

## **Ardian Fullani: Overview of Albania's latest 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, 25 July 2012.

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Today, on 25 July 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 decrease the key interest rate by 0.25 percentage point, taking the one-week repurchase agreement rate to a new historical minimum of 4.0%. This decision reflects the Supervisory Council's opinion that the further eased monetary conditions in economy are adequate to meet the inflation target in the medium run.

Simultaneously, the eased monetary conditions will provide a further incentive to the economic activity at home, by increasing the monetary stimulus 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.

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During the first half of 2012, the Albanian economy continued to maintain the parameters of macroeconomic and financial stability, against an increasingly challenging global context. Consumer price inflation, budget deficit and public debt indicators, balance of payments and financial situation of the banking system were stable or improving.

In particular, the Albanian financial sector remains well-capitalised, liquid and able to conduct its intermediation role. During this period, the Albanian economy experienced some shocks on the supply side, with structural movements in the domestic financial markets, and a slowed domestic and foreign demand. These developments drove the fall in GDP in the first quarter of 2012 and made difficult the implementation of stabilising policies on the aggregate demand.

The Albanian economy is expected to record positive growth rates as tensions may be reduced in the second half of 2012.

**Average annual inflation** marked 1.9% in the second quarter of 2012, increasing by 0.8 percentage point compared to the first quarter of 2012.

The gradual rise in consumer prices has mainly reflected the increase in unprocessed food prices, whereas prices of processed foods and those of non-food consumer goods lowered their contribution to inflation during the second quarter of 2012. The other categories in consumer prices basket showed a serene performance, and were characterised by low inflation rates.

Within the **macroeconomic** context, consumer prices continue to reflect weak inflationary pressures, both on the supply and demand sides. On the demand side, the presence of free capacities in using the production factors is reflected in the costs control in economy and in declining pressures on inflation.

On the supply side, the slowdown of imported inflationary pressures, decrease in oil and basic materials prices, steady administered prices, low inflationary expectations and minimal second-round effects did not generate inflationary pressures. Consumer price inflation remains at low rates and is expected to maintain the same rate in the period ahead. These

estimations conditioned the retaining of the **stimulating nature of monetary policy** during the second quarter of 2012. The key rate stood at the lowest historical level, providing eased monetary conditions in order to meet our inflation target and support the Albania's economic activity. Also, the Bank of Albania has continued to inject sufficient liquidity demanded by the banking system, against an expanded collateral base and at adequate maturity terms.

According to recent data from INSTAT, the **Albanian economy** recorded an annual fall of 0.2% in the first quarter of 2012. Industry contracted 19.3% y-o-y, mainly due to the significant decrease in electrical energy output. Also, Construction decreased its activity in real terms, by 17.6%, thus providing a negative contribution to the performance of the gross domestic product. By contrast, Services contributed positively to the economic activity, pointing to an annual growth of 6.0%. Agricultural sector grew 4.5%, y-o-y during this period, providing a positive contribution to the growth of the gross domestic product.

Estimations on the **aggregate demand** in the first quarter of 2012 suggest a continuing weak domestic demand. The consolidated fiscal policy determined the lack of fiscal stimulus in this period and a downturn in public sector's demand for goods and services. Private consumption remains slow, thus reflecting the prudent consumer's behaviour and the increasing tendency for saving. Private investments also remained low. Given the free production capacity, Albanian businesses found less room to increase their investments in machineries & equipment, and production, while the demand for resident buildings remains weak.

At the same time, foreign demand was sluggish in the second quarter of 2012, owing to the problems in euro zone and in our main foreign trade partners. The weak foreign demand, and the problems in electrical energy production, imposed the slow increase of the Albanian exports.

Data on economy for the second quarter of 2012 are incomplete. Indirect data signal a weak recovery of the economy in this period. Their analysis supports the estimation for a continuing sluggish aggregate demand, especially of the domestic demand. On the production side, economic sectors are expected to maintain in the second quarter of 2012 the dynamic showed in the first quarter of 2012.

**Fiscal developments** in the second quarter of 2012 were in line with those observed in the first quarter of 2012, characterised by the consolidated fiscal policy and its inclination to maintain budget deficit and public debt targets. This behaviour is reflected in the contraction of budget expenses by 2.5% in the first half of 2012

Furthermore, fiscal revenues increased by 3.7% during this period, continuing to show a slow dynamic of their taxing component. The performance of public expenditure and income in the first half of 2012 is materialised at the significant contraction of budget deficit in annual terms, at 37.7%. This deficit was ALL 16.8 billion in monetary value, and is assessed at 2.6% of GDP.

Data on developments in **foreign trade of economy** reveal a contracted trade exchange in the first five months of 2012. Value of exports marked a low annual growth of 1.3% in this period, reflecting the moderation of foreign demand and price developments in global markets. In this period, imports shrank by 2.0% in annual terms. These developments resulted to a decreased trade deficit in the first five months of the year by the annualised rate of 4.2%. Developments in foreign trade were determined mostly by electrical energy trade exchanges in this period. Excluding this effect, the growth in exports would be higher and the contraction in imports deeper, resulting in a contracted trade deficit, at 18.1%.

The performance of **monetary indicators** was in line with the developments in the real economy and our analysis show contained monetary pressures on inflation. The annual growth of M3 was 8.7% in May, maintaining the average rates of the previous month of the current year. The growth paces of money supply slowed down compared to a year earlier, reflecting the lower demand of economic agents for money. The consolidated fiscal position

was coupled with a decrease of public sector borrowing, whereas private agents of economy reflected a low demand for financing. Lending to the private sector rose by 7.5% in May, pursuing the slowing trend, which has started since the end of previous year. Along with the low demand of businesses and households, its performance reflects the selective and prudent behaviour of banks in lending.

Regarding lending problems, the Bank of Albania deems that banking system's balances are sound, sufficiently liquid, and well capitalised to comply with the economy's demand for monetary assets.

The positive position of its balances triggered the lending growth during the past years, while many countries in our region experienced contraction of lending. The banking system has reviewed and tightened lending standards during the last years; this behaviour to enhance the financial discipline of the economy is welcomed and shall positively support the long-term growth of Albania. On the other side, credit performance is increasingly experiencing the lack of demand, which is triggered by the consumers and businesses reluctance to carry out expenses and investments.

Bank of Albania deems that, notwithstanding the cyclical situation of Albania's economy, the perspectives on medium and long-term development remain positive. This is reflected by the interest of foreign investors to increase their exposure toward the Albanian economy. In particular, economy sectors related to exports, tourism and agriculture, which serves to the domestic and regional markets, provide unused development potentials.

Bank of Albania deems that, within the sound business' logic parameters, the Albanian entrepreneurs and consumers have room for a more active approach toward the growth of investments and their consumption.

**Financial markets** showed low interest rate fluctuation and operated under sufficient liquidity terms in the second quarter of 2012. The transmission of reduced rates is also observable in lek deposits market, followed by normal growth pace of deposits. By contrast, government security yields increased in the primary market, particularly the long-term yields. This performance has reflected the re-positioning of some agents in this market and the demand for financing in this period, without implying a shift of inflationary pressures. At the beginning of July, ratios improved and borrowing costs were reduced in the primary market. The second quarter also transmitted signals on eased interest rates on ALL credits from banks. Nevertheless, credit-lending paces remain low and mainly designated for short-term use, leading to fluctuating interest rates.

The introduction of new financial intermediaries, specialised in channelling the public savings to government securities, was a positive development, worth mentioning in the analysis of financial markets for the first half of year. His development along with the increased public interest on government securities, enhances the deepness of our financial system, improves liquidity, enhances its risk management capability, limits the interest rates fluctuation, increases the Albanian public debt stability and provides pressures to reduce the financing cost of the public sector.

Verified performance of economic activity at home and the information filtered from indirect indicators have shifted downward our basic projections for the **economic performance for the rest of year**. This shift reflects the materialisation of some risks around the previous basic projections, being expected and factorised in our scenarios. The domestic economy is expected to slow down during the rest of year, being conditioned by the weakening of the domestic and foreign demand.

Given the consolidated fiscal behaviour and the slowed foreign demand, the performance of the private domestic demand will determine the economic activity growth. However, its two components, consumption and investments, have not shown any recovery signal so far.

Expected developments at home and abroad result in a contained balance of inflationary pressures, determining a slow increase in consumer price in the future. The demand growth

below the potential of the economy in the upcoming period will continue to exercise low inflationary pressures. At the same time, the pressures generated by supply-side factors appear contained. Based on the insofar developments of the determinant factors of inflation and the projections for their development in the future, with 90% probability, inflation will range within 1.0% – 3.3% band after 12 months.

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***Based on the analyses of the information set out above, the Supervisory Council holds that pressures on consumer prices at home remain low over the monetary policy relevant horizon; they have been, however, on the downside over the recent months.***

On the demand side, below-potential economic growth will continue to generate low inflationary pressures, while shocks from the supply side are expected to be moderate.

The expected developments in economy and inflation imply that the simulating nature of the monetary policy will be retained during the period ahead. The Bank of Albania remains heedful to future developments and new information, ready to respond in the appropriate time and extent in order to comply with its legal mission.

***At the conclusion of discussions, the Supervisory Council decided to decrease the key interest rate by 0.25 percentage point, at 4.0%.*** This decision aims to establish the appropriate monetary conditions to comply with the inflation target in the medium run. The monetary policy, also, provides the necessary support to simulate the aggregate demand.