

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 September 2011.

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Today, on 29 September 2011, the Supervisory Council of the Bank of Albania reviewed and approved the monthly Monetary Policy Report. Based on the analysis of Albania's latest economic and financial developments and following discussions on the performance outlook, the Supervisory Council of the Bank of Albania decided to cut the key interest rate by 0.25 percentage points. Following this decision, the interest rate for one week repurchase agreements is 5.00 per cent. This cut in the key interest rate reflects contained inflationary pressures, anchored expectations of economic agents, and a more prudent fiscal policy during the period ahead. The easing of monetary policy aims at providing appropriate monetary conditions to meet the medium-term inflation target and promote economic activity through stimulating consumption and investments in Albania.

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

The month of August was characterised by a sharp decline in inflationary pressures. **Annual inflation rate** was 3.1%, or 0.4 percentage points lower than in July. In addition to decreased foreign price shocks, during this month, inflation contribution on regulated prices dropped and contribution of prices of bread and grains curbed. Furthermore, the seasonal effect of domestic agriculture production supply was stronger this year, leading to further reduction of food items annual inflation.

During 2011, consumer prices in Albania were subject to supply shocks, materialised in high imported prices. This effect was more moderate during July–August and, in the absence of sudden shocks, it is expected to subdue even further in the months ahead. Moreover, second-round effects are contained, under the influence of controlled expectations of economic agents on inflation. The domestic economic setting produced controlled inflationary pressures. Aggregate demand slowdown led to spare capacities of production factors and controlled long-term inflationary pressures on the economy.

Therefore, core inflation was 2.9% in July, showing a downward trend, and was close to our inflation target.

New economic data obtained in September are scarce. **Following our earlier analysis and based on new available information, the Bank of Albania deems that the Albanian economy continued to grow during 2011.** Economic activity relied primarily on public spending and exports surge, while the private sector demand had a slow positive performance. Consumption and investments were supported by crediting, but their upsurge is conditioned by hesitation to spend.

Following the revised budget, the fiscal behaviour during the last two months is characterised by lower spending pace and lower budget deficit increase. **Fiscal stimulus** was present in the first quarter, while in the following months the fiscal policy was more contained, which is reflected in lower annual deficit increase.

Until August, public spending posted annual growth of 5.2% in annual terms, while revenues slowed down, growing only by 2.2%. Budget deficit was ALL 30.6 billion as at end-August.

Foreign demand continues to support Albanians economic growth. Exports' annual growth was 28.8% in July. On the other hand, imports continued their downturn trend that had

started in the second quarter of the year, increasing by 4.6% in annual terms. Export uptrend and import slowdown materialised in narrowed trade deficit in July, contracting by 6.0% year-on-year. However, the economy's external position remains a structural weakness of the Albanian economy, which reflects the need for higher competitiveness of our products in global markets and conditions the effectiveness of stimulating macroeconomic policies.

Indirect indicators analysis of **private consumption** reveals its moderate performance. Consumption continues to suffer from perceived uncertainty by Albanian families, leading to higher saving although aggregate revenues increased. **Private investment** slowed down in this period, but it retained positive growth rates.

This is supported by good performance of foreign direct investments, up by 38% during the second quarter, and higher import of capital goods, which suggest higher private investment in the economy. Nonetheless, this hike is conditioned by the fact that many businesses are operating below their production capacities, limiting their needs for new investments.

Monetary inflationary pressures remain controlled in the medium run. Annual growth of money supply, M3, which resulted 11.2% in July, retained the average rates recorded last year. Money demand was affected by a moderate upward private sector demand for funding. **Lending to private sector increased by 12.5% in July**, triggered by the relatively stable increase of lending to private businesses and resurgence of lending to households. Although the banking system has eased lending standards, the Bank of Albania deems that there is still room for further easing, especially as regards credit for private investments.

Developments in **financial markets** indicate downward risk premiums and liquidity. In the interbank market, trade volume expanded further and interest rates dropped, remaining close to the key rate and displaying low volatility. Moderate government demand for funding is reflected in refrained upward trend of government bill yields in the primary market. Additionally, the yields trend retained its trajectory, showing low inflation expectations by financial market agents.

At the end of H1 2011, the situation of the financial system and banking sector was stable. The banking sector, expanded its activity and broadened its share in the country's economy. Liquidity situation is good while the deposits by the public increased at satisfactory rates; they cover more than once the value of credits and borrowing from non-residents is low.

Data indicate that lending growth rate is improving, but the credit portfolio quality continued to drop. The banking sector retains stable growth rates of net interests revenue and gross operational profit.

However, tightened capital requirement to cover credit risk, led to lower net financial results of the banking sector compared to a year earlier. However, financial performance continues to be positive and concentrated. The capital adequacy ratio followed a downward trend, even though it remains clearly above the minimum level required by the regulatory framework.

Analysis of resilience to various shocks and risks indicates that credit risk is the primary source of banking sector risk. Furthermore, the banking system is more protected from direct market risks, but it continues to be exposed to the effect, on credit quality, of undesirable exchange rate and interest rates fluctuations. Therefore, in its supervisory capacity, the Bank of Albania requested commercial banks to timely and properly identify non-performing loans, establish relevant reserve funds and take determined action to recover loans through execution of collateral. These actions, combined with reduced operational costs, would establish gradually the conditions for a positive and stable financial position, which would support better the banking sector's need for capital.

In a shorter term, the Bank of Albania has requested the banking sector to strengthen activity capitalisation, through increased shareholders capital. The Bank of Albania has oriented and monitored this process closely, so that it takes place in compliance with the development strategy and relevant risks performance. The process to strengthen capitalisation indicators in the banking sector includes creation of adequate capital above the required minimum. The

process continues in line with specifications that the Bank of Albania has discussed and communicated with the banking sector. As a result of these measures, the banking sector would remain stable and establish conditions for its higher contribution to Albania's economic growth.

Our assessments on ***economic outlook*** suggest a continuation of economic growth for the rest of the year. Foreign demand and public sector demand continue to provide positive contribution to aggregate demand upsurge, although more moderately than a year earlier. Private sector demand remains an important factor to determine economic growth in the future.

Fiscal consolidation measures and the unfavourable situation in global markets and our trade partners will shift the short-term focus of economic growth to the internal demand: private consumption and investments.

The capacity of these aggregates to compensate for the slowdown of the two main promoters of the insofar growth, will condition Albania's economy performance over the upcoming 2–3 quarters. In the longer run, the performance of the Albanian economy shall be determined by its competitiveness and productivity as well as expansion of Albanian goods and services in foreign markets. This requires intensification of structural reforms at macro- and microeconomic level as well as financial and macroeconomic stability in the country.

Taking into account the information set out above, the Supervisory Council of the Bank of Albania deemed that inflationary pressures are downward and remain controlled in the medium run. Developments in the Albanian economy will continue to generate weak inflationary pressures, as a result of the negative output gap action. On the other hand, pressures generated by developments in global economy are expected to be downward. Economic agents' inflation expectations remain anchored around the Bank of Albania target.

At the conclusion of discussions, the Supervisory Council decided to cut the key interest rate by 0.25 percentage points, down to 5.00 per cent. This decision serves to comply with the inflation target in the medium run and provides the necessary monetary conditions to stimulate economic activity. The Bank of Albania remains heedful to future economic and financial developments, with a view to take the right steps for the fulfilment of its mandate.