

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 May 2014.

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Today, on 30 May 2014, the Supervisory Council of the Bank of Albania reviewed and approved the monthly Monetary Policy Report. After discussing the recent economic and monetary developments and their outlook, the Supervisory Council decided to lower the key interest rate by 0.25 percentage point, to 2.50%.

The key rate decrease aims at creating more favourable conditions for inflation to return to our target in the medium term. The decision reflects our assessment and projections for low inflationary pressures in the quarters ahead, in response to the weak aggregate demand and the downward trend of inflation in Albania's trading partners. This move contributes to boosting domestic consumption and investments, aiming at a fuller utilization of production capacities and a faster return of inflation to our target.

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

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Annual inflation rate was 1.7% in April, slightly down from the average rate recorded in the first quarter of 2014. In the last months, the dynamics of inflation have been largely determined by the performance of food prices. The added volatility of inflation for these items, over the past months was in response to structural changes in the domestic market and the downward trend of inflation in regional markets. Prices of other items in the basket continued to give low contributions.

In spite of the volatility, medium-term inflation trends remain clear. The overall economic and monetary environment is characterised by weak inflationary pressures, reflected, in turn, in low core inflation rates. The analysis of macroeconomic factors shows that aggregate demand remains weak, maintaining economic activity below its potential level. The unutilized productive capacity led to low increases in employment, wages and production costs. Supply-side inflationary pressures remain weak, owing to the downward inflation in our trading partners, low primary commodity prices and stable exchange rate. Inflation expectations remain subdued and close to Bank of Albania's inflation target.

Regarding economic activity, recent data corroborate our earlier assessments for positive growth rates in the first months of the current year. Aggregate demand increased due to the positive performance of domestic private demand, while the public sector's contribution was negative. Foreign demand continued to grow, as reflected in export growth.

Consumption and private investments increased in the first three months of 2014, though at lower pace than in the fourth quarter of 2013. Their performance remained sluggish, reflecting the uncertainties of economic agents and tight financing conditions. The recovery in these components of demand will be a determining factor for the country's economic growth in 2014. Today's key interest rate cut aims at providing a further boost to consumption and private investments, creating premises for lower financing costs in the banking sector.

Data on **public sector** performance refer to the first four months of the current year. Revenues increased 9.1%, in annual terms, while spending shrank 5.9%. This performance materialised in the budget deficit of about 73.1% lower than a year earlier. A similar dynamics, though less intensive, is expected to persist in the months ahead. Consistently,

the Bank of Albania has been in favour and has endorsed the consolidation path of fiscal policy, deeming that such policy contributes to the reduction of risks in the economy.

Developments in the **external sector** led to an annual expansion of the trade deficit by 8.7%, during the first quarter of 2014. Albanian exports grew 11.6%; yet, the trade deficit expansion was determined by a 10.1% annual increase in imports. A more detailed analysis of trade developments shows that trade deficit expansion was attributed almost entirely to the increase in electrical energy imports. Albanian exports' growth, however, was driven by the gradual improvement of foreign demand and depreciation of the real exchange rate over the past years. A steady improvement in this area should be anchored in structural reforms supporting the increase in productivity, development of Albania's comparative advantages and reduction of vulnerabilities in certain sectors of the economy.

Forecasts for a low inflation level in the period ahead have dictated the implementation of an accommodative **monetary policy** in the last quarters. The policy rate cuts have already been passed through to interest rates in the interbank and deposits market, and to most of government securities' yields. Interest rates on loans have also reflected the expansionary stance of the monetary policy of the Bank of Albania, but they continue to contain high risk premiums for credit risk and other risks related to long-term investment. The slow performance of the economy is also reflected in the **monetary indicators**. Money supply continued to increase at low annual rates, standing at 2.1% in March. This performance has reflected the decrease in credit to the private sector and the lower financing needs of the public sector. Credit to the private sector shrank 2.4% in March. Besides the weak demand from businesses and households, the sluggish performance of credit reflects the banks' conservative lending policies. This approach is reflected not only in the interest rates on loans, but also in other lending standards applied by the banking system.

In this regard, the Bank of Albania deems that the banking system in Albania has room for and should adopt a more appropriate behaviour towards crediting the Albanian economy. The country's economic and financial reality, on-going monetary policy easing and our liquidity-injection operations, as well as the adaptation of our regulations to the market situation provide the premises for faster crediting to the economy.

Consisting in financial institutions licenced to facilitate movement of funds in the economy, the banking system should be more active in crediting, as the steady growth of the economy is a prerequisite for the sustainable growth of the banking system itself.

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The Supervisory Council concluded that the incoming available information does not alter our baseline projections on the country's economic activity. The economy is expected to record a gradual growth in the quarters ahead, driven by foreign demand and domestic private demand. The output gap will remain negative during 2014, though the gap is expected to narrow. The price performance will continue to be contained and inflation is expected to gradually approach the target. Recent information, however, reinforces our judgement for subdued inflationary pressures in the period ahead, keeping the balance of risks on the downside.

At the end of the discussions, the Supervisory Council decided to lower the key interest rate by 0.25 percentage points, to 2.50%. This further easing of monetary conditions is expected to facilitate a faster return of inflation to the 3% target of the Bank of Albania.