

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, 25 January 2012.

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Today, on 25 January 2012, the Supervisory Council of the Bank of Albania reviewed and approved the quarterly Monetary Policy Report. Based on the analysis of Albania's latest economic and monetary developments and following discussions on their 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 rate for One Week Repurchase Agreement fell to 4.50%. The key rate is reduced under the conditions of contained inflationary pressures over the monetary policy horizon as well as expectations for a more prudent fiscal policy in the period ahead. The Supervisory Council deemed that this decision provides the appropriate monetary conditions to meet the inflation target over the medium run. Moreover, this movement increases the monetary stimulus and encourages the economic activity in Albania.

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

The Albanian economy faced challenges in 2011 as regards economic growth and maintaining of macroeconomic balances. Additional attention to public finance stability in euro-area countries is reflected in added risk premiums in international financial markets and reduced willingness to invest in emerging economies. Measures for addressing financial markets concerns have led to economic activity slowdown of our trade partners and are reflected in progressive deceleration of our exports growth rates.

Moreover, higher food, fuels and primary commodity prices are translated into stronger foreign inflationary pressures, expansion of trade deficit and, potentially, weaker domestic demand as a result of negative effects on Albanian households' financial balances.

Additionally, negative developments in the global arena are reflected in added uncertainties in the Albanian economy and negative impact on domestic consumption and investments. In spite of these shocks, the Albanian economy continued to grow in 2011, albeit at lower rates.

This growth has reflected structural improvements of the Albanian economy, overall sound balances of economic agents, as well as utilisation of available capacities for macroeconomic stimulus and success to maintain macroeconomic balances.

Average annual **inflation** in the second half of 2011 was 2.9%, down by 1.1 percentage points compared with the first half of 2011. Downward inflation emerged in the second quarter and was then reinforced during the second half of the year. This resulted from reduced contribution of processed food, unprocessed food, and administered prices. In particular, food prices deviated from their seasonal behaviour in December, producing rapid curbing of annual inflation to 1.7%.

From the macroeconomic perspective, the downward inflation was influenced by both demand and supply factors, at the same time. On the supply side, slowdown of primary commodities price inflation in global markets and relative stability of the exchange rate were materialised in lower imported inflation.

On the demand side, the below-potential growth of the Albanian economy continued to keep spare capacities in output factors – labour and capital – materialising in downward pressures on wages, output costs and inflation. Economic agents' expectations remain anchored around the Bank of Albania's target, owing to its reliable monetary policy, as well. Anchored

expectations in the economy have reduced the so-called second-round effects, in other words, transmission of temporary shocks from higher primary commodity prices in global markets and output costs and higher consumer prices at home. They have provided higher flexibility for the Bank of Albania to pursue its stimulating monetary policy. Overall, these tendencies are expected to continue in the period ahead.

Reduction of inflationary pressures in 2011 and expectations for low inflation rates during 2012, motivated further easing of the **monetary policy** in the fourth quarter of 2011. The Bank of Albania cut the key interest rate twice, namely in September and November, down to the historic low 4.75%.

The Bank of Albania holds that the monetary stimulus increase will provide suitable financial conditions for compliance with its medium-term inflation target.

Furthermore, eased monetary conditions serve to boost domestic demand, which remains fragile in the presence of higher uncertainties in the economy. In addition, it factorizes prudent fiscal policy for 2012 and expected curbing of public spending contribution to economic growth.

According to latest data from INSTAT, the Albanian economy posted 0.5% growth in the second quarter, apparently slower compared with growth rates in the first quarter.

By sector, economic growth, in this period, was sustained mainly by the positive performance of agriculture and individual branches of industry and services sectors. Value-added in agriculture was up 3.4%, providing significant contribution by this sector to the overall economic growth during the second quarter. On the other hand, the services sector's annual value-added was up by 1.8%, slowing down significantly from previous quarters' rates.

Transport and financial intermediation were the main drivers of this sector, whereas most of other branches of the services sector contracted, year on year. Likewise, the industry sector shrank by 8.5% in the second quarter, after its positive performance in the last six quarters. Industry sector deceleration during this quarter was largely influenced by slashed output in "Energy, water and gas", whereas extraction and processing industry continued their upward value-added. After its surge in the first quarter of 2011, the construction sector contracted again in the second quarter, posting annualised downgrade of 1.7%.

As regards aggregate demand, during the first half of the year, economic growth was supported mainly by the public sector and foreign demand contributions, whereas internal demand was lacklustre. Available data suggest that **private consumption and investments** were sluggish during the first half of the year, thus conditioning the below-potential growth of the economy during this period.

Private consumption continues to reflect consumers' reluctance to spend and their inclination to save. Domestic consumption has not totally reflected higher available income generated by higher wages and employment rates, or expansion of funding resources, in the form of consumer loan growth during 2011. In particular, remittances shortfall during the first nine months of the year may have lessened consumption for a part of Albanian households. In addition, relatively high import prices, which burdened Albanian households' budget in the first half of the year, may have impacted consumption negatively. Against this performance of consumption during the first half, improved balances for large purchases – as suggested by the consumer confidence survey – and more consumer loans granted during the second half, suggest for higher consumption in the third and fourth quarters of 2011.

Subdued consumer spending and presence of spare capacities in the economy dampened businesses' demand for **new investments**. In parallel, higher lending prudence by banks may have discouraged, in part, the demand for investment loans.

Foreign Direct Investments were down during the first quarter of the year. Higher capital expenditures in the last quarter are expected to generate higher contribution of this

component to aggregate demand at year-end. In the mean time, improved lending terms in 2012 are expected to be translated into higher support for the system with investment loans and higher contribution to economic growth by this component of aggregate demand.

Fiscal policy was stimulating in 2011, materialised in positive contribution of public spending to aggregate demand. Public spending and budget deficit growth rates moderated after the first quarter, settled at low levels in the second and third quarters, and recorded obvious acceleration in the last quarter of the year. At the end of November, budget deficit was ALL 38 billion, reflecting 5.4% public spending increase and 0.7% budget revenues increase during this period. Acceleration of annualised budget expenditures in the last two months of the year owes primarily to higher capital expenditures during this period.

Added prudence to fiscal stability, which characterises the 2012 budget, is expected to be reflected in lower contribution by the public sector to economic growth for 2012. Nonetheless, the Bank of Albania deems that this is an appropriate step to maintain macroeconomic stability and reduce risk premiums in the economy. Budget deficit narrowing in 2012 and its funding with domestic resources would generate more room for expansion of lending to the private sector in this period.

Albanian economy continued to benefit from **foreign demand** in 2011, though at more moderate levels than in 2010. Annual growth of Albanian exports in value for the first eleven months of the year was 19.9%, implying slower rates compared with the corresponding period of a year earlier. On the other hand, imports accelerated their annual growth to 12.2%. Trade deficit widened by 8.1%, year on year, largely illustrating negative effects of price rise in global markets. A more detailed analysis of the trade deficit reveals that about 50% of its increase is created by the balance of electric energy exchange.

Moreover, in real terms, according to third quarter's data, net exports deficit narrowed and contributed positively to aggregate demand.

Annualised contraction of net exports deficit is assessed to be resulting from imports of goods and services decline by about 4.2% in real terms and exports upsurge by about 8.6%.

Monetary indicators were in line with developments in the economy's real sector. Our analysis and assessments suggest that higher monetary supply is in accordance with economic agents' demand for real money, while monetary inflationary pressures in the economy are contained. Growth of M3 aggregate was slower in the second half of 2011, influenced by lower money creation in foreign currencies. During July–October, annual average growth of monetary assets in the economy was 10.4%. Contribution of private sector's demand for loans remained unchanged. At the end of November, its annualised growth was 10.9%. Crediting remains under the influence of low demand for loans and more prudent lending policies by banks. Economic agents' behaviour continues to be conditioned by uncertainty for the future, which, in turn, conditions spending and investments in the economy.

On the other hand, credit supply is tight, as lending standards performance shows.

Financial markets during the second half of 2011 were calm and reflected relatively downward premiums on liquidity risk and inflation. Successive key rate cuts were swiftly reflected in the interbank market. In the primary market, government security yields dropped, reflecting the key interest rate cut as well as the low demand of the public sector for loans. Moreover, transmission of monetary policy signals is expected to be extended fully to the deposits and loans market, in accordance with the transmission mechanism time lags.

The Bank of Albania deems that a good part of above-analysed tendencies would be present during 2012, as well. According to our core projections, the Albanian economy will continue to grow during the year ahead, albeit below its potential. The country's economic activity will be conditioned by the solution of the crisis in the euro-area countries, economic growth of partner countries, and foreign investor's attitude to risk.

On the other hand, economic challenges in our partner countries may be transformed into positive opportunities for the Albanian economy.

Albanian economy attractiveness with low unit labour costs, macroeconomic stability and financial soundness of businesses, households and the banking system may be reflected in more foreign direct investments. While our projections factorize lower foreign demand contribution, in baseline scenarios, the widening of Albanian exports market remains a potential scenario, as well. Economic growth projections presume positive consumption and investments growth at home, in response to improvement of lending terms. The latter are expected to reflect the eased monetary policy of the Bank of Albania and reduced risk premiums in the financial system. Moreover, reduction of room for fiscal stimulus and maintaining of stable fiscal parameters will enable the private sector to create spare funds and cut down risk premiums for the economy.

Factorising our expectations for below-potential economic growth and lower imported inflation, as well as in the presence of the economy's expectations on inflation around the target, our projections suggest that, with 90% probability, consumer price inflation will range 1–3% during 2012.

Taking into consideration the information set out above, in the Supervisory Council assessment, inflationary pressures remain controlled over the monetary policy relevant horizon. Moreover, economic agents' expectations on inflation remain anchored to the Bank of Albania's target band. At the conclusion of discussions, ***the Supervisory Council decided to cut the key interest rate by 0.25 percentage points to 4.50%. This decision serves to comply with the medium-term inflation target and provides the appropriate monetary conditions to stimulate Albania's economic activity.***

Monitoring the conformity of monetary conditions with its inflation target, in this development scenario, Bank of Albania's monetary policy is expected to continue to stimulate the economy over 2012.