

Ardian Fullani: Latest economic and financial developments 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, 26 October 2010.

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At today's meeting of 26 October 2010, the Supervisory Council of the Bank of Albania analyzed and approved the Monetary Policy Report for the third quarter of 2010.

After scrutinizing the latest economic and financial dynamics at home and the expected performance in the future, the Supervisory Council of the Bank of Albania decided to keep the key interest rate unchanged at **5.00%**.

In what follows, I will elaborate upon the analysis and the main conclusions today's decision-making of monetary policy was based on.

The performance of the Albanian economy during the third quarter of 2010 reinforced the main developments in the first half of the present year, featuring gradual recovery of aggregate demand, lower risk premiums and consolidation of macroeconomic stability.

Broadly in line with our projections:

- economic growth has accelerated (resurged) and its base seems to have broadened;
- CPI inflation and expectations have been anchored close to the Bank of Albania's target for inflation;
- The external position of the Albanian economy has recovered and the exchange rate is more stable;
- liquidity in the system has increased and the interest rates have generally been downward.

These highlights reflect, *inter alia*, the macroeconomic policies pursued over the course of this period. Monetary and fiscal policies have, in a concerted manner, aimed at fuelling aggregate demand and economic growth, ensuring at the same time the preservation of macroeconomic balances.

July's state budget revision put emphasis on the measures required to be taken in view of maintaining medium and long-term fiscal sustainability, hence implying lower budget deficit and lesser impact of fiscal stimulus on aggregate demand in the short run.

This revision paved the way for pursuing an easier monetary policy. The key interest rate lowered by 0.25 p.p., hence yielding the most stimulating monetary conditions during the last decade.

Nevertheless, complex challenges remain for the Albanian economy and the economic agents. Economic growth rate, albeit positive, seems insufficient to yield improvements in the labour market and to lower unemployment. In addition, the sustainability of economic growth remains frail in the short run.

Its reliance on foreign demand and export growth may be insufficient against a background of a non-consolidated global economic outlook.

The waning of fiscal stimulus also requires greater contribution of the private sector to economic growth, hence bringing consumer and business behaviour to the forefront and accentuating the role of bank credit to their financing. ***Setting proper equilibrium between***

short-term stimulus and long-term stability requires courage and diligence from the policy-makers.

Ongoing structural reforms remain a priority in the long run. The latter should aim at broadening the potential growth rate of Albania and underpinning its macroeconomic sustainability.

In what follows I will elaborate on these issues, beginning first with a brief overview of the recent developments in global economy.

The recovery of global economic activity persisted in the second quarter of 2010, while indirect or preliminary data show more moderate growth rates in the third quarter. Economic outlook remains highly uncertain due to the fiscal stimulus withdrawal and the private sector's (unsatisfactory) soundness.

Growth in advanced economies and in our main trading partners was moderate due to the correction of private sector's balance sheets, weak lending and labour market, and low consumer confidence.

The low capacity utilization rate has yielded weak inflationary pressures at a global level. The financial markets continue to show high levels of volatility in response to the concerns over the economic outlook and the long-term sustainability of fiscal indicators.

In political terms, maintaining macroeconomic co-ordination at a global level and keeping open channels of the movement of goods, capital and technology, are considered priority measures to avoid a second recession.

This would certainly provide substantial contribution to the Albanian economy, which remains a net borrower in the global market and that has benefited largely from the growth of demand and global trade in the form of higher exports in 2010.

In light of these developments, and being largely affected by them, the Albanian economy has grown progressively over the year.

According to INSTAT, GDP grew by 3.3% y-o-y in the second quarter of 2010, considerably higher than 2.0% in the first quarter the same year. This growth was mainly driven by foreign demand, ***while domestic demand performed at more stable rates.***

This performance was reflected in improved figures in industry, particularly in its export-related sub-branches. Construction and services did not perform alike:

- The gradual recovery of domestic demand boosted further the activity in services.
- By contrast, the construction sector continues to suffer from the weak demand in the real estate market, the limited financial resources and structural concerns related to its regulation. Subsequently, activity in the construction sector posted a high annual contraction rate in the second quarter, 28.9%.

Indirect economic and financial indicators suggest that economic growth performed similarly in the third quarter as well.

The weaker impact of the fiscal stimulus and the deeper trade deficit seem to have been offset by a better performance in tourism over this period.

The more positive economic outlook in the second quarter of 2010 was also reflected in the labour market. Although unemployment rate remained almost unchanged at 13.8%, the higher activity in industry and services increased employment by 1.8%. Nonetheless, the dynamics of these indicators is less promising than the pre-last quarter of 2008 period.

The analysis of economic activity by aggregate demand components allows for a more thorough assessment of the current and expected developments. (In the absence of direct data, it continues to be based on indirect quantitative and qualitative indicators.)

Available indicators suggest that the economy grew in the second quarter in response to the higher foreign demand. The performance of domestic demand attests to a more positive private consumption, higher private investment and a more positive contribution of the public sector, albeit more moderately than in the previous year. Except for a more pronounced waning of fiscal stimulus effect, these developments are considered to have persisted in the third quarter as well.

Although **private consumption** indicators are often contradictory, the overall setting shows a better performance compared to the first quarter of 2010. The rise in average wage and employment, the increase in the import of consumer goods and the substantial improvement of the consumer confidence index reinforce and signal the resurgence of consumption in the second and third quarter of 2010.

On the other hand, the further decline of remittances and the contraction of consumer loans, the drop in the retail trade index and the higher consumers' propensity to save suggest that the growth rates of consumption remain below the expectations.

Private investment recorded positive growth rates as evidenced by the increase of capacity utilization, higher import of capital goods and better performance of investment loans.

The further increase of investment in economy is reciprocally related to banking system lending; but ultimately, it will depend on the performance of domestic and foreign demand for Albanian goods and services.

The gradual increase of the capacity utilization rate in economy, as reported by business surveys, shows that there is more room at the current juncture for increasing private investment.

Fiscal policy has been more prudent in 2010 owing to the narrower room for fiscal expansion and the public debt approaching the threshold of 60% of GDP.

Despite the **public sector's** positive contribution to sustaining economic activity, the fiscal indicators point to its lesser impact on economic growth.

The Government's prudent approach in the first eight months of 2010 in view of meeting the planned deficit figure for 2010 actualized in the annual reduction of public expenditure and budget deficit. The latter amounts to ALL 23.2 billion, which is within the projected figure in the budget and about 51% lower than in 2009.

The 2010 state budget revision in July, which established the reduction of expenditure and budget deficit by 10% and 23%, respectively, is an expression of the fiscal authority's firm commitment to safeguarding economic stability and ensuring fiscal sustainability in the long run.

The high growth rates of exports and the contained performance of imports yielded a positive contribution of **foreign demand** to economic growth in the second quarter of 2010. Foreign trade data on July and August attest to moderate annual growth rates of exports and positive annual growth rates of imports, hence leading to higher trade deficit in this period.

The growth of exports in 2010 was fuelled by the recovery of global economy and the favourable conjuncture of prices in the global markets, the depreciation of the exchange rate, the Albanian entrepreneurship efforts to expand the market and by some other factors of transitory nature.

Therefore, promoting exports in a stable and long-term fashion requires undertaking structural reforms, which will in turn enhance the competitiveness of the Albanian economy. This would ultimately serve to the transition to a more stable economic growth model and, at the same time, to curbing the reliance on foreign financial sources.

Our analysis of monetary indicators concludes that the growth of money in economy is concurrent with the economic agents' demand for monetary assets, hence creating no room for inflationary pressures in the future.

Aggregate M3's average growth was 11.2% in July and August, being in line with the nominal economic growth and the enhanced confidence in the banking system.

Its growth during this period was mainly determined by the increase of the banking system's net foreign assets. Private sector credit grew by 9.8% y-o-y, close to the previous quarter's rate. Although the better liquidity figures and the improved banks' balance sheets led to higher banking supply and provided greater room for lending, the latter has progressed at moderate rates.

Our analyses on lending in economy show that demand remains contracted and the number of worthy projects to lend is still low. The foregoing remains a constant concern for the Bank of Albania.

To this purpose, alongside the banking system, we are considering the required measures that may lead to the growth of lending in line with the cyclical and structural needs of the economy.

Economic and monetary developments elaborated above yielded an environment of contained inflationary pressures. Average annual inflation marked 3.4% in the third quarter. Against a background of below-potential economic growth, and given the absence of monetary-related inflationary pressures, inflation was largely affected by the rise in administered prices. The contribution of the latter's rise to headline inflation is 1 p.p.

In the absence of second-round effects, the effect of the rise in administered prices is expected to be transitory, while the inflationary pressures arising from domestic demand remain well contained.

On the other hand, the depreciation of the national currency has been declining, hence offsetting the rise of primary commodity prices in the world markets and the increase of inflation in Albania's main trading partners.

The absence of inflationary pressures in the medium run and the contained fiscal policy provided room for pursuing a stimulating monetary policy that sustains economic activity. In July, the Supervisory Council of the Bank of Albania cut the key interest rate by 0.25 p.p. bringing it to the historical low of 5.00%.

In addition, the Bank of Albania continued to supply the banking system with the required liquidity in order to ensure the smooth operation of the money markets and to enhance financial intermediation in economy.

The favourable liquidity situation facilitated the rapid transmission of the key interest rate cut to the interbank and the primary market, hence allowing for the reflection of this cut in other interest rates in the economy as well.

The Bank of Albania considers that the inflationary pressures remain well contained all through the time frame of the monetary policy effect: the effect of supply-side factors is expected to be offset by the downward pressures arising from the performance of demand in economy.

The projections for inflation and inflationary expectations remain well-anchored around the Bank of Albania's target. Therefore, the central bank considers that monetary conditions in economy are adequate to warrant the safeguard of price stability in the medium-run and to boost economic development further.

The Bank of Albania will, in response to actual and expected economic and monetary developments, continue to pursue a prudent monetary policy, thus providing the required monetary conditions for achieving the inflation target and safeguarding macroeconomic stability.