

Monetary Policy Transmission: Opportunities For Financial Sector Development
Bank of Albania
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Mr. Chairman, Mr. Governor,

It is a great honor for me to replace Franco Passacantando, the Italian Executive Director at the World Bank, who was invited to participate in this panel today.

But it is also a challenge for me to do so because, unlike Franco who had a long and distinguished career at the Bank of Italy, neither my professional background nor my present functions as senior advisor to the financial sector vice president in the World Bank qualify me particularly to discuss issues related to monetary policy transmission.

As a matter of fact, when I inquired with my colleagues what is that the Bank wrote on this very topic, the only document I was given dates from the early 1990s – and it deals mostly with lessons of experience drawn from industrialized countries! Indeed the World Bank does not deal with monetary policy issues – this is the domain of our partners, the IMF.

The World Bank deals with issues of financial sector structure that support and stimulate economic growth. And it is through these lenses that I will frame my comments on the topic that is on the table this afternoon.

The World Bank is concerned with helping create a strong, diverse and deep financial sector that is able to mobilize savings wherever they are created in whatever size and deploy them to support investment and production activities that create growth by whomever has a credible project to be financed. I stress “wherever”, “whatever” and “whomever” because I want to convey that a performing financial sector has to address the needs of the population at large – not only of the large corporations based in the capital city.

To support growth, the financial sector has to function through a range of institutions that specialize in different facets of financial services and that compete among them to deliver the best service at the best price to any individual client. Hence, not only commercial banks, but also savings and loan, rural and micro finance institutions for households, leasing companies for the small companies, insurance companies, pension and mutual funds for retail savings products, securities brokerage companies to create a secondary market in bonds and equities and so forth. In so doing, the activities conducted by the financial system pervade the whole economic sphere in a mutually reinforcing partnership.

I posit that when the financial sector is diverse, stable and fully integrated with the real economy, this creates the necessary condition for an effective transmission of monetary policy measures.

And an effective monetary policy, in turn, helps create the conditions for financial sector development. Let me try to illustrate this link.

First, an effective monetary policy helps reduce output and inflation volatility – which are part of the idiosyncratic risk factors of business activity in developing countries. With economic and monetary stability, entrepreneurs can make better business plans because of reduced uncertainties. In turn, bankers can make better informed credit judgments on the borrowers – thus building a better quality loan portfolio, a condition to building a sustainable banking business.

Second, monetary stability deepens the financial sector. It provides an incentive for lengthening the duration of both deposits and loans. It allows the creation of new financial products that cater to unmet needs – such as mortgage loans, long-term investment loans or pension annuities in the most sophisticated markets.

Third, it also provides an incentive to develop local currency financial intermediation or, perhaps, it removes an incentive to “dollarize” the economy with its attendant risks for the borrowers and the reduced policy flexibility for the authorities.

So, effectiveness of monetary policy transmission and financial sector development are very much intertwined, being really two facets of the same issue – that is they provide context and infrastructure for sustainable economic growth.

And in a country like Albania that is quickly building its institutions, public and private, to deliver prosperity to its citizens, one can design a financial sector development strategy that maximizes, over the longer term, the effectiveness of monetary policy.

Where to start?

First, **ownership**. As much as for monetary policy to be credible, it has to be delivered by an independent central bank free of political influence, also banks have to be free from political influence if they are to respond to changed market conditions. The forthcoming privatization of Savings Bank will place the banking sector away from potential influences.

Second, **competition**. Monopolistic or oligopolistic behaviors by banks create stickiness in customer lending and deposit rates. They also may also create a market power that weakens the hand of the central bank in steering money market rates in the desired direction. On the contrary, competition allows transmission of policy signals to the final clients.

Third, **enhancing the legal and informational framework for credit operations.**

Unless companies increase their reliance on bank financing for their operations by leveraging themselves up with as much debt finance as their balance sheets can prudently carry, neither the interest rate channel nor the lending channel can have any real impact on economic activity. For monetary policy to be effective, credit has to be a significant management variable. If it is not, which is when companies rely on internal funds (as well as they can rely on capital market or offshore finance), changes in quantities and prices of money have a limited impact on economic activity. In the Euro-area, for instance, there are discussions underway on the effectiveness of the transmission mechanism even though banks' total assets to GDP stands at 181% -- a large multiple of the ratio that is currently observed in Albania.

A subsidiary positive effect of credit deepening is the reduced liquidity level of the banking system. Without this buffer, banks have lesser degrees of freedom to shield their clients from monetary policy changes.

Fourth, **strong supervision.** The need to preserve the stability and health of the financial system requires an appropriately strong regulatory and supervisory function. Weak banks are a big impediment to monetary policy implementation and do not transmit monetary shocks well. The on-site supervisory process could be geared towards fostering an appropriate credit culture in the financial institutions. Credit discipline, as opposed to relationship lending, is an important transmission channel of monetary shocks.

A related issue is forbearance and intervention. Credit discipline is loosened if bank managers and owners do not believe that prompt corrective actions will be inexorably brought against them when prudential regulations are broken. The presence of a deposit insurance scheme augments the potential moral hazard in the system – and may offset the benefits it carries (i.e., to increase the fraction of monetary base within the banks' control).

Fifth, **develop deep money and securities markets.** For banks to decide to change their lending and deposit rates as a consequence of policy actions, they have to be satisfied that the level of rates observable in the market where the central bank intervenes is not volatile and is transmitted to the prices of the other instruments traded. This requires the presence of a range of institutional investors that have incentives and skills to trade various instruments in the secondary market. Retail investors do not provide the depth for a functioning securities market – they provide a placement outlet for the primary issuer. A related requirement is an effective payment, clearing and settlement system.

Sixth, **training bankers and financial operators.** This is, probably, the most important and difficult task – yet a vital one. The effectiveness of monetary policy hinges, at the end of the day, on the reactions of bankers and other financial operators. They are the ones who implement the decisions that eventually will find their way in the real economy. By adjusting the terms and conditions of the loan and deposit contracts, by managing the assets and liabilities correctly, by shrinking or expanding their balance sheets, by pricing out or cutting a credit line to the marginal creditworthy borrower, by

arbitraging away to other capital market instruments the movement in the instrument targeted by the central bank, they transmit your actions. Thus, they have to understand what your policies are, what your targets are and what your instruments are. And also they have to run their businesses in the most responsible way. This requires a continuous dialogue and also constant training to spread best professional practices throughout the financial system.

To conclude, my sense is that the build-up of financial leverage in this economy – which is the operating platform for monetary policy transmission, will and should take time for it to be sustainable. Leverage allows companies to carry high levels of fixed assets and working capital, which are features of stable economies with a high degree of predictability. But the agenda to create the conditions for this to take place is a long one and will take time to be fulfilled. A critical element, in my opinion, is to keep a good and constructive relationship with the banking sector and the private sector at large. With their cooperation based on their understanding of your policy goals and instruments, progress will be much faster.

I hope I was able to illustrate the many links that exist between a sound financial structure and the conditions for effectiveness of monetary policy transmission.

Thank you very much.