

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 the Bank of Albania's Supervisory Council decision on monetary policy, Tirana, 23 February 2011.

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Today, on 23 February 2011, the Supervisory Council of the Bank of Albania reviewed and approved the monthly Monetary Policy Report. Based on a thorough analysis of Albania's latest economic and monetary developments and discussions on their performance outlook, the Supervisory Council of the Bank of Albania decided to leave the key interest rate unchanged at 5.00%. The Supervisory Council confirmed that the actual monetary conditions remain appropriate for meeting the medium-term inflation target and for supporting the domestic economic activity.

I would like to proceed with a brief overview of economic developments and main issues discussed at today's meeting of the Supervisory Council.

Recent data from the **global economy** confirm the positive underlying momentum of the economic activity in developed and developing economies. Despite the gradual withdrawal of fiscal and monetary stimulus, economic growth has been stable, as a result of the recovery in the private sector demand in developing countries.

On the other hand, the higher demand has triggered a price increase in commodities, basic products and food items, thus impacting the shift of the inflationary pressures upward. Nevertheless, globally, consumer price inflation remains still contained, as long as major economies continue to be characterised by below-potential economic growth. Global financial markets are improving, but they are still fairly sensitive to fiscal perspectives of certain economies and to tensions in the Euro area. Additionally, these markets show relatively little interest in South Eastern Europe countries, including Albania.

Overall, world economic growth is expected to remain high for the upcoming period as well, contributing also to the triggering of inflationary pressures and drawing more attention of monetary authorities to macroeconomic balances.

Domestic economic and monetary developments continued to generate an environment of contained inflationary pressures. **Annual inflation** for January 2011 was 3.3%, dropping by 0.1 p.p. compared to December 2010. This decline of inflation in January is totally due to the statistical effect of neutralising the increasing impact of some administered prices on inflation. On the other hand, food items and oil prices increased significantly, as a result of rising prices in world markets. These factors contributed by about 80% to the formation of the inflation figure. Increased agricultural products prices affected mostly the low-income segments of the Albanian society.

As stated above, domestic inflationary pressures are characterised by short-term supply shocks, while the generated inflation by domestic demand is low, as reflected in the relatively stable situation of core inflation. This performance is conditioned by the existence of free capacities in the Albanian economy as well as contained monetary expansion and anchored inflationary expectations of consumers, businesses and agents in the financial market. The Bank of Albania deems that, in general terms, these factors will continue to be present during 2011.

On the other hand, the Bank of Albania, in its inflation outlook, has factored the projections on the situation of fuel and food items made so far by the IMF and FAO. In the absence of added and unpredictable supply shocks, or second round chain phenomena, inflation rate is expected to be in line with the Bank of Albania target.

I would like to continue with a more detailed analysis of current and expected developments in the Albanian economy and financial markets, also assessing their implications on the expected consumer price inflation.

Economic activity

In the absence of direct data and based on a number of indirect indicators, the Bank of Albania assesses that the Albanian economy continued to grow during the fourth quarter of 2010. The economic growth was supported mainly by the external demand for Albanian exports.

However, domestic demand has shown lately signs of recovery, as evidenced by the positive trend of bank lending, indirect consumption indicators and improved Economic Sentiment Indicator of the Albanian businesses and consumers.

Consumption and private investment, the two most important components of aggregate demand, experienced a slow progress during 2010. While disposable income of the Albanian consumers is considered to have increased in real terms, high uncertainty and tightened lending terms and conditions by the banking system deterred the domestic consumption. On the other hand, the Albanian businesses encountered insufficient demand for them to use their full capacities and higher financing costs. This situation has most affected sectors of the economy such as construction, which relies totally on domestic demand and, at a lower extent, other sectors such as industry, which generates most of its activity from external demand. Under these circumstances, investments pace was relatively lower, compared with previous years. The Bank of Albania considers that domestic consumption and investments will have a better performance during the current year.

Conditions for funding the private sector demand appear improved, while risk premia in financial markets appear lower. Uncertainty for the future should gradually decrease. Additionally, the expected positive influence of external demand and fiscal policy during 2011, are expected to stimulate domestic demand.

Correction of fiscal conduct is followed by a lower contribution to the economic growth during 2010. Public expenditure reduced by about 5% year-on-year, while the budget deficit reduced by about 4 p.p. of the GDP. The Bank of Albania has always highlighted that fiscal stability is a fundamental precondition for a long-term economic growth. In this context, we deem that respecting objectives on budget deficit and public borrowing during 2011 will yield a positive contribution to the country's economic development. Maintaining relative levels in budget deficit will eliminate a direct negative effect on economic growth, while relatively low levels of public borrowing will have an impact on the control of long-term interest rates and reduction of risk premia in financial markets.

These developments were manifested during the second half of 2010 and are expected to stimulate domestic demand during 2011, as well.

External sector of the economy continued to be characterised by a positive, though falling, contribution of foreign demand to economic growth. The correction pace of the trade deficit was slower in this quarter. Trade deficit reduced by 1.2% compared to two-digit correction rates recorded in the first half of 2010. This situation of the trade deficit is determined mainly by the acceleration of imports, which marked a year-on-year increase of 10.8% in the fourth quarter of 2010, recording a growth for the third consecutive quarter. On the other hand, Albanian exports increased by 48.8% year-on-year, maintaining high rising rates.

The Bank of Albania holds that the Albanian economy will find it difficult to maintain the same growing rates of exports during 2011; among other things, this projection reflects temporary factors that influenced on 2010 growth and is in line with the global economy situation and basic statistical effects. Nevertheless, external demand is expected to generate positive contribution to the economic growth during 2011, as well.

Monetary indicators, financial markets and inflation

Performance of monetary indicators continues to generate controlled monetary inflationary pressures on the domestic economy. Money supply increased by 12.5% in December 2010, reflecting a good performance of deposits in the banking sector during the second half of the same year. Our assessments indicate that monetary expansion is in line with the private sector demand for real money. A good progress of the economic activity and falling risk premia are also reflected on the upsurge of demand for loans by the private sector. Satisfactory parameters of the banking system in terms of liquidity and capitalisation have enabled additional support to the private sector with bank loans. In December, the growth rate of loans to the private sector reached 10.6% year-on-year. In addition to private businesses, which were the main users of credit funding during 2010, positive signals come from household consumers, whose demand for loans increased during the last quarter of 2010.

Financial markets are characterised by dropping risk premia and liquidity, reflected in a further decline of yields in the primary market and interest rates in Albanian Lek deposits and loans. In the inter-bank market, short-term interest rates remained close to the key interest rate and showed low volatility. Foreign exchange trading in the domestic market was also calm. The Albanian Lek continued to depreciate in annual nominal terms against foreign currencies, although more slowly compared to 2010.

Taking into account the information summarised above, the Supervisory Council deemed that inflationary pressures for the medium-term horizon remain contained. Consumer price situation is expected to be under the pressure of price increases in world markets, but, in the absence of second round effects, their impact is expected to be transitional. On the other hand, the actual insufficient demand will continue to condition levels below the potential domestic capacity utilisation, exercising downward pressures on inflation.

Inflationary expectations continue to be anchored around the inflation target of the Bank of Albania. In the absence of unexpected shocks to the economy, inflation is expected to be close to the Bank of Albania mid-term target. The Bank of Albania will continue to monitor the nature of these external shocks and their impact on prices in the domestic context, for a timely reaction in order to eliminate stable inflationary pressures.

After the discussions, the Supervisory Council concluded that the monetary conditions remain appropriate for meeting the medium-term inflation target and decided to leave the key interest rate unchanged at 5.00%.