The Optimal Policy Mix in the Current Environment

Lessons from the policy response to the crisis

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Overview

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1. **Motivation**
2. **The crisis in the region: sources and effects**
3. **Policy response in Albania**
4. **Remaining challenges and lessons learned**
5. **Concluding remarks**

Motivation

1. **The recent crisis exposed policy makers to a toxic combination of:**
   - Structural problems: on-going negative structural trends worsened due to the crisis
   - Cyclical challenges: how to stimulate the economy and avoid long-term implications
2. **Policy response was a combination of monetary expansion, fiscal stimulus, and structural reforms**
3. **However, the policy response was far from effective and rather incoherent:**
   - Monetary policy suffered from a weak transmission mechanism
   - Fiscal policy was constrained by lack of fiscal space
   - Structural reforms were hampered by political economy considerations
   - Policy mix suffered coordination and sequencing problems, within and between countries
4. **Policy makers should take into consideration lessons learned during the crisis and avoid repeating past mistakes**

The crisis spread in the SEE region

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1. **The EU (and global) crisis affected the SEE region through trade and financial channels**

2. **In addition, region-specific vulnerabilities in the SEE aggravated the crisis:**

- Growth model was unsustainable and structural reforms had already slowed down
- Fiscal policy was procyclical and public debt already high
- Deleveraging, due to heavy exposure to EU banks
- Financial stability concerns due to a highly euroized banking system

3. **Albania did not fall into recession, however:**

- Actual and potential growth slowed down
- Public and private sector imbalances placed constraints on economic policies
- The burden of economic stabilization fell to the central bank and to monetary policy

Policy response to the crisis in Albania: Fiscal Policy

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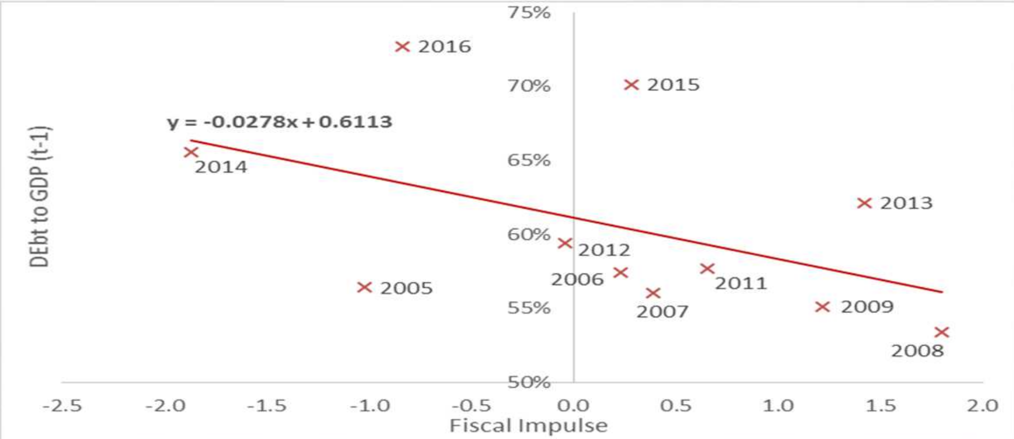

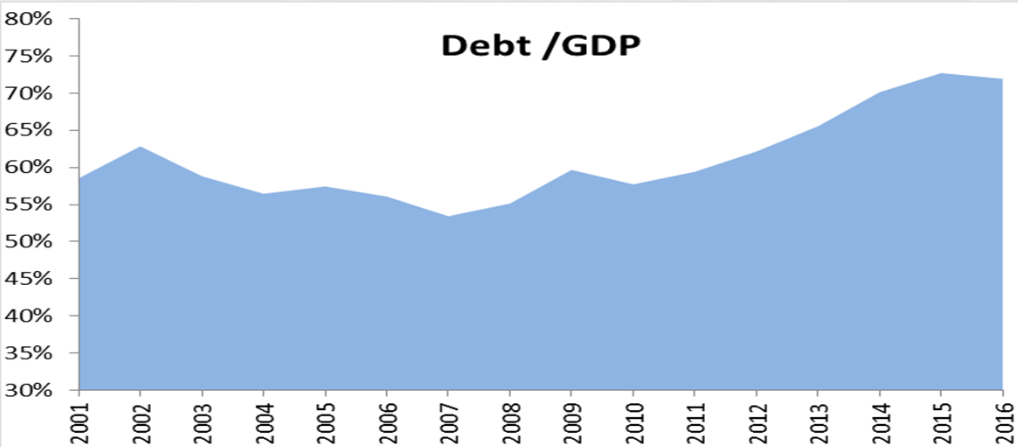

1. **Fiscal stimulus diminished early on:**
   - Increased expenditure in infrastructure projects
   - Accumulated arrears
2. **By 2013:**
   - Debt sustainability concerns emerged
   - High impact on domestic money market raised concerns about the so-called crowding-out effects
3. **Subsequently, fiscal policy turned to fiscal consolidation**

Policy response to the crisis in Albania: Financial Policies

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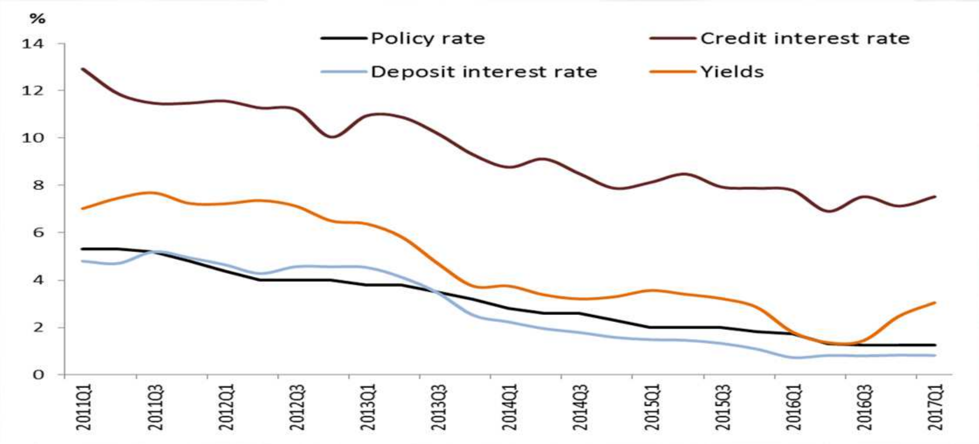

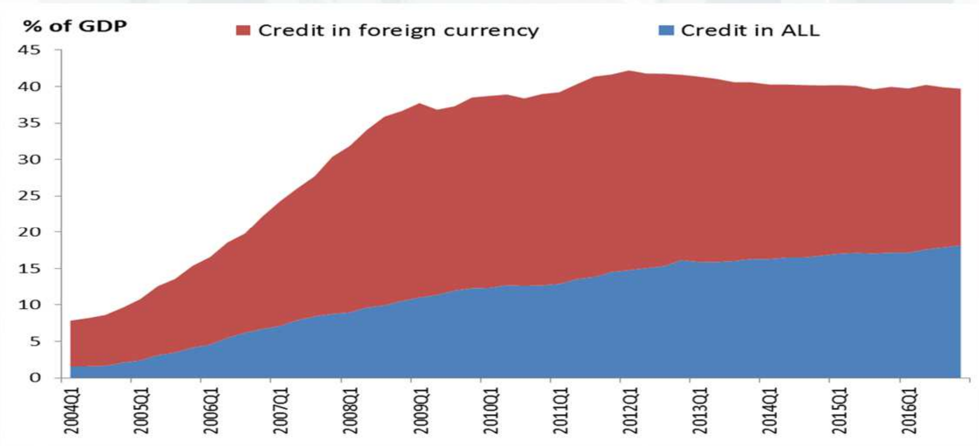

Monetary Policy:

1. Accommodative monetary policy through a series of policy rate cuts

2. Enhanced liquidity injection operations

3. Extensive use of forward guidance

Policy response to the crisis in Albania: Financial Policies (cont.)

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Macroprudential policy tried to balance conflicting objectives:

1. **Provide macroeconomic stimulus, through a package of regulatory changes designed to:**
   - Enhance credit growth, by reducing risk weights for credit portfolio growth
   - Ease the debt-servicing burden, by encouraging early loan restructuring
   - Discourage bank financial outflows, by increasing risk weights for new placements abroad
2. **Enhance financial stability, through regulatory changes designed to:**
   - Correct un-healthy lending practices
   - Preserve liquidity and capital adequacy ratios at sound levels
3. **Decrease NPLs and improve the lending environment**

Policy response to the crisis in Albania: Structural Reforms

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1. Growth enhancing reforms:

- Education reform, targeting reduced skill mismatch in the labor market
- Active labor market policies, aimed at increasing labor participation ratios
- Judicial system reform, aimed at improving law enforcement and contract compliance
- Financial sector reform, aimed at reducing NPLs and decreasing credit risk
- Energy sector reform, aimed at increasing efficiency and removing or preventing obstacles

2. Sustainability enhancing reforms:

- Pension system reform, aimed at ensuring sustainability of public finances
- Financial sector reform, aimed at enhancing financial stability through strengthening oversight and improving safety nets
- Administrative and territorial reform, aimed at reducing waste and increasing efficiency

Lessons Learned

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1. **Business cycles have not been abolished!**

2. **The ‘great recession’ risked turning into a ‘great depression’ because policy-makers were unprepared**
    - Financial imbalances implied substantial constraints and policy trade-offs at country level
    - Globally, increased economic & financial integration acted as a risk transmitter, while…
    - Limited international policy coordination resulted in an inadequate policy response

3. **Avoid time-wasting and inactivity**

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Suggestions

1. **Continue with structural reforms**
2. **Adopt clear and visionary fiscal responsibility frameworks**
3. **Enhance financial stability and adopt (and use!) a countercyclical macroprudential framework**
4. **Increase international cooperation, through:**
   - Building mechanisms to avoiding un-intended international policy spill-overs
   - Unifying financial regulation and increasing the exchange of information
5. **Preserve the credibility of monetary policy, by avoiding the burden of multiple objectives**

Thank You!