

## **Ardian Fullani: Economy and key interest rate in Albania**

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the press conference on the Monetary Policy Decision-Making of the Supervisory Council of the Bank of Albania, Tirana, 28 July 2010.

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***In its meeting of 28 July 2010, the Supervisory Council of the Bank of Albania analyzed and approved the Monetary Policy Report of the second quarter of 2010. After scrutinizing the latest economic and financial developments at home, the future outlook and the expected risk balances, at the end of discussions, the Supervisory Council of the Bank of Albania decided to cut the key interest rate by 0.25 percentage points. Following this decision, the interest rate on the repurchase agreements of one-week maturity term is 5%.***

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Economic and monetary developments of the first two quarters of 2010 were by and large in line with Bank of Albania's forecasts. Economic activity posted positive growth though at decelerated rates.

The inflationary pressures have been downward and the external balances of the Albanian economy have recovered. The financial markets were provided a breathing space and featured:

- lower risk premia,
- improved liquidity figures,
- downward interest rates, and
- relative exchange rate tranquillity.

The upcoming period is expected to feature similar characteristics.

The performance of the Albanian economy may be considered as positive, particularly when put in the context of the developments in global economy and the regional countries, and considering the challenges faced over this period. The latter represented a tough test for the sustainability of the Albanian economy, both at a macro and micro level, and in terms of the institutional and political capacities of economic management.

However, when viewed elaborately, economic and monetary developments in the first half of the present year provide numerous shadings for their interpretation. The Albanian economy still suffers the low domestic demand and activity financing-related concerns. Economic growth and economic development are not balanced yet for all the sectors of the economy. They have mainly relied on foreign demand rather than domestic demand and they attest to a more dynamic performance of industry and services and slower performance of agriculture and construction.

In addition, economic growth has been coupled with slower labour market and employment figures, hence increasing the non-utilized human and capital capacities of the Albanian economy. On the other hand, economic performance has confirmed the importance that the preservation of macroeconomic balances has to our country's stable and long-term development, as well as the need for the contribution of all economic players to guaranteeing them.

These messages, which constitute the main topics of this quarterly report, will be further elaborated below.

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The global context that outlined Albania's economic development over this period has recovered, however the financial markets and investor sentiment remain highly volatile.

**Global economy** continued to recover in the second quarter of 2010, being largely driven by the rapid economic growth in emerging economies and the fiscal and monetary stimulus in advanced economies. The euro area is showing signs of stable growth but our main trading partners, Italy and Greece, are performing less positively. Despite the higher demand, the worldwide negative output gap has yielded low inflationary pressures, which are expected to persist in the medium run as well.

However, this positive setting is still incomplete as long as unemployment remains high in the majority of countries. Public debt figures are weighed down further by the fiscal burden contracted as a result of the high-cost government measures undertaken over the last two years to fuel the economy, while the fiscal room has narrowed down substantially.

Concerns over fiscal sustainability, particularly in some euro area countries, have been also reflected in the performance of financial markets, which featured higher risk premia and elevated profit margins.

Against this global background, official statistics show that the **Albanian economy** has experienced a rebound in growth. Following the decline of GDP in the last quarter of 2009 and the weak economic activity in the early months of 2010, the available data on the real and monetary sector suggest that the Albanian economy posted positive growth rates in the first half of the present year.

According to INSTAT's preliminary data, **GDP** grew 2% y-o-y in the first quarter of 2010.

The growth in foreign demand was reflected positively in the performance of industry, which grew 27.5% for this period.

On the other hand, the slower domestic demand was manifested in moderate growth rates of services and progressive contraction in the construction sector.

The more positive performance of GDP in the first quarter of 2010 finds more support in the qualitative data. The **Economic Tendency Indicator** particularly increased 4.6 points versus the previous quarter, though remaining well below its long-term average.

Along with other indirect indicators, like credit growth trend and the higher pace of budget revenue, business and consumer expectations for the second quarter of the present year suggest that economic growth posted similar rates to the first quarter.

In absence of timely data on the performance of **demand components**, our analyses based on quantitative and qualitative indirect indicators suggest that domestic demand has been affected by the decelerated consumption and decline in investments, as well as by the lower fiscal sector's contribution.

On the other hand, the higher foreign demand and the improved terms of trade have been reflected in considerably higher exports and their elevated contribution to aggregate demand.

**Consumer spending** was contained in the first half of 2010.

- The decline in consumer loans and remittances,
- the lower increase of wages,
- the lower growth in the imports of consumer goods,
- the low consumer confidence, and

- the higher household savings trend

attest to lower growth rates of **private consumption** over the course of this period.

The latter was affected by:

- the slower growth rate of disposable income,
- the restrained financial resources,
- a more conservative consumer behaviour against a background of elevated uncertainties over the future, and
- the slower employment figures.

**Private investments** were downward in the first half of 2010; however their negative contribution was lower than in the second half the previous year.

*This performance owes to a large extent to the low capacity utilization in economy. In addition, the banks' tight lending terms have discouraged the demand for loans.*

However, the latest developments, like:

- the growth of business demand for investment loans, and
- the increase of imports of intermediate and capital goods

provide positive signals for the possible recovery of this demand component. **The public sector** continued to contribute positively to the growth of aggregate demand in the first half of 2010. The government ran an expansionary **fiscal policy**, but rather more moderately relative to the previous year.

Budget deficit, albeit narrowed 36% y-o-y, was pronouncedly higher than the projection.

Budget expenditure is 4% lower than in the first half of 2009. The annual growth rates of current expenditure slowed down to 7.1%, whilst public investments declined 33.5%.

Against a background of slow economic performance, fiscal revenue grew at low historical rates, 3.3%.

***The Bank of Albania considers that the downward revision of budget deficit and public expenditure as a positive and required step.***

- ***Guaranteeing fiscal sustainability,***
- ***lowering the risk premia associated with it,***
- ***shoring up public confidence, and***
- ***providing room for greater private sector access to financial markets***

***are some of the key elements that enabled the further easing of the Bank of Albania's monetary policy, hence preventing a plausible sterilization of our actions related to the interest rate.***

However, in order to maintain appropriate parameters of deficit and public debt figures, fiscal consolidation should progress beyond the actions undertaken in the short run. Fiscal sustainability needs to be addressed in the future through the adoption of a clear fiscal rule that should serve as a guide to and determinant of fiscal policy behaviour in the medium run and beyond.

The growth of **foreign demand** and the more favourable exchange rate position fuelled our exports, which grew 62% in the first five months of 2010. In parallel, the weak domestic demand has led to a low annual increase of imports, hence causing the balance of trade deficit to narrow 16.2%.

Consequently, net exports provided a more positive contribution to aggregate demand. They also led to the continuous correction of the current account deficit, hence stabilizing the national currency further. The downward correction of the current account deficit by 2.7 percentage points of GDP provides an encouraging signal for the sustainability of Albania's external position. However, net financial inflows into the capital and financial account reduced 62.9% y-o-y in the first quarter of 2010. In addition, remittances, which make up a major source of trade deficit financing, are down 6.7% y-o-y.

Both these concerns re-accentuate the fact that the external position of the Albanian economy remains a structural weakness that calls for further correction.

Foreign direct investments, which grew 25.8% in the first quarter of 2010, represent the safest source of current account deficit financing. They need to be further boosted with attractive policies for foreign investors and structural reforms in the Albanian economy.

Annual **inflation** marked 3.2% in June. The slowdown in annual inflation, which commenced in March this year, was triggered by the low demand-side pressures, the lower prices in agricultural products and a more stable exchange rate.

Against a background of non-utilized capacities in the labour and capital markets, the low core inflation rates attest to the low inflationary pressures balance.

The contracted demand will determine the downward inflation pressures in the coming period, whilst the performance of monetary indicators shows weak inflationary pressures of a monetary nature.

As expected, supply-side shocks on consumer prices were transitory and did not affect economic agents' expectations of inflation, which remain well-anchored around the Bank of Albania's target. Price stability has been achieved as a result of an adequate monetary policy decision-making, though amid substantial uncertainty over the future prospects and absence of timely statistical data. Over the stated period of time, **our monetary policy** was stimulating, maintaining low interest rates and injecting the required liquidity and at well-suited maturity terms, in order to boost activity in the financial markets and lending to the economy.

In response to this policy, the **interest rates** in the interbank market were stable, reflecting largely the stable liquidity position in the system, while long-term interest rates maintained a downward trend as a result of lower risk premia. In the primary market, Government security yields of all maturity terms continued to decline in the second quarter. In addition, this period featured further growth of banking system deposits and their time-related shift to time deposits. Once household savings placed in the system increased, the interest rates on deposits showed a downward tendency.

On the other hand, private sector **credit** continues to post low growth rates despite the improved liquidity figures and the lower activity financing costs. The annual growth of private sector credit averaged 9% in the second quarter of 2010.

The credit market continues to feature volatile interest rates and tight lending conditions.

However, the latest months' developments show positive signals, particularly in terms of the rather higher credit growth rates, its greater orientation towards supporting investments and the recovery of foreign currency lending to economic units that enjoy natural hedge against exchange rate risk.

The Bank of Albania has been promoting this performance and will continue to do so, and encourages the banking system and borrowers to work harder in finding effective forms, instruments and practices that fuel credit.

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Today's decision-making of the Bank of Albania reflects a comprehensive analysis of:

- the economic and financial developments that have been characterizing the Albanian economy in the latest months,
- the developments in the region and broader,
- the balance of risks, and
- future forecast and expectations.

The Bank of Albania believes that the banking system will transmit this decision to the economy timely and at the right intensity. The growth in deposits, the banking system's liquidity position and the downward Government demand provide real room for greater orientation of funds to private sector lending.

The Bank of Albania will also pay due attention to foreign currency intermediation by the banking system. The performance of foreign currency-denominated deposits and a wide array of other developments provide a safe ground for their channelling into the economy at a lower cost. This will be followed up closely in the remaining of 2010 and beyond.

***The Bank of Albania considers that the monetary conditions and the demand-supply ratios in the major markets are well-suited to maintain price stability in the medium run. Our monetary policy will continue to be prudent in view of meeting the inflation target and maintaining macroeconomic stability.***