

## FOREWORD BY THE GOVERNOR

The economic activity at home continued to improve over the second and third quarters, driven by the favourable external environment, improvement of economic agents' confidence, and better domestic financial conditions. On the other hand, overall inflationary pressures remain weak and inflation declined in the third quarter.

This diverging trend shows that the Albanian economy continues to operate below its potential and inflation remains subject to continuous supply-side shocks.

The new information and the updated forecasts have not changed the expected trend of economic and financial developments, but have postponed our estimation for the return of the economy to equilibrium and of inflation to target.

The annual inflation rate averaged 1.7% in the third quarter, down from the rates recorded in the previous two quarters. The deceleration reflected mainly the fall in food items inflation, as a result of higher domestic supply, appreciation of the exchange rate, and slowdown in inflation for these products in global markets.

In macroeconomic terms, the Bank of Albania assesses that inflation slowed down due to supply-side shocks, whose effect is expected to be of limited intensity and short lived. However, the low core inflation suggests that, even though they are increasing, medium-term pressures on inflation remain weak. The improvement in the domestic economic activity has brought the Albanian economy closer to equilibrium, as illustrated by the fall in the unemployment rate and the upward trend in the firms' capacity utilisation rate. The Albanian economy, however, continues to operate below potential, with a containing effect on pressures for an increase in wages and production costs.

According to INSTAT data, the Albanian economy grew by 4.1% in the second quarter, close to the first quarter growth rate. The growth was driven by the expansion of domestic private demand, improvement of the trade balance, and increase in public spending and high foreign direct investments during this period. The indirect available indicators suggest that economic activity continued to grow at a similar pace in the third quarter.

The positive performance of economic activity in Albania continues to benefit from our accommodative monetary policy stance, which maintains a financial environment with low interest rates and ample liquidity. It is also aided by the consolidatory fiscal policy, which reduces risk premia and increases the space



for financing the private sector. The Bank of Albania deems that these factors will continue to contribute to economic growth, and the return of the economy to equilibrium and of inflation to target.

Financial markets continue to be characterised by low interest rates. The upward trend of yields on treasury bills has not affected the cost of credit to the private sector, which - in the third quarter - remained at their historical low levels. In response, the credit to the private sector grew 3.1% on average in the third quarter, almost entirely attributable to the expansion by 9.7% of the credit portfolio in the Albanian lek. The growth of credit demand, especially in the corporate segment, was a positive development in the third quarter. Furthermore, the standards of credit to the private sector eased, although these standards remain relatively conservative.

Judging on the current development trends and the balance of underlying factors, the Bank of Albania deems that the medium-term perspective of economic development remains positive. The improvement in the economic environment is expected to support the return of inflation to target, within the first half of 2019.

Compared to the previous forecasting round, the Bank of Albania has revised slightly upward the outlook for economic growth throughout the three-year forecast horizon, whereas the projections for the return of the economy to equilibrium and of inflation to target have been somewhat postponed.

The projection for higher economic growth is underpinned by the upward revision of the assessment for the potential growth pace, in response to structural reforms that have taken place in the Albanian economy. At the same time, the upward revision of the potential postpones our projections for the return of the economy to equilibrium and of inflation to target. It implies that, compared to our previous assessments, the economy has larger production capacities and their full utilisation would require a longer time. Concerning inflation, the postponement of reaching the target reflects also the need for fully absorbing supply-side shocks and fading deceleration effects arising from the appreciating trend of the exchange rate.

The projections mentioned above factorise the strengthening of the accommodative stance of monetary policy throughout the medium-term horizon. They also remain conditioned by the materialisation of expectations for a more favourable external environment and a faster recovery of lending activity in Albania. The fall to 14.78% of the non-performing loans ratio in September shows that the balance sheets of the banking sector are improving and that the credit risk is reducing.

In this context, the Bank of Albania judges that the growth in credit demand must be followed by more favourable and far-sighted lending policies by the banking sector. In the event this is not the case, the further misbalance in the credit demand and supply would decelerate the pace of economic growth and would be a missed opportunity for the banking sector.



The new information and the updated forecasts have confirmed that the current monetary policy stance is adequate, and have underlined the need for an even more accommodative monetary policy in the medium-term horizon. This monetary stimulus will be necessary for boosting the aggregate demand in line with the production capacities of the country and for the return of inflation to target.

