

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

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the press conference on monetary policy decision of the Supervisory Council of the Bank of Albania, Tirana, 27 January 2010.

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The Supervisory Council of the Bank of Albania, in its meeting of January 27, 2010, dwelt with the Monetary Policy Statement for the second half of 2009, analysing in detail the performance of monetary and economic indicators for the second half of 2009, as well as the macroeconomic projections and the balance of risks that may associate them in the coming month. At the end of the analysis, the Supervisory Council of the Bank of Albania decided to keep unchanged the key interest rate of repurchase and reverse repurchase agreements, at 5.25 percent. The Supervisory Council assessed that this interest rate is in line with Bank of Albania's goal to keep inflation close to the medium-term target.

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The Albanian economy has just left behind a difficult year. The deep global economic crisis was soon felt even in Albania, testing the foundations of the economy: the financial stability and the macroeconomic balances. However, the good initial state of our economy and the proper response of macroeconomic policies helped to successfully cope with this test. During the first three quarters of the year, the Albanian economy ensured a positive growth, thus preserving the financial stability and the key indicators of macroeconomic stability: price stability, public debt level and balance of payments sustainability.

The global economic and financial crisis, which was significantly intensified during the first half of the year, put in question the financial system sustainability, the macroeconomic stability and the long-term development prospects of the world economy. The determined response of public authorities, increased coordination of economic policies and keeping open the world trade channels, helped preventing any negative economic spirals. The latest data on the global economy indicate a recovery of economic activity in the third quarter onwards. The monetary and fiscal stimulus packages resulted successful in terms of stabilizing the global economy.

However, the sustainability of global economic growth will remain fragile, as long as the economic activity continues to rely on significant monetary and fiscal stimuli. In particular, the public debt sustainability, which is burdened by fiscal stimulus bill to exit the crisis, is becoming a more and more aggravated problem for many countries. In this complex situation, choosing the right moment for withdrawing the economic stimuli will have a decisive importance in the future economic performance.

In a more structural aspect, the recent crisis is expected to leave visible traces in the economic development. In a long-term horizon, it seems that new economic and strategic balances are being determined, thus re-dimensioning the poles of global economic growth. In a medium-term horizon, the global economic growth rate is expected to converge in a lower balance than the one that has prevailed over the last two decades. This slowdown may be accompanied by economic and social problems for those countries, which would not know how to figure out their relevant implications. In a short-term horizon, discussions on the state's role in the economy, on economic development and growth patterns, on the philosophy and appropriate practices regulating the financial markets, will dominate the political round-table debates. In particular, the economic growth model will be a sensitive topic for economies significantly affected by the crisis, including many Eastern European countries. Promoting competitive advantage and increasing competitiveness in global markets will be the subject of discussions and intended reforms.

Turning to domestic economic developments, the analysis of available indicators shows that the Albanian economy has had a positive economic growth during the first nine months of the year. However, these indicators suggest that the growth rate was characterized by a progressive slowdown during 2009. Such performance was conditioned by reduced foreign demand and slowed domestic demand, in the presence of a tight liquidity situation, financing restriction and increased uncertainty.

According to preliminary data from INSTAT, the economic growth for the first nine-month period of the year was 4.9 percent, against 7.8 percent recorded for the same period of the previous year. In sectoral terms, the sectors that benefited most from the economic growth are the services and construction ones, while the industry sector underwent a more problematic performance.

The positive growth rate has been supported by the fiscal stimulus, while consumer demand and the contribution of external sector to the economy have been relatively stable. At the same time, private investments have declined. Consumer demand has been supported by a slight rise in employment and wages, while the mortgage and consumer credit contraction, as well as reduction of remittances have given the reverse effect. Private investments have been contracted, as a consequence of limited financing resources, reduced lending support by the banking system and limited access to international capital markets. Increased uncertainty, slowed progress of the final demand for their products and reduced capacity utilization rate have impacted on such performance.

Effects of domestic economic slowdown and the global economic crisis have appeared even in the foreign trade. Foreign economic activity is characterized by a simultaneous decline in both, exports and imports of goods and services, thus impacting significantly on the economic growth for 2009. On the other hand, fiscal stimulus, injected mainly during the first half of the year, has contributed to rapid increase of budget spending and public debt.

The economic growth below the potential has created an environment of generally reduced inflationary pressures. The annual inflation for December recorded 3.5 percent, while the average annual inflation rate was 2.2 percent. Both these indicators are in line with Bank of Albania's target on price stability. The economic activity slowdown, low main products prices in the world markets, low monetary expansion in the economy and controlled inflationary expectations offset the inflationary pressures coming from exchange rate depreciation during 2009.

The upward inflation trend during the last quarter of 2009 was expected by the Bank of Albania. It was formed mostly by transitory factors, which are not expected to generate steady inflationary pressures. In particular, this performance was influenced by rising food prices, which reflect the lagging effect of exchange rate depreciation, international markets conjunctures and structural problems of the Albanian market.

These factors are expected to exert inflationary pressures during the first half of 2010, possibly added by expected reduction of agricultural products supply, as a result of the flooding that has lately occurred. However, stable core inflation trend and low inflation rate of non-traded goods confirm that inflationary pressures exerted by domestic demand are moderate.

In the absence of other supply shocks, the slow progress of domestic demand, low growth of monetary supply and anchored inflationary expectations, are premises for keeping inflation within the target in the medium run.

The Bank of Albania pursued a prudent monetary policy during 2009, creating a suitable environment for a balanced development of the economy and for keeping inflationary pressures under check. In the presence of downward inflationary pressures and steady expectations, the hints for slow domestic demand in the next period have motivated the progressive growth of monetary stimulus during 2009. The Bank of Albania cut the key interest rate by one percentage point, down to 5.25 per cent during this period. It also

steadily increased liquidity injection, according to banking system needs for liquidity and the economy demand for funding. Concerning liquidity injection, the Bank of Albania has made use of the entire range of monetary policy injecting instruments, facilitating at the same time the access to and easing the cost of operation of the banking system with the central bank.

Also, in the presence of the exchange rate depreciation, such policy has brought about easing monetary conditions, serving the promotion of the economic activity. However, the pass-through of easing monetary policy on interest rates of banking products has been limited, due to liquidity constraints of the banking system and weakened demand of the public sector for funds. On the other hand, the banking system itself has been reserved with regards to lending, as a result of the increased risk in the economy and performance of loan portfolio quality. The alleviation of these problems would help to more fully transmit the monetary policy and enhance its effectiveness.

The country's external position continues to be characterized by a high and upward current account deficit. During the first three quarters of the year, the deficit was fully covered by capital and financial account inflows, resulting in increased foreign exchange reserves of the Bank of Albania. However, the inflows have been significantly favoured by privatization receipts and by public sector borrowing. Both these items are limited in time and size, making necessary a steadier correction of the external position of our economy. This correction should aim at covering the trade deficit with stable funding resources, in the form of foreign direct investments and promoting export industries in branches that may constitute a competitive advantage for Albania.

However, short-term developments in foreign trade for October to November show a somewhat different performance compared with the first nine months of the year, testifying a modification of the trends observed earlier. Thus, the country's exports fell in annual average terms by about 7.4 percent, recording a slowdown in comparison with the average decline by about 19 percent during the first nine months of the year. On the other hand, imports recorded an annual average decline of 17% per cent over these two months, compared with the average annual decline of 7 percent recorded in 2009. These developments contain encouraging signs for sustainability of the balance of payments in the short run

Fiscal policy had an expansionary nature during most of the year, being materialized in a budget deficit of 6 percent of GDP. The increase of budget deficit reflects both the action of automatic stabilizer in the form of decreased revenues, and the intended countercyclical character of fiscal policy, through increased wages and capital expenditures. The country's economic activity slowdown has dictated a slow pace in budget revenue growth, especially after the first quarter of the year.

In late November, the annual growth of budget revenues was only 2 percent, almost entirely reflecting the low pace of generating the tax revenues. On the other hand, public expenditures have maintained high growth rates, accounting for 16.4 percent in November. The budget deficit reached ALL 65 billion in November. The deficit has been mostly financed through foreign borrowing and privatization receipts, dampening the pressures in the domestic financial market

Rapid growth of expenditure and budget deficit during 2009 has further increased the public debt level, accounting for 58 per cent of GDP at the end of November. The Bank of Albania deems that the future budget policy orientation towards fiscal consolidation, aiming at reducing the public debt, is now a prerequisite for the macroeconomic stability in the country. As we have constantly stated, the public debt reduction will mitigate the pressure of the public sector on the financial markets, creating more room for the private sector. Consolidation of public finances will also lower the risk premiums in the economy and will raise the monetary policy effectiveness.

Monetary supply slowed down further in the second half, reflecting to a great extent, the ever lower credit growth. Annual growth of private sector loan portfolio slowed down to 10 percent in November. Unlike the first six months of 2009, when credit growth curbing was more

affected by the tightened supply, in the second half of the year the credit performance was dictated by decreased demand for loans.

The economic activity slowdown and uncertainty about the future, in the face of still tightening lending terms by banks, have guided the economic agents' decisions to postpone the investment plans and to less finance consumption from borrowing.

However, monetary developments confirm an improved situation of deposits during the second half of 2009. The change in depositors' behaviour, in the context of measures taken to prevent the spread of global crisis effects, and the foreign currency inflows in the form of remittances during summer, have contributed to stabilizing the liquidity situation of the banking system.

Financial markets were characterized by a more relaxed situation during the second half of the year. The banking system continued to be featured by liquidity constraints, which were remedied by central bank liquidity injections. Improved liquidity situation due to increased deposits in the system and fostered certainty in the market created a suitable environment for transmitting the monetary policy signal to the interbank market. The key interest rate cut at the end of October is followed by reduced yields on government securities, after the upward trend characterizing them throughout the year. In the meantime, the Bank of Albania, in accordance with time lags that characterize the monetary policy transmission mechanism, expects and requires that the key interest rate cut be transmitted to credit markets.

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The Supervisory Council's Decision on keeping the key interest rate unchanged aims to further maintain and consolidate the macroeconomic balances, considering them as a necessary prerequisite for a sustainable and long-term growth. It also guarantees the proper monetary support for the economy under this stage of development. In the future, the Bank of Albania remains willing to operate in line with the actual and expected performance of the economic indicators and in accordance with its principal objective.