

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, 27 April 2011.

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Today, on 27 April 2011, the Supervisory Council of the Bank of Albania reviewed and approved the quarterly Monetary Policy Report. Based on a thorough analysis of Albania's latest economic and financial developments and following discussions on their performance outlook, the Supervisory Council of the Bank of Albania decided to leave the key interest rate unchanged at 5.25%. The Supervisory Council holds that the actual monetary conditions are appropriate for meeting the inflation target and for continuing to stimulate the economic activity.

Let me now proceed with an overview of economic developments and main issues discussed at today's meeting of the Supervisory Council.

The Albanian economy is deemed to have had a positive performance during 2011 Q1. Economic activity increased, main macroeconomic balances improved, and risk premiums and interest rates in financial markets dropped. Economic growth during 2011 relies on foreign demand for Albanian goods as well as on domestic demand. Consumption and investments in the country remain slow, beyond the seasonal effect that characterises the first quarter. Rapid expansion of exports and moderate growth of imports have led to an improvement in trade deficit, contributing to the balancing of demand and supply for foreign currency and retaining the national currency value.

Demand-generated inflationary pressures remain contained, due to the existence of free capacities in the economy and controlled consumption, while import prices increase was a principal contributor to the price rise in the country.

In March 2011, inflation pointed to 4.3%. During the first quarter of 2011, inflation averaged 4.0%, i.e., one percentage point above the mid-term inflation target. The country's economy continued to grow during the fourth quarter of 2010, and indirect available data suggest that even the first quarter of 2011 was positive. On average, this growth is estimated to have been lower than the potential growth of the economy, suggesting that domestic demand inflationary pressures have been weak. The rapid upsurge in prices over the last two months is mainly due to the effect of food and oil prices increase in international markets, thus leading to light increase of inflationary pressures and initial appearance of second round effects, in February. In response to this phenomenon, the Bank of Albania increased the key interest rate by 0.25 percentage points at the end of March 2011. Inflationary expectations remain anchored close to the mid-term target of the Bank of Albania. In addition to the domestic demand, the relative stability of the exchange rate contributed to preventing further inflation increase.

More specifically, during 2011 Q1, inflation reflected a hike in prices of some food items, further increase of oil prices as well as an upturn in medication prices. With the warmer season approaching, domestic agricultural output is expected to contribute to an upward domestic demand, thus buffering high pressures from export prices.

The Bank of Albania deems that policies to encourage domestic production, which reduces the exposure of the Albanian economy to external shocks, are necessary.

Annual inflation of tradable goods sector in 2011 Q1 was 4.9%, explaining about 75% of the headline inflation. Primary reasons for this conduct were the actual and expected aggravated conjunctures of commodity prices, unusual geo-political situation in large economies of oil and agro-industrial products, as well as unfavourable weather conditions that has damaged

agricultural production. Inflation of non-tradable goods of the CPI basket, which represent internal pressures, in the first quarter of 2011, reached 2%. This value is close to that of the previous year and comparable to its historic average.

Inflation trend, without counting temporary effects on it, that is core inflation, was close to 3.0%, reaching high historical values. This long-term inflation component shows that inflationary outlook in the economy, though reflecting a value that is relatively higher, remains well anchored with the Bank of Albania target.

In the future, inflationary pressures along the time span of action of the monetary policy are forecasted to be high, but their intensity will be falling over the course of the year. I would like now to address, in more details, the factors that determine inflation developments and relevant risks.

During 2011 Q1, world economy demonstrated growth, while unemployment remains high. Economic growth is expected to intensify, mainly owing to the private sector, hence providing the conditions for attracting the public sector.

As a result of high divergences among countries, authorities have to deal with diverse challenges; in advanced economies focus is on reducing public debt and adjusting economic agents' financial balances, while in emerging economies the main risk appears to be about overheated economy and rapid credit growth. Inflationary pressures are considered to follow an upward trend due to supply shocks in the oil and other commodity markets. On the other hand, as a result of a rapid increase of demand in some developing countries, prices of factors of production, such as energy, raw materials and labour, increased. The forecasts reveal a heightened level of insecurity, as a result of social and political turmoil and natural disasters in some countries of the world. Price increases worldwide and the extent of their transmission to various economies, has affected decisions on interest rates applied by some central banks. Therefore, as a result of anticipation for an inflation rate above the targeted level, the European Central Bank decided to increase the key interest rate by 0.25 percentage points. Likewise, in international financial markets is noticed a slight increase of interest rates factorising anticipation for a higher inflation.

Domestic economic activity over the fourth quarter recorded a growth of 5.4% year-on-year, significantly narrowing the negative output gap. Economic growth was supported by the external demand and was boosted in positive terms by a consistent recovery of the global economy. An acceleration of the annual growth rate of real GDP during the fourth quarter was triggered by a higher positive contribution of the industry sector. Meanwhile, the added value of the services and agriculture sectors contributed positively, albeit at a lower level, to annual real GDP growth.

Latest data on 2011 Q1 from the business confidence survey, the external trade performance, and monetary and fiscal indicators support a continued domestic economy recovery, mainly due to the positive contribution of the production sector.

Partial data available on household consumption suggest a rapid rise y-o-y during 2010 Q4. In the meantime, partial data for the first quarter suggest a moderate contribution of consumption to the aggregate demand. First quarter 2011 surveys show that uncertainty for the future is considered as high by consumers, affecting the stability of consumption for upcoming periods. ***The Bank of Albania considers that in the short run, the Albanian consumer has the space to adopt a more rational behaviour towards expanding consumption.*** As regards investments, their performance is assessed to have been more stable over the last two quarters. The increase of the external demand for producing businesses, positive expectations on demand in some producing sectors as well as easing of funding terms and conditions during the last quarter of 2010 signal a continuation of the positive contribution of private investments during the current year. Nonetheless, producing capacity utilization remains low and the internal consumption situation remains unclear, suggesting that the economy continues to operate below its potential.

In 2011 Q1, government expenditures are estimated to have given an important contribution to keeping demand at positive levels, in contrast to the trend of the preceding year. At the end of 2011 Q1, budget deficit reached ALL 11.8 billion, against the surplus of ALL 0.7 billion recorded in the same quarter of the previous year.

During this period, budget expenditure increased in nominal terms by 16.8% year-on-year, mainly due to increased current expenditures. Maintaining similar growth rates over the rest of the quarters is expected to be translated into a higher contribution of expenditures to the aggregate demand, as compared to 2010. Developments observed both on revenues and expenditures side have led to a drop of the primary balance to negative values during 2011 Q1, after an apparent improvement in the last quarter of 2010.

In 2010 Q4, net position of the current account was estimated in a deficit of EUR 373.6 million or 16.4% of nominal GDP. In contrast to the first three quarters of the year, which posted a narrowing of the annual current-account deficit, in the fourth quarter of 2010, this deficit has expanded by 15.1% in annual terms. The main factor for the expansion of the current account deficit was the expansion of the trade deficit, albeit a high rise in exports of goods and services by 20.7% year-on-year. Foreign demand continued to support economic growth in the first two months of 2011. Good performance of exports contributed to a narrowing of the trade deficit by 5.9% y-o-y for this period. Average ratio of covering imports with exports was 47.3% recording its highest historic peak. Trade annual growth was 30.4% during the first two months of the year. Exports value continued its accelerating upward trend, which had started in the first quarter of 2010, and expanded by 66% in annual terms.

The three-digit growth in the electric energy exports was a key contributor to this performance, while processed metal exports and textile re-exports continued to contribute positively to the value of annual export performance.

In the post-global-crisis period, domestic economy is adapting to a new growth model, which requires significant structural changes. During this process of reallocating resources to most efficient sectors of the economy, as well as a more conservative behaviour by Albanian households towards consumption, its potential output is expected to be lower for the mid-term horizon. According to the demand components analysis, improvement of growth rate in the last two quarters may have significantly narrowed the negative output gap, but the existence of spare capacities in the economy even during 2011 suggests that the Albanian economy will continue to operate below its potential, generating weak inflationary pressures by the internal demand.

On the supply side, increasing productivity during 2010 Q4 and a slower rise in unit labour cost, generate lower inflationary pressures from the labour factor. Inflationary pressures over the level of domestic prices, which come as a result of fluctuations in the prices of oil and food items in international conjunctures, are estimated to be present during the current year, but with a continuous downward trend. Due to the aggravated geo-political situation in the world, the uncertainty that surrounds these expectations remains high. The absorbing capacity of the domestic economy to these shocks and avoidance of steady pressures on inflation will be a function of the Albanian economy performance and the control of agents' inflationary expectations.

Monetary indicators performance has reflected a slowdown of the money supply over the first two months of the current year, confirming contained monetary inflation pressures. The M3 aggregate marked an annual average increase by 11.2%. The currency component of the money supply provided a downward contribution to the broad money expansion; however, the use of foreign currency at high levels in the banking system and the economy remains one of the weaknesses of the Albanian economy. As an expression of its interest in addressing this issue, in today's meeting, the Supervisory Council of the Bank of Albania decided to waive the remuneration of the mandatory foreign reserve. This measure will encourage commercial banks effectively to reduce their funds collection costs and will favour intermediation in the national currency. The level of the demand for money by private and

public economic agents has increased. Our assessments indicate that monetary expansion is in conformity with the private sector demand for real money. The performance of loans to the private sector has been in line with its seasonal behaviour at this period of the year, increasing on average by 10.1% in annual terms. Although insofar credit developments have been slow, there are encouraging signs for a better performance of lending in the future. Private sector's demand for loans, whose low levels have been a primary obstacle for the revitalisation of lending, increased during the first quarter of the year and is expected to grow in the next quarter as well. The banking system enjoys good health and liquidity conditions for supporting a growing demand for loans, with even better lending conditions. The Bank of Albania supports the banks' initiative to clean up their balance sheets, aiming at increasing transparency and creating free funds to support lending.

The overall performance of financial markets for the first quarter of 2011 has been positive.

In light of its primary objective to maintain price stability, the Bank of Albania decided to increase the key interest rate at the end of March. This decision was reflected in higher interest rates in the inter-bank market, while it is expected to be transmitted into other markets during the upcoming period. In parallel with this move, the Bank of Albania has supplied the inter-bank market with the necessary liquidity for a normal functioning. In the meantime, in the deposit market, the downward tendency of their interest rate continued. Interest rates in the credit market varied; increased in lek and decreased in euro, though this development is deemed to represent special bank policies for certain segments of the economy. Lastly, the nominal effective exchange rate for the seventh consecutive quarter reduced its depreciating trend. Our analysis indicates that, overall, fundamental factors of the economy support a new equilibrium of the exchange rate, which, albeit higher than three years ago, is adjusting to domestic financial and economic equilibriums, supporting the strengthening of the competitiveness of the Albanian economy in international markets. The stable performance of the exchange rate has contributed to a further consolidation of the domestic financial stability, without exercising pressure on the banks' activity and conduct of economic agents.

Our future projections support the maintaining of a positive performance of the Albanian economy even in 2011. Consumption and private investment are expected to grow further, while the fiscal sector is expected to give a positive contribution to the economic growth, after a slowdown in 2010. Notwithstanding this, demand growth is expected to be below the potential of our economy even in 2011.

This will condition downward pressures on inflation from the domestic economy, which are expected to balance the effect of rising foreign prices. The Bank of Albania is determined to take all the necessary measures in due time to comply with its inflation target in the mid-term horizon.

Taking into consideration the information set out above, the Supervisory Council deemed that inflationary pressures for the medium term horizon are added; however, they remain subdued. Consumer price performance is expected to be under the pressure of price increase in international markets. On the other hand, insufficient demand will continue to condition below-potential domestic capacity utilization rate, exercising downward pressures on inflation. Inflationary anticipations continue to be anchored around the inflation target of the Bank of Albania.

At the end of its discussions, the Supervisory Council concluded that the monetary conditions are appropriate for compliance with the mid-term inflation target and decided to keep the key interest rate unchanged at 5.25 %.