

Ardian Fullani: Overview of recent economic developments in Albania

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, 26 June 2013.

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Today, on 26 June 2013, the Supervisory Council of the Bank of Albania reviewed and approved the monthly Monetary Policy Report. Based on the most recent monetary and economic developments in Albania, and following the discussions on their outlook, the Supervisory Council of the Bank of Albania decided to keep the key interest rate unchanged, at 3.75%. The Supervisory Council deems that the current monetary conditions are adequate to meet Bank of Albania's inflation target in the medium term. At the same time, these conditions ensure the necessary monetary stimulus to support the domestic demand.

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

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Annual inflation continued its downtrend in May, settling at 2.1%. Prices of agricultural products fell, thanks to the higher supply in the domestic market, shifting this month's inflation down. On the other hand, prices of other goods and services of the CPI basket ranged around the previous months levels.

From the **macroeconomic perspective**, consumer prices continue to reflect low inflationary pressures, arising from both the demand and the supply side. The cyclical weakness of the economy was associated with strong reduction of core inflation during this period. Due to spare capacities in the labour market and capital, production costs and profit margins increased at low levels, leading to lower increase in final prices of consumer goods produced in Albania. Furthermore, price stabilisation in global markets and economic agents' anchored expectations on inflation were reflected in low price rise in the domestic market. Consumer price inflation appears to be at low rates and is expected to range in these levels, in the period ahead.

The macroeconomic analysis, updated with the latest available information, suggests low aggregate demand growth during the first five months of the year. Economic growth was supported by foreign demand and higher public spending during this period, while **consumption and private investments** were weak. Over the last quarters, consumption and private investments have suffered from uncertainties for the future and tighter lending terms. Their performance will be broadly conditioned by the improvement of these two drivers.

In the first five months of the year, the **fiscal policy** was stimulating to the economy, materialised in the rapid expansion of the fiscal deficit and public spending. Additionally, the fiscal easing relied also on the taxation policy, as a number of taxes were reduced directly or indirectly. Budget expenditure surged 13.3%, mainly due to public investments during this period. Fiscal revenues fell 0.2%, mainly due to contraction in the tax component. For the first five months of the year, budget deficit stood at ALL 38.3 billion, about 1.1 times higher than a year earlier, affecting, therefore, the increase in the public debt to GDP ratio, to 62.4%. The Bank of Albania continues to draw the attention on the need for fiscal measures, which would guarantee the long-term stability of the public debt, boost financial markets' confidence in our public finance, and cut long-term costs of debt service. This objective should be the main medium-term priority of public finances.

Data on the **external sector of the economy** reveal that the net foreign demand contributed positively to economic growth in the first quarter. The current account deficit narrowed, in annual terms, settling at 9.8% of GDP during this period. Foreign trade data for April point to further narrowing of the annual trade deficit by about 5.3% in annual terms, thanks to the

rising exports. Meanwhile, for the first time since September 2012, total imports increased about 3.6% in this month. As pointed out earlier, the current account deficit constitutes a structural deficiency of the Albanian economy. Its adjustment would mitigate one of the potential sources of risks to the Albanian economy and financial markets, and broaden the space for implementing stimulating macroeconomic policies in the future.

Monetary indicators were in line with the real-economy developments and our analysis reveals that the monetary inflation pressures are weak. Annual increase of money supply accelerated in April, reversing the deceleration trend that had started in July of last year. The broad money aggregate, M3, picked up 5.2% from 4.6% in March, mainly reflecting the higher demand for funding by the public sector. By contrast, the private sector's weak demand is reflected in the sluggish credit performance. Lending to the economy slowed down further in April, marking only 0.9% annual growth. Besides the weak demand, lending deteriorated also due to banks' prudence in lending, materialised in relatively tight standards. This phenomenon is regionally dispersed and is dictated, to a large extent, by the developments in the euro area's financial markets.

The main feature of **financial markets** developments has been the downward trend of interest rates in recent months. The easing signals of the monetary policy were transmitted, though unevenly, across all the market segments. The interbank interest rates followed the latest key interest rate cut in March and remain anchored around it. In May and June, the yields continued to fall in the primary market in line with the monetary policy easing cycle. Deposits and loans interest rates are reacting more slowly conform to the time lag in the monetary policy transmission mechanism, and in the presence of economic agents' uncertainties about the future and risk premia that accompany crediting.

Insofar factual developments have not altered our **base projections** on economic developments. For 2013, economic growth rates are projected to be close to those of the past year, although the balance of risks has shifted on the down side. Foreign demand is expected to contribute less, affected by the economic slowdown in partner countries. Intensification of expenditures in the second quarter is expected to be counted as positive contribution by the public sector to the aggregate demand in this period. However, its capacity to induct stable growth on the private sector appears limited in time and restricted by requirements for compliance with budget deficit indicators. Under these circumstances, the domestic private demand remains a determinant factor for boosting aggregate demand in the future. Accumulation of financial savings and easing stimulus of the monetary policy are expected to materialise in better consumption and private spending in the period ahead. Demand growth below the potential of the economy for the rest of the year will continue to exercise low inflationary pressures from the demand side.

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At the end of discussions, the Supervisory Council decided to keep the key interest rate unchanged, at 3.75%. The outlook of economic and financial developments in Albania and abroad determines the continuation of the easing monetary conditions over the monetary policy-relevant horizon. This policy establishes the proper conditions for meeting the inflation target in the medium-term period, contributing at the same time to the growth of aggregate demand and full utilisation of production capacities in the economy.

Expected economic and financial developments require that the easing monetary conditions be maintained in the monetary policy-relevant horizon. The Bank of Albania stands ready to react duly and timely to provide the necessary monetary conditions for meeting its inflation target.