

## **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, 30 January 2013.

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Today, on 30 January 2013, the Bank of Albania's Supervisory Council reviewed and approved the biannual Monetary Policy Statement. Based on the latest monetary and economic developments in Albania, and following the discussions on their future outlook, the Bank of Albania's Supervisory Council decided to lower the key interest rate by 0.25 percentage points. After this decision, the one-week repurchase agreement rate drops to new record-low level of 3.75%. The Supervisory Council deems that further easing of monetary conditions will help in meeting the inflation target in the medium term.

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

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The Albanian economy improved slightly in the second half of 2012. This performance was driven by a fuller reflection of monetary stimulus and improved external economic and financial environment. However, the economic activity remains below potential and the growth resources appear unstable. Production growth is not reflected in decreasing the overall uncertainties, which contain private investments and consumption, and lead to downward credit demand and supply. The banking system has sound and liquid balance sheets but it remains highly prudent in terms of financing long-term investments. These tendencies will condition the economic developments over the period ahead.

Inflationary pressures were low during the last quarters. Reflecting also the Bank of Albania's prudential monetary policy, inflation settled within its target in 2012. The increase in annual consumer prices was 2.4% at year-end, while the annual average inflation rate was 2%. The inflation rate increased progressively during the first three quarters and fell slightly during the fourth quarter.

Inflation volatility was mainly driven by food prices, which were affected by the international market and domestic production. The effect of other basket goods' prices on inflation was low and slightly volatile. Regulated or administered price inflation was insignificant, while higher prices for consumer goods, oil and primary commodities in the global market did not cause any higher inflation in the Albanian economy.

From the macroeconomic viewpoint, all determinants of inflation contributed to keeping it at low levels. The incomplete utilization of productive capacity was associated with businesses' low demand for labour, hence no pressures for increase in wages and labour costs. Also, the weak demand for goods and services reduced businesses' ability to dictate final product prices and affected low levels of profit margins. On the other hand, low increase in the global market prices and the exchange rate stability helped in keeping import prices in check. Finally, expectations for a low inflation in the medium term were reflected in stable costs, prices and interest rate in medium-term and long-term contracts concluded in the labour market, in consumer goods and financial instruments.

According to data from INSTAT, the Albanian economy grew by 2.7% in the third quarter of 2012, and similar growth rates are expected for the fourth quarter as well. Services, industry and agriculture sectors supported the economic growth, while the construction sector continued to contract.

Assessment of third-quarter and fourth-quarter aggregate demand components confirms, to a great extent, the expectations noticed from previous periods. Foreign demand has been

the main driver of economic growth in the country. Net export deficit narrowed in the third quarter of the year, mainly due to growth in exports of goods and services. Third-quarter data attest to continuation of this trend. During October-November, exports grew by 14.3%, while imports fell by 5% on a year earlier. As a consequence, trade deficit has dropped by 15.5%, y-o-y. On the other hand, the domestic demand has remained sluggish due to lack of fiscal stimulus and slow performance of consumption and private investments.

Indirect available data for the third quarter of the year depict improved consumption but low private investments due to incomplete capacity utilization on production, uncertainties about the future and tighter financing conditions. Fiscal indicators have reflected the overall performance of the economy and the fiscal consolidating policy pursued in 2012. Slow growth in budget revenue and expenditure, and budget deficit contraction characterise fiscal developments. Fiscal revenue for the first 11 months of the year increased by 2.0%, y-o-y, reflecting the low contribution of related taxable component. Public expenditure increased by 0.9%, y-o-y, mostly reflecting the negative growth rates of capital spending. As a result, the budget deficit of this period marked 8% annual decline.

The fourth quarter highlighted a better pass-through of monetary stimulus in financial markets. It was also characterised by a better anchoring of interbank market rates and their decreasing volatility. The Bank of Albania has pursued an easing monetary policy during the last three years. The monetary stimulus has increased progressively during this period, bringing the key interest rate to record low levels and mitigating the liquidity pressures on the interbank market.

However, the pass-through of easing monetary policy effects on the economy has been contained due to higher perceived risk premia and changed stance by financial market agents and the real economy. Over the first half of the year, the domestic primary market faced structural changes arising from implementation of new tight measures by the European Supervisory Authorities. This development impacted on maintaining relatively high yield rates, despite the easing monetary policy and lowering short-term interest rates in the money market. Normalisation of the primary market in the second half of the year was reflected in progressively falling yields over this period. This tendency might have been passed on to ALL-denominated private sector credit costs, though with lower intensity as a consequence of risk premia reflected in private agents' credit price. Overall, controlling the borrowing in the domestic money market, expanding the Government securities investment base and stabilising the risk premia in the economy create grounds for a better functioning of transmission channels in the future. Therefore, the Bank of Albania believes that the long-term public debt sustainability and public borrowing constraint in the domestic money market help enhance the monetary policy effectiveness and increase the space for the private sector credit of the economy.

Monetary indicators were characterised by slowing growth rates in the second half of the year. They signal low monetary inflation pressures on the economy. The annual monetary supply growth averaged 5.9% in October and November, supported primarily by developments in the external sector of the economy. Money demand by the domestic agents of the economy was low. The increase in households' participation in public debt securities was reflected in lower financing of this sector by the banking system. Businesses' and households' demand for funding decelerated significantly, reflecting the low demand for consumption and investments. Also, banks continued to pursue a more prudential approach in lending, applying tight standards in response to uncertainties perceived at sector level and the economy. Responding to them, annual growth of credit to economy reached 4% in November. Credit to economy was based on the 18% increase in ALL-denominated loans, against the 3.2% decline in foreign currency-denominated loans. Also, credit growth continued to be driven by increase in business loans, while consumer loans and home loans appeared rather low.

The so-far economic activity performance and projections for 2013 support the outlook for positive economic growth close to the previous year's figure. Foreign demand is expected to contribute positively to Albania's economic growth, but this contribution is expected to be lower due to unfavourable developments in trading partner countries and relatively low diversification of Albanian exports. Private demand is also expected to be positive, taking advantage of monetary stimulus growth and domestic savings utilization. Finally, the public sector is also expected to provide a positive stimulus. Despite the positive growth, the economic activity in Albania is expected to remain below its potential during the current year and the demand-side inflationary pressures are expected to remain low during this time horizon. The Bank of Albania deems that with a 90% probability, the annual inflation as to four quarters ahead is forecasted to fluctuate within the 0.8 – 3.8% band. Low annual inflation rates and forecast for their continuation over the monetary policy time horizon dictate the maintaining and strengthening of the stimulating monetary policy over the next four quarters.

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Considering the information summarised above, the Supervisory Council deems that consumer price pressures in Albania remain weak along the monetary policy time horizon and have shifted downward during the last months. **Concluding, the Supervisory Council decided to lower the key interest rate by 0.25 percentage points, to 3.75%.** This decision aims to create appropriate monetary conditions to meet the medium-term inflation target. The easing of monetary conditions keeps the short-term financial market interest rates low, encouraging the activity and decreasing the related liquidity trading premia. By lowering the financing costs, the Bank of Albania aims to increase consumer loans and investments in the economy. This transmission mechanism promotes the aggregate demand, and under current circumstances, creates appropriate conditions for meeting the medium-term inflation target.