

Ardian Fullani: Recent economic and financial developments in Albania

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the Monetary Policy Statement for the second half of 2008, Tirana, 29 February 2009.

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World economy and the financial system in particular were severely hit in the second half of 2008. The crisis which struck the heart of the global financial system was progressively and relentlessly transmitted to the economic activity of advanced economies leading some of the latter into recession. The Albanian economy has been resilient amid this hitting wave. According to the available official data and judging upon a number of indirect indicators, the Bank of Albania notes that the economic activity throughout the year has by and large performed in line with the early 2008 projections both in terms of economic growth and preservation of macroeconomic balances. The Bank of Albania in particular has met its primary objective mandated by law, contributing to the maintenance of price stability. Average annual inflation rate marked 3.4 percent, which is close to the central bank's objective.

The recent global-scale developments attest to the further economic downturn. Despite the slackening of inflationary pressures as a result of the reduced demand and the slump in basic commodity prices, the tightening of lending standards and the fall in consumption and investment have led to uncertainties related to the duration and intensity of this troublesome situation. Against this backdrop, the facing of the economic activity contraction at a global level remains an open issue. The Euro area economy is already experiencing an economic slowdown. Euro area GDP contracted in the third quarter while the unemployment rate reached 7.8 percent in November 2008. The U.S. economy showed quite similar features. The further contraction of economic activity – owing to the deterioration of financial indicators in the U.S. corporate and household balance sheets, mirrored in lower consumption spending and reduced aggregate investment – drove the unemployment rate to reach 7.2 percent. Monetary and financial stimuli managed by central banks and the ministries of finance have helped to bolster confidence and relieve pressure on the financial institutions.

Against this backdrop, the “resilience” shown by emerging countries is displaying the first signs of weakening. In contrast to the first half of 2008, the latest data attest to the moderation of economic growth rates in the majority of these countries. The channels through which the slowdown in advanced economies has affected the emerging countries differ depending on their development characteristics. China and India have been severely hit by the slowdown in exports; Russia had hard times owing to the slump in raw material prices in the global market, while East European countries have been impacted by the tightening of funding conditions on a global level.

In contrast to many emerging countries, the Albanian economy has been sustained by domestic demand, while – although upward – foreign demand in the form of Albanian exports has provided a proportionally lower impact over the economic growth. Economic activity at home has been almost entirely sustained by domestic financial resources, while foreign financing in the form of credit lines or portfolio investment has been less considerable. Operating within all the parameters of financial soundness, the Albanian banking system has been dynamic and effective in channelling the savings towards the funding of corporate production or household consumption. This process has been also facilitated by the macroeconomic stability which enabled the fall of risk premiums in economy and helped to gradually extend the investment horizon.

These features led the economic activity at home to record adequate growth in the first three quarters of 2008, a period which is covered by statistical data. With regard to the last quarter, indirect data on economic activity – mainly financial ones – suggest a slight slowdown of

economic activity, however, remaining within the projections for 2008. Manufacturing, where construction continues to share the main weight, provided the main contribution to the increase of turnover indicator in terms of volume. Investment in major road infrastructure projects and the recovery of construction permits from the prolonged constraints triggered high growth rates in construction activity during this period. In addition, the sector of services continues to provide the primary contribution to economic growth at home. The positive developments in domestic production have been also evidenced by the increase of economic tendency indicator, derived from the business and consumer opinions, and by the increased number in employed persons. In annual terms, unemployment rate fell by 1.5 percent to 12.62 percent, being mainly triggered by the increase in the average number of employed persons in the private agricultural sector.

Notwithstanding the inflationary pressures of early 2008 – mainly triggered by supply-side shocks – CPI annual inflation was brought back within the Bank of Albania's target during the second half of 2008. In the second half of the same year annual inflation rates stood close to the central bank's target – 3.0 and 2.5 percent, respectively, in both quarters. The performance of the inflation rate in the second half mirrored the global effect of the fall in basic commodity prices (mainly foodstuff and oil prices) as well as a more favourable price conjuncture of goods and services in the domestic market as a result of their demand coverage with an ever-growing supply.

The return of inflation within the targeted band was not only conditioned by the relaxation of supply-side shocks but also by the adequate monetary conditions which provided room for the balancing of demand and supply-side factors. Monetary policy stance was neutral throughout 2008 and the key interest rate was kept unchanged at 6.25 percent. In tandem with the strengthening of several banking supervision measures in terms of credit risk management, the monetary policy has led to a more balanced credit growth and has transmitted the appropriate stimuli for consumption and savings. The adequate monetary policy and the keeping of inflation under check by the Bank of Albania have been also reflected in the anchoring of economic agents' inflationary expectations close to the 3 percent target of the central bank. In absence of unexpected shocks on financial stability, inflationary expectations or other supply-side factors, the balance of risks on inflation over the period to follow seems to be shifting downward.

In this context, worth noting is the contribution of fiscal policy which has ensured the preservation of macroeconomic balances by keeping the budget deficit at adequate levels. The carrying out of public spending in line with the budget plan has facilitated the control of domestic demand pressures and has bolstered confidence in the country's macroeconomic stability. Budget revenues collected as of end November have met the 11-month plan of the Ministry of Finance by about 96.4 percent, while expenditures met 92 percent of the plan. Following the developments in the first half of 2008, budget performance for the period July to November 2008 was characterized by a more active carrying out of expenditure. Budget deficit created after the first half of 2008 was mainly financed through foreign resources.

On the other side, the external sector of the economy continued to be characterized by the deepening of current account deficit, which in annual terms, increased by 48 percent in the third quarter of 2008 to about 252 million euros. As a share of GDP it accounted for 13.7 percent which is about 5 percentage points higher than the same period the previous year. In addition to the trade deficit widening, the deepening of current deficit was also triggered by the narrowing of the positive balance of revenues and current transfers' account. Its stability is imperative to ensure Albania's financial stability and a stable and long-term economic growth. Therefore, the dynamics in the balance of payments developments remains an area which needs constant monitoring by the Bank of Albania.

Monetary indicators had a stable performance in the second half of 2008, although the end of the period showed signs of their downward growth rates. Average annual growth rate of money supply was about 13 percent. A small part of deposits were withdrawn from the

banking system in the last months of 2008 as a result of depositors' concerns following the vague situation in the global financial system. In relative terms, these withdrawals made up a small share in commercial banks' balance sheets and did not affect the banking system's soundness indicators or impair its financial intermediation role. Credit to the private sector continued to provide the main contribution to money growth. In annual terms, credit growth fell during the second half of 2008 relative to the first half the same year. Intermediation indicators increased further; the ratio of loan portfolio to deposits and total assets was 63 and 43 percent, respectively, as of end November. Following September, the structure of loan portfolio by currency displayed a higher annual growth rate of lek denominated loans. The performance of loan portfolio by customer attests to higher annual growth rates of business loans relative to household loans. In contrast to the first half of 2008, loan portfolio to construction and trade shifted downward while loans to industry increased slightly in the second half of the year.

The performance of money markets during the second half of 2008 was conditioned by the developments in monetary indicators and the real economy. As experienced by many countries, the increased vulnerability of banks to liquidity has brought about the reduction in the interbank trading volume and upward interest rates on deposits. The coverage ratio of Government demand for money has reduced and some risk premiums have increased in the last two months. This performance brought about the increase in Government securities' interest rates and in a few cases in the loan interest rates. In response to these developments, the Bank of Albania intervened in the money market by injecting liquidity at different maturity rates. In addition, the central bank changed in November the form of repo auctions to auctions with undetermined amounts in order to better satisfy the banks' needs.

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Economic and financial developments have by and large been positive during 2008. Economic growth performed in line with the early year projections, while the main indicators of macroeconomic and financial stability remain solid. The negative impact of developments in global economy was marginal. However, as in other emerging countries, the Albanian economy cannot remain immune for long to the direct or indirect impact of the global economic crisis. The Bank of Albania public statements have constantly noted that the global crisis impact over the Albanian economy will largely depend on its intensity and duration. The persistence and deepening of the global economy crisis signal that the Albanian economy will go through a harder economic environment in 2009, which may call for the solution of many issues.

The slowing remittances and the tightening of financing conditions are the channels exposing the Albanian economy the most to shocks in the global economic environment. The expected impact of these factors would materialize in a slower economic growth in 2009. We note that the economic and financial programs of all economic agents need to reflect and consider this prospect. A slower economic growth does not necessarily translate into a crisis in Albania, but rather as a temporary development propelled by external factors. Hence, promoting policies need to be formulated based on this underlying premise. They should at no case be designed to the detriment of long-term macroeconomic stability, which represents one the most treasured assets the Albanian economy has achieved during the transition years.

The preservation of financial stability remains crucial for the long-term economic development and under constant consideration in the Bank of Albania decision-making process. In this context, confidence in the banking system and in its balance sheets would be the most rational behaviour of any individual, business or other agent in the Albanian economy. Global experience shows that the mutual interaction between the real economy and the banking system in terms of savings, use of payment infrastructure and expertise in the area of financial counselling and support with funds is a key feature of economies that have managed to progress and leave behind the transition countries' level.

In conclusion, I would like to assure the public that the Bank of Albania remains committed to creating the proper premises which boost economic activity at home, without infringing the objective of price stability. In addition it will keep working on firming up financial stability in the country. The Bank of Albania decisions will be a direct contribution to smoothing out the negative effects deriving from the international crisis and they will help to ensure the further maintenance of economic and financial balances at home.