

Ardian Fullani: Overview of recent economic 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, 27 July 2011.

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Today, on 27 July 2011, the Supervisory Council of the Bank of Albania reviewed and approved the Monetary Policy Statement for 2011 H1. Based on the 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.

The Albanian economy continued to grow during 2011 H1, although in the presence of added challenges generated by the internal and external economic developments. Tensions in global economies and financial markets, as well as increased prices of raw materials and foodstuff led to shrinkage of Albania's economic activity. The first factor raised the uncertainty of economic agents as well as risk premiums in financial markets, while high inflation imported from world markets decelerated domestic demand and increased inflation expectations at home. Despite unfavourable factors, Gross Domestic Product posted growth and main macroeconomic balances and financial stability remained stable.

According to INSTAT data, Albania's **annual economic growth** was 3.4% in the first quarter, supported by the fiscal stimulus of this period and foreign demand for Albanian products. On the other side, private consumption and investments continue to be slow, reflecting cautious consumer behaviour and existence of spare production capacities in the economy respectively.

The Bank of Albania deems that economic activity posted similar growth even in the second quarter, with higher contribution of the private sector and downward public sector and foreign demand.

Consumer prices were under added inflation pressures during 2011 H1, mainly due to foreign price increase in global markets. Average annual inflation during the first and second quarters of the year was 4.0% and 4.1%, respectively.

As regards the consumer basket items, prices of processed foodstuffs had the main impact on the formation of annual inflation. Their contribution to headline inflation floated around 55%, close to this indicator's all-time record. Inflation of non-food consumer goods, such as oil and other day-to-day consumer goods and services, was an added contribution to consumer price hike. On the other hand, the contribution of non-processed foods to inflation was stable.

Gradual upsurge of domestic food products supply during the second quarter, balanced the effect of these items price increase in international markets. Lastly, administered prices and increased excise on some products had an increasing impact on annual inflation, albeit lower compared to a year earlier.

Concerning the macroeconomic aspect, a number of factors contributed to inflation at this period, with various degrees of intensity and opposite directions of action. Upward inflation pressures were generated mostly by conjunctures of raw material and primary commodity

prices in international markets. Imported inflation was transmitted directly to increased consumer goods prices in Albania. It exercised additional pressures on production costs and inflation expectations, but these second-round effects remained controlled. Furthermore, the negative output gap continued to exercise downward pressures on prices balancing, in part, the effect of foreign price increase. The expansion of economic activity continues to be below the potential of the economy, leaving unutilized capacities in the labour and capital markets. Under these conditions, inflationary pressures from the real sector of the economy remain controlled. This is reflected also on the base inflation performance, which, although upward, remains anchored within the Bank of Albania's medium term inflation target.

Moreover, monetary indicators generated contained inflation pressures, reflecting also a **prudent monetary policy** of the Bank of Albania. In March, the Supervisory Council of the Bank of Albania decided to increase the key interest rate by 0.25 basis points, to 5.25%. This decision was made in response to added inflation pressures of foreign origin. It aimed at retaining the anchoring of economic agents expectations on inflation and minimising second-round effects. Even after this increase, domestic monetary conditions remained stimulating and provided the economy with the appropriate support at this stage of its development. In line with the action time-span, this measure is considered to have been effective in signalling the commitment of the Bank of Albania to comply with its inflation target and keep inflation expectations under control. In addition, it kept unchanged the stimulating characteristic of the monetary policy and conditions as reflected in comparatively low interest rates, banking system ample liquidity and exchange rates favouring Albanian exports.

Let me now focus on economic highlights defining the inflation performance as well as their expected development.

In line with its past year's performance, the expansion of the Albanian economy during the first and second quarters of 2011 relied mostly on the industry and services sectors growth. Owing to foreign demand, industrial output increased by 12.3% in annual terms, providing major contribution to the expansion of the economy in the first quarter. The services sector, topped by "Trade, hotels and restaurants", continued to support economic growth, although less than last year's quarters. This sector's annual growth marked 1.8% in the first quarter of 2011. The services sector performance is closely connected to consumer spending performance, which I will address later. After five quarters of contraction, the construction sector posted annual growth of 4.6%, triggered by higher public investments during this period. Lastly, agriculture maintained growth and contribution rates similar to the last quarter of 2010.

Indirect data obtained from business surveys and monetary indicators suggest that this performance is and will continue to be along the same lines even during the second quarter and beyond.

On the demand side, economic activity relied mostly on foreign demand and public spending, while private sector contribution was low.

Indirect data support the assessment for a weak **private consumption** performance during 2011 H1. In spite of increased available income and improved bank lending – as indicated by higher employment, real wage and consumer and house-purchase loans – consumer confidence was low. The Albanian consumer continues to be cautious in spending, displaying added saving preference over a number of quarters. Naturally, this behaviour is a structural correction of the consumption model shown over the past years, but the slow performance of consumer spending reflects, also, added uncertainty about the future.

While the first component is welcomed, in the context of preserving macro- and micro balances, the second component may and should be corrected: households consumption has the potential to grow and be stimulated in the short and medium run. Taking into account the significant impact of consumption on the GDP, its performance will substantially condition economic growth during this time span.

Private investments increased at moderate pace during 2011 H1 as illustrated by higher loans for investment and imports of capital goods. Although financial terms – availability, liquidity and bank interest rates – are significantly improved, the existence of spare capacities in the economy limits the demand of businesses for investment. In the short run, the position of economic activity operating below its potential conditions a slow performance of investments. In the medium run, investments performance will reflect developments in internal and foreign demand performance. Given the need for a more competitive Albanian economy and its further orientation towards exports, stimulation of investment, increase of production capacities and adoption of more advanced processes and technologies should be priorities of the country's development policies, in the macro- and micro economic aspects.

Public expenditures provided a positive contribution to the aggregate demand of 2011 H1. Following the consolidated behaviour of last year, the **fiscal policy** was a stimulating one during this period. Public spending increased by 7.4% in annual terms, led primarily by current expenditures, with an added positive contribution of capital expenditures as well. On the other hand, budget revenues were slow, increasing by 1.1% in annual terms. The differences of growth rates for revenues and public spending materialised in the expansion of the public deficit. In GDP terms, budget deficit at the end of 2011 H1 stands at **4.1% or about 1.5 p.p. higher than a year earlier**. Expanded fiscal policy was more present during the first quarter of the year, while in the second quarter it was more moderate. Revenue and spending growth rates reduced during the second quarter, leading to the need for the revision of the 2011 budget, in order to retain the parameters of public finance soundness in the short and long run. On the other hand, measures to control budget deficit through reducing public spending implies modelling the fiscal stimulus during the second half of 2011.

Foreign demand continued to provide a positive contribution to the aggregate demand. Nevertheless, as expected, its positive impact was lower than a year earlier. During the first five months of the year, Albanian exports increased by 23.3% y-o-y, which is lower compared with 2010. On the other hand, deterioration of trade terms and internal demand performance triggered the increase of imports in the first half of the year.

Value of imports increased 14.1% y-o-y during January–May, thus, leading to higher trade deficit. Following its narrowing in 2010, this deficit expanded by approximately 8.8% y-o-y during this period.

Trade deficit expansion, negative foreign currency flows in the services account and lower remittances are reflected in the expansion of the current account deficit in the first quarter, at the end of which, this deficit was at 11.8% of the GDP, illustrating the fragile position of the external sector of the economy.

The performance of the four demand components led to positive, but below potential, economic growth during 2011 H1. Unutilised capacities in the economy controlled production costs and generated controlled inflation pressures.

Monetary indicator analysis confirms our assessments for contained inflation pressures suggesting that money supply growth rates are moderate and in line with the economy's demand for real money. In average terms, M3 annual growth was 11.3% in January–May triggered by a steady growth of deposits in the banking system. Demand for money is dominated by public sector demand for funding, while the private sector's demand was more moderate. Lending to the private sector increased on average by 11.5% during the first five months of the year, about 1.5 p.p. higher than 2010 H2. In contrast to previous years, lending is oriented more towards the national currency: ALL-denominated loans increased by about 14% as at May. Lending continues to be impacted by a moderate demand for loans while the banking system has adopted prudent lending practices, with tightened lending standards for certain market segments.

Financial markets were calm reflecting low risk premiums and a good liquidity situation. In the interbank market, interest rates fluctuated around the key interest rate, following its latest increase in March. The increase in the key interest rate is also followed by the yields in the

Government securities primary market and is reflected less in the ALL-denominated deposits and loans, due to factors of liquidity and risk that accompany financial intermediation. The yields curve has retained its trend, indicating low inflation premiums in financial markets.

Summing up *the expected economic performance*, our projections and assessments suggest that economic growth will continue even in 2011 H2. Aggregate demand will be supported less by the public sector and foreign demand, while the private sector is expected to provide a larger contribution to the economy. Nevertheless, economic growth is not expected to fill completely the negative output gap. The Albanian economy will continue to have spare capacities in the capital and labour markets, avoiding potential wage – inflation spirals and producing contained inflation pressures in the medium run.

In addition, imported inflation is expected to decline and administered prices effects are expected to be eliminated in the medium run. In the presence of anchored inflation expectations by economic agents, the Bank of Albania deems that consumer price inflation will gradually settle close to its target of 3% in the period ahead.

Drawing on the information above, the Supervisory Council of the Bank of Albania deemed that inflationary pressures remain, in the short run, high. However, they are controlled and in the medium run they are expected to follow a downward trajectory.

In the absence of unexpected shocks, inflation is expected to be within the target band of the Bank of Albania throughout the monetary policy time horizon. Inflationary expectations of economic agents continue to be within the inflation 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.

We deem that the monetary conditions are appropriate to stimulate economic growth, without generating additional inflationary pressures. Given the fragile equilibriums of the Albanian economy, this philosophy will continue to lead our activity in the period ahead.

At the conclusion of 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 %.