

## **Ardian Fullani: Recent economic developments in Albania**

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the Press Conference on Monetary Policy Decision of Supervisory Council of the Bank of Albania, Tirana, 29 July 2009.

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The Supervisory Council of the Bank of Albania, at its meeting of July 29, 2009, after getting acquainted with the latest economic-financial developments at home and abroad and analysing prudentially the confidence indicators, banking system expectations and forecasts made by Bank of Albania's staff about eight coming quarters, decided to keep the base interest rate, i.e., the weekly repurchase agreement rate unchanged, at 5.75 percent.

### **This decision of the Supervisory Council is based on the following arguments:**

The economic developments in the first half posed strong challenges to the Albania economy. The global crisis affected our economy, swinging the factors and balances that have sustained the economic growth, thus testing the immunity and self-adjusting mechanisms of the economy and raising certain complex questions to economic agents and macroeconomic policies.

The economic recession hitting a major part of our trading partners is accompanied by the fall of trade exchanges and of foreign currency inflows. Rise of uncertainty in global financial markets has shaken the confidence in the financial system, exerting pressure on the tightening of financial conditions in Albania. Both these factors are reflected in reduced consumption, exports and investments, leading to economic activity slowdown and exerting pressure on fiscal indicators of budget revenues and budget deficit. On the other hand, the reduction of foreign currency inflows is accompanied by deterioration of the balance of payments indicators and the arising of depreciating pressures on exchange rate, underscoring the role of current account stability on macroeconomic and financial balances at home and the need for taking precautions to guarantee it.

World economic environment is characterised by further deepening of economic and financial crises. Curtailing of consumption and investments, under the presence of high rates of public and private debt and underlined macroeconomic imbalances, has made the world economy experience the sharpest economic downturn in last 50 years. The developed countries, USA, Euro-zone, United Kingdom and Japan have followed easing monetary and fiscal policies, aiming to hamper the economic downturn and improve the financial and capital markets situation. Under their impact, the latest data signal relative improvement signs of some macroeconomic indicators. Tensions observed over the previous periods have relaxed and the main financial indicators have shown recovering signs during the last months. In the meantime, the world inflation rates have been falling, owing to low raw materials prices and low use of productive capacities, in the presence of a low aggregate demand and increasing unemployment.

The economic activity downturn worldwide was associated with contraction of world trade, tightening of financial conditions and dropping of economic agents' confidence. The direct impact on emerging countries, such as Albania, is the fall of demand for their exports, decline of foreign direct investments and tightening of lending terms in world markets. Thereupon these countries have been increasingly affected by the crisis. According to IMF, the emerging countries of Eastern Europe are estimated to incur a contraction of about 5 percent during this year.

The Albanian economy, in the face of this unfavourable environment, has recorded a comparatively positive performance. There are few data on the real economy. The Bank of

Albania estimates that a positive economic growth has characterised the first half of year. On the other hand, low growth of credit and money supply, deteriorated business and consumer confidence indicators, slow-down of budget revenues and specific indicators of certain economy sectors, suggest that the economic growth rate has decelerated. It is still early to draw conclusions on the economic performance over the course of 2009 and onward. The Bank of Albania deems that the premises to keep positive economic growth rates in the country are present, among which the macroeconomic and financial stability of the country is of primary importance.

Economic activity at home is carried out under the presence of favourable consumer price stability. It is sustained by a soothing tendency of monetary conditions and by an expansionist fiscal policy over this period. The Bank of Albania cut the base interest rate in January and undertook liquidity-injecting operations, raising its quantity in the market. Simultaneously, we have prolonged the maturity span of injecting operations to smooth down the upward slope of interest rate curve and we have expanded the base of eligible collateral to facilitate the access of financial institution in liquid funds. These operations of the Bank of Albania have helped control on interest rate level. Bank of Albania's intervention has been more effective in controlling the short-term interest rates. The long-term interest rates of Government securities and loans revealed rising tendencies, owing to the Government's demand for financing and the increased sensitiveness of the banking system towards liquidity indicators. In parallel, the depreciating exchange rate trends have complemented the easier monetary conditions framework, providing advantage to exports and trade deficit improvement. However, as we have constantly underscored in our statements, the Bank of Albania has been attentive to managing the momentary stimulus, aiming above all the achievement of its target for maintaining the macroeconomic stability, by preserving internal and external balances.

Annual inflation in the first semester 2009 was 2.0 percent, recording a fall compared to inflation rates of the last year, but remaining within the Bank of Albania's targeted band. Low inflation rates over the first semester of the current year are due to the weakening of inflationary pressures on the demand and supply side, consequent to raw materials price cut in the international market and the economic activity slowdown at home. Inflationary pressure stability is clearly illustrated by low rates of core inflation of non-tradable goods one during this period, being reflected also in checked expectations of economic agents of the market. Meanwhile, after a long non-inflationary period and confirming Bank of Albania forecasts, the annual change of consumer prices revealed a slightly increasing tendency over the second quarter of 2009. The annual inflation marked 2.3 percent in June, reflecting a more complete pass-through of exchange rate depreciation effect on consumer goods prices. The Bank of Albania estimates that this factor may play a higher role in the future for determining these prices, comprising premises for short-term and medium-term shocks on price level.

In the face of these developments, the Albanian economy continued to be featured by low public and private savings rates even during the first half of 2009, associated with further enlargement of current account deficit and upward pressures on exchange rate performance. Simultaneous reduction of exports and imports, respectively by 19.6 and 6.3 percent on annual level, made the trade deficit contract by 1.3 percent during first five months of the year. However, reduction of emigrants' remittances by about 8 percent during the first quarter and the service account deterioration, made the current account deficit record an annual growth of 5 percentage points of GDP during this quarter. Though this deficit goes for financing, to a large extent, the capital and intermediate goods of import, its sustainability deserves a greater attention. Particularly concerning is the low degree of export to import coverage, signalling structural problems of this deficit due to still-low competitiveness in our economy.

In this direction, a special attention should be paid to checking costs and productivity growth in the economy, by raising investments in education, and by attracting most advanced technologies in production. Also, in the medium run, the macroeconomic policies should be

prudent in terms of public and private savings level, in order to control the need for using foreign financing resources.

The fiscal policy during the first half of 2009 had an expansionary stance, being featured by a rapid growth of expenditures and budget deficit. Budget revenues have recorded a more moderate growth, partially reflecting even the economic slowdown effects. Though remaining within the projected level for 2009, the budget deficit by about ALL 30 billion constitutes a much higher amount than in the same period of the previous year. Under these conditions, the Bank of Albania would appreciate the taking of measures for keeping budget deficit levels and public borrowing in check, helping the maintaining of the internal and external balances in the economy. Preserving the projected budget parameters will impact positively on macroeconomic stability, by controlling the fiscal stimulus on aggregate demand and dampening the pressures on monetary markets.

The demand for monetary assets increased during the last months. Money supply rise by about 8 percent is based on money creation in the economy from the public sector and from private sector borrowing, mainly in ALL. Loan portfolio grew moderately, by ALL 7.5 billion or about 5 times less than as of the same period of the previous year. Reduction of bank funds source and increase of uncertainty in the country influenced the significant deceleration of credit growth rates. However, credit to economy increased along the first months of the year, while the banking system has signalled no further tightening of the lending terms in the third quarter of the current year. The private sector's demand for Lek-denominated loans is faced with an increasing willingness from banks, thanks to stabilization of liquidity situation and easing of monetary conditions at start-2009. Restraint of foreign currency money supply has resulted to contraction of foreign currency component of money structure, even on the demand for money side, bringing about shifting of money supply structure towards the Lek.

In the first half of 2009, the financial market situation was influenced by increased uncertainty and revaluation of risk premiums that associated the liquidity constraint, consequent to deposit outflows and lending activity reduction. Ongoing intervention of the Bank of Albania in the money market, combined with measures that aimed at relaxing the market and encouraging the interbank market activity, as well as the maintaining of sound financial system indicators, made the end of the period record stabilization of liquidity positions and of interest rates. The latter displayed different behaviour, according to maturity term. Short-term interest rates in the money market decreased, consequent to base rate cut and improved liquidity conditions. Long-term interest rates rose under the conditions of a high demand for long-term funds and growth of risk premium. Primary market interest rate rise was transmitted to interest rates of new Lek-denominated loans of more than 1-year maturity, influenced even by the overall lending tightening tendency.

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The Bank of Albania deems that the issues of liquidity, internal and external balances in the economy and the financial soundness constitute direct challenges on macroeconomic stability and long-term development of the Albanian economy. Their treatment should be constantly oriented towards the need for observing the necessary macroeconomic balances of the country. Price stability, smoothing of monetary indicators volatility, a sound and efficient financial system, as well as sound public and private sector's balance sheets, impact on reducing the risk premium in the economy. Also, they open the way to attract foreign investments and cut the cost of borrowing from international markets. In this way, they provide an irreplaceable contribution to the country's long-term growth.

Further promotion of this growth requires constant structural reforms in the economy, which should not only address the deficiencies of our economy but also precede future development trends. Investment in infrastructure should be a priority of funds use in the economy. Also, further development and consolidation of financial market segments, completion and expansion of pension system in the favour of private incentives, investment with priority in education and medical fields deserve the attention of all stakeholders of the

economy. We also deem that it is just the time for the private sector to reflect the new development stage of the country, by enhancing and fostering its management. This requires a better management of business and financial risk, signifying also a closer cooperation with specialised agents in the market, extension of business plan horizons and their better orientation towards the global reality and the country's development priorities.

In light of this, the financial system should respond more prudentially to these requirements, enhancing the transparency and efficiency of its products. Now that the banking system has overcome the delicate moments it was faced with at end-2008, it should enhance its contribution to financing the private sector's activity of the economy. However, I avail myself of the occasion to once more emphasise that the financial stability of the banking system is another major objective, to which the Bank of Albania remains deeply committed. This system will be constantly subject to Bank of Albania's supervision and stress-test analyses.