

Ardian Fullani: Overview of Albania's latest monetary and economic developments and outlook

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, on the Monetary Policy Decision of the Bank of Albania's Supervisory Council, Tirana, 30 April 2014.

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Today, on April 30, 2014, the Supervisory Council of the Bank of Albania considered and approved the Quarterly Monetary Policy Report. 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 main interest rate unchanged, at 2.75%.

The Council deems that inflationary pressures on the economy remain subdued. Under these circumstances, the monetary policy will continue to be stimulating in the period ahead, which will provide the necessary monetary conditions for compliance with our inflation target in the medium run.

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

Data for the first quarter of 2014 are generally in line with our previous assessments of the Albanian economy and financial situation. Weak aggregate demand continues to characterise the economy, further impacting almost all the economic and financial parameters in the country. In response to the weak aggregate demand, economic growth remains low and the Albanian economy continues to operate below its potential.

The spare production capacities, both in the labour and capital markets, are reflected in low increase of employment and production costs, followed by weak inflationary pressures. From the financial point of view, the weak economic growth puts upward pressure on the budget deficit and public debt, and creates financial difficulties for businesses. These difficulties are reflected in higher non-performing loans in the economy, and negatively affect the banks' willingness to lend.

Such problems have been and continue to be present in the Albanian economy. However, new information signals that 2014 may be a turning point for the economic activity in Albania. The economic growth indices, businesses' perception and financial markets performance improved faster than our expectations. Such a development, combined with the expected improvement in the world economic outlook, subdued uncertainties, improved business climate at home, implementation of stimulating macroeconomic policies, and acceleration of structural reforms, signals that the Albanian economy may gradually improve in the quarters ahead.

The current risks to this scenario will remain present. In the following, I will dwell longer in describing the expected developments and related risks, while trying to highlight the policies that need to be implemented in order to avoid such risks.

Annual inflation averaged 1.9% during the first quarter of 2014; this is upward compared to the rate recorded in the previous quarter. The annual rate of inflation was 2.2% in March, returning within the Bank of Albania's target band. The performance of inflation during the first quarter of 2014 was largely determined by the prices of unprocessed foods. Prices of other items in the basket of goods were generally stable, providing a minimal contribution to annual inflation.

From the macroeconomic point of view, the simultaneous action of weak inflationary pressures by the domestic economy, downward imported inflation and anchored inflation expectations led to low inflation rates. The domestic economic and monetary environment has put downward pressures on prices. Owing to the fragile aggregate demand, the negative output gap persisted, despite the growth recovery in the fourth quarter of 2013. Pressures

from the labour market were subdued because of the rise in unemployment rate during 2013 and the moderate rise in wages. These developments led to a low increase of production cost and controlled businesses' profit margins. The weak domestic demand narrowed the room for businesses to pass the increase in excise duty on the final prices. Also, the imported inflation has been downward, reflecting the low inflation in our trading partners and the stability of the exchange rate. Economic and financial agents show anchored inflation expectations, with no considerable deviation from either the objective of the Bank of Albania or the average historical behaviour.

Analysing the economic performance, INSTAT data show that the gross domestic product increased by 1.1% during the fourth quarter of 2013, after a decrease by 2.5% in the third quarter of 2013. This increase was broadly determined by positive performance of domestic private demand, while the contribution of the public sector and net exports was negative. From the sectorial point of view, economic growth was generated by the positive performance of production, whereas services declined.

Aggregate demand continues to be negatively affected by the difficulties of our main trading partners, low confidence of Albanian businesses and households, tightened financing conditions. However, the domestic private demand increased in the fourth quarter, after decreasing a quarter earlier. Indirect indicators suggest that developments in private investments were positive in the fourth quarter, while final consumption by the population continued to be weak. As previously stated, the Bank of Albania maintains that developments in both components of the aggregate demand will dictate the economy's performance in the short and medium term. In this regard, we deem that the expected improvement in financing conditions and balance sheets, due to the payment of fiscal arrears, and the reduction of uncertainties will provide the needed incentives for a better performance in the forthcoming quarters. Nonetheless, the recovery of consumption and private investments will require a more courageous behaviour and higher risk taking willingness by economic agents.

Developments in the external sector signal a negative contribution from net exports during the last quarter of the year. Net exports deficit expanded, as imports increased in the fourth quarter. In January and February, the trade deficit marked an annual increase of 6.7% due to the increase in import of goods and the growth rate moderation in exports. The ability of the Albanian economy to maintain the stable pace of growth for exports and diversify the base of exported goods will be a primary factor for providing medium and long-term economic growth in Albania. In the long term, increase in competitiveness of the Albanian economy, diversification of growth sources, and integration in the regional and global markets will be prerequisites for sustainable economic growth. The Bank of Albania, therefore, supports pressing ahead with priority structural reforms in the export and import-competing sectors.

Fiscal behaviour in the first quarter was characterised by shrinking budget deficit and public spending. During this period, budget deficit decreased by about 57%, in annual terms, reflecting an increase of about 8.2% in budget revenues and a shrinking of about 2.4% in public spending. Albeit showing a higher intensity than our expectations, it is in line with the corrective fiscal policy to be pursued during 2014. Fiscal consolidation is expected to be more rapid on the revenue side, supported by a new fiscal package and a commitment for reducing fiscal evasion. Meanwhile, the clearance of arrears to businesses is expected to improve their financial situation and support economic activity in Albania.

Consistent with our previous messages, we support the corrective direction of fiscal policy, and consider this correction as an indispensable step toward improving macroeconomic balances in Albania. The implementation of a corrective fiscal policy has provided more room and opportunities for implementing a stimulating monetary policy to sustain aggregate demand and maintain our inflation target. The Bank of Albania has confidently moved in this direction.

Based on the economic outlook, and aiming at further boosting the aggregate demand, the Bank of Albania cut the key interest rate by 0.25 percentage points to 2.75%, in the first

quarter of the current year. This cut followed the previous monetary policy easing in the second half of 2013. To strengthen and better transmit the monetary stimulus, the Bank of Albania's monetary policy decisions were accompanied by continued liquidity injections and public guidance on the monetary policy direction in the near future. Our monetary policy has managed to control the inflation expectations of economic agents, keeping them anchored to our target. It has also mitigated the liquidity risk and inflation premia in financial markets, contributing to lowering interest rates in the interbank market, government debt securities market, deposit market and lek credit market. However, its transmission to higher lending activity remains incomplete. Interest on lek-denominated loans factors in the relatively high risk premia. Moreover, banks remain considerably conservative in terms of lending, by tightening the applied standards. This development reflects the financial terms in the euro area and the uncertainty perceived by financial agents in the domestic market. It is an impediment to the transmission mechanism and illustrates the need for reducing risk and improving the business climate in the economy. This commitment should be the scope of work for both public and private economic agents.

Along with the conservative policies, lending continues to be affected by lack of demand for funds by businesses and consumers. The poor credit performance, particularly as regards lending in foreign currency and credit to businesses was translated into an annual shrinkage of 2% in the loan portfolio in February.

Looking ahead, our baseline projections suggest that, after a weak performance in 2013, the trajectory of the Albanian economy will be upward in the medium-term horizon. Economic growth is expected to be more balanced during 2014, driven by both the domestic and external demand. The improvement of confidence climate will enable the real sector to benefit from the monetary stimulus, hence stimulating consumption and investments at home. Also, sustainable recovery of the world economy will sustain Albanian exports, particularly during the second half of the year. Economic growth will be supported by maintaining the current stimulating direction of economic policies, and will benefit from continuing structural reforms. This trajectory will bring the Albanian economy close to its potential and will establish the conditions for complying with the inflation target in the medium term.

In the short term, the cyclical weakness of aggregate demand is expected to keep the economy below its potential and will be accompanied with weak inflationary pressures. With 90% probability of occurrence, four quarters ahead, inflation is expected to range between 0.5% – 3.9%.

At the end of discussions, the Supervisory Council decided to keep the key interest rate unchanged, at 2.75%. Taking into account the available information, our projections, force of action of the monetary policy transmission mechanism and other financial stability considerations, the Bank of Albania deems that the monetary policy will maintain a similar stimulating direction and range within similar parameters, over the medium term.