“Albania — Opportunities and Challenges in the Move Towards Emerging Market Status.”

The Challenges of Changing Monetary Policy Setup: What Should Concern the Bank of Albania?

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Economic policy in Albania

IMF programs as an important anchor:

- in the form of binding economic and politic constrains for:
  - monetary,
  - fiscal,
  - legal.
- promoting responsible behavior of Albanian authorities.

The Challenges Ahead

- Szeleky (2006)
  - Macroeconomic Challenges idiosyncratic risks.
  - More on global risks and macro challenges today.
- Fullani (2007), Deroose (2005) objective challenges:
  - Price stability Vs. financial Stability

Objective of Discussion

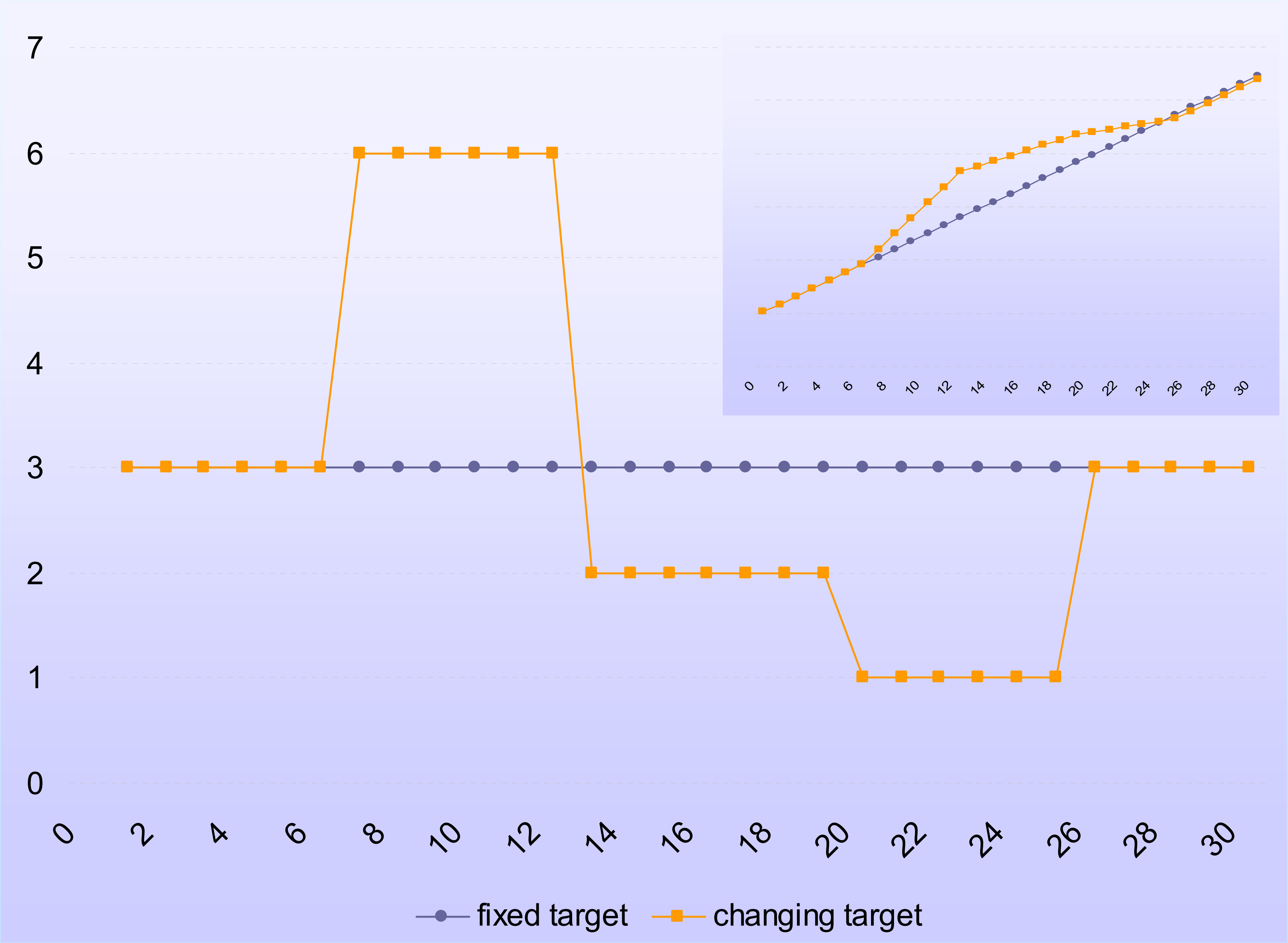
- Assumption:
  - inflation Targeting is the next regime.
- Review the vast literature produced during the last three years.
  - Identify potential gaps
  - misinterpretations in the existing literature
  - evaluate the soundness of the future policy actions based on the current knowledge from empirical models.

A target “engraved on stone”

- ***Price stability depends on the way and frequency the objective is set.***
  - Independence to set the numeric inflation target and keep it unchanged in the long run.
    - Klockers (2005),
    - Lybek (2005),
  - Luci, Gjermeni, Gazidede (2006)
    - Memorandum of Macroeconomic Stability.

A target "engraved on stone"

- Svensson (1997) price stability in the form of low and stable inflation targeting makes price level a ***trend stationary process with drift:***
  - *the value of the target decides the trend in the consumer price level.*
  - *changing the value of the target will change the trend of the inflation process and by statistical definition will introduce instability.*
- Morande and Schmidt-Hebbel (2000), "*In September 1999 the central bank announced a point target of 3.5 percent for 2000 and a stationary target range of 2-4* ***percent for the indefinite future***"



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fixed target
changing target

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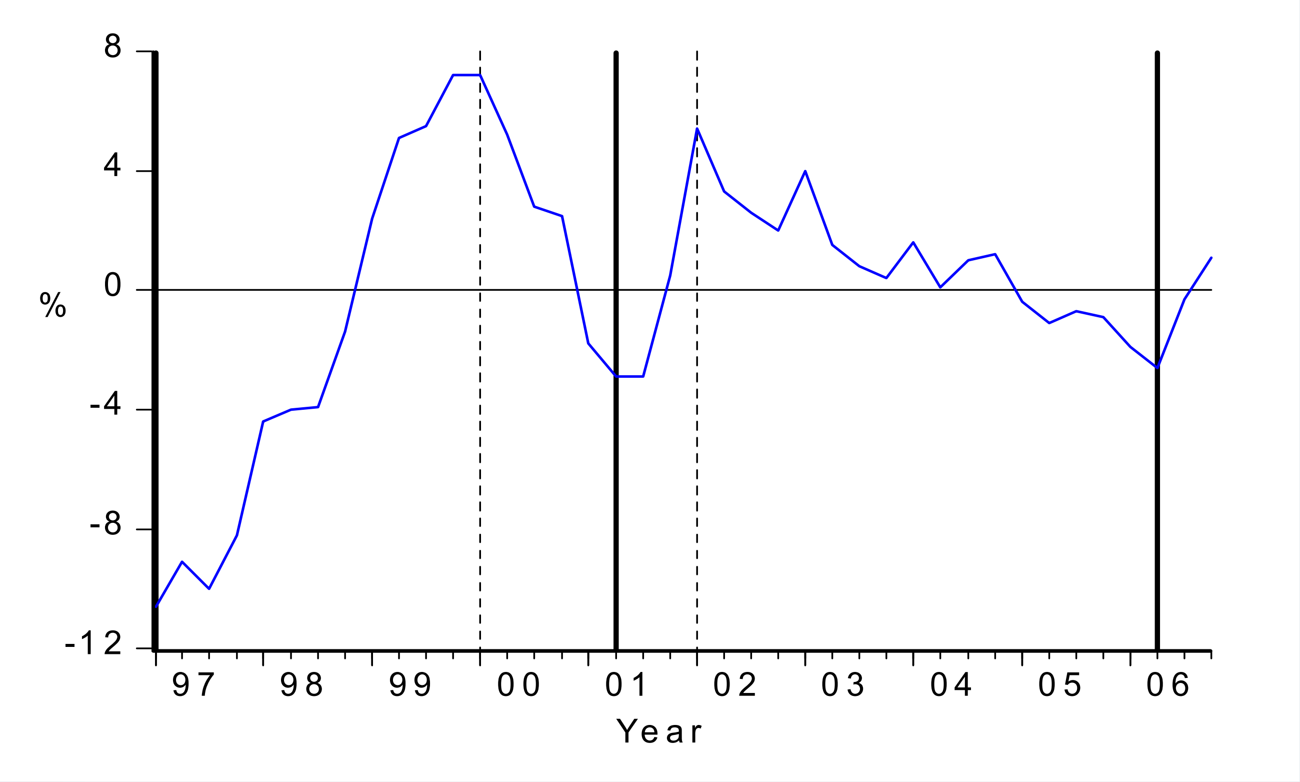
What is the optimal inflation objective?

- The BoA Inflation target must be higher than the ECB:
  - supposed differences in the productivity between Albania and its trade partners.
  - possible strong Balasa-Samuelson effects.
- Empirical investigation
  - Olters(2005), Celiku&Haxholli(2008)
    - *Data problems (length and availability)*
    - *Non conclusive results*

Alternative method

Graph 1. *Output gap based on the production function method*



Source Kota 2007, Measuring potential output andoutput gap in Albania

The role of money

- Luci and Ibrahimi (2005)
  - the rate of growth of M3 does not provide information for inflation developments.
- Celiku *et. al* (2006)
  - impact of money on inflation:
    - *is relatively small compared to the other explanatory variables*
    - *materializes well beyond the 12 months period set as the time horizon for monetary policy inflation objective.*

Does money deserve a role?

- Woodford (2006) arguments to include money:
  - the monetarist theory;
  - comparison of inflation models that do not include money to economic principles;
  - empirical evidence of long-run relationship between money growth and inflation;
  - the reliability of monetary policy based on short run Philips Curve inflation forecasts.
- Issing (2006) money provides important information for the long run trend of inflation, and a robust base for cross-checking analyses.

Currently monetary statistics are one of the most reliable and accurate sources of statistical information in Albania

Yes it does!

- Themeli and Kolasi (2006)
  – predict that monetary aggregates might provide useful information for long run analyses.
- Tanku (2006)
  – money demand is cointegrated with output, interest rate, inflation and exchange rate in a stable long run relationship.

Monetary aggregates may provide useful information regarding long run trends in inflation.

The role of money

Be aware of:

- Find the most representative aggregate.
- Structural changes.
- Policy communication.

Do the same with asset prices

- – Important economic sector.
- – Not included in CPI (potential signal loss).

- Empirical investigation and communication is a must.

The role of transmission mechanism

- Kolasi Shijaku and Shtylla (2007) review history of transmission mechanism:
  - Different variables;
  - Different time frame;
  - Some channels are not identified;
  - Statistics are very poor.

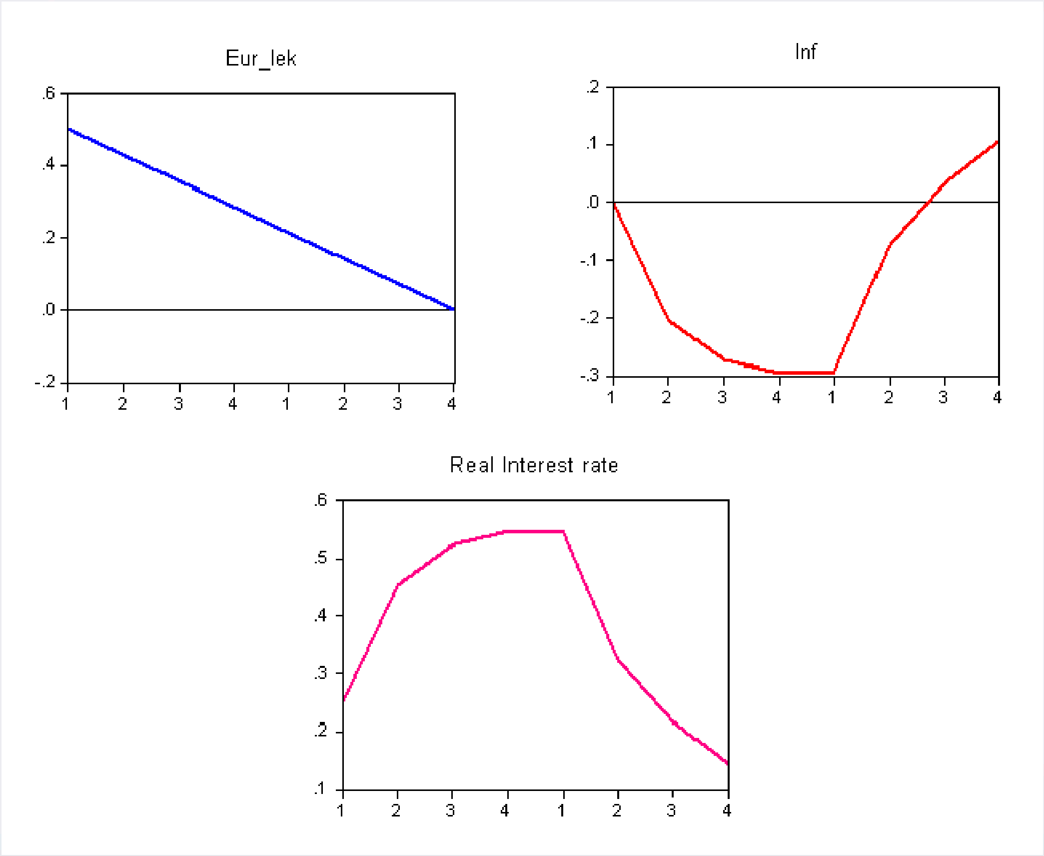
Transmission mechanism

- The marginal understanding of the transmission mechanism is and will remain a serious challenge for the conduct of the policy in the future.
- Structural Changes (possible structural breaks).
- Dollarisation.
- Understand and predict possible changes.

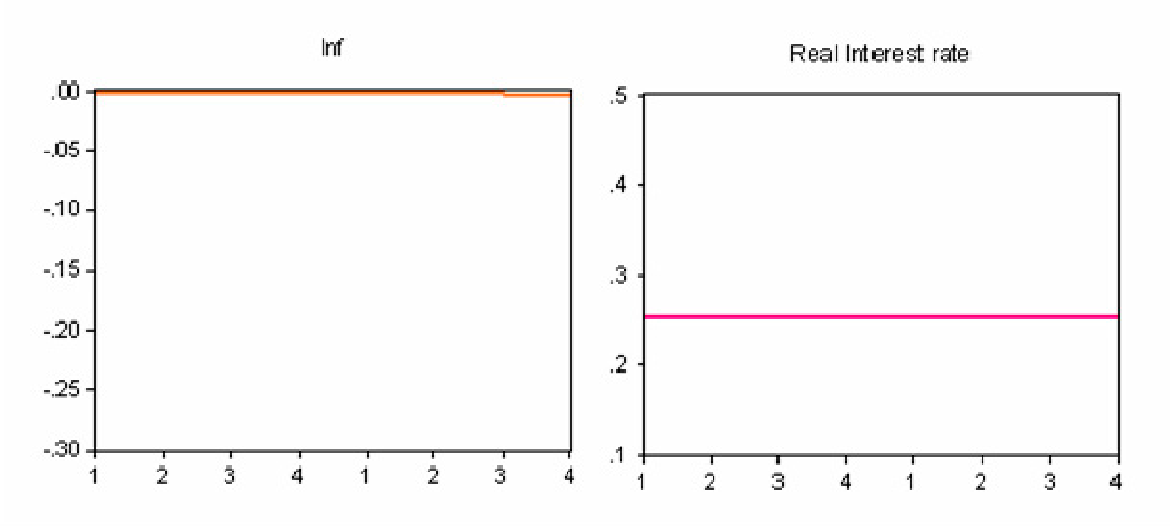
The role of exchange rate channel

- Monetary policy transmission works through exchange rate channel.

25 bp interest rate increase in base rate and UIP: immediate appreciation of 0.5% and then a gradual depreciation back



25 bp increase in the base rate and no exchange rate reaction



The role of exchange rate channel

- Adopt a hands-off approach
  - every single intervention might yield to unpredicted effects of monetary interest rate change intervention on inflation.
- What if exchange rate changes pose potential threats to inflation?
  - monetary policy intervention (interest rate change).
- Can BoA avoid interventions in the foreign exchange market?

The role of exchange rate channel

- Tanku, Vika and Gjermeni (2007) offers a viable compromise:
  - the Bank of Albania's intervention in the foreign exchange market should not be related in any way with the achievement of the inflation target.
  - must be followed by a public statement that explains clearly the nature of the intervention.
  - states publicly that it does not contain any policy signal.

Statistics!

Conclusion

- The focus of inflation targeting literature on the central bank, its final objective and the implications for monetary policy, creates the illusion that inflation is a commitment of the central bank to price stability.
- Inflation targeting is a commitment of a group of institutions; it is an anchor to sound economic management.
- All economic agents should properly understand the implication of their actions and respect the constrains that such regime imposes.
- Institutions should restrain from intervening in any direct or indirect way that can influence or raises risks to the price level stability in the long-run.