Bank of Albania

MONETARY POLICY REPORT
2013 Q1
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The primary objective of the Bank of Albania is to achieve and maintain price stability. Promoting long-term investments, maintaining the purchasing power of money, enhancing the efficiency of fund allocation in the economy and safeguarding the financial stability are some of the benefits provided by an economic environment characterized by stable prices. This is the greatest contribution that the central bank can make to sustain a stable and long-term economic growth.

In line with its approved Monetary Policy Document 2012-2014, the Bank of Albania is committed to achieving and maintaining annual inflation at 3.0%, with a tolerance band of +/-1 percentage point. The announcement of the quantitative target for inflation aims at anchoring economic agents’ expectations and reducing the risk premium.

In view of achieving this goal and enhancing its transparency, the Bank of Albania prepares and releases its Monetary Policy Report. This Report is the main instrument of the Bank of Albania to communicate its monetary policy to the public. It provides a thorough assessment of the latest macroeconomic developments and the factors that have affected and are expected to affect the performance of consumer prices in Albania.

The Monetary Policy Report for the first quarter of 2013 was approved by the Supervisory Council of the Bank of Albania on 30 April 2013. The economic analysis in this Report is based on the latest available statistical data as at 18 April 2013.
Albania’s economy grew by 1.6% in 2012, according to data from INSTAT. It weakened over the past year, reflecting the overall uncertainty surrounding the internal and external environment. Despite the unfavourable developments, Albania’s main indicators of internal and external balances remained within the sound parameters. During this period, inflation was within Bank of Albania’s target and the soundness indicators of the banking system improved. Maintaining these balances creates proper macroeconomic grounds for long-term and stable growth.

Data from INSTAT show that consumer prices increased by 2.5% on average, in 2013 Q1. Food prices, accounting for 90% of total inflation, continued to determine the performance of inflation. On the other hand, food price inflation was balanced by the decreased non-food consumer price inflation. This item’s inflation reflected the lower oil prices as a consequence of lower international oil price. Its downward effect on inflation led to lower prices for durable consumer prices, while the prices for other consumer goods were not very volatile.

From the macroeconomic viewpoint, inflation continued to reflect the weak aggregate demand-side pressures and the lack of supply-side shocks. The below-potential growth of the aggregate demand brings about incomplete utilisation of productive capacities and generates weak pressures for rising wages, production costs, and business profit margins. Against this setting, internal pressures on consumer prices were weak, as also shown by the low core inflation rate. On the other hand, imported inflation was contained due to low inflation in the partner countries and the exchange rate stability.

The latest data on the real economy are as at 2012 Q4. They show that the Albanian economy grew by 1.7%, supported by the expanded activity of the services, industry and agriculture sectors, while the construction sector continued to contract. The data on the economic activity over Q1 are insufficient. Our analyses based on indirect data show that the economic growth was low. It was supported mainly by the external demand, while domestic demand components performed sluggishly. Private investment and consumption remained weak due to uncertainties for the future, slowed disposable income, tighter financing standards, and spare production capacity.

The performance of budget indicators in 2013 Q1 highlights a higher fiscal stimulus. Budget deficit increased 41.5% in this quarter, reflecting the decline by 3.6% in fiscal revenues and increase by 1.4% in public spending. The Bank of Albania, once again, draws attention to the significance of maintaining fiscal balances and keeping the budget deficit and the public debt at bearable
and harmless levels for the Albanian economy. In our opinion, maintaining the budget discipline should continue to be the fiscal policy’s medium-term priority. In the long term, the Albanian public debt should be reduced and anchored to a reliable, effective and transparent fiscal rule.

External sector developments show a continued positive contribution of net exports to aggregate demand growth. Data on external trade for January and February show that the trade deficit narrowed by 27.1% y-o-y, also reflecting further growth of exports and weak performance of imports. Over this period, imports contracted by 9.5% in annual terms, while exports maintained high annual growth rates, up by 18.6%.

Monetary developments were in line with the real-economy performance during the first quarter of the year. Over the first two months of the year, all the segments of the economy performed sluggishly. At end-February, the banking sector loan portfolio was only 1.7% higher than a year earlier. As we have already emphasized, the low demand for business and consumer loans remains the main concern of lending. However, bank lending policies were conservative and this was reflected in the relatively tight lending standards. The outlook for contained consumer prices and weak economic growth over the periods ahead led to further easing of the monetary policy at the beginning of the year. In January, Bank of Albania’s Supervisory Council cut the key interest rate by 0.25 percentage points, to 3.75%. By anchoring the inflationary expectations, mitigating the liquidity pressures and lowering the short term interest rates, the monetary policy aimed to cut the long-term financing cost of the economy and boost credit for consumption and investments. The financial market segments reflected unevenly the Bank of Albania’s easing monetary policy. The key interest rate cut was swiftly and fully reflected in the interbank market and the primary government securities market. It was partially transmitted to the deposit market and less to the credit market. These developments illustrate the fact that the monetary policy effectiveness is lower, in the presence of higher risk premia and structural changes in the financial market behaviour and the real economy. Therefore, the Bank of Albania supported its stimulating monetary policy by making several changes in easing the supervisory and macro prudential regulatory framework. These measures, which we detailed over the past month, aim to further reduce the liquidity premia and intermediation costs in financial markets, in order to boost lending and increase the economic activity.

Our projections for 2013 suggest for economic growth close to previous year’s figure. The external demand will be the main driver of economic activity growth, while the fiscal policy is expected to contribute to the same direction but at a lower intensity. On the other hand, the performance of private consumption and investment remains weak and unstable. The continuation of below potential growth of the economy will lead to weak inflationary pressures over the periods ahead. In the absence of foreseen supply-side shocks, consumer prices will continue to increase at low rates. The Bank of Albania expects that, after four quarters, with a 90% probability, the annual inflation will fluctuate within the 0.6 - 3.6% range. The low annual inflation
rates and forecasts for their continuation over the monetary policy-relevant horizon call for maintaining the stimulating monetary policy over the next quarters. Also, the Bank of Albania reaffirms the need for continuing and deepening structural reforms that would enhance productivity and foster the competitiveness of the Albanian economy. These reforms pave the way for expanding the economic potential and should be regarded as the main instrument in supporting Albania’s long term sustainable growth.
II. PRICE STABILITY AND BANK OF ALBANIA’S TARGET

In 2013 Q1, annual inflation was 2.5%, showing a downtrend along its quarters. This performance was determined by the demand-side inflationary pressures, against the short-term supply-side ones. The medium-term exchange rate stability helped smooth imported inflationary pressures. Market agents’ stable inflation expectations around the inflation target, inflation forecasts and economic growth outlook supported the formulation of a stimulating monetary policy in 2013 Q1.

Short-term projections show that inflation will continue to fluctuate around the lower limit of the target band, mainly due to persistence of the negative output gap along the year. However, against the backdrop of heightened economic uncertainties, unexpected external or domestic shocks may raise the volatility of expectations.

II.1 CONSUMER PRICES, TARGET AND MONETARY POLICY

In 2013 Q1, annual inflation was 2.5%, standing around the lower limit of the target band. The long-term inflation components performance determined considerably the downward trajectory in January-March 2013, while the short-term one carried over the expected effect of the low comparative basis.

Inflation developments attested to Bank of Albania’s assessments of weak demand-side inflationary pressures. Uncertainties surrounding the economic activity continued to be reflected in a low capacity utilisation rate and volatile labour market balances. In the medium term, these developments led to formation of a low inflation profile from the labour and producer costs in the country. The relatively long stability of the national currency in the domestic foreign exchange market continued to support the weakening of the above inflationary pressures. These factors dominated over the price rise for some goods and services in 2013 Q1.1

Inflationary and macroeconomic developments are preceded by a prudential decision-making in the monetary policy-relevant horizon. In January,

1 Particularly, in this quarter, agricultural seasonal product prices picked up.
Bank of Albania’s Supervisory Council cut the key interest rate by 25 basis points for the sixth consecutive time since September 2011, hitting record low (3.75%). This monetary policy stance intended to make use of the room for boosting the domestic demand, in the context of projections for low inflationary pressures, slowing economic activity and steady inflation expectations by market agents.

Implementing its monetary policy, the Bank of Albania continued to conduct regular open market operations, injecting liquidity of a seven-day maturity. The central bank also employed reverse repos of one-month maturity. The liquidity injected into the system was slightly less than in the previous periods, while the auction yield was continuously close to the key interest rate. The impact of the macro-prudential measures package is expected to support the transmission of the last decision, not only to banks but also to the real sector of the economy. The aim of those measures is to enhance lending flexibility and efficiency, and maintain financial stability in Albania.

II.2 Inflation by Item

Structurally, the food prices volatility accounted for 90% of Q1’s inflation. The increase in unprocessed food prices, which accounted for 70% of the headline inflation, continued to be noticeable.

Unprocessed food prices provided the highest contribution by 1.7 percentage points to this quarter’s annual inflation. Within this item, ‘vegetables’ marked
the highest increase, deviating from the usual increase characterising this period. This item’s annual inflation was 12.5%, almost double compared to the previous year’s 7.6% rate. The vegetables price rose due to failure to meet the demand for these goods from the domestic supply given the unfavourable weather conditions in Q1.

Processed food price marked less contribution to inflation rate (0.5 percentage points) than in a quarter earlier due to inflation decline in almost all main items\(^2\). This item’s annual inflation remains lower than in the previous year\(^3\) due to stable global prices for these goods and stable exchange rate.

Other items continue to make a low contribution to headline inflation. The annual inflation of the ‘regulated prices’ was 1.5% in Q1, contributing modestly by 0.1 percentage points to headline inflation. This item’s contribution is expected to be close to that of the past nine-month period, provided there are no administrative increases mainly in electrical energy prices.

During the first quarter, the contribution of ‘non-food consumer goods’ dropped by 0.4 percentage points on a quarter earlier. This drop was due to the diminishing effect of the environment tax on oil price compared to January 2012. Besides this effect, the oil price itself has fallen consecutively during the last four months. Also, the lower vehicle insurance contract price contributed to downward inflation of this item, which reached a negative rate (-0.3%) in March.

Since past year’s September, the ‘housing’ item has continued to contribute negatively to inflation formation.

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\(^2\) Price cut was seen in ‘milk, cheese, eggs, oils and fats’ and ‘sugar and sweets’.

\(^3\) It stood at 2.4% a year earlier, while in January 2013 it marked 1.9%.
Chart 4. Annual inflation by items of goods and services, in %

Source: INSTAT and Bank of Albania.
III. MACROECONOMIC DEVELOPMENTS

The Albanian economy registered low economic growth in 2012, hence deepening the gap between it and the potential growth. The external and domestic economic weakening was materialised into 1.6% expansion of the gross domestic product during this year. Albania’s trading partners’ economic and financial situation was reflected in a low demand for Albanian exports due to tight financing conditions for foreign capital, elevated uncertainties of economic agents and contained inflationary pressures. Private consumption, as the main determinant of price setting, weakened substantially. Due to a sluggish consumer demand, businesses had less room to raise consumer prices and investments. Against the backdrop of weak inflationary pressures, the consumer price inflation remained low in 2013 Q1.

The economic and monetary assessments and projections show that consumer prices will increase in line with Bank of Albania’s target along the monetary policy-relevant horizon. The medium-term inflationary pressures remain anchored to central bank’s target.

III.1 EXTERNAL ECONOMY

Preliminary and indirect data support assessments and projections that the global economy is entering a recovery phase. However, this recovery is exposed to uncertainty factors displaying non-homogeneous paces within the advanced economies group. Based on the latest IMF data, after the sluggishness over the first quarter, the global economy is expected to improve gradually in the remainder of 2013. Though revised down, the global growth forecast is 3.3% in 2013 and 4.0% in 2014. Annual inflation in advanced economies was downward in March, mainly due to oil price performance and specific transitory factors.

Table 2. Selected macroeconomic indicators.

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Source: ECB, FED, Eurostat and respective statistical institutes.

1 2013 Q1; 2 March 2013; 3 2012 Q4; 4 February 2013

4 WEO, April 2013
ADVANCED ECONOMIES

The euro area continues to suffer from the sovereign debt crisis. Its economy contracted 0.9% in 2012 Q4. Decline in German exports and slowing French economy are the main drivers of the negative growth. Indirect data suggest a slight quarterly improvement of the euro area’s economy in 2013 Q1. However, the performance of the sovereign debt crisis in the peripheral countries such as Cyprus and Slovenia will affect the economic climate over the next months. Unemployment rate hit a record high of 12% in February 2013.

The US economy slowed its annual growth to 1.7% in 2013 Q1. This slowdown has reflected the weak performance of private investments, government expenditures and exports. These developments have led to decline in the value added generated from higher consumer spending and non-resident investments, and decreased imports. For the period ahead, government spending is likely to remain low due to automatic austerity measures that became effective in March. Government debt is expected to each debt ceiling in May. Debates to raise the debt ceiling lead to lack of clarity. During the next two quarters, growth is expected to remain similar to Q1’s rate, growing higher at year-end. Unemployment rate was slightly downward in Q1, down to 7.6% in March.

China’s economic activity continued to grow in 2013 Q1, though at a lower rate than the 7.9% average rate in 2012 Q4.

ECONOMIES IN THE REGION

Turkish economy recorded lower annual growth in 2012 Q4, pursuing a downward trend over the past two years. Net exports and government spending supported the growth, while consumer spending and private expenditures contracted. Indirect data show greater growth in Q1 due to expanded industrial output and increased confidence index. The economic growth is expected to improve slightly over the quarters ahead.

Italy’s economy recorded negative growth again in 2012 Q4. Curtailed consumer spending and investments determined the economic growth, while contracted imports and increased exports have somewhat offset this effect. The forecasts show that this economy will continue to grow in 2013, though at lower absolute values.

In Greece, the annual growth rate remained negative but decelerated its decline. The negative rate has reflected the sharply contracted consumer spending and investments. Net export growth has influenced on the reverse side due to decreased imports. Forecasts for the future show that the Greek economy will continue to contract over the next years but it will improve gradually.

The FYROM economy recorded weak annual growth in Q4, while in 2012 the growth resulted negative. Net exports and investments improved, while consumer spending remained low at year-end. The sectoral analysis highlights
improvement in construction and production sectors. The annual growth for 2013 is projected to be somewhat higher and in positive terms.

Table 3. Economic figures for countries in the region

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<td>4.5 (2011)</td>
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<td>2.4</td>
<td>12.8&lt;sup&gt;1&lt;/sup&gt;</td>
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Source: Respective statistical institutes, IMF, EcFin, Eurostat
<sup>1</sup> 2012 Q4
<sup>2</sup> January 2013
: Unavailable data

III.1.1 PRIMARY COMMODITY PRICES AND FOREIGN INFLATIONARY PRESSURES

Average international oil price per barrel was downward in January-March 2013. According to the European Brent index, the price of a barrel of oil was on average USD 112.5 in the first quarter, down by 5.1% in annual terms. The decreased global demand for this product and the increased production in the North Sea were main the factors affecting the annual oil price cut in this quarter. On the other hand, contracted production in Saudi Arabia in January and February added the supply-side pressures, resulting in 2.2% quarterly oil price rise.

Based on the IMF index, primary commodity prices fell by 4.1% in annual terms and increased by 2.8% in quarterly terms, in 2013 Q1. This performance reflected mostly the oil price dynamics. Food prices marked 6.7% annual growth, standing at about 2.0 percentage points below the value recorded in 2012 Q4. On a quarter earlier, these prices increased by 1.0%, reflecting the uncertainties about the euro area sovereign debt crisis on the one hand, and the US dollar’s appreciation in foreign exchange market on the other.<sup>5</sup>

<sup>5</sup> Based on the Nominal Major Currencies Dollar index of the Federal Reserve, in 2013 Q1, the US dollar gained momentum against the foreign currencies basket, both in annual terms (2.7%) and monthly ones (2.2%). It is worth noting its appreciation against the Japanese yen by 16.4% and 13.6%, in annual and quarterly terms, respectively.
Foreign consumer prices performed in line with the contained rising rates of the primary commodity prices. Import Price Index, which reflects a higher correlation with the domestic goods inflation, increased by an annualised rate of 5.0% on average in the first two months of the year. The performance of this index attests to volatile inflationary pressures, which were contained in January and higher in March. The lek’s slight depreciation in terms of the NEER index by only 0.5% on an annual basis appears to have had a peripheral role. Reflecting the developments in both components, Imported Inflationary Pressures Index (IIPI) expanded by 5.5% on average over these months, to about 2.0 percentage points below the previous quarter’s level.

Inflation developments in Albania during the first quarter of the year highlighted different contributions from imported inflation and domestic one, in the context of headline annual inflation close to the previous quarter’s rate. The inter-sectoral inflation differential resulted positive and expanding during this quarter. This development reflected the tendency of a higher inflation generated from the CPI basket of goods than that of services in the Albanian economy. Goods inflation was significantly affected by the low comparative basis of the 2012 Q1, while the services inflation pursued the average downward trend that had started five quarters earlier. Inflation developments confirmed Bank of Albania’s assessments of the presence of low domestically generated inflationary pressures. Due to above trends, the contribution of the domestic to headline inflation dropped further, down to 24% in this quarter. Consequently, the expanded contribution of imported inflation (76%) to forming the headline inflation was favoured.

6 It is a new assessment index of import inflation pressures, comparable to traded inflation of our CPI basket. Import price index is based on the inflation rates of ‘Food, beverage and tobacco’ item for 18 main countries and the inflation of goods of Bulgaria, Germany, Greece, Italy and Turkey. The final value of the indicator is calculated as a weighted average of the above-mentioned CPIs and the monthly weights of their import.

7 IIPI is calculated as the annual growth of the import price index with the value of the NEER index for the respective month. Imported inflationary pressures appear to impact on inflation with a 1-3 month lag. However, fiscal measures undertaken by foreign countries, which do not necessarily affect the Albania’s import prices, continue to influence this indicator.

8 Mainly the traded sector inflation of the basket, as the sector whose prices where more exposed to foreign competition.

9 A proxy for measuring non-traded inflation, net of the CPI basket.

10 The effect of intervention in the insurance services market and reduction of the regulated price inflation contribution due to cancelling out of the drinking water price rise a year earlier, were added to the downward trend of the domestic inflation contribution.
III.1.2 MONETARY POLICY AND FINANCIAL MARKETS

The major central banks kept their key interest rates unchanged: the European Central Bank at 0.75%, the Federal Reserve at 0-0.25%, the Bank of England at 0.5% and the Bank of Japan at 0-0.1%.

In the euro-area money market, the euribor rates did not reflect any obvious changes, remaining at levels similar to those of end-2001. The ample liquidity in the market due to ECB’s actions has supported this performance. Yields on bonds in equity market showed a downward trend and higher volatility during the first quarter. They fell during the first two months but increased slightly at end-March due to agents’ uncertainties around the spillover effects from the Cyprus crisis. In the foreign exchange market, the euro appreciated against the major foreign currencies (British pound, Japanese yen, Chinese renminbi, and the U.S dollar) in Q1. On average terms, the euro was 0.79% higher, and appreciated about 1.79% against the U.S. dollar, on a year earlier.

III.1.3 IMPACT ON ALBANIAN ECONOMY

Unfavourable developments in our trading partner economies will continue to affect the Albanian economy, particularly in 2013 H1. The slow paces of economic growth in these countries are expected to be reflected in slower dynamics of domestic export growth in the current year. Imported inflationary pressures on price-setting links (primary commodity prices and...
consumer prices) are expected to be contained and will continue to help keep the exchange rate stable. Though the developments in the global financial markets do not reflect any tensions or liquidity shortages, the foreign financial conditions remain tight.

III.2 GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

Albania’s economic activity interrupted the accelerating growth rate in 2012 Q4. After the 2.9% annual growth in Q3, the gross domestic product grew 1.7% in annual terms, and stood almost unchanged in quarterly terms (0.05%), in Q4. The increase in the services sector activity continued to boost economic growth, while the production sector contracted due to weaknesses in the construction sector.

In line with our assessments and projections, the economic growth slowdown at end-2012, reflected primarily the sluggish domestic demand. Consumers’ and businesses’ reluctance to spend and invest and the limited room for fiscal stimulus were materialised into a downward contribution by the domestic demand to the real growth over this quarter. On the other hand, the positive contribution by the net foreign demand exceeded expectations due to a sharper decline in imports and a higher increase in exports.

The real economic growth was 1.6% in 2012, decelerating on a year earlier. The sluggish external and domestic demand produced a lower expansion of aggregate demand.

Source: INSTAT and Bank of Albania.
Available data\textsuperscript{11} shows that the economic weakness continued in 2013 Q1. The domestic private demand maintained the low year-end levels, reflecting consumers’ and businesses’ reluctance to spend and invest, lower growth of the private sector’s disposable income, financial sector’s tighter financing conditions and lack of fiscal stimulus. On the other hand, foreign demand continued to contribute positively to aggregate demand expansion at the beginning of the year. Overall, exports are expected to benefit from the recovery of foreign demand, and the easing monetary policy is expected to boost the domestic private demand.

### III.2.1 OUTPUT BY SECTOR

GDP grew slower in Q4 than in Q3 (2.9%) and Q2 (2.1%), reflecting the negative developments of the productions sector and the lower dynamism of the services sector. The production sector contributed negatively by 0.5 percentage points, while the services sector contributed by 2.2 percentage points to annual GDP.

Businesses involved in the confidence surveys report an improved economic performance reflected in a higher economic sentiment index in 2013 Q1. However, this index remains markedly below its long-term average. By sector, a higher confidence index in industry and construction, though below the historical average, suggests for a more positive performance of the production sector. By contrast, the downward trend of the services confidence index suggests for slower growth rates in Q1.

\textsuperscript{11} We base our assessment of economic performance in Q4, on imports and exports of goods in value, credit to economy as of February and on fiscal and qualitative indicators from confidence survey for Q1.
The value added in the industry sector slowed down its annual growth rate to 7.8% and contributed by 0.8 percentage points to annual GDP growth, in Q4. The impact of external demand on this sector’s performance is signalled through the decelerated annual growth in the industrial product exports. The processing industry did not support the performance of the industry sector over this quarter, contracting by 4.6% in annual terms. The negative contribution of this branch accounts for about 3.6 percentage points in the performance of the overall industrial activity. By contrast, the value added by the extractive industry branch was about 27.9% higher than in the corresponding period a year earlier. The high increase in the value added from the electrical energy, gas and water branch owes considerably to the comparative base effect.

The positive growth rates of industrial export expansion over January-February and the increase in the industry confidence index, production and overall business condition, suggest for positive developments in the industry sector, in 2013 Q1.

Value added in construction sector continued to post annual decline by 15.4% in Q4, mitigating the average contraction rate by 17.4% in the first three quarters. The sector contracted the annual GDP growth by about 2.2 percentage points, in Q1.

The increased number of building permits and of

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12 The impact is reflected mainly on the processing and extractive industry branches with an export-oriented profile.

13 In 2011 Q4, the value added in ‘Electric energy, gas and water’ decreased in quarterly terms by about 52.8% (the historical average of quarterly changes of the value added from this branch in Q4, swings around 20.2%).
public investments in engineering works in 2013 Q1 are expected to gradually improve the performance of the construction sector during this year. The upward trend of the confidence index, demand and production, and overall business condition in the construction sector suggests for positive signs in this sector’s performance over Q1.

During 2012, the value added in activities related to agriculture, hunting, forestry and fishing expanded at higher rates than the 5.0% historical average. In Q4, the value added from these activities recorded 6.1% annual growth. The unfavourable weather conditions in 2013 Q1 are expected to affect negatively the domestic agricultural production, hence the performance of the overall agricultural sector.

The performance of the services sector was reflected in the slower annual growth of its value added in Q4, about 4.0%. This sector’s dynamics appeared slower in Q1, even compared to the 5.5% historical average growth rate. The expanded activity in the branches of other services, post and telecommunication, and hotels and restaurants, by 3.3, 2.1 and 0.6 percentage points, respectively, supported the higher production in the services sector. The contracted activity in trade and transport has contributed negatively by 1.2 and 0.8 percentage points, respectively, to annual value added of the services sector.

14 ‘Other services’ include: Monetary and financial intermediation; real estate, leasing and business-related services; public administration, protection and social security; education; healthcare and other social activities; other collective, social and individual services.

Source: INSTAT and Bank of Albania.

Source: INSTAT and Bank of Albania.
The value added in other services decelerated its annual growth rate to 7.8% in Q4. This performance reflected mainly the sluggish dynamics of the ‘real estate, leasing and business-related services’ sub-branch, whose contribution has dropped to 4.2 percentage points in the quarter under review, from 7.1 percentage points in Q3. Value added in post and telecommunication services continued to increase by 24.0% in annual terms due to positive developments in communication activities. In the quarter under review, the activity related to hotels and restaurants was characterised by a high dynamics, reflected in the 9.4% annual value added increase.

On the other hand, the value added in trading activity recorded 3.6% annual decline in Q4, reflecting, to a great extent, the performance of the ‘wholesale trade’ sub-branch. By contrast, the activity of the retail trade and repair of vehicles increased. The performance of transport branch, which is closely related to performance of the industrial output and external demand, also continued to contract, though at smoother rates than in the first three quarters of 2012.

The downward trend of survey indicators for service businesses suggests that this sector will face unfavourable developments in 2013 Q1.

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**Box 1 House Prices**

*House price index continued to trend down in 2013 Q1*, falling by 10.8% from 2012 Q1. *Deflated with the consumer price index, the annual contraction in the house price index was 13.0% for the period under review. Rental Price Index also performed alike, dropping 11.7% in 2013 Q1. In annual real terms, it dropped 13.8%.*

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15 Referring to volume turnover index, communication sub-branch increased by 24.5% in annual terms in Q4, from 19.0% in Q3. This indicator for the post sub-branch recorded 2.1% annual contraction, from 5.8% in the previous quarter.

16 The volume turnover index on wholesale trade recorded 3.0% annual growth in Q4, a lower rate than the expansion by 12.5% recorded a quarter earlier and the 7.8% historical average.

17 The volume index on the retail trader recorded 5.5% annual growth, from 0.2% a quarter earlier, while the same index on trade and repair of vehicles recorded 7.5% annual growth, from 2.5% a quarter earlier.
Housing market developments were affected mainly by the demand-side factors. The decline in the average wage in the economy and the slow performance of house purchase loans over the previous year, conditioned the domestic market demand. According to the Bank Lending Survey 2013 Q1, mortgage loan standards eased slightly, but the household demand for this type of loan decreased. Data from construction confidence survey and bank lending survey signal that the consumer demand for house purchase will recover in 2013 Q2. This development, combined with the interrupted supply (decline in construction permits, mortgage loans) in the construction sector, will determine price changes over the period ahead.

Price-to-rent ratio expanded slightly to 2.15 as at the end of the period under review due to smaller decline in rental price. This level is 0.05 percentage points higher than the price-to-rent average following 2007.

House prices in Albania compared to some countries in the region

Central banks regard house price surveys as very important, after the global financial crisis that arose from the housing market imbalances. Central banks may not be indifferent to house prices developments, since the volatility of these prices may weigh on the financial system and may determine the business cycle. Chart 18 compares the annual changes in the domestic house price index with the annual changes in GDP. The chart shows that there exists a positive correlation between the house price cycle and the economy cycle, and the first precedes the GDP cycle with several months.

The section following this box presents a comparative analysis of house price development in Albania, other countries in the region, and Europe. Chart 19 compares the annual volatility of house prices in Albania and abroad. After the general price decrease in 2008 (about one year after the USA recession), the house price indices have been more volatile. Starting from 2012 H2, house prices in Albania pursued a downtrend. This trend is noticed also in other countries in the region, and in the aggregate house price index for the European Union. In some countries under analysis, the rates of increase have been in a negative territory over several years.

The price-to-rent ratio is a simple indicator that may be used to assess the stability of these prices in the domestic market and to compare prices among several countries. Chart 20 (left) shows the ratio of a standard house (in

19 Prepared by Ermelinda Kristo.
20 After the rapid correction of the house prices in some countries following 2008, many researches have underlined the importance of house prices in the economic activity, and also in determining the business cycle, e.g., Leamer (2007), Ferrara and Koopman (2010) for the euro area countries.
21 A simple correlative analysis suggests that house prices precede the real GDP developments with four quarters. Researches on other countries have found similar results. Eurostat has calculated the price index for Europe, since 2000.
the centre of a major city) price to annual rent, based on the latest data for 2012. The ratio takes values from the trough (12 for Hungary) to the peak (31 for Greece).23 For Albania, this ratio shows that the price for a house in downtown Tirana is 27 times its annual rent. However, this index has dropped by 25% relative to 200924.

Given that the value of this ratio in the case of Albania is influenced more by the lower rent price than the high house price, the house price to income per capita ratio is also considered and compared to other countries in the region and in the rest of Europe.25 The indicator in this case takes lower values for developing economies and higher values for less developed countries, as Chart 20 also shows (right). By contrast to the first indicator, this indicator dropped in almost all countries (excluding Greece and Serbia). For Albania, in 2012, this indicator dropped by 8% compared to three years ago. The analysis of both composite elements - the average house price and GDP per capita - suggests that it is the slowdown of the first (rather than that of the second) that has led to drop of this indicator.

*)The indicator is calculated by dividing the average price of a house in the centre of major cities, with a surface of 120 m², to annual cost of the average rent for the same houses = \( \frac{\text{Price}}{\text{Rent} \times 12} \)

**) This indicator is calculated as a ratio of the price for a typical house (100 m²) in the centre of the city to GDP per capita of the respective country.

23 As a general rule, a ratio higher than 20 shows that it is more preferable to rent than to buy a house.

24 This indicator does not consider the changes in the basic factors that influence the house prices from one country to another, the demographic movements within the country and the preference for owning versus renting a house.

25 The average rent for a residence in Albania is absolutely the lowest in all the countries under review.
The aggregate demand slowdown, in 2012 Q4, reflected mainly the sluggish domestic demand, while the contribution of net exports increased. Available data show that private consumption contributed positively, while private investments contracted and fiscal stimulus lacked during this quarter. Consumer spending was highly volatile in 2012, with a slight increase determined by low increase in disposable income and uncertainty around the stability of financial resources. Private and public investments lacked, while external demand increased its contribution, hence becoming the main generator of Albania’s economic growth.

Available data on aggregate demand performance in 2013 Q1 show ongoing domestic demand sluggishness in all its components. On the other hand, the external demand is estimated to have contributed positively, as suggested by further narrowing of the trade deficit during the first two months.

Our analysis and projections for 2013 show that the external demand and fiscal stimulus will continue to support the economic growth, but its stability will depend on the revival of consumption and private investments. The real economy is expected to reflect the favourable financial market developments, influenced by the easing monetary policy.

III.2.2.1 Domestic private demand components

Our assessments of private consumption highlight its positive contribution to aggregate demand in 2012 Q4. Available data show higher consumption of short-term goods and services but lower consumption of durable goods. Value added in the services sector accelerated the growth rate in Q4, to 8%, from the 5% average in the first three quarters. Retail trade index recorded 5.5% annual growth in this quarter, above the 4.6% average for the last five years. On the other hand, the annual decline in import of vehicles in 2012 Q4 reflects mostly the comparative base effect.

Increased disposable income and consumer loans financed consumer spending in 2012 Q4. The disposable income, after settling at levels comparable to those of the previous year, increased in the first three quarters, mainly due to higher remittances in Q4. The need to finance private consumption was also reflected in the reduction of savings growth rates.

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27 Improvement of the services confidence index also signalled positive developments, increasing by 9.4 percentage points in 2012 Q4.

28 Import of vehicles increased 493% in 2011 Q4, mainly due to approval of easing fiscal measures for purchase of vehicles.

29 Based on the slowdown of the growth rates of household deposits and savings in securities, and also on the downtrend of the savings-expenditures balance obtained from the consumer confidence index in the last two quarters.
Balancing the available information, it comes out that in 2013 Q1 consumer spending will be lower than a quarter earlier. The decline in imports of food and beverages, and the balance of large purchases highlight a weaker consumer demand for goods in this quarter. Despite the increased employment in 2012 Q4 and slightly improved consumer confidence in 2013 Q1, the macroeconomic factors affecting consumer decisions have remained similar to a year earlier.

Private investments continued to contract in 2012 Q4, given the performance of import of machinery and equipment, foreign direct investments and capacity utilization rate. Import of machinery and equipment has continued to fall since 2012 Q2, to -24% in the last quarter. Foreign direct investment inflows dropped by 34% over this period. Private investments were less supported by investment loans, whose growth rates decelerated significantly.

Overall, investment was influenced by cyclical weakness of the economy, business uncertainty about the future economic outlook and low capacity utilisation rate. Private investment sluggishness was influenced by both demand-side factors and supply-side ones. The building permits for residence and engineering constructions, which generally precede the construction sector investments growth with some months lag, resulted less than a year earlier. Also, business loan standards remained tight.

Indirect data show a weak performance of private investments in 2013 Q1. Import of machineries and equipment continued to drop in January-February, 30

30 The impact of easing measures taken by the government to exempt imports of machineries and equipment from the VAT scheme, is expected to materialise to increase of this item’s import, hence affecting the level of investments in the economy in the coming quarters (Law No. 125/2012, dated 20.12.2012 “On some amendments to the Law No.7928, dated 27.04.1995 “On the value added tax”)
though at slower paces than in the previous year. While the confidence of businesses operating in the production sector of the economy improved during the period under review, their assessment of the level of investments in the economy is downward. Low capacity utilization rate and below-historical average financial condition throughout the economy continued to determine the reluctance to invest. The growth of investment loan was downward in January-February, hence confirming the banks’ assessment of business demand deterioration31.

### III.2.2.2 Fiscal Indicators and Fiscal Policy32

Fiscal policy in 2013 is projected to stimulate the economy. The fiscal stimulus for this fiscal year will be based on two main pillars. First, it is directly planned to be an added contribution of the public sector to aggregate demand, in the form of the final consumption of government and public investments. Second, the fiscal easing is planned to function indirectly through tax policies in the form of some tax exemptions. The combination of these factors is expected to be transmitted to a higher budget deficit than in the previous year, and hence (under unchanged conditions) to a higher public debt stock as a share of GDP.

Unlike expectations,33 the slow expenditure dynamics was translated into a negative contribution (in real terms) of the public sector to aggregate demand growth, in 2013 Q1. The direction of public sector’s impact on aggregate demand growth was mostly driven by the downtrend of capital expenditures. On the other hand, budget revenues were downward due to tax revenues. The

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31 According to the lending activity survey for the 2013 Q1, the demand for loan for investment purposes has been falling. On the other hand, the bank standards for loans extended for this purpose have tightened.

32 Fiscal data on the quarter are obtained from MoF publication of April 17 and are still preliminary.

33 The (direct) fiscal stimulus was expected to be mostly concentrated in the first half of the year.
downtrend of these revenues was due to lower imports in annual terms, partial materialisation of the effect of other fiscal measures on VAT exemption, and weakening domestic economy. The budget deficit expanded by about 41.5% in annual nominal terms.

Budget expenditures in Q1 were about ALL 89.1 million or about 1.4% higher than in the same period a year earlier. Excluding the effect of the KESH loan disbursed in February 2012, the annual total expenditure change would be 3.7%. Current expenditure increased by 6.4% in annual terms, contributing by about 5.2 percentage points to total expenditure. Capital expenditure contributed by about -1.6 percentage points to annual change of total expenditure during this quarter. Social security spending, unemployment economic benefit and payment of public debt interests were items contributing most to expenditure growth rate. Operational and capital expenditures which contracted 17% and 9.9%, respectively, in annual terms, influenced on the opposite direction.

Expenditure items, which are a proxy for final government consumption, increased in annual terms, though their positive impact on aggregate demand has not fully offset the lower gross fixed capital formation.

Budget spending for 2013 Q1 accounted for about 28.6% of GDP, or about 0.5 percentage points lower than the average ratio for Q1 for the past four years. The below average ratio was determined by slow performance of capital spending, which accounted for 4.1% of GDP, or 1.1 percentage points below the average for the same time period. On the other hand, current expenditures maintained similar ratios to previous years’, accounting for about 24.4% of GDP.

Budget revenues also registered lower ratios as a percentage of GDP. Total revenues were about 24.2% of GDP in 2013 Q1, about 2 percentage points below the Q1’s average for the past four years. Tax revenues estimated at 22% of GDP account for about 72% of this deviation.
Budget spending for 2013 Q1 were about ALL 75.6 billion or about 3.6% lower than the same period a year earlier. Tax revenues contributed negatively by about 4.6 percentage points, while grants revenues and non-tax ones contributed positively by about 1.0 percentage point to the 3.6% annual decline of total revenue.

The annual decline in revenues was mainly due to lower revenues from VAT, excise taxes and local government. More specifically, VAT revenues contracted by about 9.7% in annual nominal terms, contributing by about -3.3 percentage points to annual change of total revenues. The lower level of VAT revenues is due to some factors: lower imports, expanded VAT exemption base through recent fiscal measures, as well as higher reimbursements than a year earlier.

Developments in main tax items (VAT, excise tax, local government) suggest for continuation of fragile domestic economic activity, market actors’ higher reluctance to invest, and likely increase in incentive for partial tax evasion.

34 This is the contraction with the highest historical magnitude recorded for revenues collected from the VAT in Q1 of the year.
35 For the first two months of the year, the import value dropped by about 9.5% in annual terms.
36 In December 2012, some fiscal facilities were adopted related to VAT exemption on import of machineries and equipment of ALL 50 million, machineries for accomplishing contracts and investments in the active employment sector and in the agribusiness sector (notwithstanding the investment value), as well as processing machineries imported from small entities, which pay personal tax income. Also, iron and cement, which are used as raw material for hydro-power plant constructions, were added to VAT exemption.
37 Gross VAT (minus reimbursement effect) contracted by about 6.7%, while the net one (evidenced in the budget consolidated table) decreased by 9.7%.
38 VAT collected on the performance of production of goods and services in the country is 8% lower in annual terms.
39 Illustrated by the 11.2% contraction in annual nominal terms of import of machineries and equipment for the first two months of the year.
40 Though its quantification is difficult, during economic slowdown periods, economic literature suggests for a higher incentive for lower reporting of tax duties by tax-payers.
Budget deficit was ALL 13.5 billion at the end of 2013 Q1, or about 4.3% of GDP, up by about 41.5% in annual nominal terms. The budget deficit deepened mostly (about 70%) due to the lower level of revenues on a year earlier.

The budget deficit financing was totally based on borrowing instruments in the domestic securities market. New borrowing through issue of government securities was about ALL 19 billion, or about 40% above the overall budget deficit created during this period. This has led to shifting of the major part of domestic borrowing planned for 2013 (about 69.2%) to Q1. Regarding domestic borrowing by maturity, long-term instruments dominated over short-term ones. Participants’ demand in the primary securities market, concentrated
mostly on long-term instruments (2, 3, 5 and 7-year bonds), appears to have been in line with the Government’s borrowing policy. In this context, addition of domestic borrowing was realised at 83% by long-term instruments, while the remainder belongs to the treasury bill portfolio.

In line with the budget deficit, the primary deficit also expanded in annual terms, adding the grounds for public debt growth in the future. The primary deficit moving sum to GDP accounted for about 0.5% of GDP at the end of 2013 Q1, or about 0.3 percentage points higher than a year earlier.

Public debt\textsuperscript{42} at end-2012 amounted to about ALL 818.5 billion, accounting for about 60.7% of GDP, about 1.8 percentage points higher than a year earlier. The domestic debt stock accounted for about 34.9% of GDP at end-2012, or 1.1 percentage points higher than a year earlier. Foreign debt accounted for about 25.8% of GDP, or about 0.7 percentage points higher than a year earlier.\textsuperscript{43}

### III.2.2.3 External Demand and Foreign Trade

Net external demand was the main driver of economic growth in 2012 Q4. During this quarter, real net export deficit narrowed by about 12.2\%\textsuperscript{44} in annual terms. This narrowing was due to about 3.4\% lower imports of goods and services in real terms, and higher exports by about 3.6\%.

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\textsuperscript{42} Data on domestic debt published by the MoF and on foreign debt published by the BoA, for 2012 Q4.

\textsuperscript{43} About 8\% of this addition was due to the exchange rate effect.

\textsuperscript{44} Unit Value Index calculated and published by the INSTAT is used for switching imports and exports from nominal to real terms. Consumer Price Index and the Harmonised Consumer Price Index of services, as measured by the Bank of Albania, are used for imports and exports of services.
Real exports continued to be supported by higher increase in the real depreciating pressures on the national currency in 2012 Q4. Based on the performance of the REER\(^{45}\), the lek depreciated by 0.91% in real terms, over this period.

Overall, in 2012, though at a lower magnitude than in 2011, developments in the balance of imports and exports of goods and services were materialised into a positive contribution of this component to the real aggregate demand growth. Such a behaviour is assessed to have passed on to the 2013 Q1. Foreign trade for January and February indicates narrowing of trade deficit by about 27.1% in annual terms due to decline in imports. Excluding the electrical energy trade flow, the trade balance contracted 16.6% in annual terms. Trade exchanges registered about 1.6% annual decline and import to export coverage ratio reached 50.5%. This ratio is about 11.9 percentage points higher than in the same period a year earlier.

Exports increased by 18.6% in annual terms during the first two months. Exports had dropped by about 17.7% in annual terms in the same period a year earlier. During this period, increase in exports was triggered by the positive contribution of export of goods included in ‘Minerals, fuels and electrical energy’. Within this category, crude oil export increased by about 41.7% in annual terms. Also, due to the low comparative base on a year earlier, exports of metals and re-exported products increased by 21.9% and 9.8%, respectively, in annual terms.

\(^{45}\) The Real Effective Exchange Rate (REER), is measured as a geometric weighted average of domestic prices, compared to trading partners’ prices and the NEER. A decline in the index implies a real appreciation, whereas an increase in it implies a real depreciation of the national currency.
Total imports recorded an annual decline of 9.5% during January - February. Contraction in imports was markedly driven by decline in imports of goods included in ‘Minerals, fuels, and electrical energy’. This category marked significant contraction in import of electrical energy. Excluding this effect, total imports dropped by about 1.3% in annual terms. Contraction in import of ‘Machineries, equipment and spare parts’ and ‘Food, beverages and tobacco’, also contributed to decline in total imports.

Box 2: Balance of Payments Highlights

During this period, Albania’s net current account position registered a deficit of EUR 1021.3 million, down by about 13.8% on a year earlier. Current account deficit over this period was about 10.5% of nominal GDP or about 2.3 percentage points lower than in 2011. Similarly to 2011, current account dynamics in 2012 was broadly affected by the performance of trade balance and services account. The combined improvement of their net position, compared to the corresponding period of the previous year, contributed significantly to narrowing the current account deficit.

Table 4. Balance of Payments indicators

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</thead>
<tbody>
<tr>
<td><strong>Current account (in EUR million)</strong></td>
<td>-366.4</td>
<td>-290.4</td>
<td>-251.8</td>
<td>-242.8</td>
<td>-236.3</td>
<td>-1185.4</td>
<td>-1021.3</td>
</tr>
<tr>
<td>yoy</td>
<td>2.8%</td>
<td>26.7%</td>
<td>-23.9%</td>
<td>-6.2%</td>
<td>-35.5%</td>
<td>-13.8%</td>
<td></td>
</tr>
<tr>
<td>/ GDP</td>
<td>-15.8%</td>
<td>-13.5%</td>
<td>-9.8%</td>
<td>-9.4%</td>
<td>-9.8%</td>
<td>10.5%</td>
<td></td>
</tr>
<tr>
<td><strong>Trade balance</strong></td>
<td>-658.6</td>
<td>-465.3</td>
<td>-475.5</td>
<td>-540.5</td>
<td>-517.8</td>
<td>-2,241.6</td>
<td>-1,999.2</td>
</tr>
<tr>
<td>Exports, f.o.b.</td>
<td>360.0</td>
<td>325.8</td>
<td>394.2</td>
<td>402.5</td>
<td>403.1</td>
<td>1,405.5</td>
<td>1,326.4</td>
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<tr>
<td>Imports f.o.b.</td>
<td>-1,018.6</td>
<td>-791.2</td>
<td>-869.7</td>
<td>-943.0</td>
<td>-920.9</td>
<td>-3,647.1</td>
<td>-3,424.8</td>
</tr>
<tr>
<td>Balance of services</td>
<td>41.3</td>
<td>8.5</td>
<td>26.2</td>
<td>132.6</td>
<td>27.9</td>
<td>134.9</td>
<td>195.1</td>
</tr>
<tr>
<td>Credit</td>
<td>428.5</td>
<td>293.8</td>
<td>381.1</td>
<td>578.1</td>
<td>402.1</td>
<td>1,747.4</td>
<td>1,655.1</td>
</tr>
<tr>
<td>Debit</td>
<td>-43.0</td>
<td>-88.6</td>
<td>-70.7</td>
<td>-78.5</td>
<td>-55.5</td>
<td>-197.3</td>
<td>-293.3</td>
</tr>
<tr>
<td>Net FDI income</td>
<td>-7.0</td>
<td>-54.8</td>
<td>-29.8</td>
<td>-42.0</td>
<td>-26.2</td>
<td>-53.2</td>
<td>-152.8</td>
</tr>
<tr>
<td>Current transfers</td>
<td>240.7</td>
<td>206.8</td>
<td>225.3</td>
<td>185.8</td>
<td>253.9</td>
<td>898.5</td>
<td>871.7</td>
</tr>
<tr>
<td>Credit</td>
<td>266.6</td>
<td>243.5</td>
<td>265.2</td>
<td>224.1</td>
<td>285.8</td>
<td>1,003.8</td>
<td>1,018.6</td>
</tr>
<tr>
<td>Debit</td>
<td>-25.9</td>
<td>-36.7</td>
<td>-39.9</td>
<td>-38.4</td>
<td>-31.9</td>
<td>-105.3</td>
<td>-146.9</td>
</tr>
<tr>
<td>Net remittances</td>
<td>182.5</td>
<td>166.5</td>
<td>171.6</td>
<td>140.8</td>
<td>196.3</td>
<td>664.5</td>
<td>675.3</td>
</tr>
<tr>
<td>Capital and financial account (in EUR million)</td>
<td>284.9</td>
<td>258.3</td>
<td>185.5</td>
<td>174.4</td>
<td>249.1</td>
<td>978.1</td>
<td>867.3</td>
</tr>
<tr>
<td>yoy</td>
<td>-30.7%</td>
<td>15.1%</td>
<td>-21.3%</td>
<td>-25.2%</td>
<td>-12.5%</td>
<td>-11.3%</td>
<td></td>
</tr>
<tr>
<td>/ GDP</td>
<td>12.3%</td>
<td>12.0%</td>
<td>7.2%</td>
<td>6.8%</td>
<td>10.3%</td>
<td>8.9%</td>
<td></td>
</tr>
<tr>
<td>Balance of income</td>
<td>10.3</td>
<td>-40.4</td>
<td>-27.7</td>
<td>-20.6</td>
<td>-0.2</td>
<td>22.7</td>
<td>-89.0</td>
</tr>
<tr>
<td>Credit</td>
<td>53.2</td>
<td>48.2</td>
<td>43.0</td>
<td>57.8</td>
<td>55.3</td>
<td>220.1</td>
<td>204.4</td>
</tr>
<tr>
<td>Debit</td>
<td>-43.0</td>
<td>-88.6</td>
<td>-70.7</td>
<td>-78.5</td>
<td>-55.5</td>
<td>-197.3</td>
<td>-293.3</td>
</tr>
<tr>
<td>Net FDI income</td>
<td>-7.0</td>
<td>-54.8</td>
<td>-29.8</td>
<td>-42.0</td>
<td>-26.2</td>
<td>-53.2</td>
<td>-152.8</td>
</tr>
<tr>
<td>Capital account</td>
<td>27.8</td>
<td>12.9</td>
<td>43.0</td>
<td>9.8</td>
<td>15.6</td>
<td>84.9</td>
<td>81.4</td>
</tr>
<tr>
<td>Financial account</td>
<td>257.0</td>
<td>245.3</td>
<td>142.5</td>
<td>164.6</td>
<td>233.5</td>
<td>893.2</td>
<td>785.9</td>
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<td>A. Liabilities</td>
<td>398.0</td>
<td>307.5</td>
<td>277.7</td>
<td>378.4</td>
<td>224.4</td>
<td>1302.5</td>
<td>1188.0</td>
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<td>FDI</td>
<td>288.2</td>
<td>205.5</td>
<td>191.1</td>
<td>164.5</td>
<td>183.7</td>
<td>745.4</td>
<td>744.9</td>
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<td>Portfolio investment</td>
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<td>14.5</td>
<td>19.6</td>
<td>7.8</td>
<td>21.0</td>
<td>75.7</td>
<td>62.9</td>
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<tr>
<td>Other investments</td>
<td>88.6</td>
<td>87.5</td>
<td>67.0</td>
<td>206.0</td>
<td>19.7</td>
<td>481.3</td>
<td>380.2</td>
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<tr>
<td>B. Assets</td>
<td>-141.0</td>
<td>-62.2</td>
<td>-135.2</td>
<td>-213.8</td>
<td>9.2</td>
<td>-409.2</td>
<td>-402.1</td>
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<td>FDI</td>
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<td>-2.7</td>
<td>-0.3</td>
<td>-7.7</td>
<td>-7.0</td>
<td>-29.9</td>
<td>-17.7</td>
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<tr>
<td>Portfolio investment</td>
<td>14.4</td>
<td>-61.0</td>
<td>9.9</td>
<td>-26.4</td>
<td>-10.0</td>
<td>-88.8</td>
<td>-87.5</td>
</tr>
<tr>
<td>Other investments</td>
<td>-135.8</td>
<td>1.5</td>
<td>-144.8</td>
<td>-179.7</td>
<td>26.2</td>
<td>-290.5</td>
<td>-296.9</td>
</tr>
<tr>
<td>Errors and omissions</td>
<td>75.3</td>
<td>35.4</td>
<td>73.8</td>
<td>158.0</td>
<td>-36.0</td>
<td>178.6</td>
<td>231.2</td>
</tr>
<tr>
<td>Reserve assets</td>
<td>6.2</td>
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<td>-7.5</td>
<td>-89.7</td>
<td>23.1</td>
<td>28.7</td>
<td>-77.3</td>
</tr>
</tbody>
</table>

Source: Bank of Albania.

The latest data on the Balance of Payments are as at 2012 Q4.

Nominal GDP for 2003-2010 is the one published by INSTAT. Bank of Albania’s Monetary Policy Department projections are used for 2011 and 2012.
Services account surplus expanded by about 44.6% in annual terms in 2012, hence contributing significantly to narrowing the current account deficit. The widening surplus in this account was primarily driven by the marked improvement in net income from travel services. Net balance of the income account resulted in a deficit of EUR 89 million in 2012. The orientation of developments in this account was mainly determined by the increasing outflows of income on foreign direct investments, which posted EUR 152.8 million in 2012, from EUR 53.2 million in 2011. The surplus of current transfers account, an important financial resource for the current account deficit, narrowed by 3% in annual terms, in 2012, primarily due to the decline in ‘Other current transfers’ items. This account’s main sub-item - ‘net remittances’ - increased slightly by 1.6% in 2012.

Capital and Financial Account

Capital and financial flows (net) registered a positive balance of EUR 867.3 million in 2012. This account’s surplus was about 11.3% lower than a year earlier and accounted for about 8.9% of nominal GDP. Currently, the capital and financial account surplus managed to finance about 84.9% of the resulting current deficit in 2012. Foreign direct investment inflows posted EUR 744.9 million, close to 2011’s figure (EUR 745.4 millions). Net portfolio investments increased our assets invested abroad by about EUR 24.6 million in the period under review. Other net investments posted a positive balance, contributing by about EUR 83.4 million to the increased liabilities of residents to non-residents.

As at end-period, international reserve totalled about EUR 1,972.5 million, sufficient to cover 4.5 months of imports of goods and services.
The latest economic data show that the economy continues to be characterised by spare capacity, hence transmitting weak demand-side inflationary pressures. Based on our latest assessments, the negative output gap deepened further during 2012 due to sharper deceleration of production growth compared to potential growth rates. Against a backdrop of low economic growth, costs of factors of production have increased slowly, hence mitigating the pressures for consumer price rise. Businesses, which continue to work under low earning rates, have influenced similarly, without reflecting any tendency to increase their final product price.

The deepening of the output gap on the negative direction in 2012 was reflected in low historical values of the long-term inflation trend in 2013 Q1. Core inflation, as the main measurer of this trend, was about 1.1% and accounted for only 30% of total annual inflation. Over the same period, net non-traded inflation of the CPI basket posted 0.78%, contributing marginally (10%) to headline inflation formation. The above inflation rates, as forecasted, turned out to be lower than in the same period a year earlier. However, the downward trajectories were faster than expected in the short term. They were specifically determined by the decreased core inflation and net non-traded inflation in March 2013. In consequence, in Q1, the short-term supply-side pressures contributed more to headline inflation than the long-term ones. They were materialised into the non-core inflation and tradeable inflation rates, by 6.4% and 3.4%, respectively. The short-term price volatility reflected mainly the low comparative base effect of the Q1 of the previous year.

As at March 2013, the core annual inflation, as an average of two measurements, was 0.7%, while the net non-traded one was 0.45%. Interventions of the Competition Authority in the vehicle insurance market led to a marked decline in respective tariffs.
IV.1 LABOUR MARKET, WAGES AND COSTS

The economic activity has slowed progressively over the past four years. Employment has been rising, leading to decline in labour productivity. Revival of the labour productivity would condition, inter alia, the future economic developments. The labour market conditions continue to determine the negative dynamics of wages and other labour costs, hence transmitting weak inflationary pressures.

The labour market indicators for 2010-2012 were reviewed after the publication of the 2011 Labour Force and Census Survey, bringing methodological changes in employment statistics of the agricultural private sector and unemployment rate. The latest data from the labour force survey\(^{49}\) show that employment in the economy has increased, while the number of unemployed and the unemployment rate have decreased. The latter stood at 12.8% at year-end. Long-term unemployment rate performed similarly, standing at 7.8%.

\(^{49}\) Since 2007, employment in private agricultural sector is assessed through a Labour Force Survey (LFS), an annual survey conducted by INSTAT with households. From 2010 Q3 to end of 2012 Q2, INSTAT based its estimate on the number of people employed in the said sector, on the 2009 LFS. In 2012 Q3 and Q4, the assessment was based on 2010 LFS results. After the 2011 LFS publication, employment in the private agricultural sector has been updated. From 2010 Q3 to 2011 Q2, the 2010 LFS results have been used. Since 2011 Q3, the 2011 LFS results have been used. Given that the agricultural sector has the major share in employment in the economy, changes in the number of the employed in this sector affect substantially the employment rate and, against an unchanged number of the employed, on the unemployment rate. After the updating, the number of the employed in the agricultural sector from 2011 Q3 is 36,892 persons higher. Consequently, the unemployment rate in the economy during that period turned out to be lower. The number of agricultural sector employed from 2010 Q3 to end of 2011 Q2 is 21,256 persons less. Consequently, the unemployment rate in the economy over that period was higher than the reported figure. The analysis in this report is based on latest data.
Employment in the non-agricultural private sector affected positively the increase of employment in the economy, offsetting the reduction of employment in the public sector. Employment in the agricultural sector remained unchanged both on a quarter earlier and on a year earlier. The number of people employed in the non-agricultural private sector increased by 6.7%, while in the public sector decreased by 0.6%, in Q4.

The distribution of employment by sector of economy in Q4 can be analysed on the basis of short-term statistics. Employment index in the services sector expanded significantly, by 15.9%, y-o-y. The number of people employed in the production sectors\(^\text{50}\) contracted by 3.8% in this quarter. Employment in construction marked the largest decline, down by 11.0%, y-o-y, in the production sectors. Increase in trade sector employment was the highest in the services sectors, with 19.9% on a year earlier. However, this increase was accompanied by a significantly decreased average wage.

In 2013 Q1, businesses were less pessimistic in their assessments of employment condition in the economy during this period.

Wages

Average wage in economy continued the downward trend that had started since the beginning of the year, when it contracted for the first time since 2006. However, the pace of its contraction has decelerated over the quarters, recording 4.1% annual contraction in the period under review. Deflated with the consumer price index, the average wage in economy recorded 6.5% real annual decline. The average wage in the public sector increased by 4.8% in real annual terms. According to business survey, wages in economy contracted in 2013 Q1.

\(^\text{50}\) Excluding agriculture
Wage analysis by sector is based on short-term statistics. Wages marking higher contraction were those in hotels (by 8.2% in real annual terms) and trade (by 6.1% in real annual terms). By contrast, in the production sectors, the decline in the value added and employment was associated with slight increase in the average wage on a year earlier (by 1.0% in real terms).

Labour productivity and unit labour cost

In 2012 Q4, the annual dynamics of the labour productivity (LP) in the non-agricultural economic activity fell for the fourth consecutive time (-5.4%). This decline was driven by a sharper slowdown in the value added growth rate compared to a more modest contraction of employment growth rate. The annual average change of this indicator for the year fell by 7.8%, against the increase by about 4% in the previous year.

In Q4, the unit labour cost (ULC) in the non-agricultural sector continued to fall (-1.1%), y-o-y, but at lower paces than in the previous quarter. This development was due to less annual reduction in the average real wage indicator (-6.5%), against the deepened negative pace of the labour productivity.

For 2012, the non-agricultural economic activity in annual average terms did not register any growth of the unit labour costs (-0.9%), indicating lack of inflationary pressures from this factor during the first months of 2013. However, unsteady developments in the labour productivity and low share of tradable sectors in the economy remained among the main factors that hindered the competitive advantage in the labour cost.
The negative pace of the labour cost for non-agricultural businesses was associated with annual decline in the industrial output cost for goods destined for the domestic market (-0.2%), in Q4. This performance was driven mainly by the decline in the processing industry producer price index (-0.6%), where the oil processing one played an important role (-1.5%). Overall, industrial processing and extractive costs of this commodity did not exercise any pressures on its price in the domestic market, in 2013 Q1. Food processing industry operated with relatively higher costs than in 2012. The 2012 Q4 recorded 2.5% annual growth, curbing along its months. This behaviour within the quarter was passed on to the annual inflation dynamics of the processed food item in 2013 Q1.
IV.2 INFLATION EXPECTATIONS

Inflation expectations of consumers, businesses and financial agents fell slightly in 2013 Q1. Medium term expectations, as a better reliable indicator of monetary policy, stood close to the previous quarter’s figure and Bank of Albania’s inflation target, in 2013 Q1.

The index that quantifies the anchoring for consumers was 0 in 2013 Q1, showing that their expectations were within their long-term average. Developments in the anchoring index were similar for both businesses and financial agents, in Q1, returning to negative values. Its value shows that expectations are less than one standard deviation below their historical average.

**Chart 37. Agents’ inflation expectations and inflation anchoring index**

Source: Consumer and Business Confidence Surveys, Banks’ Survey, Bank of Albania.

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51 The Bank of Albania measures economic agents’ inflation expectations through business and consumer confidence surveys and financial agents’ expectations survey.
52 Medium-term expectations are the inflation expectations two years ahead and are measured only for financial agents through a monthly survey conducted by them.
53 The index that quantifies the anchoring is calculated by deducting from their level the long-term average and by dividing it to the respective standards deviation.
V. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

V.1 FINANCIAL MARKETS

Money expansion decelerated further in 2013 Q1. Private economic agents’ demand for money continued to weaken due to uncertainty and cyclical weakness, and further tightening of lending standards. The financial market displayed a good transmission of easing monetary policy signals in the primary market (money and deposit market), assisted by the favourable liquidity condition and controlled risk premia. This transmission lacked in the credit market, due to the low credit level and competition in this market. Overall, the monetary policy and financial development picture attests to contained inflationary pressures over the medium-term period.

V.1.1 MONETARY POLICY TRANSMISSION IN THE FINANCIAL MARKET

Given the low inflationary pressures and assessments of a weak domestic demand, the Bank of Albania lowered the key interest rate by 0.25 percentage points at end-January, to a new record low of 3.75%. This was the sixth lowering in the central bank’s easing monetary policy that had started since September 2011. The decision was followed by same-size interbank rate cut. The monetary easing was transmitted to government security yields, mainly of one-year and above one-year maturity. On the other hand, yields on short-term instruments remained almost unchanged. The downward pressures on the money market and the long-term equity market were supported by the relatively high volume of lek-denominated liquidity in those markets.

The monetary policy transmission was slower in lek deposit and credit markets. The first was characterised by a moderate interest rate cut on all maturities and increase in respective deposits in January-February. This behaviour has reflected the strategy for absorbing funds after end-year celebrations and for preserving the market share. Preliminary data on March and April show reduced costs of lek funds, in line with the monetary policy stance. Similar to euro-area countries in the region, the transmission of the monetary easing into the credit market was weak. The decline in the primary market yield, a reference indicator to determine the credit price, was not pursued by lek credit interest rates. They fluctuated in January and February due to considerable changes in new loans extended.

![Chart 38. Average change in yield rates and in the key interest rate, in 2013 Q1 compared to 2012 Q4*](image-url)
over both months. For Q2, the banks have reported tighter business loan conditions, factoring in the credit margin increase. They have also reported easing costs for new lek loans.

Interbank Market

The interbank rates were downward, while the volume of transactions increased noticeably in 2013 Q1. The spread between overnight rate in the money market and the key rate did not change during this quarter, while, overall, they displayed a higher volatility than a quarter earlier. The transaction profile during this quarter was similar to a year earlier, when the one-week maturity ones had the largest share. The Bank of Albania continued to conduct regular open market operations by injecting liquidity of 7-day maturity. The central bank also employed reverse repos of one-month maturity. The liquidity injected into the system was slightly less than in the previous periods, while the auction yield was continuously close to the key interest rate.

The overnight rate averaged 3.64% in Q1, or 0.18 percentage points lower than in the previous quarter, while the 7-day rate dropped to 3.86%, from 4.05%. The average volume of overnight transactions increased by ALL 1.2 billion to ALL 3.0 billion, while that of 7-day transactions increased by ALL 2.7 billion to ALL 9.8 billion.

Yield performance

Q1 was characterised by declining yields on all government securities. After the key interest rate cut at end-January, the 12-month yield dropped significantly from 6.60% at year-start to 6.14% at end-March. The downtrend

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54 The spread between the overnight interbank rate and the key rate in this quarter resulted 18 percentage points, i.e., similar to a quarter earlier.

55 The standard deviation of the overnight interbank rate was 0.2087, from 0.0663, in 2012 Q4.
of yields is obvious particularly in long-term instruments, though the budget deficit was financed mainly by using these instruments, in Q1. This quarter was characterised by increased demand for investments in 7-year notes, the most long-term instrument in the market and the less competitive one so far. Yield on fixed-rate notes for this maturity fell 0.88 percentage points from September 2012, while the margin accepted for variable-rate notes fell 0.37 percentage points.

The yield and liquidity offered by participants in this segment was high, generating a weak pressure on determining the yield. This led to re-opening of some auctions and the financing of deficit through long-term instruments was beyond expectations in 2013 Q1. The yield curve shifted down and the slope diminished due to decreased asked premium on securities of above one-year maturity.

Foreign exchange risk

Nominal effective exchange rate (NEER) remained relatively stable in 2013 Q1. The NEER\(^{56}\) rates averaged 0.4% in annual terms and -0.3% in quarterly terms.

The higher demand for foreign currency in this quarter, based on the seasonal behaviour of foreign companies for repatriating their profits, appears to have been offset by the contracted demand for imports in the first two months of the year, hence lowering the depreciating pressures in the foreign exchange market. The above-mentioned developments are confirmed also by the smooth performance of the exchange market pressure index.

\(^{56}\) NEER - Nominal Effective Exchange Rate, as measured against the currencies of Albania’s main trading partners, namely Italy, Greece, Germany, Turkey and China. Higher NEER implies the lek’s depreciation.
In 2013 Q1, the lek was stable against the basket of major currencies in the domestic foreign exchange market. Furthermore, the lek appreciated against the euro by 0.3% in annual terms. On a quarter earlier, the lek appreciated against the US dollar by 1.8% but remained unchanged against the euro. Developments within the quarter show that the significantly decreased imports in January influenced the lek’s appreciation against the euro at the beginning of the year, to be followed by recovery of the euro over the next months. Concerning volatility, the USD/ALL ratio was volatile and in line with the EUR/USD performance in the international markets, whereas the dynamics of the EUR/ALL ratio appears smooth over this quarter. Compared to the currencies of the countries in the region, the lek’s volatility stands below the lower limit of the range.

*The euro/national currency volatility is measured as a 30-day standard deviation. The peak and trough volatility levels in each period represent the maximum and minimum standard deviation of selected ratios. The selected countries include Poland, Czech Republic, Hungary, Romania, Turkey and Serbia.*

Source: Bank of Albania.

Source: Bank of Albania.
V.1.2 BANKING SYSTEM AND LENDING CONDITIONS

In January and February, time deposit rates in lek and euro trended down for all maturity terms. The system’s response to base rate moves in the lek deposit segment, though on the same direction, was slow. The 12-month deposit interest rate dropped on average by 0.06 percentage points in January-February, from 2012 Q4. Reluctance to lower the interest rates consecutively made deposits the most attractive form of household savings investments, alongside the rapid increase in government security investment. The spread between return on both investments was lower during this period. Preliminary data show further decline in a broader base for new lek deposit rates over March-April.

The spread between lek time deposit interest rate and euro ones increased slightly due to the larger decline of the latter. Interest rate on 12-month deposits averaged 2.76% in January-February, from 2.92% in 2012 Q4.

Interest rates on lek loans increased during the first two months of the year, mostly driven by developments in February, when new lek loan contracted significantly. This was immediately reflected in increasing the interest rate resulting partially from the effect of change in credit weight and partially from application of higher interest rates on extended loans. A larger effect was noticed in short-term loans, whose interest rate increased 2.31 percentage points, to 11.57% in February. On average, the interest rate on this maturity was 1.13 percentage points higher in January-February than in 2012 Q4. This figure would have been lower given that at the end of the past year large short-term loans with favourable interest rates were extended to state-owned enterprises.

Lending cost continues to be tighter for businesses, whose lending standards were generally tighter. The medium-term loan continued to be upward,
associated with reduced loan size, whereas the long-term loan, mostly mortgage loan, continued to reflect a steadily downtrend. Compared to the previous quarter, it fell 0.26 percentage points, to 9.46%, in January-February.

Interest rates on new euro loans were highly volatile and the lending cost was relatively tight. Lending in euro continued to slow, and the applied interest rates were affected by certain loans. January marked a sharp decline in long-term loans, to 5.60%, from 6.91% in December, impacted by a considerable loan with a low interest rate, while in February interest rates were upward. Bank experts stated that they expect interest rate cut on euro loans over the quarter ahead.

V.2 MONETARY INDICATORS

Economy continued to perform poorly in 2013 Q1. After a low expansion in last two months of 2012, the loan portfolio contracted by about ALL 3.1 billion in January-February. These developments slowed down the annual growth rate to 1.7% at end-February, from 2.4% at year-end. The sluggish credit performance is still affected by supply and demand-side factors. The private economic agents’ demand for bank financing remained low and downward due to the sluggish economic activity and uncertainties surrounding the outlook. Banks continued to be cautious in selecting and lending to their clients, by keeping lending conditions tight.

* It includes the lower comparative base effect as a consequence of loan portfolio reclassification in one of reporting banks. The reclassification led to reduction in the household mortgage loan stock by ALL 5.77 billion and increase by the same amount in the business investment loan stock in December ’11, whose effect cancelled out in December ’12.
Economic agents’ demand for lek loans has marked a turning point since December, decelerating the growth rate during the two following months. The portfolio of lek loans to economy increased by 12.6% in annual terms in February, down by about 1.4 percentage points from December. Lek loan portfolio developments reflect primarily the reduction of the new loan disbursed over this period. At the same time, the stock of foreign currency loans contracted, y-o-y, substantially dictating the developments in the total outstanding loans.

As at end-February, private sector credit was about 0.7% higher than a year earlier. Monthly developments confirm the contraction of this portfolio by about ALL 3.3 billion since December, partially reflecting the advance repayments of business loans, mainly in foreign currency. The expansion of the private sector credit portfolio in annual terms was totally supported by business loans. Households’ low demand for financing determined the contraction of household loan portfolio.

Business loan portfolio grew 2.6%, y-o-y, in February, from 3.2% at end-Q4. By purpose of use, the business loan portfolio was primarily driven by the weaker performance of investment loan, which was still conditioned by the low capacity utilisation in production. This portfolio increased 2.3%, y-o-y, in February, down by 2 percentage points from the year-end. Financing the needs for liquidity improved slightly compared to December. Working capital loan increased by about 3% at end-February, but the annual change of this portfolio resulted significantly lower than its 18% average rate over the same period a year earlier.

Distribution of credit by sector of economy in January and February was uneven. Credit extended over January financed mainly the industry sector, while in February, credit supported ‘Trade, hotels and restaurants’ sector. Credit development by sector during both months highlights an overall reduction in the loan portfolio for all the sectors of the economy, except for
transport and telecommunication. In annual terms, businesses in the industrial sector resulted with the fastest growth of financing, posting 13.3% in February. The business loan portfolio in the construction sector continued to fall, down by 9.5% in February relative to a year earlier.

The annualised household growth rate remained at the negative territory in the first two months of the year, to -0.7% at end-period, from the positive rate of 0.5% in December. Household loan reduction indicates households’ low demand for financing due to uncertainties surrounding their sources of income. Household loan developments by purpose of use reflected the poor performance of mortgage loans, which recorded a negative rate of -1.4% in February. Consumer loans to households increased by an annual rate of 1.5%, from 3.5% in December. Their developments over the first two months of the year reflected mainly the short-term nature of credit in the form of bank advances.

The Bank Lending Survey results for 2013 Q1 57

The bank lending survey results show that the household loan standards eased slightly, while the business ones continued to tighten in 2013 Q1. Business loan standards tightened for small and medium-sized enterprises and for big enterprises. Banks reported tightening of lending standards for working capital loans and for investment purposes. By purpose of use, the standards of household loans eased for house purchase and tightened for consumer loans.

Main drivers of tightening the business loan standards were: specific sector-related concerns, non-performing loans situation in the banking system and macroeconomic setting in the country. The current or expected level of bank’s liquidity, competition in the banking system and Bank of Albania’s decisions were the factors that led to easing of household loan standards.

57 The survey conducted in March 2013 covers bank lending developments in 2013 Q1 and banks’ expectations for lending in 2013 Q2. You can find a detailed analysis of Bank Lending Survey Results on www.bankofalbania.org, under Publications.
Business and household demand for loan was downward. For businesses, the decline in the demand occurred in small and medium-sized enterprises and in investment loans. For households, the demand continued to be downward in both house purchase loans and consumer loans.

Current and expected macroeconomic situation in the country, and the use of alternative financial resources are the main factors affecting negatively the business demand in 2013 Q1. The decreased consumer confidence and the use of alternative financial resources have continued to affect negatively the household demand for loan.
Monetary aggregates

Over the first two months of the year, the rate of monetary expansion slowed down to 4.8%, from 5% at end-2012. Contribution by main item on the liability side, in general, remained similar to a quarter earlier. The contribution of foreign currency deposits was similar to the lek one but significantly lower than in 2010-2011. Compared to this period, the annual rate of total deposit growth slowed to 6.1%, remaining close to 2012 Q4’s levels. This performance through the years has reflected, besides the stability of liquidity and confidence in banks, the introduction of new instruments for household investment (see Box 3). The significant slowdown in foreign currency deposit growth rates determined the decline in total deposit growth rates. This slowdown reflected both lower cross-border foreign currency inflows and lower contribution of money against the backdrop of a weak lending activity in foreign currency. Deposit performance by economic agents shows ongoing growth of household time deposits in lek.

The money aggregate in lek, the M2, reflected a steadier performance than a quarter earlier. Even though lending in lek slowed its growth rate, the less negative effect of banks’ financing to government helped keep the M2 aggregate growth constant, at 3.4%. At the same time, the ongoing contraction in the currency outside banks and the weak performance of the liquid aggregate, M1, over the last two year, confirms the low inclination of households to hold and use liquid assets, under the conditions of weak consumption in the country. As a result, the ratio of currency outside banks to M2 hit record low, 27.8%.
Box 3 Introduction of various financial instruments: impact on the broad money

M3 aggregate or the broad money has had a distinct slowing trend over the last four years. This trend was sharper in 2012 and in the first two months of 2013. The Bank of Albania assigned great importance to the analysis and projections for M3, considering it as one of the main drivers of medium and long-term inflation. Monitoring the M3 aggregate is important because it represents the most liquid part of economic agents’ financial assets and the total volume that the banking system extends to the private and public sector. In this sense, the M3 aggregate is a proxy for the aggregate demand expansion and provides signals for the generation of current or potential inflationary pressures on the economy. In this box, we will explain that the performance of M3 over last quarters, beyond economic slowdown, it reflects the financial system expansion with new financial mediators and the diversification of the way Albanians hold their savings. First, we will make an overview of the M3 aggregate concept and then we will analyse the specific developments impact on financial system.

The M3 aggregate is the broadest concept of the money supply in the Albanian economy. It sticks to the liquid concept of measuring money through the International Monetary Fund methodology. The M3 aggregate includes currency outside banks and all deposits by resident economic agents with the banking system, demand or time deposits of a maturity term up to two years, in all the currencies. However, the concept and the way of measuring money in the economy vary, depending on financial innovations and developments. Overall, economies with advanced financial systems that are characterised by the presence of more advanced financial instruments employ more comprehensive forms of the broad money concept. The M3, M4 or M5 aggregate, besides the classic savings instruments such as residents’ deposits with the banking system, include other instruments as well, such as deposits with other financial institutions, joint investment funds, residents’ deposits at branches of domestic banks operating abroad, securities or various financial derivatives.

The past year saw a similar performance in Albania. During this period, household investments in government securities increased, sometimes intermediated by newly-created investment funds. This development implied shifting of financial savings by households from banking deposits to government securities and to investment funds shares, which are not include in calculating the M3 aggregate. In this context, the past year’s slowed M3 expansion reflected not only the overall slowing trend of the economy and the demand for monetary assets but also the financial portfolio diversification tendency of the Albanian households. The following charts illustrate this developments. The M3 aggregate growth marked 4.9% in February 2013, while the money supply, including households’ securities stock, marked a higher rate, 7.2%. In March ’12 – February ’13, the gap between the annual rate of both indicators averaged 1.8 percentage points, tending to expand over the first two months of 2013.

Given the above, we deem that the monetary aggregate moves should be cautiously monitored and interpreted. The monitoring of monetary aggregates should consider the impact of financial market innovations on them. Also, interpretation of their moves should consider that the correlation between monetary aggregates and real economy varies in time. Change in the form of holding savings affects the M3 aggregate structure defined by methodology, but does not violate the broader concept of the money supply in the economy, which is higher than the one measured conventionally.

Prepared by Olta Manjani
Further details on monetary indicators calculation methodology are found under the IMF’s material titled “Factors Underlying Definitions of Broad Money: an Examination of Recent U.S. Monetary Statistics and Practices of Other Countries”. 
From the viewpoint of the demand for money, the M3 aggregate shows further weakening of economic agents’ demand for money, mostly seen in the sharply decreased contribution that credit to economy has made in terms of money creation. At end-February, the loan portfolio contributed by 0.08 percentage point to money creation, close to the lowest level of 0.1 percentage point reached at end-2012. Besides development in the loan portfolio, the reduction in banks’ government financing has raised the negative contribution that the domestic credit has made to money creation. Excluding price swings, the real broad money growth was 2.3% due to contracted domestic credit in real annual terms.
The foreign currency component of the money demand, assisted by the good performance of the external sector of the economy, has contributed positively to money expansion but lesser than two years earlier. This performance is in line with our expectations for slowing cross-border foreign currency inflows and the lower use of the financial leverage in foreign currency by the banking system. The picture of the first two months of 2013 attests to our expectations for a weak performance of the demand for money during this year. However, the outlook for the second half of the year is better due to both easing monetary policy signals and incentives provided by the credit revival package of macro-prudential measures taken recently by the Bank of Albania.