

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

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the Press Conference on the Monetary Policy Decision of Bank of Albania's Supervisory Council, Tirana, 31 July 2013.

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Today, on 31 July 2013, the Supervisory Council of the Bank of Albania reviewed and approved the Monetary Policy Statement of the Bank of Albania on the first half of 2013. Based on the latest monetary and economic developments in Albania, and following the discussions about their outlook, the Bank of Albania's Supervisory Council decided to lower the key interest rate by 0.25 percentage points to 3.50%. Lowering the key interest rate would improve the conditions for a higher aggregate demand, hence helping inflation fall back toward the Bank's 3.0% target. Further easing of monetary policy takes into account expectations for a contractionary fiscal policy over the second half of the year and makes room for a fast and low-cost adjustment of public finances.

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

The first months of 2013 confirmed our assessments of Albania's slow economic growth and weak inflationary pressures. Albania's economic activity continues to suffer from sluggish aggregate demand reflecting economic agents' uncertainties about the future, relatively tight lending standards, and economic weaknesses of our main trading partners. However, amid a challenging macroeconomic environment, Albania's economic and financial stability remains stable. In the first half of the year, inflation remained low due to weak demand-side pressures and anchored inflation expectations. The latter reflect Bank of Albania's prudential monetary policy.

This policy has enabled the long-term interest rate cut and has contributed to maintaining the banking system soundness parameters. Also, Albania's improved external position, together with the national currency's stability and financial sector's overall sound balances, have further strengthened the financial stability and ensured one of the pillars necessary for its long-term development.

The second-quarter **inflation** turned out 2.2%, a lower rate than in the first quarter. Lower agricultural product inflation and steady prices for other CPI basket items shifted this quarter's inflation down. Agricultural price inflation accounted for about 90% of the headline inflation, reflecting both the price volatility of agricultural products and their relatively high share in the CPI basket.

From the macroeconomic perspective, the presence of spare productive capacity continues to determine the inflation performance. The sluggish growth of aggregate demand is associated with low increase in investments, employment, wages and labour costs in the economy. This chain of factors is further translated into weak pressures for consumer price rise. It is also confirmed by the record low rates of core inflation over this period. On the supply side, the low price rise in the domestic market has reflected the price stability in global markets and economic agents' anchored inflation expectations.

With regard to **economic developments**, INSTAT data show that the first-quarter **economic growth** was 1.7%, remaining similar to the previous year's figure. The economic activity expansion in the first quarter relied heavily on the industrial sector growth, while the agriculture and services sectors marked a positive but weak growth.

By contrast, construction sector continued to contract. Available information on the second quarter suggests that the economy performed better, mainly reflecting the high fiscal stimulus during this period.

From the demand components perspective, economic growth during the first half of the year owes mainly to higher exports and public spending over this period, while the contribution of consumption and private investments appear weak. Though monetary stimuli increased during the last quarter, uncertainties about the future contracted **consumption and private investments**. These uncertainties are reflected in a cautious behaviour of Albanian households and businesses and their reluctance to take risks. Their higher inclination to save and the lower degree of borrowing improve the private sector balance sheets but impact negatively the aggregate demand and medium-term economic growth.

Performance of fiscal indicators in the first six months of the year reflected an expansionary fiscal policy, which was manifested in higher budget spending and fiscal deficit. This stance was more noticeable in the second quarter. The increase in budget spending impacted positively on the economic growth over this period, but the overall impact of the fiscal policy will depend on the degree of observing the budget indicators adopted for 2013. Public spending marked 12.2% annual growth in the first half of this year, influenced heavily by capital spending. On the other hand, budget revenues for this period were down by 2.9% on a year earlier, reflecting the weak performance of tax revenues. These developments are materialised in a significantly increased budget deficit, which turned out to be twice higher than a year earlier.

The **budget deficit** dynamics was reflected in a higher **public debt** over this period.

At the end of the first quarter, the public debt as a share of GDP accounted for 63.3%. The public debt constitutes one of the major weaknesses of the Albanian financial system. Therefore, the Bank of Albania suggests that taking immediate measures to control this debt would contribute significantly to reducing uncertainties and risk premia in the economy. Taking advantage of the opportunity, we reiterate the need for putting in place a reliable and transparent fiscal rule. This is the best way to discipline the fiscal policy and preserve the trust of financial markets about the Albanian public debt in the long run.

Data on **the external sector** of the economy show that foreign demand contributed positively to Albania's economic growth and to trade deficit narrowing during the first half of the year. This behaviour was due to the 17.4% annual growth in exports and the 6.3% annual decline in imports over the same period. Consequently, the trade deficit dropped 22.2% over this period.

The insofar adjustment of the trade deficit is a positive development of the Albanian economy. However, this deficit reduction is heavily thanks to transient factors. Detailed analysis of trade exchanges confirms high concentration of Albanian exports in certain geographical regions or in certain product groups and their low value added. For stable growth of exports and sound adjustment of the trade deficit, the policy-makers' attention should focus on increasing the competitiveness of domestic products and expanding the base of exports through accelerated **structural reforms**.

Financial market developments have reflected the low risk premia and inflation, hence enabling better transmission of easing monetary policy signals that started at the beginning of this year. Interbank interest rates have performed in line with the key interest rate, with slight volatility.

The primary market yields on government securities have dropped sharply, particularly on longer-term maturities. Over the last months, the interest rate cut was faster on deposits but lower on loans. Interest rates on loans responded more slowly than other market rates due to low lending to economy during the last months.

Monetary developments highlight continuation of weak inflationary pressures in the economy. The annual money-supply growth acceleration reflected primarily the private sector's added demand for financing over the last two months. Also, households' and businesses' demand for money remained weak. Private sector credit slowed down sharply, and at the end of May it was 0.2% lower than a year earlier. The weak lending performance

is increasingly reflecting the businesses' lower demand for loan, alongside the tight lending standards.

Meanwhile, the past three months recorded households' higher demand for loan, hence signalling a probable revival of this loan.

Our projections for ***the economic outlook*** support the assessment that the Albanian economic activity will grow slowly over the period ahead, at levels comparable with those of the first half of the year. Foreign demand will be the driver of economic growth in the coming quarters, while the first-half fiscal stimulus is likely to lack in the second half of the year. Indirect data do not yet reveal any signals for consumption and private investment recovery. ***The below-potential economic growth will be associated with weak demand-side inflationary pressures and in the absence of any unforeseen supply-side shocks, consumer prices will increase at low rates.*** Annual inflation, as to four quarters ahead, is expected to fluctuate around the 1.1% – 3.8% range, with a 90% probability of occurrence. Against this setting, our monetary policy will keep on preserving its stimulating nature even over the quarters ahead.

Also, we will continue to provide the banking system with all the liquidity needed for a smooth functioning of financial markets.

Concluding, the Supervisory Council decided to lower the key interest rate by 0.25 percentage points, to 3.50%. The Supervisory Council deems that this lowering would create better monetary conditions to meet our medium-term inflation target, which will continue to guide our monetary policy.