Bank of Albania

QUARTERLY MONETARY POLICY REPORT 2013 Q4

**THE REPORT REFERS TO BANK OF ALBANIA'S MONETARY POLICY STATEMENT 2013 H2, APPROVED BY THE SUPERVISORY COUNCIL'S DECISION NO. 2, DATED 29.01.2014*

* The economic and monetary analysis in this report is based on the latest statistical and qualitative data available as of 17 January 2014.

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C O N T E N T S

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C H A R T S

1. FOREWORD BY THE GOVERNOR

Year 2013 was a difficult one for the Albanian economy. Aggregate demand and economic growth remained at low levels; inflation fluctuated around Bank of Albania's lower targeted band, while the budget deficit and public debt increased sharply due to unfavourable economic environment, both in the country and abroad. Moreover, Albania's June parliamentary elections added uncertainties to the economy and financial markets. As we have already stated, consumption and investments continue to suffer from low confidence and tight lending terms. Fiscal policy is faced with a high public debt level, which has limited the possibilities for macroeconomic stimulus. On the other hand, the external environment was characterised by ongoing euro-area problems, hence limiting our export growth and making financial markets pursue conservative policies in terms of lending to developing economies.

However, 2013 saw positive developments. Financial markets were characterised by improved liquidity and downward interest rates, in response to Bank of Albania's easing monetary policy. Also, the introduction of new financial agents and instruments has further deepened these markets. The banking system remains solid and well-capitalised, regardless of increase in non-performing loans. The current account deficit has dropped, creating better premises for a sustainable external position of the economy and stable exchange rate. These developments have contributed to maintaining macroeconomic stability.

Analysing the specific developments in the second half of 2013, the official data show a slowing economic activity and a sustained downtrend in inflation.

Average annual inflation reached 1.5% in the fourth quarter, remaining unchanged from the third quarter. In December, inflation rose to 1.9%, almost entirely due to prices of foods, particularly unprocessed foods. Prices of other CPI basket items were generally stable and had marginal impact on inflation.

From the macroeconomic viewpoint, the weak aggregate demand, lower imported inflation and subdued inflation expectations led to a low inflation rate.

Third-quarter gross domestic product fell by 2.3%. This fall was mostly determined by short-term shocks arising from the full fiscal stimulus withdrawal and post-election uncertainty, which is believed to have negatively affected consumption, investments and tourism over this period. Excluding agriculture, the other sectors of the economy dropped, in annual terms.

All the aggregate demand components performed poorly over the second half of the year. Private consumption was at low levels, reflecting the low consumer confidence and decelerated income growth. The low inflation rates contributed to maintaining the savings value. However, Albanian households continued to display cautious behaviour toward consumption. Private investments deepened the downtrend in the second half of the year, reflecting the lower final demand, boosted uncertainty and tight bank lending terms. Periodic surveys report that businesses' financial position remains difficult and restrains their ability to invest.

Fiscal policy was stimulating in 2013, mainly concentrated in the first half of the year. The fiscal stimulus was carried out by increasing spending and reducing taxes. The latest fiscal data are as of November 2013. During the first 11 months of the year, the budget deficit increased 71.5% in annual terms, budget spending increased 4.7%, while fiscal revenues dropped 3.1%. The latter was due to easing tax policy and poor economic performance. Fiscal developments in 2013 worsened the public debt dynamics. This debt tends to increase during periods of economic slowdown, in response to counter-cyclical fiscal policies and the effect of automatic stabilisers. However, given the essential role of fiscal sustainability in the overall economic and financial stability, and the high level of Albania's public debt, the Bank of Albania has called for and supported measures for controlling and reducing this debt in the medium term.

In this context, we reiterate our message for anchoring this process to a fiscal rule, which will orient the fiscal policy in the long term and will be reliable and transparent to all Albanian and foreign economic agents.

Developments in the external sector of the economy signalled sluggish external demand in the third quarter of the year. Though trade deficit dropped, the external sector impacted negatively on the economic growth due to lower tourism revenues. In October and November, the external trade data show ongoing annual nominal contraction in the trade deficit, by 11.9%, due to increase in exports by 12.0% and decrease in imports by 2.0%. The Albanian economy's capacity to maintain and speed up the positive export growth rates will determine the country's medium and long-term economic growth. In the medium term, rising exports help offset the weak domestic demand, while in the long term, a higher competitiveness of the Albanian economy in the global markets should be at the core of Albania's new economic growth model.

The weak demand for consumption and investment, and banks' conservative lending policies have slowed the monetary indicators. The increase in money supply slowed down to about 2.5% in October and November due to private sector's lower demand for funding. Lending to economy continued to contract and in November, it was 2.4% lower than a year ago.

The above monetary and economic dynamics has exerted weak inflationary pressures. The low aggregate demand has expanded the negative output gap.

The labour market pressures have been subdued against a setting of unchanged unemployment rate, moderate wage rise, and partially-used capacities. These developments kept producer prices and profit margins subdued and were reflected in low core inflation rates over this period.

Also, imported inflation has been downward due to lower primary commodity prices in the international market and stable exchange rate.

Based on the economic outlook and aiming to boost aggregate demand, the Bank of Albania lowered the key interest rate by 0.5 percentage points, to 3.0% in the fourth quarter. Also, Bank of Albania's monetary policy decisions were associated with ongoing liquidity injections and orientations toward the future monetary policy stance. This policy has managed to keep liquidity premia and inflation in check, by contributing to lowering the interest rates in the interbank, government debt securities, lek loan and deposit markets.

However, the lending rates in lek did not fully reflect our monetary policy, indicating the presence of high risk premia and containing the monetary stimulus transmission to the economy. These risk premia were also reflected in other lending terms, which are unrelated to the lending rates and appear tighter as compared to their historical performance.

Under the Bank of Albania's baseline scenario, the economy will improve slightly during the current year. Increase in exports and a better performance of consumption and investments will continue to support the aggregate demand. The monetary policy will support the domestic demand, by maintaining macroeconomic stability and continuing pumping monetary stimulus into the economy. Also, payment of arrears will help improve the balance sheets of firms and the private sector, and is expected to improve business borrowing. Excluding the payment of arrears, the 2014 budget has projected a fiscal adjustment needed against the backdrop of a rapidly increasing public debt. Reflecting the weak economic and monetary dynamics in Albania, inflationary pressures are expected to be weak. Four-quarter-ahead inflation is expected to fluctuate between 0.7% and 3.8%, with a 90% probability of occurrence. This requires maintaining a stimulating monetary policy in the medium term.

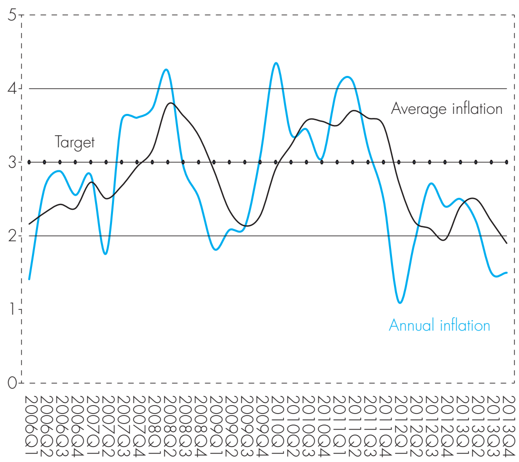
Bank of Albania deems that year 2014 will mark a turning point to the Albanian economy. Maintaining economic and financial stability, the improving external environment, implementation of macroeconomic simulating policies and continuing structural reforms will pave the way to the sustainable and long-term development of Albania.

2. PRICE STABILITY AND BANK OF ALBANIA TARGET

Inflation was low in 2013 H2, reflecting a macroeconomic environment with weak inflationary pressures and anchored inflation expectations. Also, imported inflation did not pick up, thanks to exchange rate stability and downtrend in primary commodity prices in Albania's main trading partners.

Bank of Albania's monetary policy reinforced its stimulating stance in 2013, at a higher intensity in Q4. Financial markets reflected better the key interest rate cuts in Q4, while the Bank of Albania continued to inject liquidity into the economy through repurchase agreements. The outlook for the Albanian economy and financial markets is expected to be reflected in an inflation rate within the tolerance band over the medium-term horizon.

Chart 1 Annual inflation (in %)



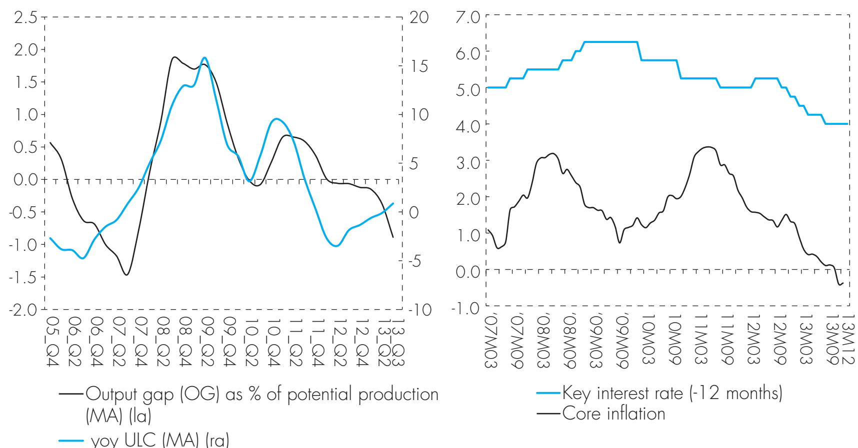
Source: INSTAT and Bank of Albania.

2.1 INFLATION AND MONETARY POLICY

Annual inflation rate averaged 1.5% in 2013 Q4, remaining below the lower limit of Bank of Albania's tolerance band but similar to previous quarter.

Decline in food prices and aggregate demand, and exchange rate stability contributed to keeping inflationary pressures weak in Q4.[1] Other factors, such as falling prices of primary commodities in international markets, incomplete utilisation of production capacity, and weak pressures for wage rise, led to subdued producer prices and profit margins.

Chart 2 Output gap and annual change in unit labour cost (ULC)*. Key interest rate and annual core inflation



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

1 *The average 12-month inflation rate dropped from 2.2% in Q3 to 1.9% in Q4, while the core inflation rate fluctuated around negative values.*

Assessing the projections for low inflation and economic activity, the Bank of Albania carried out two consecutive cuts in the key interest rate in 2013 Q4, to a record low level of 3.00%. These decisions are in line with the past signals for pursuing a stimulating monetary policy, aiming to keep inflation within the target in the medium term. Financial markets responded to monetary stimulus and interest rates dropped in both short and long-term segments. Ask premia for Government debt securities dropped to record low levels, and hence yield-curve flattening. The banking system operated under adequate liquidity conditions, controlling the liquidity premia in the economy. The Bank of Albania injected up-to-three month (maximum term) liquidity and the interbank rates approached the key interest rate. Over the same time, the lek deposit interest rates dropped significantly below the key interest rate, a trend that continued even in January.[2] On the other hand, the new loan interest rates dropped in October and November, but the spreads between them and other market rates widened. The lending market remains squeezed due to weak demand for loans and associating high risk premia. However, the Bank of Albania assesses that the downtrend in loan interest rates for all maturities over both months is a welcomed development and creates premises for better functioning of this transmission channel.

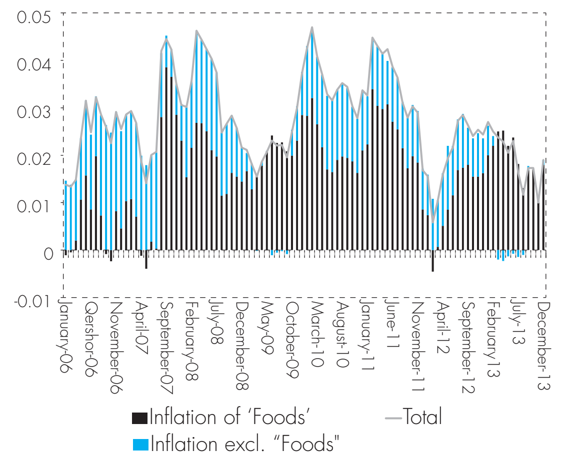
The monetary policy will stay accommodative, in response to projections for low inflation rates, slow economic growth and weak monetary indicators dynamics. Bank of Albania's surveys indicate that inflation expectations remain anchored to the monetary policy target.

2.2 INFLATION BY ITEM

The performance of food prices, particularly the unprocessed food prices, determined inflation developments in 2013 H2. Price volatility in other CPI basket items contributed slightly to formation of headline inflation rate.

In Q4, unprocessed food prices contributed 1.5 percentage points to the headline inflation, similar to Q3. This item's annual inflation averaged 7.6%, almost as high as the previous quarter's rate but at a higher volatility. The imbalance between the demand for and supply of this item's products caused significant price volatility, particularly in November, when they dropped significantly.[3] Also, unprocessed food prices were low even in the countries of the region, and hence lower imported inflation for this item.

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



Source: INSTAT and Bank of Albania.

2 Information from preliminary data as of January 2014.
3 Monthly inflation recorded a negative rate (-0.5%), which was never seen in any other November.

Processed food prices in Q4 resulted in a lower inflation than in Q3. This item's annual inflation and contribution to headline inflation were -0.6% and -0.1 percentage points, respectively, the lowest values since 2009, influenced by the favourable conjuncture of global prices for these goods, and the stable exchange rate over this quarter.

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

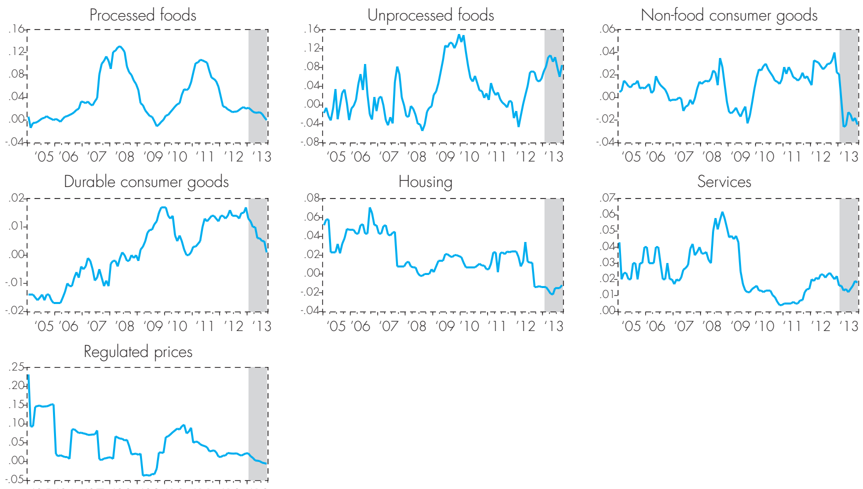
	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3	2013 Q4
Processed foods (pp)	0.7	0.4	0.4	0.6	0.5	0.3	0.1	-0.1
Bread and grains (pp)	0.2	0.0	0.0	0.0	0.1	0.1	0.1	0.0
Alcohol and tobacco (pp)	0.1	0.1	0.1	0.2	0.1	0.2	0.1	0.1
Unprocessed foods (pp)	-0.6	0.5	1.3	1.0	1.7	2.0	1.5	1.5
Fruit (pp)	0.3	0.3	0.5	0.5	0.3	0.4	0.8	0.5
Vegetables (pp)	-1.2	-0.1	0.7	0.2	1.2	1.5	0.5	1.1
Services (pp)	0.0	0.2	0.2	0.2	0.2	0.1	0.1	0.1
Regulated prices (pp)	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0
Fuels and energy (pp)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Housing (pp)	0.3	0.2	0.0	-0.2	-0.2	-0.2	-0.1	+0.1
Non-food consumer goods	0.6	0.4	0.5	0.5	0.1	-0.2	-0.2	-0.1
Durable consumer goods (pp)	0.0	0.1	0.2	0.2	0.1	0.1	0.0	0.0
Consumer Price Index (y-o-y, in %)	1.1	1.9	2.7	2.4	2.5	2.2	1.5	1.5

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

During this quarter, the contribution of non-food consumer goods continued to record negative values, albeit lower than a quarter earlier. The inflation rate picked up (-0.8%, from -1.8%), hence making no significant contribution to the formation of the headline inflation rate (-0.1 percentage point).

House prices have changed significantly since last September. While in the past this item's inflation and contribution had recorded negative values, after September, inflation edged up to 1.3%, contributing by 0.1 percentage points to the headline inflation (from -0.1 percentage points a quarter earlier).

Chart 4 Annual inflation by items of goods and services, in %



Source: INSTAT and Bank of Albania.

Other items with a smaller share, continue to make negligible contribution to inflation rate. It is worth mentioning that in Q4, services, durable consumer goods and regulated prices made a total contribution of only 0.1 percentage points.

3. MACROECONOMIC DEVELOPMENTS

Updated macroeconomic analysis reveals further weakening of economic activity and inflationary pressures over 2013 H2. The economic activity recorded 2.3% annual contraction in Q3, reflecting the cyclical weakness of aggregate demand and the temporary shocks arising from post-election situation over this quarter. Our economic projections show low economic growth for the quarters ahead, reflecting the weakening external demand, limited space for the counter-cyclical fiscal policy, and lack of signals for recovery of consumption and private investments.

Aggregate demand is likely to remain below the productive capacity of the economy in the current quarter, keeping inflation at low rates. Also, external inflation pressures are likely to remain weak due to low inflation in Albania's trading partners and stable exchange rate. Finally, the anchored inflation expectations have been reflected in stable costs in the economy and remain in line with price stability over the medium-term horizon.

3.1. EXTERNAL ECONOMY

3.1.1 ECONOMIC GROWTH AND MAIN MACROECONOMIC BALANCES

Global economy continued to recover gradually but at uneven paces across different countries. Indirect preliminary data show that the recovery picked up pace in 2013 Q4. However, the global economic performance remains fragile and uncertain. Advanced economies have played a positive role in global economic recovery as their economies started to pick up in 2013 H2. On the other hand, emerging and developing economies did not maintain their earlier paces of growth. Inflation dropped, while inflationary pressures remained subdued.

Table 2 Selected macroeconomic indicators

Countries	GDP change		Unemployment rate	Inflation rate	
	2013 Q3/ 2013 Q2	2013 Q3/ 2012 Q3	November 2013	December 2013/ November 2013	December 2013/ December 2012
USA	0.7	1.6	6.71	0.3	1.5
Euro area	0.1	-0.4	12.1	0.3	0.8
Germany	0.3	1.1	5.0	0.4	1.4
France	-0.1	0.2	10.9	0.3	0.7
United Kingdom	0.8	1.5	7.42	0.4	2.0
Japan	0.5	2.7	4.0	0.03	1.53

Source: ECB, Fed, Eurostat and respective statistical institutes.
1 December 2013, 2 August-October 2013, 3 November 2013.

ADVANCED ECONOMIES

Preliminary data from Eurostat show that the euro-area economy grew 0.1% in Q3. The annual contraction by 0.4% was lower than a quarter earlier (-0.6%).

The analysis of factors reveals that contraction in external demand made a major contribution, while consumer spending made a neutral contribution to GDP formation over this quarter. Preliminary data for November and December (consumer and business confidence indices and indicators on sales and industrial new orders) show a positive performance, pointing to an upward GDP in Q4. Unemployment rate remained flat over the last months. It was 12.1% in October, falling for the first time after two-year rise. Inflation trended down in all the euro-area countries, reflecting the lack of supply and demand-side pressures. Prices are expected to be within the ECB's target over the quarters ahead.

The U.S. economy continued to grow in 2013 Q3, pursuing a positive trend since year-start. Consumer spending, local government expenditures and investments were the main drivers of economic growth over this quarter. These developments were held back by import growth and federal government expenditure cuts. Inflation was low in 2013 Q4 but the annual inflation rate trended up month after month. Unemployment rate was 6.7% in December, reaching the pre-crisis (2008) levels. The U.S. Federal Reserve announced it would taper its monthly bond purchases by USD 10 billion to USD 75 billion per month.

Preliminary data on Q4 transmit unclear signals. Lower consumption is expected due to government shutdown in October. On the other hand, industrial output and retail purchases picked up in November, while employment remained modest. After resolving the parliamentary crisis on approving the 2014 budget, the business and consumer expectations have moved in the positive direction.

ECONOMIES IN THE REGION

Italy's economy continued to contract in 2013 Q3 but at a moderate rate. Positive developments were seen in industrial output and net exports, which contributed positively to GDP due to falling imports. At the same time, the other sectors such as agriculture and services continued to contract but at a slower pace.

Greece's economy continued to contract in 2013 Q3, albeit at a weaker pace. Only net exports contributed positively, while investments and consumer spending continued to perform negatively. The Greek economy is expected to contract less in 2014.

Turkey's economy continued to grow at high rates in 2013 Q3, driven by high consumer spending, and increase in private investments and industrial output. Public spending contributed less than in the previous periods, while net exports impacted negatively on economic growth. Political turmoil in Q4 and the news about the U.S. drawdown of quantitative easing are expected to impact negatively the trust of foreign markets in the Turkish economy.

FYROM's economy continued to grow at positive rates in 2013 Q3. Sharp growth in the construction sector was the main driver of growth, while consumer spending decelerated its pace of growth significantly. Investments contracted further, while net exports contributed negatively but at a mitigated effect. For the period ahead, FYROM's economy is expected to be stable and the economic activity is expected to improve.

Table 3 Economic figures for countries in the region

Countries	GDP change 2013 Q3/2012 Q3	Annual inflation December 2013	Unemployment rate November 2013
Italy	-1.9	0.7	12.7
Greece	-3.0	-1.8	27.82
FYROM	3.3	1.4	28.71
Serbia	3.7	2.2	20.12
Croatia	-0.6	0.3	17.41
Turkey	4.4	7.4	9.72
Kosovo	2.53	0.5	30.93
Albania	-2.3	1.9	12.81

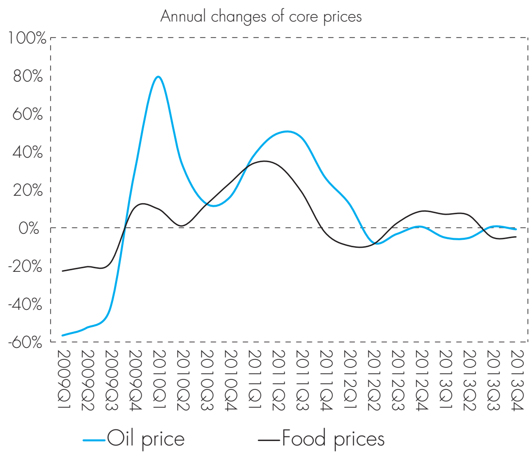
1 2013 Q3; 2 October 2013; 3 2012

Source: Respective statistical institutes, IMF, EcFin, Eurostat

3.1.2 PRIMARY COMMODITY PRICES

The European Brent index averaged USD 109.7 per barrel in 2013 H2. Though the oil price has not changed in annual terms, it rose 2.0% from H1. Geopolitical tensions, lower North Sea oil production and constantly contracting exports from some OPEC member countries (Iraq, Iran, Libya and Nigeria) were some of the factors affecting the oil supply in the international markets. The positive data on the U.S. and Chinese economies, and the higher demand in the advanced European economies in December, led to a rising oil price. In spite of above developments, the expanded supply from countries outside OPEC is likely to lead to a lower average oil price, to about USD 105.4 per barrel in 2014.[4]

Chart 5 Primary Commodity Prices (in %)



Source: IMF, EIA.

Based on the periodic IMF Primary Commodity Price Index, in 2013 H2, the primary commodity prices remained quite similar to those of a year earlier, rising by only 0.4%. This index remained almost unchanged from H1, reflecting, on the one hand the higher oil price, and on the other hand, the lower metal and food prices. Over the same period, in line with the rising supply of agricultural products, food prices dropped both on a yearly (4.9%) and half-yearly (2.9%) basis.[5]

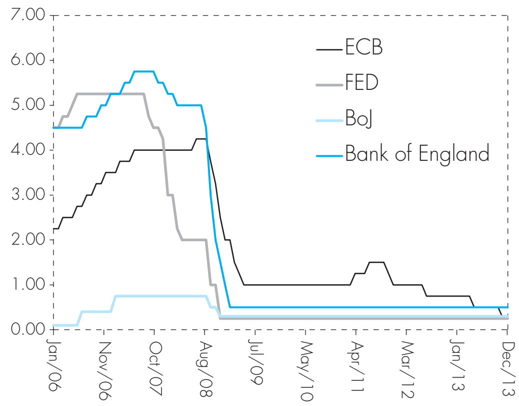
4 Based on January 2014 Review of U.S. Energy Information Administration.

5 The falling primary commodity price dynamics (excluding energy) was driven by the lower investment pace in emerging and developing economies due to the U.S. Federal Reserve's withdrawal of monetary stimulus. At the same time, falling inflation in many advanced economies has lowered investments in these commodities, considered as a form of hedging against inflation.

3.1.3 MONETARY POLICY AND FINANCIAL MARKETS

The European Central Bank, at its meeting of November 2013, decided to lower its key refinancing rate by 0.25 percentage points, to 0.25%. The other major central banks kept their key interest rates unchanged, respectively, Federal Reserve at 0-0.25%, Bank of England at 0.5% and Bank of Japan at 0-0.1%.

Chart 6 Key interest rates of selected central banks

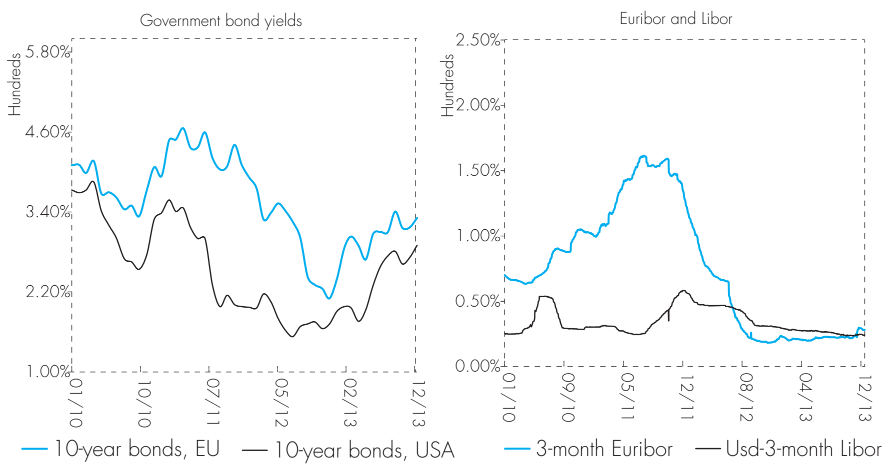


Source: Respective banks (ECB, Fed, BoJ and BoE).

In the euro-area money markets, the euribor rates picked up slightly in Q4, though their level is still low. Larger fluctuations appeared in December, primarily driven by agents' temporary behaviour at year-end. The ECB continued to extend limit-free liquidity, contributing to keeping low interest rates in the money market. In capital markets, the long-term government bond yields increased slightly in both Euro area and the U.S. The effect of the Federal Reserve's announcement that it would start to withdraw the monetary stimulus and the better-than-expected results on some indirect economic indicators led to higher yields over this period. The opposite was seen in ask premia on debt securities of the countries conducting fiscal consolidation. Interest rates on these debt securities dropped, smoothing the yield spread between debt securities and bonds to a positive estimate.

In the foreign exchange markets, the euro appreciated against the U.S. dollar and many other major currencies, such as the Japanese yen and Chinese renminbi. On average bilateral terms, in Q4, the euro appreciated by 2.78% on a quarter earlier, while in December, it was traded at USD 1.3704 on average, or 1.6% higher than in November.

Chart 7 Selected global financial indicators



Source: ECB, Reuters.

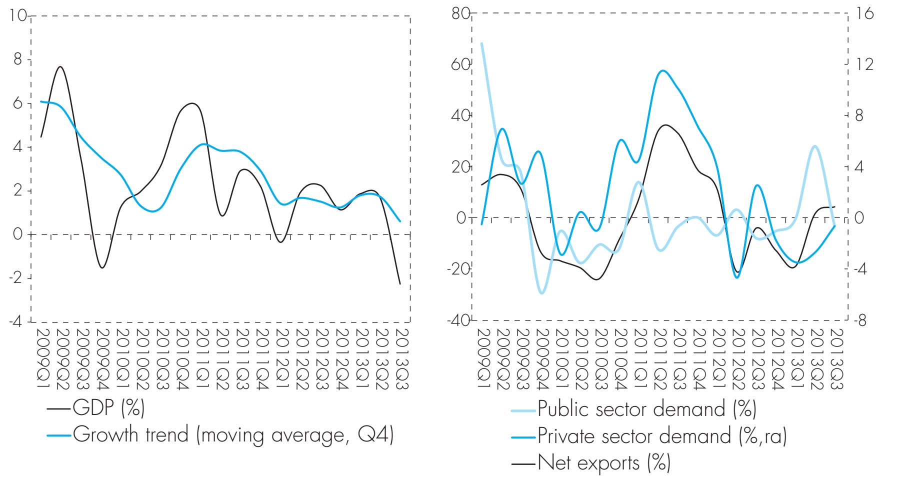
3.1.4 IMPACT ON ALBANIAN ECONOMY

Developments in international financial markets and economies will continue to provide weak support to Albania's economic growth and weak inflationary pressures on the Albanian economy. However, projections for an improved euro-area economic activity over 2014, particularly in Italy, our main trading partner, are expected to impact positively on Albania's exports. Expectations for a lower average oil price may lead to a lower domestic oil price. 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 of primary commodities and consumer goods, and weak pressures over the national currency, the imported inflation pressures on domestic consumer prices will remain subdued.

3.2 GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

The Albanian economy contracted in 2013 Q3, after five quarters of economic growth. Gross domestic product (GDP) dropped 2.3% in annual terms, from up by 1.8% in H1. The quarterly production dynamics moved away from the seasonal model, falling by 2.0% in quarterly terms.[6] Besides lower aggregate demand, economic agents' uncertainty due to political rotation materialised partially into economic decline. The domestic demand components remained weak, in line with our forecast. The private sector's demand continued the downtrend begun since 2012, reflecting the low business and consumer confidence, tight financing conditions, and slowing income in this sector. Unlike in the previous quarter, the sluggish private demand was not offset by the other aggregate demand components. Public sector's contribution to GDP growth,

Chart 8 GDP and annual dynamics of aggregate demand components



Source: INSTAT and Bank of Albania.

[6] *The quarterly rate is calculated on the basis of the seasonally-adjusted GDP published by INSTAT.*

by about 2.4 percentage points in H1, decreased the annual GDP growth by 0.5 percentage points in Q3. Also, real net exports contributed negatively due to contraction in imported goods and decline in tourism revenues.

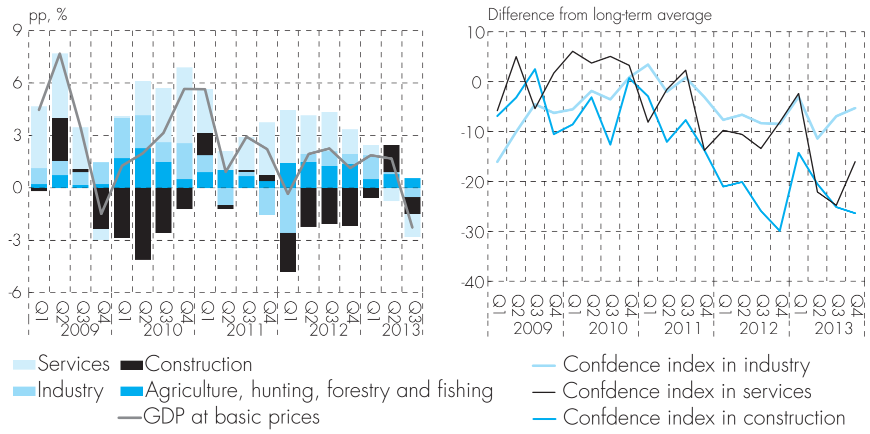
In line with developments in the aggregate demand components, the value added in the economy contracted in almost all the sectors, excluding agriculture. Production sector dropped in Q3 due to contraction in the industrial and construction output. On the other hand, the services sector continued to contribute negatively to economic performance in Q3.

Updated analysis and macroeconomic projections shift down the balance of risks to economic growth in the short term.[7] The poor economic performance will reflect primarily the weak consumption and private investments. Consumers' reluctance to spend will continue to hinder the private consumption recovery. Also, the weak dynamics of private investments reflects the perceived uncertainty about the macroeconomic outlook and an environment with tight lending terms and spare capacities. The public sector's room for encouraging economic growth is limited. External demand is expected to maintain its positive contribution to Albania's economic growth but it will be smaller due to Albania's relatively low export base. In the medium term, private sector demand is expected to recover, thanks to monetary stimulus injected into the economy over the last two years and the external demand from stable recovery of the world economy.

3.2.1. OUTPUT BY SECTOR

Gross Domestic Product, after expanding by 1.9% and 1.7% in Q1 and Q2, respectively, pointed to a negative performance of the economy in 2013

Chart 9 Contribution of sectors to annual GDP and confidence indices



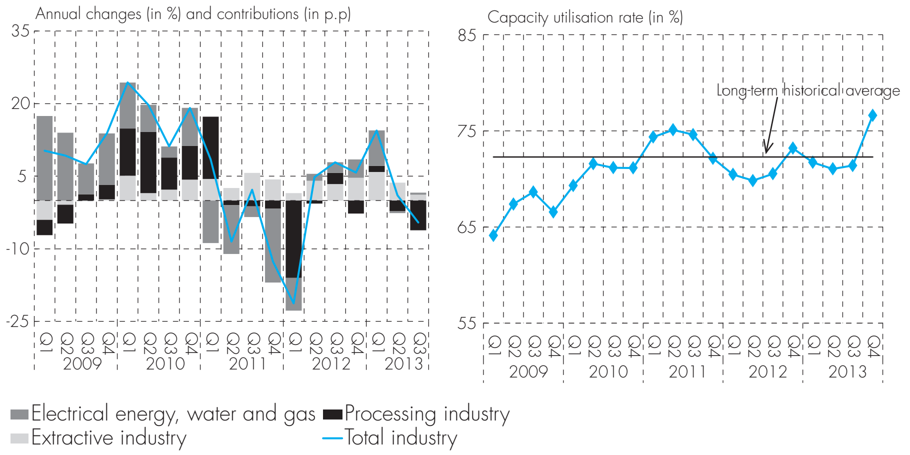
Source: INSTAT and Bank of Albania.

[7] *To assess Albania's economic performance in 2013 Q4, we rely on the value of imports and exports of goods; lending to the economy as of end-November; fiscal indicators; and qualitative data obtained from Q4 confidence surveys.*

Q3.[8] Services sector contributed negatively about 1.3 percentage points to annual GDP. In the production sector, only agriculture gave a value added that contributed by 0.5 percentage points to GDP growth. This was insufficient to offset the contraction in industry and construction, whose annual contribution to GDP growth fell by 1.5 percentage points.

Industrial activity, after slowing down in Q2, dropped in Q3. Value added in industry dropped 4.6% in annual terms, in Q3, after the slight increase by 1.1% in Q2. This sector contributed negatively by 0.5 percentage points to annual GDP growth. Further slowdown in industrial exports and the sluggish domestic demand affected industrial developments. Branch analysis reveals that the rapidly falling value added in the processing industry determined the industrial activity performance. 'Extractive industry'[9] and 'Electrical energy, water and gas' generated a slightly higher value added on a year earlier. The survey data show a slight increase in confidence indices and productive capacity utilisation rate in the industrial businesses. These developments point to better performance of this sector at year-end.

Chart 10 Contribution of industry branches to value added, and capacity utilisation rate



Source: INSTAT and Bank of Albania.

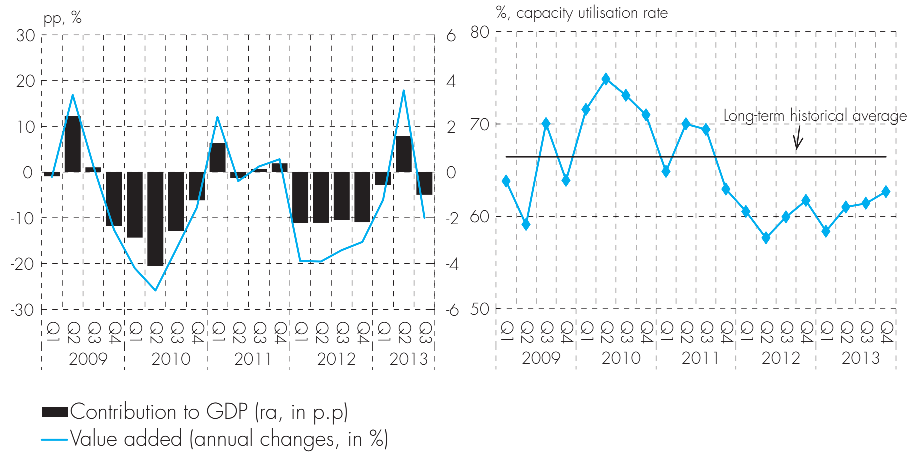
Construction sector performed negatively in Q3. The value added in this sector reversed the previous quarter's upward trend, down by 10.0% in annual terms. This confirmed our assessments that the second-quarter improvement was temporary. Construction contributed negatively by 1.0 percentage points to annual GDP growth. Decline in construction output reflected the low level of public investments and the weak housing demand. However, the higher

[8] *In January 2014, INSTAT published the value added series at basic prices by economic activity as of 2013 Q3. Besides new data entry for Q3, the series were revised for a period starting from 2012 Q1.*

[9] *The annual growth rate of the value added from extractive industry resulted significantly lower in 2013 Q3 (about 6.3%). This reflects, to a certain extent, the base effect, since in 2012 Q3, the quarterly growth of the value added from the extractive industry was high (about 16.1%).*

number of building permits[10] granted during the first three quarters suggests that residential buildings will perform better over the periods ahead. The continuing downtrend in the confidence indicators, mainly due to projection for lower production, suggests that construction remained on the downside even in Q4.

Chart 11 Value added, contribution and capacity utilisation rate in the construction sector



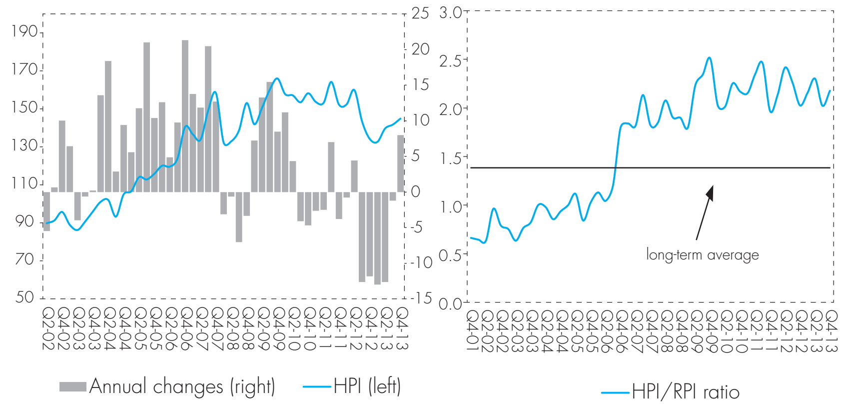
Source: INSTAT and Bank of Albania.

[10] *The number of granted building permits is a leading indicator of developments in the construction sector. It trended up in 2013, though it is still low compared to its historical values. According to the latest data, 88 construction permits were granted in Q3. The data are published by INSTAT in the "Quarterly Statistical Bulletin", 2013 Q3".*

*BOX 1 HOUSE PRICES**

House price index increased in 2013 Q4. Deflated by inflation, it increased by 8% and 2.3%, respectively, in annual and quarterly terms. During the year, the house prices trended down, reflecting the weak demand and the presence of unsold inventory. The real increase in Q4 reflected mostly the base effect. The rental price index increased slightly by about 0.5% in Q4, after the double-digit figure of 10.3% in Q3. This indicator's historical behaviour is characterised by a high volatility, which gives signals for a non-stabilized rental price market in Tirana.

Chart 12 House Price Index and price-to-rent ratio

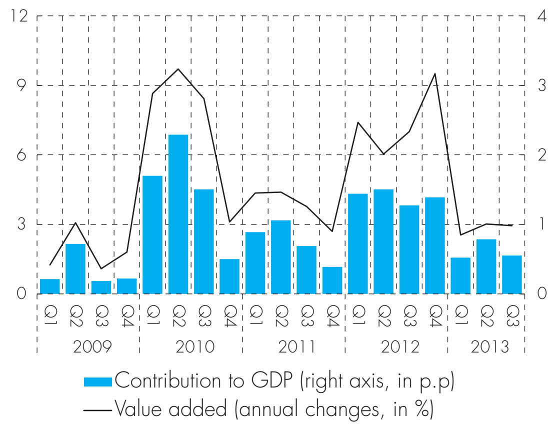


Source: Bank of Albania.

The above developments affected the increase in price-to-rent ratio, which is 7.5% higher than a year earlier and 58.9% above the historical average.

** Analysis of house and rental prices is based on information only for Tirana.*

Chart 13 Value added in agriculture, hunting, forestry and fishing, and their contribution to annual GDP growth

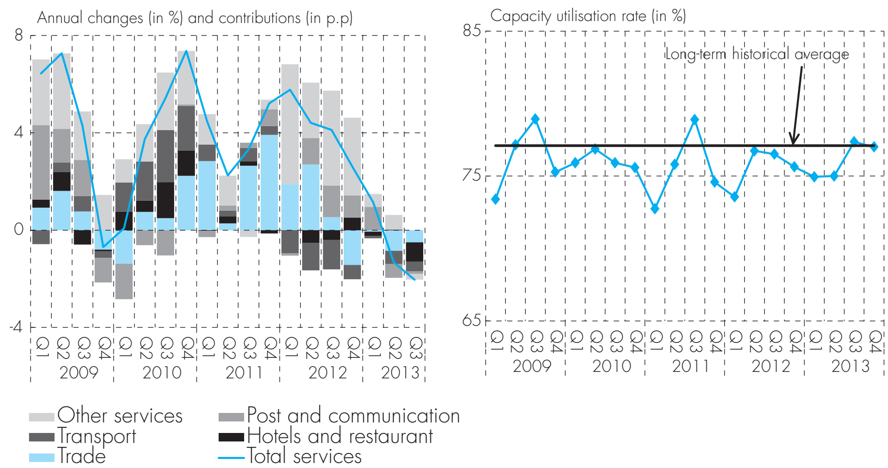


Source: INSTAT and Bank of Albania.

In Q3, 'Agriculture, hunting, forestry and fishing' generated a value added of 2.9% higher than in the same period a year earlier. During the year, agriculture grew by 2.8% on average, lower than the average historical growth rate of 4.2%.

The value added in the services sector continued to fall in Q3, compared to the same period a year earlier. This indicator dropped 2.0% in annual terms, from 1.3% a quarter earlier. Contraction in the activity of 'Hotels and restaurants' determined the value added from services, lowering it by 0.8 percentage points. However, even the value added from trade, transport and post-communication, and other services[11] resulted lower than a year earlier. The value added of other services dropped 0.5% in annual terms, after expanding modestly in the first two quarters of the year. The value added of trade, transport, post and communication services curbed the paces of annual decline to about 1.6%, 4.2% and 1.2%, respectively. In Q4, the significantly improved business confidence suggests for a possible interruption of the downtrend in the services sector.

Chart 14 Contribution of services to value added and capacity utilisation rate



Source: INSTAT and Bank of Albania.

3.2.2. AGGREGATE DEMAND

The third-quarter economic result was influenced by negative developments in all the aggregate demand components. In line with our assessments, consumption and private investments remained weak and the external demand for goods slowed down. On the other hand, the external demand for Albanian services dropped, unlike the seasonal increase seen during the tourism season in Q3. Despite the ongoing contraction in goods import, the sharp drop in tourism revenues was the main driver of the larger real net export deficit and negative contribution of the external demand to economic growth. Domestic demand was weak, reflecting the lack of fiscal stimulus and the downward performance of private investments and consumption. The factors determining private investments and consumption, such as uncertainty about the future and slowing disposable income, point to a weak domestic demand in the near future.

Private consumption dropped in 2013 Q3, after having slowed down in 2012. The low consumption continued to be reflected in the performance of the retail

[11] *Other services include: Financial intermediation; immovable property, leasing and business-related services; public administration, protection and social security; education; healthcare; and other collective, social and individual services.*

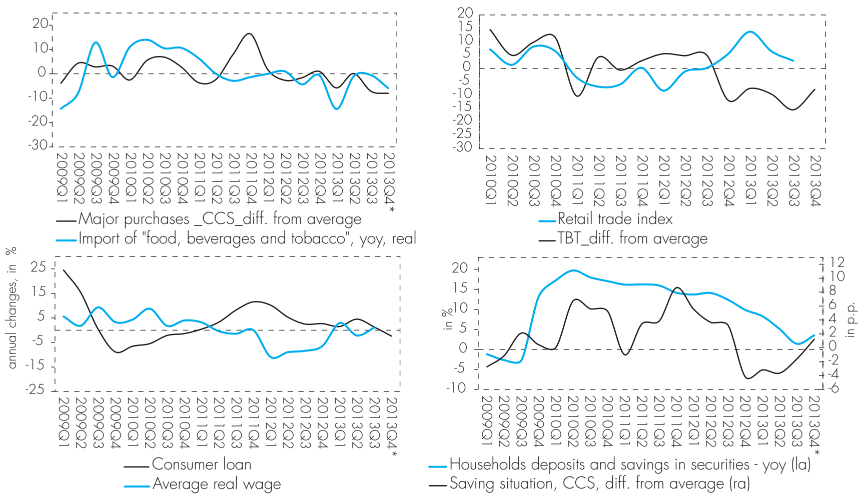
trade index, which decelerated the growth rate to 2.9%, from 10.1% in the first half of the year. Low consumer confidence, slowing income in the recent years and tight lending conditions led to weak consumption. During this quarter, the drop in consumption reflected, among others, the added uncertainties related to post-election situation. This uncertainty is believed to have affected negatively the consumption of services in particular, and less the short-term consumption.[12]

The third quarter saw slight improvement in domestic sources of consumption financing, supported by low and stable inflation rates. Bank consumer loans continued to increase but at much lower rates than in the first half. On the other hand, decline in remittances (-16.2%) in Q3 made a negative impact on financing consumer spending.

Households' inclination to save is also reflected in the performance of deposits and security investments. In spite of low interest rates, household savings in the form of deposits and security investments increased by 3.5% in October-November. The increase in the savings balance, based on the consumer confidence survey, confirms the same trend.

The short-term indicators point to weak consumption in Q4. Consumer goods import and consumer loans dropped y-o-y. On the other hand, the survey indicators signal stabilised confidence in the economy, in Q4.

Chart 15 Indirect private consumption data and financial resources



Source: INSTAT and Bank of Albania.

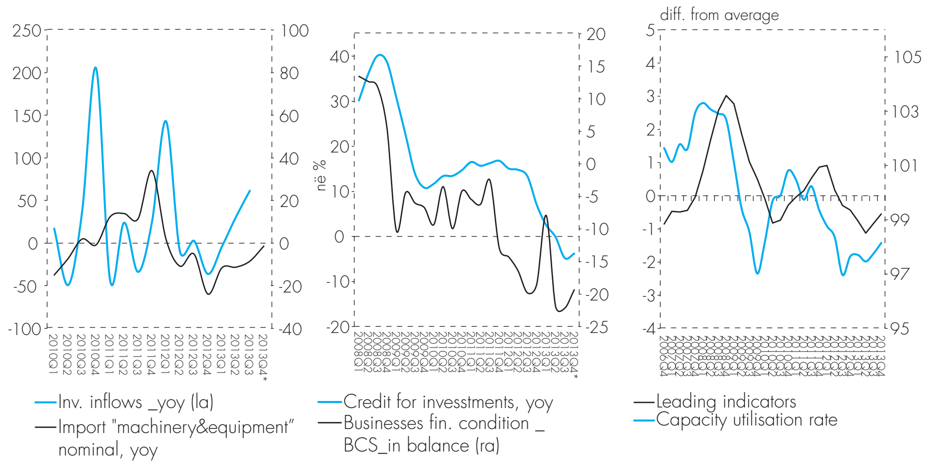
Private investments contributed negatively to aggregate demand in Q3. This demand component suffered from a sluggish final demand, elevated uncertainty and tight lending terms. Indirect data used as a proxy for private investments suggest that they deepened further their downtrend in Q3. Import of machinery

[12] *The value added of the services sector, excluding trade, registered a more pronounced decline than the value added of the trade sector.*

and equipment dropped 8.5% y-o-y, in Q3. Investment loans continued to drop, while businesses reported worsened financial conditions in the Q3 confidence survey. The survey on bank lending activity showed that banks perceived a substantially low business demand for investment loans, in Q3.

Indirect short-term data signal a lower negative contribution of private investments to aggregate demand over Q4. Capital-goods import decelerated the downtrend to 1.4% in Q4[13], from -10.5% on average in the first three quarters of the year. Recovery of investments in the future is also supported by the increase in the capacity utilisation rate to 74.7%, up by 2 percentage points from a quarter earlier. Based on the confidence survey results, the business financial condition remained significantly below the historical average, though it improved slightly in Q4. Also, investment loans continued to drop but at a slower rate in Q4.

Chart 16 Proxies for private investment



Source: INSTAT and Bank of Albania.

FISCAL INDICATORS AND FISCAL POLICY

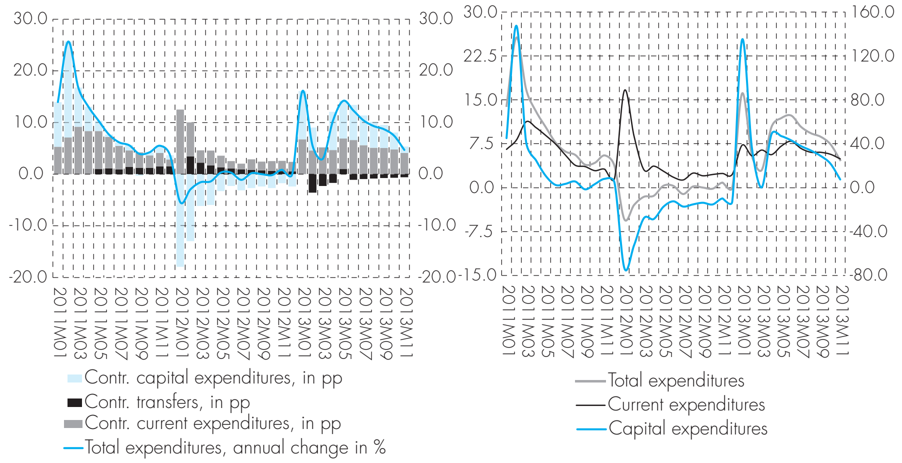
The discretionary fiscal policy in the first 11 months of 2013 was easing, materialised into a higher budget deficit and public debt. The higher fiscal stimulus in the form of higher public spending, and the implementation of an easing tax policy, which has incorporated a higher number of tax duty exemptions, as well as the direct or indirect cut in some taxes, point to budget deficit expansion.[14] The public sector's contribution to increasing the domestic demand was positive in the first half of the year, either in the form of public investments or government final consumption. After the first half of the year, the fiscal expansion contracted further, mainly due to lower capital investments. Developments in December are expected to determine the direction of public sector's impact on aggregate demand for 2013 Q4.

[13] *The annual percentage of change in import of machinery and equipment for Q4 is proxied by the annual growth rate for the first two months (October, November) of the quarter.*

[14] *For more information on the easing fiscal measures that entered into force in 2013, see the Monetary Policy Statement for 2013 H1.*

Budget expenditures as of end-November were about ALL 352.7 billion, or about 4.7% higher than in the same period a year earlier. The budget expenditure growth rates slowed down significantly after the first half of the year, mainly due to capital expenditure trend. The latter, after up by 43% in 2013 H1, dropped by 35.2% y-o-y in July-November 2013. At the end of the 11-month period, capital expenditure was about ALL 57.1 billion or 7.5% higher in annual nominal terms.

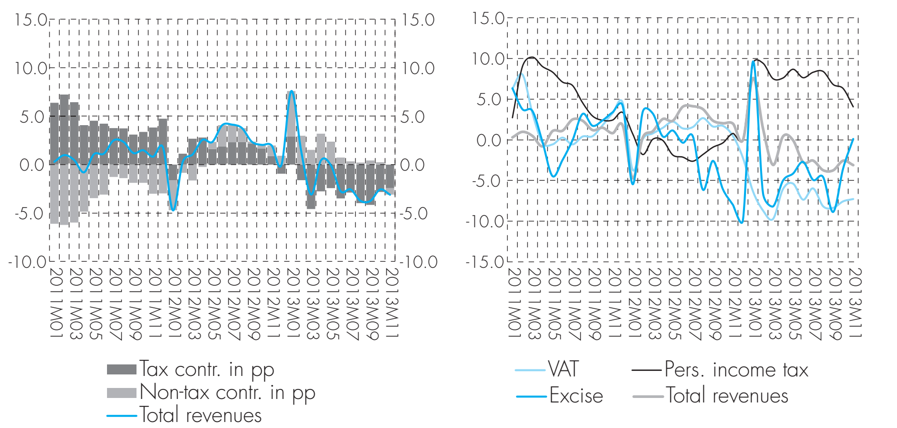
Chart 17 Annual change in budget expenditure by contributions of both main categories (left), and annual change in main expenditure items (right)



Source: Ministry of Finance.

On the other hand, current expenditures displayed an almost similar behaviour throughout the period under review. For the 11-month period, they reached about ALL 295.6 billion or about 4.9% higher than in the same period a year earlier. 'Social security' and 'Other' expenditure made the highest contribution to current expenditure growth.[15]

Chart 18 Annual change in budget revenues by contributions of both main items (left) and annual changes in main revenue items (right)



Source: Ministry of Finance.

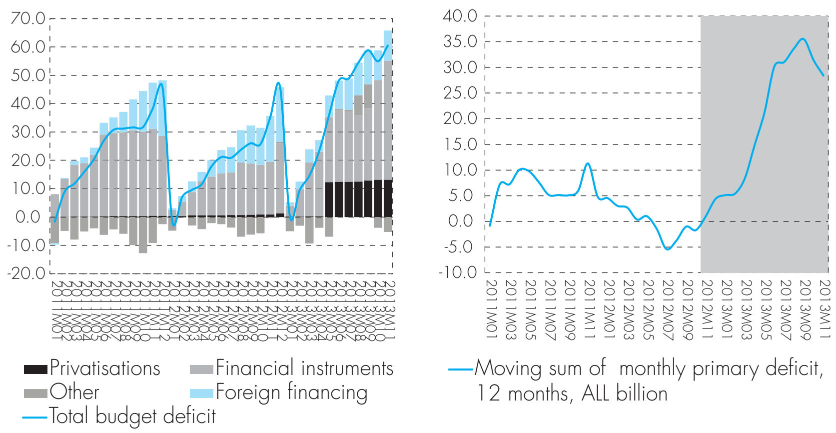
[15] *'Other' includes spending for economic assistance, unemployment compensation and compensations for former politically persecuted people.*

Budget revenue dynamics along the 11 months of 2013 was contrary to that of expenditures due to downward tax revenues. The downward rates of tax revenues reflect, at the same time, the poor performance of the domestic economic activity, the materialised effect of the easing fiscal measures that entered into force at the beginning of the fiscal year, and the lower imports in annual terms.

As of end-November, the realised budget revenues were about ALL 292.2 billion or 3.1% lower in annual nominal terms. VAT revenues made the largest contribution to revenue drop, by about 2.6 percentage points. The only tax items that increased steadily almost throughout the whole period under review are the social security and personal income tax revenues. At the end of the period, revenues from personal income tax were 4.1% higher than a year ago, mainly due to higher dividends. Social security revenues resulted about 4.2% higher, reflecting the wider tax-paying range, which, to a certain extent, may be due to structural measures that entered into force in May of this year.[16]

Budget deficit at the end of the period under review resulted about ALL 60.5 billion, meeting about 72% of the annual plan for the whole fiscal year. On a year earlier, the budget deficit was about 71.5% higher. The higher demand for borrowing on a year earlier was satisfied through long-term debt instruments with a maturity of 2-10 years. The newest security market instrument, the 10-year maturity bond, was first issued in October 2013. Its issue in October and November accounted for about 20% of the total new borrowing in the domestic securities market. On the other hand, for the 11-month period, the

Chart 19 Budget deficit and its financing by instruments, in ALL billion (left), and moving sum of primary deficit (right)



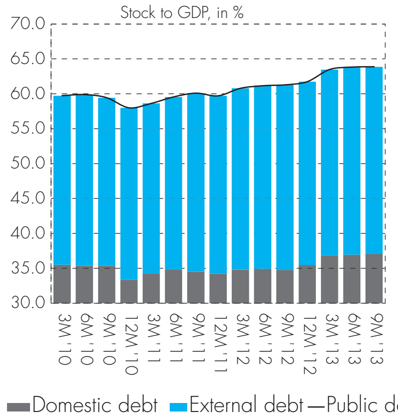
Source: Ministry of Finance, Monetary Policy Department calculations.

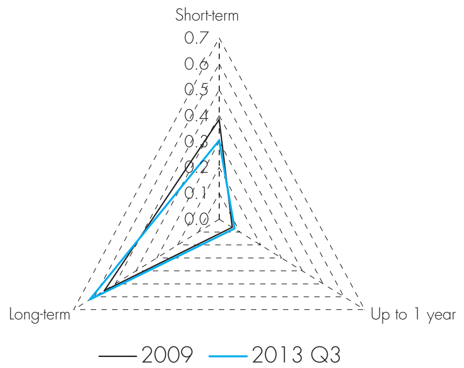
[16] *In May 2013, the Law No. 107/2013 entered into force, exempting the wage income tax for wages below ALL 30,000. Also, by the Council of Ministers' decision No. 353, dated 24.04.2013, private-sector employers, who employ youngsters aged 16-30 that have earned a university degree or have completed the high school and vocational education levels, as well as vocational courses, may benefit the 100% monthly financing of obligatorily social and health insurance for three years, i.e., the part of employers' contribution.*

government treasury bill portfolio dropped by about ALL 3 billion. Overall, the domestic borrowing funded about 69% of the total budget deficit. Privatisation receipts were an important source of budget deficit financing. They financed about 22%, while external sources financed the rest.[17]

The added fiscal vulnerabilities during this budget year were reflected in a worsened primary deficit dynamics, whose moving sum reached the highest values in the last four years. At end-November, the primary deficit moving sum was about ALL 28.4 billion, slightly improved from September 2013, mainly due to public spending restraint after 2013 Q3.

Chart 20 Public debt as a percentage of GDP* (left), and public debt by maturity (right)





* Public debt is calculated on the basis of security borrowing and excludes government arrears.
Source: Ministry of Finance, INSTAT and Monetary Policy Department calculations.

The change in the borrowing profile during the last years has improved the public debt maturity structure held by the Government. During the last years, public debt portfolio shifted from short to long-term maturity, in view of reducing the debt refinancing risk. However, the amount of domestic debt that falls due within a budget year is still high and may pose a potential liquidity risk to domestic securities market in the short term and the fiscal stability in the medium and long term.

NET EXTERNAL DEMAND

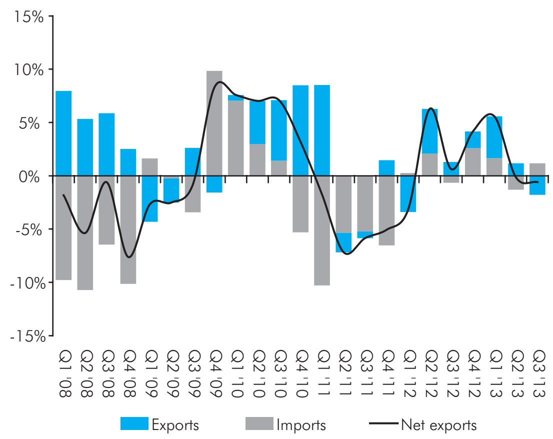
Net exports contributed negatively to aggregate demand in 2013 Q3. The deficit in real net exports expanded for the second consecutive quarter by about 2.5% in annual terms, with the higher price per unit of export of goods playing a key role. Real exports and imports of goods and services dropped by 3.5% and 1.6% annually, respectively.[18]

[17] Foreign financing accounted for about 18% of total financing over this period. The 9% balance in deficit financing is in the form of deposit for the account of the government.

[18] Unit Value Index, as calculated and published by the INSTAT, is used to switch from nominal to real terms of imports and exports of goods. As this index is not yet available for 2013 Q3, we use an index calculated on the basis of historical values of the unit value index for imports and exports. For imports and exports of services, we use the Consumer Price Index and the Harmonised Consumer Price Index of services, as calculated by the Bank of Albania and Eurostat, respectively.

External trade data for July-November 2013 show trade deficit narrowing by about 15.3%, in annual terms. This performance was sustained by decline in imports and expansion in export value of goods. A similar trend is recorded in the external trade volume, where the goods export expanded by 5.8% in annual terms, while import fell by 1%. Trade exchanges increased by about 1% in annual terms, while the import coverage ratio stood at 47.8%.

Chart 21 Net export contribution to aggregate demand



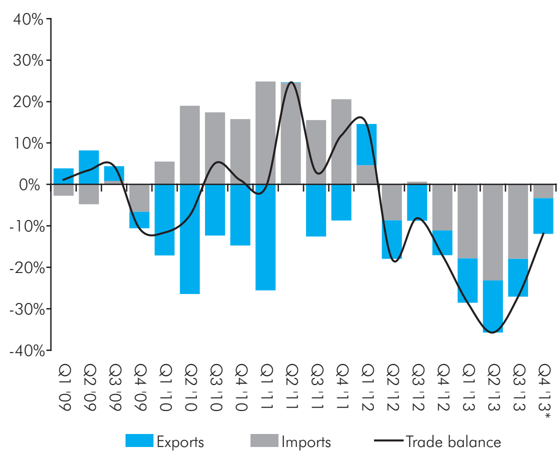
Source: INSTAT and Bank of Albania.

Against the backdrop of an improved external demand, domestic exports continued to trend up during 2013 H2, albeit at more moderate rates than in the same period a year earlier. Total exports increased by about 12.9% in annual terms, over this period (July-November). Similar to 2012, the performance of exports was heavily determined by the positive contribution by 7.1 percentage points of export of goods included in 'Minerals, fuels and electric energy'. Besides the export of electrical energy, this item showed positive developments in the export of all other sub-items. Re-exports of goods included in 'Textiles and footwear' increased by about 15.7% in annual terms. By contrast, exports of goods included in 'Construction materials and metals' dropped by about 15.3% in annual terms, during July-November 2013 (mainly due to the decline in export of cast-iron and steel).

Exporting activity continues to be oriented mainly toward Albania's trading partners, such as Italy, Spain, China and Central European Free Trade Agreement (CEFTA) member countries. Besides Albania's main trading partners, exports to Malta and Great Britain increased at fast rates, in annual terms, with crude oil as the main exported commodity.

Import of goods trended down in July-November 2013, with the most accelerated paces in August and September. During this period, total imports fell by about 3.8% y-o-y. The weak domestic demand and lower average price per unit of import were key drivers of the falling total import value.

Chart 22 Contribution of imports and exports to trade



Source: INSTAT.
*The values as of October-November 2013.

As in 2013 H1, import of goods included in 'Minerals, fuels and electrical energy' continued to be the main driver of the falling total import value. Overall, imports of these goods dropped 13.5% in annual terms, contributing about 2.8 percentage points to total import contraction. As in the previous years, import of electrical energy continued to play an important role in this item's imports and in total imports. Excluding this component, total imports fell by 1.7%. Import of goods included in 'Construction materials and metals' continued to contribute negatively by about 2.1 percentage points to total imports, mainly due to decline in import of cast-iron, steel and articles thereof, ceramic products, glass and glassware. The progressive decline in import of goods included in 'Machinery, equipment and spare parts' impacted on the same direction. During the period under review, import of vehicles fell about 4.9% in annual terms. The annual fall in import of "Construction materials and metals' and 'Machinery, equipment and spare parts' signals a low investment level in the country.

In geographic terms, Albania's importing activity does not show any changes. About 62.1% of total imports have their origin from the European Union, led by Italy (mainly fuels and products used as raw materials in contract manufacturing), Greece (mainly food, cast-iron, steel and fuels) and Germany (mainly machinery and equipment, pharmaceutical products). About 7.3% of total imports originate from CEFTA member countries, dominated by Serbia, Macedonia and Kosovo. The importing activity with the European Union and CEFTA member countries marked annual decline. Other important partners include China and Turkey that accounted for about 13.8% of total imports in July-November 2013.

BOX 2: BALANCE OF PAYMENTS HIGHLIGHTS, 2013 Q3

The overall balance of payments saw increased foreign reserve assets by about EUR 34.5 million in 2013 Q3. As of end-September 2013, foreign reserves totalled EUR 2.030,2 million, sufficient to cover 4.7 months of imports of goods and services. Albania's net current account balance recorded a deficit of EUR 191.6 million in Q3. After the expansion recorded in Q2, the current account deficit returned to the contracting trend, down by about 21.1% in annual terms. It accounted for about 7.8% of nominal GDP[19], or about 1.8 percentage points lower than in the same period a year earlier. The ongoing trade deficit adjustment and the positive net balance in revenue account were the main drivers of the annual decline in the current account deficit, in 2013 Q3. By contrast, the tourism season corresponding with the post-election period was a driver of accelerated annual contraction in the net positive balance of the services account. Immigration cycle maturity and the non-favourable labour market conditions in the countries, where Albanian immigrants reside (particularly in Italy and Greece), led to a continuously worsening net balance of the current transfers account.

Net flows to capital and financial account recorded a positive balance of EUR 79.5 million in 2013 Q3, financing 41.5% of the current account deficit for this period. Capital and financial flows fell substantially by about 54.4% from the same period a year earlier, accounting for about 3.2% of nominal GDP. The annual fall in foreign currency flows to these accounts was determined by the annualised 60.7% decline in the net flows to financial account. This result was influenced by the negative balance of EUR 204.7 million in other net investment account, despite the accelerated increase in Foreign Direct Investments (FDIs) in Albania. Net FDIs increased by about

[19] Nominal GDP for 2003-2011, as published by INSTAT. The quarterly distribution is made on the basis of quarterly real GDP weights. Bank of Albania's Monetary Policy Department projections are used for 2012 and 2013.

64.6% relative to 2012 Q3. Net portfolio investments for 2013 Q3 recorded a positive balance of EUR 11.3 million. The other net investment account contributed by EUR 204.7 million to growth of residents' assets invested abroad.

Albanian assets invested abroad increased by about EUR 250.9 million, from the increase by EUR 179.7 million in the same period a year earlier. Private and public borrowing recorded a negative balance of EUR 3.7 million in Q3, from EUR 28.5 million in the same period a year earlier. The fall in total borrowing was due to principal payments made by the private sector. Overall, (private and public) debt payments lowered Albania's dues by about EUR 30.6 million during the quarter under review.

Table 4 Balance of Payments indicators

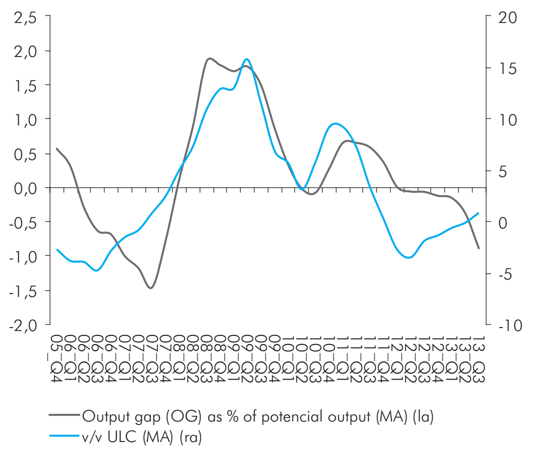
	Q1 '12	Q2 '12	Q3 '12	Q4 '12	Q1 '13	Q2 '13	Q3 '13
Current Account (in EUR million)	-290.4	-251.8	-242.8	-236.3	-224.7	-296.9	-191.6
Annual change	26.7%	-23.9%	-6.2%	-35.5%	-22.6%	17.9%	-21.1%
/ GDP	-13.8%	-10.0%	-9.6%	-9.9%	-10.2%	-11.5%	-7.8%
Balance of trade	-465.3	-475.5	-540.5	-517.8	-332.4	-397.6	-437.6
Exports, f.o.b.	325.8	394.2	402.5	403.1	381.6	458.8	454.7
Imports, f.o.b.	-791.2	-869.7	-943.0	-920.9	-714.0	-856.4	-892.3
Bilance of services	8.5	26.2	132.6	27.9	-43.9	-37.3	46.6
Credit	293.8	381.1	578.1	402.1	283.6	346.9	524.7
Debit	-285.4	-354.9	-445.4	-374.2	-327.5	-384.2	-478.1
Travel services - export	185.1	246.4	445.3	268.4	171.2	227.3	361.7
Travel services - Import	-180.8	-240.1	-325.6	-256.1	-205.8	-258.7	-335.7
Travel services - Net	4.3	6.2	119.7	12.3	-34.6	-31.5	26.1
Balance of income	-40.4	-27.7	-20.6	-0.2	-11.3	-23.7	35.3
Credit	48.2	43.0	57.8	55.3	42.2	47.4	53.1
Debit	-88.6	-70.7	-78.5	-55.5	-53.5	-71.1	-17.8
FDI income - net	-54.8	-29.8	-42.0	-26.2	-35.1	-47.6	4.9
Current transfers	206.8	225.3	185.8	253.9	163.0	161.7	164.1
Credit	243.5	265.2	224.1	285.8	195.7	193.8	198.1
Debit	-36.7	-39.9	-38.4	-31.9	-32.6	-32.0	-34.0
Remittances -net	166.5	171.6	140.8	196.3	122.3	104.4	119.0
Capital and Financial Account (EUR million)	258.3	185.5	174.4	249.1	208.5	338.5	79.5
Annual change	15.1%	-21.3%	-25.2%	-12.5%	-19.3%	82.5%	-54.4%
/ GDP	12.3%	7.4%	6.9%	10.4%	9.5%	13.1%	3.2%
Capital account	12.9	43.0	9.8	15.6	9.7	4.8	14.8
Financial account	245.3	142.5	164.6	233.5	198.9	333.7	64.7
A. Liabilities	307.5	277.7	378.4	224.4	229.3	322.3	333.6
Foreign direct investments	205.5	191.1	164.5	183.7	197.0	249.3	265.6
Portfolio investment	14.5	19.6	7.8	21.0	21.8	21.9	21.8
Other investments	87.5	67.0	206.0	19.7	10.5	51.1	46.1
Currency and deposits	69.1	34.8	164.8	3.7	6.1	21.9	41.2
B. Assets	-62.2	-135.2	-213.8	9.2	-30.4	11.4	-268.9
Foreign direct investments	-2.7	-0.3	-7.7	-7.0	-2.1	-11.7	-7.5
Portfolio investment	-61.0	9.9	-26.4	-10.0	-28.9	-106.5	-10.5
Other investments	1.5	-144.8	-179.7	26.2	0.6	129.6	-250.9
Currency and deposits	-11.0	-133.2	-178.2	67.0	-4.0	92.4	-278.5
Errors and omissions	35.4	73.8	158.0	-36.0	-7.5	44.8	146.5
Reserve assets	-3.2	-7.5	-89.7	23.1	23.6	-86.4	-34.5

Source: Bank of Albania.

3.3. CYCLICAL POSITION OF THE ECONOMY, WAGES, LABOUR COSTS AND INFLATION TRENDS

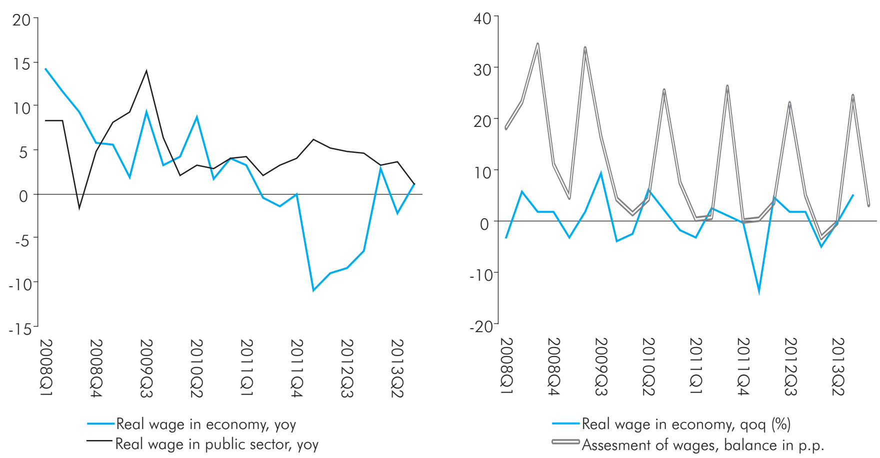
Recent months' economic figures have been in line with Bank of Albania's projections for the persisting negative output gap and weak inflation pressures. Aggregate demand shrank 2.3%, widening the negative output gap in 2013 Q3. The cyclical economic weakness was reflected in the partial utilisation of capacities in the capital and labour markets. The labour market remained sluggish in the period under review. Unemployment rate remained unchanged from end-2012, settling at 12.8% in 2013 Q3. Government's fiscal measures[20] introduced in May seem to have encouraged the declaration of employees, leading to increase in employment in the private non-agricultural sector in the first nine months of 2013. However, unemployment rate remained high and generated weak pressures for the raise in wages in the economy. In addition, the weak final demand restricted businesses' ability to dictate final product prices, resulting eventually in low profit margins. In the absence of unexpected supply-side shocks and in the presence of the anchored inflation expectations, the conditions of the real economy and the weak domestic demand, in particular, will keep inflation rates low in the period ahead.

Chart 23 Output gap and annual change in unit labour cost



Source: INSTAT and Bank of Albania.

Chart 24 Annual increase in wage indicators (in %) and wages in the economy



Source: INSTAT and Bank of Albania's calculations.

[20] *Based on Council of Ministers' Decision, as of 1 May 2013, wages up to ALL 30,000 shall be exempt from Personal Income Tax. Referring to Official Gazette No. 53, 15 April 2013, Law No. 107/2013, dated 28.03.2013: On some amendments to Law No. 8438, dated 28.12.1998 "On personal income tax ", as amended, and Council of Ministers' Decision No. 353, dated 24.04.2013: "Employment promotion programme for unemployed job seekers", published in the Official Gazette No. 73, 9 May 2013.*

3.3.1 WAGES

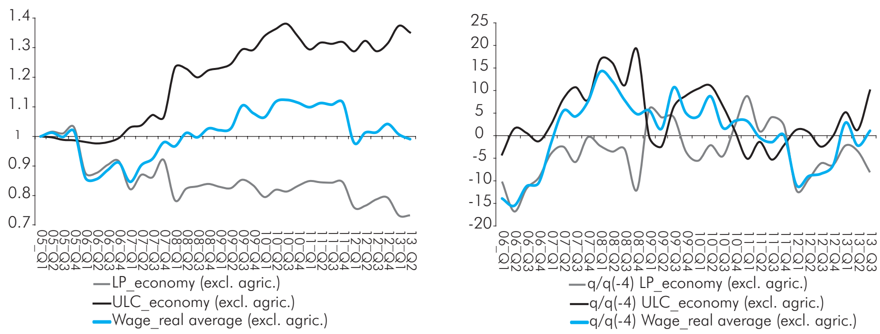
In 2013 Q3, wages rose 2.6% and 3.6% in annual and quarterly terms, in line with the raise in minimum wage. Deflated by inflation, average wage index increased by 1.1%. The performance of wages, however, was not uniform across the sectors. The increase in real wage was mainly affected by the 3.8% wage rise in industry, with extractive industry and energy production being the leading branches. The real wage remained unchanged in services but dropped in construction. Public sector wages rose in annual terms, albeit at a slower rate than in Q2.

The latest confidence survey data on 2013 Q4 signal the drop of wages in all sectors of the economy.

3.3.2 LABOUR PRODUCTIVITY AND UNIT LABOUR COST

In 2013 Q3, labour productivity (LP) in non-agricultural sectors hit an annual rate of -8.2%. The past two years' negative dynamics deepened further in Q3 due to lower value added vis-à-vis the positive employment rates. The deep downtrend in LP, coupled with the slightly higher average wage in annual real terms (1.1%), materialised into the annual increase in unit labour costs (ULC) by about 10%.

Chart 25 LP, ULC and average real wage (left); annual change in % (right)*



Source: INSTAT and Bank of Albania's calculations.

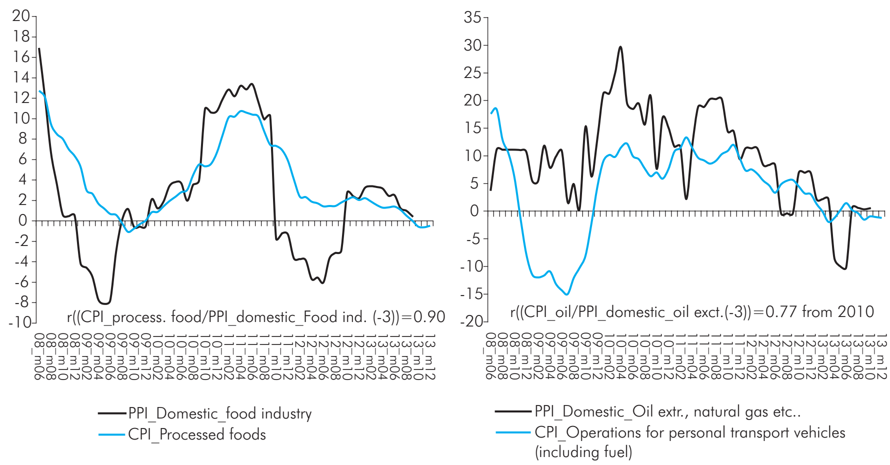
* The measures refer to LP and ULC of the economy, excluding agriculture. The calculations use value-added data (seasonally adjusted - INSTAT, GDP, 2013 Q3), and short-term statistics for employment and wages (INSTAT, Short-term statistics, 2013 Q3). Short-term statistics exclude agriculture, therefore the value added is considered excluding agriculture. Average real wage index is derived after deflating it by the CPI (2013 Q3). For comparison purposes and to assess the trend in wage index, the indicators are re-based on the value of each indicator in 2005 Q1. The latest estimates also reflect the changes arising from revising the value added series, and employment and wage fund indices. The indicators are seasonally adjusted (value added and CPI) - left-hand chart, while annual changes are applied to the seasonally unadjusted series - right-hand chart.

This hints that even the slightest increase in average real wage may translate into considerably higher unit labour costs, under the conditions of lower output and labour productivity.

3.3.3 INDUSTRIAL PRODUCER PRICES

Major industry branches, such as food and oil extraction, did not exert added producer price pressures on the prices of these products destined for the domestic market. The curbed rise in food processing industrial producer prices continued through 2013 Q3 (0.9%)[21], leading eventually to the annual fall in processed food prices during Q4. The stable producer prices in oil extraction and refining industry during Q3 kept domestic fuel prices steady and inflation in negative territory during Q4.

Chart 26 Annual changes by domestic CPI and PPI and respective correlations



Source: INSTAT and Bank of Albania.

3.3.4 DOMESTIC INFLATIONARY PRESSURES

The persistent weakness of aggregate demand continued to be reflected in deeper reduction in main inflation trends in 2013 H2. Long-term and domestic inflation in the economy, measured through core and net non-traded inflation components, marked -0.24% and 0.35%, respectively, in Q4. Core inflation fluctuated around negative rates[22], while net non-traded inflation pursued a more moderate downward tendency. Short-term inflation components also marked relatively low rates in Q4. Annual non-core and traded inflation marked 4.98% and 2.0%, respectively. They were affected significantly by November's volatile prices of agricultural products, whose supply in the domestic market was particularly higher than demand.

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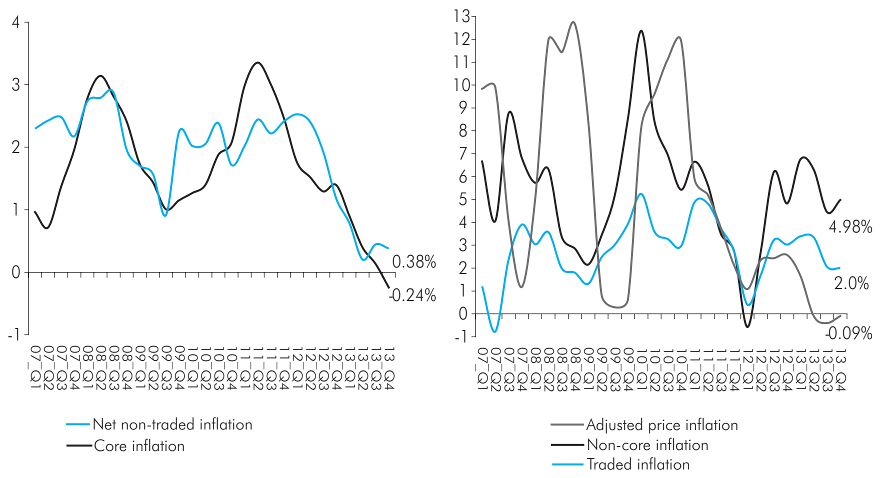
[21] *In 2013 Q2, the relevant Producer Price Index (PPI_domestic_Food industry) was 2.7%.*

[22] *The annual series of core inflation had not hit negative quarterly rates since 2005 Q1, when it marked -0.4%.*

Chart 27 Long-term inflation trends (left); short-term trends (right)

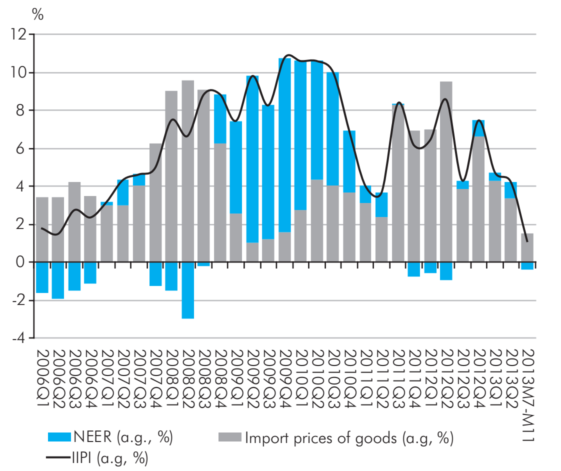


Source: INSTAT and Bank of Albania's calculations.

3.4 IMPORT PRICES AND IMPORTED INFLATION

The inflationary pressures stemming from Albania's major trading partners were downward, albeit positive, from H1. Imported Inflationary Pressures Index (IIPI)[23] rose 1.1% on an average annual basis, or 3.4% percentage points less than in H1. Import Price Index[24], which is closely and positively correlated with domestic goods' inflation, pointed to volatile and fast falling inflationary pressures during October and November. For the period under review, this index rose 1.5% on an annual basis, from 3.8% in H1. In the meantime, the stable lek in NEER terms (lek's appreciation by 0.5% in annual terms) during 2013 H2 played a dominant role in curtailing the import price rise pass-through to domestic headline inflation.

Chart 28 Contributions of import prices of goods and exchange rate to IIPI



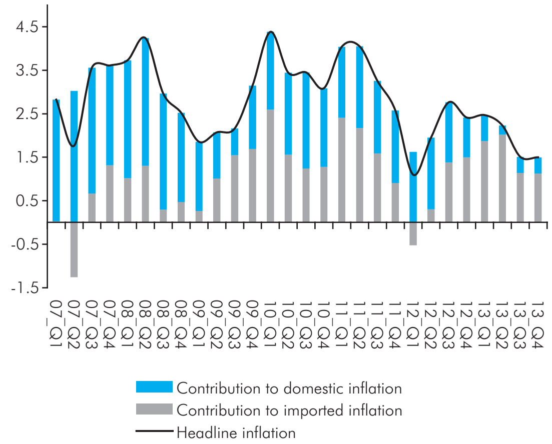
Source: Bank of Albania.

The lower headline inflation in 2013 H2 was affected by the curbed increase in imported inflation and weakening domestic inflationary pressures. In Q4, imported inflation contributed by around 1.1 percentage points (75%) to the formation of headline inflation, the rest being formed by domestic inflation.

23 *IIPI is calculated as the sum of the annual increase in import price indices and the NEER index value for the respective month. Imported inflationary pressures impact inflation with a 1-3 month lag. This index is, however, affected by the fiscal measures taken by other countries, which do not necessarily affect domestic import prices.*

24 *A new index measuring imported inflationary pressures, comparable to traded inflation of Albania's CPI basket. Import Price Index is based on the inflation rates of 'Food, beverages and tobacco' for 18 major countries, and 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 29 Contribution of imported and domestic inflation to annual headline inflation



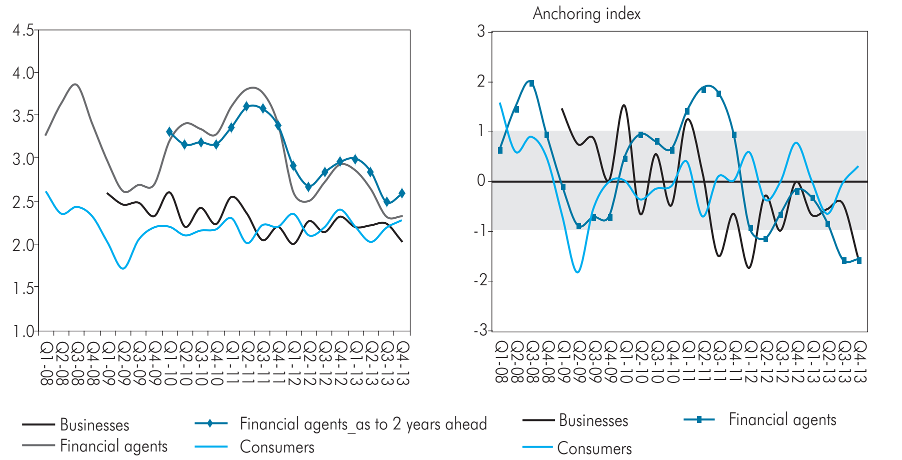
Source: INSTAT and Bank of Albania's calculations.

On average, in Q4, imported and domestic inflationary pressures had an almost similar share to the previous quarter.[25]

3.4.1 INFLATION EXPECTATIONS[26]

Inflation expectations moved around a band of 2-2.4% in 2013 Q4. Consumer expectations for one-year-ahead inflation and financial agents' expectations for medium-term inflation[27] rose 0.1 percentage point from Q3. Conversely, business expectations were 0.2 percentage points lower than in Q3. Financial agents' expectations for one-year-ahead inflation remained similar to the previous quarter.

Chart 30 Inflation expectations of different agents and Expectations Anchoring Index



Source: Consumer and Business Confidence Surveys and Financial Agents' Survey, Bank of Albania.

Expectations Anchoring Index[28] showed better anchored consumer expectations throughout 2013. In Q4, this index was 0.3, suggesting that consumer expectations were very close to their historical average. Expectations Anchoring Index for businesses and financial agents shifted from 0 to below historical average (around two standard deviations).

25 *There was a sharp decline in the contribution of imported inflation in November, which was offset by a similar increase in December.*

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

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

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

4. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

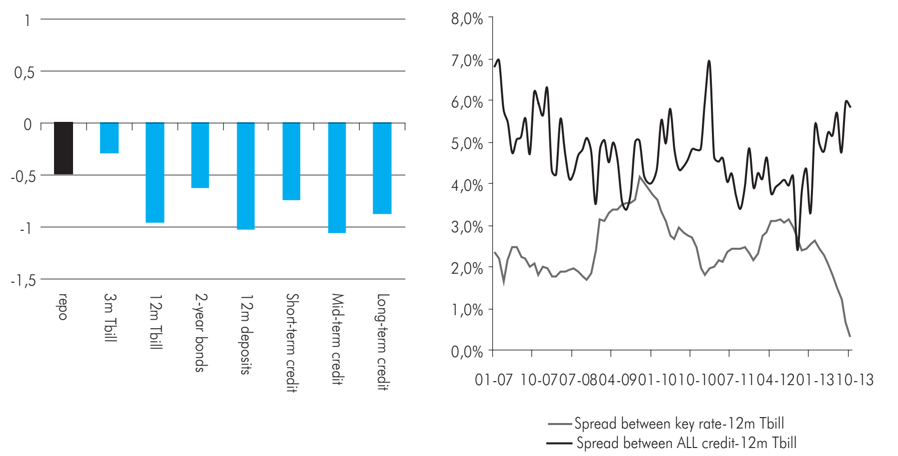
In 2013 Q4, the financial sector performed in line with the sluggish cyclical performance of the Albanian economy, which saw weak demand for financing. Banking system's liquidity and capital were above the regulatory requirement. Banks, however, offered less financial intermediation to the private sector despite the numerous promotional offers to boost demand for borrowing. The low growth of money in Q4 provided evidence for poor money creation in the economy. Foreign inflows, coupled with the recovered fiscal sector demand for financing, continued to support money creation in the economy. The performance of bank lending confirmed the absence of lending and financial intermediation for the private sector.

In parallel, Government's added demand for financing and the launch of new instruments contributed to financial market deepening and paved the way for enhancing its efficiency in the future, providing a new framework for investments and better price-setting for financial products. However, similar to other countries in the region, the transmission of primary market's positive signals into a broader spectrum of the financial sector is expected to be slow due to low elasticity of demand for funds to interest rates. Based on this performance, monetary-related inflationary pressures are expected to remain weak.

4.1 FINANCIAL MARKETS

Interest rates in the Albanian financial market showed downward tendency in 2013 Q4. The same tendency was maintained for the most part of the year. The financial market reflected Bank of Albania's decisions and signals for pursuing an easing monetary policy in the medium-term period. Central bank's steering approach to the market led to lower risk premia in 2013 H2.

Chart 31 Average change in interest rates and key rate in 2013 Q4 versus 2013 Q3 , spread from reference rate



Source: Bank of Albania.

Liquidity pressures were weak, while financial agents' inflation expectations remained anchored around Bank of Albania's target. Consequently, money market, capital, and loan and deposit rates in domestic currency dropped to minimum levels.

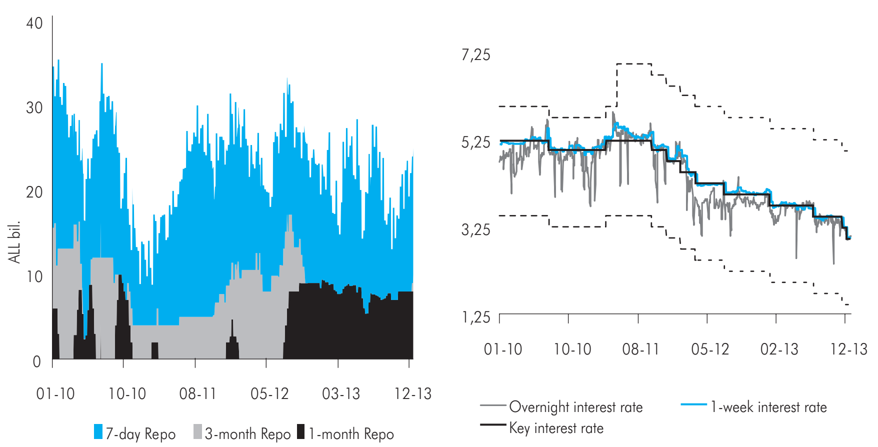
In the interbank market, banks maintained similar volumes to the previous quarter, hence confirming the recovery of this source to meet their immediate needs for funds. Interbank rates performed in line with the key rate. In the primary market, the fall in yields was broadly supported by financial agents' demand, at a time when investment and lending to the real economy remained subdued.

Banks continued to apply high rates on business and consumer loans, thereby dampening the effect of this year's monetary easing. The overall performance of the Albanian economy has, on the one hand, conditioned the growth of demand and, on the other, has influenced the price of lending, which is failing to benefit from the fall in 12-month T-bill yields, used as a reference rate, and the key rate.

INTERBANK MARKET

Interbank rates dropped on both maturities during 2013 Q4. Bank trading volume grew slightly, while one-week transactions continued to maintain the advantage over overnight ones. The spread between the overnight money market rate and the key rate widened slightly.[29] The Bank of Albania continued to conduct regular open market operations by injecting liquidity of one-week maturity and applying reverse repurchase agreements of one and three-month maturity. The liquidity injected into the system was less than in the previous periods, while the interest rate applied at these auctions was close to the key rate.

Chart 32 Bank of Albania open market operations and interbank rates



Source: Bank of Albania.

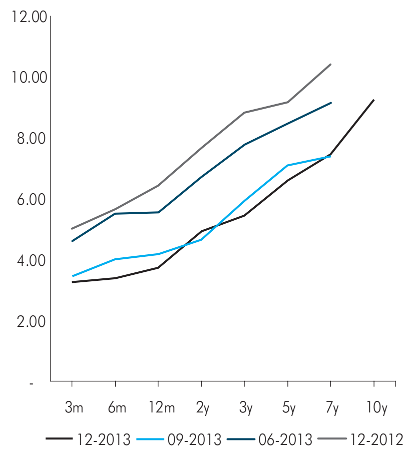
[29] *The spread between the overnight interbank rate and the key rate was 12 basis points in Q4, from 8 basis points in Q3.*

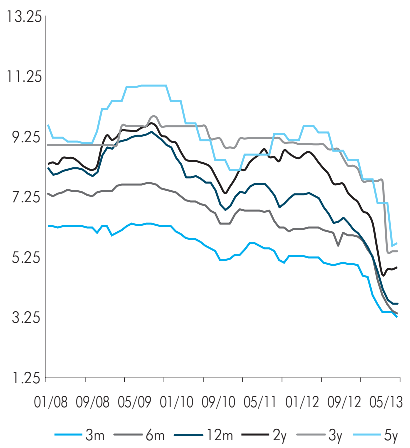
The overnight rate averaged 3.27% in Q4, from 3.52% in Q3. One-week rate dropped by 0.15%, to 3.39%, in Q4. Average bank trading volume increased by ALL 0.5 billion to ALL 14.7 billion, mainly due to increase in daily volume by the same amount (from ALL 3.1 billion to ALL 3.7 billion).

YIELD PERFORMANCE

Following the key interest rate cut and the liquid Government securities market, the yields hit minimum levels in 2013 Q4. There was increasing interest in investing in securities, enabling, in turn, the satisfaction of Government's added demand for financing. The largest portion of investment shifted to longer maturities, which triggered further fall in ask premia. The 10-year fixed and floating-rate bond was auctioned for the first time in October 2013. Following its success, it was re-auctioned in November. The yields were under pressure in December when demand for financing was more concentrated and failed to be satisfied. This period saw the auctioning of bonds of all maturities but 3- and 10-year ones.

Chart 33 Government security yields in the primary market





Source: Bank of Albania.

The average 12-month yield settled at 3.71% in December, from 4.18% in September. It dropped continuously through every auction[30], while its spread with the key rate narrowed further in Q4.

Bond yields did not show similar performance to T-bills', with two-year bond yields increasing slightly in 2013 Q4. Financial agents' preference shifted to securities with a longer maturity and auctions for the issuance of two-year bonds were not satisfied. Two-year bond yields rose to 4.92% in December,

[30] *Except for December's auction, when the 12-month yield increased by 0.18 percentage points.*

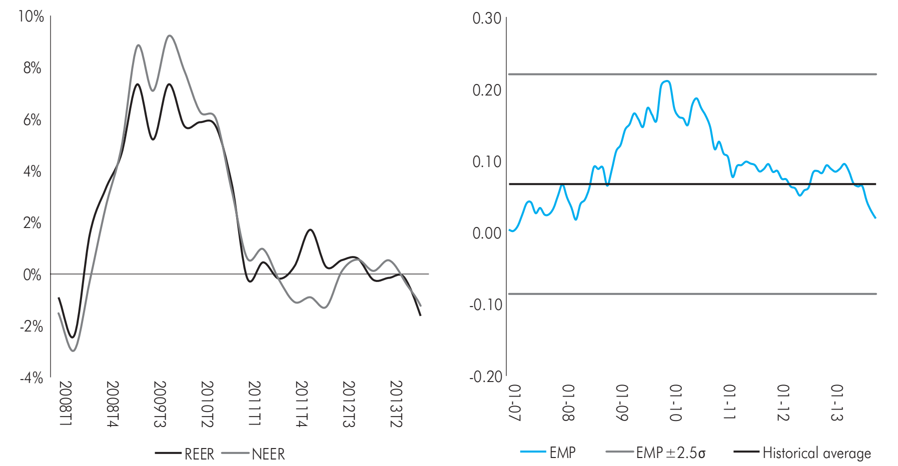
from 4.67% in September, while the 3, 5 and 7-year bond yields settled at 5.45%, 7.70% and 7.38%, respectively, registering an average decrease of 1.80%[31] from end-Q3. The margins on floating-rate bonds dropped in Q4, confirming agents' lower risk perception and downward expectations for economic activity.

EXCHANGE RATE

The Albanian lek appreciated slightly in 2013 H2. Despite euro's appreciation against the Albanian lek, the latter's sharp appreciation against the U.S. dollar and the increased share in trade with China and Turkey kept the NEER index[32] lower than in 2012 H2. In annual terms, the NEER pointed to a stable lek in Q3 (+0.02%) and to its appreciation in Q4 (-1.2%).

In annual real terms, the lek appreciated by 0.7% in 2013 H2, being entirely driven by the nominal exchange rate performance. Domestic and trading partners' inflation differential remained at a similar level. In line with the above developments, the exchange market pressure index did not show added pressures on the domestic currency.

Chart 34 Annual change in NEER and REER, and the Exchange Market Pressure Index



Source: Bank of Albania.

Despite the trade deficit narrowing during July-November, economic agents' higher demand for foreign currency and lower remittances brought about weakening of the lek against the euro in 2013 H2. One euro was traded at ALL 140.3 on average, or 1.2% higher than in the same period in 2012. Lek's depreciation against the euro was 0.5 percentage points higher versus 2013

[31] More specifically, yields on 2, 3, 5, and 7-year fixed-rate bonds dropped 2.03%, 2.73%, 0.75% and 1.74%, respectively.

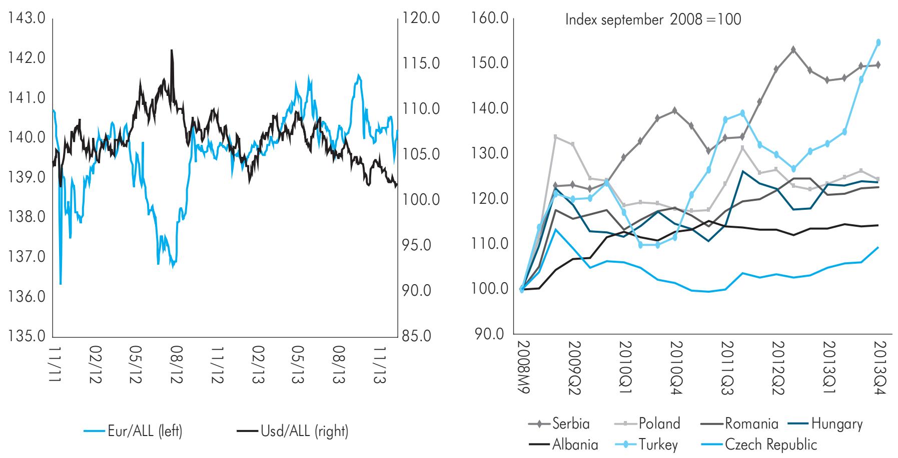
[32] NEER – Nominal Effective Exchange Rate is measured against the currencies of Albania's five main trading partners, namely Italy, Greece, Germany, Turkey and China. An increase in NEER implies lek's depreciation.

H1, due to more favourable performance of Albanian exports in 2013 H1 and euro's appreciation in the international markets in the past quarters.[33]

The U.S. dollar was volatile in the domestic foreign currency market, in line with its performance in the international markets. During 2013 Q2, one dollar was traded at ALL 104.55 on average, depreciating by 4.1% in annual terms. The lek appreciated 2.1% against the U.S. dollar from 2013 H1.

From a regional viewpoint, the Albanian lek remains one of the most stable currencies. In 2013 H2, almost all regional currencies, except the Romanian leu, depreciated against the euro.

Chart 35 Euro/lek and U.S. dollar/lek (left), and euro/domestic currency in selected Central and Eastern European and Balkan countries (right)



Source: Bank of Albania.

DEPOSIT AND LENDING INTEREST RATES

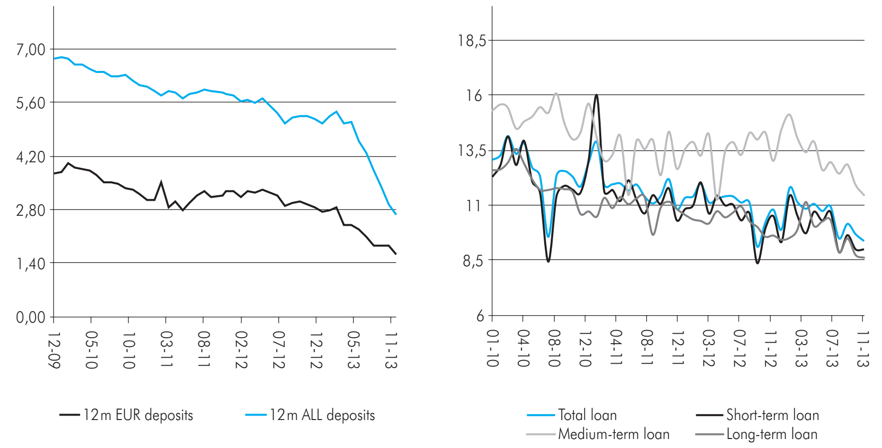
Lek and euro deposit rates were downward in 2013 Q4.[34] Lek deposit rates decreased during Q4, reflecting the general tendency of interest rates in the domestic financial market. Euro deposit rates appeared more stable, decreasing at a moderate pace, albeit in the same direction as the lek. On average, the 12-month lek deposit rate was 2.65% in November, down by 1.04 percentage points from Q3. Except for the one-month maturity, deposit rates decreased in all other main maturities. Preliminary data point to further decrease in new lek deposit rates in December.

The spread between lek and euro time deposit rates narrowed due to a larger decrease in the former. The 12-month euro deposit rate averaged 1.74% in October and November, from 1.92% in 2013 Q3.

[33] In annual terms, in 2013 Q3 and Q4, the euro appreciated 5.9% and 5.0%, respectively, against the U.S. dollar.

[34] The data on deposits and lending refer to October and November 2013.

Chart 36 Lek and euro deposit rates (left) and lending rates in lek (right)

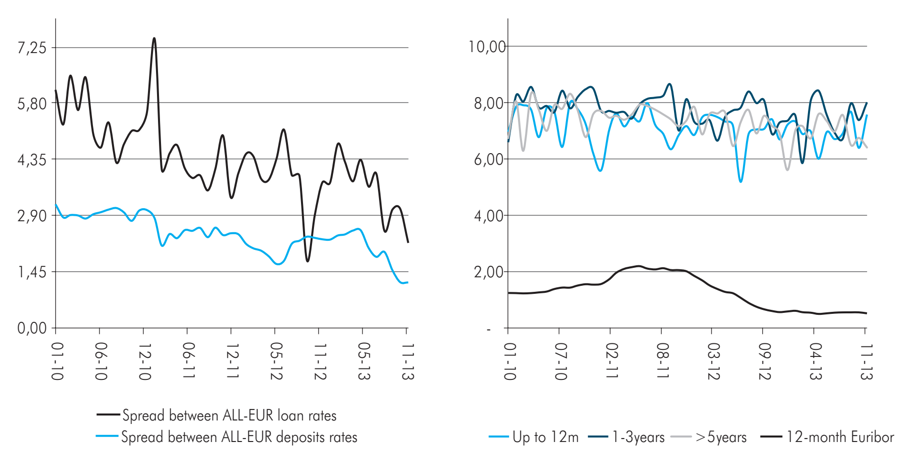


Source: Bank of Albania.

Interest rates on new lek loans maintained downward tendency in 2013 Q4, which was more pronounced in November. Lending rates decreased for all maturities. In October and November, lending rates averaged 9.52%, down by 0.67 percentage points from third quarter's average. The 3- and 6-month moving average of lek loans confirmed this period's downtrend. The decrease in lending rates on businesses was sharper than those on households. By item, investment and working capital loans, and overdrafts, showed larger decrease. In addition, interest rates on mortgage loans maintained the downtrend begun since April the present year.

Euro lending rates manifested dissimilar performance during 2013 Q4. They were volatile, albeit remaining below the past quarter's average. Unlike lending in lek, euro lending rates were mainly affected by higher interest rate on short-term loans and slightly less by the one on medium-term loans.

Chart 37 Spread between lek and euro rates (left) and lending rates in euro (right)



Source: Bank of Albania.

The cost of euro lending was relatively tight. Interest rates on overdrafts and working capital loans increased, whereas those on investments dropped slightly. While lending to households shrank, the interest rates applied were quite similar to the previous quarter.

BOX 3 SUMMARY OF BANK LENDING SURVEY RESULTS[35]

Bank lending survey results for 2013 Q4 show that lending standards applied to businesses tightened, while demand for loans remained weak. The net percentage of banks reporting tightening of lending standards on businesses was 6.4%, after hitting 0% in 2013 Q3. On the other hand, the lending standards applied to households eased during Q4. The net percentage of banks reporting easing of lending standards was 10.8%, markedly higher than the past two years' average.

Specific business sector-related concerns, non-performing loans situation in the banking system and the overall macroeconomic situation in Albania were the main factors contributing to the tightening of lending standards applied to businesses. Their negative contribution deepened further in 2013 Q4. On a positive note, competition was the main factor contributing to easing the lending standards on households.

Banks continued to report further fall in demand, most notably from businesses. The net percentage of responses reporting increase in household demand for loans rose modestly to 3.7%, from -2% a quarter earlier.

Chart 38 Lending standards and business demand for loans (net balance)

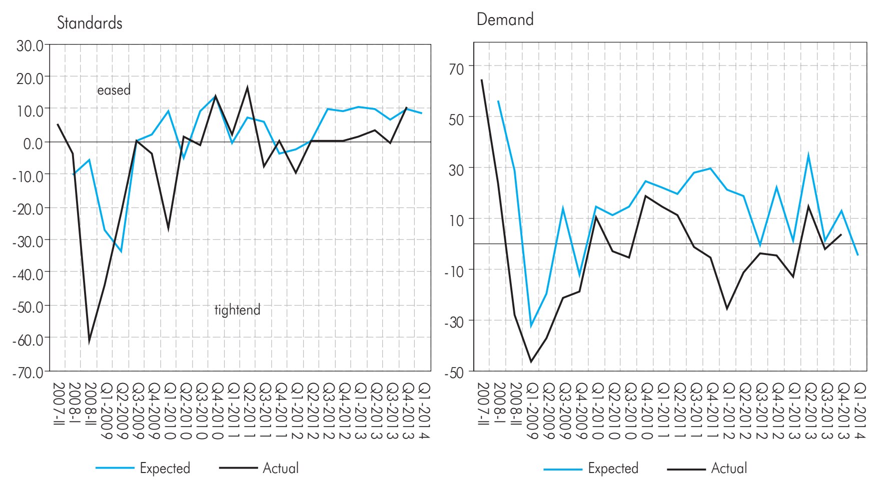
Source: Bank Lending Survey, Bank of Albania.

[35] *The survey conducted in December 2013 covers bank lending developments in 2013 Q4 and banks' expectations for lending in 2014 Q1.*

The fall in business demand continued to be adversely driven by the current and expected economic situation, alternative financial resources, business investment financing and, for the first time in 2013 Q4, the negative impact of working capital financing. Concerning households, the need to finance housing and consumption contributed to higher demand for loans. Conversely, consumer confidence continued to make negative contribution to consumer demand, as reported by banks.

For 2014 Q1, banks expect lending standards to ease on businesses and households, in light of the weak demand for loans.

Chart 39 Lending standards and household demand for loans (net balance)



Source: Bank Lending Survey, Bank of Albania.

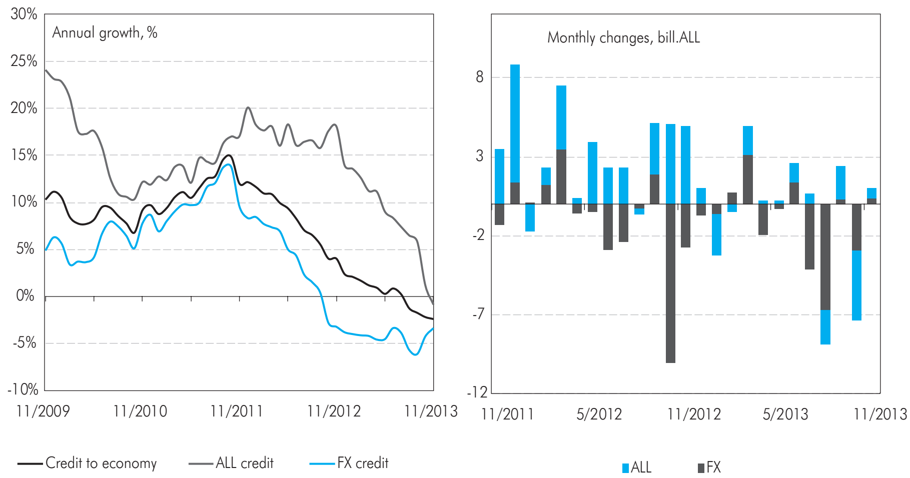
4.2 LENDING

Lending to the economy worsened further in 2013 Q4. After the low growth in H1, the loan portfolio shrank ALL 10 billion[36] in Q3 and ALL 6.4 billion in October and November. The weak performance of lending in H2 led to its annual contraction. As of end-November, it was 2.4% lower y-o-y. Foreign currency lending continued to shrink both in monthly and annual terms. As a reflection of the base effect[37], the annual contraction in foreign currency lending was more moderate in October, settling at 3.4% in November. Lending in lek showed weak performance throughout 2013, slowing markedly in Q3 and registering an annual fall of 0.9% in November. The fall in lending to the economy also materialised into its lower impulse to economic activity. As of end-Q3, credit-to-GDP ratio was 40.6%, down by 1.8 percentage points, y-o-y.

[36] *This shrinkage was also a reflection of banks' cleaning up their balance sheets.*

[37] *Foreign currency lending fell considerably in October 2012 and its effect was carried over into the next 12 months.*

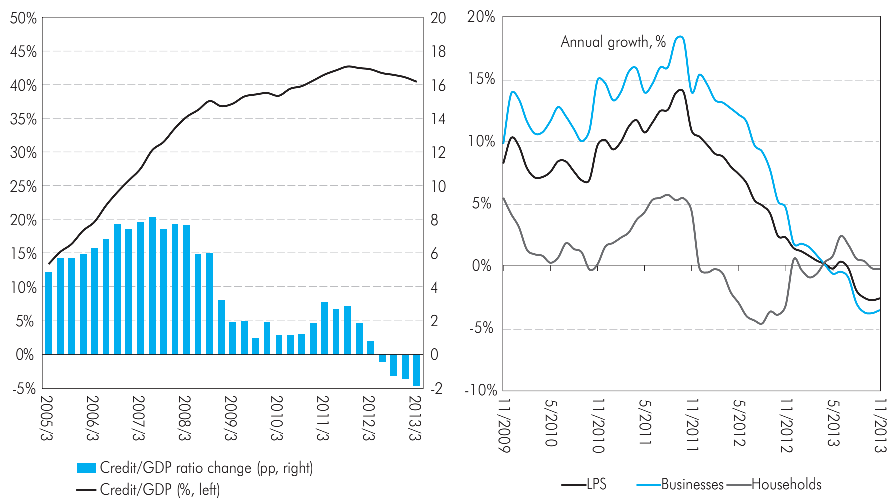
Chart 40 Lending to the economy



Source: Bank of Albania.

The performance of lending to the economy reflected the fall in bank lending to the private sector of the economy. As of end-November, lending to businesses and households was 2.6% lower y-o-y. On the demand side, consumers were reluctant to consume and borrow due to heightened uncertainty and worsened consumer confidence. Sluggish consumption and economic activity led to lower new business investments and borrowing needs. In light of the anaemic demand, banks maintained their conservative approach to risk-taking, most notably in businesses. The analysis of lending standards points to a still high risk premium applied by banks, despite their easing on individual segments. This approach was expressed into rigid lending rates, despite the higher monetary stimulus into the economy, and the use of other non-price criteria to rationalise lending.

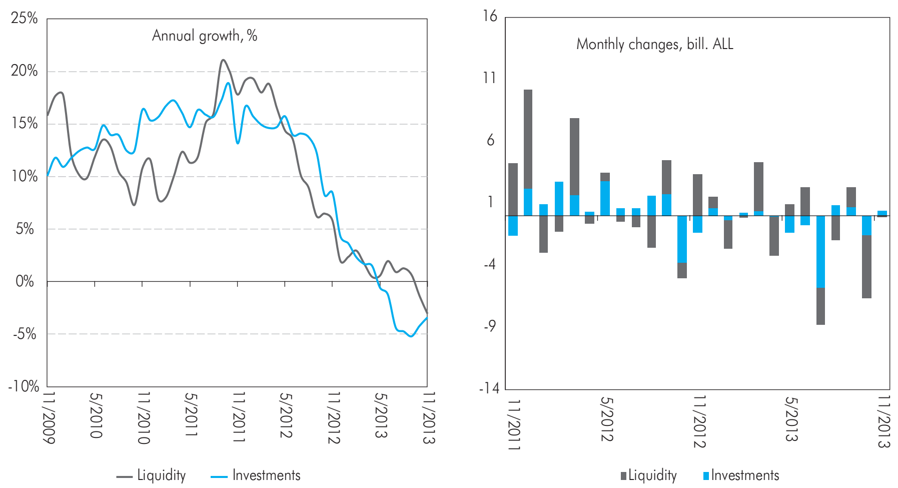
Chart 41 Lending to the private sector



Source: Bank of Albania.

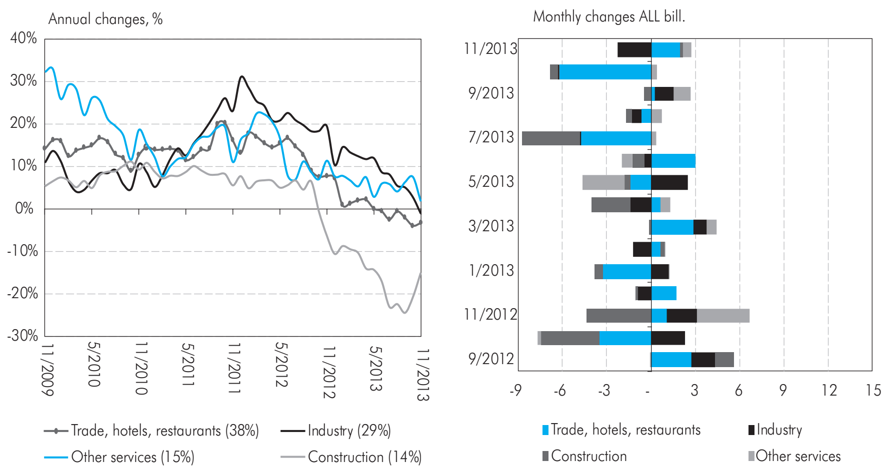
Bank lending to businesses continued to show poor performance in October and November, being also driven by the tight lending conditions and weak business demand for borrowing during 2013. The analysis of bank lending survey pointed to the fall of business demand for investment and working capital loans. On the other side, banks further tightened the lending standards applied to businesses, most notably for investment purposes. The annual contraction in lending to businesses, begun since May 2013, peaked at 3.8% in October, while moderating to 3.5% in November. Lending for investment purposes continued to shrink, albeit at a slower pace than in Q2. Lending for working capital purposes also shrank annually in October and November. As of end-November, these two portfolios were 3.4% and 3.0%, respectively, lower y-o-y.

Chart 42 Lending to businesses by purpose of use



Source: Bank of Albania.

Chart 43 Lending to businesses by sectors of economy



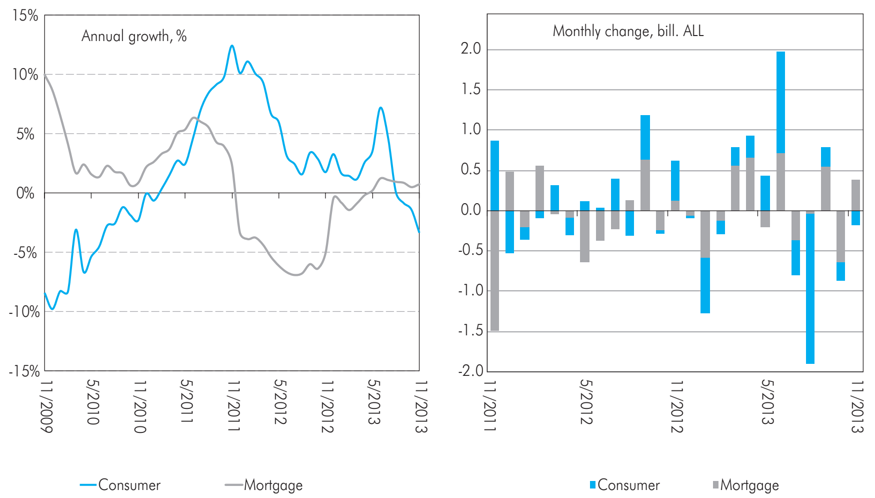
Note: The brackets show each sector's share in business loan.

Source: Bank of Albania.

The poor performance of lending to businesses was notable in all sectors of the economy. Lending to agriculture and other services were the only segments to register growth in October and November, albeit at a low level. The contraction in bank lending was most notable in industry and trade, hotels and restaurants. As of end-November, the growth of lending to other services dropped to 1.8% annually, while lending to trade, hotels and restaurants, and industry shrank 3.3% and 1.1%, respectively. Longer-than-one year contraction in lending to construction persisted in the period under review, albeit at a slower pace, settling at 15.0% in November.

Lending to households deteriorated further in October and November. After recovering in 2013 Q2, it slowed in Q3 and contracted further in the months under review. As of end-November, household loan portfolio was 0.3% lower y-o-y. Banks reported weak household demand for loans in Q4, despite the easier lending standards. The weak household demand was attributable to their reluctance to spend and invest, and their tendency to save, as a reflection of the low consumer confidence and lack of optimism for the future performance of their finances.

Chart 44 Lending to households by purpose of use



Source: Bank of Albania.

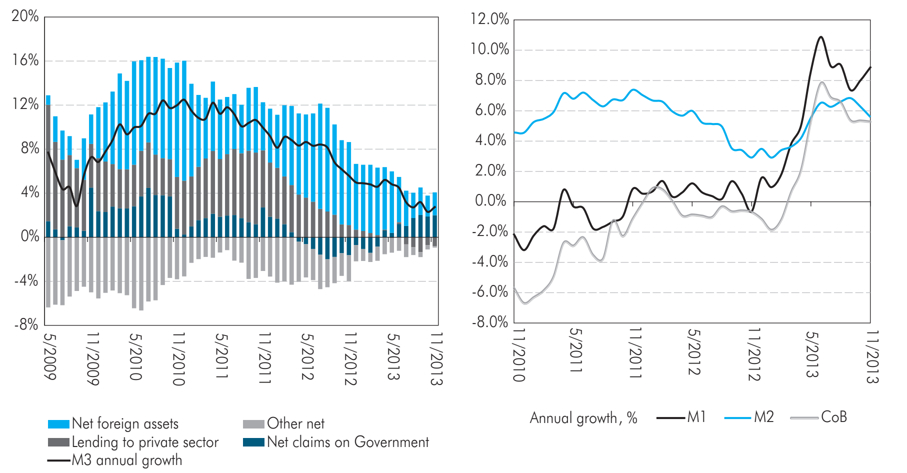
Outstanding household loans for mortgage and consumer purposes shrank in October and November. Consumer loans shrank faster in annual terms, being 3.3% lower y-o-y in November. Mortgage loans grew 0.7% annually, fluctuating around positive, albeit low, rates.

4.3 MONETARY INDICATORS

In 2013 Q4, money supply grew at a comparable rate to Q3, but considerably lower than in H1. M3 aggregate annual growth of 2.7% in November reflected the positive, albeit lower, contribution of foreign assets by 2 percentage points.

Fiscal sector financing made similar contribution to money growth. Lending to the private sector continued to contract, reducing the contribution to money creation further to -1.2 percentage points. In real terms, the growth of M3 broad money aggregate was near record low at 1.7%, confirming the presence of weak inflationary pressures deriving from the domestic monetary developments in the medium-term period.

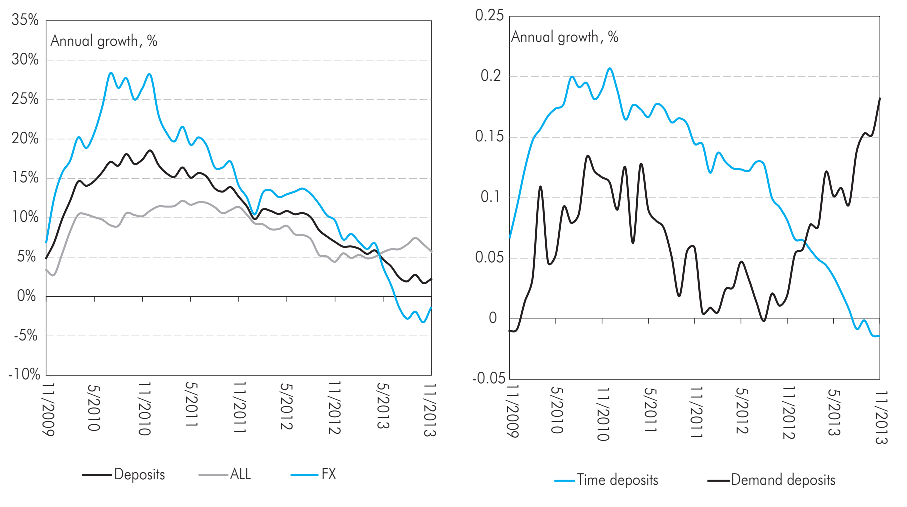
Chart 45 Monetary indicators



Source: Bank of Albania.

The annual growth of M2 aggregate slowed to 5.6% in November, from 6.8% in Q3, attributable to the lower Government borrowing from the banking sector. In October and November, the increase in Government financing was almost entirely met by households.[38] In parallel, the reduced lending in lek led

Chart 46 Deposits by currency and maturity



Source: Bank of Albania.

[38] *Not included in the measurement of M2 aggregate.*

to lower money creation in domestic currency and slower growth rates of M2. Similar to Q3, the most liquid component, M1, grew 8.1% annually, driven by the higher economic agents' preference for demand deposits. Currency outside banks to M2 aggregate ratio stood at 28.3% for the second month in a row, dropping from the peak level of 28.9% in June 2013 and reflecting greater concentration of Government spending in the first half of the year.

The performance of deposits during October and November provided evidence for the decline in total deposits denominated in lek and foreign currency. As of end-November, lek deposits were about 5.7% higher y-o-y, hence slower than 7.4% in September. The monthly contraction in lek deposits was attributable to the fast decrease in lek deposit rates in 2013 H1 and the launch of new and high-yield financial instruments outside the banking system. Foreign currency deposits shrank 1.3% y-o-y, due to reduced foreign inflows and scarcer creation of foreign currency. In parallel, time deposits contracted, whereas demand deposits in lek and foreign currency increased. In November, demand deposits increased by 18.4% in annual terms, whereas time deposits fell by 1.4%. This shift was present in lek and foreign currency household deposits, and business foreign currency deposits. Total household deposits grew 1.9% in annual terms, down 0.6 percentage points from end-Q3.

5. OUTLOOK FOR THE ALBANIAN ECONOMY IN 2014

The Albanian economy has been decelerating in the recent years, attributable to the cyclical weakness of aggregate demand and structural problems inherent in the country's economic development.

The unfavourable external economic environment, heightened uncertainty, lower income and tight lending conditions contributed to slow growth in aggregate demand and economic activity. The Albanian economy operated below potential in the past quarters, generating weak pressures over inflation and driving the central bank to pursue a stimulating monetary policy. On the other hand, fiscal policy was more cautious, conditioned, among other things, by the high public debt. The macroeconomic stimulus contributed to maintaining macroeconomic balances, containing risk premia and improving financial market activity. Its results in the real economy were, however, poor due to altered behaviour of economic agents and low risk appetite in financial markets. The performance of aggregate demand will be the main driver of economic growth in the short and medium-term period.

Based on the available information, the Bank of Albania forecasts that economic growth will pick up slightly in 2014. Although consumption and investment will remain weak, the economy will not suffer from last year's short-term shocks to aggregate demand. The external sector is expected to make positive contribution to economic growth due to improved demand from Albania's trading partners. The Government will implement a tight fiscal policy; however, its effect on the economy is expected to be offset by the higher monetary stimulus. The payment of public arrears owed to the private sector will help improve business and banking system's balance sheets, with positive effects on investment and lending. Also, IMF and World Bank arrangement with Albania will help boost financial guarantees and reduce uncertainties. The injection of foreign funds into the economy will provide greater room for lending to the private sector. Sluggish lending in the recent years has reflected the weak demand for investment and conservative bank lending policies, which were partly imposed by the financial stress facing the European banking system. Accordingly, EU-wide stress test exercise, projected to be conducted by the ECB in June 2014, will create a more favourable environment to boost lending.

Below-potential growth will condition weak demand-side inflationary pressures. In the absence of supply-side shocks, consumer prices will rise at a low rate. One year-ahead annual inflation is expected to fluctuate around 0.7%-3.8%, with a 90% probability of occurrence. This implies that Bank of Albania's monetary policy will keep on preserving its stimulating nature in the medium-term period. Also, the central bank will continue to supply the banking market with the required liquidity. Lastly, the Bank of Albania's monetary policy will keep on maintaining its steering approach, aiming at enhancing transparency about its monetary policy stance and impacting the long-term segment of rates on the interest rate curve. The stimulating nature of monetary policy is expected to boost lending and steer savings toward consumption.

Financial markets are expected to keep on lowering risk premia emerged during 2013. Given the adequate liquidity situation in the banking system, short-term rates will fluctuate in a narrow range. In addition to the monetary policy stance, primary market yields will also be impacted by demand-side financing pressures. The latter are expected to be manageable as the Government is committed to keeping budget deficit within the projected levels. Yields will be in check following financial agents' expectations for low inflation. The shift and flattening of the Government debt securities' yield curve will make room for gradual transmission of lower risk premia into private sector lending.

Monetary projections for 2014 point to higher money growth than in the previous year. The improved growth rates of broad money will accommodate economic agents' demand for money and, accordingly, the loan portfolio will improve slightly.

Structurally, the Albanian economy continues to suffer from the low efficiency and product diversification, low competitiveness in the global markets and the overall legal and political climate, which does not favour the promotion of foreign and domestic investments. In addition, the economic structure remains oriented toward non-tradable goods, which only serve the domestic market. Services and construction sectors, in particular, have been the largest capital beneficiaries; yet, they continue to show a high inventory level and low efficiency. Albania's stable and long-term growth will require shifting financial resources and re-orienting the labour market and business attention toward export or industries competing against imported goods. This process will take time; however, it should be supported through continuous structural reforms and accommodating macroeconomic policies in the medium-term period. The solution to these problems will condition the performance of all economic and financial indicators in the future.