

Ardian Fullani: Overview of Albania's recent economic and financial developments

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, on the Monetary Policy Decision-Making of the Bank of Albania's Supervisory Council, Tirana, 27 June 2012.

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Today, on 27 June 2012, 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 monetary developments, and following discussions on their performance outlook, the Supervisory Council of the Bank of Albania decided to keep the key interest rate unchanged at 4.25%.

The Supervisory Council deems that the monetary conditions are adequate to meet the inflation target in the period ahead, while they provide the needed monetary incentive to support the domestic demand.

Let me now proceed with an overview of the economic and monetary developments and key topics discussed at today's meeting.

Annual inflation marked 1.9% in May, continuing to pursue a gradual upward trajectory. Inflation rate in May was largely driven by the rise in food prices, whose performance triggered inflation's behaviour over the last two years. The impact of other commodities' basket on inflation remains stable and slightly volatile.

Within the macroeconomic context, the analysis of economic and financial developments reveals the lack of strong and sustainable inflationary pressures, which is reflected on the current low annual inflation rate. As aggregate demand increased below its potential, free production capacities were created in the economy, generating weak pressures on the increase in wages. Imported inflation remains moderated, owing to the contained performance of core commodity prices, the moderated inflation in Albania's trade partner countries and the stable exchange rate. Also, economic agents' inflation expectations remain low, administered prices provide a minimum effect, and monetary developments and liquidity in the economy are in line with the mid-term price stability.

Data available on the economic performance for the first five months of 2012 show that economic expansion slowed down. Estimations based on indirect, qualitative and quantitative data reveal a sluggish production sector in the first quarter of 2012, whereas services improved compared to the fourth quarter of 2011. On the demand-side, economic developments in this period show a moderated foreign demand and a sluggish domestic demand. The latter is determined by the weak performance of private sector's expenditures and investments, and the low fiscal stimulus.

January – May 2012 is characterised by a consolidating behaviour of **fiscal policy**.

Budget deficit decreased by 6.5% y-o-y during this period, reflecting the increase in budgeted revenues and expenses, by 2% and 0.8%, respectively. Notwithstanding the short-term reduction of fiscal stimulus, Bank of Albania deems as indispensable for the public sector to focus on consolidating and reducing public debt indicators. The implementation of this policy will provide short- and long-term benefits to the Albanian economy in the form of lower risk premiums in financial markets and more credit opportunities for the economy.

Foreign demand, the main source on the increased aggregate demand in the last two years, appeared moderated during the first four months of 2012. The relevant partial information,

obtained from the external trade data, shows a contraction of 4% in Albanian exports during the first months of year.

This contraction is largely driven by the reduced exports of electric energy. Excluding the latter, Albanian exports grew by about 7% y-o-y, albeit insufficient to maintain the growth paces during 2012. At the same time, imports shrank during the first four months of 2012, by 1.8% in nominal terms. These developments are materialised in a narrowed trade deficit in goods and services, by about 2.3% for this period. The narrowed trade and current account deficit are welcomed, particularly given the high fluctuation of global financial markets.

Monetary developments were in line with the performance of the real economy. Monetary supply rose by 8.3% y-o-y in April, about 0.5 p.p lower compared to March. This deceleration reflected the lower financing by banks to the government and the decelerated demand of the private sector for monetary assets.

Annual increase of credit to the private sector marked 8.1% in April. Given that uncertainties concerning the external and domestic macroeconomic developments augmented, private sector's demand for banking credit continues to fall. Households demand for consumer or mortgage loan shows weak, due to their increased propensity toward savings. Business demand for credit has been downward, due to the failure to utilise producing capacities in full and the uncertainties on the demand performance in future.

The banking system continues to be increasingly prudent regarding crediting, albeit its balance sheets remain completely sound and able to encourage credit growth at home.

The decelerated crediting is a known phenomenon within the context of global financial markets, and characterises the developments in all regional economies. Banking credit and foreign direct investments are the two main financing sources of private sector's long-term investments slowdown in Albania. In this light, the Bank of Albania deems that businesses and banking system have room for closer collaboration and better mutual understanding to support crediting.

Financial markets operated under liquidity terms and showed low interest rate fluctuation. Indicators related to soundness of the banking system are positive and stable, and adequate to enhance financial intermediation. Interest rates in the domestic currency trended downward in April and May, notably in inter-bank and deposits markets. This tendency was followed by increased inter-bank trading and lek deposits. On the other side, the relatively high yields rates of government Treasury bills, since the beginning of year, seem to considerably factorise structural changes in primary market and do not transmit added inflationary pressures.

In the light of the Bank of Albania's analysis on the expected fiscal and monetary developments, this trend may return in the second half of year, along with the improved demand and supply ratios for public sector securities.

Basic projections on the expected economic performance in the future continue to align with our previous estimations for an economic growth, but below its potential. Economic slowdown in Albania's trade partner countries is expected to impose a sluggish foreign demand during the rest of year. Given the lack of room for a substantial fiscal stimulus, the main drivers of domestic demand will be the consumption and private investment, which have shown few recovering signal so far. Overall, the expected economic developments at home and abroad are expected to condition a slow rise in consumption prices at home.

Real and monetary sectors convey low pressures on prices; also, inflation in global markets is expected to be low, whereas inflationary expectations are anchored.

The gradual subsiding supply shocks and the termination of base effects impact are expected to be followed by a slight rising inflation trend in the second half of year. At a high probability, consumer prices inflation is expected to remain below the target over the medium run. These circumstances, in the absence of unexpected shocks, encourage the further

maintaining and strengthening of the monetary policy's stimulating nature. The reconfirmed commitment of the government to continue the fiscal consolidation process even in the next review of budget, as well as the calmer situation in global markets, will pave the way to review the monetary policy position.

Based on the analysis of the information set out above, the Supervisory Council holds that inflationary pressures on consumption prices at home remain low over the monetary policy horizon. On the demand side, below-potential economic growth shall continue to generate low inflationary pressures. Also, supply-side pressures, both of external origin and generated by the macroeconomic environment at home, are expected to remain moderated. ***At the end of the discussions, the Supervisory Council decided to keep the key interest rate unchanged at 4.25%.***

The Supervisory Council remains committed to meet the main target of the Bank of Albania, to maintain price stability in the medium run.

Without jeopardising this target, the Supervisory Council remains vigilant and monitors carefully the macroeconomic and financial developments at home and abroad, to assess the monetary leverage for supporting the economic growth and maintaining the domestic and external equilibriums at home.