B a n k o f A l b a n i a

MONETARY POLICY REPORT
2013 Q2

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C O N T E N T S

BOXES

TABLES

C H A R T S

OBJECTIVE

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 second quarter of 2013 was approved by the Supervisory Council of the Bank of Albania on 31 July 2013. The economic analysis in this Report is based on the latest available qualitative and statistical data as at 23 July 2013.

I. FOREWORD BY THE GOVERNOR

The first months of 2013 confirmed our projections for slow economic growth and weak inflationary pressures in Albania. Economic activity continues to suffer from sluggish aggregate demand reflecting economic agents' uncertainties about the future, relatively tight lending standards, and downturns in the economies of our major trading partners. However, despite the challenging macroeconomic environment, Albania's economic and financial stability remains stable. In the first half of the year, inflation remained low due to weak demand-side pressures and anchored inflation expectations. The latter reflect Bank of Albania's prudential monetary policy, which has enabled the decrease in long-term interest rates and contributed to maintaining sound banking system parameters. Also, Albania's improved external position, coupled with the stable domestic currency, and financial sector's overall sound balances, have further strengthened the financial stability and ensured one of the pillars needed for its long-term development.

The second-quarter inflation averaged 2.2%, edging down relative to the first quarter. Reduction in agricultural commodity inflation and price stability of other goods of the basket pushed this quarter's inflation down. Agricultural price inflation accounted for about 90% of the headline inflation, reflecting both the volatility in agricultural commodity prices and their relatively high share in the CPI basket.

From the macroeconomic perspective, the presence of spare production capacity continues to determine the performance of inflation. The sluggish growth of aggregate demand was associated with low increase in investments, employment, wages and labour costs in the economy. This chain of factors was further translated into weak pressures for consumer price rise. It was also confirmed by the record-low rates of core inflation over this period. On the supply side, the low price rise in the domestic market has reflected stable prices in the global markets and economic agents' anchored inflation expectations.

Regarding economic developments, data from INSTAT show that the first-quarter economic growth was 1.7%, similar to the rate seen at the end of the previous year. The economic activity expansion in the first quarter relied heavily on the industrial sector growth, while the agriculture and services sectors marked a positive but weak growth. By contrast, construction sector continued to contract. Available second-quarter data suggest that the economy performed better, mainly reflecting the high fiscal stimulus over this period.

From the demand components perspective, economic growth during the first half of the year was mainly attributable to the higher exports and public spending over this period, while the contribution of consumption and private investments appeared weak. Though monetary stimuli increased during the past quarters, uncertainties about the future curbed consumption and private investment. These uncertainties are reflected in a cautious approach of Albanian households and businesses, and their reluctance to take risks. Their higher inclination to save and the lower degree of borrowing improve the private sector's balance sheets but affect adversely the aggregate demand and medium-term economic growth.

Performance of fiscal indicators in the first half of the year reflected an expansionary fiscal policy, which was manifested in higher budget spending and fiscal deficit. This stance was more pronounced in the second quarter. The increase in budget spending impacted positively on the economic growth over this period, but the overall impact of fiscal policy will depend on the degree of observance of the 2013 budget indicators. Public spending increased 12.2% in annual terms in the first half of this year, heavily influenced by capital spending. On the other hand, budget revenues for this period dropped 2.9% on a year earlier, reflecting the weak performance of tax revenues. These developments were materialised in a significantly higher budget deficit, which resulted more than twice as high as a year earlier.

The public debt increase over this period reflected the budget deficit dynamics. At the end of the first quarter, the public debt accounted for 63.3% of GDP. It constitutes one of the major weaknesses of the Albanian economy and the financial system. Therefore, the Bank of Albania suggests that taking immediate measures to control this debt would significantly contribute to reducing uncertainties and risk premia in the economy. Taking advantage of the opportunity, we reiterate the need for putting in place a reliable and transparent fiscal rule, as the best way to discipline the fiscal policy and preserve the financial market confidence in the Albanian public debt in the long run.

Data from the external sector of the economy show that external demand contributed positively to Albania's economic growth and trade deficit narrowing during the first half of the year. This behaviour was due to the annual growth in exports by 17.4% and annual decline in imports by 6.3% for the same period. Consequently, trade deficit dropped 22.2% over this period.

The insofar trade balance adjustment is a positive development for the Albanian economy; however, the narrowing of the deficit is mainly due to transitory factors. Detailed analysis of trade exchanges confirms high concentration of Albanian exports in certain geographical regions or product groups and their low value added. For stable growth of exports and sound adjustment of trade deficit, the policy-makers' attention should focus on increasing the competitiveness for domestic products and expanding the base of exports through accelerated structural reforms.

Financial market developments reflected low inflation and risk premia, hence enabling better transmission of easing monetary policy signals from year-start. Interbank interest rates were close to the key interest rate and slightly volatile. The primary market yields on Government securities dropped sharply, particularly on longer-term maturities. During the last months, the decrease in interest rates was fast in the deposit market but weak in the credit market. Credit interest rates responded more slowly than other market rates due to the low credit to economy during the last months.

Monetary developments highlight continuation of weak inflationary pressures in the economy. The annual money-supply growth acceleration reflected mainly the public sector's higher demand for financing over the last two months. Also, household and business demand for money remained weak. Private sector credit slowed down significantly, and at end-May, it was 0.2% lower than a year earlier. The poor lending performance is increasingly reflecting the weaker business demand for loans, besides the tight lending standards. Over the past three months, household demand for loans increased, hence signalling a possible recovery of this type of loan.

Our projections for the economic outlook support the assessment that the Albanian economic activity will grow slowly over the period ahead, at levels comparable to those of the first half of the year. External demand will be the driver of economic growth in the coming quarters, while the first-half fiscal stimulus is not expected to persist in the second half of the year. Indirect data do not yet reveal any signals for recovery of consumption and private investment. Below-potential economic growth will be associated with weak demand-side inflationary pressures and in the absence of any unforeseen supply-side shocks, consumer prices will increase at low rates. Annual inflation as to four quarters ahead is expected to fluctuate around the 1.1% - 3.8% range, with a 90% probability of occurrence. Against this setting, our monetary policy will retain its stimulating nature over the quarters ahead. Also, we will continue to provide the banking system with all the liquidity needed for the smooth functioning of financial markets.

II. PRICE STABILITY AND BANK OF ALBANIA'S TARGET

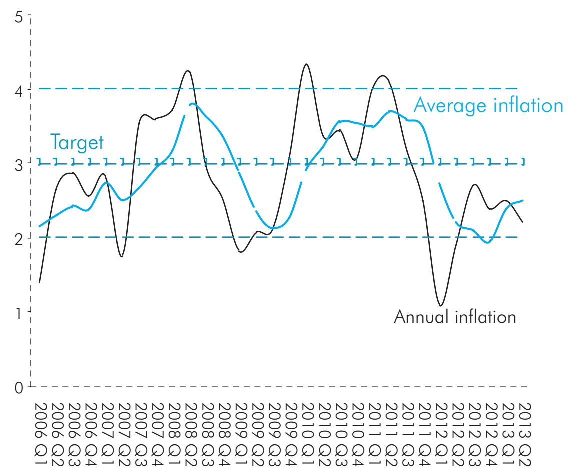
Inflation stayed low during the second quarter. Its performance was determined by the food price volatility, while the other items of the basket had a more stable performance and made a low impact on inflation. The macroeconomic environment was characterised by weak inflationary pressures. The sluggish aggregate demand was reflected in incomplete productive capacity utilisation, further transmitting weak pressures for increase in wages, production costs and profit margins. On the supply side, prices of final products and primary commodities in the global markets were relatively calm, while the performance of the exchange rate and inflation expectations was stable.

Bank of Albania's monetary policy retained its easing stance during the second quarter. The financial markets reflected better the previous key interest rate cuts during this period, while the Bank of Albania continued to inject liquidity into the economy through repurchase agreements. The expected performance of the Albanian economy and the financial markets is likely to be reflected in low inflation over the mid-term horizon. This forecast suggests that the Bank of Albania will continue to pursue an easing monetary policy over the period ahead.

II.1 INFLATION AND MONETARY POLICY

The Albanian economy faced moderate inflationary pressures during the last 12 months. Annual inflation rate averaged 2.2% in Q2, remaining below Bank of Albania's target and lower than the previous quarter's 2.5% rate.

Chart1 Annual inflation (in %)

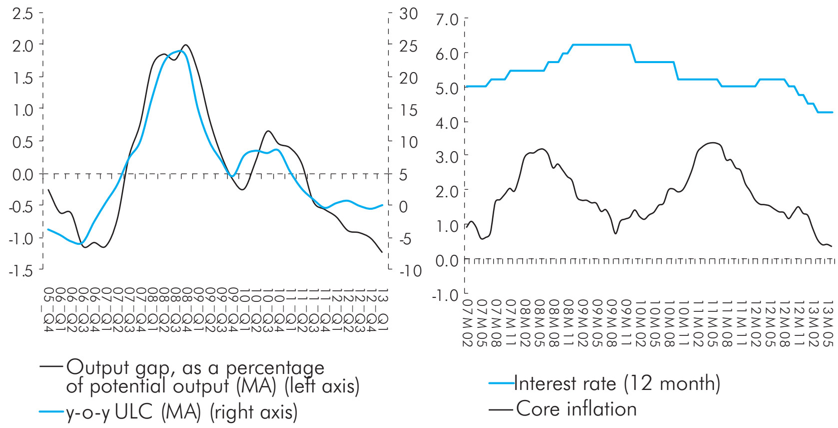


Source: INSTAT and Bank of Albania.

International primary commodity prices dropped during this period but the moderate inflation rates were affected mainly by the weak domestic demand. Decline in consumption and investments determined the incomplete utilisation of productive capacities and led to low increase in wages and production costs. These developments were also reflected in a downtrend of the core inflation, hence leading to lower headline inflation.

Reflecting the weak current and expected inflationary pressures, the Bank of Albania continued the easing monetary policy in Q2[1]. The key interest rate was kept unchanged at its record low of 3.75%, but it continued to supply the banking system with the liquidity needed for the functioning of monetary markets.

Chart 2 Output gap and annual change in the unit labour cost (ULC) (left)*; key interest rate and annual core inflation (right)



Source: Bank of Albania calculations.
*Note: MA (four-term moving average to flatten the short-term volatility).

The Bank of Albania continued to carry out regular liquidity-injection operations of 7-day and 1-month maturity term. The improved funding and liquidity demand and supply ratios, as well as the signals for the pursuit of a stimulating monetary policy over a mid-term horizon, were reflected in an overall downtrend of interest rates in the economy. However, the decrease in interest rates was more noticeable on deposits and government debt instruments, and less on loans. This development highlights the presence of high risk premia in the Albanian economy, which is related to banks and businesses' perception of a slow economic outlook and tight lending terms imposed by the euro-area financial situation. Similar to all the other countries in the region, the presence of high risk premia in the economy have led to incomplete pass-through of the easing monetary policy to aggregate demand growth. In light of this fact, in March, the Bank of Albania approved a package of stimulating macro-prudential measures – expected to materialise in the future – to boost lending and improve the monetary policy transmission mechanism.

II.2 INFLATION BY ITEM

Food prices, particularly the unprocessed ones, determined the inflation developments in 2013 H1. The other CPI basket items generally contributed less or negatively to inflation.

Annual 'unprocessed food' inflation averaged 10% in Q2, up by 1.5 percentage points from the previous quarter. The high inflation rate over this

[1] *In January 2013, Bank of Albania's Supervisory Council lowered the key interest rate by 25 basis points for the sixth consecutive time since September 2011, to a record low of 3.75%.*

period was due to imbalances between the demand for and supply of these products, in response to the seasonal fluctuations in the domestic agricultural supply. Unprocessed food prices were high in the countries in the region as well, and hence, their performance in the domestic market was under the pressure of international market developments.

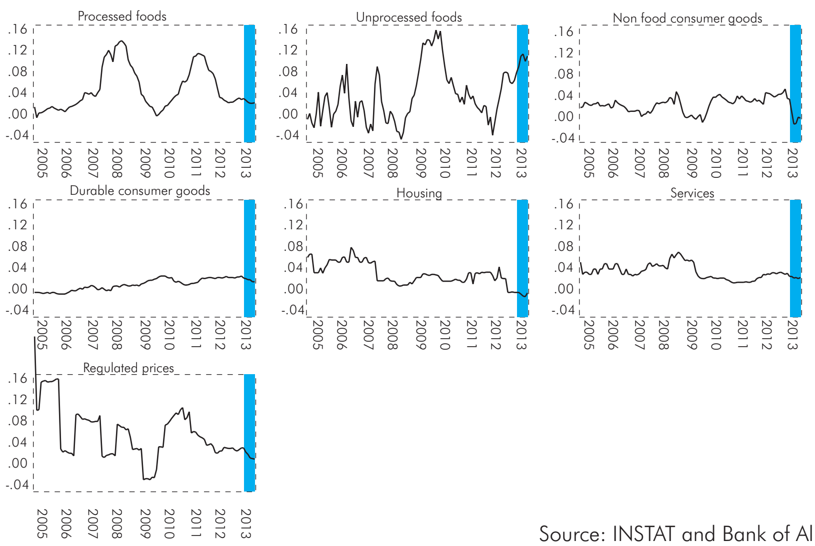
'Processed food' prices resulted in a lower inflation than a quarter earlier. This item's annual inflation and contribution to headline inflation were 1.3% and 0.3 percentage points, being the lowest rates in the last two years. As always, the conjecture of these goods' prices in the global market remains the main driver of this item's price performance.

Table 1 Annual contribution of key items to annual inflation (in percentage points)

	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2
1. Processed foods (pp)	2.2	2.5	2.2	1.6	0.7	0.4	0.4	0.6	0.5	0.3
Bread and grains (pp)	0.7	1.0	0.8	0.5	0.2	0.0	0.0	0.0	0.1	0.1
Alcohol and tobacco (pp)	0.5	0.4	0.4	0.4	0.1	0.1	0.1	0.2	0.1	0.2
2. Unprocessed foods (pp)	0.6	0.5	0.0	-0.1	-0.6	0.5	1.3	1.0	1.7	2.0
Fruits (pp)	0.2	0.4	0.2	0.3	0.3	0.3	0.5	0.5	0.3	0.4
Vegetables (pp)	0.1	-0.4	-0.6	-0.7	-1.2	-0.1	0.7	0.2	1.2	1.5
3. Services (pp)	0.0	0.0	0.1	0.0	0.0	0.2	0.2	0.2	0.2	0.1
4. Regulated prices (pp)	0.4	0.3	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Fuels and energy (pp)	0.2	0.3	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0
5. Housing (pp)	0.2	0.3	0.3	0.3	0.3	0.2	0.0	-0.2	-0.2	-0.2
6. Non-food consumer goods	0.6	0.5	0.4	0.6	0.6	0.4	0.5	0.5	0.1	-0.2
7. Durable consumer goods (pp)	0.0	0.1	0.1	0.1	0.0	0.1	0.2	0.2	0.1	0.1
Consumer Price Index (y-o-y, %)	4.0	4.1	3.2	2.5	1.1	1.9	2.7	2.4	2.5	2.2

Source: INSTAT and Bank of Albania.
**The table presents some of the main items.*

Chart 3 Annual inflation by item of goods and services (in %)



Source: INSTAT and Bank of Albania.

During this quarter, 'non-food consumer goods' and 'housing' contributed negatively. Non-food inflation rate remained one of the lowest in the past ten years (-1.8%), contributing significantly to the fall of headline inflation rate (-0.3 percentage points). This fall was due to a lower international oil price and cancelled-out effect of environment tax on the oil price (which was present throughout 2012). Housing inflation rate continued to be negative (-1.9%), despite the higher prices of 'rent' and 'imputed rent' sub-items.

The other less-weight items continued to make low contribution to annual inflation, similar to a quarter earlier. The annual 'regulated price' inflation was 0.2% in Q2, contributing marginally to headline inflation.

III. MACROECONOMIC DEVELOPMENTS

The analysis of economic and monetary developments, updated with new information from Q2, depicts weak inflationary pressures. These pressures are conditioned by weak-but-below potential economic growth, relatively stable inflation in international markets, anchored inflation expectations and controlled expansion of monetary assets. Particularly, the below-potential growth of the Albanian economy remains the main contributory factor to the weak inflationary pressures.

Aggregate demand remained weak in 2013 H1. External demand and increased fiscal stimulus supported the economic growth, while consumption and private investment remained weak. INSTAT data show that the first-quarter economic growth was 1.7%. Our projections suggest that the second-quarter growth has remained close to that but marginally higher due to higher fiscal stimulus. Consumption and domestic investments will significantly determine the economic growth. Albanian businesses and consumers remain reluctant in undertaking long-term consumption or investment plans; however, they are expected to find a higher support from better transmission of the easing monetary policy. Also, the fiscal policy stance in the mid-term horizon will be another driver of economic developments over this period.

III.1 EXTERNAL ECONOMY

III.1.1 ECONOMIC GROWTH AND MAIN MACROECONOMIC BALANCES

Global economy continued to recover in Q2, despite the slowing and uneven growth rates across countries. The recovery of global economy is expected to continue at moderate paces but uncertainties continue to weigh on it. Advanced economies have recorded modest growth rates, while emerging ones have displayed stronger growth rates. Inflation rates have been downward in advanced economies but non-homogeneous in emerging economies due to specific transient factors.

Table 2 Selected macroeconomic indicators

	GDP change		Unemployment rate	Inflation rate	
Countries	2013 Q1/ 2012 Q4	2013 Q1/ 2012 Q1	May 2013	June 2013/ May 2013	June 2013 June 2013
USA	0.6	1.8	7.61	0.2	1.8
Euro area	-0.2	-1.1	12.2	0.1	1.6
Germany	0.1	-0.3	5.3	0.1	1.8
France	-0.2	-0.4	10.9	0.2	0.9
United Kingdom	0.3	0.6	7.8	0.20	2.9
Japan	0.7	3.5	4.1	0.12	-0.32

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

[1] *June 2013*

[2] *May 2013*

ADVANCED ECONOMIES

Referring to the latest data, the Euro area GDP for 2013 Q1 contracted 0.2% in quarterly terms and 1.1% in annual terms. Excluding Germany, which recorded positive growth (0.1%), most of the euro-area economies contracted. This was primarily due to decreased private consumption and overall weakening of productive activity, while the labour market remained sluggish and recorded a high unemployment rate, particularly for young age groups. Leading indicators improved slightly over the past months, supporting the possibility for economic recovery over the rest of the year. In the presence of a constrained demand, inflationary pressures remain moderate and prices are expected to perform within the ECB target.

In Q1, the United States economy grew 1.6% in annual terms, slowing the growth rate for the third consecutive quarter. The growth was driven by the revival of consumer spending and private investment, and the slower contraction of government spending. Net exports and immediate deceleration of non-residential investments have contributed negatively. Indirect data signal positive growth in Q2, almost similar to a quarter earlier. Unemployment was downward in quarterly terms. The weak performance of industrial output and expectations for lower government spending remained on the downside. According to expert forecasts, the economic growth is expected to remain flat until Q4, to later accelerate over the periods ahead.

ECONOMIES IN THE REGION

Italian economy continued to contract in Q1, reflecting the drop in services and industrial output sectors. The second-quarter data indicate improved net exports due to contracted imports, and a weak performance of construction and industry sectors.

Greek economy continued its downtrend in Q1, displaying curtailed consumer spending and investments. In the external sector, contraction in trade deficit made positive contribution. Preliminary data suggest that the hardship that the Greek economy is going through will continue over the quarters ahead. Government and consumer expenditures will continue to suffer from public-sector job cuts needed to repair balance sheets and benefit financing from the troika of international institutions.[2]

Turkey's GDP accelerated its growth rate in 2013 Q1, to the 3% annualised rate. Increased public spending was the main driver of growth, while contracted private investment and curtailed net export affected adversely. Indirect data on economic activity depict positive developments until May, though the political unrest that started in June is expected to restrain the economic growth for Q2. According to forecasts, the economic growth for 2013 is expected to be 3.2%, up by one percentage point on a year earlier.

Table 3 Economic figures for countries in the region

Countries	GDP change	Annual inflation	Unemployment rate
	2013 Q1/2012 Q1	June 2013	April 2013
Italy	-2.3	3.6	12.22
Greece	-5.3	1.0	26.9
FYROM	2.9	4.2	29.91
Serbia	2.1	9.8	24.1
Croatia	-1.5	2.0	18.11
Turkey	3.0	8.3	9.3
Kosovo	4.5 (2011)	2.6	:
Albania	1.7	2.3	12.81

Source: Respective Statistical Institutes, IMF, EcFin, Eurostat.
1 - Value for 2013 Q1; 2- Value for May 2013; Unavailable data

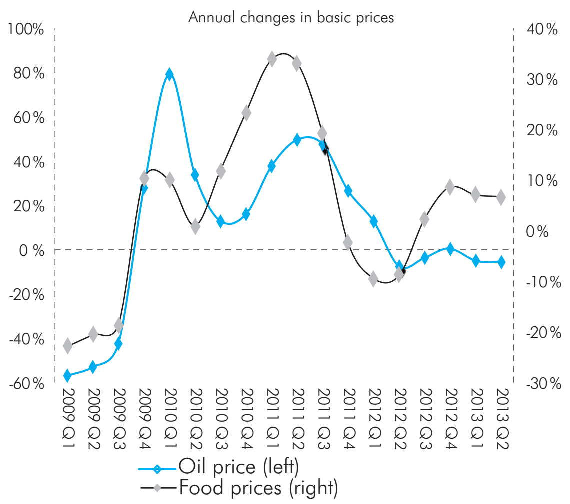
The FYROM economy accelerated the growth rates, attesting to increased investments and consumer spending, and improved external balance due to sharp decline in imports. All the sectors of the economy expanded, in particular the construction sector, which recorded sharp growth. Indirect data give mixed signals for Q2, fluctuating around their values from month to month. Economic institutions' forecasts suggest for a slightly slower growth over the quarters ahead.

III.1.2 PRIMARY COMMODITY PRICES

Average international oil price per barrel continued to trend down in 2013 Q2. The European Brent oil price averaged US$ 102.6 per barrel in Q2, down by 5.4% in annual terms. Compared to Q1, the oil price drop was sharper, down by 8.8%. The contracted global oil demand and higher production from non-member OPEC countries are the main contributory factors to the downward oil price for the period under review. In line with this, Fed statements for re-dimensioning its quantitative easing programmes and the forecasts for contraction in the Chinese economy appear to have played a complementary role in June. In the meantime, the political situation in Egypt has elevated supply-side uncertainties, leading to oil price rise from late June and onward.

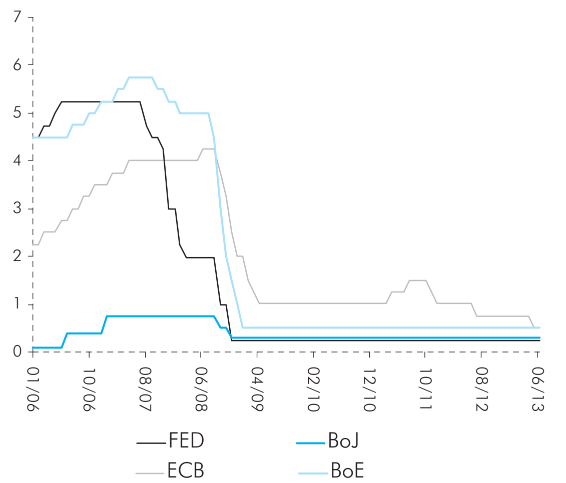
[2] *The troika of institutions that decide on disbursement of rescue packages to the Greek Government consists of the European Union, the European Central Bank and the International Monetary Fund.*

Chart 4 Basic prices (in per cent)



Source: IMF, EIA.

Chart 5 Key interest rates



Source: Respective banks (ECB, Fed, BoJ and BoE).

The IMF index for primary commodity prices also trended down. For the quarter under review, this index dropped 2.4% in annual terms and 4.4% in quarterly terms. Besides a lower oil price, this index reflected contraction in base metal prices due to weakening demand from advanced economies. Food prices increased 6.7% in annual terms, remaining 0.4 percentage points below the figure for 2013 Q1. Compared to the previous quarter, these prices increased only 0.8%, reflecting mainly the increase in corn prices.[3]

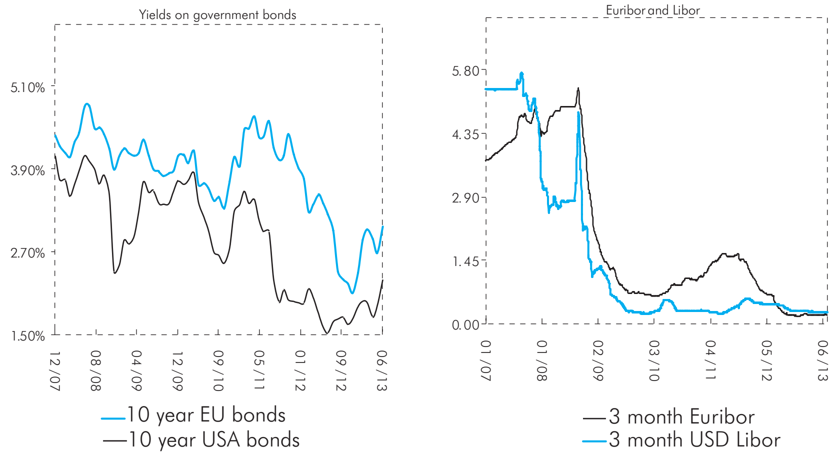
III.1.3 MONETARY POLICY AND FINANCIAL MARKETS

The European Central Bank, at its meeting of May, decided to lower the key interest rate by 0.25 p.p., to 0.50%. The other central banks kept their key interest rates unchanged, respectively, as follows: 0-0.25%, Federal Reserve; 0.5%, Bank of England; and 0-0.1%, Bank of Japan.

In the euro-area money market, the euribor rates transmitted the last interest rate change effected in May, hence pursuing a downward trend. ECB and Fed's "free money" offer during this period, impacted on keeping low money market interest rates. Government bond yields in capital markets were volatile, edging up by the end of the quarter. Agents' ameliorated expectations for the euro-area economic outlook, and the effect of Fed's news for a potential change in the quantitative easing, conditioned the upward trend of yields during this period. In foreign exchange markets, during this quarter, the euro depreciated against the U.S. dollar and the sterling appreciated against the Japanese yen. On average bilateral terms, in Q2, one euro was traded with US$ 1.3062, depreciating by 1.12% from 2013 Q1, but appreciating by 1.84% from a year earlier.

3 *The higher corn prices were due to higher maize price in response to constrained supply for exports and delays in sowing in the United States.*

Chart 6 Selected global financial indicators



Source: ECB, Reuters.

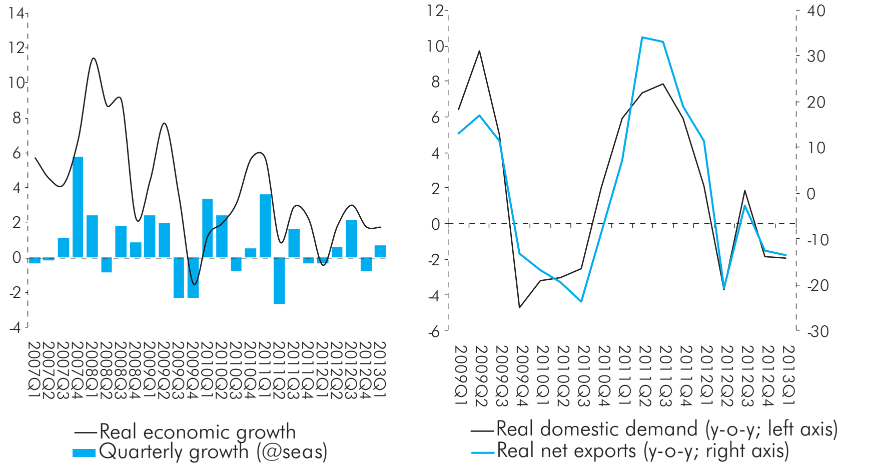
III.1.4 IMPACT ON ALBANIAN ECONOMY

Developments in international financial markets and economies do not support Albania's economic growth and will continue to exert weak inflationary pressures on the Albanian economy. The aggregate demand in trading partners is expected to contract in 2013 H2, hence being reflected in an expected slowdown in the domestic export growth rate. Though the global financial market developments do not display any tensions or liquidity shortages, the external financing conditions remain tight. Against the backdrop of an external economic environment characterised by moderate prices for primary commodities and consumer goods, inflationary pressures on domestic consumer prices are likely to be contained.

III.2 GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

According to INSTAT data, the Albanian economy grew by 1.7% in 2013 Q1. In line with our assessments, the external demand and the fiscal stimulus pushed the economic growth, while the domestic private demand remained sluggish. Overall uncertainties perceived by economic and financial agents continued to affect the economic growth rates. Also, the tight lending terms in the country and abroad, and the poor performance of our major trading partners did not support the aggregate demand growth.

Chart 7 GDP (left) and annual dynamics of external and domestic components of economic growth (right)



Source: INSTAT and Bank of Albania.

The available data show a slightly higher and more balanced economic growth for Q2[4]. The domestic private demand revived, reflecting mainly the fiscal stimulus of this period. However, the acceleration of growth in Q2 is expected to be short-term. For 2013, the economic growth is expected to remain close to that of a year earlier. It will rely heavily on consumption and private investments. These two important aggregate demand components remain subject to elevated uncertainties, still tight lending terms and more cautious stance of economic agents about the sustainability of their balance sheets. Therefore, the economic growth projection is subject to many risks and uncertainties.

III.2.1 SECTORAL OUTPUT

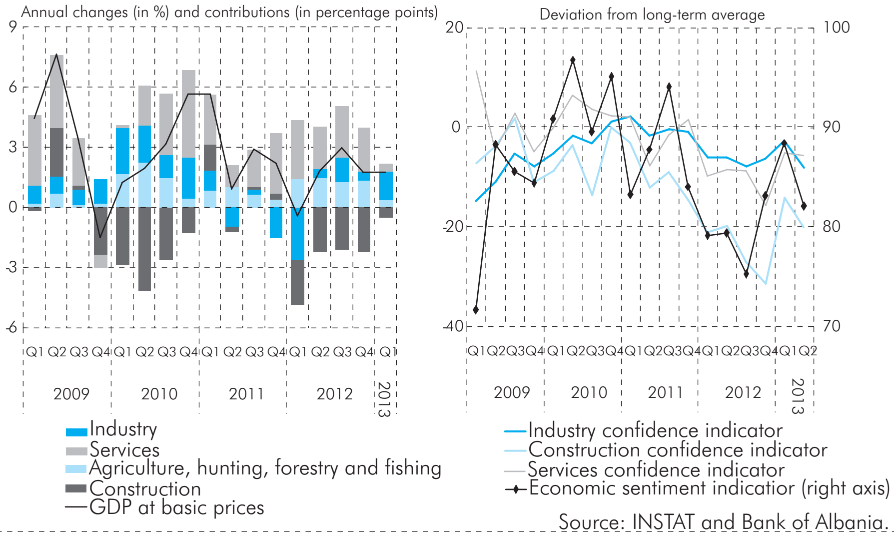
The sectoral contributory profile to economic activity growth turned out different from the previous quarter and the past year. In Q1, the industry sector supported significantly the expantion in economic activity, while the services sector slowed down sharply. The construction sector, on the other hand, continued to contract but at low rates.

During the quarter under review, the production sector[5] contributed the most (1.3 percentage points) to economic growth, while the services sector contributed only 0.4 percentage points. The improved trend of the production sector in 2013 Q1 reflected mainly the increased value added from the industrial activity.

[4] *We base our assessment of economic performance for Q2 on imports and exports of goods in value, on credit to economy as of May and on fiscal and qualitative indicators from confidence surveys for Q2.*

[5] *The production sector includes 'Agriculture, hunting, forestry and fishing', 'Industry' and 'Construction'. The services sector includes 'Trade, hotels and restaurants', 'Transport', 'Post and telecommunication', and 'Other services'.*

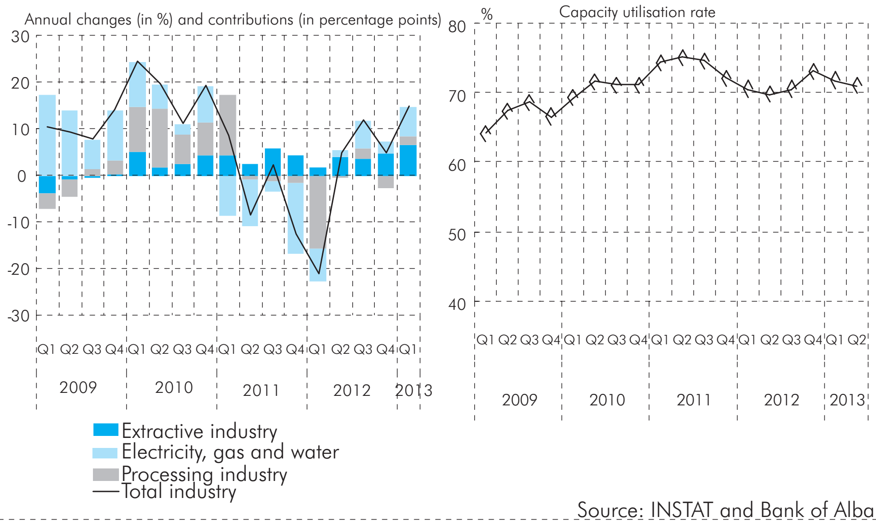
Chart 8 Sectoral contribution to annual GDP (left); confidence indicators (right)



Source: INSTAT and Bank of Albania.

Specifically, the industry sector generated a 14.8% higher value added than in the same period a year earlier, contributing 1.4 percentage points to annual GDP growth. The industry sector dynamics was affected positively by the external demand, reflected in accelerated annual growth rates of exports of industrial products. 'Extractive industry' and 'Electric energy, gas and water'[6] branches increased the total value added in industry, respectively by 6.5 percentage points. Processing industry also performed positively, with a 2.5% higher value added in annual terms. The lower growth rate of industrial exports during April-May and the reduced confidence indicators suggest for a decelerated activity in the industry sector, in Q2.

Chart 9 Value added in industry branches by contribution and capacity utilisation rate in industry

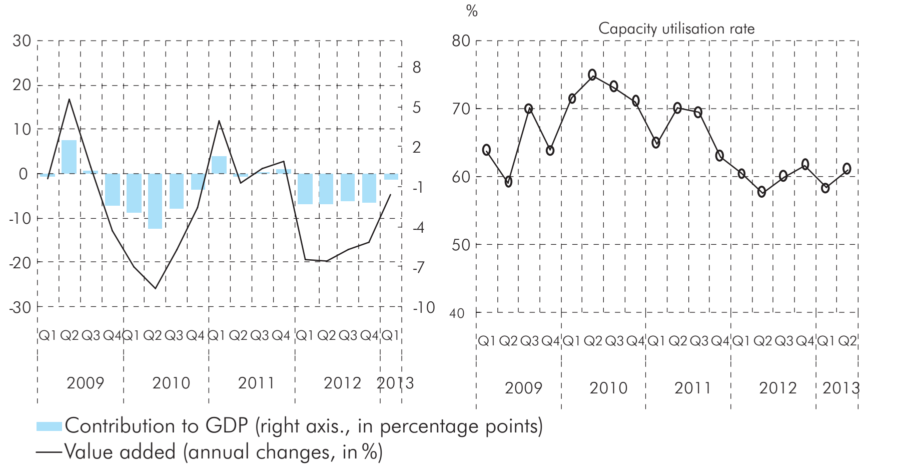


Source: INSTAT and Bank of Albania.

6 *The higher value added in 'Electric energy, gas and water', and in 'Processing industry' reflected also the low comparative base effect. In 2012 Q1, the value added dropped 43.1% in the electric energy, gas and water and 22.5% in the processing industry, in annual terms.*

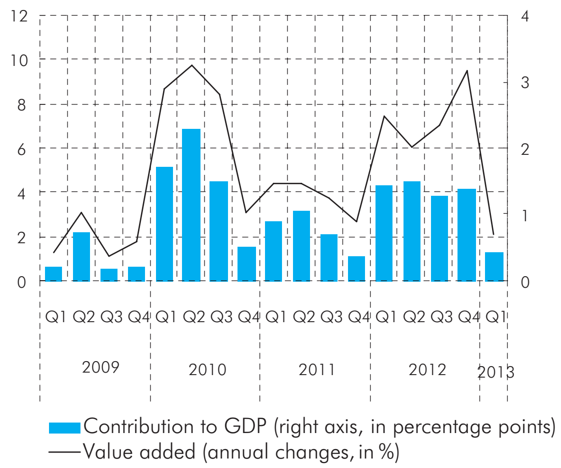
Construction sector, despite contracting in 2013 Q1, decreased its negative contribution to annual GDP by 0.5 percentage points. The value added in the construction sector continued to drop, though at mitigated rates (-4.8%, from -17.8% on average in 2012). In 2013 Q2, the performance of the construction sector is expected to improve, mainly thanks to increase in public investments. Also, business assessment of a slightly higher rate of capacity utilisation in Q2, suggests for a more positive dynamics of the construction sector.

Chart 10 Value added, contribution and capacity utilisation rate in the construction sector



Source: INSTAT and Bank of Albania.

Chart 11 Value added in agriculture, hunting, forestry and fishing and their contribution to annual GDP growth



Source: INSTAT and Bank of Albania.

Activities related to agriculture, hunting, forestry and fishing continued to boost GDP growth in Q1, though with less contribution (0.4 percentage points). This sector's annual growth decelerated to 2.1% over this period.[7]

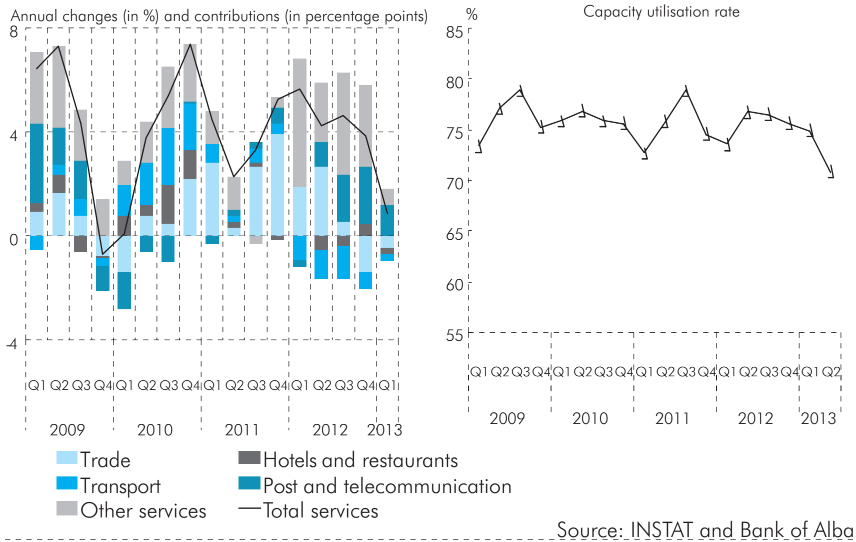
The services sector decelerated further in 2013 Q1, generating a 0.9% higher value added than in the same quarter of the previous year. This dynamics, significantly lower than the 5.3% historical average[8] resulted from a combination of lower expansion rates in other services branches[9], post and telecommunication, with the more contracted activity in transport, trade, hotels and restaurants.

[7] The performance of the value added in the agriculture sector reflected the comparative base effect, which in 2012 Q1 posted a high annual growth (7.4%).

[8] Annual historical average rates of first quarters since 2005.

[9] 'Other services' include the following branches: Monetary intermediation; immovable property, leasing and business-related services; public administration, protection and social security; education; healthcare; and other collective, social and individual services.

Chart 12 Value added in services branches by contribution and capacity utilisation rate in services



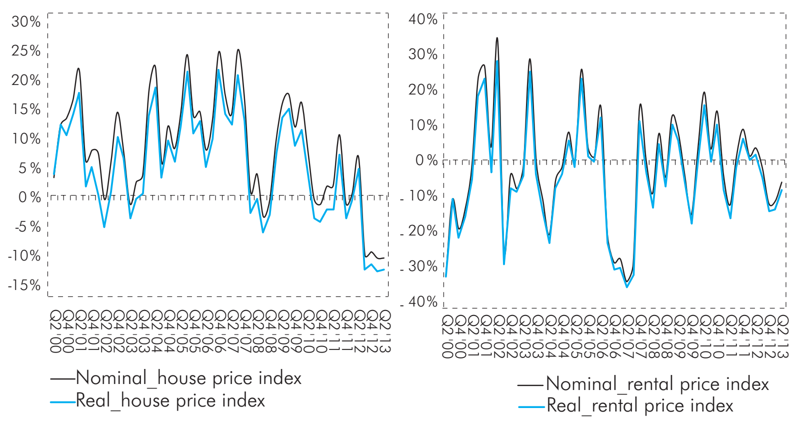
Source: INSTAT and Bank of Albania.

More specifically, the value added by other services posted 1.3% annual expansion, which is lower than the 6.1% long-term historical average. The sub-branch of immovable property, leasing and business-related services made a larger negative contribution. Also, the branch of post and telecommunication turned out to be slower than in the past two quarters, reflected in the 15.4% annual value added expansion. On the contrary, the value added from trade, hotels and restaurants continued to fall by 2.1%, adversely affected more by the hotel and restaurant services. Also, the transport branch continued to drop by an annualised rate of 2.9%. Services confidence index dropped in Q2.

*Box 1 House and Rental Prices**

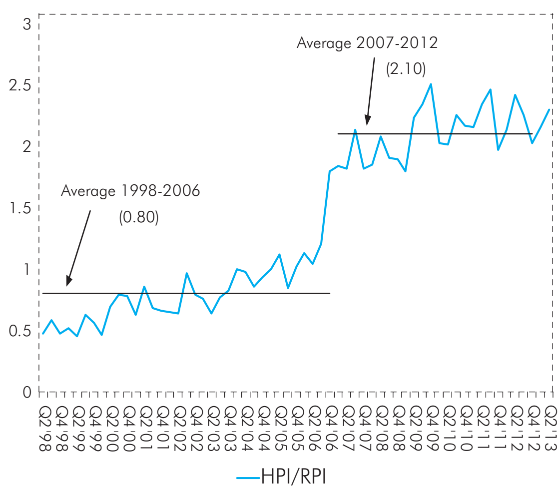
House Price Index continued to trend down in 2013 Q2, falling 10.7% in annual nominal terms. Deflated with the consumer price index, the contraction in the house price was 12.7%. Rental Price Index also performed alike, dropping 6.3% in annual nominal terms, in 2013 Q2. In annual real terms, it dropped 8.3%.

Chart 13 House Price Index and Rental Price Index (annual change, in %)



Source: Bank of Albania.

Chart 14 Price-to-rent ratio



Source: Bank of Albania.

In 2013 Q2, the house price performance reflected the sluggish consumer demand and the poor performance of house purchase loans. However, based on the Bank Lending Survey, mortgage loan standards eased over the first two quarters of 2013, and the household demand for this type of loan increased marginally. This development, combined with the expectations for a recovery of supply (improvement in the construction confidence index and pickup in construction permits) will determine price changes over the period ahead.

The latest developments in the housing market show that selling prices continued to fall relative to rental prices, based on the analysis of price-to-rent ratio. This ratio is about 4.7% lower than in the same period a year earlier. Compared with the previous quarter, this ratio increased 6.8% (because of the house price rise in quarterly terms). The price-to-rent ratio, albeit downward, remains above its historical trend.

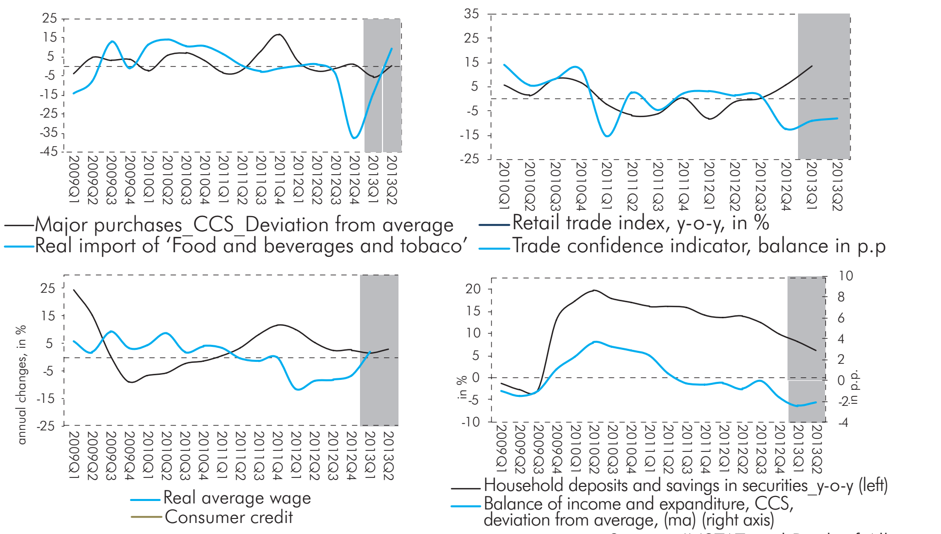
* *The analysis of house and rental prices is based on respective information only for Tirana.*

III.2.2 AGGREGATE DEMAND

The external demand and fiscal stimulus supported the economic growth in Q1, while the domestic private demand remained sluggish. The deep narrowing of net exports reflected the positive contribution from the external demand to economic growth, whereas private consumption and investments continued to suffer from the weak confidence in household income stability and tight lending terms over the past year. Indirect available data for Q2 point to: continuation of positive but decelerated contribution of external demand; higher fiscal stimulus; and, higher private domestic demand. Uncertainty and tight lending remain risks on the downside and suggest for lack of a stable trend toward recovery of the latter.

Weakening of private consumption continued in 2013 Q1 and Q2. Indirect quantitative and qualitative data from surveys confirm the downward contribution of private consumption to aggregate demand in Q1. Quantitative data from imports and surveys point to lower consumer demand for durable goods.[10] On the other hand, the higher value added from some branches of the services sector[11] and the higher retail trade index indicate increase in the consumption of daily consumer goods. This allocation of expenditures has reflected the developments in the main financing sources of consumption. The real wage index, after dropping 8.7% in 2012, increased 2.1% in 2013 Q1. The cautious consumer behaviour toward spending on durable goods was reflected in the low growth of consumer credit, in Q1.

Chart 15 Indirect data on private consumption and sources of its financing



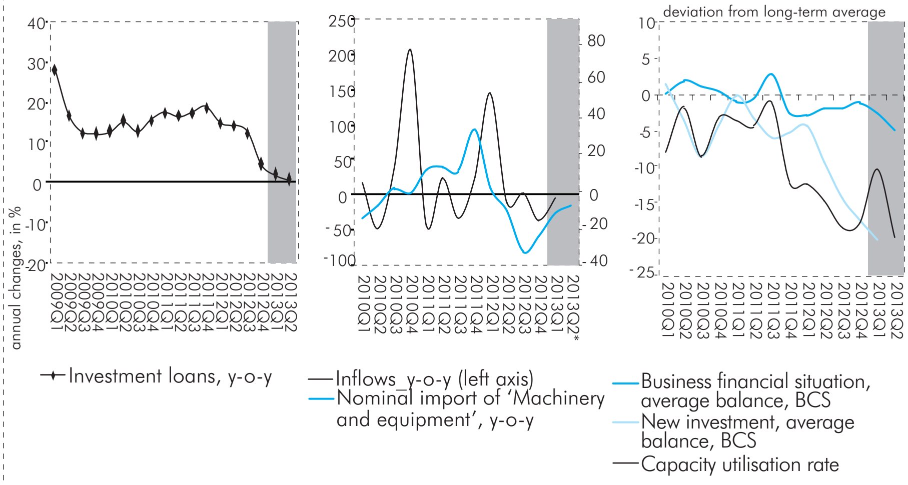
Source: INSTAT and Bank of Albania.

[10] The annual decline in import of vehicles and the exacerbation of large purchase balances.

[11] Consumer demand for services is proxied by the value added in 'Hotels and restaurants', 'Post and telecommunication', 'Financial activities', 'Real estate and leasing', 'Administrative and defence expenditures', 'Health', and 'Other services'.

According to indirect qualitative and quantitative data, the dynamics of private consumption improved in Q2. Import of consumer goods increased 8.8%, after the negative rates recorded over the past three quarters. Improvement of confidence indicators in the trade sector suggests for a continuously increased consumption of goods and services in Q2. The private consumption recovery was also supported by the increase in consumer loans (3.1% in April-May, from 1.5% in Q1), a nd the easing fiscal policy measures in Q2.12

Chart 16 Indirect private consumption data



Source: INSTAT and Bank of Albania.

The set of indicators that proxy private investments in the economy suggest for their still low level in Q1. The still high non-utilised capacity rate, uncertainty for the future and tight lending terms continue to discourage undertaking of new private investments. Import of 'Machinery and equipment' dropped 12.3% in Q1, continuing the 2012 downtrend. In line with the weakening demand, investment loans decelerated during the first months of the year.

Qualitative data from Q2 business confidence surveys point to low capacity utilisation rates in the economy and pessimistic assessments of the financial condition, irrespective of the high public investment stimulus during this quarter, on private investments, particularly on the construction sector. The capacity utilisation rate in this sector increased in Q2. Import of capital goods halved its downward rate in Q2 (to -11%, from -24% in Q1). On the other hand, the lending terms remained tight in Q2.

FISCAL INDICATORS AND FISCAL POLICY

The discretionary fiscal policy in 2013 H1 had underlying easing features, reflected in the rapidly growing rates of the budget deficit. The higher fiscal stimulus in the form of higher public spending, and the implementation of an easing tax policy that led to a higher number of exemptions from tax duties,

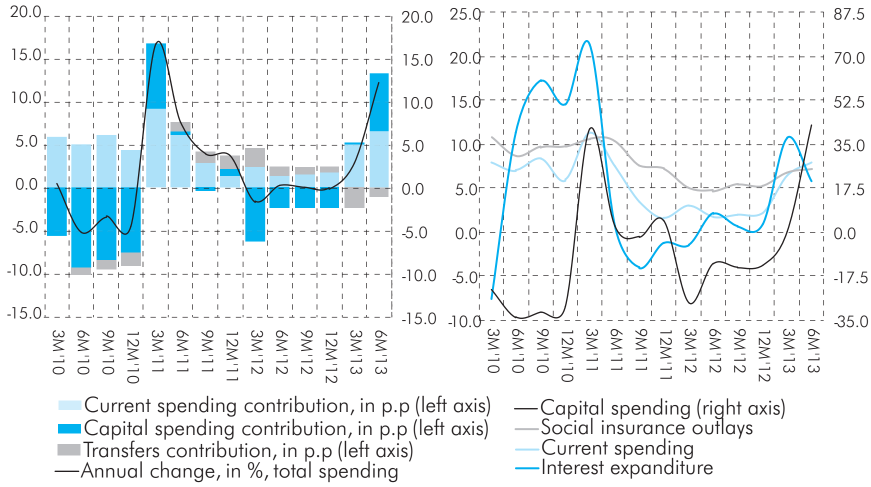
[12] *See "Fiscal Indicators and Fiscal Policy".*

as well as the direct or indirect cut of some taxes[13] highlight the budget deficit expansion.

Budget spending increased considerably in both categories, particularly after Q1. Their intensification during this period is expected to materialise into a substantial positive contribution of public spending to aggregate demand growth for Q2. On the other hand, budget revenues continued to contract due to negative rates recorded in the tax revenue category. The subsequent developments are reflected in an exacerbated dynamics of primary deficit, which is transmitted into further increase in public debt.

Budget spending in 2013 H1 reached ALL 205.1 billion, with an annual growth rate of 12.2%.[14] Capital spending made a high contribution to total expenditure growth, by about 6.7 percentage points. This category of expenditure increased rapidly, by 84% in annual terms, a phenomenon not seen since 2011 Q1. Capital spending in 2013 H1 was about 42.5% higher than in 2012 H1. On the other hand, current spending pursued a progressively upward profile during the quarter under review. At end-H1, current spending resulted 7.9% higher than a year earlier, with major contribution by social security and economic assistance outlays (by 2.7 and 2 percentage points, respectively).

Chart 17 Annual change of budget spending by contribution of both main categories (left) and annual change of main expenditure items (right), 2010 Q1 - 2013 H1



Source: Ministry of Finance.

[13] In 2013 H1, the existing legislation on taxes was amended, as follows: alterations and amendments to the Law on VAT, expanding the range of VAT exemptions; (ii) amendments to the Law "On national taxes", effecting a lower tax on fuels; (iii) amendments to the Law "On personal income tax", excluding from the personal income tax liability the category of employees whose wage is up to ALL 30 thousand (on the wage difference from ALL 20-30 thousand). Also, this period saw the re-entry into force of the Law "On legalizing the capital and forgiving part of tax and customs debt", and the Law on "Re-evaluation of real estate", both laws being part of the 2011 fiscal amnesty (which ended in March 2012).

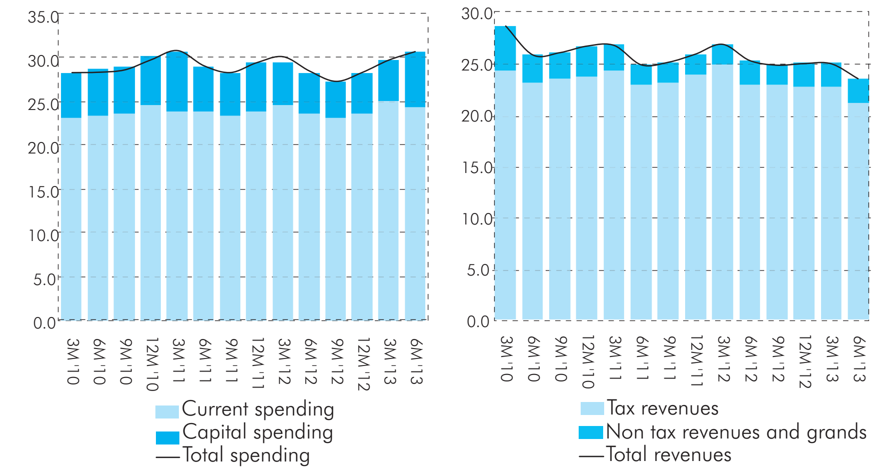
[14] The annual change of total expenditure, excluding the effect of the KESH loan disbursed in February 2012, was about 13.3%.

In Q2, the public sector made a higher contribution to economic growth in the form of final government consumption due to the profile of expenses that are a proxy for this aggregate demand component (personnel expenses and items proxying the purchase of goods and services by the public sector). The fiscal stimulus was also urged considerably by public investments, hence contributing directly to aggregate demand growth.

Budget spending for 2013 H1 accounted for about 30.6% of GDP, or up by 2 percentage points from the first-half average of the period between 2010 and 2012. The above-average ratios of the previous three years were heavily determined by the capital spending trend, which accounted for 6.2% of GDP, or up by 1.1 percentage points from the time span average. Current expenditures accounted for about 24.4% of GDP, recording higher ratios than the 2010-2012 average.

The budget revenue profile in terms of GDP appears contrary to that of fiscal expenditure. Total revenues for 2013 H1 accounted for about 23.4% of GDP, or down by 1.8 percentage points from the first-half average of the period between 2010 and 2012. The lower ratios of total revenues as a percentage of GDP were fully determined by tax revenues, which were markedly downward during this year, accounting for about 20.9% of GDP or down by 1.9 percentage points from the average of the past three years.

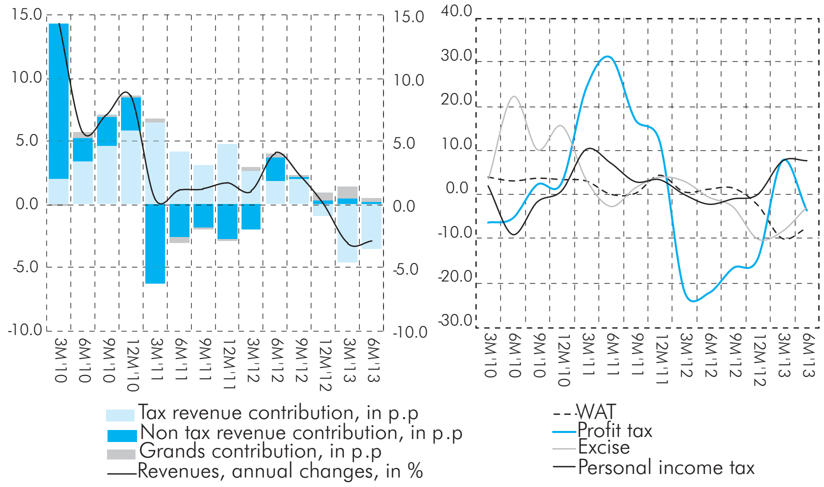
Chart 18 Main fiscal indicators as a percentage of GDP by expenditure (left) and revenue (right), 2010 Q1 - 2013 H1



Source: Ministry of Finance, INSTAT and Monetary Policy Department calculations.

H1 fiscal revenues totalled ALL 156.8 billion, or down by 2.9% in annual nominal terms. The contraction in total revenues over this period was driven by the lower tax revenues. This category dropped continuously in annual terms during this year, unlike its historical behaviour. H1 tax revenues dropped 3.9% on the same period a year earlier, mainly due to lower annual levels of VAT, excise tax, profit tax and national tax revenues. The downward dynamics of tax revenues resulted from a combination of weakening domestic demand with the set of fiscal measures taken during this budget year.

Chart 19 Annual change of budget revenue by contribution of both main categories (left) and annual change of main revenue items (right), 2010 Q1 - 2013 H1



Source: Ministry of Finance.

VAT revenues made the highest negative contribution to tax revenue change (by about 2.8 percentage points). The downward dynamics of VAT revenues resulted from lower imports in annual terms, continuation of a decelerated economic activity in the country during this period, and higher reimbursement from a year earlier.[15]

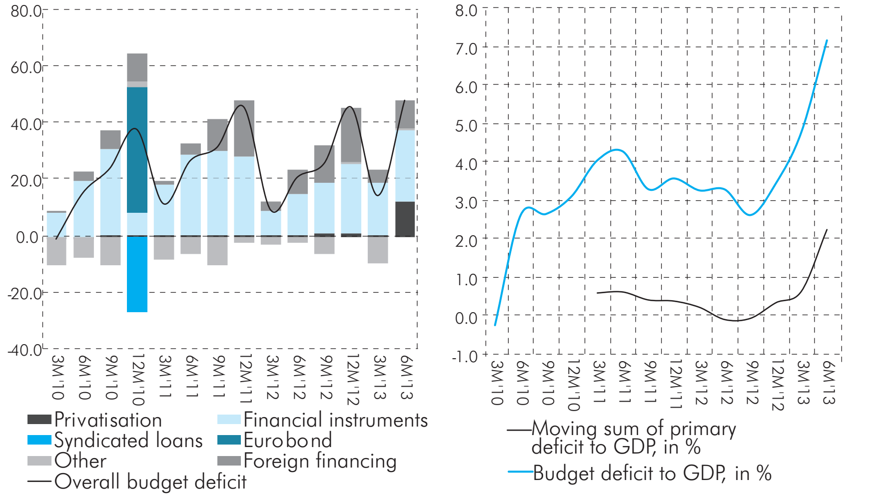
The budget deficit for 2013 H1 resulted about ALL 42.2 billion, or up by ALL 27.1 billion from the same period a year earlier, largely reflecting the rapidly increasing budget spending. Sharp expansion of budget deficit, particularly in Q2, led to shifting of the major part of domestically planned borrowing (about 90.1%) for 2013, to H1 of the year. Domestic borrowing financed about 52.4% of the six-month fiscal deficit, whereas the foreign one financed about 21% of it.[16] Budget deficit financing relied largely on privatisation receipts, alongside security issuance and foreign borrowing. Privatisation receipts posted about ALL 15.8 billion and represent mostly the hydro-electric power stations privatisation receipts. Net privatisation receipts (factoring into the effect of VAT reimbursement to Kurum sh.a.) accounted for about 25.7% of total budget deficit in H1.

Breaking down the domestic borrowing by maturity, long-term instruments dominated over short-term ones. Participants in the primary security market sought mostly long-term instruments (2, 3, 5 and 7-year bonds), in line with the government borrowing strategy. In this context, long-term instruments account for 88% of the domestic borrowing, while the Treasury bill portfolio accounts for the rest.

[15] *VAT net revenues contracted 7.4% in annual terms, but factoring into the reimbursement effect during this period, their contraction would have moderated to about 4.9%. VAT reimbursement by ALL 3.5 billion to Kurum company also played an important role. At the same time, for the first five months of the year, the VAT collected on import of goods contracted 5.3%, almost similar to imports in value for the first five months of the year (5.5%). On the other hand, the VAT collected on production of goods and services in the country continued to post negative growth rates, by about 2% (for H1 of the year).*

[16] *The remainder after including privatisation receipts (1%) belongs to the 'Other' item, which represents mostly the government liquidity position.*

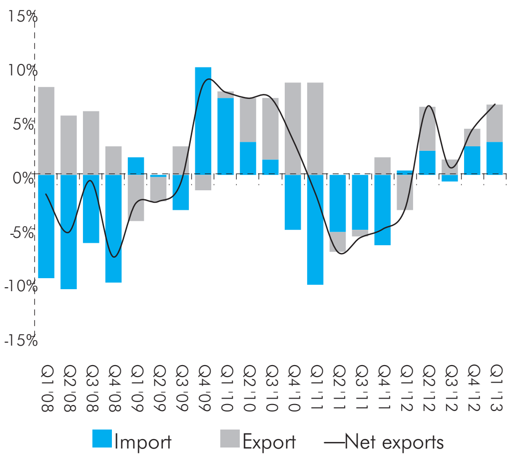
Chart 20 Budget deficit and its financing by instruments, in ALL billion (left); primary deficit and budget deficit as a percentage of GDP (right), 2010 Q1 - 2013 H1



Source: Ministry of Finance, INSTAT and Monetary Policy Department calculations.

Developments in budget revenues and expenditure present an exacerbated dynamics of the primary deficit, whose moving sum rose to its highest level since 2010 Q1 (at about 2.2% of GDP). It is assessed that the considerably increased primary deficit in this period will result in a higher debt for the following period. Public debt as of end-Q1 2013 posted about ALL 849.8 billion, accounting for about 63.3% of GDP. This ratio is up by 1.8 percentage points from end-2012, mainly due to a higher domestic debt stock. The latter was about ALL 493.5 billion, or about 36.8% of GDP, whereas the foreign debt stock accounted for about 26.5% of GDP, up by 0.4 percentage points from end-2012.

Chart 21 Contribution of real net exports to real GDP (in percentage points)



Source: Bank of Albania, INSTAT, Eurostat.

NET EXTERNAL DEMAND

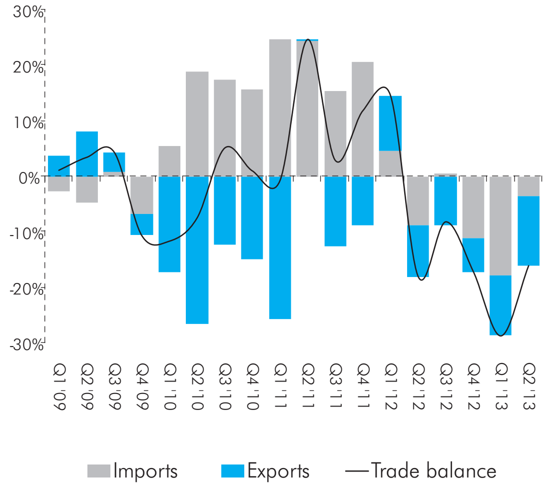
Net external demand continued to contribute positively to aggregate demand in 2013 Q1. During this quarter, the real net export deficit[17] narrowed by about 21.2% in annual terms. The 9.4% increase in real-term export of goods and services and the 4.3% decline in annual real imports determined this narrowing.

Foreign trade data for 2013 H1 show that the trade deficit narrowed by 22.2% in annual terms, mainly due to higher exports. Excluding the electric power trade flows, the trade deficit contracted by 12.1% in annual terms. Trade exchanges increased

Unit Value Index, as calculated and published by INSTAT, is used to switch from nominal to real terms of imports and exports of goods. Consumer Price Index and Harmonised Consumer Price Index of services, as measured by the Bank of Albania and Eurostat, are used for imports and exports of services.

by about 0.5% in annual terms, and the import to export coverage ratio marked 50.5%. This ratio is up by 10.2 percentage points from the same period a year earlier.

Chart 22 Contribution of imports and exports to trade balance



Source: Bank of Albania.

Against the background of a positive external demand, domestic exports continued their upward trend in 2013 H1, at higher paces than in the same period a year earlier. Total exports increased by 17.4% in annual terms, during the period under review. Similar to 2012, the performance of exports was heavily affected by the positive contribution of export of goods included in 'Minerals, fuels and electrical energy'. This item highlights positive development in the export of all its sub-items: crude oil, mineral oils and their distillation products, electrical power, minerals (chromium ore, in particular) and salts, sulphide, oxides and cement. Exports of re-exported goods included in 'Textile and footwear' increased by about 8.1% in annual terms, in 2013 H1. Exports of goods included in 'Construction materials and metals' dropped by 10.4% in annual terms (mainly the export of cast-iron and steel).

Total imports dropped by about 6.3% in 2013 H1. The higher domestic demand was satisfied by domestic production, particularly in the energy sector. Import of goods included in 'Minerals, fuels and electrical energy' dropped, hence determining the performance of total imports. Within this item, imports of electrical energy fell by about 77.7% from the same period a year earlier. Excluding the electrical energy, total imports fell by 0.4%. The lower import of goods included in 'Food, beverage and tobacco' also influenced on the same direction. The import of fruit and grains, meat and fish, alcoholic and non-alcoholic beverages, and tobacco also drooped. The import of goods included in 'Machinery, equipment and spare parts' also contributed significantly to total import drop, signalling a low investment level in the economy.

*Box 2 Balance of Payments Highlights**

Overall Balance of Payments for 2013 Q1 highlights drop of foreign reserve assets by about EUR 23.6 million. During this period, the current account deficit was EUR 214.6 million, down by 26.1% in annual terms. This deficit accounted for about 9.8% of nominal GDP, or about 4.0 percentage points lower than in the same period a year earlier. Net foreign currency flows to capital and financial account contracted by about 20.7% in annual terms, and financed about 95.4% of the current account deficit registered in 2013 Q1.

In 2013 Q1, the current account dynamics was largely affected by the trade balance performance. In annual terms, the trade deficit contracted by about 30.8%. Services account balance exacerbated in 2013 Q1, mainly due to lower net income from travel services.

Developments in the balance of trade and services determined the narrowing of net exports by about 20.7% in annual terms, in the period under review. The net balance of income account continued to be in deficit for the fifth consecutive quarter. In 2013 Q1, this account marked a deficit of EUR 12.0 million, from EUR 40.4 million a year earlier. This account deficit narrowing was due to the lower investment income outflows. The surplus of current transfers account narrowed 22.9% in annual terms. Remittances - the main sub-item of this account - fell by 30.3% in annual terms.

Capital and financial flows (net) registered a positive balance of EUR 204.8 million in 2013 Q1. The surplus of this account was about 20.7% lower than in the same period a year earlier and accounted for about 9.4% of nominal GDP. Net foreign direct investment posted EUR 194.9 million, down by 3.9% in annual terms. Net portfolio investment increased our assets invested in non-resident economies by about EUR 10.2 million, in 2013 Q1. Other net investment closed with a positive balance of EUR 10.4 million during the period under review. The decline by about 88.3% in annual terms of the financial flows to this account was mainly affected by the lower flow of resident liabilities to non-residents, relative to the same period a year earlier. Total borrowing dropped in 2013 Q1 by about 47.6% in annual terms. Government borrowing dropped by about 6.5% in annual terms. Principal payments for private sector credit reduced resident liabilities by about EUR 25.9 million, in 2013 Q1.

Table 4 Main Balance of Payments indicators (in EUR million)

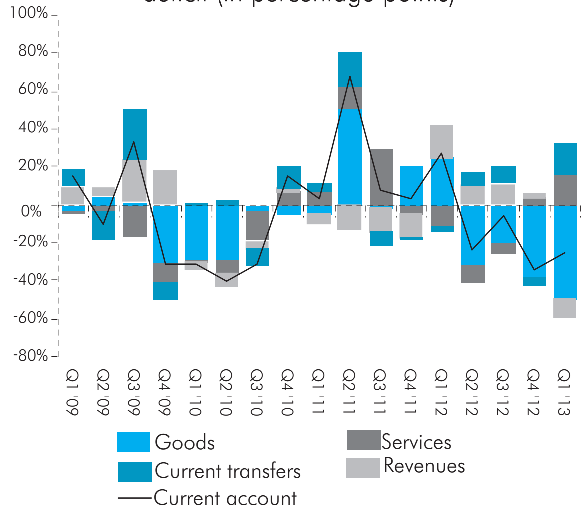
	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1
Current account (in EUR million)	-290.4	-251.8	-242.8	-236.3	-214.6
Y-o-Y	26.7%	-23.9%	-6.2%	-35.5%	-26.1%
/ GDP	-13.8%	-10.0%	-9.6%	-9.8%	-9.8%
Trade balance	-465.3	-475.5	-540.5	-517.8	-322.1
Exports, f.o.b.	325.8	394.2	402.5	403.1	381.2
Imports f.o.b.	-791.2	-869.7	-943.0	-920.9	-703.3
Balance of services	8.5	26.2	132.6	27.9	-40.0
Credit	293.8	381.1	578.1	402.1	277.3
Debit	-285.4	-354.9	-445.4	-374.2	-317.3
Travel - export	185.1	246.4	445.3	268.4	171.2
Travel - import	-180.8	-240.1	-325.6	-256.1	-205.8
Travel - net	4.3	6.2	119.7	12.3	-34.6
Balance of income	-40.4	-27.7	-20.6	-0.2	-12.0
Credit	48.2	43.0	57.8	55.3	41.6
Debit	-88.6	-70.7	-78.5	-55.5	-53.6
Net FDI income	-54.8	-29.8	-42.0	-26.2	-35.1
Current transfers	206.8	225.3	185.8	253.9	159.5

Credit	243.5	265.2	224.1	285.8	192.1
Debit	-36.7	-39.9	-38.4	-31.9	-32.6
Net remittances	166.5	171.6	140.8	196.3	116.1
Capital and financial account (in EUR million)	258.3	185.5	174.4	249.1	204.8
y-o-y	15.1%	-21.3%	-25.2%	-12.5%	-20.7%
/ GDP	12.3%	7.4%	6.9%	10.3%	9.4%
Capital account	12.9	43.0	9.8	15.6	9.7
Financial account	245.3	142.5	164.6	233.5	195.1
FDI (net)	202.8	190.8	156.9	176.7	194.9
Portfolio investment (net)	-46.4	29.5	-18.6	11.0	-10.2
Other investments (net)	89.0	-77.8	26.3	45.9	10.4
Errors and omissions	35.4	73.8	158.0	-36.0	-13.8
Reserve assets	-3.2	-7.5	-89.7	23.1	23.6

Source: Bank of Albania.

* *The latest data on the Balance of Payments are as of 2013 Q1.*

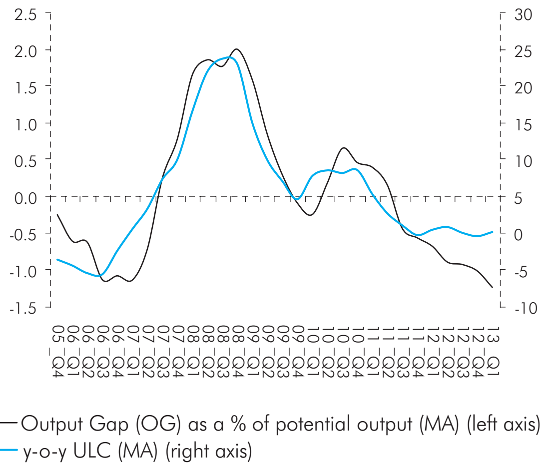
Chart 23 Contribution to current account deficit (in percentage points)



Source: Bank of Albania.

Foreign reserve assets dropped by about EUR 23.6 million as of end-2013 Q1. As of end-March 2013, foreign exchange reserve stock totalled EUR 1.955,6 million, sufficient to cover 4.5 months of imports of goods and services.

Chart 24 Output gap and annual change in unit labour cost



Source: Bank of Albania.

III.3 CYCLICAL POSITION OF THE ECONOMY, WAGES AND LABOUR COSTS

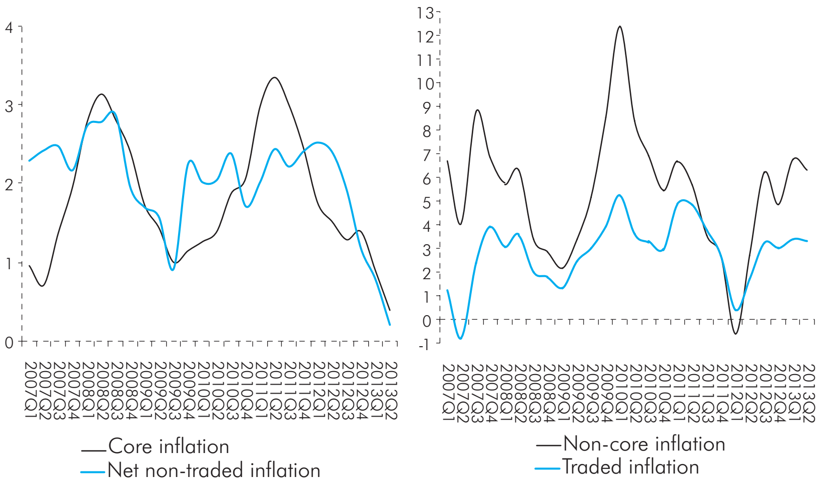
Below-potential economic growth gave rise to a negative output gap.[18] The latter was reflected in incomplete utilisation of production capacities, low increase in employment and, consequently, lower increase in wages and producer prices. The frail economic cycle narrowed businesses' room to increase the final prices of their products and services, and has determined their corrective behaviour toward costs over the last years. Wages and labour costs maintained a downward tendency during the period under review.

Inflation was low in 2013 H1 in face of the low demand and absent supply-side shocks. The sluggish domestic demand dynamics was also reflected by the main inflation trends. Core and net non-traded inflation decreased at rates higher than expected – mainly in 2013 Q2 – marking near-record low rates of 0.4% and 0.2%[19], respectively. Their annual contributions were also minimum, at 12 and 3 percentage points. Short-time supply-side pressures in 2013 Q2 remained comparable to a quarter earlier. Non-core and traded inflation fluctuated around 6.3% and 3.3% during April-June 2013. The statistical effect of 2012 H1's low base subsided almost completely at end-2013 Q2.

[18] *Output gap is a macroeconomic concept measured as: (actual output-potential output)/ potential output. In order to estimate the potential output, we apply different statistical filtering methods. For more information see: Bank of Albania, Monetary Policy Report for 2011 Q1, Box 2: Potential output and output gap.*
Our estimates show that potential GDP growth has also fallen in the recent years. On the one hand, this contraction reflects the need for restructuring the Albanian economy, redistribution of resources across sectors of the economy and re-qualification of its other segments and, on the other hand, the tighter lending standards over the past year.

[19] *Core inflation is measured as the simple arithmetic average of two measures: permanent exclusion and trimmed mean. In 2013 Q1, core and net non-traded inflation marked 1% and 0.8%, respectively, in annual terms. Other economies also saw record low core inflation rates - considerably lower than headline inflation - in 2013 H1 (quarterly inflation reports of Romania and Serbia). The relatively low core inflation has become part of economic debate in large economies as well (USA).*

Chart 25 Long-term inflation trends (left); short-term trends (right)



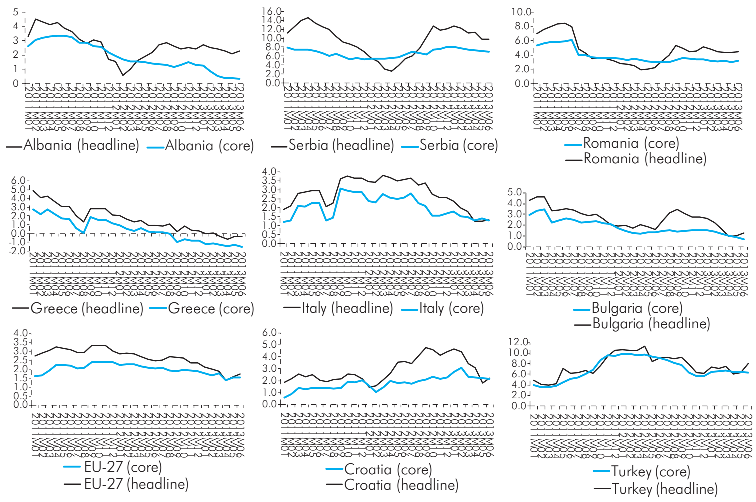
Source: INSTAT and Bank of Albania's calculations.

*Box 3 Core versus Headline Inflation, a Comparative View with other Economies**

Core inflation in Albania has been pursuing a falling tendency over a one-year period, more pronounced in 2013 H1, and has entered the band of low record rates of the series. Despite the continued monetary policy decisions to boost demand, in light of the moderate inflation expectations, headline and core inflation fluctuated around low rates. The low core inflation was a result of the accumulating weak inflationary pressures from demand in the economy.

*But is the low core inflation of the recent periods simply an Albanian phenomenon? Data on core inflation** show that other economies in the region, such as Serbia, Romania, Greece, Italy and Bulgaria, are also experiencing: (i) lower core inflation than headline inflation; (ii) downward core inflation; (iii) wider amplitudes of headline and core inflation in average annual terms in the last two years.*

Chart 26 Headline and core inflation in Albania and other countries



Source: Eurostat, Bank of Albania, National Bank of Serbia.

Based on the latest analyses in the inflation reports and macroeconomic developments by country, in addition to the individual country characteristics, the decreasing core inflation in these economies, similar to Albania's case, was mainly due to the weak aggregate demand pressures, weak performance of monetary indicators and non-inflationary expectations, in the absence of shocks and second-round effects from primary commodity prices and wages. Table 5 ranks the countries by the difference between headline and core inflation, in descending order.

Table 5 Ranking of countries under review

Countries	Annual headline inflation, average M1:11-M6:13 (in per cent)	Annual core inflation approach as permanent exclusion, average M1:11-M6:13 (in per cent)	Difference = Headline - Core (in percentage points)
Serbia	9.6	6.8	2.9
Greece	1.6	0.4	1.2
Slovenia	2.4	1.3	1.1
Croatia	2.9	1.8	1.1
Bulgaria	2.6	1.8	0.8
Romania	4.6	3.8	0.8
Italy	2.8	2.0	0.8
Albania	2.7	1.9	0.8
Czech Republic	2.6	1.9	0.7
EU-17	2.7	2.0	0.7
Turkey	7.6	7.0	0.6

Source: Eurostat, Bank of Albania, National Bank of Serbia and author's own calculations.

* *Prepared by E. Çeliku.*

** *Eurostat approach, (HCPI, excluding 'Energy' and 'Seasonal foods'), updated on 16 July 2013; National Bank of Serbia (CPI, excluding 'Energy', 'Food, tobacco and alcoholic beverages'); Bank of Albania (MPD), permanent exclusion measure (similar to Serbia's core inflation approach).*

III.3.1 LABOUR MARKET

According to INSTAT's data, the labour market saw modest increase in employment and wages in the private non-agricultural sector in 2013 Q1. The latest available data show that employment in the economy increased in Q1, driven positively by the private non-agricultural sector. Average and real wage rose, y-o-y, whereas the unemployment rate remained unchanged at 12.8%.

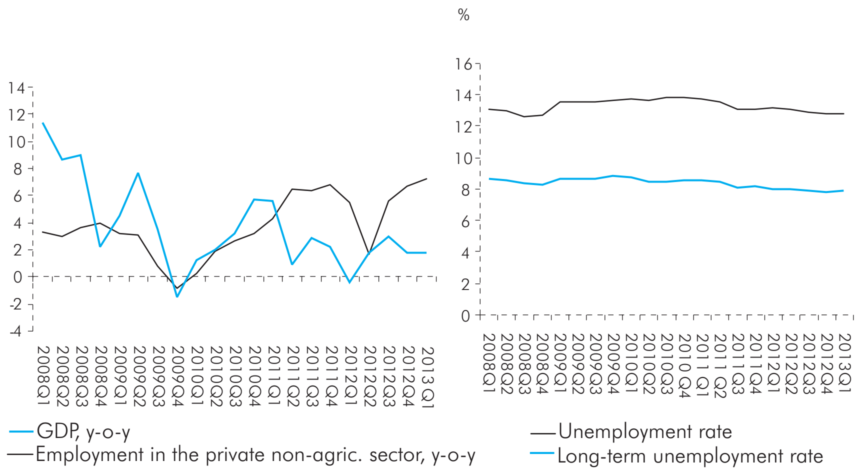
Table 6 Key employment figures

Annual change, in %	2010	2011	2012	2013 Q1
Labour force	-1.4	5.0	1.4	1.5
Total employed	-1.5	5.8	1.7	1.9
Employed in the public sector	-0.2	-0.6	-0.6	-0.4
Employed in the private agricultural sector	-4.2	7.6	0.0	0.0
Employed in the private non-agricultural sector	3.1	6.7	6.7	7.2
Total registered unemployed	-0.2	-0.1	-0.8	-1.0
Unemployment rate	13.8	13.1	12.8	12.8

Source: INSTAT.

Data on labour force show that it rose 1.5%, y-o-y. The number of employed people increased 1.9%, whereas that of unemployed dropped 1.0%. The performance of employment continued to be driven by the annual increase in employment in the private non-agricultural sector by 7.2%, whereas employment in the public sector continued to maintain the downward tendency begun since 2010 Q2. Employment in the agricultural sector remained unchanged both q-o-q and y-o-y. The latest short-term statistics show an increase in employment in industry, construction and services.

Chart 27 Employment in the private non-agricultural sector and GDP (left); unemployment rate and long-term unemployment (right)



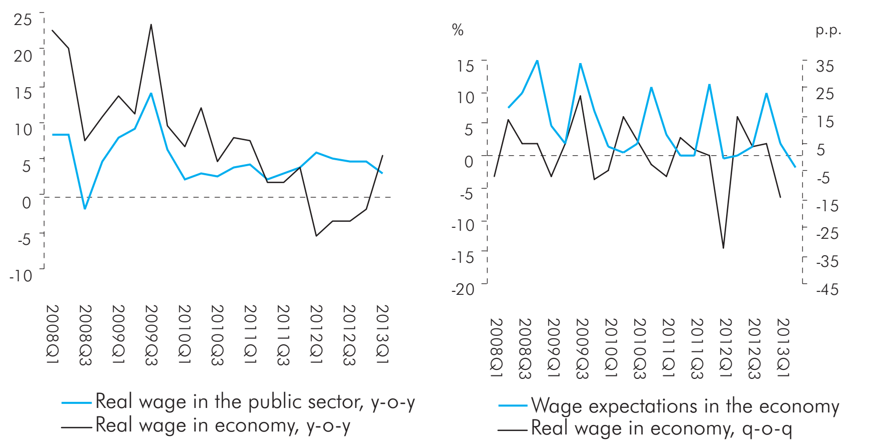
Source: INSTAT.

According to the Business Confidence Survey, businesses were slightly more optimistic about employment in the economy during 2013 Q2. The improved employment was mainly attributable to the increase in employment in industry and services. Business expectations for employment in 2013 Q3 remain positive.

III.3.2 WAGES

After registering continuous fall in 2012, average wage index in the economy rose 4.6% in 2013 Q1, as reported by the latest short-term statistics. CPI-deflated, real wage recorded an annual increase of 2.1%. The performance of wages in Q1 was positively affected by the increase in wages in the production sector. On the other hand, wages in services continued the downtrend begun since end-2011. Real wage in the public sector rose 3.3% in annual terms.

Chart 28 Annual increase in wage indicators (in per cent) and wage expectations in the economy



Source: INSTAT and Bank of Albania calculations.

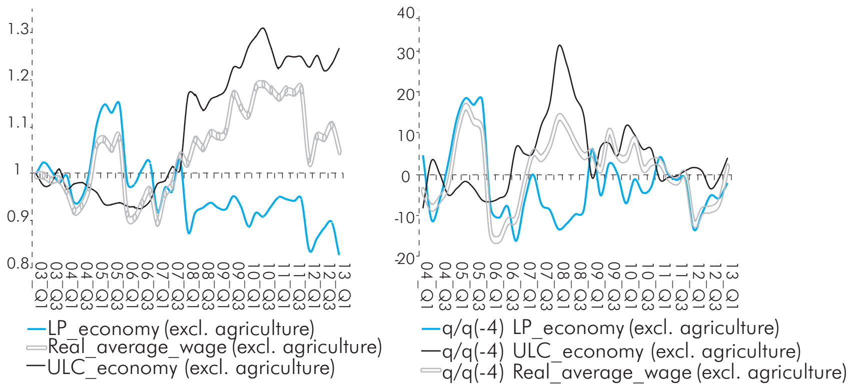
For 2013 Q2, businesses expect falling wages in industry and construction and rising wages in services. According to business confidence surveys, wages in the economy are expected to rise in Q3 in line with the minimum wage revision every July.

III.3.3 LABOUR PRODUCTIVITY AND UNIT LABOUR COST

Labour Productivity (LP) in the non-agricultural economic sectors continued to manifest a negative annual pace in 2013 Q1 (-1.9%), but lower than in the previous quarters due to the slower annual growth rates of employment versus the modest increase in the value added of the non-agricultural sectors of the economy.

Productivity and wage dynamics were reflected in the unit labour cost (ULC) increase by 3.9%. The latter was driven by the increase in average real wage by 2.1% versus the negative LP dynamics. The imbalance between wage and LP performance, expressed in higher ULC, was largely attributable to the construction sector. In 2013 Q1, the construction sector saw lower LP (-3%), whereas the average real cost rose 4%, bringing about an annual increase in unit labour cost by about 7%. LP in industry dropped while remaining almost similar to the previous year for the services sector.

Chart 29 LP, ULC and average real wage (left); annual changes (right)*



*The measures refer to LP and ULC figures in the economy, excluding agriculture. The estimates use value added data (seasonally adjusted - INSTAT, GDP, 2013 Q1) and short-term statistics for employment and wages (INSTAT, Short-term statistics, 2013 Q1). Short-term statistics exclude agriculture, therefore the value added is considered excluding agriculture. Average real wage index is derived after deflating it to the CPI (2013 Q1). For comparison and assessment of trends, the indicators are re-based on the value of each indicator in 2003 Q1. The latest assessments reflect also the changes arising from the review of the value added series, employment indices and pension funds. The indicators are seasonally adjusted (value added and CPI) – left-hand chart, whereas the annual changes have been applied to the seasonally unadjusted series (right-hand chart).

Source: INSTAT and Bank of Albania calculations.

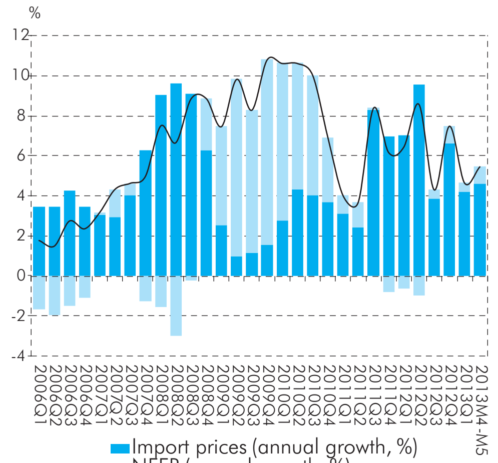
LP and ULC estimates for non-agricultural sectors on a branch level do not yet support the creation of a tendency that may produce added inflationary pressures from wages.

III.4 IMPORTED PRICES AND IMPORTED INFLATION

Inflationary pressures deriving from Albania's main trading partners were subdued in 2013 Q2, being in line with the commodity price performance. Import Price Index[20], which is well-correlated with domestic inflation, increased 4.6% in annual terms during April-May. The performance of this index attested to volatile inflationary pressures, which were subdued in April and mounted in May. During the same period, lek depreciated 0.82% annually in terms of the NEER index, hence playing greater role in the formation of the Imported

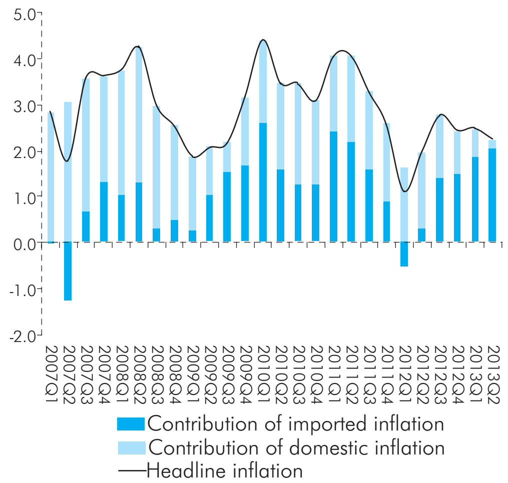
[20] *It is a new index measuring imported inflation pressures, comparable to traded inflation of Albania's CPI basket. Import Price Index is based on the inflation rates of 'Foods, beverages and tobacco' for 18 main countries and the goods' inflation of Bulgaria, Germany, Greece, Italy and Turkey. The final index value is calculated as the weighted average of the above-mentioned CPIs and the monthly weights of their import.*

Chart 30 IIPI and contributions of import prices and exchange rate to IIPI



Source: INSTAT and Bank of Albania calculations.

Chart 31 Contribution of imported and domestic inflation to annual headline inflation



Source: INSTAT and Bank of Albania calculations.

Inflation Pressures Index (IIPI)[21]. The latter increased 5.4% during these months, standing about 0.8 percentage points above the previous quarter's level.

Quantitative assessments of imported inflation during 2013 H1 show a slight rising trend, driven by the relatively fast weakening of the domestic component of headline inflation. In 2013 Q2, imported inflation provided greater contribution to headline inflation than in Q1. It accounted for about 90.5% of annual headline inflation, the rest being accounted by the domestic component, including inflation of regulated prices[22].

III.5 INFLATION EXPECTATIONS[23]

Surveys relating to inflation expectations in the short-term period point to their slight decrease in 2013 Q2 for almost all economic agents. Medium-term expectations[24] remain well-anchored around Bank of Albania's inflation target band of 2-4%. Expectations Anchoring Index[25] provides signals for low inflationary pressures over a one-year period. It marked close negative figures for financial agents, business and consumer expectations, slightly below their long-term average (less than 1 standard deviation).

Table 7 Business, consumer and financial agents' inflation expectations

Expectations	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2
One-year ahead inflation, consumers	2.1	2.2	2.4	2.2	2.0
One-year ahead inflation, businesses	2.3	2.1	2.3	2.2	2.2
One-year ahead inflation, financial agents	2.5	2.7	2.9	2.9	2.6
Two-year ahead inflation, financial agents	2.7	2.8	3.0	3.0	2.8

Source: Bank of Albania, Business Confidence Survey, Financial Agent Expectations Survey.

21 *IIPI is calculated as the sum of the annual growth of the import price indices and NEER index value for the respective month. Imported inflationary pressures impact on inflation with a 1-3 month(s) lag. This index is, however, affected by the fiscal measures taken by Governments, which do not necessarily affect the domestic import prices.*

22 *This inflation also hit the lowest level on record.*

23 *Bank of Albania measures economic agents' inflation expectations through business and consumer confidence surveys and financial agents' expectations survey.*

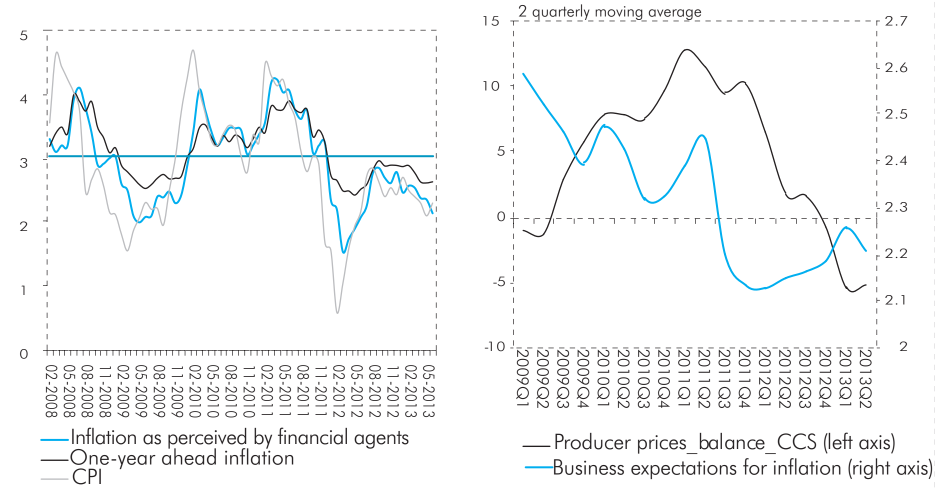
24 *Medium-term expectations refer to two-year ahead inflation expectations and are measured only for financial agents through a monthly survey.*

25 *Expectations Anchoring Index is measured by deducting their long-term average and dividing it by the respective standard deviation.*

Financial agents' perceived inflation was close and slightly above the official inflation rate in 2012 and 2013 H1. June's measurements show that, for the first time this period, perceived inflation stood 0.2 percentage points below the official inflation. Financial agents' inflation expectations for the future, albeit less volatile, showed sharp adaptive nature.

Business expectations, which stabilised at low rates in 2012 and the first two quarters of 2013, and the falling producer prices suggest low inflation rates in the future.[26]

Chart 32 Inflation as expected and perceived by financial agents, expected inflation and producer prices



Source: Bank of Albania, Business Confidence Survey, Financial Agent Expectations Survey.

[26] *Weak pass-through to new price setting and negotiations for wage setting.*

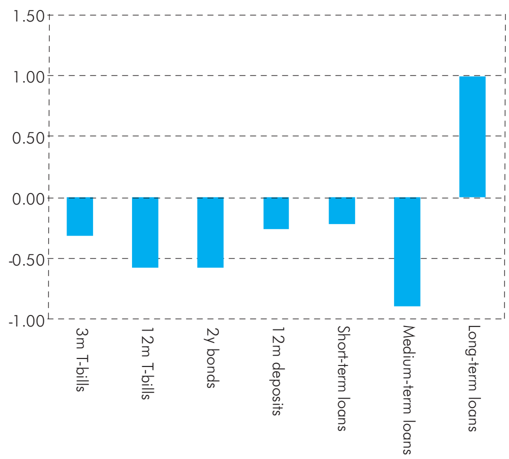
IV. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

Monetary and financial developments in Q2 were in line with the cyclical performance of the economy, signalling subdued inflationary pressures for the medium-term period. The higher public borrowing and coverage of funding needs by the banking system contributed to the creation of domestic currency and a better performance of lek monetary aggregates. Private economic agents' demand for money was generally weak as a reflection of the cyclical performance of the economy. Below-potential economic growth and uncertainties about the future led to further tightening of bank lending standards despite the satisfactory liquidity and capital figures in the banking system. Notwithstanding the easy monetary policy, lending costs remained high. In the meantime, the accommodative monetary policy signals were transmitted to the primary securities and deposit market in 2013 Q2.

IV.1 MONETARY POLICY AND FINANCIAL MARKETS

The Albanian financial market saw downward interest rates and risk premiums in 2013 Q2. Since the last key interest rate cut by the Bank of Albania, financial market rates have reflected the monetary policy stance, albeit at different intensity and velocity. The lower interest rates were most evident in Government securities, with the yields dropping continuously over the months. Lek deposit and credit markets showed slower pass-through of the monetary policy signal. The former saw moderate decrease in interest rates of all maturities, whereas the rates on lek loans were volatile and subject to risk premiums.

Chart 33 Average change in interest rates and key interest rate in 2013 Q2 versus Q1*



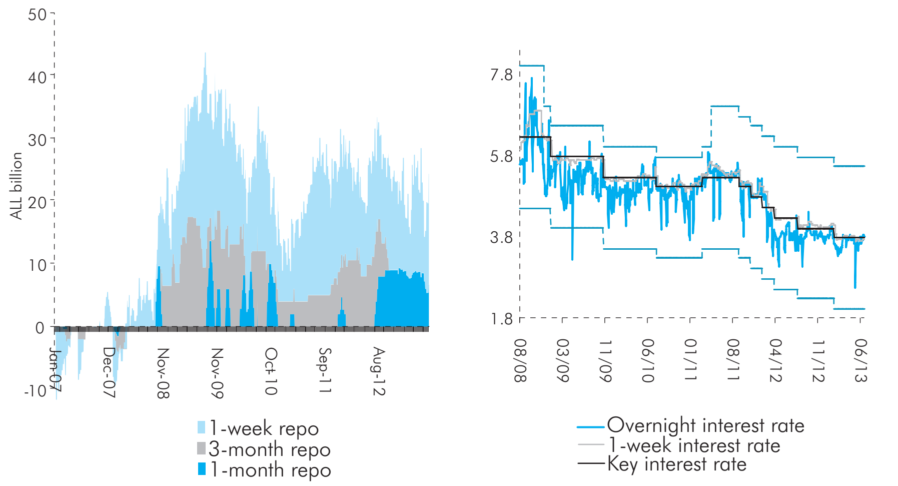
*New lek loan and deposit rates for Q2 are the average for April and May.
Source: Bank of Albania.

The temporary strategies to attract deposits and maintain the market share slowed the decrease in deposit rates during Q1. However, the latter decreased at a faster pace in April and May. Preliminary data on June show faster approach of bank deposit rates to the monetary policy signal. There was weaker pass-through of monetary easing to the credit market during this period.

IV.2 FINANCIAL MARKETS

Overnight interbank rates in 2013 Q2 were similar to Q1, whereas one-week interest rates showed downward tendency. Bank trading volume reduced slightly, remaining however higher than the past year's average. One-week transactions continued to have the highest share in traded volume, while reverse repo transactions grew higher during this period. Interest rates were stable for both maturities, standing below or close to the key rate. The spread between the overnight rate in the money market and the key rate narrowed during this quarter[27], while showing lower volatility from the previous quarter.[28] The Bank of Albania continued to conduct regular open market operations by injecting liquidity of one-week maturity. It also used reverse repurchase agreements 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.

Chart 34 Bank of Albania open market operations (left) and interbank rates (right)



Source: Bank of Albania.

Overnight rate averaged 3.67% in Q1, quite similar to the previous quarter (3.64%), whereas the one-week rate dropped to 3.74%, from 3.86%. The average volume of overnight transactions fell ALL 1.1 billion to ALL 1.9 billion, whereas that of one-week transactions fell slightly by ALL 0.7 billion, to ALL 9.1 billion.

YIELD PERFORMANCE

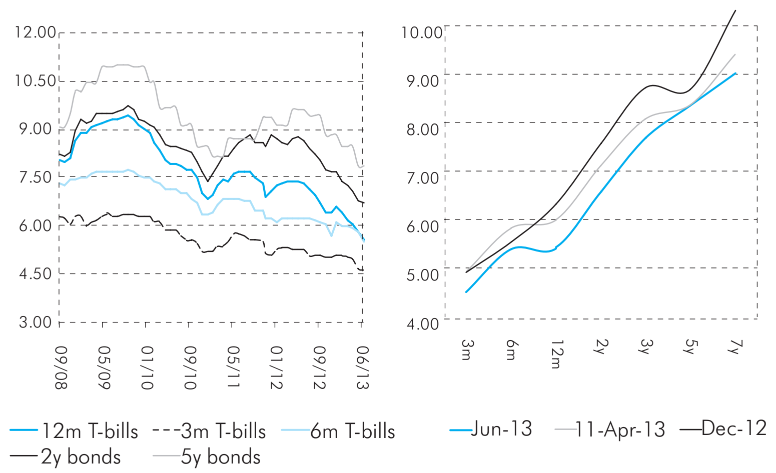
Government security yields registered continued decrease in 2013 Q2. The downtrend in yields observed in Q1 reinforced further in the following months for all maturities. The 12-month yield dropped considerably to 5.35% in early

[27] *The spread between the overnight interbank rate and the key rate was 9 basis points, from 18 basis points in the previous quarter.*

[28] *The standard deviation of overnight interbank rate was 0.2054 in 2013 Q2, from 0.2087 in Q1.*

July, from 6.13% at end-March. The drop was sharper in securities with a maturity of longer than one year, narrowing as such the spreads between maturities and, consequently, diminishing the yield curve slope. The relaxed liquidity situation in the market and agents' tendency to invest in Government securities continued to contribute to sharpening the downward pressures of debt security yields during this period. There was a higher share of long-term instruments in financing the deficit. In the meantime, the banking system showed a preference for these debt securities, exerting downward pressures on their premiums.

Chart 35 Primary market Government security yields



Source: Bank of Albania.

The yield curve shifted down and the slope diminished due to the lower ask premium for securities with a maturity of longer than one year. The yields on fixed and variable rate bonds of 3, 5 and 7-year maturity recorded continuous drop in 2013 Q2. The current yields[29] stand on average 0.41 percentage points below their level in March.

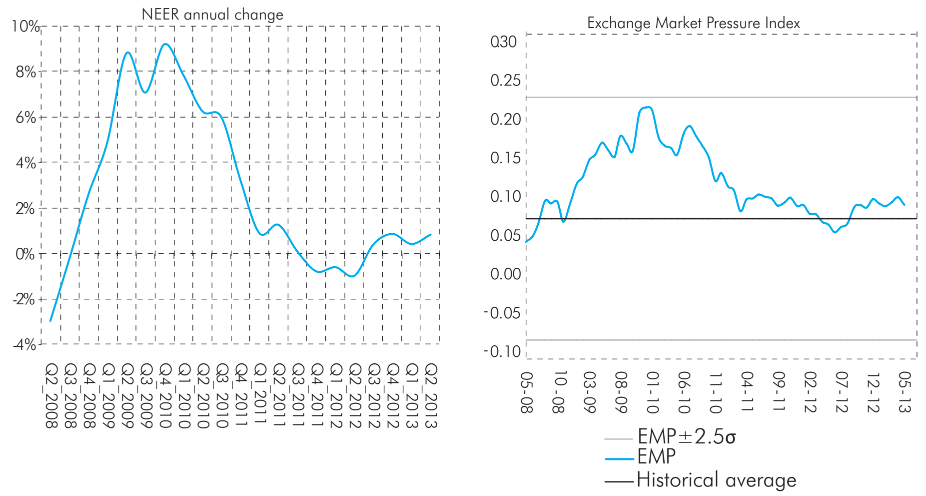
EXCHANGE RATE

The nominal effective exchange rate continued to manifest a slight depreciation trend in 2013 Q2. The NEER[30] increased 0.8% on average, both in annual and quarterly terms. The NEER dynamics reflected primarily lek's depreciation against the euro in face of the higher public and private sector demand for foreign currency. In addition, the foreign exchange market appeared relaxed and free of any pressures over the domestic currency.

[29] The 2, 3, 5 and 7-year bond yields currently stand at 6.70%, 7.78%, 8.45% and 9.12%, from 7.22%, 8.18%, 8.89% and 9.52% at end-March 2013.

[30] NEER – Nominal Effective Exchange Rate is measured against the currencies of Albania's five main trading partners, namely Italy, Greece, Germany, Turkey and China. Higher NEER implies the lek's depreciation.

Chart 36 Annual change in NEER and the Exchange Market Pressure Index

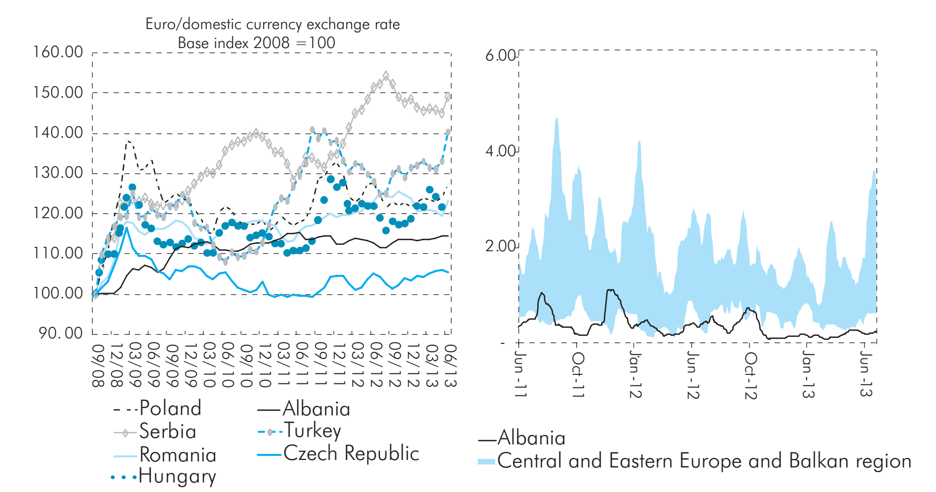


Source: Bank of Albania.

The euro continued to strengthen its position against the Albanian lek, being traded at ALL 140.71 on average, or 0.7% higher than in Q1. The lek depreciated by 1.0% in annual terms, reflecting the growing demand for the euro due to the rising imports during April and May. The higher demand for foreign currency brought about higher euro/lek exchange ratios, peaking at ALL 141.44 on 14 June, the record level since November 2011.

The U.S. dollar was volatile in the Albanian foreign exchange market, in line with its performance in the international markets. During 2013 Q2, one dollar was traded at ALL 107.77 on average, appreciating by 1.9% in quarterly terms. Y-o-y, the U.S. dollar depreciated by 0.8% against the lek.

Chart 37 Euro/lek volatility versus the currencies of Central and Eastern Europe and the Balkan region (right)



Source: Bank of Albania.

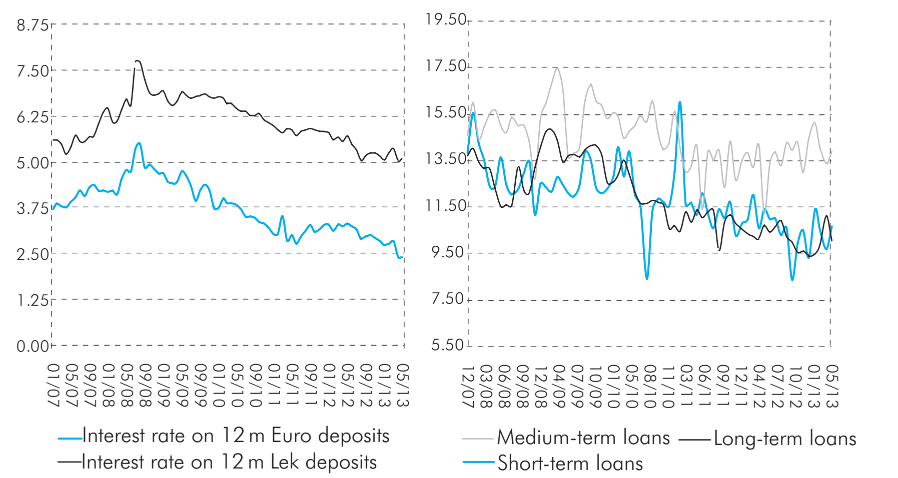
Almost all currencies of the countries in the region depreciated considerably against the euro in June. Compared to these countries, lek's volatility continues to remain below the lower band.[31]

BANKING SYSTEM AND LENDING CONDITIONS

Interest rates on lek and euro time deposits decreased for all maturities in April and May. After the slow response to lek's key rate cut in Q1, deposit rates decreased at a faster pace in the following months. On average, the interest rate on 12-month deposits decreased 0.26 percentage points in April and May, from Q1. Starting from March, there was a more homogeneous decrease in the deposit rates between the maturities. Certain deposit segments, however, were affected by the promotional campaigns of individual institutions, aiming to increase their market share. Deposits remain the main tool in attracting public savings, while preliminary information suggests further decrease in new lek deposit rates in June.

The spread between lek and euro time deposit rate widened further due to the larger decrease in euro rates. The interest rate on 12-month euro deposits averaged 2.41% in April and May, from 2.79% in 2013 Q1.

Chart 38 Lek and euro deposit rates (left) and lek loan rates (right)



Source: Bank of Albania.

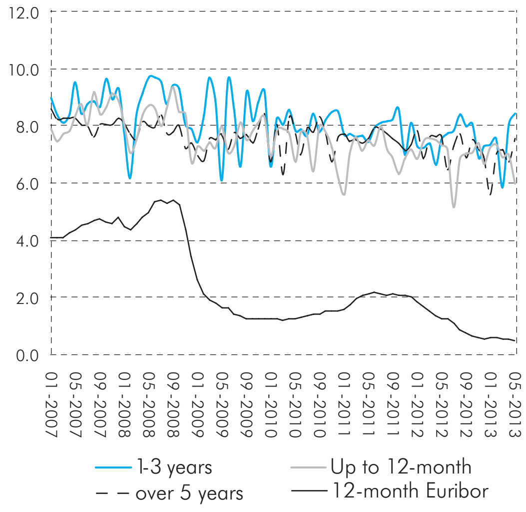
The interest rates on new lek loans were volatile in 2013 Q2, alternating between periods of increase and decrease, driven primarily by the share and price applied by individual banks. The interest rate on new loans averaged 10.93% in April and May, almost similar to Q1 (10.94%). Excluding the effect of loans extended by individual banks, the interest rate on loans showed a downward trend, in line with the overall financial market performance. The

[31] *The euro/domestic 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 the selected ratios. The selected countries include Poland, the Czech Republic, Hungary, Romania, Turkey and Serbia.*

downward rates were the most present in short-term loans, which displayed sharp volatility in May. Interest rates on medium-term loans also decreased during the period under review.

The average lending cost continued to be tighter for businesses, with banks generally applying more stringent lending standards. Medium-term loans have, since March, shown a downward trend, being also followed by a slight increase in the loan volume. Unlike in Q1, long-term loans, mostly applied to mortgage loans, shifted upward in Q2, increasing by 0.99 percentage points, to 10.59% in April and May.

Chart 39 Euro loan rates



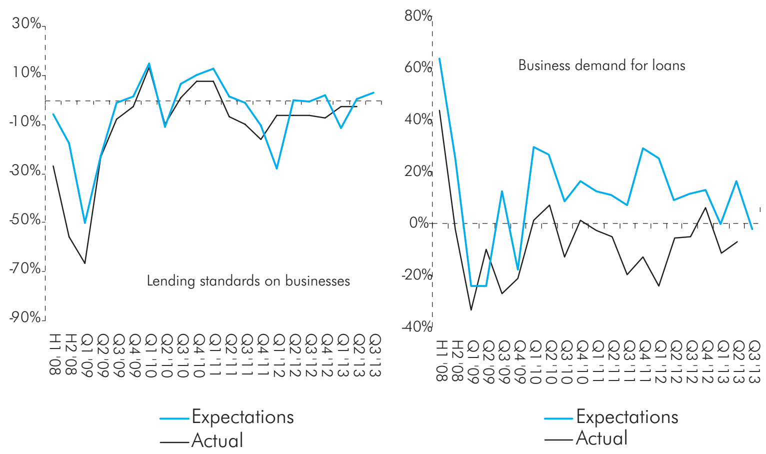
Source: Bank of Albania.

Interest rates on new euro loans remained highly volatile and the lending cost was relatively tight. Lending in euro showed a nearly similar performance to that in lek and the applied rates were affected by individual loans. Interest rates on long-term loans decreased markedly in April. Their share, however, did not affect the total loans' average, which increased due to the high rates applied to short-term loans. In May, this effect had an opposite impact, with the interest rate on new euro loans decreasing but without displaying any clear trends.

*Box 4 Summary of Bank Lending Survey Results**

Bank lending survey results show that the lending standards applied to households eased during 2013 Q2, whereas those applied to businesses continued to tighten. By purpose of use, the lending standards applied to households eased on both house purchase and consumer loans. Business lending standards tightened on small and medium-sized enterprises but remained unchanged on large enterprises. Banks reported tightening of lending standards on working capital and investment loans.

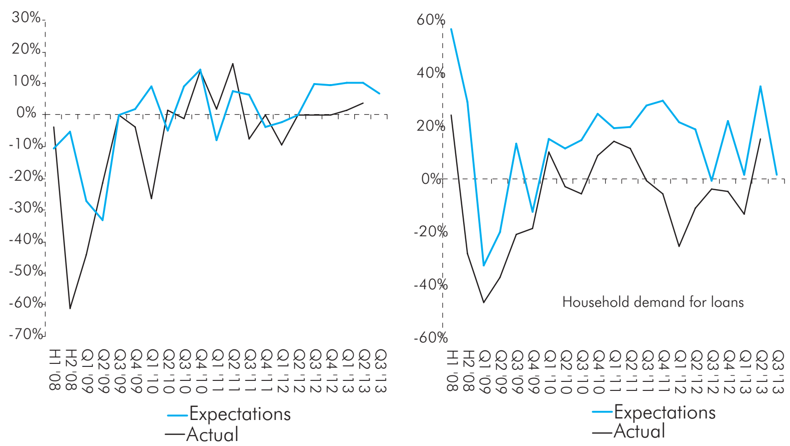
Chart 40 Lending standards and business demand for loans (net balance)



Source: Bank Lending Survey, Bank of Albania.

Specific business-sector related concerns, non-performing loans in the banking system and the overall macroeconomic situation in Albania were the main factors contributing to the tightening of business lending standards. On the other hand, Bank of Albania's decisions and liquidity situation contributed to easing the lending standards applied to businesses. Concerning households, competition in the banking system, bank's current or expected liquidity level, capital adequacy and Bank of Albania's decisions contributed to easing the lending standards. Non-performing loans, households' financial situation and developments in the real estate market continued to drive the tightening of lending standards applied to households.

Chart 41 Lending standards and household demand for loans (net balance)



Source: Bank Lending Survey, Bank of Albania.

Demand for loans was lower for businesses and higher for households. In businesses, demand fell in large enterprises and investment loans. Concerning households, demand was, for the first time since 2011 Q2, higher on both house purchase and consumer loans.

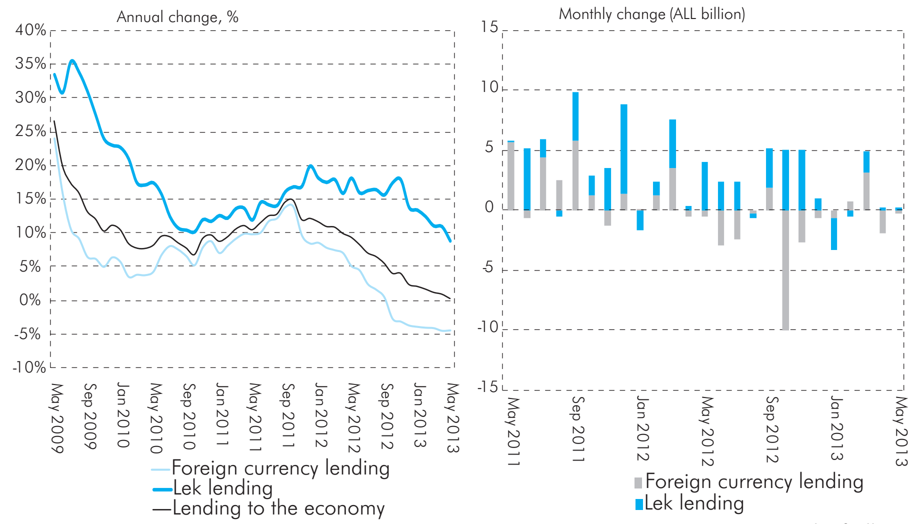
The current and expected macroeconomic situation in Albania and the use of alternative financial resources were the main factors contributing negatively to business demand for loans during 2013 Q1. The need to finance house purchase and consumption, developments in the real estate market and bank lending standards had a positive impact on household demand for loans.

* *The survey conducted in June 2013 covers bank lending developments in 2013 Q2 and banks' expectations for lending in 2013 Q3.*

IV.3 LENDING

Lending to the economy showed poor performance in April and May, manifested in the contraction of outstanding loans. Its annual growth slowed down further to 0.3% in May, from 1.2% at end-Q1. Foreign currency lending to the economy fell during these two months and its annual contraction deepened further to 4.6%. In the meantime, lending in lek grew in monthly terms, but substantially lower than last year's growth. Its poor performance in the first five months reflected in the continuous slowdown of its annual growth, which fell to 9.0% in May.

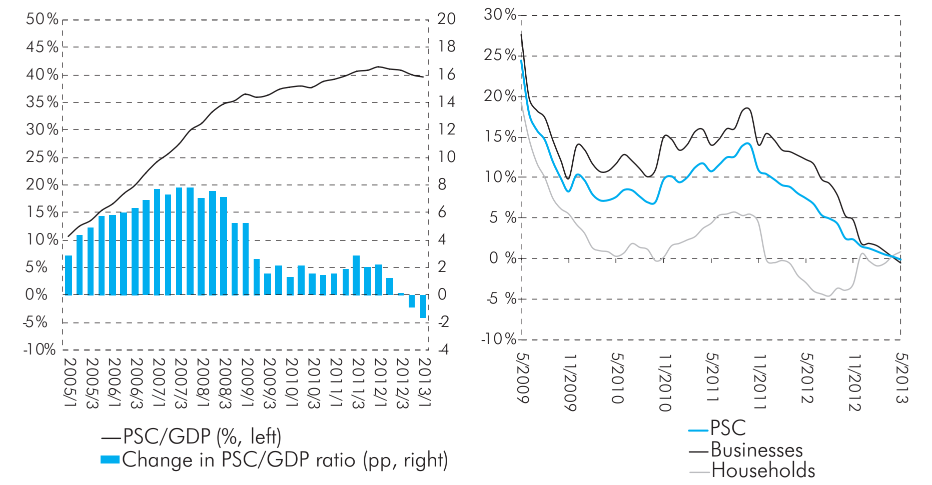
Chart 42 Lending to the economy



Source: Bank of Albania.

Developments in lending reflected primarily the low private sector demand for borrowing and banks' reluctance to undertake risk, which is particularly associated with lending to businesses. Private sector credit contracted by ALL 1.8 billion in April and May. At end-May, it was 0.2% lower than a year earlier. While lending to businesses performed poorly, lending to households registered positive developments during April and May. The low level of lending to the economy was also reflected in the reduced leverage in the economy, as measured by the private sector credit-to-GDP ratio. This ratio was estimated at 39.7% at end-Q1, down by 1.7 percentage points y-o-y.

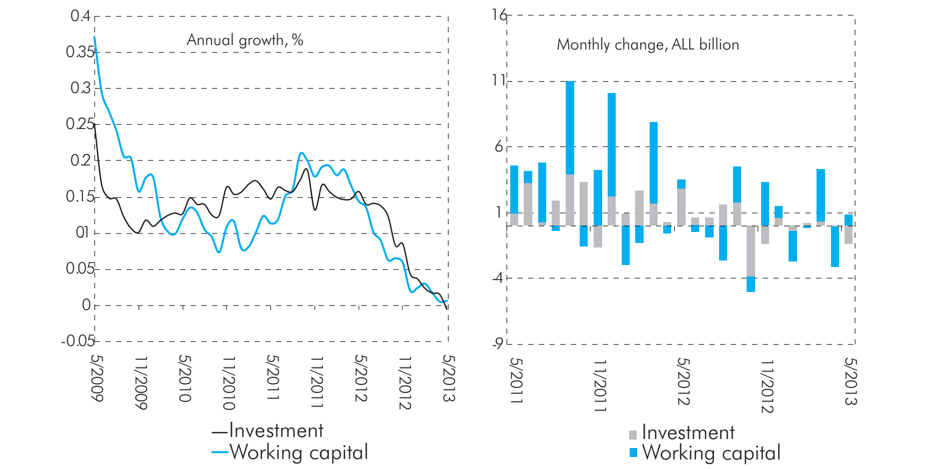
Chart 43 Private sector credit



Source: Bank of Albania.

Lending to businesses fell ALL 3 billion in April and May. After recording close to zero rate in April, its annual change hit a negative rate of 0.6% in May. Lending to businesses was simultaneously affected by the unfavourable demand and supply conditions. Business demand for investment loans fell further in 2013 Q2, while that for working capital remained low. Banks were also reluctant to lend to businesses, reflecting it in the further tightening of lending standards applied to businesses during this quarter. Lending to businesses performed poorly both in terms of working capital and investment loans. The annual growth of working capital loans slowed to 0.6%, whereas investment loans contracted by 0.6% in annual terms, following the rapid slowdown in the previous months.

Chart 44 Business loans by purpose of use

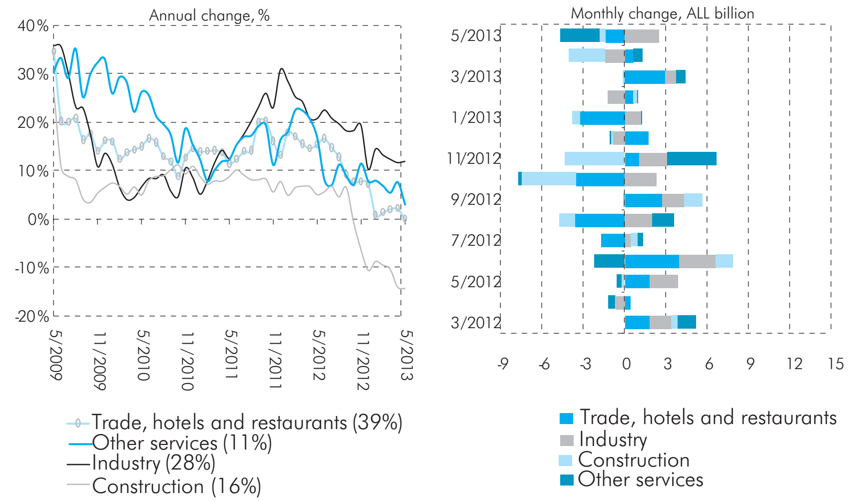


Source: Bank of Albania.

Note: The monthly change in investment loans in December 2011 does not include the increase arising from reclassification.

The analysis of lending by sectors of economy shows that only lending to the industry sector increased in April and May, maintaining a high annual growth of 11.9%, on average. By contrast, lending to services and construction contracted considerably. Consequently, the annual growth of lending to trade and other services slowed down to 0.1% and 2.1%, respectively, in May, while lending to construction deepened the contraction to 14.3% in annual terms.

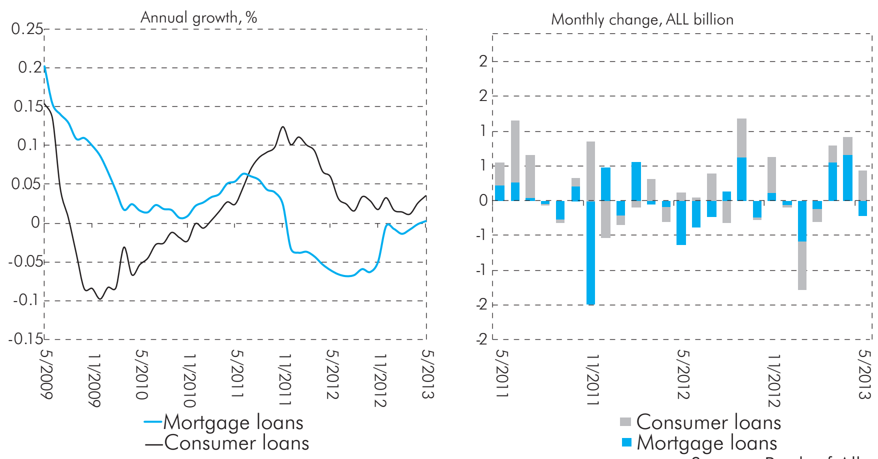
Chart 45 Business loans by sector of economy



Source: Bank of Albania.

In April and May, lending to households maintained the positive performance of March. After the poor and volatile monthly performance until February, outstanding household loans grew by about ALL 2 billion in these three months. This was also reflected in the improved annual growth rates, which were positive in April and May. In May, lending to households recorded an annual change of 0.8%, from -0.6% at end-Q1. These developments are in line with banks' reporting of added household demand for loans in Q2. In turn, the higher demand was complemented with better credit supply conditions, due to the easier lending standards applied to households.

Chart 46 Household loans by purpose of use



Source: Bank of Albania.

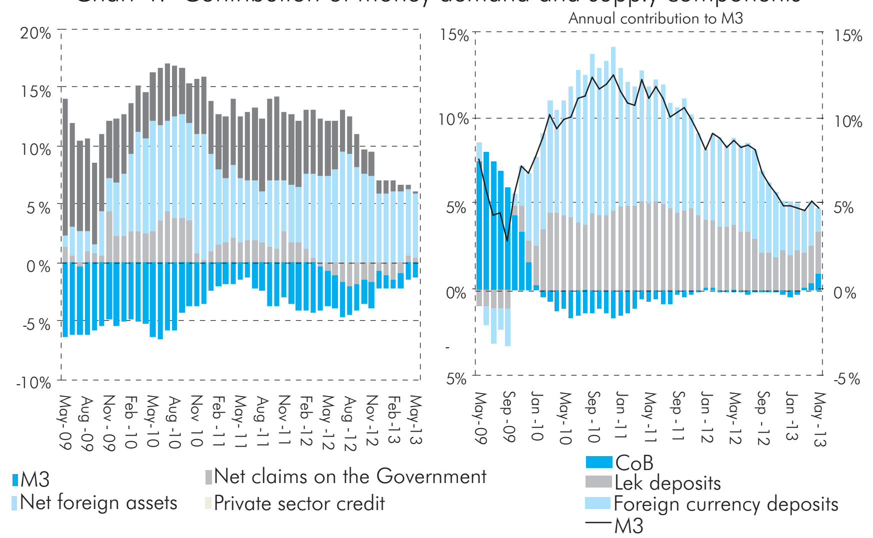
Note: The monthly change in mortgage loans in December 2011 does not include the reduction arising from reclassification.

Lending to households saw improvement in both consumer and mortgage loans. Consumer loans accounted for about 60% of the increase in lending to households in April and May. The positive performance of consumer lending in these two months relative to Q1 was also reflected in its improved annual growth. The latter stood at 3.6% at end-May, from 1.2% at end-Q1. Mortgage loans also improved their annual growth rate to 0.2% in May, from -0.8% at end-Q1.

IV.4 MONETARY INDICATORS

Monetary assets in the economy registered stable growth rates in April and May and improved slightly from Q1. At end-period, broad money aggregate, M3, grew 4.8% annually, from 4.6% in March. The growth of money supply was driven by the considerable slowdown of commercial banks' foreign assets and the increase in fiscal sector borrowing. This sector increased its demand for domestic borrowing, which was generally met by the banking sector and less by private economic agents. In the meantime, the contribution of lending to the economy to money growth fell to 0.1 percentage point in May, driven by the low private economic agents' demand for money and the still tight banking sector supply-side factors.

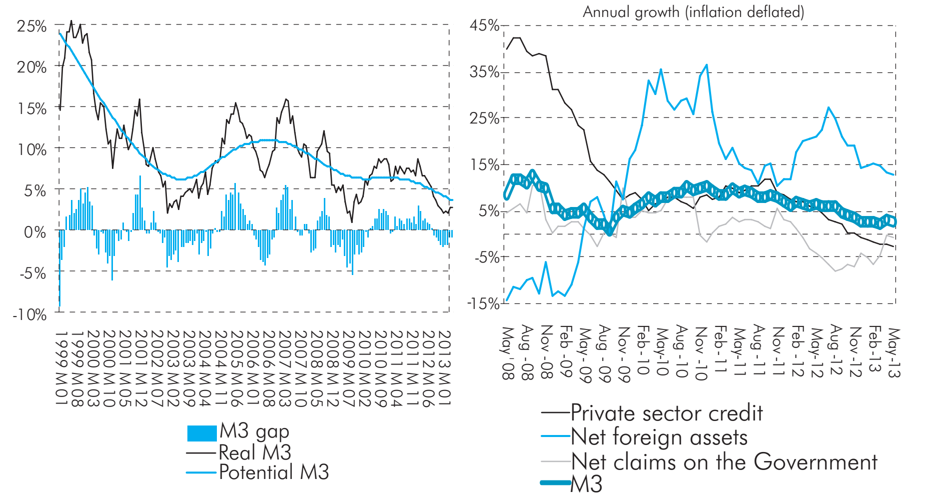
Chart 47 Contribution of money demand and supply components



Source: Bank of Albania.

The improved performance of the monetary aggregate in lek, M2, reflected the faster creation of currency in the Albanian lek than a quarter earlier. In May, M2 recorded an annual growth rate of 5.5%, or about 1.9 percentage points higher than at end-Q1. The growth of money supply in lek was primarily driven by the fiscal agent's activity and the positive lending in domestic currency. Government's net domestic borrowing grew 1.2% in May, relative to the annual negative rates in Q1. Despite the lower growth rates, lending to the private sector in the Albanian lek performed considerably better than foreign currency lending. The growth rates of the latter continued to shrink both in annual and monthly terms.

Chart 48 Money gap and money demand components

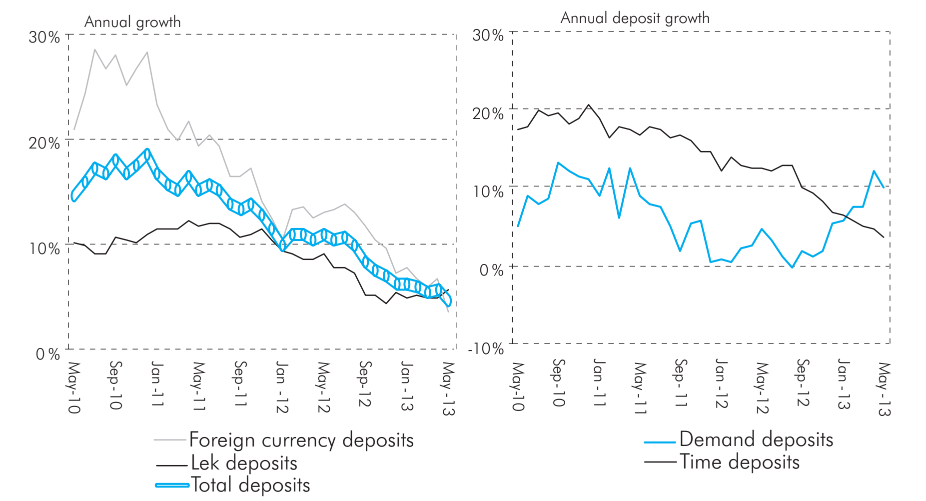


Source: Bank of Albania.

Liability-side money supply developments provided evidence for a shift toward the more liquid component. This tendency was also seen in the M1 aggregate performance, which displayed an uptrend and recorded an annualised rate of 8.6% in May, from 3.8% at end-March. M1 aggregate performance confirmed the added economic agents' demand for liquid monetary assets and, at the same, the improved public sector activity. Currency outside banks-to-M2 ratio rose to 28.3% at end-period, from 27.9% in March.

As at end-May, banking system deposits were about 4.7% higher y-o-y, hence slowing down from the first quarter's growth rate of 5.4%. In absolute terms, total deposits grew about ALL 8.4 billion in April and May. This growth saw higher concentration in April, primarily due to the increase in business deposits.[32]

Chart 49 Contribution of economic agents' deposits to total stock



Source: Bank of Albania.

[32] *Due to the temporary transfer in a large business account.*

The performance of deposits by currency confirmed higher growth of lek deposits against the contraction in foreign currency deposits. The lower foreign flows from abroad, in line with external sector developments, and the low bank lending in foreign currency led to lower creation of foreign currency. The launch of new financial instruments into the market relating to keeping savings in foreign currency is also believed to have contributed to the stock contraction.[33] The time structure of deposits provided evidence for a shift toward demand deposits during this period, due to a temporary phenomenon in business lek deposits.

[33] *This relates to the launch of the private investment fund in euro.*

V. OUTLOOK FOR THE ALBANIAN ECONOMY

The Albanian economy enters the second half of 2013 H2 with low and below-potential economic growth, but with generally solid and improving economic and financial stability. Its future performance will reflect the inertia of economic and financial agents' behaviour, the outlook for the global economy and European financial markets, but also the domestic economic policies and implementation of structural reforms. The baseline scenario for the development of the Albanian economy in the medium-term period is that of a slow economic growth but with improving economic and financial soundness parameters, with falling risk premiums and funding costs. Domestic demand boost, its orientation toward productive activities and higher competitiveness of Albanian products in the global markets will be the main drivers of long-term economic growth. They will largely depend on the acceleration of reforms, at the macro and microeconomic level, and the maintenance of economic and financial balances in the medium-term period.

After the sluggish performance in the last two years, economic activity in Albania will continue to suffer from the weak aggregate demand in 2013 and the medium-term period. This performance is expected to keep economic growth low and below potential. In the macroeconomic aspect, the sluggish economic growth will be reflected in low inflationary pressures and continued stimulating monetary policy in the future. In addition, the low expansion of economic activity will condition low growth rates of public revenue, which will further call for cautious state budget planning and implementation in order to improve and keep the public debt sustainability figures in check. On the other hand, the sluggish economy will generate low demand for credit and slow expansion of financial intermediation during this period. In the microeconomic aspect, the slow economic activity will call for businesses and financial agents' constant caution, in terms of keeping their balance sheets sound through the enhancement of operational efficiency, market expansion, and structure and cost control.

Growth in 2013 is expected to be slightly above the previous year's rate. External and fiscal sectors are expected to provide major contribution by spending items of aggregate demand, whereas consumption and private investments are expected to remain sluggish. Short-term projections for economic growth indicate continued negative output gap and low inflation pressures in the following quarters. Forecast models suggest that one-year ahead inflation will, with a 90% probability, fluctuate around 1.1%-3.8%. This forecast is based on anchored inflation expectations, continued negative output gap, stable exchange rate and absent supply-side shocks over the same time horizon. Downside risks dominate this forecast, mainly relating to a possible lower economic growth than forecast. With a view to meeting the inflation target, the stimulating monetary policy is expected to persist in the medium-term period. Lending to the private sector will grow further over the policy-relevant horizon, benefiting from this stimulus and other Bank of Albania macro prudential incentives. This growth is expected to be higher in 2014 H1 and contribute to increasing private demand and gradually closing the negative output gap.

The Bank of Albania will continue to remain fully committed to achieving the inflation target. The latter will represent the exclusive focus of our monetary policy in a future-oriented background and in the presence of a free floating exchange rate regime. Our liquidity management operations will continue to orient toward the observance of our operational framework, implying the supply of the banking system with the required liquidity, with a view to keeping interbank rates stable and reducing liquidity risk premia in the economy.

The banking system is liquid, well-capitalised and profitable. Being so, it has succeeded in transmitting the accommodative monetary policy signals to almost all financial market segments and products. Failure to transmit these signals to the growth of lending to the economy mostly relates to the low credit demand and specific concerns facing individual sectors of the economy. A marginal analysis evaluates that the tighter lending policies imposed by the European regulators or parent banks originating from the euro area have also provided their impact on Albania and other countries in the region. The Bank of Albania considers that with a view to meeting the economy demand for financing and liquidity, the banking system should be more flexible in terms of diversifying the portfolio, designing pro-active policies and applying differentiated risk premiums to sectors or businesses with stable growth prospects.

The Bank of Albania is confident that maintaining a sound and operating banking system represents a valuable asset to the Albanian economy, initially to weather various potential shocks and, in a long-term horizon, finance the growth needs.