

## **Ardian Fullani: Review of the Albanian economy in 2009 and outlook for 2010**

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the press conference on monetary policy decision-making of the Supervisory Council of the Bank of Albania, Tirana, 24 February 2010.

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In its meeting of February 24, 2010, the Supervisory Council of the Bank of Albania analyzed and approved the Monetary Policy Monthly Report. After being introduced to the latest economic and financial developments at home, to their projections for the future and the expected balance of risks, at the end of discussions, the Supervisory Council of the Bank of Albania decided to keep the key interest rate unchanged at 5.25 percent.

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The performance of global economy attests to the ongoing improvement of economic activity. The majority of advanced and emerging economies experienced economic growth over the course of the second half of 2009.

The growth in global trade activity, the undisturbed financial markets' developments and the improved confidence indices reflect and bring about more optimistic future expectations. In particular, the financial system stability and the progressive improvement of its balance sheets are promising signs for greater support to the economic activity. The improved global economy was coupled with upward inflation rate trends, owing mainly to the recovery of demand and higher primary commodity prices.

However, the low capacity utilization at global level is projected to rein in the inflationary pressures in the medium run. The frail economic growth over 2010 will be at the forefront of policymakers' agenda. Moreover, it will condition the preservation of monetary and fiscal incentives during this period, albeit at more moderate rates.

As far as the Albanian economy is concerned, the latest available information suggests that domestic demand contracted further in the last quarter of 2009.

Private investments contracted over the course of the year 2009, owing to the slower domestic and foreign demand, the low capacity utilization, the deteriorated business confidence and the tight lending conditions. In addition, consumer confidence indices, retail sales and consumer goods' imports signal the further slowdown of private consumption in the last quarter of 2009. This slowdown reflects a more moderate increase of available income, lower support by the banking system for consumer and mortgage loans and increased public uncertainty over the future. Consumer expectations for the future suggest that the contribution of private consumption to economic growth will be low over the next two quarters. Economic activity at home has been sustained by high fiscal stimulus during 2009; however, budget projections suggest that the fiscal stimulus will fall off in 2010. Foreign demand posted positive performance for the last quarter of 2009, featuring lower trade deficit during this period. However, given its relatively small share of the GDP, the impact of this correction to the economic growth of 2010 is projected to be moderate.

Annual inflation marked 3.6 percent in January while average annual inflation rate increased to 2.4 percent. The annual increase in consumer prices was in line with the Bank of Albania's target for inflation in January, standing at the upper limit of the tolerance band. The upward inflation trend in January owes mainly to the higher food prices following the latter's rise in the global markets and the lagged effect of the exchange rate depreciation. The contribution of other consumer price basket items to inflation, albeit upward, was still low. ***The latest***

***energy price rise effect on February's inflation is expected to contribute by 0.5 percentage points to the annual inflation rate.***

The Bank of Albania assesses that the performance of the Albanian economy has yielded balanced inflationary pressures. This is also confirmed by the performance of core and non-traded inflation, whose rates marked 1.4 and 1.7 percent, respectively, in January. These trends suggest that the inflationary pressures exerted by domestic demand are weak, while the increase of inflation over the last months owes mainly to supply-side factors.

The Bank of Albania considers that these factors will only affect temporarily and their pressures on inflation are expected to gradually dampen in 2010. The same performance seems to be also expected by the main economic agents, whose inflation expectations remain anchored close to the Bank of Albania's target.

The Bank of Albania has been pursuing a prudent monetary policy over this period. The increase of monetary stimulus in economy, without prejudice to macroeconomic stability and keeping the economic agents' expectations stable, was the major focus of our policy. Our decisions have in particular aimed at providing adequate monetary conditions for the observance of the inflation target in the medium run and smoothing out the Albanian economy's way to more stable economic and financial balances. This philosophy will continue to guide our decision-making in the period to follow.

The latest data on Albania's external position cover only foreign trade. The analysis attests to the annual narrowing of trade deficit by about 17 percent in December. In annual terms, exports of goods increased 27 percent, while imports declined 10 percent. The relative coverage ratio of imports with exports increased to 23 percent. Despite this performance, the external position of the Albanian economy remains a concern as long as it is characterized by a high current account deficit. The shift of deficit to more stable levels will be at the forefront of the country's economic policies in the medium and long run.

As we have continuously stated, fiscal policy was counter-cyclical throughout 2009, underpinning the trend that began in 2007–2008. Budget deficit amounted to ALL 79.9 billion in 2009, reflecting at the same time the accelerated increase of budget expenditure and slowdown of fiscal revenues. Budget expenditure increased 8 percent in 2009, while revenues grew only 2.7 percent, in part owing to the gradual contraction of economic activity.

The Bank of Albania considers that fiscal policy should prioritize the measures required to guarantee the sustainability of public debt. The increase of the latter during 2009 and the higher sensitivity of the financial markets to this indicator, call for the reliable commitment of fiscal policy with respect to its long-term sustainability. Therefore it is crucial to reach the projected fiscal balance through the conditioning of the fiscal expenditure carried out by the budget revenues' collection rates. On the one hand, this policy implies a smaller fiscal stimulus for 2010, but on the other it will lower the risk premiums in economy and provide more room for borrowing in the domestic financial markets of the private sector of the economy.

The latest monetary developments attest to the low growth of broad money and lower banking intermediation in lending to the public and private sector. However, the banking system's liquidity indicators seem to have become more stable. In annual nominal terms, money growth was 7 percent, similar to November's growth rate. Deposits grew for the second consecutive month, owing to a large extent to the increase of time deposits.

Relative to the previous year, private sector lending grew 11 percent in nominal terms. In real terms, it grew by only 4 percent. The growth of lending owes mainly to the higher lending to business for liquidity purposes. By contrast, household loans continued to contract in annual terms. Despite the improved lending activity in December, its annual growth rate remains low. The slow lending performance owes to the high risk premiums materialized in tight lending conditions, and to the economic agents' uncertainty for the future, materialized in low demand for private sector credit.

The exchange rate depreciated further in January, albeit at lower paces than in the previous month. In nominal effective annual terms, it depreciated 8 percent in January. Monthly developments attest to the slight depreciation of the ALL vis-à-vis the Euro and the USD. The Bank of Albania considers that the balance of factors affecting the exchange rate seems more stable for 2010.

The Bank of Albania continued to inject the required liquidity in January in order to buttress its interest rate cut move and the relaxation of monetary conditions in October 2009. These injections were followed by the decline of interest rates in the interbank market, the decline of the Government T-bill yields and the downward ALL loans and deposits' interest rates.

The interbank market attested to the further increase of trading volumes signalling the efforts for a more effective liquidity management by the banking system.

The recovery of lending will substantially condition the performance of the Albanian economy over the following period. Its recovery will push the demand for borrowing by the economic agents and at the same time will provide more favourable lending conditions by the banking sector. The Bank of Albania has taken the proper measures in this regard, supplying the banking system with appropriate liquidity and taking the necessary measures to lower the borrowing cost. However, it expects a more complete reflection of these measures by the banking system. We believe that, without prejudice to the best and prudent lending practices, there is room for a more encouraging behaviour of the banking system in terms of boosting consumption and private investments in economy.

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After discussing the current and expected economic performance, the Supervisory Council of the Bank of Albania concluded that the inflationary pressures will mount in the short term; however they are expected to quickly fall in the medium term.

The slower money growth, the low domestic demand, the moderate growth rates of economic activity, the low capacity utilization by businesses and the stable inflation expectations will balance the pressures exerted by the exchange rate and higher administered and foreign prices.

The Bank of Albania has been carefully monitoring the economic and financial situation in the regional countries and their expected performance in the future. The possible implications for the Albanian economy through the trade and financial channels remain at the focus of our analysis.

Considering the economic situation and political realities in the Euro area's economy, we conclude that the transmission of these concerns to other economies will be contained. Moreover, the Bank of Albania believes that the Albanian economy enjoys firm macroeconomic balances, sufficient to cope with all potential shocks over our economy.

In conclusion, the Supervisory Council decided to keep the key interest rate unchanged at 5.25 percent. This decision helps to maintain and consolidate the macroeconomic balances further, considering macroeconomic stability key precondition for a stable and long-term growth. It also serves to anchor the inflation expectations and guarantee the adequate monetary support to the economy at this stage of development.

The Bank of Albania remains committed to act in concordance with the actual and expected performance of economic indicators. The shift of the inflationary risk balance downward, the strengthening of financial stability and inflation expectations in economy will be carefully considered in the future decision-making of the Bank of Albania.