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, 30 October 2013.

* * *

Today, on 30 October 2013, the Supervisory Council of the Bank of Albania reviewed and approved the quarterly Monetary Policy Report. Based on the most recent monetary and economic developments in Albania, and following the discussions on their outlook, the Supervisory Council of the Bank of Albania decided to keep the key interest rate unchanged, at 3.5%.

The Council notes that the inflationary pressures deriving from the real and financial sectors of the economy are weak and will continue to remain so. These circumstances require the stimulating monetary policy to persist in the period ahead. The monetary stimulus, transmitted through the low key interest rate and continuous injection of liquidity, provides the required conditions for meeting our medium-term inflation target.

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

***

The Albanian economy was characterised by slow economic growth and weak inflationary pressures throughout 2013. Economic growth slowed down to 1.1% in the second quarter, while available information suggests weak economic activity will continue in the third quarter.

The weak private demand offset the increasing positive impulses generated by the fiscal stimulus and foreign demand, in the first half of the year. Consumption and private sector investments were weak, whereas foreign demand continued to slow down, given the economic situation in our trading partner countries.

The private agents' uncertainty about the future was reflected in low propensity to spend and weak credit demand. This uncertainty prevented the transmission of the monetary stimulus to the economy. Moreover, banking system conservative policies maintained the lending standards tight, and prevented the normal functioning of the monetary policy transmission mechanism.

Against this backdrop, economic and financial stability of the country was preserved. Private agents' expectations on inflation were anchored around Bank of Albania's target, showing a good perception of monetary policy signals, and effective communication of the Bank of Albania. The banking system remains sound and well capitalised with ample liquidity to ensure the return of financial intermediation to adequate levels, in spite of credit quality-related problems.

Average annual inflation continued the decelerating trend in the third quarter, settling at 1.5%. The profile of inflation was determined almost entirely by the contribution of inflation from prices of agricultural products.

Beyond the seasonal effect related to satisfying demand with domestic agricultural produce, these prices fell thanks to the drop in import prices for processed foodstuff in the countries of origin. Prices of other consumer goods categories provided low contribution to headline inflation, hence offsetting each other.

Low inflation rates, especially in the long-term component, point to the presence of the negative output gap. The weak domestic demand has created spare capacities in the economy, and has led to weak pressures for higher production costs and wages. Additionally, stable prices and exchange rates in global markets resulted in contained pressures from imported inflation. Developments in the real economy, especially the weak domestic demand and low monetary expansion, will condition low inflation rates to continue even in the period ahead. Inflation expectations remain anchored and in line with price stability.

During the second quarter, economic growth was driven by public sector demand, whereas other components were weak. Though higher than in the first quarter, consumer spending did not manage to provide significant contribution to economic growth. The performance of this domestic demand component continues to be affected by high uncertainties and limited financing resources.

Against the low consumer demand, presence of spare capacities, and relatively tight lending standards, private investments remained low.

Developments in fiscal indicators during the first nine months of the year point to a stimulating fiscal policy, especially in the first half of the year. Stimulating features were present both in terms of expenditure and revenues. During this period, budget expenditure increased 8.3% from a year earlier, driven by both current and capital expenditure. At the same time, revenues marked a 4% annual decrease, reflecting the decline in most of its constituent items. The performance of revenues and expenditure led to the budget deficit amounting about 1.25 times higher than a year earlier, most of which was funded through domestic long-term instruments. Budget deficit dynamics was reflected in further expansion of public debt.

Data from the external sector of the economy show that foreign demand, net, was weak in the second quarter. Real exports, net, narrowed by 1.5% during this period, contributing negatively to aggregate demand.

Their performance was determined simultaneously by increase in imports and deceleration of exports, in real terms. Foreign trade data for goods, for July-August, reveal that trade deficit narrowed 15.1% in annual nominal terms, during this period. Exports surged 15.8% during this period in annual terms, whereas imports dropped 3.0%.

Financial markets continue to reflect low risk and inflation premia. In the interbank market, trading volume increased and interest rates fell, showing lower volatility. In the primary market, yields fell further, especially on securities with longer term to maturity. The yields curve moved downward and its slope was reduced. Interest rates continued to fall in the deposits market, while, in August, interest rates on credits fell as well. In spite of this, credit performance was weak during these months.

Following the persisting deceleration over the first half of the year, private sector credit contracted in July and August. As at end-August, it stood 2.0% lower than a year earlier. Credit performance reflected the weak credit demand from both businesses and households, as well as the tight standards of the credit supply.

In the last months, a positive factor observed, and encouraged by the Bank of Albania was the write-off of non-performing loans having no hope of recovery from banks balance sheets. Beyond its statistical effect in the short run, cleaning the banks' balance sheets is part of a complex process of non-performing loan portfolio management.

If implemented efficiently and actively, in the long run, this process may establish the premises to release lending capacities in the economy and recover healthy credit increase.

The monetary indicators analysis attests to weak monetary inflation pressures in the economy. Annual growth of monetary supply decelerated significantly, to 2.7% in August. The deceleration was driven by the weaker performance of foreign currency inflows and lower demand for borrowing from the private sector. On the other hand, increased lending to the public sector through the banks supported the growth of money in the economy.

Economic growth is expected to be weak for the rest of the year, in the presence of sluggish foreign demand and absence of the fiscal stimulus. Meanwhile, available data insofar do not signal recovery of consumption or investments in the near future.

Below-potential growth of the economy will condition contained consumer price rise in the period ahead. In the absence of unexpected supply-side shocks, one-year ahead annual inflation is expected to range between 0.4%–3.1%, with 90% probability.

Taking into account the above forecasts, the stimulating nature of the monetary policy will continue in the quarters ahead. The Bank of Albania will continue to supply the banking system with adequate liquidity for the smooth functioning of financial markets.

***

At the end of discussions, the Supervisory Council decided to keep the key interest rate unchanged, at 3.5%. The Supervisory Council deems that the current monetary conditions are adequate to meet our medium-term inflation target, and provide the monetary stimulus necessary to recover the domestic private demand.