

Ardian Fullani: Recent economic and monetary developments in Albania

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the press conference on the Monetary Policy Decision of the Bank of Albania Supervisory Council, Tirana, 31 August 2011.

* * *

Today, on 31 August 2011, the Supervisory Council of the Bank of Albania reviewed and approved the Monthly Monetary Policy Report. Based on the 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 actual and expected economic developments and main issues discussed at today's meeting of the Supervisory Council.

Annual inflation in July was 3.6%, following the downward trend noted in the second quarter of the year. Consumer price performance continues to be under the pressure of rising prices in global markets, although lower than in previous months. Annual inflation was primarily formed by the contribution of processed food prices, most of which are imported. Decline of the annual inflation rate reflects the downward contribution of unprocessed foods as a result of increased supply of domestic agricultural products, a seasonal development, which in July 2011 appeared to be stronger than a year earlier. On the other hand, regulated-price goods and non-food goods had a low and downward contribution to this month's inflation.

In line with Bank of Albania's expectation, controlled inflationary pressures by the domestic economy, as well as anchored inflation expectations created a favourable environment for a rapid reduction of imported inflation effects.

Consumer prices during 2011 were mainly affected by supply shocks, materialised in higher prices of imported goods and some products subject to excise, or with regulated prices. These effects appeared to be more moderate in July; in the absence of sudden shocks, they are expected to decrease further in the months ahead. Below-potential economic growth continued to generate controlled inflationary pressures on the demand side. Hence, core inflation stopped increasing and is set around the Bank of Albania's target of 3%. Moreover, stabilisation of inflation expectations of economic agents and the prudent policy of the Bank of Albania regarding their anchoring are reflected in moderated second-round effects on inflation.

(Following, I will describe in more detail economic highlights defining the inflation performance and their expected development.)

Although in an unfavourable external environment characterised by added uncertainties in our trade partners, the **Albanian economy** continued to grow during the second quarter of 2011.

In the absence of direct data, the Bank of Albania deems that economic growth during this period is similar to the one recorded in the preceding quarter, thus remaining below Albania's potential growth rate. Economic activity relied on the public sector and external demand, although more moderately than in the first quarter of the year. In the meantime, the private sector demand appears sluggish, also conditioning our projections for economic growth for the rest of the year.

- **Private investments** continue to be slow, compared with their historical rates and the country's needs for quantitative and qualitative production capacities. This

The expected easing of funding terms during the second half of the year as well as the decline of perceived uncertainty by businesses and individuals are expected to be accompanied by the somewhat more positive performance of private consumption and investments in this period.

- Stimulating nature of **fiscal policy** during the first half of the year is reflected in a positive contribution of public expenditures to economic growth. For the first seven months of the year, public spending increased by 5.9% in annual terms. Moreover, performance of fiscal revenues was slow, reflected in their annual growth of 2.3% during this period. This behaviour of income and expenditures is materialised in a higher budget deficit than a year earlier. Fiscal impulse to the economy was consistent throughout this period. It showed tendencies of moderation during the second quarter, which are expected to strengthen further during the rest of the year, in conformity with the revised budget of 2011.
- Contribution of **foreign demand** to economic growth was lower during the second quarter of the year. Trade deficit in the second quarter was 20% higher compared to a year earlier.

Our exports shrank by about 2.8% year-on-year for this period, a reflection of reduced exporting of energy, which is a volatile component in exports. Despite this development, the core basis of exports continues to maintain more sustainable growth rates. On the other hand, **imports** continued their annual growth, albeit at a lower rate compared to the first quarter of the year.

Aggregate demand performance triggered economic activity growth but was inadequate to fully utilise Albania's output capacities. Developments in the labour market seem sluggish and do not have premises for emergence of stable inflationary pressures.

Signals from economic information are confirmed also by the **monetary indicator analysis**. In June, annual growth of M3 aggregate was 11.8%, around average rates of the past 12 months. Our assessments show that the expansion of monetary supply is in line with the performance of the economy's demand for monetary assets.

In June and throughout the second quarter, the public sector demand for funding was high, in line with the intensity of the fiscal activity during that period of the year. Furthermore, the private sector demand for funding continued to be moderate. Lending to private sector posted annual growth of 11.6% in June, in line with the second quarter's performance.

Financial markets are characterised by a serene environment with contained risk premia. Interbank market experienced increased trade volume; interest rates were close to the key rate and had low volatility. In the primary market, government's demand for funding is reflected in the increased yields of government securities. However, the trajectory of yields retained its trend, showing low inflation expectations by market agents.

As regards the economy's performance outlook, our projections and assessments suggest a continuation of economic growth, in terms relative to those of the first quarter. Composition of aggregate demand is expected to be different to the one of the first half of the year: private sector of the economy is expected to be more vivacious in the second half, while the contribution of the public and external sectors are expected to be more moderate. Size and speed of the private sector recovery shall define the stability of economic growth in the future. In spite of assessments for increased aggregate demand, economic activity in Albania is expected to remain below its potential, thus conditioning the continuation of spare

capacities in the economy in the period ahead. Subsequently, inflationary pressures originating from the aggregate demand are expected to be contained. In addition, foreign prices effect is expected to be more moderate in the upcoming months while inflation expectations of economic agents continue to be within the target band. Consumer price inflation is expected to continue its downward trend in the next months, gradually approaching the Bank of Albania target.

Taking into consideration the information above, the Supervisory Council concluded that inflationary pressures in the medium term are contained.

In the absence of abrupt shocks, inflation is expected to drop further and stay within the target band of the Bank of Albania during the time span of the monetary policy action. Risks distribution remains overall symmetric: slower than projected economic growth would lead to a rapid reduction of inflation, while a further consolidation of imported inflation could keep inflationary pressures high for a longer time.

At the end of discussions, the Supervisory Council concluded that the monetary conditions remain appropriate for meeting the medium-term inflation target and decided to leave the key interest rate unchanged at 5.25 %.

In the near future, the downward inflation trend and shift to the downward section of the risks balance may establish the premises for a revision of the monetary policy. In any case, the future its future position shall factorise the new information obtained, aiming to adopt monetary conditions to respect our objectives.

The Bank of Albania remains fully committed to anchor inflation expectations in accordance with its inflation target and to support sustainable and long-term development of the Albanian economy.