

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, 28 August 2013.

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Today, on 28 August 2013, the Supervisory Council of the Bank of Albania reviewed and approved the monthly Monetary Policy Report. Based on the latest 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 3.5%.

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

According to INSTAT data, **annual inflation** in July was 1.6%, falling from a month earlier and standing below our 3% inflation target. Inflation's sharp decline in this month is expected to be temporary. It was driven by low seasonal food prices and the downward dynamics of prices for some other CPI basket items. However, the main consumer basket groups and items continue to be characterised by low annual inflation rates.

Albania's economic and financial developments have generated low inflation rates. Aggregate demand and economic growth remain weak, thus falling short of the full utilisation of the country's production capacities.

This situation does not support employment and creates low pressures on the increase of wages, production costs, and profit margins. Likewise, imported inflationary pressures appear contained, reflecting the moderate performance of global prices and the stability of the exchange rate. Finally, the expected inflation from the real and financial sectors appears low, whereas the situation of liquidity is in line with the moderate price rise in the medium term. The Bank of Albania deems that, in general, these trends will persist in the period ahead and will determine low inflation rates in the medium-term horizon.

Updated economic analyses suggest that economic activity expanded at low rates during the first half of the year.

Aggregate demand and economic growth appear to have improved slightly in the second quarter, in response to higher fiscal stimulus and better performance of consumer spending, while private investments remain weak.

Moreover, foreign demand continued to provide positive contribution to boosting economic activity. The latest data from the external sector point to trade deficit narrowing by 14.6%, in July, in annual terms. It narrowed thanks to the increase of exports by 23.9% and the slight increase of imports by 1.2%.

Fiscal policy was stimulating during the first seven months of the year, being characterised by rapid increase of public expenditure and direct or indirect reduction in some of the taxes. During this period, budget expenditure surged 10.4%, whereas budget revenues fell 2.6%. This situation was reflected in the budget deficit being 2.3 times higher than in the same period a year earlier.

The deficit expansion supported the aggregate demand in this period; however, it implies the implementation of a prudent fiscal policy for the rest of the year, under the conditions that space for borrowing in the second half of the year is exhausted.

The easing **monetary policy**, lower demand for borrowing by the public sector, and good liquidity situation in the banking sector have contributed to further cutting of interest rates in July and August. In particular, the interest rate cut was more noticeable on government securities and deposits in lek and less on loans in lek. This development continues to point to

the presence of relatively high risk premia in the financial market and illustrates also the conservative lending policies applied by banks. Similarly to the experience of many other economies, it reveals that the complete transmission of the eased monetary policy to better lending terms for the private sector remains problematic.

On the other hand, the private sector demonstrates elastic demand against the relatively low credit cost, hence dampening the transmission of the monetary stimulus to the economy.

Under these circumstances, credit expansion to the economy continued to mark low growth rates. As at the end of the second quarter, credit to the economy stood 0.9% higher than in the same period a year earlier. In addition to the weak economic activity, the economic agents' perception of uncertainty continues to slacken the private sector's demand for credit. Nonetheless, in June, the private sector credit recovered slightly, compared to the previous two months. As at end-June, the M3 aggregate was up 4.5%, in annual terms.

Looking ahead, the Bank of Albania deems that the drivers of economic growth remain weak and uncertain.

In particular, private investment and consumption suffer from uncertainties and reluctance of households and business to undertake long-term commitments. Furthermore, lending terms, both at home and abroad, remain relatively tight, hence discouraging credit and investment. The performance of these components will determine the economic outlook in the future.

In a medium-term horizon, the baseline scenario of expected developments is characterised by weak and below-potential economic growth – in line with the one noted over the past two years. ***In the absence of imported inflation pressures, or other supply-side shocks, inflationary pressures are expected to be weak and the annual consumer price rise is expected to be in the lower half of the target band.***

This development scenario requires maintaining the stimulating trend for economic policies, to support aggregate demand and recovery of potential growth rates. In terms of macroeconomic policies, the Bank of Albania deems that the primary objective of the fiscal policy in the future should be to maintain and enhance the public debt sustainability. This course of action will strengthen the confidence of financial markets in Albania's public finance and reduce the costs for servicing the debt in the long term. The macroeconomic context generated by it would create better conditions for the development of the private sector and would leave more space to transmit and strengthen the monetary stimulus to the economy.

At the end of discussions, the Supervisory Council decided to keep the key ***interest rate unchanged, at 3.5%***. The Supervisory Council deems that the monetary conditions are adequate to meet Bank of Albania's inflation target in the medium term. The current conditions ensure the necessary monetary stimulus to support the domestic demand. The Supervisory Council deems that the expected dynamics of economic and financial developments will require maintaining the easing trend of the monetary policy into the medium-term horizon.