channel operates on the same side as the balance sheet channel, and opposite to the competiveness channel.

[4] *This specification reflects the common practice of indexing the interest rate for euro loans to the 3-month Euribor) in the Albanian banking sector.*

The actual impact of ERP shocks on the aggregate demand is depicted in the right-hand side panel. Focusing on the post-crisis period, we can observe that after the initial depreciation on account of negative ERP shocks, the subsequent increase in FX lending rates dragged down aggregate demand. After the stabilization of the exchange rate, the following positive ERP shocks helped lowering the CDRP for FX lending and had a positive impact on demand and growth. It is worth pointing out this channel is pretty weak though, even in comparison to the balance sheet channel.
As a result, we can conclude this section on the quantitative assessment of the financial shocks with the following observations:

1. Though most of the output gap volatility appears to be caused by demand shocks, the Albanian economy is frequently subject to financial shocks.
2. Amongst this latter type, the ERP shocks appear to have both a higher persistence and a larger impact. Though ERP shocks have various propagation channels in Albania, some of which act on opposite sides, the competiveness channel prevails over the balance sheet and CDRP propagation channel. As a result, shocks to the exchange rate have the 'normal' sign of impact for a small open economy, in spite of the heavily euroized financial sector.
3. Amongst the other two types of financial shocks, the LRP shock appears to be more frequent and of a higher importance compared the CDRP shock.
4. From a historical perspective, Albania was hit with negative LRP, CDRP and ERP shocks in the immediate aftermath of the crisis. The aggregate impact of financial shocks was, however, positive to aggregate demand, as the competiveness channel propagating the ERP shocks strongly outweighed the others. On the other hand, we have experienced positive shocks in all three identified dimensions recently, with the aggregate impact on demand being negative.

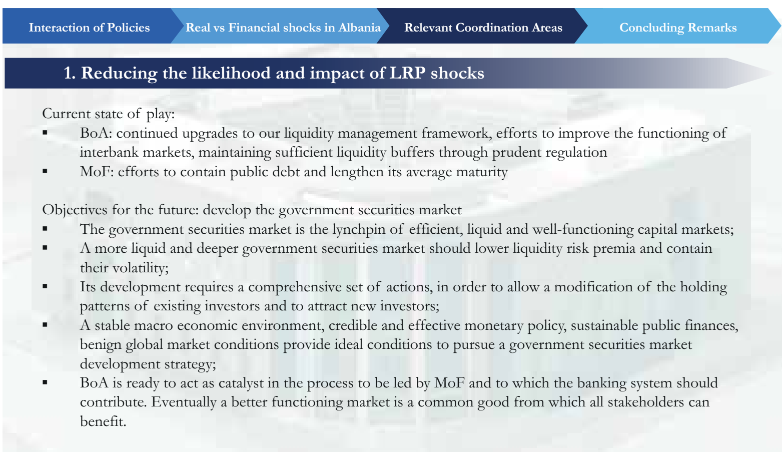
3. RELEVANT AREAS OF COORDINATION

This last section builds upon the identified list of financial shocks and tries to describe a few preventive measures the Bank of Albania has undertaken over the years, either to reduce the probability of shocks or to mitigate their impact. It's worth pointing out immediately the measures described here have more of a structural nature, meaning they are geared towards improving upon a few areas of financial market imperfection. The question of deploying ad-hoc measures – either ex-ante in a shock-prevention attempt, or ex-post in an impact-mitigating manner – remains open.

3.1 REDUCING THE LIKELIHOOD AND IMPACT OF LRP SHOCKS

The Bank of Albania has put considerable effort into developing money markets in Albania, with the clear goal of improving their liquidity, enhancing their efficiency and promoting their resilience to shocks. To that extent, the Bank of Albania has upgraded its liquidity management framework, aiming at stable and liquid markets, while at the same time striving for the transparency and predictability of our operations. We have also broadened the range of securities we accept as collateral on our liquidity injecting operations, as well as developed regulations towards increasing liquidity trade on the interbank market.

Figure 12. Reducing the likelihood and impact of LRP shocks



However, an important project for the future is to improve the functioning of the primary and secondary markets for government securities. The government securities markets are the lynchpin of liquid and well-behaved financial markets. Therefore, with the invaluable assistance of both the World Bank and the IMF, the Ministry of Finance and the Bank of Albania have been assessing different options towards improving the primary and secondary markets. Amongst the options being investigated, are: introducing a primary dealer system, probably only at certain segments of the yield-curve; simplifying the issuance calendar; and encouraging continued quoting on the secondary market. We are confident that a well-developed and liquid secondary market for government securities would decrease both the likelihood of shocks to liquidity risk premia and their impact.

3.2 REDUCING THE LIKELIHOOD AND IMPACT OF CDRP SHOCKS

The CDRP shocks – as defined here – arise for either of three causes: (i) a change in the perception of default probability, or loss-given-default, amongst certain parts of the banking sector, that is not warranted by changes in economic or financial conditions; (ii) a change in local or international regulation affecting either lending activity in particular, or banking sector activity in general; or, (iii) a rapid change in the competitive structure of the banks' lending activity.

Figure 13. Reducing the likelihood and impact of CDRP shocks

The first potential origination channel entails largely structural factors, most of which reside out of the remit of the Bank of Albania. Political risk, business environment and prospects, legal environment and legal practice concerning contract enforcement and collateral execution, all play a role in determining a bank's perception on default probability and collateral execution rates. The Bank of Albania constantly strives to raise awareness, amongst all relevant institutional stakeholders, on the intended and un-intended consequences that the overall lending environment has on credit and economic growth. Concurrently, we have increased our transparency in terms of expected economic and financial developments in the future.

On the second CDRP-shock originating channel, we have strived to align our domestic regulations with best international practices and – especially – the EU directives. Furthermore, the Bank of Albania engages in a timely and open dialogue with the banking system, on all areas relevant to the banking and lending activity. All these actions aim at avoiding surprises and help decrease the probability of CDRP shocks.

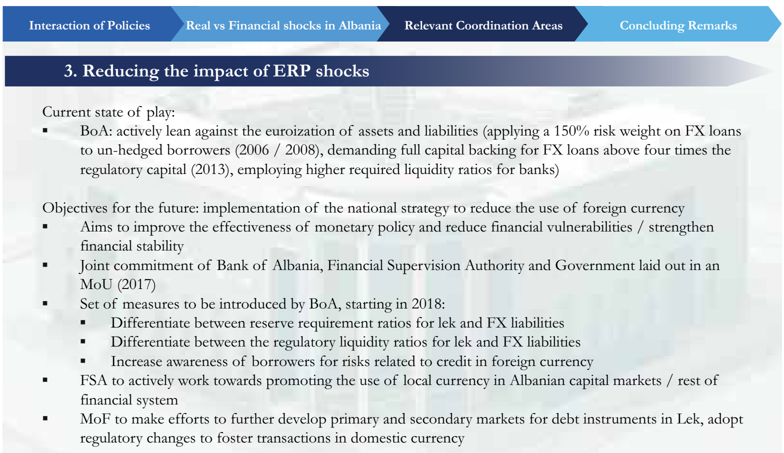
The third CDRP-shock originating channel is more difficult to control and regulate. However, aiming to preserve sound competition amongst banks and sound balance sheets at an individual level, the Bank of Albania does help mitigate these potentially idiosyncratic CDRP shocks.

All the aforementioned actions strive to reduce the likelihood of CDRP shocks. On the other hand, a special feature of post-GFC developments in Albania has been the rapid build-up in NPLs in the banks' balance sheets. This phenomenon was due to both an increased incidence of defaults and to a notoriously lengthy, unpredictable and inefficient collateral execution mechanism. In a clear recognition of this fact, the Bank of Albania has undertaken a far-reaching action plan geared towards reducing NPLs and improving the collateral-execution mechanism. Amongst several actions undertaken, we can highlight the revision of the Bankruptcy Law, the revision of the legal and regulatory environment regarding the functioning of private bailiff offices, the revision of the Tax Code related to the treatment of provisioning of lost credits and recovered collateral, as well as the revision of banking sector regulations aiming at encouraging early credit restructuring. This latter stream of action has paved the way towards a decreased impact of CDRP shocks in the future.

3.3 REDUCING THE LIKELIHOOD AND IMPACT OF ERP SHOCKS

As we discussed before, ERP shocks appear to have the strongest impact amongst all financial shocks we studied in Albania. We also showed the impact of an ERP shock is in reality a composite of the impact of the ERP shocks on the trade balance on one hand, and on the CDRP for FX loans and balance sheet effects for non-hedged borrowers of FX loans on the other. The last two channels arise because of the high level of euroisation in our financial system and they work in the opposite direction to the first channel.

Figure 14. Reducing the likelihood and impact of ERP shocks



Reducing the likelihood of ERP shocks is inherent to the Bank of Albania's goal of ensuring monetary and enhancing economic and financial stability. Our past record shows we have been – by and far – successful in this endeavor.

On the other hand, we have also been cognizant of the high level of euroization in our financial system. As discussed before, this high level of euroization introduces a dynamic between ERP shocks, financial market variables and economic activity, that is, the reverse of what we would observe in more mature economies and financial systems. In addition to jeopardizing financial stability, this dimension would induce an unpredictable propagation of ERP shocks into the economy.

The Bank of Albania has constantly leaned against the euroization of loans in the country. To that extent, we have actively leaned against the euroization of assets and liabilities (applying a 150% risk weight on FX loans to un-hedged borrowers, starting from 2006). We have also demanded full capital backing for FX loans above four times the regulatory capital (starting from 2013) and have employed higher required liquidity ratios for banks.

However, in recognition of the adverse impact that the high level of euroization exerts on both financial stability and the effectiveness of the transmission of monetary policy, the Bank of Albania, the Financial Supervision Authority and the Albanian Government agreed on a national strategy to reduce the use of foreign currency. This strategy was presented in a joint MoU signed in April 2017. It aims to improve the effectiveness of the monetary policy and reduce financial vulnerabilities/strengthen financial stability. More specifically, because of the complex nature of the euroization drivers in Albania, the signatories to the MoU agreed to take concrete measures in each of their specific areas of expertise in order to promote the usage of the national currency and discourage the use of foreign currency.

The set of measures intended to be introduced by BoA in 2018, include:

1. Differentiation between required reserve ratios for lek and FX liabilities;
2. Differentiation between the regulatory liquidity ratios for lek and FX liabilities;
3. Increased awareness of borrowers for risks related to credit in foreign currency.

To conclude this section, it is worth pointing out that all the previously identified areas of reforms strive to achieve a set of objectives that cuts across various dimensions of monetary, financial and economic stability. Therefore, they should not be seen from the reductive vantage point of monetary and macro-prudential policy coordination.

4. CONCLUSIONS

The debate on the coordination between monetary and macro-prudential policies is not yet settled. However, there is growing recognition of the channels through which they affect each other. Furthermore, subject to a careful cost-benefit analysis, the economic literature seems to converge on the benefits of coordination between monetary and macro-prudential policies for small, open and financially-integrated economies.

Albania's economy is prone to financial shocks. These shocks arise from unexpected changes in liquidity, exchange rate and credit default risk premia. Our empirical investigation finds ERP shocks have – by far – the largest impact on the economy. The propagation mechanism of ERP shocks is also more complex, entailing a competiveness channel, a balance sheet channel, and a CDRP for FX loans channel. On the other hand, LRP and CDRP shocks are both less durable and more volatile compared to the ERP shocks. To the extent these financial shocks affect output and – ultimately – inflation, they are of a legitimate interest to the monetary policy of Bank of Albania.

In recognition of this fact, the Bank of Albania has been actively engaged in the past to decrease financial market frictions, to decrease the likelihood of financial shocks, and to contain their impact. Three major and ongoing flagship projects of financial reform - the further development of primary and secondary market for government securities, the implementation of the NPLs resolution strategy, and the implementation of the national de-euroization strategy - will help contain the impact of financial shocks in the future.

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FINANCIAL DEEPENING IN ALBANIA. OPPORTUNITIES AND KEY POLICY PRIORITIES

*Guido Della Valle**

1. INTRODUCTION

In this presentation I will first discuss why there appears to be scope for financial deepening in Albania, and then I will focus on some of the policy priorities to encourage a gradual deepening of the financial sector.

2. SCOPE FOR FINANCIAL DEEPENING

There is scope for financial deepening in Albania when the matter is looked at from three key dimensions:

- Cross-country comparison with neighboring countries;
- Model-based estimates of the credit norm;
- Estimate of the benefits from financial deepening

2.1 Cross-country comparison

Albania's financial depth is lower than its regional peers. Credit to the domestic private sector (CPS) represented 35 percent of bank assets

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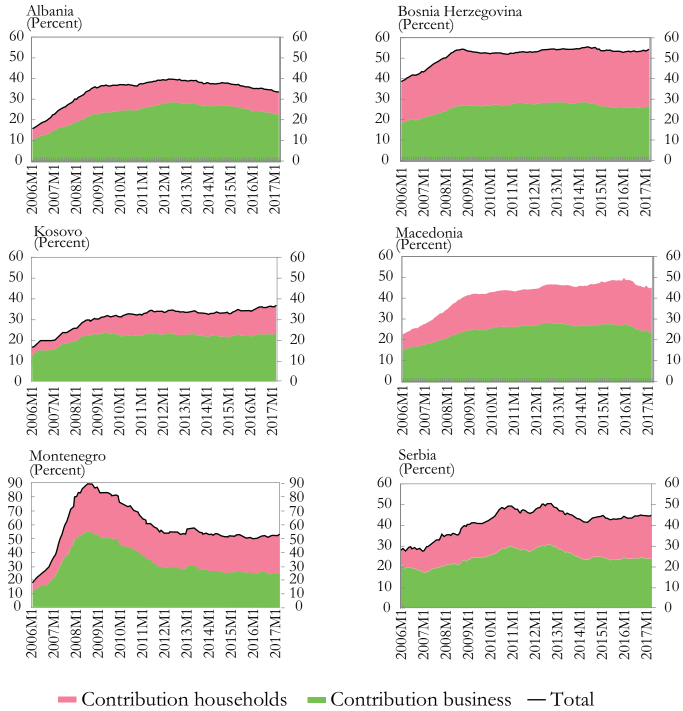
compared to above 50 percent in regional peers, as about ¼ of bank portfolios were allocated to the public sector. Following the global financial crisis, banks have tightened lending standards to address weak risk management practices and an inadequate NPL-resolution framework. Since 2015, credit consolidation has accelerated as banks were forced to write-off impaired assets. Albania is also facing deleveraging pressures from EU-owned banks mainly due to low profitability, the tightening of EU regulation, and a general strategic refocusing taking place within EU banks. Lack of credit demand has further induced banks to place funds overseas — mainly in foreign currency among subsidiaries abroad.

CPS-to-GDP ratio in Albania is the lowest in the Western Balkan region. Figure 1 shows that CPS in Albania at the beginning of 2017

Figure 1. Credit to the domestic Private Sector in Western Balkan countries



Source: IMF staff estimates

was the lowest in the region, followed by Kosovo and Serbia. However figure 1 also shows that (i) it is the contribution of households within the CPS which is lower than in neighboring countries, while the contribution of business is in line with peer countries. The lower leverage of households can also be a factor of strength and evidence of resilience; (ii) the recent deleveraging experienced by the Albanian banking sector and the contraction in the CPS has been mild and is not unique to Albania. In the region Montenegro experienced a sharper deleveraging than Albania, starting from an higher CPS to GDP ratio. Meanwhile Macedonia and Serbia have experienced a broadly similar pattern both in terms of magnitude and in terms of composition, with a contraction mostly arising from business.

2.2 Estimates of the credit norm

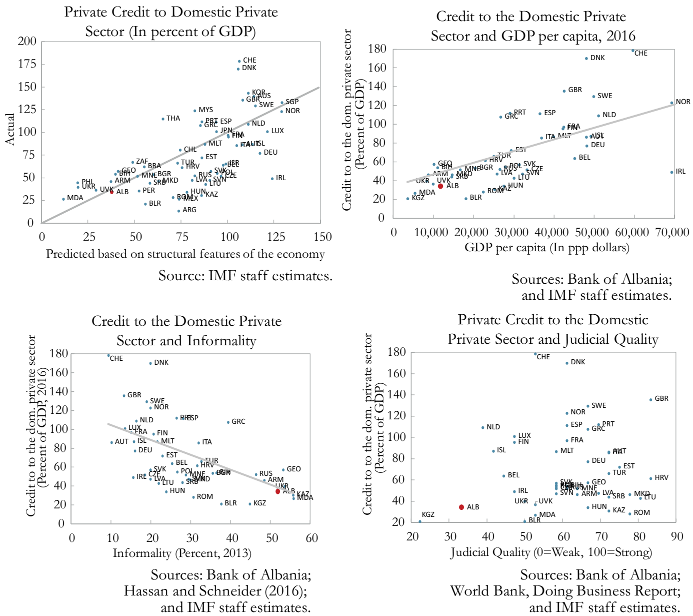
Credit gaps are negative in Albania as evidenced in figure 2, panel A. Different measures based on different models show small credit gaps. In 2016, credit gap estimates based on IMF-REI May 2015 show that the CPS-to-GDP ratio was about 4 percent below long-term levels. Alternative measures of credit gaps also show similar results. Estimates based on the methodology set out by Cottarelli, Dell'Ariccia and Vladkova-Hollar[1] that include more dimensions reach the same conclusion.

Low credit-to-private sector is explained by low income, high informality, and institutional obstacles such as judicial quality; but even when these factors are taken into account the CPS in Albania is slightly below the levels these factors would justify as displayed in figure 2, panels B, C, and D.

An important institutional obstacle is related to enforcing contracts and recovering collateral. Persisting uncertainties concerning land property titles preventing their use as collateral is another institutional obstacle. Also, low coverage of credit registry and narrow, limited and not always reliable information about borrowers, their creditworthiness, their credit exposure, their income and financial accounts contributed to higher NPLs, stricter lending standards, and a resulting weaker credit penetration.

[1] *See IMF WP/03/213.*

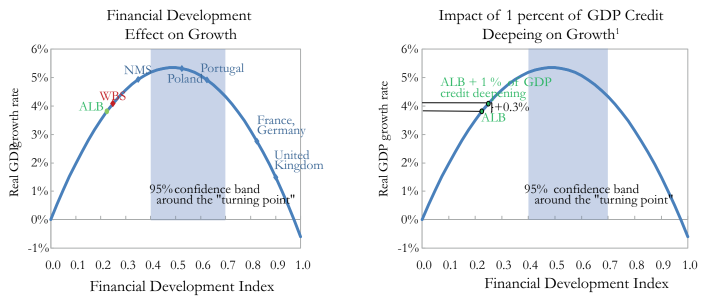
Figure 2. Credit to the Domestic Private Sector in Albania and in neighboring countries. Explanatory factors



2.3 Benefits of financial deepening

Credit deepening can have a positive impact on the medium-term economic growth of Albania given the limited financial development. Studies show that the relationship between credit deepening and growth is a concave function. Initial financial development has a positive impact on economic growth, but excessive financial development can have negative implications on financial stability and may lead to the misallocation of human capital away from productive sectors. The level beyond which further financial deepening can be counterproductive for growth has not yet been reached in Albania. Financial deepening can boost economic growth by incentivizing savings, improving resource allocation, and facilitating trade. Based on estimates derived from the financial development index a 1 percentage point expansion in credit to GDP ratio in Albania is associated with an 0.3 percentage point increase in the medium term growth, as displayed in figure 3.

Figure 3. Growth Implications of Credit Deepening



1/ Assuming institutions improve to allow a 1 percent increase in credit to GDP.

Sources: IMF SDN/15/08; and IMF staff estimates.

Sources: IMF SDN/15/08; and IMF staff estimates.

3. POLICY PRIORITIES

Having ascertained that there is scope for financial deepening in Albania and that such a process can have positive effects on economic growth, the key question becomes: what are the policy priorities on which to focus to facilitate this gradual deepening process?

Financial deepening is a complex and multi-dimensional process that requires the cooperation of all parties involved.

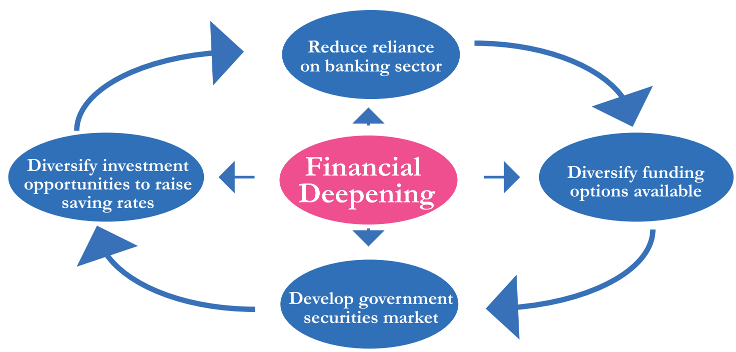
Legislation and regulation should help complete he non-performing loans disposal process and the banks' balance sheet repairs that weigh on credit supply. They should also address non-bank structural obstacles to credit such as certainty over property titles and the efficiency of court proceedings.

At the same time, structural reforms are needed to increase economic competitiveness, ameliorate the business climate, increase potential growth, and maintain financial stability to underpin credit demand. Amongst these reforms, I would like to mention the recent announcement in Albania of an ambitious de-euroization strategy which should minimize financial stability risks and boost domestic market development.

The banking system should also play its part. It should adapt to the new global and EU regulatory landscape, manage the deleveraging process in a smooth manner, avoid herd behavior, and find a new balance between the unrealistic growth expectations of the previous decade and the current gloomy outlook. These actions should create the favorable conditions to ensure that the actions I will focus on in the remainder of my presentation will succeed.

In particular, I would like to focus on four, strictly interwoven, but not exhausting priorities displayed in figure 4.

Figure 4. Policy Priorities for financial deepening



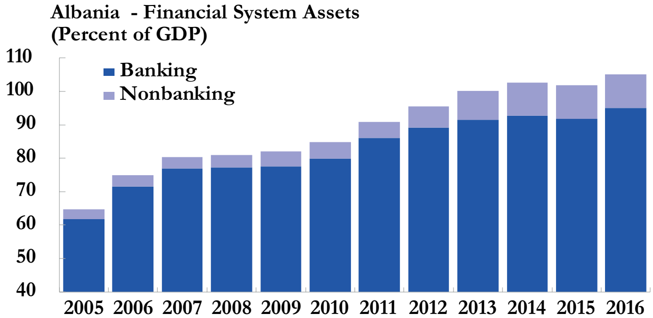
Source: Author

First of all, there is scope to reduce reliance on the banking sector, while strengthening the intermediation capabilities of the banking sector, which will remain predominant. Second, there appears to be a need to diversify the set of funding options and instruments available to corporates to fulfill their funding and capital needs. Finally, and linked to the first two priorities, there appears to be a need to diversify investment opportunities, thereby also contributing to raising saving rates.

3.1 Reduce reliance on the banking sector

The Albanian financial system is dominated by banks. Banks' assets currently account for 95 percent of GDP, while the assets of long-term funding institutions (insurance, pensions, investment funds), which grew rapidly from 2012, account for 10 percent of GDP. Around 85 percent of the banking system is under foreign ownership, of which 63 percent is held by EU banks. Shadow banking activities are virtually non-existent as shown in table 2 above and in figure 19 below.

Figure 5. Financial System Assets



Sources: Bank of Albania; and IMF staff estimates.

The tightening of EU regulation and the reallocation of capital due to low profitability mean that EU subsidiaries may continue downsizing in emerging Europe. Albania is extremely vulnerable because banks headquartered in the EU account for 63 percent of the banking system. Euro area cross-border banking groups with operations in CESEE tend to have overall weaker balance sheets than their peers, and they are therefore less able to support their local subsidiaries. Furthermore euro area banks with subsidiaries in Albania are relatively weaker than euro area banking groups with subsidiaries in Central Eastern Europe and the Baltics, due to the closer links of the subsidiaries in the latter to the Nordic countries. Therefore not only do euro area banks with subsidiaries in CESEE have a weaker capital position than their peers, but also within the euro area banks with subsidiaries in CESEE, those operating in Albania have an even weaker position.

Hence, in the years to come, banks alone, while playing their part, are unlikely to be able to fund a sizeable expansion of the CPS-to-

GDP ratio, while there is scope for other financial intermediaries to play a larger role.

At the same time, while reducing the reliance on the banking sector, it is important to attenuate the supply-side constraints to bank credit provision. In this respect the pursuit of the equivalence regime may make Albanian market more appealing from a corporate perspective, raise RoE and ensure EU-based banking groups maintain and increase local market engagement. According to the Capital Requirements Regulation, the exposures of institutions in third countries may be treated in the manner laid down therein with a preferential treatment awarded to sovereign exposure from a risk-weight perspective. This is provided that the third country applies to institutions prudential, supervisory and regulatory requirements at least equivalent to those applied in the European Union.

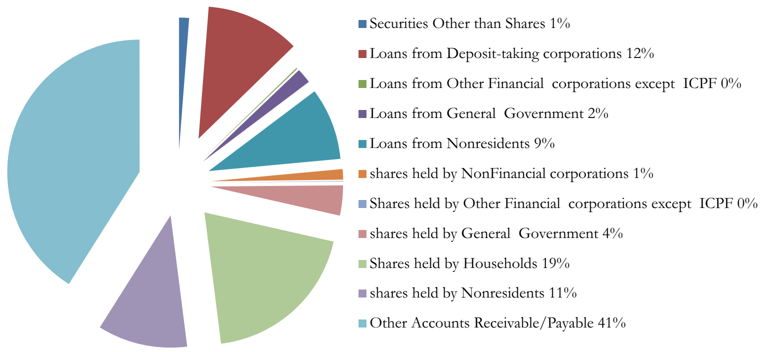
3.2 Diversify funding options

Strictly intertwined with the priority to reduce the reliance on the banking system, is the second priority on which I want to focus: to diversify the range of funding instruments available to corporates.

Non-financial corporations (NFC) have a set of funding needs that cannot be totally fulfilled by short-term bank credit extended in the form of floating interest rate loans. You can see from figure 6 that besides account payable, trade credit, loans from deposit-taking corporations represent a sizeable share of the liabilities of NFC, together with shares held by households. No security market exists. No private equity market exists. Therefore, NFCs are exclusively reliant on trade credit and expensive bank loans. Lack of medium and long-term debt instruments entails a reliance on short-term trade credit and variable interest bank credit, exposing NFC to interest rate risk and weakening the financing positions of the corporates extending short-term trade credit.

Shares and equity represent a sizeable part of the liabilities of NFCs but the lack of an efficient market in which they can be traded and in which equity can be raised has several consequences for the funding structure of NFCs.

Figure 6: Liabilities of non-financial corporations

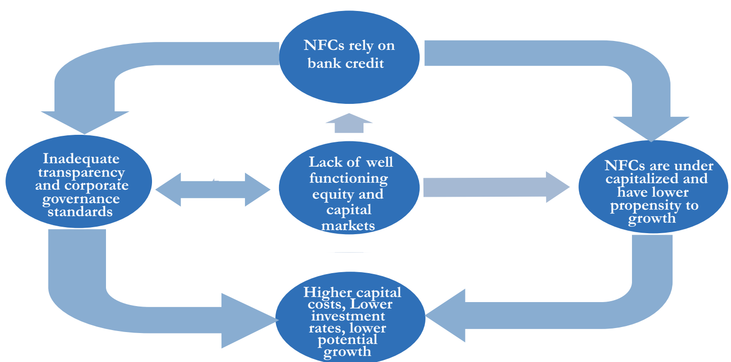


Sources: Bank of Albania and author's calculations

They remain dependent on bank credit extended by a concentrated banking sector. They remain undercapitalized and have a lower propensity to grow for which they need risk capital and long term funding sources. Transparency and corporate governance standards remain inadequate with control and ownership that can hardly be transferred. A corporate governance model with small, family owned, tightly controlled, highly leveraged small corporates is maintained.

At the same time, while inadequate transparency and corporate governance standards are a result of insufficient capital market developments, they also hinder capital market developments. This

Figure 7. Lack of well-functioning equity and capital markets



Source: Author

eventually results in higher capital costs, higher funding costs, lower investment rates, a lower rate of fixed capital accumulation, and lower productivity, competitiveness and economic potential growth rates. I show this process and the corresponding relationships in figure 7.

The continuous process to formalize the economy and promote best corporate governance standards is a prerequisite for any effort to succeed, as no efficient and sound equity and capital market can exist and survive without sound corporate governance standards and high transparency requirements.

3.3 Develop the government securities market

Besides transparency and sound corporate governance standards, another essential element to enable a well-functioning capital market is the development of the government securities market. In fact, the government securities market is the lynchpin of efficient, liquid and well-functioning financial markets in general, in which financial instruments can be effectively priced and liquidity and interest rate risks efficiently managed.

A well-functioning government securities market brings several benefits to the financial market as a whole. It provides a reliable benchmark yield curve off which other debt instruments can be priced. It facilitates the development of interest rate derivatives to better manage the interest rate risk. It provides the opportunity to develop the trading and settlement infrastructure from which other financial instruments can benefit. It enhances market liquidity and helps to better manage liquidity risk. It helps attracting foreign investors that may later on diversify into credit products. Last but not least, it enhances the effectiveness of the monetary policy transmission mechanism.

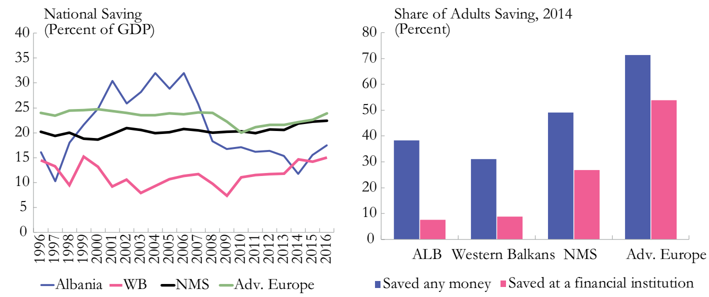
Not surprisingly, the government securities market is normally always the first capital market segment to develop. The success in this regard may be seen as a common good from which all stakeholders, including the Ministry of Finance, the central bank, the financial regulators and the banking system can strongly benefit.

It is therefore encouraging that the Ministry of Finance in Albania, with the strong support and encouragement of the Bank of Albania, is taking concrete steps to promote the development of this market segment. The initial reaction from the banking sector has also been encouraging. There is a concrete chance the development strategy may move from the design to the implementation phase in 2018 with the launch of a pilot project we have been discussing.

3.4 Diversify investment opportunities to raise saving rates

While overall saving rates in Albania are broadly comparable to the saving rates in other Western Balkans countries, there is a lower share of individuals saving at a financial institution. I display the saving rates in figure 8, panel A, and the savings in a financial institution, in panel B. This is not linked to mistrust of banks, which is instead higher than in neighboring countries and rising, as evidenced by the Oesterreichische Nationalbank (OeNB) regular Euro survey.

Figure 8. Albanian saving rates and savings in a financial institution. Comparison with neighboring countries



Sources: INSTAT; and IMF staff calculations.

Sources: World Bank, Global Financial Inclusion database; and IMF staff estimates.

There can be several reasons for this pattern. The implications however are obvious. In a context in which the public debt-to-GDP ratio is still high and the public debt still attracts a sizeable share of national savings, as well as in a context in which financial investments from abroad remain limited, unless saving rates are lifted, there might be a dearth of private capital to finance private investment. This relationship is illustrated by equation (1):

$$\Delta BCPS = \Delta BD + \Delta FXL + \Delta OL - \Delta BCG$$

Where BCPS stands for bank lending to private sector; BD for bank deposits; FX stands for FX liabilities; OL for other liabilities and BCG stands for bank credit to the government.

The equation shows that, unless there is a crowd-in effect and the banks' credit to the government declines, an increase in the bank credit to the private sector requires either foreign financial investment or an increase in banks' deposits.

In terms of policy priorities, to raise saving rates at financial institutions several actions may be required. The efforts to fight informality should continue. The efforts to preserve a sound, efficient and well-capitalized banking system should also continue. They are yielding fruits as evidenced by the increasing confidence demonstrated by the Euro Survey of OeNB. Against this background, the diversification of the financial sector may provide greater investment opportunities better matching individual preferences, with better return-risk trade-off more geared towards longer-term investment, whilst, at the same time, financial stability risks arising from excessive risk concentration and reliance on few intermediation channels can be reduced.

At the same time, it may be necessary to address a few weaknesses. They include the bank funding that takes place mostly via short-term deposits. They also include the negligible weight of public and private pension funds, whereas they can be important vehicles to raise saving rates, mobile savings and provide long-term capital to the economy. They also include the highly concentrated portfolio of investment funds. Investment funds have grown and have reached a sizeable share of the GDP but their portfolio remain concentrated in illiquid government securities, which raises financial stability risks and limits the value added in terms of professional investment service and the yield pick up that they can provide.

But this latter aspect only confirms how strictly interwoven all the elements are. Investment funds can only provide a higher yield pick-up via investments in longer-dated government securities while ensuring the liquidity of their shares if the government securities market liquidity is enhanced. They can only diversify their portfolio and mitigate the concentration risk if additional capital markets segments develop.

4. CONCLUSIONS

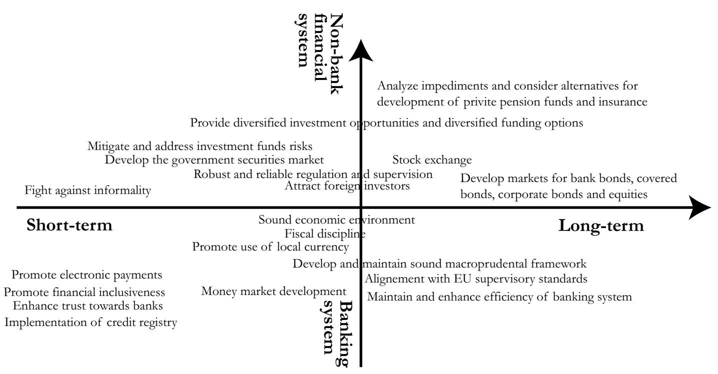
Let me conclude.

There is scope for financial deepening in Albania to close moderate credit gaps, catch up with neighboring countries and contribute to higher potential growth.

This requires the elaboration and adoption of a comprehensive financial system development strategy to move gradually away from a bank-centric financial system, and allow a gradual diversification of the funding options available to corporates and investment instruments available to individuals.

Such comprehensive strategy should probably have several components mapped in figure 9 along two dimensions: the time horizon over which they should be implemented, and the focus on the banking system or the non-bank financial system.

Figure 9. Deepening the Albanian financial system



I will not dwell of each single component displayed in the figure, although, as explained in my presentation, most components are strictly intertwined so that one cannot succeed without another and all are required to be pursued to varying extents.

Several initiatives have already been adopted or are being considered to create a favorable environment to financial deepening and remove already identified bottlenecks. Key amongst the reforms already under way are the judicial reform and the efforts to promote the development of the government securities market. If successful they are likely to be a catalyst and enable elements of further positive changes in other parts of the financial system.

There is however scope to consider extra efforts. They may include efforts to mobilize savings, increase saving rates, diversify investment opportunities, improve the risk-return profile of investment opportunities, and enhance financial inclusivity, which, despite good relative confidence towards the banking sector, remains lower than in neighboring countries. Efforts may also include attempts to strengthen the institutional investors' basis and attract, to a limited extent, foreign investors into the market. Money market development should accompany the deepening of the financial market, while the authorities should be attentive in addressing in a timely manner any institutional, regulatory, or legislative constraints that may stand in the way of this development,while encouraging the establishment and development of an effective and efficient market infrastructure.

Increasing saving rates, ensuring that they can be mobilized in an efficient manner to provide structural funding sources, while also attracting potential extra capital from abroad, is particularly important in order to prevent a bad equilibrium in which lower saving rates and impairment in the provision of capital result in lower investment rates which, in turn, depress medium- to long-term economic growth and saving capabilities.

On the lending side, efforts may include attempts to diversify in the long-term the funding instruments available to corporates, and reduce the exclusive reliance on bank debt. In light of EU-wide regulation, persisting indebtedness in the CESEE, and idiosyncratic factors related to the capital positions of the euro area banking groups operating in Albania, it is unlikely that any radical change in the strategy followed by the subsidiaries of euro area banks in Albania will take place.

In the short- to medium-term efforts should include the continuous pursuit of initiatives to facilitate a sound credit risk assessment from the banks, and facilitate a speedy and effective resolution process of NPLs with a view to lowering both the probability of default and loss given default. They may also include coordinated efforts to halt the deleveraging process of EU banks and facilitate the capital release that may result from an assessment of equivalence in the supervisory and regulatory arrangements with those applied in the Union. Such efforts should ultimately result in higher RoE of the banking sector in Albania, which has declined during the crisis from the pre-crisis levels and continues to weigh on perceived market attractiveness.

THE ROLE OF FINANCIAL INCLUSION AS AN INSTRUMENT OF GROWTH, POVERTY REDUCTION AND FINANCIAL STABILITY

*Linda Van Gelder**

I will be speaking on the role that financial inclusion plays in growth and poverty reduction as well as in the Central Banks' objective to maintain financial stability.

Financial inclusion is important.

When we have financial inclusion, people and businesses access financial products and services that are affordable and meet their needs.

Financial inclusion facilitates day-to-day living. It helps families and businesses plan for long-term goals and weather unexpected emergencies. When people hold accounts, they are more likely to use credit and insurance, to start and expand businesses, to invest in education and health, to manage risk, and to weather shocks, all of which can improve the overall quality of their lives.

For businesses, financial inclusion helps to finance investments, to lower transaction costs, to manage shocks, and to make safe and secure payments. For small and young firms that often face

* *Linda Van Gelder, World Bank Regional Director for Western Balkans*

greater constraints, we see that access to finance is associated with innovation, growth and job creation.

And as an aside, financial inclusion has become a global priority. It is an enabler for 7 of the 17 Sustainable Development Goals, and it is recognized as a priority by the G20. The World Bank Group also considers financial inclusion a key enabler to reduce extreme poverty and boost shared prosperity, and has put forward an ambitious global goal to reach Universal Financial Access by 2020.

There has been progress towards financial inclusion globally, but significant challenges remain:

- 2 billion adults worldwide do not have a basic account, mostly because financial services are not yet affordable or designed to fit low income users. Other barriers to opening accounts include long distances to financial service providers, a lack of necessary documents, and lack of trust in financial service providers.
- In addition to individuals, micro, small and medium sized enterprises often lack adequate financing to thrive and grow. This is often due to lack of collateral and credit history, and business informality.
- Some groups are more financially excluded than others: Women, the rural poor, and other remote or hard-to-reach populations, as well as informal micro and small firms are most affected.

How financially included are the Western Balkans?

In the Western Balkans financial inclusion remains low compared to European standards. According to the World Bank Findex Survey conducted in 2014, only about 6 out of 10 adults have a bank account at a formal institution. In Albania, it is less than 4 out of 10 (38 percent). Figures are even lower for the poor and for women.

Despite highly liquid banking systems, MSMEs – the backbone of the Western Balkan economies - continue to have limited access to credit, and when they do, it is often high cost and with stringent conditions. Around 15 percent of MSMEs in the region consider access to finance the biggest obstacle in doing business (Enterprise Survey 2013) compared to around 7 percent of large enterprises. Moreover, survey results show that more than two thirds of investments in the region were financed from internal funds. At the same time, the proportion of new investments financed via banks remains low, at an average of 15 percent.

In order to improve financial inclusion, there needs to be a wider range of financing instruments that meet the needs of households and enterprises. Improvements in credit and financial reporting would help reduce information asymmetries. Strengthening financial sector infrastructure as well as the legal and regulatory framework for secured transaction and insolvency can support an expansion of lending to underserved segments of the population. Moreover, financial institutions should be encouraged to develop delivery models tailored to the characteristics of MSMEs.

And I should also mention that advances in technology can help financial services to reach low-income individuals and small firms at lower cost and risk. The digitization of cash-payments is introducing more people to transaction accounts, and mobile-based financial services bring convenient access even to remote areas. Technology advances also bring in nontraditional providers of financial services such as peer-to-peer lending firms like Lending Tree, or nonfinancial institutions such as e-commerce sites like eBay or Amazon that have set up financing arms.

Financial inclusion is linked to financial stability.

I've talked to you about financial inclusion. But how is this linked to the Central Bank's objective of financial stability? An inclusive financial system that reaches all citizens provides a more stable and diversified retail deposit base and therefore a positive impact on financial stability. But on the other hand, too much loose credit can lead to financial bubbles and crises. And digital technologies and the growth of innovative non-bank financial institutions pose new regulatory challenges.

When designing and implementing financial sector policies, policymakers and regulators need to strike a balance that fosters synergies and avoids trade-offs between the objectives of financial stability and financial inclusion.

Countries that have achieved the most progress toward financial inclusion while safeguarding financial stability have put in place an enabling regulatory and policy environment that encourages competition (allowing banks and non-banks) and innovation that expands access to financial services. However, creating this innovative and competitive space has to be accompanied by appropriate consumer protection measures and regulations to ensure responsible provision of financial services in order to maintain financial stability.

A recent World Bank publication (Risks and Returns: Managing Financial Trade-Offs for Inclusive Growth in Europe and Central Asia) explores the right balance across the dimensions of financial development (stability, efficiency, inclusion, and broad depth). Considering the tradeoff between household use of credit and financial stability, and the synergy between higher firm savings and stability, the study recommends that countries in the region reduce barriers to firm savings while monitoring closely the growth of household credit.

World Bank engagement with the Bank of Albania

From our perspective at the World Bank, I am proud to say that we look back at years of collaboration with the Bank of Albania focused on balanced financial sector development, including financial stability, efficiency, and inclusion.

The Bank of Albania has shown strong leadership in advancing reforms in several areas of financial inclusion. For example, we have partnered on strengthening the regulatory, supervisory and resolution regime for Savings and Credit Associations that provide financial services to the underserved, mostly rural, segments of the population. This has led to a sounder and consolidated sector. The World Bank also supports the Government in its land and property registration reforms, an important contribution to enhanced financial inclusion and stability, but also vital for attracting investment.

We also support the Bank of Albania's efforts in strengthening the legal and regulatory frameworks for payment systems and remittances. Remittances are often the first entry point into the financial sector for both the sender and beneficiary. Moreover remittances are important to Albania, at 8.84 percent of GDP, but are also costly. For every 100 Euro sent in remittances, the cost is 8.47 Euro. The Remittances and Payments Program, generously supported by SECO, aims to increase efficiency of retail payments.

Lower cost means more money to beneficiaries. And by linking remittances to transaction accounts, this can be a stepping stone to access other financial products. The program will also help to increase the competitive space for innovative payment service providers, enhance transparency, and promote consumer protection. The World Bank is very pleased to support these efforts.

In recent years, Bank of Albania and the World Bank have also worked closely together on other important financial sector issues aimed at strengthening financial stability and efficiency. For example, the adoption and ongoing implementation of a bank resolution framework has been key to strengthening the financial safety net in Albania. I also want to acknowledge the efforts aimed at the development of a voluntary corporate debt restructuring framework for the resolution of NPLs, and the development of a government bond market, all of which the World Bank has been pleased to support.

GOVERNORS' PANEL:

FINANCIAL MARKETS, FINANCIAL INCLUSION AND THEIR IMPORTANT ROLE FOR FUTURE DEVELOPMENTS IN MACROECONOMIC AND FINANCIAL STABILITY

This panel discussed the role of the financial market and its infrastructure, in particular the role of missing links (money market, pension funds, mutual funds etc., and other market segments), and recent FinTech expansion in current developments with respect to risks, resilience and the efficiency of monetary and financial stability policies.

Chair: Jens Bastian, Independent Economic Consultant

Gent Sejko, Governor, Bank of Albania
Belma Čolaković, Chief Economist, Central Bank of Bosnia and Herzegovina
Fehmi Mehmeti, Governor, Central Bank of the Republic of Kosovo
Radoje Žugić, Governor, Central Bank of Montenegro
Aneta Krstevska, Chief Economist, National Bank of the Republic of Macedonia

GOVERNORS' PANEL

Jens Bastian: Now, ladies and gentlemen, after this exceptionally big lunch there is now further food for thought, and I hope that it will not create any digestive problems.

This is, ladies and gentlemen, the last panel of this conference. This panel has a rather ambitious title, which I will briefly repeat. It includes financial markets, financial inclusion, and their role for future developments in two aspects of stability; namely macroeconomic and financial stability. In many ways you have here what the English would call the "Full Monty". It is thus a challenging and ambitious panel to discuss, but, as we have heard already in this morning's two previous panels, it is also a matter of urgency to continue this discussion and to further identify elements of risk, or as this morning's panel was called, risk and risk resilience.

Now, we have here five distinguished panellists, some of whom have already spoken to you, like Governor Sejko, to my right. However we also unfortunately have one no-show, the Governor of the Central Bank of Bosnia & Herzegovina, Senad Softic. He has been unfortunately prevented from attending because he was called to Parliament for urgent legislative business - but who better to send as an alternative than his chief economist? I therefore welcome Belma Čolaković, who at short notice has been able to come. Thank you for being here. These five panellists will have ten to twelve minutes to put forward their views on a number of issues, which I will just briefly highlight. They are at liberty to pick and choose if they want to focus on all of them or some of them.

These issues focus on the role of the missing link, which we have discussed in the previous panel before lunch already, for example elements like money markets, pension funds, mutual funds, but also risk pricing, and risk mitigation. We have heard extensively from different colleagues at the Bank of Albania how mitigation processes are currently taking place. But all this requires a legislative framework, an institutional and regulatory architecture. We invite the panellists to consider that element. Finally, we heard in the panel before lunch, from Linda from the World Bank, about financial inclusion, which includes, as the term suggests, aspects of a lack of access to financing instruments, e.g. the basic aspect of the availability of bank accounts, but also financial literacy.

As a moderator my key job is to let others speak, and therefore I would now as the order of business, first invite Governor Sejko to give us his view on some or all of these aspects. Sir, you have the floor.

Governor Sejko: Thank you very much. I'll try to generalise, because we could talk for hours on what you already mentioned. I will try to tackle the most critical points from the point of view of the Bank of Albania, with respect to the challenges we have seen in the market and based on our experience during recent times.

I already emphasized, and it was also brought up by other colleagues, that in Albania the banking sector is the main channel of financial intermediation. The banking sector represents 90% of the financial industry, or of the financial system. The other 10% is represented by non-bank financial institutions, which are already doing a great job, as they are growing. However it will take a bit of time for them to expand their share because most of them operate in rural areas.

In this context, banks are playing the major part in offering all the products, financial and banking ones. First, in terms of lending they play the main role by influencing economic growth, helping businesses as well as households to obtain finance, and also by expanding the range of the financial products that they have offered during the last ten years. The trend dates back long before the crisis started, lasting more than 15 years, starting from the year 2000. The competition in the banking sector after the privatisation of large, state owned banks was very strong and productive, which has brought very positive effects in our market. This positive impact has materialised not only in terms of lending activity, as banks had started to compete in this area right after the largest bank in Albania was privatised and entered the lending market, followed by other banks; but also in other segments of the financial market. Competition has grown continuously in all financial products. This growth was associated with an increasing number of individuals holding bank accounts. However, the number of these accounts is still very low. Despite the tremendous progress made during the last 15 years, as emphasized in the morning session, we still have a lot of work to do in terms of financial inclusion. Currently only 6% of the population has a credit card, 22% of the population has a debit card, and about 38% of the population has a bank account. So, we can see the great potential the banking industry has to generate business in terms of retail banking and in terms of banking products.

While on one hand there is continuous progress in terms of financial inclusion, on the other hand there are lots of obstacles. Many banks have been facing difficulties in terms of their risk strategies. The crisis in the euro area has created a lot of troubles. Many banks have been deleveraging, and therefore driving down the lending rate in the economy. This was associated with an increase in NPL ratio, which reached up to around 25%. That figure was alarming, therefore we were obliged to prepare a detailed action plan in an effort to involve all the actors that were able to influence the objective of decreasing NPLs. Our analysis had identified many elements that needed to be addressed, including not only regulatory issues, but also legal issues, fiscal related issues and other small problems that needed to be resolved. Luckily we have managed to bring the NPL ratio down at 14.8%, but there are optimistic expectations for a further decline, which is going to enhance the optimism of the commercial banks to continue lending to the economy. Following that decline, we have seen a positive lending growth of 3%.

I don't want to talk long about monetary policy, because the topic of today is not monetary policy; but one piece of good news we have as a central bank is the higher lending growth in the local currency, which is on average 10%.

So we are experiencing 10% growth and we are seeing negative growth in foreign currency. This is good news in terms of avoiding foreign currency risk in repaying loans in the future. This is a direct result of the accommodative monetary policy of the Bank of Albania. Interest rates have been decreasing, and the customers of the banks find the pricing of loans offered in local currency more convenient and motivating. However we have a euroized economy and this limits our monetary policy. In this context, the central bank has been preparing a draft strategy towards de-euroization, in cooperation with our international partners, the International Monetary Fund and the World Bank. Sometimes a de-euroization plan is misunderstood, even by some analysts, who are saying that we have started the accession process for joining the European Union and we are going towards the euro, so why would you fight the euro? We are preparing the de-euroization strategy exactly because we are going towards the euro. We need to increase the effects and the transmission of our monetary policy, so the more the local currency is dominating the market, the more our monetary policy could be transmitted in the lending process while the financial system could be more stable, and in this context we can accelerate growth and convergence. In one moment it is easy to implement the euro with decision-makers, but this moment will take many years, probably decades, to prepare for. We are ready not only to be members of euro, but our economy is competitive enough to have euro as a currency at the very end of the process.

We as a central bank have also taken many other measures in terms of developing the financial system and maintaining financial stability. We approved a resolution law last year, and now we have established a Resolution Department in order to closely follow these issues. The Bank of Albania accelerated this process after the Greek crisis two years ago. We were really shaken, and not only us, but the whole region was also shaken. We understood that we needed to be better prepared, especially from the legal point of view, to manage stress situations that could come from the crises. Now we have a resolution unit and a resolution law in place.

Earlier, many years ago, the Bank of Albania created a Financial Stability Department, therefore we were able to proceed a bit more quickly in addressing risks that unfolded in the market. So to this extent, we have been prepared and we have been resisting stress well. The banking sector has been quite resistant. Even with the high NPL level, banks were able to maintain the capital ratio. None of the banks were under-capitalised, indeed they are well over-capitalised. The capital adequacy ratio on average in Albania is around 16% and banks are over-liquid.

They are over-liquid, but this is a cost for the bank. This is a good thing in terms of the health situation of the bank, but on the other side it is not healthy in terms of efficiency. During all these years we have been trying to discuss with our colleagues re-orienting strategies towards industries that represents greater potentials and less risks in the banking sector, in order to translate the extra liquidity into loans, and into bank finance for the economy. While this is not easy, there has been good progress made.

As emphasized earlier, our economy suffers from a very low rate of penetration of banking services among households. Financial inclusion is critically important. There are economic studies which have indicated that the more developed and sophisticated the market is, the faster the country grows and develops. With the current trend that we are experiencing, it is obvious that we are lagging behind compared to developed economies, but on the other hand this should not be seen only as an obstacle but also as an opportunity. It means that there is significant potential for growth, and represents the chance for banks to expand their business to cover all households and all demographics by increasing the use of exciting financial instruments and financial services, and by introducing new ones. However there is also a lot of work for us to do as regulators and supervisors in order to regulate these new market instruments and new market segments.

Since the banking sector, as mentioned earlier, is the main channel of lending and of providing products to households and businesses, we have been trying and cooperating with other regulatory agencies in Albania, namely the Financial Supervisory Agency, the Government, the Ministry of Finance, deposit insurance agencies and with all agencies to incentivise and make the other segments of capital markets more attractive.

The capital market was not actually active at all during the transition period in Albania. We did establish the Albanian Stock Exchange in the years 1993-94, if I am not wrong. We thought that by establishing the stock exchange, we would have free capital markets and the market would emerge and become effective. We were completely wrong, as the stock exchange did not function at all for many reasons. The key reason was informality. With that high level of informality that we had in the country, we could not have an active stock exchange. Recently, we are trying to reactivate the stock exchange through private initiatives. It is very crucial to activate the secondary market and resolve capital markets. We need to have more complete markets.

I highlighted in the morning session that the financial banking sector cannot be a substitute for other segments of the financial sector. Individuals, but not only individuals, businesses as well, need to have other investment alternatives. Banks are quite conservative, which on one side is positive, but on the other hand such risk averseness makes them quite tight in terms of their lending criteria. Especially after the crisis, they tightened their risk criteria because they had to. They faced a drastic NPL increase not only in Albania but in the entire region, as well as in the Eurozone. Banks were shocked, they faced another situation, as they were not a preferred business partner anymore. Before the crisis banks were running, one after the other, to increase targets and budgets in order to generate profits and to expand portfolios. Yet at a certain moment they saw that a good part of their portfolio was turning into NPLs. Then immediately they tightened their risk criteria.

So in that situation, the customers of the banks, households and businesses, found no other way of financing. Small businesses, micro-businesses and family businesses in particular were not able to obtain a loan from the bank because they didn't find them attractive. Instead they found huge bureaucratic procedures, and therefore the banking sector was not convenient. So they either tried to find alternatives in informal markets, or did not obtain finance at all, therefore closing their own businesses.

On the other side we have an overlapping situation. We have a market full of liquidity, and therefore there has been a mismatch. In order to sort out this liquidity mismatch, to increase the profitability in this market and improve competitiveness in the market, it is imperative that we activate other segments of the financial market and alternative instruments which are more attractive for the households and micro and small enterprises. We are trying, but this process takes time and it is not something that can be done in a day. It is a challenge that can be completed step by step, and it is important to start.

Informality remains high in Albania, as we are well aware, but there are initiatives to fight informality and if we take it for granted, assuming this is a big problem and therefore give up on taking initiatives, the problem will never be sorted out. So, by taking steps to fight informality and to activate the other financial markets we are confident that the customers of banks will find other investment alternatives to the informal sector.

In addition to these challenges, the financial education level is very low in Albania. We as a central bank are trying hard to contribute with all the means at our disposal, but it is not an easy objective to accomplish. We have expanded the role of the central bank beyond education in monetary policy and price stability to discuss and introduce financial products, because they are complex, complicated and are not easily understood. The focus is first and foremost to introduce simple products like deposits and saving accounts, and offering to explain the basic concepts of finance like savings, budgeting, interest rates and inflation. Commercial banks are playing a very crucial role in promoting this, not because they have as their own objective financial education, but just by exercising their activities, especially retail banking, and by competing with each other, they are in a way familiarising the market agents with the products. Step by step people are becoming more and more aware, but with a financial inclusion index of 38%, as mentioned earlier, we still have a very low level of financial inclusion.

So, there is huge potential for businesses to bank, and there is huge work to be done by us as a central bank in terms of financial education, but also by the banks on their own. PR and marketing activity for example by commercial banks are the perfect tools for financial education, because by trying to sell their own products banks are just explaining what the product is, and people are seeing what a loan is, what a deposit is, what insurance is, and so on.

There is a lot of work to do, but we are on the right track, and the positive news is that the economy is growing in the region. In Eurozone there are signals of growth. Seeing signals of growth, the markets start to calm down and think more rationally, because in a turbulent situation nobody thinks about generating business, but only about reducing risk in existing portfolios. Now is a moment when we have been quite prudent in risk regulation, that is in terms of regulatory aspects, but we must also promote the market, together with the regulation, to incentivise certain initiatives for activating all the segments of financial markets in collaboration with the banking industry and all actors. Doing so will hopefully accelerate our integration process and convergence, because as I mentioned, the more developed the financial market is, the faster the growth rate in the economy and the better it will be for the welfare of citizens.

I will stop it here, maybe I went too long, and we can continue later.

Jens Bastian: Thank you very much Governor Sejko. That is a perfect ending for the welfare of markets and citizens. That's why we are here, that's why we are entering in this dialogue with each other. I would now like to pass the floor to Belma. She will give us her view as the chief economist from the Central Bank of Bosnia & Herzegovina.

Belma Čolaković: First of all, thank you for the invitation and congratulations for organizing this wonderful conference. Once more I have to pass the Governor's regrets for having to cancel at the last minute. I will try to be an adequate replacement. I will breeze through his Power Point slides that he sent a few days ago, just to emphasise the key points that we wish to share with you regarding the financial market infrastructure, the missing links etc.

I am going to go through the slides with a pinch of artistic freedom, so if you disagree with something, is not necessarily the opinion of the Central Bank, but myself.

In search for the answer as to why we have financial systems at this stage of development, I am going to start with what we have at our disposal in Bosnia and Herzegovina. I will talk about the structure of the financial system, not in very many details, but from the perspective of types of segments of the financial system, the intermediaries and the links between them, and the existing legal framework. Our financial system, from the perspective of structure, is identical to those anywhere in the world; we have currency, payment systems, financial intermediaries and their regulators, and supervisors and financial markets and their regulators and supervisors.

When one sums up across these different types of intermediaries, we have over 120 financial intermediaries. The assets of the financial sector in 2016 were about EUR 14.5 billion, of which about 90%, just as in the case of Albania, is concentrated in commercial banks. However, we do not have savings and credit cooperatives, we do not have investment banks, and there are reasons for that. Some of them are historical, and some of them depend on the level of economic development. I will touch upon some of those later in the presentation, but I might answer more questions, if you are interested to talk about this issue, later in the Q&A session. The regulators are at the entity, the sub-state level, with coordination at the state level, with the exception of stock market intermediaries, which are the sub-state level only.

When it comes to financial markets and their regulators, we have, due to a complex state structure, two of each (at the sub-state level) stock exchanges, Securities and Exchange Commissions and Securities registries. However, the main activity in these stock exchanges has been, especially over the last few years, driven by the government sector, mainly through the primary issues of the entity level debt. Banks usually buy those issues and they hold them to maturity. The secondary market activity in this segment is almost non-existent, which we see as a major problem for financial stability, because what it actually means is that government debt is recorded at the book value in commercial banks, not at the market value. We have a rather underdeveloped spot market, as well as the forex market, and no derivatives market.

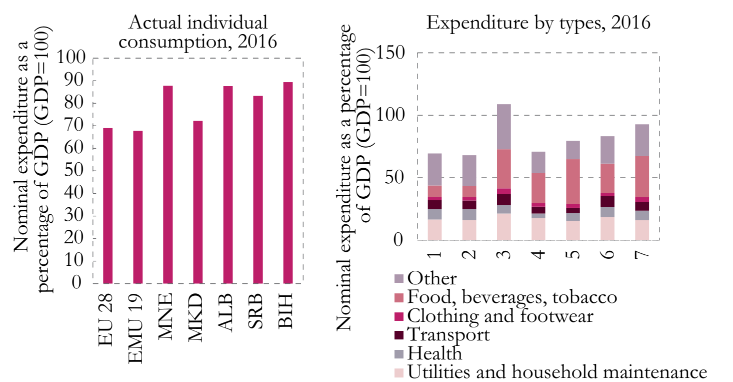
When it comes to legal framework, just like in any other financial system in any other country, there is law on the central bank, that is, apart for the currency, relevant for the payment systems as well. The payment system mechanisms are further regulated by the directives of the central bank. The laws on banks have all the standard and necessary elements, including minimum capital requirements, appropriateness of the stakeholders and management structure, circumstances under which a licence may be revoked, an authorisation for collecting deposits and extending loans, obligations related to prudential supervision of banks, and obligations in the area of AML and the financing of terrorism. Other laws relevant for the functioning of the banking sector are: laws on the central bank, laws on deposit insurance, and the entity laws of the banking agencies.

Similarly, the laws on capital markets and stock exchanges, including those on securities registers and intermediaries, all have standard elements. Other relevant laws are those on banks and institutional investors, corporate law, and laws related to public debt management. There are two very important things to highlight here. We do not have anything beyond pillar one in terms of a pension system. Only the mandatory state pension system exists, which means that we do not have large domestic investors, especially in capital markets. Also, insurance agencies are limited in terms of their investment, because our laws allow them to invest only in domestic securities and hold deposits with commercial banks. Apart for being a limiting factor in financial system development, this is another major source of potential financial risk for financial stability, because there is this huge semi-hidden connection between commercial banks and the insurance sector.

From everything mentioned so far, it is clear that risks in the banking system may be potentially undervalued as government securities are mostly valued at book prices, not market prices, and the tools for the mitigation of other risks in banking sector are rather scarce. Furthermore, due to the dominance of banks within the financial system, and the absence of large domestic investors, there is no credible estimate of credit risk for local companies. There is no incentive for commercial banks to contribute to developing stock markets, because if the company issued debt in the stock exchange, there would be less work for the banks. This is because banks are currently the only large enough investors in Bosnia & Herzegovina to actually buy out any potential issue, and this ultimately means that required yield would be close to the interest rate charged by bank. The presence of foreign investors in financial markets is rather weak, which may not be good from the perspective of economic growth, but also implies lower risk for an unsustainable overestimation of a local currency.

I believe that the main reasons why we have such a weak financial market infrastructure in developing countries are the stage of country's development, which affects the level of available income, and historical issues.

Level of available income in the country



Source: Eurostat

To illustrate my point, I have here depicted actual individual consumption for 2016 in EU28, EMU19, Macedonia, Montenegro, Albania, Serbia and Bosnia; and also expenditure by types. Nominal expenditure, expressed in percentages of GDP, across the region, is much higher compared to that in the EU - which is a consequence of much lower GDP, in nominal terms, in the region. However, if you look at the right hand side graph, expenditures of a regular household in the region on things such as clothing and footwear, health, transport, or utilities and household maintenance, are at roughly at the same level as the EU. This could imply that there are quite a lot of administered prices and government influence in the region. But look at the fraction of GDP consumed by food and beverages. It is not that Bosnians are consuming 4 times more than people in the EU; it is just that the average income is much lower than that in the EU. So, when you have people spending 90% of what is earned in the country on the basic necessities, there is really very limited scope for development of very complex instruments and large activity in the markets.

And also, let us not forget these other factors. We were talking about the regulatory factor in the financial system, but what about commercial laws and the ways of registering companies and their management, and consumer protection in the financial system? The representative of the World Bank has already touched upon some of these issues in one of the earlier sessions. Furthermore, protection of creditors' rights and insolvency management systems are the mechanisms that ensure efficient, transparent and reliable methods for debt collection, including taking over ownership. In countries like Bosnia & Herzegovina it is very difficult to close a company, which is one of the obstacles for the smooth functioning of the financial system. Access to credit and property ownership rights is a foundation for the development of complex financial instruments, and the process of changing the ownership of land is very slow in Bosnia. And finally, let us not forget the judiciary system; people want a system that is unbiased, predictable and efficient. We do not have that in Bosnia & Herzegovina. Out of court settlement procedures are weak and lax - almost non-existent. As we do not have trade courts, the courts are burdened with all these cases of insolvency, of companies trying to be resolved, credit issues etc.

When it comes to financial literacy and financial inclusion, neither are at a very high level. The macroeconomic shock in 2008 indicated an extremely low level of financial literacy and, as Governor Sejko already touched upon, we still have to teach people how to read main contracts, including contracts with the banks: what do they mean, what kind of interest rates imply what, and what are the consequences of breaching the contract. Unfortunately, most of the people that I know working in financial literacy programmes in

Bosnia & Herzegovina - we already have quite a few of them, the central bank is taking part to some of them - actually have to teach people how to budget their salary, how to plan expenses, and other basic skills in managing personal finance.

When it comes to financial inclusion, we are not only talking about the number of deposits with commercial banks, as all formally employed, and the majority of retired people who have at least one bank account, which means that the number of users of traditional banking products is on the rise. We are talking about the possibility to finance start-up companies, to be more involved, to move, maybe, a bit higher on the ladder when it comes to the banking sector or financial sector services. The estimates are that only about 61.6% of the population were internet users in 2016. The vast majority of those were using it for Facebook, Instagram and social networks, very few of them for actual financial education. According to the census, in 2013 over 14% of the population was older than 65 years of age, we have a very rapidly ageing population, a massive outflow of young people, and very negative population growth rates over the past few years. We also have a high non-active population rate - only 42.8% of the population's labour force in Bosnia & Herzegovina is active, and 38% of the work capable population possesses a primary school or lower level of education. So, when we are thinking opening the door of the financial system to all those possible types of products that we can have, we really have to bear in mind what the system looks like and what its social characteristics are.

With rising financial literacy, financial inclusion might be raised through promoting the practice of accepting online and mobile payments by small stores, farms or tradespersons, developing platforms that enable investment into startups, or promote peer to peer lending or lending to small businesses. There are several non-profit organizations in BH that support young and/or new social entrepreneurs, often via "angel investing". There are also companies that are specializing in financing startup IT companies.

Clearly, there is a great potential for the development of non-banking financial products, which would raise financial inclusion, even in country with rather unfavourable population characteristics.

However, in a country where the grey economy is estimated to range anywhere from between 10 to 30% of GDP, the introduction of these new products may pose a serious threat for financial stability, if it is not paralleled by adequate changes in legal framework and oversight mechanisms. Promoting online and mobile payments, without connections to fiscal authorities, could shift a part of activities from the formal into the grey economy. Investing into startups requires a reliable system of registering investment and/or settling claims, as well as details on the company and ownership structure in order to prevent fraudulent activities. Furthermore, without an adequate system of control, potential cases of money laundering could be hard to detect.

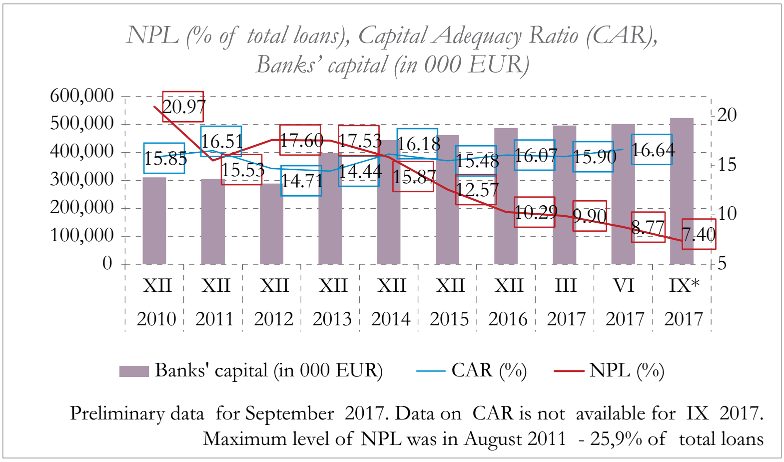
I will finish with the message that it is an absolute prerequisite to build a system that would enable the development of non-traditional banking products and services in a way that would promote growth, while keeping risks for the financial system at an acceptable level.

Jens Bastian: Belma, thank you for giving a very vibrant delivery of your Governor's presentation, including adding your own views on a number of issues. I would like now to invite the third panellist, the Governor of the Central Bank of Montenegro, Mr. Radoje Žugić. Sir, you now have the floor.

Governor Žugić: Dear friends, dear Governor Sejko, thank you for your invitation. It is my pleasure to be here with you and I have prepared a short presentation about my bank's development and financial market infrastructure in my country, Montenegro. This year the situation in the banking system has significantly improved, and most of the indicators have reached the best levels ever recorded.

Total assets are over EUR 4 billion, deposits are over EUR 3 billion, and total loans stand at EUR 2.6 million. This data clearly shows that we have a very healthy financial structure and that the most important source for credit activity is domestic deposits. Interest rates have also reached a historical low level, a historical minimum.

Non-performing loans have fallen to the level of 7.4% from more than 25%, which is one of the best results recorded in the region. Banks are very liquid and the solvency ratio is more than 60% higher



than the minimum prescribed by the law. In order to improve the business environment and as part of the process of harmonization with EU regulation, the Central Bank of Montenegro has prepared six new draft laws. It is expected that this will accelerate the EU accession process. Certainly there is resilience in the banking system in terms of the regulatory framework and support for overall fiscal consolidation in our country.

The financial system in Montenegro is bank oriented and around 90% of total financial assets are in the hands of banks. It is clear that banks are the most developed part of Montenegro's economy. In the rest of the financial system there are regulatory frameworks and competent regulators already developing. All non-banking institutions, issuance companies, investment funds, pension funds, the stock exchange and others are present in the Montenegro market. Yet unfortunately many economic players have not placed their trust in other financial institutions and they have only a minor share of financial assets.

The central bank of Montenegro operates on the principles of a socially responsible institution. In our daily operations we constantly promote the principles defined in the United Nations' Global Compact. Moreover, following these socially responsible operating principles, we always try to make a contribution to improving financial education and financial inclusion. The level of financial literacy is currently very low in our society, while financial products are becoming more and more complex every day. Many studies show the clear connection between poverty and the level of financial education. I will quote an OECD study that demonstrated that in a situation of low level of financial inclusion and low level of financial education there remains a high probability of indebtedness and bankruptcy. Currently, we are in the process of preparing a national strategy for financial education. We will organize a number of lectures in both elementary and secondary schools in order to increase the level of financial literacy among the students. We will also organise a public campaign to promote general financial education and we are planning many more activities.

Recently, in the meeting that was organized by the European Department of the IMF for the governors and finance ministers of the Western Balkans, we heard that one of the challenges being faced since the global financial crisis is that there have been almost no new entries into the banking system. I can say that the situation in Montenegro is just the opposite, and we have increased the number of operating banks by 50%. Currently there are 15 banks in Montenegro and the share of foreign ownership is more than 80% of total banking assets. In addition, we receive almost constant interest in opening new banks. This is not a surprise, because we have created a very stimulating banking environment. The best recognition of this is the fact that the Montenegrin banking system indicator of received credit is ranked in seventh place in the world according to the World Bank report Doing Business 2017. Thank you for your attention.

Jens Bastian: Thank you Governor. That indeed was the Doing Business report that was just published a few days ago, and included some pleasant surprises regarding the ranking of individual countries from this region, including progress that has been recognised by the World Bank report in Montenegro. Thank you for that statement. I would now like to invite our fourth panellist Aneta Krstevska, chief economist of the National Bank of the Republic of Macedonia.

Aneta Krstevska: Thank you. It is my pleasure to join this panel, and to also to join this conference this year. I am amongst the regular guests here and always glad to come. Also, apologies from our Governor for not being able to join this event.

Well, I will mention some of the experiences from our economy regarding some of the issues that were mentioned at the beginning of this panel. The structure of the financial system in Macedonia is similar to Albania and other countries in the region - we have a dominance of the banking sector. I think it is slightly less than in other countries, it was 85% last year, but several years ago this percentage was 90%. So, what happened in the meantime?

There is a higher share in the assets of the overall financial system by the private pension funds, mainly private pension funds from the second pillar that are obligatory for the younger population. If you check the share of the voluntary pension funds, their role is still negligible.

Also, what is increasing in the last couple of years, especially due to the global crisis, are the assets of the insurance companies, especially life insurance, and in addition to that, we have seen high, two digit growth in the assets of the investment funds (although from a relatively low initial stage). Actually, I think that investment funds really offer something new on the market and they have been quite creative. They offer different packages for investments in shares of companies abroad, or investments in securities in different regions of the world. They really present a unique opportunity for these types of investments, keeping in mind the capital limitations that are in place for these types of investments for the individual investors.
I think that the global crisis, having in mind this low interest rate environment, really was a unique opportunity for the non-bank financial institutions to further develop, and to increase their share in the overall financial system. However, as I already mentioned, we didn't see too much change regarding the structure in the financial system. Actually, it seems that the main preference for investments are still banks' deposits, which is of course related to the fact that they can provide a stable return and also they are more secure financial instruments, keeping in mind deposit insurance vis-à-vis the other financial instruments of the non-bank financial institutions.

Finally, it seems that it is up to investors' attitudes. They are measuring between risk and return, they are trying to optimize their portfolio and so far the preference is still for the banks' deposits. It seems that financial instruments of non-bank financial institutions are attractive so far only for investors with higher risk appetite; or maybe they require higher financial literacy, or having larger funds available for investments.

Regarding the role of the private pension funds, I would like to mention that they are really supportive regarding the developments of the other market segments. They are especially very active on the domestic government securities market. Actually they are already amongst the main players, investors, in the government securities market; therefore this means that they supported the development of this market segment, oriented towards providing budget financing at a lower cost. Finally, in this way, there is no crowding-out impact for the banks in the sense that banks now have more room to orient towards private sector, the way it should be.

On the other hand, the stock exchange in Macedonia still has a negligible, small role, with the exception of the years before the global crisis. In 2006-2008 we really had a big turnover on the stock exchange, but at the time we also had the entrance of regional institutional investors. What I would like to mention about the stock exchange is that our stock exchange is part of a regional project of connecting the stock exchanges in the region. This project started some three years ago with three countries: Macedonia, Bulgaria and Croatia. Currently, there are six countries, with the joining of Serbia, Slovenia and Bosnia & Herzegovina. The results from this trading are still to be seen, keeping in mind the overall global recovery and the eventual pickup of the stock exchange markets in the region. However, this project means larger investment opportunities for the citizens and countries of the region. Finally, this is a very nice example of regional cooperation in favour of strengthening the development of the financial markets.

Generally speaking, in macroeconomic terms competition is good, so we need competition between the banks and also we need competition between banks and non-banking financial institutions. As I have already mentioned, we have different types of market segments, but we don't see real flows of funds between different market segments, and we don't see real reprising between the financial instruments. However, this means that our banks must take into account the presence of their competitors outside the banking sector, especially when they design their business strategy, and especially regarding their funding policy. We have seen several episodes in the past in which the banks really behaved like they had a comfortable position in the financial system, mainly speaking about their funding, besides the fact that the central bank undertook different types of measures affecting structure of funding, we didn't see a full transmission of these measures further by the banks. Thus, having more competitive non-banking financial institutions eventually will increase the efficiency of the banking sector, improve monetary policy transmission mechanism and finally contribute towards strengthening the macro - financial stability.

Access to finance has been mentioned in many reports as one of the limitations for more investments and growth support in this region. Access to finance is especially important for start-ups and small companies that are facing a lot of risks, especially at the beginning of their operations, but generally speaking it is not only the banks to blame for this issue. The point is that actually, we are still missing and we should support the development, establishment and operations of specialized institutions that will take into account this type of risks. In Macedonia, the development of the venture funding and the business angels network is still in the initial stages; however, just a couple of years ago we established a separate fund for innovation financing, which is still operating with some limited scope.

In addition to this, what is also important is the establishment of a proper credit guarantee scheme. Currently, in this regard, we have some kind of credit insurance products (mainly for predefined risks) provided by the Macedonian bank for development promotion. All these are just initial steps, they should be promoted and developed further in order to improve the financial institutional structure.

My last point will be about financial literacy, which is definitely an important concept for financial system development. In addition to what has already been said, I would like to add that in the OECD report on the competitiveness of the region it is mentioned that not only is financial literacy at a low level in the region, but this is also the case with investment readiness. It is related to the ability of entrepreneurs to develop ideas about business plans and to sell these ideas, to provide financing for the realisation of a business project. According to different types of surveys, we have many arguments that this is really a situation in Macedonia. On one hand, we have small firms complaining about access to finance but, on the other hand, we have banks complaining that in fact they don't receive good, valuable projects, which is partly related to the low financial literacy of the entrepreneurs and probably to lower ability to develop business plans.

Anyway, financial literacy, inclusion and investment readiness are all part of the different types of initiatives around the region, especially within the Strategy for South-Eastern Europe 2020. Our central bank, just to mention, is actively involved and has a lot of activities regarding the financial education of the population and definitively we will continue in this regard. Thank you.

Jens Bastian: Aneta, thank you very much. Thank you also for this encouraging point that you mentioned at the beginning of your intervention regarding the cooperation of stock exchanges, who are gradually linking forces with each other in the region and reaching out to other countries, as in the example you mentioned of Bulgaria. It is a point that we will return to. Now, last but not least, and I would like to thank you for your patience, we have the Governor of the Central Bank of the Republic of Kosovo, Fehmi Mehmeti. You have the floor, please.

Governor Mehmeti: Thank you very much. Governor Sejko, thank you very much for the invitation. It is a pleasure for me to take part in this very important event, where different points of view are discussed regarding financial markets and the outlook on banking and macroeconomic developments.

Turning to Kosovo, the financial sector has been expanding each year. Within the financial sector, the banking system dominates, accounting for around 70% of the assets of the financial sector. Our banking system is well capitalized, liquid, and profitable. Looking at the latest data on banking sector assets - we are talking about September 2017

- we can see they have reached approximately EUR 3.7 billion – growing 9.3% in annual terms. Lending constitutes the main element, registering EUR 2.7 billion, or 10.4% annual growth. Talking about lending, I wanted to highlight a very important element: that lending and the banking sector in Kosovo are considered as one of the main drivers or main supports of economic development, given that about 70% of these loans are dedicated to enterprises, or that enterprises are the main beneficiaries of loans in Kosovo. We may say that we have a very qualitative loan portfolio, given the fact that according to the latest data I informed you on earlier, from September 2017, non-performing loans decreased at 3.5%, so we have a very low level of non-performing loans. If we look at the structure of performing loans, standard loans are continuously increasing, and in annual terms they have increased somewhere over 22%.

Regarding deposits, they have reached around over EUR 3 billion, and at the same time registering around 8% growth in annual terms. Deposit growth shows the public confidence in the banking sector. In deposits, we have the reverse of what I mentioned about loans, in that we have over 70% of deposits from households and the rest from enterprises.

Much progress has been made in the legislative field regarding the banking sector; I will mention some. Actually, since 2015, we have started to apply risk-based supervision and today banks are screened only for the risks on which they focus or they can face in the future. The same applies regarding financial intermediation. The reality is that we as a region lag behind EU countries on financial intermediation. Meanwhile, in the framework of the region, Kosovo – taking into account that we are a new financial system - has the lowest percentage of financial intermediation, despite the continuous increase of lending. Financial intermediation in Kosovo is at approximately 40%, while the average in the countries of the region is at around 50%, but lending growth is continuously approaching the percentages of the region. As an example, we can point out, on the issue of financial intermediation, that several of the sectors that we consider as very important for the economic development of Kosovo have a much lower lending level than other sectors, as in the case of the agriculture. On this issue, realistically, the percentage is around 4% of the lending portfolio, but taking into account the agriculture sector as well.

Meanwhile, we also have low percentages on mortgages, which are in an earlier stage of development. That said, in this context, the government of Kosovo and the central bank jointly have not been idle, given that we have created a fund for guaranteeing loans, which has begun to give the first signals in support of small enterprises, particularly in the field of agriculture. The latest data show that we have a good growth of lending in this sector. The Fund was established by donors, with the participation of the Government of the Republic of Kosovo, and guarantees around 50% of the total loan principal. Currently, this fund has made around EUR 30 million available to banks. Somewhere over 40% of this amount was used by banks for lending purposes. In the future, we expect the situation to improve significantly and very soon reach the level of financial intermediation of the other countries of the region.

Another issue, which I think significantly affects the financial intermediation which is one of the central bank's objectives, is financial education. We are paying a lot of attention to our priorities, to financial education regarding the financial services that are provided, and this has yielded its results based on the fact that the people have understood us well. They know how to treat the services offered by the banks and use them well.

Another issue that significantly affects and increasingly contributes to financial intermediation is the use of information technology by banks, something the central bank is very supportive of. The increase in the use of information technology by banks makes their financial services and products easier to access and cheaper.

I would like to highlight another issue that I think is very important and it is topical for this conference. If we look at the countries of the region, we assess that we have managed to develop many financial systems that are stable and supportive of the economic development of their country; but, in almost all these countries the financial system is dominated mainly by the banking sector, while the other segments remain underdeveloped.

In particular, it is important to highlight the lack of development in the capital market, which may represent a very important source of funding and stability for the economy of a country. The high reliance on only one funding source, which in this case is the banking sector, cannot contribute enough to moving faster towards our convergence as a country and as a region with the economies of EU countries. Moreover, the concentration on one source, or the mono-dimensionality of financial support, makes our economies more vulnerable to potential shocks that may arise. Consequently, the development of the capital market not only offers alternative development opportunities, but also a very good opportunity for withstanding the exposure of our economies vis-a-vis potential crises. In this regard, there is by now a general agreement that the development of capital markets is a dual benefit mechanism: it is a driving force for development and a safeguard of a country's financial and macroeconomic stability.

The development of the capital market requires the fulfilment of certain conditions that are very important, yet not easy to achieve. In this context, I highlighted the importance of macroeconomic stability in the development of the capital market.

Here we must also highlight the importance of strengthening financial institutions, such as banks, insurance companies, pension funds, etc. These institutions are important in mobilising the savings of individuals and households and putting them in the service of the capital market. Also, financial reporting and transparency, specifically approximation with financial reporting standards and the advancement of contract execution, remain very important areas for the development of capital markets. Equally important is the adequate protection of investors, whether internal or external, as well as the engagement, as I mentioned earlier, in financial education focused on the role and importance of the capital market.

The Central Bank of the Republic of Kosovo is advancing financial legislation, corporate governance and disclosure of information, always considering that for an effective capital market, sound actors are also required. The development of the capital market is entirely in line with the Central Bank's main objective of financial stability.

This is due to the fact that, as mentioned earlier, the withstanding of the banking sector and other sectors is also considered a safeguard for stability or the financial sector.

That should suffice for now. Thank you.

Jens Bastian: Fehmi, thank you very much. Kosovo is the youngest country in Europe, but from the data that you presented on NPLs, the youngest country in Europe has the lowest level of NPLs. You also mentioned a number of growing pains, which are similar to what is happening to some of your neighbouring countries, for example when you focused on banks and financial assets. So there are lessons to be learned and to be applied in cooperation with your colleagues from other central banks in the region so that your growing pains may not be as harsh and last as long as those experienced in neighbouring countries.

Now, we have heard ladies and gentlemen, five presentations from five different countries, with different emphases. I would like to briefly ask if any of the panellists would like to respond to something that a colleague of theirs from another central bank has said, and then I would like to open discussion for a Q&A session with the audience. So first, just for a moment, back to the panellists. Is there anything that you would like to add to what has been said? [Pause] I see that is not the case.

That means that we have ample time for the Q&A with the audience. Thank you for your patience and I would now like to invite the audience to ask questions and make comments. The only elements that I would like to ask from you are two things: one, please identify yourselves so that we know with whom we are entering into the dialogue and second, keep your questions or your comments "snappy" as they say in English. That means short and precise. Who would like to have the first pick of the cherry? Piroska, please.

Q: Piroska Nagy-Mohacsi from LSE. So, my question is the following. We haven't discussed whatsoever, rightly so because it is very fiscal, one source of potential convergence finance, which is EU accession funds, or structural funds. It seems to me that these are a very important source of growth and credit and actual transformation of finance for this region. It has already been done, but the use as in other regions is relatively slow. It also gives the potential, notwithstanding all the difficulties that come with close-borders collaboration, for some regional interaction and all the dynamics that comes from it. Short question: what can central banks do to accelerate the regional vision and implementation of EU structural funds, accession funds - whatever comes? Because it seems to me that central banks are in politics, and this is a very important political, fiscal area. Yes it is political, but it is something that you with your credibility can do something with.

Jens Bastian: Piroska, thank you very much. This is a critical question and I think it is also one which deserves an in-depth answer. Who would like to take the lead? Governor Sejko, please.

Governor Sejko: Thank you. Actually, this is a very impressive question. What can the central banks do? Mainly this is an issue that by all means should be related to the government activity. We as a central bank have our homework, our duties, in the process of integration. Most of the audience is already informed on the latest efforts by the governments of the region to coordinate efforts in order to have an open market, to operate as a single regional market. These efforts are mostly focused on increasing trade activity among the countries, because there are very low levels of trade flows among the countries in our region.

There is broad consensus that the region has great potential in terms of regional trade. In that regard, there is also an agreement in place since a few years ago that aims to promote the countries' trade activity. But in my view this regional interaction mentioned has a broader purpose. It has the intention of promoting growth not only of trade but of all economic activities among the countries, and of coordinating and better harmonizing all the South Balkan countries' efforts. Individually our economies have small markets, where they are efficient, profitable, interesting and with a lot of potential, but still they are relatively small.

I mean, all countries together represent a market of around 20 to 25 million inhabitants, which is almost of a similar size to that of Romania, or maybe slightly smaller than Romania. So, all together, if we have perfect coordination, we would basically represent only Romania. Still, this example indicates how important joint coordination between the countries is in order to represent our economies. Clearly, this is mostly with the intention of promoting foreign direct investments that are a huge necessity for all our economies. Some countries are better and some are worse in terms of the progress so far. We are going with a few main projects, in terms of the total figure we have good results, but in terms of the progress, in terms of the future, we have to do a lot of work. Some countries are doing better in attracting those investments, however all countries need that kind of progress.

So, we as central banks have our part to play in this process. The most important issue to address is how to attract foreign direct investments, to bring capital, know-how, technology, and increase GDP and ultimately decrease unemployment of course. But we need to play a crucial role especially as a regulator, in addition to our task in steering monetary policy that aims to incentivise investments, consumption and lending to the economy. However, as a regulator of the financial system, as we mentioned earlier, all countries have a very similar situation with 80-90% of the financial market composed by the banking sector. We are all regulators of the banking sector. Key departments like the financial stability department, banking supervision and other similar departments focus on the regulatory aspects of the banking sector. Furthermore, we have an even greater task to coordinate business efforts with the banking sector, although the regulatory and legal role is key here. We are also playing additional roles sometimes to coordinate business; mainly corporate business for some commercial banking activities. I believe these aspects are helpful to become more attractive to all EU funds.

A particular issue in Albania, which is not a secret and is not only with respect to EU funds but also regarding World Bank funds, is that we have a very low level of usage of those funds due to our weakness in proposing serious projects which would be more attractive. This requires a lot of work to be done on our side, as a government and institutions. On the other side, in term of attracting the funds, we have a liquid market, but this holds for longer term maturities which helps in terms of repayment with lower prices. Basically, we have to take advantage of these market conditions. As a central bank we definitely have to play our role. Thank you!

Jens Bastian: EU funds are amongst the cheapest sources of financing available, and you say, rightly so, that you have a very low absorption rate of such funds. Anybody else here on the panel? Belma please, would like to add to this issue?

Belma Čolaković: I am coming from a country that is very complex politically, so what I say here might apply to other countries to a different extent. The central bank is usually, in all modern countries, not highly synchronized with the electoral cycle in the country. It means that their policies are going to be more long term. That's why the central banks in the region are usually the first starting points when the European Commission's experts come, when the IMF mission comes, the EBRD, the World Bank, you name it. So, the first place where they can get a snapshot view, like a parachute view of all the system, of the entire macro-economic environment is the central bank. On the other hand, we very often do not have the legal mandate to impose some things. What we at the central bank in Bosnia & Herzegovina have learned is that we have to start building what we call gentlemen's agreements – such as a standing committee for financial stability– trying to pass the message to other important institutions in our country about what it means to actually have a unified voice towards the EU, to have a very clear goal and how to work in synergy to accomplish that goal, and that is something that the EU wants to see. We cannot unlock the EU funds unless we start harmonizing our practices and reporting standards, and unless we are very clear of what we want to achieve in the country. Maybe that's why the role of the central bank in such environments is more pronounced that it is in more developed countries.

Jens Bastian: Would any of the colleagues on the panel like to add to that? Please, Mehmeti.

Governor Mehmeti: The Central Bank of the Republic of Kosovo has a very good cooperation with the Government of the Republic of Kosovo. The central bank is considered as the fiscal agent of the Government of the Republic of Kosovo. For this reason, we have been a beneficiary of many IPA projects over the years. In terms of funding for several projects for creating new jobs as well, Kosovo is signatory to an IPA agreement worth around EUR 80 million, if I am not mistaken. Their goal is to invest, in particular, in infrastructure and alleviating unemployment in Kosovo.

On the other hand, if we consider the achievements I mentioned and the investments - based on the latest data we have over this period, I'm talking about the first half- of 2017 - foreign direct investments in Kosovo have increased significantly if we compare them with one year earlier, and may be around 30% higher than they were earlier. This is for many reasons. In the first place, we have created a good legal infrastructure that is in full harmony with the European Union directives, and second, we have achieved, and are in the process of, increasing the security that is considered essential to foreign investors.

In relation to taxes, we have managed to have the lowest tax levels in the region, we may say - and the same of many other countries - this one of those conditions which appeal to foreign investors. Thus, in this context, we coordinate with the Government of the Republic of Kosovo on the orientation of the investments that come to Kosovo, and this attests to the continuity of the support that we have had and used, lately as well, with IPA projects in Kosovo. Actually, just recently, in the past year, we have had many projects from the International Monetary Fund at the level of professional capacity building. The IMF has supported us continuously during this process, since we have a young financial system, and overall the economic system of Kosovo is a new system. If we refer to, as mentioned earlier, the issue of pensions, we have built a new pension system, depending on the fact that from the early years after the war in Kosovo we have had technical assistance, a period with international supervision, and after that we have continued with technical assistance, from the IMF, the World Bank or the European Commission, which is why we have achieved such a level of development.

Hence, when talking about development, for your information, the latest data show that we have recorded 4.3% economic growth and our forecasts are for 4.6% at the end of the year. Meanwhile, we also have seen a significant improvement of the trade deficit. If we look at this in relation with doing business, Kosovo has made considerable progress. The issue of finance is very much in our focus. If we look at lending facilities, Kosovo is ranked in twelfth place in the last World Bank Doing Business report. Therefore, all these are the issues that are affecting investment growth in Kosovo. At the same time, recently we have had an IPA agreement that is supporting us in the economic development of Kosovo. That's why I mentioned all these improvements towards economic growth, foreign direct investments, etc., since these are the result of the coordination with institutions, which in this case are of the European Union, the International Monetary Fund and the World Bank.

Thank you!

Jens Bastian: Thank you, Governor. Can I invite another question or comment from the audience, please? Yes, our colleague from Austria.

Q: National Bank of Austria. I have one question about this de-euroization. I think this will be a very difficult thing, because, first, you have a lot of pre-conditions. You have to have a functioning capital market with long-term financing also available, and, up to now, you have no success story which has achieved it. You have only two success stories on de-dollarization, Israel and Peru, I have not heard of other success stories, so this is a very difficult process and you should be aware of that. And it could be very costly, because you have to subsidize the national currency in one way or another. So, you should talk a bit with the Serbian colleagues, who are having some difficulties.

Jen Bastian: A fascinating question, I think, that should invite some responses, please, from the panel. Sir, Governor.

Governor Sejko: You are absolutely right. As a starting point, we already have had some progress without starting the de-euroization plan due to our accommodative monetary policy. As I mentioned previously, the proportion of the lending portfolio in lek is increasing. We had 80% of total loan portfolio in euro a few years ago, compared to slightly more than 50% today. The figure should go down as the trend is continuing. So only through the accommodative monetary policy we have achieved some kind of de-euroization in lending.

But euroization is high in the economy for several reasons. First, because our main trading partners are European countries and second because we have a lot of emigrants who bring money home. Although remittances have been decreasing, still they continue to be a significant source of financing for receiving families. Italy and Greece are our neighbouring countries, and business activity with them is increasing. Euro is an international currency and it is strong nowadays. Furthermore, before the euro we had the dollarization. There were dollars in the market back then, now we have euros.

We don't intend to have zero euroization as a matter of fact, because there is a lot of business in euro. We are aware that the point is not to get euro out of the market. We need to decrease the share of euro loans savings and exchange in order to increase the efficiency and the transmission of the monetary policy. In addition, our intention is to raise our influence in terms of financial stability by raising exposure in lek of the borrowers that generate their income in lek and the use of financial instruments in lek vs the ones in euro in the banking system, as well as outside it. Clearly, one of the factors that has an impact on NPLs is the unhedged exposure of borrowers.

So, these are our main intentions. We have had success so far. We intent to implement new measures with the intention of additional success. We are taking some measures in coordination also with the Ministry of Finance and other regulatory actors in the market, because we have euroization not only in the financial market, but also in the real economy as well. It is not rare that prices of durables and real estate are quoted in euro, which is unnecessary. Why should car prices be denominated in euro? People generate income in lek, they go exchange money in euro and pay for the apartment in euro. There are no reasons, good financial reasons, or incentives for such behaviour. We have not and are not having fluctuations in inflation or the exchange rate. Albania adopted a free floating exchange rate regime, and has quite a stable currency. Sharp fluctuations in inflation and the exchange rate are memories of a distant pasts, years ago. Recently our currency has been appreciating, which is another story. I don't want to elaborate any further on that topic. The key point is why use euro when it is not necessary? Why buy in euro in the market?

In this instance, the government must and needs to take some additional measures to be stricter. By law the currency in the territory of the Republic of Albania is the lek. There is no need to use euro and there are actions to be taken that promote the use of domestic currency. In the financial market, relevant especially for the banking sector, we are planning to take some measures regarding the weight in the required reserve of the bank foreign currency liabilities. A higher weight will aim to reduce use of the euro. Also increasing transparency is very important, because, as the argument holds for financial inclusion and financial literacy, people do not understand financial concepts like foreign exchange risk, and other similar concepts. Therefore, the more transparent the financial market is, the more prudent the clients of the banks will be towards the risk they might accept in the future.

So far we have made good progress without taking specific actions or imposing specific rules and regulations - just exerting our routine tasks as a central bank in terms of steering monetary policy or applying macro-prudential rules to support long term macro and financial stability, while in the meantime emphasising the potential risk of currency mismatch for business and households. The euro domination in the market has been diminishing but it is still very high, therefore we intend to implement additional measures. Of course, we cannot and do not intend to get rid of the euro as we are going towards Europe and there is a lot of euro in the market. Euroization will continue because of imports, exports and remittances, but we want to bring it to a more reasonable level and this is how we plan to proceed. Thank you!

Jens Bastian: Thank you Governor. Aneta, please join the conversation.

Aneta Krstevska: In Macedonia, we have also had some success in dealing with de-euroization. Actually, relative to the period before the global crisis, we have a reduction in the share of deposits with foreign currency components in overall deposits by around 18 percentage points, followed by a similar trend on the asset side of the banking sector' balance sheet. Actually, this is partly due to the lower level of confidence and lower return in the euro denominated financial instruments during the crisis period. In addition, we have supported these positive trends by central bank measures like diversification in the reserve requirements ratio in favour of domestic currency deposits.

In this regard, what the EU institutions requested from the central banks in the region is to work on this issue and actually this year we have also developed a separate strategy for dealing with de-euroization with lot of comprehensive measures in this area, by involving other institutions in the country. The main point is to keep the euroization under control, at a level that is not damaging the monetary policy transmission, especially in this period while we are still with independent monetary policy. Thank you.

Jens Bastian: Can we have another round of questions or comments from the audience, please. Altin.

Q: Altin Tanku, Bank of Albania. I have a question for the panel. What additional contributions can central banks give in the role of banking supervisory authority, or payment system authority, or resolution authority in terms of financial inclusion? I am referring to these recent FinTech developments like peer-to-peer lending or crypto-currency like BitCoins. Thank you very much.

Jens Bastian: Who among the panellists would like to have the first go? From the central bank of Montenegro, please.

Governor Žugić: I want to comment on some of the questions earlier. All of us are from small and open economies with strong spillover effects, positive and negative, and all of us have different monetary policies but the same goals. Kosovo and my country are using euro, but both our countries are not members of the euro area. My country will be very soon, I hope, a member of the European Union, and we use the euro and we don't have strong monetary instruments, but our monetary policy is especially financial stability. We have strong fiscal adjustment now. The government and the central bank have very positive cooperation, and our economic growth in Montenegro amounted to more than 4% in the first two quarters.

About the last question, about financial inclusion, every day our bank is operating with social responsibility, especially with regards to financial inclusion, we work a lot with young people and youth. Only a few days ago we had one exhibition in the Money Museum in the Royal city, Cetinje, about using jewellery as money. It was an occasion for secondary and primary schools, for the children, for the youngest and all these people in Montenegro. Now we have a low level of financial inclusion, but our intention is to create more and more financial inclusion in the future.

Jens Bastian: Thank you, sir. Belma, would you like to add to that?

Belma Čolaković: I guess that all depends on the structure of banking supervision in each individual country. In the case of Bosnia & Herzegovina we have sub-state banking supervision, which is coordinated at the level of the central bank. Well, in this case P2P lending and similar types of transactions usually are unsupervised, but they, as I said, should be monitored, recorded, we should know what's happening there.

So there must be some system of, well, not control, but maybe an information-sharing about what's happening. In that perspective, in Bosnia and Herzegovina I see information shared through the standing Committee on financial stability on what might be the inter-linkages between financial intermediaries, banks primarily, and companies that are engaging into peer-to-peer landing. We must understand how many outstanding exposures to commercial banks those institutions that are borrowing from others already have, in order to adequately assess the risk to financial stability. So, I am not saying that we should necessarily regulate them, but we really have to have a very clear understanding of what the potential risks are and what the exposures are before everything goes out of proportion and we start having all those various problems emerging.

Jens Bastian: Governor, please.

Governor Sejko: Very good question, as a matter of fact. We as a central bank have a very crucial task to play. So far, we have created the National Payment Committee, under the central bank umbrella, as the modernisation of the payment systems is very imperative and is very important nowadays.

We have seen that the current trend in the banking market, and broadly in the financial market, is to move towards digital banking and mobile banking. Retail banking is being modernised and we see certain initiatives in the market, but these initiatives are taken separately, and sometimes are not successful. Some companies are investing money, energy and time in cooperation with some banks.
In this context, we as a central bank could play a very important role to harmonise the efforts, study the market, and put certain rules for the modernisation of the payment system. This modernisation will create a lot of facilities to the clients, but also will save time, efforts and money for the banking sector, being under our coordination, in order to not have 100, or 10, or 20 different platforms competing with each other and not being used.

There is a lot of space for the central bank in this context to coordinate efforts between certain parties in this game. Not only between commercial banks and the clients, but also with governmental institutions, especially the ones that provide utilities. Most of the efforts and investments towards digital banking are made in intermediating utility payments in order to facilitate life by using a mobile phone. There is a lot of progress in some more developed countries. The mobile phone is used also for other payments, even for retail purchases, in supermarkets and other retail units. So, in this context, we as a central bank can play a role and we are working on that and we need to coordinate with the banking industry and other actors.

In addition, regarding financial inclusion, we luckily have a museum, like our colleagues in Montenegro, and we are organising activities that encourage financial education. It is working, but unfortunately the museum is only here in Tirana. We need to educate the whole population. However, step by step, there are a lot of activities. Actually we are taking this very seriously and have put a lot of attention and effort into it. Every year, we organise at least one educational week. We call it 'Money Week', and during this week we organise different educational activities in coordination with many public institutions, especially with schools. We coordinate with the Ministry of Education, and have prepared a book for primary and for high schools. Financial education is now becoming a part of the education programme. Students are visiting the museum, and we have joint efforts with the Ministry of Education. On the other side, we have just launched the programme "Nights of the Museum", as the activity is called, with a lot of lectures and with the involvement of the most senior members of the central bank starting with the Deputy Governors and the directors. So, it is still only one institution, there is a need for efforts from different institutions, but we work step by step. Commercial banking, as I mentioned, can play a very important role. I mean just by doing their normal activity, they educate people.

Jens Bastian: Thank you, Governor. Now I give the word to Governor Mehmeti from Kosovo.

Governor Mehmeti: I emphasized in the previous round that the focus of the central bank is to increase the percentage, or the financial intermediation, and in this context I mentioned the two main factors: one of them is financial education, and the other the technological development of banks that is consistently increasing access, or development, or the financial intermediation that facilitates this issue. But your question is very on point, and I will mainly focus on what the central bank has to do in order to increase furthermore the issue of financial intermediation.

We must continue more intensely the efforts to support the development of the financial system's stability and to increase financial inclusion. The central bank has consistently pursued a proactive approach by providing the financial system with the necessary infrastructure for efficient and sustainable functioning. In this context, we have managed to have open - but prudent - licensing policies so as to foster competition, and the products and financial services for different groups of clients.

I have already elaborated on issues of financial education and technological development. Thank you very much.

Recap

Jens Bastian: Thank you very much, Governor. It is now advanced in time. We have listened, we have debated, and we have exchanged views on a variety of matters in this concluding panel. I would like to briefly summarize some of the key aspects of our conversation before I formally announce this panel closed and give Governor Sejko the opportunity for some concluding remarks on this conference overall. First of all, I'd like to thank all the panellists and the audience for a lively, engaging conversation about, as we heard this morning, technical issues which nevertheless can be brought to life and thereby enter into a dialogue on issues of financial stability, financial outlook, resilience and, as we just concluded in our question and answers section, regarding financial inclusion.

There are some aspects that I have learned in the course of this panel. I think there are reasons to be cautiously optimistic about the region, and individual countries within the region, in some cases more, in some cases less, but there is a trend of optimism gaining ground. The term success story is often overstated or used in a premature manner, but I would argue that we have heard evidence in the course of the different panels today that suggest that there are success stories emerging. They need additional water to grow, to expand and to have deeper roots, but these green sprouts are visible and they are tangible.

Secondly, challenges obviously remain and many of the panellists and speakers have reminded us of these challenges. We still have a financial sector that is bank-dominated, to the point, as we heard from the colleague from the central bank of Montenegro, that 90% of financial assets are in the hands of commercial banks. We also heard that while NPLs are declining in volume, NPL resolution remains a challenge, a work-in-progress to find solutions, as Piroska has emphasized.

I was very happy to hear that while stock markets are starting to re-emerge in individual countries in the region, it is important to identify synergies between stock markets. Governor Sejko emphasized the need to fight informality in the financial sector. And it is important when we hear about financial literacy, about educational outreach activities, that we look not only at how we organize museums and tours (which I can highly recommend given that I had that opportunity yesterday evening during your kind reception Governor), but that as we heard from the Governor of Montenegro as much as from other governors, that there are outreach activities into areas where it matters most: schools, primary and secondary schools. To try and connect there, to talk about the issues that we have also debated here today, to make them tangible, because this is the future generation that will not only look for jobs, including in central banks, but that will also have to define how they deal with financial affairs in the future.

Governor Sejko emphasized that while gradually emerging from a crisis, you can generate opportunity instead of focusing only on regulating risk. I like that process. Generating opportunity while not forgetting the emphasis on risk. It includes, for example, looking at the incentive structure of banks in domestic markets, how to expand the non-bank financial system, the pricing of lending in domestic currency. These are opportunities that are waiting to grow, that need regulatory intervention and supervision from central banks.

And lastly, ladies and gentlemen, what we have also heard, and with some very vibrant examples, is about cooperation; country to country, regional cooperation. We heard from Aneta for example that there are now synergies to be identified with regard to stock markets, reaching out to countries within the region and in the broader area, for example to Bulgaria. I think this element of linking forces, as reflected in stock market activity, is a red thread that resonates throughout our conversations during this conference, trying to establish and to identify opportunities of how to link forces. We heard in very emphatic terms this morning that cooperation with multilateral financial institutions is critical, all the way to the point that the Finance Minister of Albania has made it clear that, if the IMF wants to leave we'll have to chain the Fund, we won't let it leave, it is here to stay. Bas (from the IMF), you have your work cut out, but you are, as we have heard, a very welcome guest and one with whom to do business in Tirana. That is something which is looked at favourably in Albania. Such a positive perception of the IMF is not a given in the region. The World Bank is proactive here, as Linda has identified, with regard to long-term cooperation in the areas of financial inclusion. And last but not least, we wouldn't be here together if there was not a sense of cooperation, of reaching out across central banks, but also from central banks to universities.

To the University of Oxford, to St. Anthony's College and to the activities that are represented by Othon and other participants here with regard to SEESOX. I think these outreach activities are part and parcel of our cooperation endeavour that we have established in the course of the past years and I think that there is enough energy and spirit in this room, and political capital available, to continue this kind of cooperation in the future.

So, I thank you for your attention, I've said enough, but I do think that the Governor deserves the last word. Governor Sejko, please.

Governor Sejko: Thank you very much, Jens, for a perfect recap. You covered in an excellent way the main topics of the conference today. I was telling some colleagues that the conference is quite intensive. We have some distinguished speakers, with very good presentations, indeed very excellent presentations, and I thank them for coming and contributing to this conference. All the presentations are really interesting, but having limited time overall, with each individual speaker in the panels having limited time, meant that we didn't have enough time to elaborate as much as necessary the positive messages, and the smart and all-important messages given by the speakers. I would like to apologise for that. However I think that one day is more efficient, because two days may be too long for participants that have tight agendas. It would force our guests to spend more time here.
Basically, I hope that you got the messages of the conference. I am not going to do the recap again, but everything is clear regarding the banking sector. I don't feel the need to repeat it in detail, but broadly speaking the banking sector is critically important for intermediating funds in all our economies. All over the world the banking sector is indispensable for intermediation, but the markets elsewhere are more sophisticated. The insurance market and the capital markets are very important parts of financial intermediation, so a key question is "why in our less developed economies does the banking sector represent on average around 90% of the financial sector?" As we saw in this conference, it remains very important and it plays its role.

The central bank of course needs to play its regulatory role in order to activate more parts of the financial markets, as the banking sector cannot be a substitute for other parts of financial markets like investments funds, pension funds, the stock exchange and other financial market segments. As a result, somehow the banking sector is forcing itself to fill up the gap. But in order to have a contemporary economy we need to play the role as regulators and to foster the development of other markets. We need also to modernize payment systems, which are vital for a well-functioning financial market. We are working on that and will continue to work, but we need the cooperation of the banking sector again in order to modernize it.

I don't need to repeat the other comments. I would like to thank all the distinguished participants in this conference, the governors, chief economists, colleagues from the central banks, other colleagues from international institutions. Thank you very much and I would like to close today's Conference. Thanks a lot.