

A COMPARATIVE ANALYSIS OF SELECTED MONETARY POLICY INDICATORS IN NORTHERN MACEDONIA AND ALBANIA IN THE LAST DECADE

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Abstract

This paper intends to explore and describe some of the main monetary policy indicators in the Albanian economy and Northern Macedonia. The countries under study have some general similarities as follows: both are countries with a transition economy operating in the open market economy for no more than 30 years; both countries have been part of communist regimes for a very long time; both of these countries are a potential candidate to be part of the European Union. The target exchange rate strategy is the monetary policy pursued by the Central Bank of Northern Macedonia in fixing the local currency exchange rate within the Euro to maintain a certain level or within a specific interval the exchange rate of that country. According to the economist, one of the most important reasons a country has financial stability is the efficiency of monetary policy instruments in the short and long run. In the international economic sphere, both countries under analysis are exposed to the risks of appreciation or devaluation of the exchange rate, trade barriers, and any other risk related to financial crises that may affect the region's countries.

Keywords: monetary policy, transitions countries, inflation, monetary policy instruments

JEL: E52

Methodology

This paper will present a descriptive and analytical analysis regarding the leading monetary policy indicators in Albania and North Macedonia. The

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methodology used in this study is to analyze the data obtained from the central banks of each country and the World Bank. Secondary data are obtained from these official sources from 2010 – 2021. This paper is based on the descriptive analysis of the monetary indicators' data to reach conclusions and recommendations for policymakers. The following discussion is intended to summarize the Bank's monetary policy development history of Albania and Northern Macedonia, focusing on its current forms. The macroeconomic environment and the operation of the transmission mechanism limited the choice of exchange regime 1992 exchange rate. Experiencing the places in transition does not give us a clear answer as to which course regime exchange gives significant results. On the contrary, it seems the choice should be based on assessing the country's specifics, and, most importantly, it should also be coordinated with other macroeconomic policies. Judging now, a few years later, the functioning of the free exchange rate regime, we can conclude that we have made the right decision.

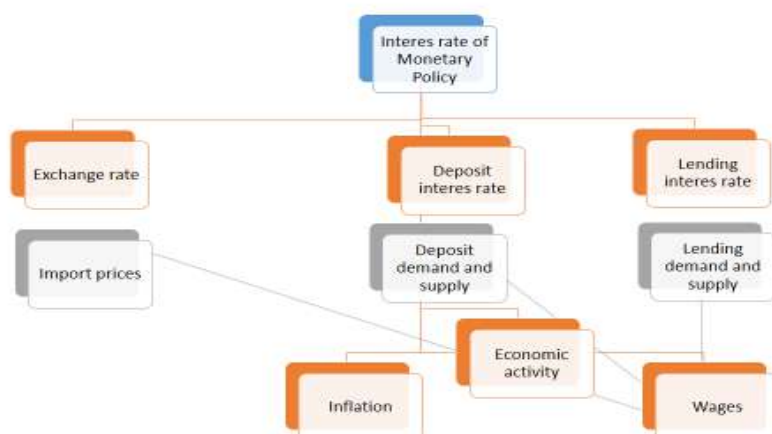
Introduction

The Monetary Policy in Central Bank of Albania during 2010 – 2022

Albania's and Northern Macedonia's transformation into a free-market economy meant the abolition of price and credit controls and a financial system based on second banks (a two-tier banking system). Monetary policy has constantly been evolving, gradually becoming a modern monetary policy. This process is influenced not only by the new economic realities of the country but also by the Bank of Albania's desire to be at the forefront of reforms. The Central Bank of Albania's objective is to implement the monetary policy and draft an exchange rate policy. The Bank of Albania has oriented the performance of liquidity and interest rates toward meeting the inflation target. At the same time, while maintaining an independent monetary policy, it has had more flexibility in dealing with crises, as was the case of the deposit withdrawal of 2002.

Choosing between two monetary policy regimes, targeting exchange rate or monetary targeting, was conditioned by the fact that the support of a fixed exchange rate at that time was practically impossible. Although stabilizing effects on inflation and interest rates could have been faster in a fixed mode of exchange, the Bank of Albania's foreign exchange reserves were deficient then. Moreover, the current account deficit was constantly expanding as a result of the changes in the structural economy. In these circumstances, the regime was given priority of monetary targeting, where the intermediate objective was, and is, total money supply (M3 aggregate).

The classical transmission channels' classifications include the exchange rate, real interest rates, and money supply. The implications of these channels for price stability are as follows:

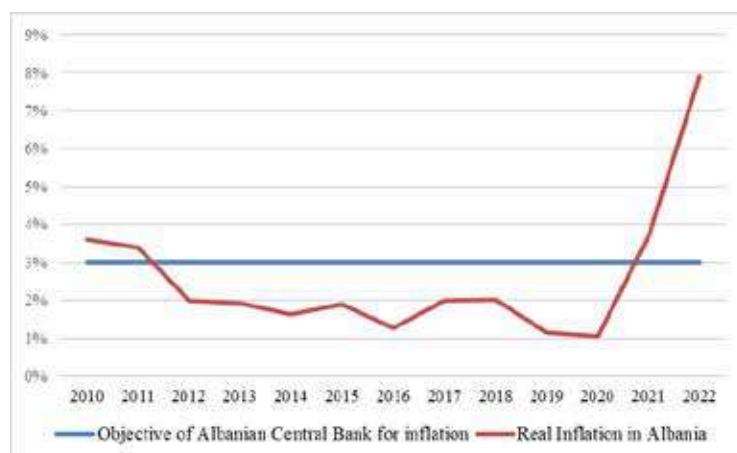


Source: Bank of Albania

Figure 1: Transmission Monetary Policy

Developments in the world economy, especially in those countries with which it has trade relations, strongly affect the Albanian economy. For this reason, external factors and monetary policy will influence the exchange rate channel. These external influences may obscure monetary policy decisions in Albania. In terms of Albanian trade, imports are more significant than exports. The distribution of exports in the balance of payments is relatively low. Therefore, the exchange rate shift from export prices over the volume of exports and economic growth will be limited. People in Albania can invest their money in bank deposits or treasury bills. Alternative investments such as securities or bonds are rare. Thus, although deposit interest rates may react to changes in monetary policy, changes in the volume of deposits compared to changes in deposit interest rates may be negligible. This means that, due to a tight (relaxed) monetary policy, deposit rates may increase (decrease), but the volume of deposits may remain unchanged. The expansion of lek loans in Albania is still low. Thus, although lending interest rates may react to changes in monetary policy and the effect on credit demand or supply may be strong, the overall impact through the credit channel is expected to be smaller. This means that a tighter (smoother) policy can lead to higher (lower) loan interest rates and even more (less) credit demand, although, in general, the change in credit is small. The report of 2022 published by the Albanian Central Bank expresses that the monetary policy instruments

(a low-interest rate and a level of inflation below 3%) have positively impacted Albania's economic development and financial stability.



Source: Bank of Albania, 2022

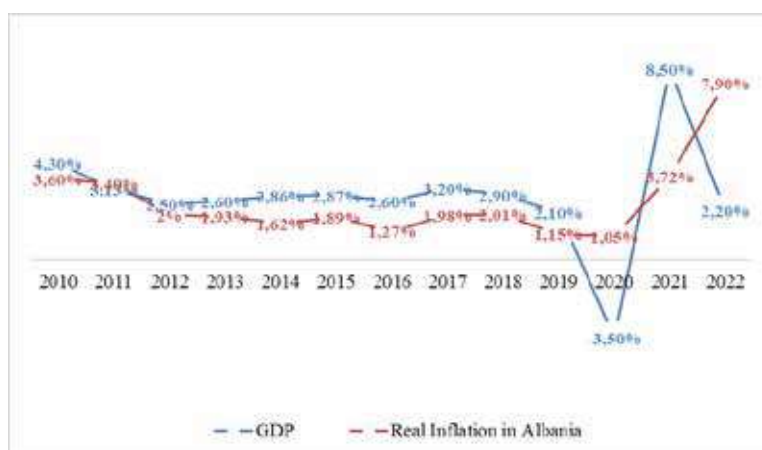
Figure 2: Inflation level in Albania 2010 – 2022

Figure 2 presents the inflation performance in Albania during the last twelve years, comparing it with the target set by the Bank of Albania for maintaining financial stability. The consequences of the recent financial crisis were felt in the Albanian economy, especially during 2010 – 2011, in the increase of inflation, respectively 3.6% and 3.4%. This is due to the severe consequences of the crisis of two of Albania's central partner countries for import and export relations, such as Italy and Greece. Inflationary developments in the following years have had a downward trend, below 3%. The lowest level of inflation was recorded in 2020 at about 1.05%, while its highest value was marked in the third quarter of 2022 at around 7.9%.

The increase in inflation has been driven by the increase in prices in the international market, but it has also started to be transmitted to the increase in production costs and inflation expectations in the country. For these reasons, price increases in the country appear to be broad-based and relatively stable.

The highest economic rate for the case of Albania was marked in 2021, with a value of 8.5%. If we look at the graph, this indicator seems to be a downward trend, and in 2020 the economic growth rate is in negative values (value in 2020 marks -3.50%). The same trend has been in inflation, with an average over ten years of about 2.36%, thus maintaining the limit set by the Central Bank for price stability. The growth of the world economy is slowing down while inflationary pressures remain high. The war in Ukraine and ongoing problems in global production and trade chains – shocks that raise costs and hold back

production – have translated into high inflation and the synchronized slowdown of all developed and developing countries.



Source: Bank of Albania (2022).

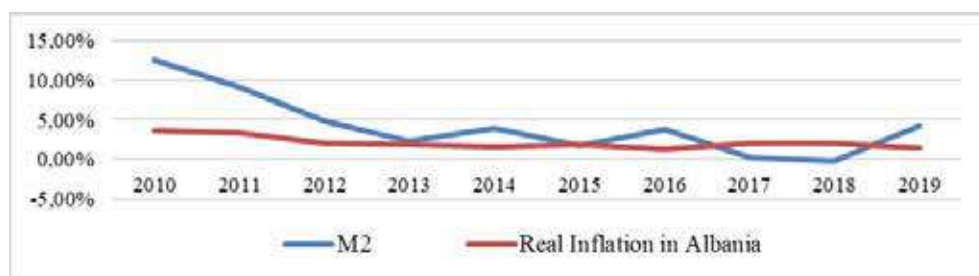
Figure 3: Inflation and GDP in Albania

In the graph below, we look at the relationship between the M2 aggregate and the inflation rate in Albania. Many authors have studied the relationship between monetary aggregates and prices in different economies.

According to Suriname et al. (2011), a study that includes data for the period 1980 – 2010 concluded that there is a positive relationship in the short term between the two main variables of the study. On the other hand, Paun and Topan (2013) conducted a study on the citizens of Romania and concluded that: inflation as a monetary phenomenon is statistically significant and is positively related to inflation. While according to this same study, the monetary indicator M1 is not correlated to inflation.

According to Madurapperuma (2007), there is a strong positive relationship between monetary indicators (money as a whole) and inflation; it is precisely the amount of money in circulation that increases the price level in the economy. The literature considers that inflation and money have constantly influenced each other and are manufactured phenomena, generally by countries' central banks. An important point to note is that countries with lower development and highly dependent on union policies, for example, the Western Balkans and their relations with the EU, do not show a positive relationship between M1 and CPI, a hypothesis for this situation may be indirect. Developing countries are trying to align their monetary policies with EU policies to speed up their integration. There is a direct relationship between these two variables presented in the graph;

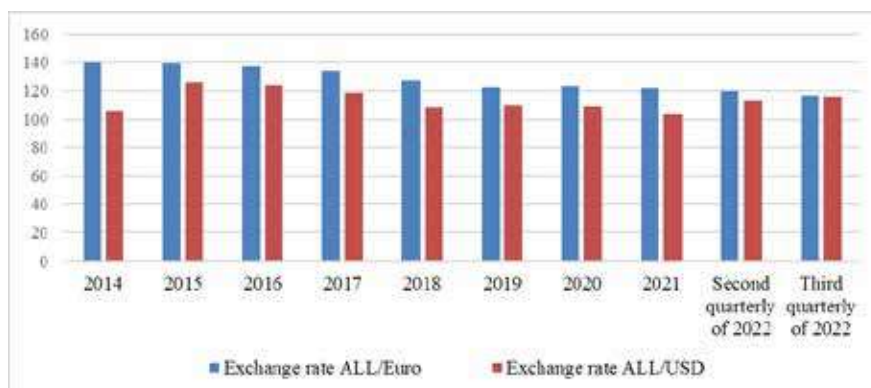
the increasing level of M2 aggregate in the economy tends to cause an increase in inflation.



Source: Bank of Albania (2019).

Figure 4: M2 and inflation level in Albania

Average annual inflation was 7.9% in the third quarter of the year, remaining 1.2 percentage points higher than a quarter ago. Inflation followed an upward trend, peaking at 8.1% in September. The continued increase in inflation moved it 4.6 percentage points above the average of the January – September period last year. The escalation of the crisis in Ukraine intensified the increase in the prices of energy, raw materials, and essential foods in the international market, being transmitted directly and indirectly from the added costs to consumer prices.



Source: Bank of Albania (2021, 2022).

Figure 5: Exchange rate ALL/Euro and ALL/USD

The lek has continued to appreciate against the Euro even in the third quarter of the year, beyond what is dictated by seasonal behavior but remaining within normal trading parameters. The appreciation of the lek against the Euro, which started at the end of April, culminated in the third quarter; the euro/lek exchange

rate was 117.1 on average lek/euro, from 120.4 lek/euro in the second quarter of the year and 121.9 lek/euro in the first quarter. In the first three weeks of October, the EUR/LEK exchange rate fluctuated near the average of September and August, with an annual lek appreciation of 3.9%.

In general, the development of the lek against the Euro has been determined by the movements of demand and supply within normal trading conditions. Both the volatility of the euro/lek exchange rate and the spread between the quoted selling price and the buying price has fluctuated close to their normal values.

The lek has significantly depreciated against the US dollar, reflecting the strong appreciation of the latter against the Euro in the international market. The dollar was quoted at an average of 116.3 ALL in the third quarter and 119.4 ALL in the first three weeks of October, from 113.0 ALL in the second quarter.

The faster normalization of the monetary policy by the Federal Reserve compared to that of the ECB has led to the acceleration of the devaluation of the Euro against the dollar by 18.7% in annual terms. This performance has been transmitted in an annual depreciation of the lek by about 14.0% against the US dollar in this period.

The Western Balkans countries, Albania and North Macedonia faced the negative consequences of the pandemic, which appeared in all sectors and indicators of the economy. Northern Macedonia was the country that recorded the most significant economic contraction reaching a value of -12.7%, mainly caused by the reduction of investments and consumer spending. Kosovo had the same trend, again facing a reduction in investment and consumer spending. The inflation rate in these countries started to increase in September 2020, when the economy started to emerge from stagnation due to the pandemic.

Table 1: The macroeconomic indicators in Western Balkan countries

Country	Changes in GDP Q2 2022 (in %)	Inflation Q2 2022 (in %)	Unemployment rate Q2 2022 (in %)
North Macedonia	2.8	18.7	14.5
Serbia	3.9	14	8.9
Kosovo	2.1	12.7	20.5
Albania	2.2	8.1	11.1

Source: Relevant Central Banks

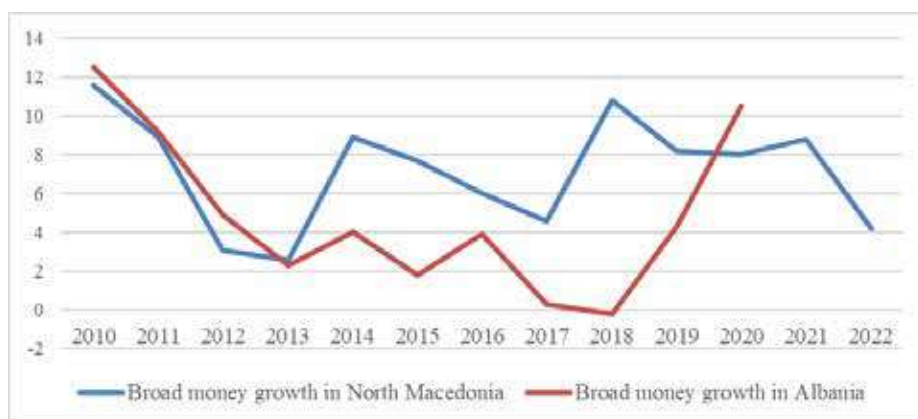
One problem that transition countries face, such as Albania, is using foreign currencies in conducting many transactions instead of national currency. The market failure view, in broad terms, suggests that as economic agents engage

in foreign currency financial activities, such as borrowing and lending, financial euroization increases while the risks from the exchange rate are ignored. The presence of market imperfections/externalities, such as moral hazard and asymmetric information, encourage borrowing or lending in foreign currency without fully internalizing the associated risks. One example is the high positive correlation between currency and default risk (exchange rate and credit risk). This suggests that foreign currency debtors often go bankrupt in cases of devaluation without seemingly considering (ex-ante) the possibility of exchange rate fluctuations.

The North Macedonia Central Bank Monetary Policy 2010 – 2022

Northern Macedonia, after 1995 pursued a monetary policy of exchange rate targeting, which has brought financial stability to the country in recent years. The IMF classifies the monetary policy regime of Macedonia as a fixed exchange rate one (concerning the EUR).

One of the monetary policy transmission channels followed by the Central Bank of Northern Macedonia is establishing the key interest rate. As one of the monetary policy instruments, the NBRM has increased the reserve requirement rate for foreign currency liabilities from 20% to 50% during this period. In the second quarter of 2019, the gap between key interest rates (ECB and NBRM) and short-term market interest rates widened on average. With the increase of the NBRM interest rate in May 2016, the interest rate gap between the ECB interest rate for refinancing operations (0.00%) and the interest rate for treasury bills from 3.25% widened to 4.00%.



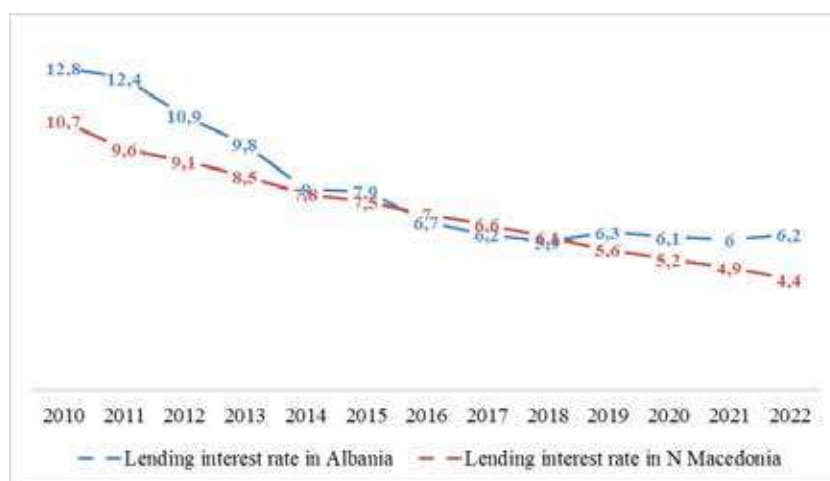
Source: National Bank of North Macedonia and Albania (2022)

Figure 7: Broad money growth in North Macedonia and Albania, 2010 – 2022

According to the figure above, the growth rate of money in circulation for Albania in recent years has had an increasing trend, marking the value in 2019 of about 4.3% of GDP, while for Northern Macedonia, this indicator for the same year decreased by 2.6 percentage points. After this period, the countries' central banks under analysis pursued a tight monetary policy due to the effects of the financial crisis and unfavorable political developments. The Central Bank of Albania has been even stricter with its monetary policy compared to Northern Macedonia because, despite the declining trends of this indicator in both economies, the value of broad money has always been higher in Northern Macedonia compared to Albania (exception is made only during the year 2010 – 2011).

In October 2022, the broad money (monetary aggregate M3) remained at the previous month's level. Regarding the components, growth was registered in long-term deposits for up to two years, with a moderate increase in short-term and demand deposits. Decrease was registered only in the currency in circulation. On an annual basis, the broad money increased by 4.2% due to the increased short-term deposits and demand deposits, given the fall in long-term deposits up to two years and currency in circulation.

Increased political uncertainty has negatively affected the confidence and expectations of economic agents, leading to the withdrawal of deposits from the banking system and an increased propensity to dispose of foreign currency. The chart below presents the performance of loan interest rates for Northern Macedonia and Albania during 2010 – 2022.

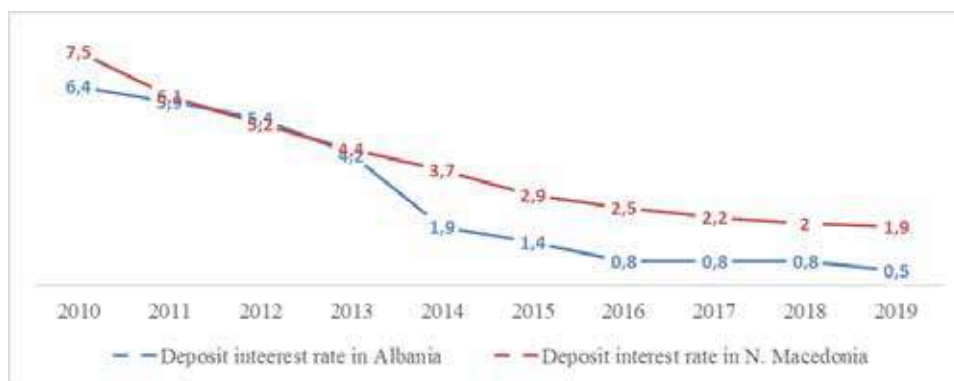


Source: National Bank of North Macedonia and Albania (2022).

Figure 8: The lending Interest rates in Northern Macedonia and Albania, 2010 – 2022

The respective Central Banks have pursued liberal policies by stimulating the economy and business with low lending rates. However, comparing the two economies, we can say that the loan interest rate is higher in Albania than in the neighboring country. The exception is the interest rate on foreign currency loans to households with a minimal quarterly decline.

The following chart presents the trend of deposit interest rates for both countries, Albania and northern Macedonia. As it turns out, this indicator has had a downward trend over the last ten years. The graph shows that the interest rate on deposits in Northern Macedonia has been relatively higher than in Albania.



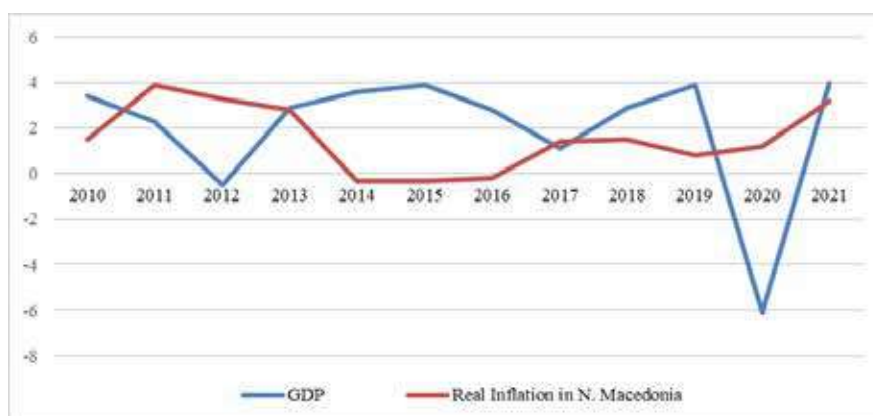
Source: National Bank of North Macedonia and Albania (2022).

Figure 9: The deposit Interest rate in Northern Macedonia and Albania, 2010 – 2022

The recent global crisis has also affected many manufacturing sectors, with the Republic of North Macedonia reducing exports of textiles and metals. Albania's GDP was negative in 2009, with a value of around -0.9% . After 2010, when GDP growth was 1.8% , the recovery began to emerge (Sadiku et al., 2013). Figure 10 shows an inverse relationship between the two variables, GDP and the inflation rate in Northern Macedonia. After 2017, we see an increasing trend of real GDP, while its highest value was recorded in 2015 at about 3.9% , where inflation is -0.23% . In 2019 the value of real GDP was 3.2% , and the recorded inflation was 0.77% .

As Northern Macedonia is one of the potential countries for EU membership, its Central Bank, through monetary policy instruments, is taking measures to reduce inflation below 2% . From 2010 to 2022, the inflation rate has been a single-digit number, so the monetary policy strategy of targeting the exchange rate has successfully stabilized the economy's price level. Food prices contributed significantly to the CPI increase in 2019, even though they

rose only moderately in the second half of the year (1.2%), declining from 2.1 % annual growth in the year's first half. Prices for fuels, utilities, and transport dropped in 2019. According to a study by Sadiku, M., Saliu, F., and Sadiku, L. (2013), the exchange rate seems to be the primary source of inflation in Western Balkan countries that should join the EU. Hence a wise strategy will be to stabilize the exchange rate, which is one of the Maastricht criteria. The lower inflation in the Republic of Northern Macedonia compared to its level in Albania is related to the fixed exchange rate regime implemented in the economy of Northern Macedonia. According to many studies, countries in transition, especially those in the Western Balkans, use the exchange rate as a shock absorber. In this way, the fixed exchange rate regime in Northern Macedonia played a significant role in maintaining price stability.



Source: National Bank of North Macedonia (2021).

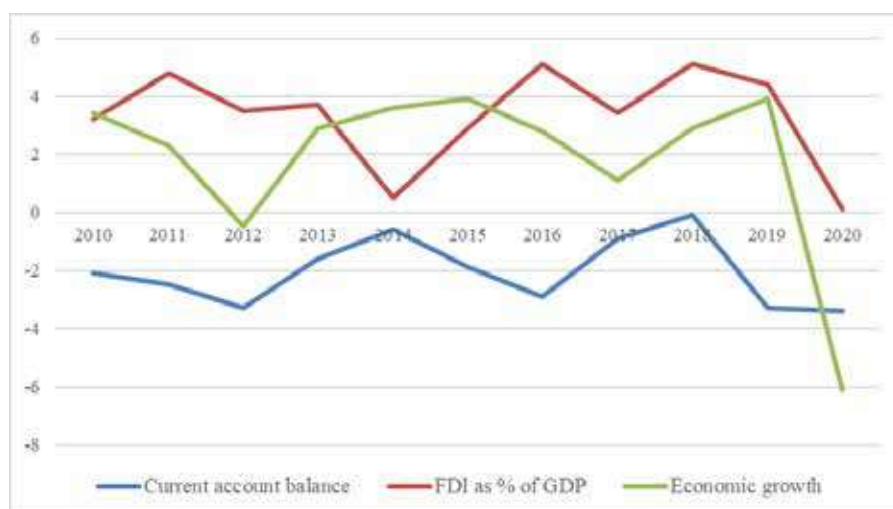
Figure 10: Inflation and GDP in North Macedonia

According to annual report of Bank of North Macedonia (2021), the gross domestic product (GDP) in 2021 was 720 414 million denars, and in comparison with 2020, it increased by 7.6% in nominal terms. The real GDP growth rate in 2021, compared to 2020, was 3.9%

Data shows that economic growth and FDI as % of GDP fluctuated significantly during the last ten years, and the current account balance was negative too. The main factors that have influenced the FDI performance in Northern Macedonia are:

- Northern Macedonia has a high level of corruption.
- The Western Balkans countries follow a competition policy to absorb as much FDI as possible.

The level of FDI in 2019 was about 1.3 percentage points lower than its value in 2018 or about 25% less. The lowest value of FDI during the last ten years was recorded in 2014, with about 0.5% of GDP.



Source: National Bank of North Macedonia

Figure 11: Current account balance and FDI as % of GDP

Like the FDI level, economic growth in northern Macedonia has fluctuated from year to year, and the main factors influencing it are the effects of the financial crisis and the unstable political climate in the country. The lowest value of economic growth was recorded during 2012, with about -0.5, otherwise known as the review period. After 2012, the Macedonian economy experienced growth with an average of about 2.75%. The highest value of economic growth was recorded in 2015, around 3.85%. In the same year, FDI overgrew from 2.9% of GDP in 2015 to 5.1% in the following year.

Comparisons of the monetary policy of Albania and Macedonia with the ECB

The process of integration of candidate countries in the European Union is related to the degree and ability to respect and implement the legislation and policies set by the union. Once the countries become part of the European Union, meeting the Maastricht criteria is essential to become part of the Eurozone using the Euro as their official currency.

Two of the many convergence criteria that countries are significant to meet are:

- In each country, the Central Bank must be free to implement the best and most appropriate monetary and fiscal policies.
- The country should have a developed financial system for monetary and financial stability and effectiveness in policy implementation.

During the last decades, the inflation level in developing countries (such as Albania and Northern Macedonia) has been higher than in European Union countries. This is because the price level of some transition economies is too low relative to the EU and, thus, higher. The money supply is considered the best measure of convergence between the transition economy candidates for EU membership and the Eurozone countries. Transition countries must adhere to and respect the European Central Bank's monetary policy to reach the same inflation and financial development level as the Eurozone.

Conclusions

The Western Balkans countries, Albania and Northern Macedonia, faced the negative consequences of the pandemic, which appeared in all sectors and indicators of the economy. Northern Macedonia was the country that recorded the most significant economic contraction reaching a value of -12.7%, mainly caused by the reduction of investments and consumer spending. One problem that transition countries face, such as Albania, is using foreign currencies in conducting many transactions instead of national currency. The market failure view, in broad terms, suggests that as economic agents engage in foreign currency financial activities, such as borrowing and lending, financial euroization increases while the risks from the exchange rate are ignored. The presence of market imperfections/externalities, such as moral hazard and asymmetric information, encourage borrowing or lending in foreign currency without fully internalizing the associated risks.

The respective Central Banks have pursued liberal policies by stimulating the economy and business with low lending rates. However, comparing the two economies, we can say that the loan interest rate is higher in Albania than in the neighboring country, with about 0.6% more in 2019 (6.2% and 5.6% for each country). The exception is the interest rate on foreign currency loans to households with a minimal quarterly decline.

The economic situation in these two countries has continued to show signs of slowing down, reflecting the high prices of energy, and food transport, which have been translated into high inflation rates, increased uncertainty, and tightening of financial conditions in most countries.

High and stable inflationary pressures have forced central banks to tighten monetary conditions, increase interest rates, and withdraw monetary incentives. The economic performance is expected to continue to be weak, and it is affected by the prolongation of the war and the developments affecting the production chains. The tightening of financial conditions is expected to curb demand and bring down inflation rates.

Economic activity in the region's countries has increased positively in the second quarter of the year. The growth rate has decreased in all countries except North Macedonia. Consumer spending has slowed down in all countries; the progress of investments has been different between countries, while government spending has decreased due to the end of the aid packages for COVID-19. In North Macedonia, solid investment growth has countered government spending and consumption reduction.

Inflation rates have reached double digits, the highest in a decade.

The region continues to feel the impact of the war in Ukraine, which has been followed by rising energy, food, and transport prices. Even the basic inflation rates have shown an upward trend, testifying to more stable inflationary pressures in these countries. Inflation rates in the region are expected to continue to register high values until the end of the year and further follow a downward trajectory. Economic performance in the region is expected to slow down further in the presence of high inflation rates and monetary tightening by central banks.

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