

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, 29 January 2014.

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Today, on 29 January 2014, the Supervisory Council of the Bank of Albania reviewed and approved the Monetary Policy Statement of the Bank of Albania on the second half of 2013. Given Albania's latest monetary and economic developments and discussions on their outlook, the Supervisory Council of the Bank of Albania decided to keep the key interest rate unchanged, at 3.0%.

The Supervisory Council deems that the inflationary pressures from the real and financial sectors of the economy are weak and will remain so. These circumstances require maintaining a stimulating monetary policy over the period ahead. The monetary stimulus, transmitted through the low key interest rate and ongoing liquidity injection, provides the proper conditions for meeting our inflation target in the medium term.

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

Year 2013 was a difficult one for the Albanian economy. Aggregate demand and economic growth remained at low levels; inflation fluctuated around Bank of Albania's lower targeted band, while the budget deficit and public debt increased sharply. The unfavourable economic environment, both at home and abroad, led to this performance. Moreover, Albania's June parliamentary elections added uncertainties to the economy and financial markets. As we have already stated, consumption and investments continue to suffer from low confidence and tight lending terms. Fiscal policy is faced with a high public debt level, which has limited the possibilities for macroeconomic stimulus. On the other hand, the external environment was characterised by ongoing euro-area problems, hence limiting our export growth and making financial markets pursue conservative policies in terms of lending to developing economies.

However, 2013 saw positive developments. Financial markets were characterised by improved liquidity and downward interest rates, in response to Bank of Albania's easing monetary policy. Also, introducing new financial agents and instruments has further deepened these markets. The banking system remains solid and well-capitalised, regardless of increase in non-performing loans. The current account deficit has dropped, creating better premises for a sustainable external position of the economy and stable exchange rate. These developments have contributed to maintaining macroeconomic stability.

Analysing the specific developments in the second half of 2013, the official data show a slowing economic activity and a sustained downtrend in inflation.

Average annual inflation reached 1.5% in the fourth quarter, remaining unchanged from the third quarter. In December, inflation rate edged up to 1.9%, almost entirely due to higher prices of foods, particularly unprocessed foods. Prices of other CPI basket items were generally stable and affected slightly on inflation.

From the macroeconomic viewpoint, the low inflation rate was determined by the sluggish aggregate demand, lower imported inflation and subdued inflation trends.

Third-quarter gross domestic product dropped 2.3%, driven heavily by short-term shocks arising from full fiscal stimulus withdrawal and post-election uncertainties, which impacted

negatively on consumption, investments and tourism over this period. Excluding agriculture, the other sectors of the economy dropped, in annual terms.

All the aggregate demand components performed poorly over the second half of the year. Private consumption was at low levels, reflecting the low consumer confidence and the decelerated income growth. The low inflation rates contributed to maintaining the savings value. However, Albanian households continue to show a cautious behaviour toward consumption. Also, private investments deepened the downtrend in the second half of the year. The performance of this component has reflected the lower final demand, the boosted uncertainty and the tight bank lending terms. Periodic surveys report that the financial position of businesses remains difficult and this restrains their ability to invest.

Fiscal policy was stimulating in 2013, mainly concentrated in the first half of the year. The fiscal stimulus is carried out by increasing spending and reducing taxes. The latest fiscal data are as of November 2013. During the first 11 months of the year, the budget deficit increased 71.5% in annual terms, budget spending increased 4.7%, while fiscal revenues dropped 3.1%. The revenue drop was due to easing tax policy and poor economic performance. Fiscal developments in 2013 worsened the public debt dynamics. This debt tends to increase over the periods of economic slowdown, in response to fiscal counter-cyclical policies and the impact of automatic stabilisers. However, given the essential role of fiscal sustainability in the overall economic and financial stability, and the high level of Albania's public debt, the Bank of Albania has requested and supported the taking of measures to control and reduce this debt in the medium term.

In this context, we reiterate our message for anchoring this process to a fiscal rule, which will orient the fiscal policy in the long term, and will be reliable and transparent for all Albanian and foreign economic agents.

Developments in the external sector of the economy signalled a sluggish foreign demand in the third quarter of the year. Though trade deficit dropped, the external sector impacted negatively on the economic growth due to lower tourism revenues. In October and November, the external trade data show ongoing annual nominal contraction of the trade deficit, at 11.9%. This contraction was due to increase in exports by 12.0% and decrease in imports by 2.0%, over this period. The Albanian economy's capacity to maintain and speed up the positive export growth rates will determine the country's medium-term and long-term economic growth. In the medium term, increasing exports helps offset the domestic demand sluggishness, while in the long term, increasing competitiveness of the Albanian economy in the world markets should be to the core of Albania's new economic growth model.

The low demand for consumption and investment, and the banks' conservative lending policies, have slowed the monetary indicators. The increase in the money supply slowed down to about 2.5% in October and November due to private sector's lower demand for funding. Lending to economy continued to contract and in November, it was 2.4% lower than a year ago.

The above monetary and economic dynamics has exerted weak inflationary pressures. The low aggregate demand has expanded the negative output gap. The labour market pressures have been subdued against a setting of unchanged unemployment rate, moderate wages, and partially-used capacities. These developments have affected the control on output costs and profit margins, and are reflected in low core inflation rates over this period.

Also, imported inflation has been downward due to lower primary commodity prices in the international market and stable exchange rate.

Based on the economic outlook and aiming to encourage aggregate demand, the Bank of Albania lowered the key interest rate by 0.5 percentage points, at 3.0% in the fourth quarter. Also, Bank of Albania's monetary policy decisions are associated with ongoing liquidity injections and orientations toward the future monetary policy stance. This policy has

managed to keep liquidity premia and inflation in check, by contributing to lowering the interest rates in the interbank, government debt security, lek loan and deposit markets.

However, the lek loan price has not fully reflected our monetary policy, indicating the presence of high risk premia and containing the monetary stimulus transmission to the economy. These risk premia are also reflected in other lending terms, unrelated to the loan price, and appear tighter as compared to their historical performance.

Under the Bank of Albania's baseline scenario, the economy will improve slightly during the current year. Increase in exports and a better performance of consumption and investments will continue to support the aggregate demand. The monetary policy will support the domestic demand, by maintaining macroeconomic stability and ongoing injection of monetary stimulus in the economy. Also, payment of arrears will help improve the balance sheets of firms and the private sector, and is expected to improve business borrowing. Excluding the payment of arrears, the 2014 budget has projected a fiscal adjustment needed against the backdrop of a rapidly increased public debt. Reflecting the weak economic and monetary dynamics in the country, inflationary pressures are expected to be weak.

After four quarters, inflation is expected to vary 0.7%–3.8%, with a 90% probability of occurrence. This will require maintaining a stimulating monetary policy even in the medium term.

At the end of discussions, the Supervisory Council decided to keep the key interest rate unchanged, at 3.0%. Given the expected inflation developments, the Supervisory Council deems that the monetary policy will remain stimulating in the medium term. The monetary stimulus intensity may increase further over the periods ahead, in the event the economic and monetary developments continue to shift the balance of the downside inflation risks. In any case, the Bank of Albania remains determined to ensure price stability, in accordance with its inflation target.

The Bank of Albania deems that 2014 will be a turning point for the Albanian economy. Maintaining financial and economic stability, improving external environment, pursuing stimulating macroeconomic policies and continuing structural reforms would open the way to Albania's stable and long-term development.