

Ardian Fullani: Recent economic and monetary developments in Albania

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the press conference on the Monetary Policy Decision of the Bank of Albania Supervisory Council, Tirana, 29 June 2011.

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Today, on 29 June 2011, the Supervisory Council of the Bank of Albania reviewed and approved the monthly Monetary Policy Report. Based on an analysis of Albania's latest economic and financial developments and following discussions on their performance outlook, the Supervisory Council of the Bank of Albania decided to leave the key interest rate unchanged at 5.25%. The Supervisory Council holds that the actual monetary conditions are appropriate for meeting the inflation target and for continuing to stimulate the economic activity.

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

Annual inflation pointed to 4.2% in May, remaining close to preceding months levels. Under higher foreign prices pressure, the prices of "processed foods" and "non-food consumer goods", including oil, were the main contributors to inflation rates. In the meantime, the seasonal effect of increased domestic supply of fruits and vegetables is reflected in a lower contribution of the "unprocessed food" to inflation. The rise of some administered prices and the effect of higher excise tax rates for some goods continued to provide a constant, but positive, contribution to annual inflation.

Inflation's performance over the recent months was consequent to the balance of two main factors' opposite actions. On the upward trend, high primary commodity and raw materials prices in world markets were transmitted to the domestic inflation in the form of higher imported inflation. In the short run, this phenomenon also contributed to core inflation, which was up compared with last year. High net inflation rate of non-tradable goods showed that a part of higher commodity prices materialised in second round effects in inflation.

Latest developments in inflation affected also the economic agents' inflation expectation, which, however, remain within the target band of the Bank of Albania.

On the downward trend, domestic economy developments continued to provide an environment with contained inflationary pressures. Our assessments on economic activity suggest positive growth rates for the first quarter, although below the potential. Under these circumstances, the Albanian economy continued to be characterised by spare productivity capacities – labour and capital – and negative output gap, continuing to exercise downward pressures on inflation. Similarly, the monetary development analysis confirmed the presence of contained monetary pressures on the domestic economy.

Following, I would like to address the economic factors that determined inflation developments and their expected performance.

Albania's economic activity, during the first months of the year, took place in the context of a growing **global economy**, amid increasing inflation pressures and added uncertainty in financial markets.

Global economic activity continued to grow during the first half of 2011, led by rapid expansion of demand in emerging economies. On the other hand, high demand and geopolitical tensions were reflected in higher raw materials and primary commodity prices, thus increasing inflationary pressures at global level. Developments in financial markets reflected the concern over the fiscal position stability in euro area peripheral countries, hence

rising risk premiums on a wide scale. On a balance, risks on future performance of global economy were expanded, while space for a response of fiscal and monetary policies narrowed.

Against this setting of international economic developments, the **Albanian economy** is assessed to have grown over the first months of 2011. Foreign demand contributed positively to the aggregate demand, but, as expected, Albanian exports contribution to economic growth was lower than in 2010. Moreover, the public sector demand supported the economic activity growth. On the other hand, consumption and private investments performance was considered as slow.

Indirect indicators of these domestic demand components signal their weak performance, despite improved financing conditions and a more appropriate climate for private sector development. Uncertainties for the future, as stated in the low consumer confidence, dictated a conservative behaviour of individuals towards consumption and a higher preference towards saving. Given the under-utilised output capacities, the business need for new investment was low.

The positive momentum of global economy continued to boost our exports, although to a lesser degree compared to last year. In April, exports' annual growth was 10.8% while imports expanded further, reaching an annual growth of 16.7% in this month. These foreign trade developments materialised in deepened **trade deficit** during this period, resulting in 19.5% year-on-year. Overall, balance of payments developments confirm the frailty of Albanian economy's **external position**.

Current account deficit, estimated at 11.8% of the GDP in the first quarter, remains high. The Bank of Albania has constantly underlined the need for taking measures to reduce it and ensuring sustainable funding sources by attracting capital inflows, in the form of foreign direct investments.

Balance of payment developments were reflected in a relatively stable **exchange rate**. Under the conditions of a balancing demand and supply, the domestic currency demonstrated stability, slightly depreciating in effective and nominal terms in May. Future exchange rate performance will be conditioned significantly by external economy balances and individuals' preferences for their financial asset portfolio structure.

Public sector expenditures were an important stimulus of economic activity during the first months of the year. In January–May, these expenditures were up by 10.3% year-on-year, while decelerated fiscal income reflected the private sector's low demand. These developments were reflected in the budget deficit of about 1.7 times higher compared to a year earlier. Expenditure growth slowed down during the second quarter.

This behaviour is expected to continue for the rest of the year, conditioned by the commitment to respect the 2011 deficit and public debt target. This fiscal policy approach is expected to be formalised in the July budget revision, which should take into consideration the public debt's long-term stability.

Against the above-mentioned developments, **monetary indicator** analysis confirms controlled inflationary pressures originating from the domestic economy. Money supply annual growth was 12.2% in April, staying close to its historic trend. Monetary expansion reflected the accumulation of liquidity in the banking system, revealing the households' preferential behaviour towards saving. Our assessments point out that monetary expansion is compliant with the private sector's demand for real money, thus indicating controlled monetary-related inflationary pressures.

The contained behaviour of the private sector about spending and investing is reflected also in a low demand for **bank lending**.

Annual growth rates of lending to the private sector ranged 10%–12% in the four first months of the year, on average, only 2 percentage points higher than a year earlier. The business

demand to cover liquidity needs was their main driver for loans, while lending to households increased by low rates.

Developments in **financial markets** speak of low risk premiums and liquidity. Short-term interest rates in the inter-bank market stayed close to the key interest rate and demonstrated contained volatility. In the primary market, government securities yield surged in the last three months, in response to a higher demand of the public sector for funding. Nevertheless, their curb remains lower in comparison with a year earlier, pointing to more favourable financial conditions in the economy.

Looking ahead, assessments and projections of the Bank of Albania suggest continuation of positive growth in the upcoming period. In a longer-term horizon, under diminishing external impulses to the aggregate demand and a more contained fiscal behaviour, growth rates acceleration will be conditioned by the resurgence of the private sector.

In this regard, the Bank of Albania deems that the economic climate provides the conditions and space for even higher consumption and private investment growth.

Despite positive growth rates, the Albanian economy is expected to remain and operate below its potential, with the demand conditioning the continuation of the negative output gap and contained inflationary pressures. On the other hand, inflation performance will continue to be under foreign prices pressure for the upcoming period as well. In the absence of unexpected developments, the effect of shock from foreign prices is expected to fade away while the effect of administered prices increase is expected to be neutralised during the third quarter of the year. Therefore, inflation is foreseen to return within the Bank of Albania target band by the year-end. Although risks about this base scenario are added as a consequence of uncertainties of the global economy, they remain balanced.

Drawing on the information above, the Supervisory Council of the Bank of Albania deemed that inflationary pressures are, in the short term, high, but with a downward trajectory; in the medium term they remain controlled.

In the absence of unexpected shocks, inflation is expected to be within the target band of the Bank of Albania along the time horizon of monetary policy action. Inflationary expectations of economic agents continue to be within the target range, which is essential under the conditions of the simultaneous presence of the negative output gap and high foreign prices. The Bank of Albania is fully committed for anchored inflationary expectations in compliance with its inflation target and stands ready to accomplish its mandate, by preventing materialisation of constant pressures on inflation.

Following 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 5.25%.