

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 July 2014.

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Today, on 30 July 2014, the Supervisory Council of the Bank of Albania reviewed and approved the Monetary Policy Statement of the Bank of Albania on the first half of 2014. Based on 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 2.50%. The Supervisory Council deems that the inflationary pressures from the real and financial sectors of the economy are weak and will remain so. Under these conditions, the monetary policy will remain stimulating, hence providing the adequate monetary conditions for inflation to return to the target over the medium term.

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

The Albanian economy improved in the first half of the year. Economic growth stood in positive territory and apparently there are progressive signs of recovery; the country's economic and financial stability remains solid, while the trend of domestic and external financial conditions are on the easing side. Economic activity expanded, due to the increase in private consumption and investments, and was supported by a stimulating macroeconomic policy mix. In the first half of the year, the economy performed, overall, in line with our projections; however, inflation's performance was worse than expected, as a result of disinflationary pressures from the external environment and other supply-side shocks.

The Bank of Albania expects the tendencies noted in the first half to continue in the second half of 2014 and in the next year. Economic growth will continue to maintain positive rates and improve further, contributing to the gradual return of inflation to target within the medium term horizon predicted by the monetary policy transmission mechanism. In our judgment, macroeconomic policies should continue to be stimulating for as long as the Albanian economy continues to operate below its potential capacities and inflation or inflation expectations are not consolidated around Bank of Albania's target. Yet, the landscape of expected developments contains some risks. I would like to list four of them: (i) sources of growth are not stabilised, (ii) our economy is very sensitive to supply-side shocks, (iii) our projections are subject to macroeconomic policies, which should continue and prudently establish a balance between the short-term stimulus and medium and long-term equilibriums; and (iv) economic performance will depend on the acceleration of structural reforms, both at macro and microeconomic level.

Following, I will dwell in more detail on the issues I mentioned above.

During the first half of the year, inflation was low, standing below our target. Average inflation was 1.6% in the second quarter of 2014, down from the rate recorded in the previous quarter. Annual inflation fell to 1.5% in June. It continues to be determined by the performance of unprocessed food prices, while other groups of the CPI basket provided low contribution to inflation.

On the macroeconomic aspect, the low inflation rate reflected the unutilised capacity rate, low inflation rates in our trading partners, and downward short-term inflation expectations.

According to INSTAT data, the Albanian economy grew by 1.65% during the first quarter of the year. This growth rate was on the upper bound of our projections. Preliminary data suggest that economic growth is expected to be stronger in the second quarter of the year.

From the sectorial perspective, both the manufacturing and services sector contributed positively, hence showing a more diversified basis of contributors than in the previous year. From the perspective of aggregate demand components, economic growth was driven mostly by the rise in private consumption and investments, reflecting the improved confidence in the economy, higher foreign direct investments, and more favourable financial conditions. Indirect indicators show that private investments were the main contributor, while the final consumption of households, albeit upward, remains weak. In the meantime, the expansion of the net export deficit and the public sector's demand provided negative contribution.

Net export deficit expanded, as a result of the increase in imports in the first quarter of the year, driven in large part by the intensification of imports of goods for investment purposes. Albanian exports continued to grow, but data on the foreign trade of goods showed a cumulative annual expansion of the trade deficit during January – May 2014, by approximately 6.7%. The capacity of the Albanian economy to horizontally diversify the range of exported products, and to vertically increase the value added of such products will be a primary factor for ensuring long-term economic growth.

Fiscal policy was consolidating over the first half of the year, reflecting in part the strong stimulating bias of the fiscal policy implemented during the first half of the past year. However, it largely reflects the correction of the upward trend of public debt. The consolidating nature of the fiscal policy is materialised in both increasing revenues and declining public expenditures – mainly capital expenditures. The budget deficit in the first half reached ALL 22.2 billion, standing 54.3% lower than in the previous year. As with any consolidating fiscal policy, the direct effect of such developments on aggregate demand has been negative. The Bank of Albania has, however, urged for and supported this fiscal move, being confident that its resultant effect will be positive. In the medium and long term, a lower public debt level decreases risk premiums and increases the economy's capacity to withstand unforeseen shocks. In the short term, a consolidating fiscal policy contributes to creating better lending conditions for the private sector. Also, it has enabled the Bank of Albania to implement a stronger stimulating monetary policy. On the aspect of public finance, in Bank of Albania's judgement, adopting a fiscal rule that will serve as an instrument for disciplining budget deficit and public debt indicators is indispensable. Public expenditure should have a more linear distribution throughout the year and a better compliance with the planned levels.

Despite the positive pace of economic growth, output gap remains negative and the utilization capacity rate is below its average. The unutilised capacities in the economy have led to low increase in employment and wages, production costs and profit margins, being the main drivers for low inflation rates. Imported inflation has been downward because of low inflation rates in our trading partners and the steady performance of the exchange rate. To a large extent, the downward imported inflation has also determined the downward profile of inflation at home during the first half of the year. Economic agents' inflation expectations remain subdued, not showing any grounds for a rapid increase of it.

Reflecting the poor performance of inflation and in the presence of a consolidating fiscal policy, the Bank of Albania has strengthened the easing trend of the monetary policy. Following the two cuts in February and May, the key interest rate currently stands at 2.50%. The Bank of Albania has continued to guide the public on the expected direction of the monetary policy in the future and has continued its liquidity-injecting operations in the banking system. Our monetary policy has been successful in calming financial markets, mitigating pressures for liquidity and controlling medium-term inflation expectations. Being in line with the specifics of particular segments and reflecting the time lag of the transmission mechanism, our monetary policy easing has been reflected across all the segments of the financial market. This policy has managed to cut down financing costs of the banking system and of the public and private sectors, and has contributed to establishing adequate conditions for the expected growth of demand and economic activity. Until now, however, it

has not been reflected in the real economy up to the desired levels. As previously stated, it relates largely to high risk premiums, which arise from uncertainties for the future. The Albanian consumers and businesses appear reluctant to increase consumption and investment, despite the lower interest rates in the banking system. Credit supply has been relatively tight, due to the perceived risk by banks and risk aversion policies adopted by European banking groups operating in Albania.

The second quarter has provided signals for an increase in credit demand, although credit expansion remains in negative territory. In May, credit outstanding for the private sector was 1.8% lower than in the previous year. The Bank Lending Survey for the second quarter of 2014 suggests for easing lending standards applied to both businesses and households, and their upward demand for credit. New credit has been dominated, for months, by credit extended in the Albanian currency. This is a welcomed development as regards the enhancement of monetary policy effectiveness. The Albanian reality and world experience suggest that credit recovery will continue to be conditioned by the steady improvement of the economic activity at home, reduction of risk premiums in certain sectors of the economy, and more positive developments in the labour market.

Looking ahead, economic growth and inflation will continue to experience low rates. In this context, our country does not differ from the rest of the countries in the region and other European countries in general. Baseline projections of the Bank of Albania show that the Albanian economy will grow at higher rates than in the previous year, sustained mainly by the expansion of domestic demand. Easing of monetary conditions, adjustment of private and public balances, and improvement of economic agents' confidence are expected to feed in the domestic demand. The fiscal policy is expected to be consolidating, in line with the medium-term budget plan and commitments with the International Monetary Fund. Structural reforms initiated in certain sectors of the economy are expected to regulate and stimulate their activity, as well as contribute to easing lending standards applied to them. The financial system remains well capitalised and liquid, while the expected revision, on the easing side, of lending standards will lead to a more active role of it credit to the economy.

Weak inflationary pressures, present in the Albanian economy, are expected to be dominant in the near future. With 90% probability of occurrence, inflation is expected to range within the 0.9–3.6% interval, four quarters ahead. From the available information, taking into account our projections, the action force of the monetary policy transmission mechanism and other financial stability-related considerations, the Bank of Albania deems that the monetary policy will remain stimulating during the medium-term period. In our judgement, maintaining the stimulating side of the monetary policy ensures inflation's return to target within a reasonable timeframe, and corroborates the recovery of domestic demand.

Concluding, I would like to dwell also on the risks related to the above-mentioned projections. First, in the presence of a consolidating fiscal policy and under the current situation of global markets, our growth projections are conditioned by the increase in private consumption and investments. These components of demand have been upward during the first half of the year; yet, factors contributing to this growth do not appear consolidated. The easing monetary policy contributes to establishing more favourable lending conditions, but it should be followed by sustainable improvements in the labour market, company balance sheets, and business climate as well as boosted confidence on the country's long-term development perspective. Second, our projections and the country's economic development remain subject to unforeseen supply-side shocks. The performance of energy production, agricultural sector, oil price, commodity prices, and final product prices in international markets has a significant impact on economic activity and inflation in Albania. Third, macroeconomic policies should preserve the stimulating mix, as well as the composition and intensity of this mix. Implementing consistent policies would contribute to enhancing the confidence at home and reducing the risk premiums. The fiscal policy should be in accordance with commitments for the consolidation of fiscal indicator and settlement of financial obligations to the private sector. Monetary policy will continue to remain stimulating,

but its extent and duration will be exclusively serving to meet our inflation target. Finally, the Albanian economy needs comprehensive structural reforms that would enhance Albania's competitiveness in international markets and expand our productive potential. Without structural reforms, macroeconomic policies would not generate long-term growth for a country. Our country should honour all its commitments to the European Union, arising from the status of the candidate country. Moreover, the public sector should have well-integrated and long-term development plans, while the private sector should make more efforts to enhance its efficiency and find new markets. This is the only way we could ensure more sustainable growth and faster convergence with European Union countries.

At the end of the discussions, the Supervisory Council decided to keep the key interest rate unchanged, at 2.50%. The monetary stimulus may increase further, in the event the economic and monetary developments will shift the balance of inflation risks downside. The Bank of Albania remains committed to complying with the medium-term inflation target, and stands ready to use all its instruments to reach this target.