Ardian Fullani: Overview of recent economic developments in Albania

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 September 2013.

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Today, on 25 September 2013, the Supervisory Council of the Bank of Albania reviewed and approved the monthly Monetary Policy Report. Based on the most recent economic and monetary developments in Albania, and following the discussions on their outlook, the Supervisory Council of the Bank of Albania decided ***to keep the key interest rate unchanged, at 3.5%.***

The Council notes that the inflationary pressures from the real and financial sector of the economy are weak and will remain so. This setting requires persistence of the stimulating monetary policy in the period ahead.

The monetary stimulus, transmitted through the low key interest rate and continuous injection of liquidity, provides the required conditions for meeting our inflation target in the medium-term period.

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

According to INSTAT's data, ***annual inflation*** fell to 1.2% in August. The rapid fall in inflation over the past two months was mainly attributable to the low rise in food prices, and particularly in seasonal food prices. The negative inflation of non-food consumables and housing prices also drove annual inflation down. Similar to the previous months, the inflation of other basket items' goods and services remained low and positive.

Despite the generally weak inflationary pressures, the Supervisory Council notes that the low inflation rates of the past two months were driven by ***transitory supply-side factors***.

The analysis of ***macroeconomic factors*** suggests that the contained consumer prices continue to reflect, to a large extent, the low demand in the economy and the negative output gap. The low capacity utilisation rates have subdued the rise in wages, producer prices and profit margins. Imported inflation has also been low due to the low inflation rates in Albania's trading partners and the stable exchange rate. Lastly, the performance of liquidity and inflation expectations is in line with the low inflation rate.

There is scarce new information about developments in the real economy in the second and third quarter of 2013. The analysis of available indirect data signals positive, albeit low, growth.

Unlike the previous quarters, the public sector was the main driver of aggregate demand growth in the second quarter, whereas net exports made a slightly negative contribution. Private sector demand remains weak, signalling sluggish consumption growth and contracted investments.

The performance of budget indicators reflected the expansionary fiscal policy pursued in the first half of 2013. As at August, budget expenditures were 9.2% higher than a year earlier, considerably due to the increase in capital spending. On the other hand, revenues performed poorly, registering an annual decrease of 3.8%, which materialised into the budget deficit being around 1.3 times higher than a year earlier. The higher deficit is reflected in the further increase in public debt-to-GDP ratio to 63.5% at the end of the second quarter.

The Supervisory Council notes that the adoption of a fiscal rule, which would effectively and transparently support the public debt sustainability, would be the right step toward lower risk premia and long-term fiscal policy discipline. The fiscal rule would also establish a consistent framework for drafting medium-term paths of budget expenditure and deficit, allowing in turn the simultaneous fulfilment of the cyclical needs of the economy and the long-term objective for fiscal stability.

Data on the ***external sector of the economy*** point to the negative contribution of external demand to economic growth in the second quarter of 2013, due to the increase in net export deficit by 1.5% over the same quarter. On the other hand, July data show that the trade deficit shrank 14.6% in nominal terms, driven primarily by the high annual increase in exports by 23.9%. Despite the short-term volatility, the external position of the Albanian economy remains one of its structural weaknesses. It reflects both the low competitiveness of Albanian products in the global markets and the need for better long-term balance between savings and investments in the economy.

The financial markets saw downward inflation and liquidity risk premia, and fuller transmission of key rate cuts to different market segments. Interbank rates stood close to the key interest rate and showed low volatility. Government security yields in the primary market dropped rapidly across all maturities, particularly on those with a longer maturity, hence smoothing the yield curve slope. Interest rates on deposits decreased as well, whereas those on lek loans continued to show little response to the Bank of Albania's monetary stimulus. The full transmission of monetary policy signals to the credit market was subdued by the presence of high default risk premia, and banks and businesses' low risk appetite. Consequently, lending to the private sector shrank 1.5% in annual terms, due to some balance sheet adjustments in individual banks, poor performance of lending to households and contraction in corporate lending.

New available information keeps our baseline projections for the ***economic outlook*** unchanged. The Albanian economy is expected to record low and positive growth rates, albeit substantially below potential. In the absence of room for stable fiscal stimulus, the growth of aggregate demand in the short-term period is expected to be driven by the external demand. In the long run, the magnitude of economic growth will be determined by the performance of consumption and private investments. Below-potential growth will give rise to weak demand-side inflationary pressures. Supply-side pressures will also be subdued in the period ahead. In the absence of unexpected supply-side shocks, annual inflation is expected to be low in the quarters ahead.

At the end of discussions, the Supervisory Council decided to keep the key interest rate unchanged, at 3.5%. The Council notes that the current monetary conditions are appropriate to ensure our inflation target is met in the medium-term period, providing at the same time proper monetary stimulus to recover private demand. In particular, the rapid drop in the yields over the past month reflects the low key interest rate, low inflation expectations and the reduced Government borrowing from the domestic markets. The drop in the yields, in turn, provides room for lower rates on private sector credit. The projection of a similar setting for the future would allow better monetary policy transmission to the economy.