

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 monetary policy decision of the Bank of Albania's Supervisory Council, Tirana, 25 May 2011.

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Today, on 25 May 2011, the Bank of Albania's Supervisory Council reviewed and approved the monthly Monetary Policy Report. Based on a thorough analysis of Albania's latest economic and monetary developments and discussions on their outlook, the Supervisory Council decided to maintain the key interest rate unchanged, at 5.25%. The Supervisory Council judges that the current monetary conditions are appropriate to meet inflation target and continue the economic activity stimulus.

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

The Albanian economy continues to maintain a positive development trend. Recovery in domestic demand over the first four months of the year and the positive contribution of external demand, have impacted on positive growth of the Albanian economy. Also, the major macroeconomic balances have remained stable and the financial system indicators appear to have generally improved.

Following the shock of February, CPI inflation has followed a downward trajectory, reflecting the subdued inflationary pressures on the economy and Albanian financial markets. Available data on 2011 Q1 show that the economic activity has registered growth; however, the persistence of some spare capacity suggests that this growth remains below potential. Negative output gap implies the existence of low domestic demand-induced inflationary pressures; however, persistent shocks to import prices caused inflation expectations to move up slightly. On the other hand, relative exchange rate stability and increased domestic food supply are factors that have made a positive contribution to lowering the inflation rate. Aiming at stabilizing inflation expectations in the medium term, the Bank of Albania raised the key interest rate by 0.25 percentage points at end-March. This move has been transmitted to financial markets, in line with the time lags of monetary policy transmission mechanism.

Inflation rate rose to 4.1% in April 2011, falling back gradually towards the Bank of Albania's target. Its performance has reflected the increases in food prices, in the excise tax of some goods, and to some extent, the administered price inflation. Higher supply of agricultural products, likewise in March, made a positive contribution to lowering the annual inflation rate. Compared to the previous month, consumer price index fell by 0.6%, hitting the lowest monthly inflation rate of April in the last decade.

Processed Foods and Non-food Consumer Goods, including oil and pharmaceuticals, have been main drivers to inflation. The first item, following the increase in primary commodity prices in global markets, has determined and will continue to determine the inflation rate throughout 2011. The second item has registered positive upward values as a result of global conjuncture of this item's commodity prices, particularly oil prices.

Besides the increase in basic food prices, April's inflation rate has reflected also the second-round effects, being materialised in higher prices of several services. The Bank of Albania judges that the Albanian economy should find space to face the external supply shocks or international price fluctuations by promoting domestic production in some key sectors.

Annual inflation of tradable goods sector resulted 4.9% in April, accounting for about 73% of the headline inflation rate. High inflation rate of this sector of the Consumer Price Index (CPI) basket continued to be affected by high primary commodity prices in global markets, non-optimistic mid-term anticipations related to them, and depreciated exchange rate pass-

through. On the other hand, the decline in this item's share to determining the headline inflation was an outcome of entry of domestic agricultural supply into the market. Non-tradable goods inflation, reflecting better the domestic inflationary pressures, settled at 2.5% in April, attesting to a slight upward trend. April's core inflation, which strips out the temporary effects, was close to 3.3%, reaching historical highs.

Monthly paces of inflation rise, which are a better signal about inflation expectations trend, however, registered slower paces than in the previous months. Core inflation shows that the economy's inflation expectations, although reflecting a relatively higher rate, remain well anchored at the Bank of Albania's target.

The Bank of Albania judges that in the period ahead, inflationary pressures along the time horizon of monetary policy stance will remain relatively high, but their intensity will decrease during the year. In the following, I will analyse in detail the factors determining inflation developments and related risks.

During the first months of 2011, global economic activity continued to grow, although the signals coming from confidence indicators suggest that risks associated with these positive developments are in place. Global inflationary pressures have increased as a consequence of a higher demand and persistent supply-side shocks. In advanced economies, fiscal consolidation and public debt reduction remain the major concerns, whereas inflation pickup has decreased the space for monetary stimulus.

In advanced economies, the positive global demand momentum has led to increased aggregate demand, while the upward inflationary pressures have made the central banks respond by tightening the monetary policy. In financial markets, the public balance health has determined the yield performance in several countries, while the political tensions have elevated the demand for safer instruments. The outlook remains highly uncertain, as a consequence of higher global prices, fiscal consolidation in some euro-area countries and less space for fiscal and monetary stimulus.

Returning to Albanian economy, the latest data on 2011 Q1, obtained from business confidence surveys, the performance of external trade activity, and monetary and fiscal indicators, support the continued recovery of the domestic economic activity, primarily due to positive contribution of production sector. External demand and fiscal stimulus are factors of major influence on this growth. The data analyzed by the Supervisory Council show that Q1's budget spending rose by 16.8%, sustained in part by ALL 12.5 billion budget deficit increase, compared to the same period a year earlier.

April's data show a decelerated growth of budget revenues over this period, underlining the necessity of taking measures to observe the budget deficit projection. Real economy data suggest a slow consumption growth, due to uncertainties about employment outlook. On the other hand, better performance of business credit and increase in capital goods imports suggest that investments have been positive, reinforcing the grounds for a sustainable economic growth in the future. Continued business investments in turn require the response of consumer demand, about which the Bank of Albania judges that there is room for recovery. On the other hand, long-term investment growth will be conditioned by the ability of the Albanian economy to attract foreign capital. In this context, responsible institutions at macro and microeconomic level should further strengthen the work for structural reforms, which develop the comparative advantages of the Albanian economy and enhance our economic competitiveness in goods, labour and capital markets. The Bank of Albania judges that preserving the macroeconomic stability parameters is an indispensable condition to orient its work towards maintaining price stability and supporting financial stability at home.

2011 Q1's data on trade activity performance at home show a slight trade deficit narrowing, due to increased imports and decelerated export growth over March. Merchandise trade deficit shrank by roughly 0.3% y-o-y, accounting for 22.1% of GDP. Import coverage by exports ratio averaged 44.5%, or up 9 percentage points from the same quarter of the previous year. During the period under analysis, exports in value continued their upward

trend having started since 2010 Q1 and expanded by 45.4% y-o-y. However, following a speeded-up growth over the first two months of the year, our export growth rates were significantly mitigated in March. During the same period, imports grew by 15.9% y-o-y. The division of imports according to their final use highlights the rapid growth of imports of intermediate and capital goods. The outlook of these trends may be associated with expanded current account and trade deficits in the country. The Bank of Albania is very attentive to this development, since it significantly conditions the external balances of Albanian economy and the foreign exchange market.

Monetary expansion during 2011 Q1 was in line with economic agents' money demand, marking a steady year-over-year growth of roughly 11%. The 6.2% y-o-y growth of real money supply remained close to historical lows. Moderate growth rates of M3 aggregate and other monetary indicators are in line with so-far assessments of existence of contained monetary inflation pressures. This trend is also supported by developments of currency outside banks. This indicator continued to fall y-o-y, and together with the shift of deposit structure to longer maturity terms, it indicates economic agents' lower preference for liquidity.

In March, the annual broad money expansion was supported by increased private sector credit, which rebounded in line with its seasonal trend path. The upward contribution of private sector's demand for money has offset the gradual decline in net foreign assets. Public sector's demand for money has been upward, supportive to the government's more active stance over the first quarter of the year. In annual terms, the private sector loan portfolio grew by 11.5% from 10.3% in February.

Business loan remains the main contributor to expanding the private sector lending. In the meantime, in March, household loans also showed positive signs.

Overall, financial markets performed positively during the first four months of 2011. The information transmitted from financial markets shows agents' anchored inflation expectations. Key interest rate rise at end-March is passed-through to short-term money market interest rates, leading to a slight flattening of T-bill yield slope. In deposit market, interest rates continued to fall, reflecting also the correction of their high rates having been marked after 2008. The foreign exchange market has operated smoothly and the exchange rate has continued to depreciate at low annual paces. The Bank of Albania has supplied the interbank market with the necessary liquidity for their normal functioning.

To sum up, the Bank of Albania judges that the relatively high inflationary pressures over the first quarter of the year generally resemble transitory shocks. Other factors affecting inflation, such as current and expected economic performance against the potential rate of development, expansion of monetary assets in the economy, and the public's expectations of financial markets, exert inflation-restraining impact.

Our projections for the rest of the year support the maintaining of positive performance of Albanian economy. Consumption and private investments are expected to grow further, whereas following the 2010 slowdown the fiscal sector is expected to provide a positive contribution to economic growth. However, the demand growth is likely to be below our economy's potential even for 2011. This will condition the downward inflation pressures from the domestic economy, which are expected to offset the foreign price rise effect. On the other hand, the Bank of Albania is determined to take appropriate measures to meet its inflation target in the medium term.

The Supervisory Council judges that, based on the above overview, medium-term inflationary pressures are in check. Inflation expectations remain anchored at the Bank of Albania's inflation target. In the absence of any unexpected shocks, inflation is expected to be within the Bank of Albania's target over the medium term. Also, the risks around this central scenario appear to be balanced.

At the end of the discussions, the Supervisory Council concluded that monetary conditions appear suitable for meeting the inflation target in the medium term and decided to maintain the interest rate unchanged, at 5.25%.