

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, 25 June 2014.

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The Supervisory Council of the Bank of Albania reviewed and approved today 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 decided to keep the key interest rate unchanged, at 2.50%. The Council considers that the gradual transmission of earlier interest rate cuts to the financial markets will provide adequate monetary conditions for inflation to return to target over the medium term.

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

Annual inflation rate was 1.6% in May, slightly down from the previous month. Inflation fell due to the reduction of health care prices, while prices of other items in the basket recorded low volatility. As with previous months, annual inflation continues to be determined by unprocessed food prices, which contribute around 88% to its final rate.

From the **macroeconomic** perspective, the performance of consumer prices continues to reflect weak inflationary pressures, both from the domestic economy and the external sector. The negative output gap does not favour an increase in employment and wages, leading thus to a low increase of other production costs. Imported inflationary pressures remain subdued; inflation in Albania's trading partners and the rise in commodity prices are at low levels, while the exchange rate is stable. Inflation expectations and the liquidity situation in the economy are in line with the low inflation rates for the period ahead.

Indirect available data on **economic activity** signal for positive growth rates in the first months of the year. Aggregate demand improved, driven by both private domestic and foreign demand, while the consolidating fiscal policy pursued during this period did not contribute to an increase in demand.

Incoming data for June have not changed our assessment on the performance of **private consumption and investments**. While these important components of aggregate demand were upward during the period, their performance remains weak. Their steady recovery continues to be impeded by uncertainties faced by households and businesses and reflected in the greater risk aversion of the real and financial sectors of the economy. The Bank of Albania expects further improvement in private consumption and investments for the rest of the year, reflecting, among others, its easing monetary policy. The pace of recovery of these two indicators will determine the short and medium-term dynamics of the country's development.

Data on public sector performance show a consolidating **fiscal policy** over the first five months of the year. This policy materialised in a budget deficit of about 68% lower than the previous year. The tightening fiscal policy is evident both on the revenue and expenditure side. Fiscal revenues increased 9.0% in annual terms, while budget expenditures were 7.5% lower than the previous year. Our monetary policy easing has also taken into account this feature of fiscal policy that the Bank of Albania has urged and supported. However, the Bank of Albania would like to bring to attention the need for a more uniform distribution of expenditures and budget deficit over the year, to enhance their effectiveness and avoid the fluctuations that their excessive concentration may cause to the country's economic and financial indicators.

The improved **foreign demand** and positive dynamic of some sectors of the economy were reflected in an increase in annual exports by 10.3% in April. The detailed analysis of trade data reveals encouraging signals about re-exporting and agricultural activities. Trade deficit, however, expanded 1.8% in April, due to the simultaneous increase of imports by 6.0%. In particular, the energy situation continues to burden the trade balance of the country due to high levels of energy imports. Structural improvements to the economy and a more favourable external environment would pave the way for a faster growth of Albanian exports. The Bank of Albania considers this channel as the most appropriate tool to support the country's sustainable growth in the medium and long term.

Projections for low annual inflation rates, against the backdrop of below-potential economic growth, have dictated the pursuit of an easing monetary policy by the Bank of Albania. At the end of May, monetary stimulus was strengthened by a further cut in the key interest rate. Available information on financial markets shows that this cut has been fully transmitted to the interbank and government securities markets. It was also reflected in lower financing costs of the banking system, creating, in turn, premises for the transmission of stimulus to the lending interest rates and further to the economy. The Bank of Albania calls on the banking system to comply with this important link of the transmission mechanism.

Despite the easing of monetary conditions, the economy's demand for financial assets remains weak. **Monetary indicators** for April show a slower annual growth of money supply, to 0.7%. Its performance reflects the weak borrowing demand from the public sector and the contraction of credit to the private sector. In April, credit to the private sector was 2.4% lower than in the previous year, continuing to shrink for all but a year. The poor credit performance reflects mainly the contraction of credit to businesses. The analysis of credit demand and supply factors shows that there are uncertainties on both sides, which are materialised in high risk premiums. As we have previously stated, the steady improvement of crediting will follow the improvement of economic activity in the country.

At the end of discussions, the Supervisory Council concluded that the incoming available information does not alter our baseline projections. The economy will see a gradual growth during the year, with an improved pace over the second half. Nevertheless, the increase of aggregate demand will remain below the economy's potential even during 2014, thus determining the gradual return of inflation to target.

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