

Ardian Fullani: Recent economic and financial developments in Albania

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the press conference on Bank of Albania (BoA) Supervisory Council decisions on Monetary Policy, Tirana, 26 January 2011.

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In its meeting of 26 January 2011, the Supervisory Council of the Bank of Albania reviewed and approved the Monetary Policy Report for the second half of 2010.

Following a thorough analysis of Albania's latest economic and financial developments and discussions on performance outlook, the Supervisory Council of the Bank of Albania decided to keep the key interest rate unchanged at 5.00%. The Council holds that current monetary conditions are appropriate for meeting the medium-term inflation target.

I will proceed with a brief overview of economic developments and key issues discussed at today's meeting that led to this decision.

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The Albanian economy recorded a positive development during the second half of 2010. The economic activity continued to mark growth, while main macroeconomic balances improved and risk premium and interest rates in financial markets decreased. The economic growth during 2010 relied mainly on foreign demand for Albanian goods and services, while domestic consumption and investments remained at low levels albeit positive developments. Inflation pressures remain controlled as a result of the existence of free capacities in the economy and anchored inflation expectations. Rapid expansion of exports and moderate increase of imports led to improved trade and current account deficits, contributing to foreign currency demand and supply balancing and increased exchange rate stability.

Monetary and fiscal policies have conveyed a careful macroeconomic stimulus. Withdrawal of the fiscal stimulus during the second half of the year, led to a more stimulating monetary policy, by reducing the key interest rate in July and a fuller introduction of it into the financial markets during the following period.

Financial markets were characterised by an improvement of liquidity indicators and a decline in interest rates in almost all financial instruments. Furthermore, a prudent fiscal policy rendered budget deficit and public debt in line with 2010 forecasts.

These developments are expected to be brought forward, in broad terms, in 2011 as well. Economic growth is expected to remain comparable to levels of 2010. However, it is expected to be driven by domestic demand to a large extent. The banking system is in a much better position compared with two previous years in terms of supporting the increase of domestic consumption and investment with funds.

Moreover, inflation pressures are forecasted to be under control, budget deficit and public debt are expected to be further consolidated, and external position of the economy is expected to be more stable. Respecting this picture has important implications, which I will address later in more details, for policymakers and economic agents.

Latest developments in global economy are characterised by continued economic growth in most developed countries and emerging economies. In developed countries, economic growth was lower as a result of measures taken to consolidate public finances and withdrawal of fiscal stimulus. On the other hand, emerging economies maintained higher growth rates, expanding their demand for raw materials and consumption goods, thus adding global inflation pressures.

Economic growth is expected to continue in 2011, but uncertainties remain high. Global macroeconomic misbalancing, which appeared in high levels of trade deficit for some of the developed countries, may materialise in shocks to main currencies exchange rate and free trade exchanges worldwide.

In addition, concerns over public debt and fiscal stability levels for some of the euro area countries continue to affect the sensitivity of financial markets and their tolerance to risk. Regardless of latest growing tendencies, the balance of inflation pressures is considered to be in check for the current year as well, as a result of continued existence of non-utilised capacities.

Keeping free movement of people and capital at world levels, taking timely corrective measures on public debt situation, as well as creating effective mechanisms to prevent and buffer financial crisis effects at local level, will be important challenges for policymakers. On the other hand, monetary policy of main central banks will continue to be cautious, introducing an appropriate monetary stimulus into the economy in order to promote economic activity without affecting the actual and projected inflation levels.

The Albanian economy recorded a positive growth during the third quarter. According to data reported from INSTAT, real annual growth of the GDP amounted to 4.9%, that is, higher than figures recorded during the first two quarters of the year. Economic activity improvement relied mostly on trade, tourism and other services. The industry sector maintained the same contribution to the economic growth, while construction sector activities continued to shrink for the fourth consecutive quarter. Developments in demand components follow the tendencies of the beginning of the year and are in line with our previous assessments. Available data suggest that economic growth continued to be stimulated to a large extent by foreign demand; meanwhile fiscal consolidation during the second half of the year predictably yielded a slowing effect to the economic activity. Private consumption and investment remained low during the second half as well, despite improvement of financing conditions for the activity. Private consumption continues to be subject to a hesitating approach by consumers to spend and a low support by banks. Increased salaries, employment and remittances in the economy were not fully factorised in optimising individuals for the future, as proven by low levels of consumer confidence index for the third quarter of 2010.

In addition, sluggish consumer demand and non-utilised capacities in the economy did not encourage businesses for new investments. However, with the improvement of financing conditions and further increase of demand, contrary to the first two quarters, private investments are considered to have given a positive contribution during the third quarter.

Fiscal policy followed a cautious line during 2010, aiming to keep budget deficit and public debt in check. Budget deficit until November of this year was 23.1 billion Lekë, marking a reduction of 64%, year-on-year. Reduction of the budget deficit by 4 percentage points of the GDP during 2010 demonstrated a fiscal consolidation both in public revenues, which increased by 9.6% until November, and budget spending reduced by 4.8% during the same period. In particular, budget deficit reduction and public borrowing control in domestic financial market contributed to improved banking system liquidity and reduced interest rates in the financial market. Continuation of this tendency during 2011 would be a welcomed development for the Albanian economy. The Bank of Albania deems that the philosophy of caution pursued in 2010 in budget expenditures and public borrowing should be present for the current year as well.

Foreign demand continued to support economic growth even during the third and fourth quarters. January – November 2010 recorded a narrowing of the trade deficit by about 9.2% in annual terms, which came as a result of growth in exports by about 58%. On the other hand, imports marked a more moderate growth – around 6.4 per cent – during the first eleven months. Improvement of trade deficit was favoured by an underestimating tendency of the exchange rate, moderate growth of domestic demand as well as climate and global market structures supporting Albanian exports.

Nevertheless, contribution of net foreign demand to the economic growth of the third quarter is considered to be lower compared with the first half of the year. Annual improvement of trade deficit by 10.7% in the third quarter was lower than the one recorded in the first two quarters of 2010. Furthermore, trade of goods in the first two months of the fourth quarter proves a lower contribution of the external economy for the last quarter of 2010. The growing tendency of imports and an expected slowdown of exports growth may halt the process of correcting foreign trade balance and reduce its influence on the economic growth for 2011. In the aspects of macroeconomic policies, these developments suggest that strong stimulating policies for the economy may be buffered by a rapid increase in imports that accompanies the increase in domestic demand. In the structural aspect, these developments reiterate the need to continue with structural reforms, which should orientate the Albanian economy towards a more stable development model and a higher competitiveness in global markets. Among other things, these reforms, should aim at establishing a favourable climate to attract stable capital flows as in foreign direct investments or long-term capital inflow.

A further increase of aggregate demand enabled the Albanian economy to move closer to its producing potential, yet remaining clearly under-utilised. Consequently, decreasing pressures on inflation continued to be present even during the second half of the year. Average annual inflation was 3.1% in the first quarter of the year, dropping by 0.4 percentage points from its average level of the third quarter and getting closer to Bank of Albania's target. During 2010, inflation was influenced by increased administered prices, rising trend of basic goods prices, food products and oil prices in international markets, and underestimating tendencies of the exchange rate.

Annual inflation increase to 3.4% in December was due to increased agricultural products prices, reflecting this increase in global markets. Yet, anchored expectations on price stability and disinflation pressures by the real economy balanced the action of the above-mentioned factors of demand on inflation, halting their transition to second round effects and stable inflation pressures.

The Bank of Albania considers that the inflation rate is expected to range within our target of 3 per cent, during the entire year. The increasing effect on the inflation of supply factors is balanced by the negative output gap and existence of non-utilised capacities in the economy.

Controlled inflation pressures and fiscal policy created space for a gradual increase of the monetary stimulus in the economy during 2010. The Supervisory Council of the Bank of Albania decided to reduce the key interest rate by 0.25 percentage points in July, taking it to the lowest historical level of 5.0%. In parallel with this move, the Bank of Albania supplied the interbank market with the necessary liquidity for a proper functioning of financial markets.

In the operational aspect, a change of form of our objective in June served to a better orientation of banking system refinancing with liquidity, resulting in a liquidity premium reduction in the system and a better orientation of interest rates in the inter-bank market. Financial markets were more relaxed with their risk premium gradually falling. Interest rate in the primary market continued its dropping tendency since a year ago, as a reflection to the moderate demand of the fiscal sector for funding and the good liquidity situation of the banking system. Moreover, the reduction of the key rate was followed, to a satisfactory degree, by [falling] interest rates in deposits and loans in Lekë, hence enabling a good introduction of monetary policy decisions into the economy.

Beyond a better transmission of monetary policy decisions on interest rates of financial markets during the second half, the Bank of Albania deems that their introduction into the real economy remains incomplete. Referring to developments in lending to the economy during the second half, loans to the private sector, on average, increased with same pace as during the first half. Annual lending growth in November amounted to 10.1% almost commensurate with the level at the end of the first half. Slower increase of loans to the private sector gave a low contribution to money supply expansion in the economy, reconfirming controlled inflation pressures by the domestic economy. Broad money

M3 growth came close to its historic average during the fourth quarter of the year, marking 11.9% and mainly in time deposits in the banking system.

Although banks did not tighten their lending terms and conditions – on the contrary, during the second half of the year there were signs of easing – demand for bank lending by the private sector was low. This remains low due to the existence of negative output gap by businesses and the growing consumer tendency to save under a perceived added insecurity for the future and a more cautious behaviour towards actual consumption. Reduction of risk premia in financial markets, maintaining positive economic growth, employment and salaries, as well as a clearer short-term perspective of the economy are expected to contribute to an increased demand for bank loans in the coming period. The banking system meets the prerequisites, in terms of liquidity, capitalisation and more favourable financing conditions to response to this demand.

Our outlook for the future supports keeping a positive progress of the economy for 2011. Growing demand is expected to be subject to the comparatively better progress of the domestic demand during this year. Private consumption and investments are expected to rise further, while, after the slowdown in 2010, the fiscal sector is expected to contribute positively to the economic growth. In spite of this, the growing demand is considered to be below the potential of our economy even for 2011. This will condition declining inflation pressures of the domestic economy, expected to balance the effect of foreign and administered prices increase.