

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, 26 September 2012.

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Today, on 26 September 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 4.0%. The Supervisory Council deems that the monetary conditions are adequate to meet the inflation target in the medium term and provide the needed monetary incentive to support domestic demand and economic growth.

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

Annual inflation in August was 2.8%, increasing 0.1 percentage points from July.

Inflation continues to be determined primarily by price rise of foods and oil. Prices of other goods of the basket appeared relatively stable and provided low contribution to headline inflation.

According to our estimates, inflation reflects mostly the temporary effect of supply factors related mainly to developments in global markets, as well as the possible structural movements in the internal market. Against this setting, the inflationary pressures originating from the domestic economy appear contained. Weak domestic demand and below-potential economic growth are reflected in slow increase in production costs, anchored inflation expectations and controlled monetary expansion. The Bank of Albania deems that, overall, these developments will continue to determine inflation's performance in the period ahead.

Indirect data on **economic performance** in the second and third quarters of the year suggest positive-but-slow economic growth. The Albanian economy has capitalised on the better performance of foreign demand and exports during this period, while domestic demand has remained weak.

In the absence of stimulus by the public sector, indirect data point to weak dynamics of consumption and private investments. Hence, consumers' higher prudence is reflected in lower consumption and higher savings by Albanian households.

As noted in earlier statements, this behaviour reflects to a large extent the correction of consumption levels noted in the economy until the end of 2008. All the same, in the context of the current situation in the economy and global financial markets, the consumers' reluctance to purchase durable goods reflects also their uncertainty about future developments. The Bank of Albania deems that the deceleration of consumption in response to uncertainties about the economic outlook may become a spiral with macroeconomic indicators having mutual influence between them. Contraction of consumption is associated with downward domestic demand, leading to subsequent slowdown of economic growth and lower household income. Our analyses and projections have continuously suggested that the macroeconomic situation and the Albanian economy have sustainable basis for long-term development. This reality should be translated into a more realistic behaviour towards higher consumption levels in the economy, within the boundaries of solid household budgets.

Likewise, private investments are considered as relatively low and conditioned by spare production capacities, expectations for ultimate demand for goods and services in the future, and added prudence by banks to lend. In particular, private sector's weak demand is also reflected in its low demand for loans in the recent months. In response to these developments, private sector credit continued to decelerate its annual growth rates to 5.5% in July. The Bank of Albania has continuously provided the required conditions to stimulate crediting. This approach is implemented by easing the monetary policy, injecting continuously liquidity into the banking system and establishing the proper supervisory and regulatory framework. These actions have led to relatively rapid growth of lek-denominated loans against foreign currency-denominated ones. Nonetheless, in our view, businesses may cooperate more closely with the banking system. On its side, the banking system should be more flexible and pay attention to macroeconomic and sectoral development perspectives, while businesses have investment opportunities in those branches of the economy whose potential is still unexploited.

The third component of aggregate demand, public expenditures, had low contribution to Albania's economic growth.

In the first eight months of the year, **fiscal policy** was consolidative. During this period, budget expenditures shrank 0.4%, year-on-year, due to lower growth rates of current expenditure and contraction of capital expenditure. During the first eight months of the year, fiscal revenues increased 3.7%, registering record-low growth rates. Prudent expenditure policies were materialised in budget deficit contraction. In January-August 2012, the deficit was about 29% lower than a year earlier, contributing to maintaining long-term fiscal stability. We deem that continuing to pursue this policy, oriented towards medium and long-term stability of public debt indicators, is necessary and productive given the current condition of financial markets.

Aggregate demand continued to support economic growth in the second quarter of 2012. Net export deficit narrowed 23.9% during this period, reflecting higher exports and lower imports than a year earlier. Foreign trade data reveal that the positive impulse is carried forward in July as well. Year-on-year, exports grew 11.6% during these months, whereas imports recorded low annual growth rates, namely 1.1%. These developments have led to trade deficit narrowing by 5.2%, year-on-year.

Monetary developments point to moderate monetary inflationary pressures on the economy. Money supply retained its expansion rates of earlier months, registering 8.4% annual growth in July. Its performance reflects the low demand of the domestic economy for monetary assets. The performance of **financial markets** has reflected the improved liquidity conditions, lower risk premiums and inflation situation in the economy. Interest rates in the interbank market went down, transmitting the most recent cut of the key rate in July. Additionally, yields in the primary market of government securities continued their descent. Further easing of monetary conditions is expected to be transmitted also to interest rates in other segments of the financial market, conform to the time lag of monetary policy transmission mechanism. In the improved context of domestic financial markets and in the presence of a sound banking system, the Bank of Albania expects that its earlier decisions to ease the monetary policy will be eventually transmitted in full to the economy.

Projections **for the economic outlook** are in line with the baseline scenario assessed in previous months.

Economic activity at home is expected to remain low, conditioned by weak consumption and private investments as well as limited space for fiscal stimulus. Consequently, inflationary pressures remain low and in check, reflected in the performance of inflation expected to range close to Bank of Albania's target.

At the end of the discussions, the Supervisory Council decided to keep the key interest rate unchanged at 4.0%.