

Ardian Fullani: Overview of Albania's latest economic and financial developments

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, on the Monetary Policy Decision-Making of the Bank of Albania's Supervisory Council, Tirana, 31 October 2012

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Today, on 31 October 2012, the Bank of Albania's Supervisory Council reviewed and approved the quarterly Monetary Policy Report. Based on the analysis of Albania's latest economic and monetary developments, and following discussions on their performance outlook, the Bank of Albania's Supervisory Council decided to keep the key interest rate unchanged, at 4.0%. The Supervisory Council deems that the current monetary conditions are adequate to meet Bank of Albania's inflation target in the medium term. Keeping the key interest rate at its minimum historical level ensures the necessary monetary incentive to promote Albania's domestic demand and economic growth.

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

The Albanian economy was faces with a challenging global environment over the first three quarters of 2012 due to difficult situation of the world economy, and particularly of the euro area. Domestically and externally generated supply shocks determined the economic growth profile and continued to test Albania's macroeconomic and financial foundations. Over this period, the Albanian economy was faced with slow foreign demand growth, increased financial risk premia and tendencies of several financial market agents to reduce exposure to Albanian economy. These developments were also reflected in low consumption and investment levels. Along with the reduced fiscal stimulus in 2012, they resulted in a weak aggregate demand and low economic growth during the first three quarters of the year.

Despite the negative impact on economic growth rate, the financial and macroeconomic stability resulted stable. In spite of demand volatility and supply concerns, inflation resulted low and in check, reflecting, inter alia, good anchoring of public expectations around the 3% target. Fiscal balance sustainability, Albania's improved external position, and sound real-sector and financial-sector balances in the economy further strengthened Albania's economic and financial stability over this period.

Average annual consumer price inflation resulted 2.7% in the third quarter of the year, increasing gradually along the year.

Added contribution of prices for unprocessed food and non-food consumer goods mostly created this quarter's annual inflation rate. On the other hand, prices of other basket items were stable and slightly volatile. The economic and monetary analyses confirm the presence of weak demand-induced inflationary pressures. Developments in the real sector of the economy conditioned the controlled price rise of domestic products. These tendencies have been reflected in the downward trend of core inflation and low non-traded inflation of the consumer price index basket.

Consumer price performance continued to reflect the low pressures from other cost elements. In particular, import prices were low and given the relative exchange-rate stability, they transmitted low pressures from imported inflation.

Following the economic contraction in the first quarter, Albanian economy fell by 2.0% y-o-y, in the second quarter. Economic activity growth was generated by agriculture, industry sectors and some branches of the services sector, while the construction sector fell sharply.

From the viewpoint of aggregate demand, the second quarter's economic growth was mostly supported by the foreign demand, while the domestic demand remained sluggish. Consumer spending, though higher than in the first quarter, did not return to past year's rates of increase. This component of the domestic demand remained influenced by the perceived uncertainty, lacked dynamisms in the labour market and slowed available income. Confronted with a low ultimate demand for their products and in the presence of spare capacities and relatively tight lending terms, private investments also remained low. In particular, during the first half of the year, the low private investment level reflected households' low demand for housing.

Public spending and fiscal stimulus were also weak, reflecting the consolidating fiscal policy and observing the fiscal restrictions required by law. Fiscal consolidation, which is based mostly on reduced expenditure, is illustrated through the downward trend of budget deficit over the period. The budget deficit resulted about ALL 25.7 billion during the first three quarters of the year, down by about 19%, y-o-y. Until September, the realised expenditures were about 0.2% lower than a year earlier, while the budget income increased 2.3%.

The data on developments in the external sector of the economy show Albania's significantly improved external position. The value of exports increased 6.7%, y-o-y, in the first quarter, reflecting the moderation in the foreign demand and performance of global market prices. Over the period, imports contracted by 0.9%, y-o-y. These developments led to an annual contraction of trade deficit by 5.4% until August, positively influencing the aggregate demand growth. Also, the sharply decreased current account deficit in the second quarter is a positive signal for the long-term stability of this indicator and assists in stabilizing the demand for and supply of foreign currency in the domestic market.

Developments in the monetary sector attest to low inflationary pressures in the economy. Monetary assets expansion slowed over the third quarter, reflecting the decline in the domestic demand for money.

The public sector's prudential behaviour has led to a low demand for monetary assets, particularly from the banking sector. On the other hand, the slow economic activity and available spare capacities appear to have restricted the private sector's demand for monetary assets. Private sector credit increased by 5%, y-o-y, in August, following the slowing trajectory having started since the second half of 2011. Developments over the past months show that banks are more active in national currency intermediation, while they have decreased their foreign currency intermediation. This development is driven by banks' readiness to invest lek funds and economic agents' increased awareness of foreign currency credit risk.

Regarding lending concerns, we would emphasise that the weak credit performance owes mostly to economic agents' low demand for monetary assets. However, the bank credit supply appears somewhat tightened.

The banking system remains prudential in selecting the projects it finances, as a consequence of deteriorated loan portfolio quality and uncertainties surrounding the future outlook. Banks continued to maintain tight lending standards, appearing rather selective in assessing the business plans and meeting the demand for loan. Overall, the Bank of Albania assesses that creating a positive climate assists in recovering lending and the demand for loan. The Albanian banking system remains well-capitalised, liquid and capable of meeting the economy's needs for credit. However, within the parameters of financial prudence, it should be forward-looking about its decisions and more flexible in providing financial support to Albanian business.

Financial markets were characterised by a downward interest rate trend over the third quarter, associated with low liquidity pressures and reflecting the Bank of Albania's easing monetary policy.

Increased interbank market activity suggests the increased efficiency in using this market and is a good premise for developing the overall monetary market in Albania. Over the period, the easing monetary policy signals in terms of lowering the government security yields were better transmitted. This transmission was favoured by completion of structural movements in the banking system and reduced government demand for funding. Deposit interest rates continued to fall as well, but as already reflected by the high deposit growth over this quarter, they did not restrain the increase in financial savings at the banking system. The easing of financial costs was not fully transmitted to the private sector credit segment during July-August. In particular, additional costs required by banks to anchor the new credit remain tight, in response to the perceived uncertainty and their reacting mechanism for credit risk reduction.

Against the backdrop of slow current and expected economic developments, aggregate demand and inflation, the monetary policy deepened its stimulating nature in the third quarter. As at end-July, the key rate was lowered by 0.25 percentage points, down to its historical minimum of 4.0%. This was the fifth key rate lowering since September 2011. Parallel to that, the Bank of Albania continued to supply the banking system with the required liquidity through its variable liquidity-providing operations.

Future outlook suggests that inflationary pressures remain low. Our analyses and projections conclude that the economic activity will remain below potential, exerting pressures on the downside inflation. At the same time, the supply generated pressures appear contained.

Based on current performance of inflation-determining factors and their future outlook, after 12 months inflation is expected to fluctuate around 1.2% – 3.4%, with a probability of 90%. The expected inflation and economic outlook imply the maintaining of a stimulating monetary policy for the period ahead. The Bank of Albania remains heedful to future developments and new information, and stands ready to intervene timely and duly to meet its legal mission.