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Past Experiences and Current Mindset Reveal Crisis Mechanism and Financial Sustainability Insights: Evidences from Albania

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Abstract

Periodic economic crises have been a well-recorded phenomenon in nations with capitalist economies since the first half of the 19th century. The effects and repercussions of the global financial crisis of 2007 were undoubtedly felt, even in a small nation like Albania. During the crisis, it became evident that traditional policies that stressed macroeconomic stability were insufficient and that bold action by central banks was necessary to offer flexibility in monetary policy regulations and ensure crisis recovery. This article provides a theoretical explanation of the crisis process as well as a discussion of the Bank of Albania's policy decisions made during two separate crises, the Global Financial Crisis and the Covid-19 Pandemic. In order to emphasize the most significant events and interpret the insights in each stage of the financial cycle, this article was undertaken from the perspective of comparison of various timelines. When looking at financial crises from a macroeconomics perspective, the descriptive method is used to analyse the evidence in a country like Albania. The findings of this study highlight the measures made by the Bank of Albania and the government to manage the economic crisis and strive to reduce its long-term repercussions. The purpose of the study is to provide macroeconomic indicator data on the Central Bank of Albania's response to the aforementioned crises in order to aid policymakers in reflecting on the direction of their policies during two separate periods of crisis.

Key Words: crisis mechanism, central bank measures, economy cycles

1. Introduction

It is widely acknowledged that crises are neither uncommon nor exceptional in the capitalist system. Capitalist economies experienced a long period of growth, punctuated by brief periods of recession, from the end of World War II to the middle of the 1970s. (IMF, 2011b). In 1929, the United States experienced the start of the last global crisis, which later spread to the rest of the world. The governments of the most developed capitalist economies at the time, like the United States and Great Britain, were powerless in the face of a persistent unemployment rate of 20–25%; in fact, their restrictive economic policies only made things worse because they failed to understand the true nature of the crisis (World Financial Review, 2014). In recent years, it has become evident that accelerating GDP growth and bringing down inflation boost sustainability for both industrialized and, to a lesser extent, developing countries. The most recent financial crisis served as a stark reminder of the importance of quick crisis responses and the effectiveness of monetary policy tools in addressing all plausible scenarios, including the failure of a sizable financial system. Discussions on these topics frequently center on the question of how much importance should be given to guaranteeing financial stability as opposed to, say, preventing inflation or fostering economic growth. What can a central bank accomplish and where does it stand? It should keep pursuing its initial objectives, which are to promote a macroeconomic environment characterized by low inflation and sustained economic growth (BIS, 2009b). If central banks are to successfully implement a monetary policy whose major objective is to reduce inflation, they must also engage in other activities, such as the development of financial legislation and the enhancement of banking supervision (Schinasi, 2004). The necessary reserve ratio and lowering interest rates are two frequent applications of monetary policy tools. Let's examine how economic crises function in capitalist systems.

1.1 Why and How Financial Crises Occur

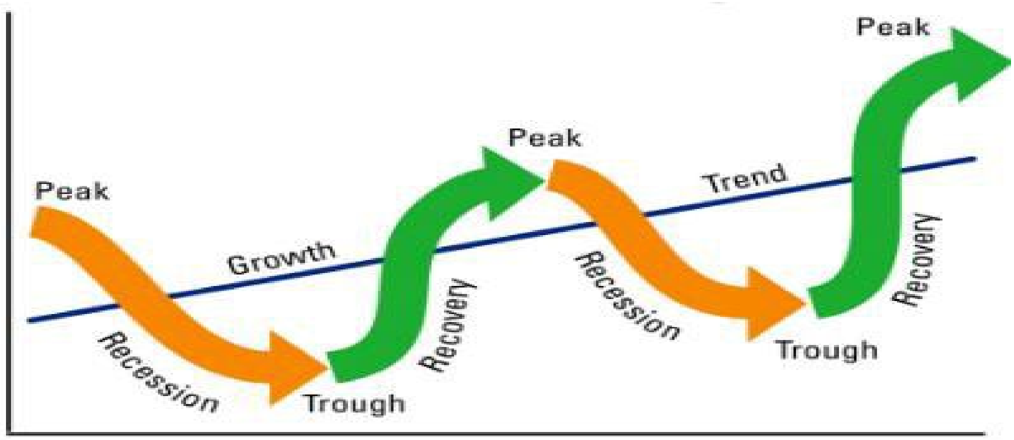
Economic crises are frequently described as periods of rapid and ongoing declines in economic activity. What occurs is the question? Stocks rise as income and consumption fall because businesses can't sell their items or output during the crisis. As a consequence, prices decrease and unemployment increases. The rise in unemployment causes a fall in income and consumption. All of these factors contribute to a drop in investment and output. If this condition persists for an extended amount of time, the economy will enter a period of depression, similar to 1929-1939. The worldwide economic crises of 1929-1939 and 2007 started in the same nation, the United States. They followed a period of ecstatic economic and industrial boom and progress. Alternately, the crisis may be explained by conducting detailed research on finance, production, the structure of markets, and credit, in addition to the complicated links between financial systems and the real economy.

1.2 Discussion on Economic Cycles and Financial Crises

Capitalism is a cyclical economic paradigm. Academics, economists, and historians talk about how long economic cycles last, how they might be reversed, and how to avoid crises. In addition, the crisis represents the end of the economic cycle (Borio, 2014). Crisis situations arise when this culminating component is at its highest. Illustrating cyclical economic activity is crucial prior to doing a crisis analysis (Kuznets, 1940). Several phases comprise the economic cycle:

a) Recovery
b) Expansion
c) Recession
d) Depression

Chart 1: Economic Cycle Phases



Source: Adapted from Kuznets -1940

During the expansion phase (also known as the recovery phase), prices, production, employment, and income all reach a peak, but they all decline during the recession period. Employment, output, prices, and incomes all stop declining during the depression phase of a recession, which is the lowest point in a recession. Beyond this, recovery usually picks up again. This cyclical process therefore follows its typical course. The economy will be in a stable phase if the cycle keeps occurring at the frequency depicted in the graph above, which means that it will cycle back to a previous phase after each one. Historical evidence shows that the economy is changed, i.e., that a society can achieve prosperity by creating a cyclical pattern whose form repeats but whose content is constantly changing. The economic structure changes significantly when moving from one economic cycle to the next. It has been observed and proven that economies go through cycles, even while they are experiencing higher levels of employment, output, and revenue. Economists use the term "trend" to refer to an upward trending circumstance. Of obviously, there is also the question of why the capitalist economy exhibits a cyclical trend. Why does this occur, and what economic factors contribute to it? Both Kalecki and Keynes have made contributions to the literature that attempt to explain this occurrence. The function of entrepreneurs in a capitalist economy is crucial. Investment choices made by the latter group are a primary driver of global economic cycles and economic growth. According to Kalecki (1990), "During times of prosperity, not only does the amount of activity grow, but so do prices." These two things work together to boost profits, which in turn fortifies investments. Investments are contingent on a variety of economic factors, but most significantly on the rate of return, i.e., the profits generated through the sale of produced products. The adoption of "orders" to invest creates an increase in productivity after a given period, which subsequently leads to a reduction in profitability after that. Both the pricing level and the overall level of activity have reduced as a direct result of this. The limitation of investments is influenced by the loss in activity, which over time translates into a decrease in output, which then raises prices. Goods are in higher demand while the economy is in its recovery and growth phases, which correlate with times of "well-being" (prosperity). Costs inevitably rise as a result of this. Since this is the case, there is a need for increased production capacity. Constantly rising production costs and demand will result in higher business profits. Companies are making more money, which reflects well enough for their bottom lines. According to Kalecki (1979), the rapid development of the primary economic indicators, and particularly of profits, has a beneficial effect on the hopeful expectations of entrepreneurs.

Profitability and expectations will have an impact on investment activity. As a direct consequence of this, the creation of new items will go up, and after a certain amount of time, this will cause a rise in overall output. This circumstance generates an excess of manufacturing capacity, which intensifies the competitiveness between businesses. These businesses will be forced to reduce prices in order to move their warehoused products. This circumstance is not the result of luck, but rather the result of discounts and promotions. At the same time, business owners' expectations begin to decline, leading to a pessimistic outlook on the current state of affairs. At this stage, potential benefits also begin to decline. This circumstance first undermines investments and eventually brings them to a halt. Consequently, production starts to decline. At this moment, the recession phase begins, which transitions progressively into the depression phase. It is characterized by a decline in productivity, which, together with the resulting pessimism, leads to the closure of businesses and organizations. When the economic crisis reaches the level of a depression, not only do unsuccessful businesses fail, but even prosperous ones are in threat. During a time of depression, the significant fall in output results in a lack of supply compared to demand, and this excess demand promotes a rise in profit margins as well as an increase in the prices of the firms themselves. As company owners anticipate more profits, they are more likely to put more money into their companies, signalling the start of a new economic upswing. There are other highly significant economic factors that are not taken into consideration in the explanation of the indicated cycle, but instead rely on the interaction between investments and profitability.

The business cycle is supposed to exist in a capitalist economy with free competition, where it endures despite changes in the economy's seasonality or historical circumstances, even in today's markets controlled by monopolies or oligopolies.

1.3 The Dynamics of the Crisis Including its Root Cause

The capitalist economy's crisis is a challenging economic problem. The interpretation and comprehension of crises remain the same. If it were not so tough, then with time and prior crises, we would have learned how to regulate and manage it as well as possible, and why not even prevent it in the future. We can only gain insight into what is really happening and why the "credit" crisis is important by comprehending the complex linkages among economic structure, market form, and financial markets.

Since the Great Depression of 1929, crises have usually occurred as the economic cycle hits its peak. Prior to the onset of the crisis, the financial markets were characterized by enthusiasm, with brokers engaging in many risky transactions. All open transactions involving the purchase and sale of securities on the stock market in order to borrow the funds necessary for the execution of contracts from banks without the required capital coverage are called "speculative". When the payment system becomes complex and extends to all market participants, banks demand payback of loaned funds. People are scrambling to sell their assets right now to get their hands on the money they need. When the value of securities drops drastically, businesses and financial institutions throughout the supply chain go insolvent. Companies in the production sector feel the effects of the liquidity crisis in the same manner that the financial sector does; as a consequence, output drops, businesses shut down, employees lose their jobs, and bankruptcies and layoffs rise, leading to a surge in the unemployment rate. When the conditions indicated above are brought into being, the ghost of the "Great Depression" crisis of 1929 resurfaces in people's minds. In terms of the development of modern capitalism, this day has been and will continue to be significant. There have been several cyclical crises before to this one, but none with the same disastrous social and economic effects (Field, 2011). The history of England, a major nation in the nineteenth century, reveals that crises erupted regularly, on average, every ten years before to the First World War.

Figure 1: The Crisis in England in 1825-1920

Source: Author

Years of stagnation followed, productivity and productive forces broke down, and accumulated goods began to be transported solely for the purpose of depreciation. The massive production moved along its path slowly. A rise in industrial and commercial rates heralded a new age of industrialization. Six times between the year 1825 and 1877, these crises challenged their characteristics, which Fourier termed a "crise plethorique" (crisis of abundance). Engels uses this historical crisis passage to highlight the repetitive occurrence of crises inside the capitalist system. This crisis is characterized as an abundance crisis according to Fourier (Riasanovsky, 1969). To put it another way, the paradox of poverty brought on by wealth is becoming a reality for the first time in human history. There were several global economic crises between 1825 and 1921. When the crisis hit in 1828, 1838, 1864, and 1882, France was at the heart of the action each time. Between 1848 and 1857, the crisis erupted in essentially the same locations throughout Europe. It was in 1866 when Italy and England, simultaneously, were the nations that were at the core of the problem. The crisis began at the same time in Germany, Austria, and the United States of America in the year 1873. Since this time period and continuing up to the present, it is generally accepted that the United States of America will become the focus of any crisis that occurs in the globe. As shown by Engels, between the years 1873 and 1890: "After each cyclical crises, the years of stagnation, the deterioration of goods amassed in the warehouse, and the loss of productive forces are followed by the phenomena of renewal, which then kick-starts a new period of growth.". The economy was able to bounce back and put its pieces back together without any outside interference. The 1929 financial crisis was an exception that refuted capitalism as a whole.

1.4 Forms That Financial Crises May Take

"Loss of trust in a country's currency or other financial assets that causes investors to withdraw cash" is another generic meaning. Caprio and Mishkin contend that "financial crises often originate or provoke the failure of the banking system and are the primary cause of the decline in the value of financial assets, most frequently on the capital and securities markets". Bordo, Eichengreen, Klingebiel, and Martinez-Peria describe financial crises as "episodes of financial market turbulence marked by major liquidity issues and the insolvency of financial market actors." Hunter, et al. (1998) describes it as: "a financial crisis is a disturbance of the financial markets that impairs the ability of these markets to disperse money; thus, financial intermediation and investments cease". Others, on the other contrary, define financial crises as events that are frequently followed by a decline in the value of financial assets or by the popping of the so-called "bubbles" that develop in the markets for these assets. It is the public's abrupt actions during a financial crisis that drain the banks' reserves, forcing the government to step in and try to avert a collapse.

2. The Origins, Causes, and Phases of the 2007 Financial Crisis

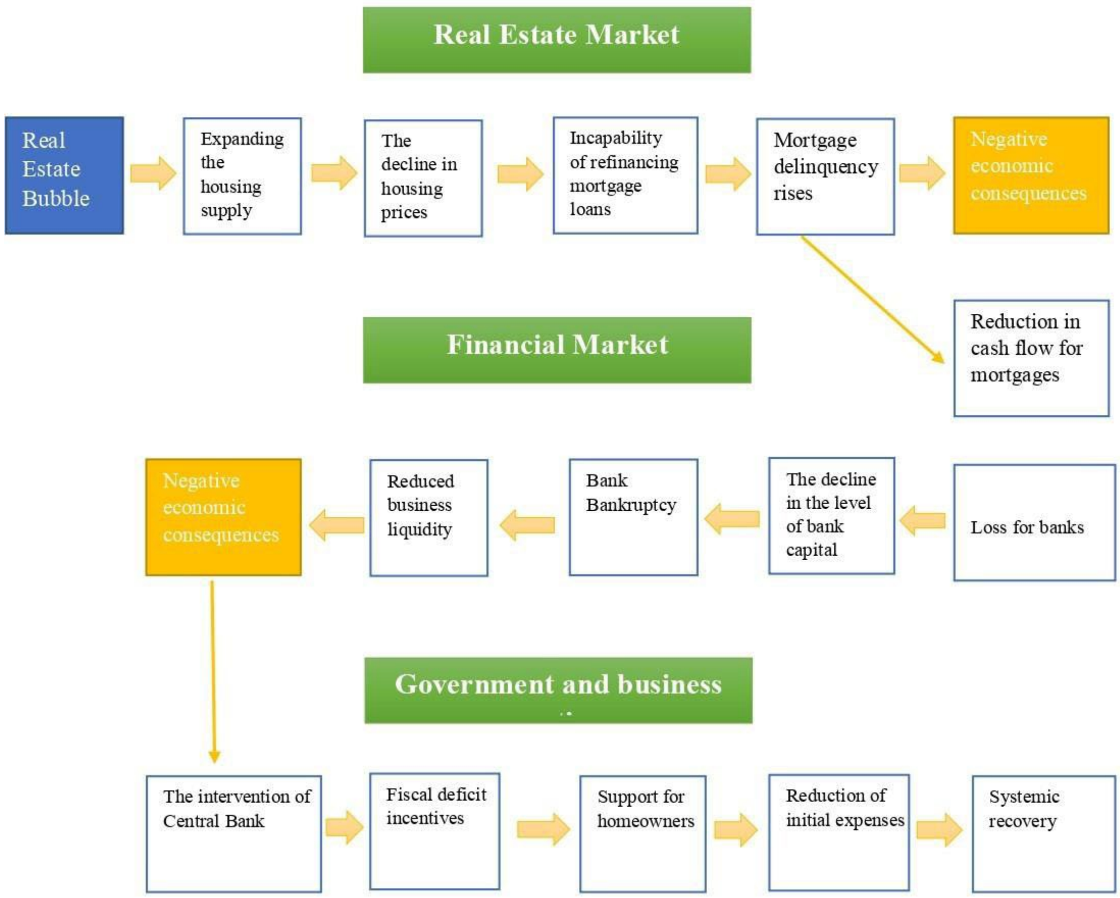
When the financial crisis first began to manifest itself in 2007, it was merely referred to be one caused by subpar lending and the US property market. John B. Taylor has stated, "As a consequence of the government's failure to intervene and the failure to diagnose bank lending and liquidity concerns, the previous financial crisis occurred". The majority of stock markets throughout the globe were experiencing significant losses. Only the market in the United States had dropped by forty percent over that time span. What had taken place was no longer able to be undone. The economic crisis caused the failure of a great number of financial institutions, including commercial banks, investment banks, and insurance firms. During that time span, inquiries that needed responses were posed.

- Would it continue to be restricted to the United States only?
- Would it also spread over Europe?
- Would it have an impact not just on developed countries but also on developing countries?

This crisis had a significant influence on the actual economy, and its negative repercussions are still being felt as of today. The collapse of 158-year-old "Lehman Brothers," one of the four largest investment banks in the United States, was an explosion on the surface of the financial crisis, but it was certainly not the end of the crisis or the shocks that the American economy in particular and the global economy in general were going through. The well-known credit crisis in the United States, sometimes known as the "mortgage credit crisis", also had a role in this bankruptcy. Agricultural and food price problems, as well as the decline in the value of the dollar on international markets, all played a part. All of these factors have been significantly dominant in the American economy for more than two years, and consequently, in the global economy as well.

The implementation of inappropriate investment and lending policies by this bank in the "housing loans" sector (including the provision of loans for houses without the application of strict criteria, an increase in insolvency, and the return of these loans) has contributed to the current crisis, which leads one to the conclusion that the plexus of these factors and elements was at the root of this shocking event. Reactions and complexities in the American financial system as well as in the world economy at that time were certainly not absent. Of course, this is not to say that they did not exist. The rate of inflation reached a high of 5.4%, and it was observed that the cost of all forms of energy, including gas, oil, and electricity, went through a period of moderate inflation as well. Just two days after the bankruptcy of the "Lehman Brothers" bank, American International Group (AIG), the largest insurance company in the United States and the world, made a request to the authorities of the American state for "financial assistance and support," informing them of her dire financial situation. The credit condition of the 20 biggest banks had a loss in value of $300 billion, the same amount that the FED utilized to encourage lending on its own behalf (Swedberg, 2010). Each bank attempted to "eliminate risk from itself." On the financial market, the process of their mergers, purchases, or sales was already evident. In contrast, shocks were instantly felt on the stock markets of New York, Asia, and Europe, where the prices and indexes of these shares decreased immediately. This event resulted in significant losses for several banks and stock market participants, hence raising the uncertainty in these markets. As a consequence of the fall in demand, the worldwide oil markets instantly responded to the shock of the international financial markets and the failure of this bank by reducing prices.

Figure 2: "Subprime Crisis" illustration



Source: Hui Tong, Shang-Jin Wei (2008)

- The real estate market
Prices fell dramatically after the "mortgage" credit bubble for home purchases burst at the end of 2006. During this time, individuals with mortgage loans were unable to make their payments. The availability of home loan refinancing decreased. The number of instances in which loan instalments were not paid as agreed upon also continued to rise. The economy was put under strain as a result of this circumstance, which increased the likelihood of a recession. "As long as home prices have this shock and as long as values remain uncertain, the crisis will unavoidably persist," says Alan Greenspan.

- Financial market
Greenspan claims that "the enthusiasm from the notion that money markets are self-regulating was the source of the disaster." Investors and financial institutions dealing in Mortgage-backed securities (MBS) suffered massive losses as a result of this uncertainty or drop in cash flows. They had to liquidate assets to make up for lost revenue. Losses incurred by the banks reduced their available capital for lending. Several major banks and hundreds more mortgage businesses failed. The rise in interest rates caused loans to become even more costly. When compared to the "boom" era, the value of credit plummeted and investment in businesses declined dramatically.

- Reactions from the Government and the Private Sector
Central banks intervened and reduced interest rates as part of their involvement to stimulate the economy. American taxpayers and homeowners were able to refinance their homes thanks to tax credits (stimulus packages). The actions of the government were taken in the period 2007-2008, that is, not at the moment when the effects on the financial market appeared. During the various stages of the crisis, one of the most important actions done by the Federal Reserve was to lower interest rates on many occasions. Based on the information presented above, it is possible to comprehend what transpired in the American real estate loan market, which constitutes a small "portion" of the financial sector and was the origin of the first spark that ignited the global financial crisis in 2007. Many economists believe that exceptionally low interest rates, which averaged almost 1% annually from 2002 to 2004, and the practice of maintaining this rate for an extended period of time, have been a particularly harmful factor. This theory was verified by a "boom" in the number of real estate transactions. By the traditional plan, "the bank loans the borrower, and if the borrower fails to make the loan instalments, then in this circumstance the bank takes the property," the borrower would be in default on the loan and the bank would take the property (Bellenzier, et al 2010). It has been argued that the "concession of loans with advantageous rates is perceived as a transfer of money in favour of the upper classes impoverished, keeping workers' salaries low" (Pressacco 2008, Margiocco 2008, Passarella 2009, Barba e Pivetti 2010). That is to say, allowing people from various socioeconomic groups to own homes was a way to make up for the unequal distribution of wealth in society. Important figures in the worlds of economics and finance, such as Alan Greenspan, Dominique Strauss Kahn, Ben Bernanke, and Jean Claude Trichet, amongst others, have given considerable consideration to that time period. A "turbulence of the American financial markets," as they put it, the crisis needed to be controlled carefully to prevent it from escalating and spreading to Europe and the rest of the globe. The dollar's quick depreciation against the euro during this period of market "turbulence" reflected the terrible situation of the US economy. Crisis, recession, or

stagflation in the economy? The daily increase in pessimism over the state of the American economy, money, businesses, and consumers was noticeable. England was the first country in Europe to feel the effects of the financial crisis in the first quarter of 2008, followed by Switzerland, Germany, France, etc. The International Monetary Fund (IMF) puts the cost of this crisis at $1 trillion, and its predictions for growth and inflation in the world's major countries were pessimistic to say the least. In the end, it was decided that the "recipes" for getting out of the prior crises weren't applicable to the current one.

3. The 2007 Economic Crisis in Albania

Even Albania was unable to escape the world financial crisis in 2007. We have a weak economy that provides us with little revenues. The country's GDP and exports are less than those of other wealthy countries. In the fourth quarter of 2008, the impacts of the global financial crisis became apparent. This was characterized by a slowdown in lending, changes in the balance of payments, a reduction in optimism among company and individual entrepreneurs, a slowdown in economic growth, and a decline in income. In 2009, these adverse impacts will escalate. Although there are no international financial markets in Albania, they are vital for the parent banks of Albanian banks. This is because of the inherent difficulty of accumulating enough funding. These lending activities are essential to the success of these banks in Albania, but they can't function without access to borrowed cash. It may be easier for banks with a strong loan-to-deposit ratio to avoid these charges. Since many economic actors rely largely on loans to fund their operations, the greater cost of borrowing will be passed on to consumers and businesses. Albania's banking sector made efforts to slow down the previously aggressive lending that had been commonplace. Crediting was tough in the banking sector at the time since interest rates on loans were high. This resulted in a rise in the percentage of loans that are considered “bad”. Therefore, the growth rate of loan activities decreased due to the high level of non-performing loans. Even in Albania, the worldwide trend was mirrored by a decline in real estate values, which threatened the financial system and the actual economy. Reductions in revenue from immigration and exports were among the first repercussions the nation experienced. The depreciation of the lek made it abundantly evident that Albanians were confronting the global economic crisis. Several indicators demonstrating the effect of the crisis in Albania: 1) The rise in inflation and the steady depreciation of the lek on the foreign exchange market; 2) A precipitous decline in real estate sales; 3) A decline in the process of obtaining loans and bank deposits; 4) The gradual rise in prices for consumer goods in particular. We know that the financial crisis reduced people's ability to buy things since imports fell. Foreign investment dropped, immigrant income dropped, food and non-food prices rose, commercial banks foreclosed on borrowers, house prices fell as a consequence of higher costs for imported components, and commercial interest rates fell as a result of the crisis. The Albanian economy benefited greatly from remittances. The money that immigrants send home is a huge boon to both their families' finances and the economy as a whole. Albania's weak financial system prevents its residents from spending more than their income. Moreover, the majority of households have limited means of subsistence. Reduced disposable income as a consequence of the financial crisis has led to reduced household expenditure, particularly as a result of a decline in income from immigrant remittances.

Which areas of our economy are being hit the hardest as a result of the current crisis?

According to BoA[1]'s financial sustainability report (2013), the construction sector, export firms, and processing industries were the most hit by the global economic crisis. Business owners in these areas reportedly have a harder time making their loan payments to commercial banks in Albania. The construction industry had liquidity issues as a consequence of customers' unwillingness to spend at a time when credit to the economy as a whole was contracting. Unfortunately, the delays of overseas partners affected exports as well, causing cash flow issues. On the other hand, commercial banks started conducting more in-depth reviews of loans when interest rates rose, particularly in the Eurozone. The banking industry was hesitant to provide long-term funding. The rise in "nonperforming loans" was another factor in the reduction in available credit (NPL). Regarding the conditions of the loan, commercial banks increased the demand for collateral in proportion to the amount of the loan, therefore tightening the lending criteria. Now, firms will be required to hold a greater quantity of real estate in order to get loans from banks.

4. Financial Sustainability

The Bank of England initially used the term "financial sustainability" to elaborate on the idea of monetary policy objectives that were not directly related to the maintenance of price stability in 1994.There are a number of different ways to define financially sustainable practices. According to statements made by the Governor of the Swedish Central Bank in the year 2004, "the idea of financial sustainability remains difficult to define". According to Wim Duisenberg, "monetary stability is defined as stability in the general level of prices, which is understood as the absence of ardent inflationary or deflationary pressures." Wim Duisenberg is of the opinion that "monetary stability is defined as stability in the general level of prices." However, there is no one, agreed-upon definition of financial sustainability. Despite this, there should be widespread agreement that financial stability is essential to the smooth operation of the many components that make up the financial system as a whole. The phrase "financial sustainability" has only lately appeared in academic writings as a direct consequence of the crisis, although central banks have always paid close attention to this issue. The need to ensure the safety of the United States' banking system was a major factor that prompted the Federal Reserve's founding in 1913. "The FED was founded to end the era of monetary and financial instability and to assign macroeconomic functions, including monetary regulation and banking supervision," according to Greenspan (2007). The majority of researchers who have examined "financial stability" have chosen to examine such problems by referring to its dual meaning in an attempt to define "financial instability." On the basis of their examination of the economic history of the 20th century, the identification of such circumstances, and their potential causes, "financial instability" became simpler to describe. Maintaining a stable financial system is just part of financial sustainability. Because of its many links and interactions with the management of monetary policy, it merits investigation from a macro viewpoint as well. According to Blejer, "anyone with a basic understanding of this issue may declare that financial stability encourages and stimulates progress. In reality, from a broad analytic standpoint, the assertion that financial sustainability supports economic growth raises several issues. How is projected financial volatility going impact development? According to Clarida, et al., (2000), financial instability erodes trust, which is a prerequisite for progress. As a result, businesses stop investing and

1 Bank of Albania, (BoA)

institutions shut their doors. Instability has a negative impact on the financial industry as well, driving up the cost of operations and increasing the number of problems inside the payment system. What measures may be taken to decrease financial volatility? Financial stability is a widely recognized public benefit. Everyone may enjoy the advantages of financial security. This is a theoretical explanation for the government involvement required to decrease and safeguard the market from financial volatility. A second point is that the financial industry is unique. It is susceptible to market failures, and these forms of market failures are justified by government intervention. To promote financial stability, one may argue that the market should be left alone. Organizations that are either contractually unable or financially insolvent will eventually fail. It is widely understood that the ability to move quickly on the market and dependable information are essential for ending the crisis.

5. The Bank of Albania's Monetary Policy Tools that Contribute to the Country's Financial Stability

Due to the withdrawal of deposits from Albanian commercial banks as a result of the global financial crisis in 2007, the whole banking industry was deficient in liquidity. The goal of the monetary policy instruments used by the Bank of Albania was to control liquidity and match the level of short-term interest rates. This isn't the only reason these tools have been used; they've also contributed to the expansion of the interbank market. Market operations attempt to improve the effectiveness of monetary policy transmission by stimulating interbank market activity and satisfying its demands (BoA, 2013). This was reflected in the rise in interest rates and the banks' reduced involvement on the money market. The Bank of Albania modified a number of its monetary instruments in order to ease the country's banking system.

- **The primary market operation**

In order to carry out open market activities, one of the most common tools used was a repurchase agreement with a maturity of one week. BoA started to withdraw liquidity via the one-week repurchase agreement in order to control the seasonal excess of liquidity created by the return of money and budget funds (BoA, 2013).

- **Open market operations**

The conclusion was that the prior crises' resolutions were not applicable to the current situation. Thus, the dynamics of crisis events necessitated the utilization of all available market mechanisms (BoA, 2013).

- **Regulatory market operations**

Although the primary market operation occurs once each week, market adjustment operations can occur whenever necessary. This takes place under exceptional circumstances, such as when there is a requirement to moderate interest rate swings brought on by sudden and long-term shifts in the system's liquidity (BoA, 2013).

- **Structural market operations**

When there is a requirement for making long-term modifications to the liquidity structure, such as those that are accomplished through the purchase or sale of government bonds, these kinds of activities are the ones that are carried out. The primary objective of these operations is to exercise control over the composition of the market. Towards the beginning of 2008, the Bank of Albania downsized its portfolio of government bonds, and at the conclusion of that same year, the BoA held five auctions to purchase treasury bonds in whole from commercial banks. These events took place simultaneously (BoA, 2013).

5.1 Impact of the CoviD-19 Pandemic on Albania's Economy

Based on the heavy reliance on tourism and remittances, the macroeconomic data indicated that the GDP decreased by 7.5% in 2020 (compared to 2.2% in 2019). It's also worth noting that the earthquake that occurred in November of 2019 had a significant negative impact on economic activity, notably in the first quarter of 2020. To put it another way, the government deficit was expected to reach roughly 7% of GDP by 2020, while the public debt was expected to reach just above 80% of GDP. Additionally, Albania's economy shrank by 10.2% in the second quarter of 2020 and by 3.5% year-over-year in the third quarter. Reductions in investment, private and public consumption, and exports, which fell by a significant 35%, were the initial causes of the current economic downturn. Considering that Italy saw a significant slowdown of about 18% in exports in the second quarter of 2020, it is possible that this decline is attributable to the correlation between the two. Recent construction projects in the wake of the earthquake led to an increase in investment growth of 4.1% year over year, which helped to mitigate the recession. When it comes to trade, transportation, and hospitality services—all crucial to the Albanian economy—their decline by 27% was a major factor in the economic downturn. One of the hardest hit industries in Albania was tourism, which accounts for about 20% of GDP. The number of foreign tourists declined by 61.5% in July 2020 compared to the previous year. Also, unemployment devastated the country, with 34.000 jobs lost and the jobless rate rising by 0.6 percentage points year on year to 12.5%, indicating a deterioration in the labour market in Albania. In the third quarter, business conditions improved, resulting in a rise in the unemployment rate to 12.1%. In the middle of the crisis, the European Commission chose to launch membership talks with Albania.

To mark the beginning of the pandemic, the Albanian currency, the ALL, depreciated in value by over 7%. However, the currency has since strengthened, and by the fourth quarter of 2020, the average exchange rate was at ALL 123.7 per euro, which was only 1.9% higher than the yearly average for 2019. The depreciation of the ALL versus the EUR and the sharp rise in food costs caused the CPI inflation in Albania to climb from 1.4% in 2019 to 1.9% in the second quarter of 2020, before falling to 1.1% in December 2020. All sectors of the economy were heavily impacted by the crisis, leaving a significant mark on the Albanian economy, which is vulnerable to any type of economic shock, not just of this magnitude.

5.2 How the BoA Reacted to the COVID-19 Pandemic

The Bank of Albania quickly moved to assist the Albanian economy, which is being negatively impacted by the coronavirus pandemic, in reaction to a health crisis brought on by COVID-19 that pushed the government to take urgent measures and disrupted public life. The policies aim to reduce the negative effects on businesses and individuals and set the stage for a quick economic recovery. The bank of Albania regularly has analysed the situation and extends its willingness to use all available operational instruments and regulatory space to mitigate the pandemic's impact on the economy and the Albanian financial system in particular. The steps implemented by the Bank of Albania, within the scope of its authority, enable and complete the fiscal package announced by the Albanian government, which aims to shift a significant portion of the cost of mitigating the financial crisis from the private to the public sector. Different measures were taken under the dynamic structures of the institution as follows:

- **Monetary Policy**

The actions adopted in the field of monetary policy attempt to reduce the cost of borrowing and the economy's constant demand for credit. The realization of these preconditions opens the path for the realization of medium- and long-term price stability target.
Lowering the policy rate reduces new borrowing costs, debt servicing expenses, and liquidity for Albanian businesses and people. It helps the monetary policy transmission mechanism function smoothly and eases strain on economic operators' balance sheets, giving them more time, space, and breath to handle the shock.
To strengthen the Bank of Albania's accommodative monetary policy stance, the weekly liquidity injection auction shifted from restricted amount to fixed price auction in mid-March.

This reform allowed commercial banks to take unlimited liquidity from the Bank of Albania at the cost of its policy rate, as 0.5%. The Bank of Albania wants to avoid the burden of supplying liquidity to the banking sector and other market operators so the entire economy may operate normally. In addition to the opportunities created for the continued lowering of credit costs on the market, this move gives economic agents more options for addressing the current issues.

In addition, the Bank of Albania has expanded the size of its liquidity injections beyond the one-week timeframe in order to achieve the specified goal.

- **Exchange rate**

The Bank of Albania has continued to closely monitor the behaviour of the exchange rate on the domestic foreign exchange market in an effort to avoid/minimize instances in which market operators are under pressure to operate on this market. The Bank of Albania emphasizes that it operates under a free-floating exchange rate framework, where the value of the “Lek” against foreign currencies is freely set on the foreign exchange market. The Bank of Albania may conduct foreign exchange market operations to minimize disruptions in the local foreign exchange market, adjust the exchange rate to a level established by major macroeconomic parameters, and enhance or decrease the foreign currency reserve.

- **Guidelines to banks**

Commercial banks operating in Albania have been given guidance by the Bank of Albania on how to best handle this procedure in a coordinated manner: (i) the compilation of internal procedures for this purpose, which should be transparent, clearly and carefully communicated to all functions and units of the bank; (ii) use of electronic means of communication, as electronic mail or digital platform, as a more effective way to address the clients' applications to postpone the credit payments; (iii) instruction on some criteria for assessing the clients' applications by type of client (households and enterprises), the need for postponing the payments; iv) recommending that entities focus on cases addressed through a valid application and address all problematic exposures prior to the order's entry into force; v) calculating interests, penalties, and instalments for the postponed period; vi) recommending gradual documentation of agreements signed with clients to avoid legal and operational risks and vii) a recommendation requiring organizations to identify credits with a postponed instalment using a particular code for internal monitoring and reporting, as well as future reporting to the Bank of Albania.

- **Eased treatment of banks' exposures**

The Bank of Albania also took action by making it simpler for banks to oversee their exposure to foreign-currency debt instruments issued by the Albanian government in 2020. The easing consists of weighting by 0% the investments of banks in these securities for calculating the risk-weighted assets according to the capital adequacy regulation and for excluding/reducing the exposures to these securities from the calculation of the maximum allowed exposure according to the regulation on large exposures. This lenient treatment will be in effect until the maturity date of these instruments.

- **Support to citizens**

Due to the tough financial circumstances caused by the COVID-19 pandemic, the Bank of Albania's measures to reschedule loan payments have enabled banks and non-bank financial institutions to defer by three months the payment of loan instalments owed by their clients.

To make this possible, all borrowing enterprises and households who are economically and financially affected by the created situation and want to benefit from the provided facility must present their argued applications to the financial institution (bank, non-bank, savings and loan association) with which they have entered a borrower-lender relationship.

Then, the financial institution (bank, non-bank, savings and loan association) will examine the application in partnership with the borrower and propose the appropriate solution based on the particulars of the situation.

In the meantime, the borrowers, whose solvency is unaffected and unharmed by the situation, must continue to pay their obligations to these institutions.

6. Conclusions and Recommendations

BoA ensured that banking system was always liquid and able to honour its responsibilities to depositors by implementing regulatory adjustments that increased the volume and quality of commercial banks' liquidity. Under the parameters of Albanian banking and financial market, BoA has taken measures to mitigate potential problems in advance.

BoA was also able to mitigate the impact of nonperforming loans and the outflow of foreign currency from Albania by providing sufficient capital in accordance with the rules established and strictly supervising commercial banks. However, monetary policies alone cannot combat the economic crisis and financial instability because not all instruments used can produce immediate or long-term results.

The value and significance of the stability of the financial system must be understood independently, and not as the sum of the intermediaries and markets from which it is composed, because the challenge of financial stability is closely tied to the capacity to identify and quantify risks, and to put into effect policies that are effective in addressing them.

For measuring systemic risk, policymakers should not presume that any quantitative method is sufficient.

The risk for commercial banks that have made foreign currency loans must be reduced through the use of appropriate pricing mechanisms, whereas the risk for borrowers with local income who have received foreign currency credits can be reduced through the use of constrained LTV and DTI rates. Commercial banks must be able to identify, address, and manage these weaknesses.

Abbreviations

AIG- American International Group
FED- Federal reserve
MBS- Mortgage backed securities
IMF- International Monetary Fund
GDP- Gross Domestic Product
BOA-Bank of Albania
NPL- Non Performing Loan
CPI- Consumer Price Index
LTV- Loan to Value
DTI- Debt to Income

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