Bank of Albania

MONETARY POLICY REPORT 2014 Q4

THE REPORT Refers TO BANK OF ALBANIA’S MONETARY POLICY STATEMENT FOR 2014 H2, ADOPTED BY THE SUPERVISORY COUNCIL’S DECISION NO 2, DT. 28.01.2015

January 2015
## CONTENTS

### OBJECTIVE

1. **STATEMENT BY THE SUPERVISORY COUNCIL**

2. **Price Stability and Bank of Albania’s Target**
   2.1 Inflation target and monetary policy
   2.2 Inflation by item

3. **MACROECONOMIC DEVELOPMENTS**
   3.1 External economic environment
   3.2 Gross Domestic Product and aggregate demand
   3.3 Cyclical position of the economy, wages, labour costs and inflation trends
   3.4 Import prices and imported inflation

4. **MONETARY DEVELOPMENTS AND FINANCIAL MARKETS**
   4.1 Financial Market Developments
   4.2 Lending
   4.3 Monetary indicators
B O X E S

Box 1 Housing market prices 24
Box 2 Balance of Payments developments during 2014 Q2 33
Box 3 Summary of Bank Lending Survey Results 43
Box 4 CESEE Bank Lending Survey Results, 2014 H2 47

T A B L E S

2. PRICE STABILITY AND BANK OF ALBANIA’S TARGET
   Table 1 Contribution of key items to annual inflation 14

3. MACROECONOMIC DEVELOPMENTS
   Table 2 Selected macroeconomic indicators 16
   Table 3 Economic indicators for countries in the region 18
   Table 4 Balance of Payments indicators 33
2. PRICE STABILITY AND BANK OF ALBANIA’S TARGET

Chart 1  Annual inflation  12
Chart 2  The key interest rate and annual core inflation  13
Chart 3  Annual inflation of food products  13
Chart 4  Annual inflation by items of goods and services  14

3. MACROECONOMIC DEVELOPMENTS  15
Chart 5  Annual change in basic prices  18
Chart 6  Key interest rates of selected central banks  19
Chart 7  Selected financial indicators in the international markets  19
Chart 8  GDP and annual dynamics of aggregate demand components  21
Chart 9  Contribution by sector to value added and confidence indicators  22
Chart 10  Contribution by branch to value added in industry and capacity utilisation rate in this sector  22
Chart 11  Valued added and capacity utilisation rate in construction  23
Chart 12  House Price Index and price-to-rent ratio  24
Chart 13  Value added in agriculture, hunting and forestry, and its contribution to economy  24
Chart 14  Contribution by branch to value added in services and capacity utilisation rates in this sector  25
Chart 15  Indirect data on private consumption and sources of its financing  26
Chart 16  Proxies for private investments  27
Chart 17  Orientation of fiscal policy, proxied by the change in the primary deficit  28
Chart 18  Annual change in total quarterly expenditure by contribution of main items and annual change in main expenditure items  29
Chart 19  Annual change in quarterly revenues by contribution of main items and annual change in main revenue items  30
Chart 20  Contribution of net exports to aggregate demand  31
Chart 21  Budget deficit accumulative in per cent of GDP and its financing instruments by quarter  31
Chart 22  Import and export orientation by item  32
Chart 23  Output gap and contribution of core inflation; unemployment rate  35
Chart 24  Wages in the sectors of the economy and productivity  36
Chart 25  Long-term inflation trends and short-term trends  37
Chart 26  ILPI and contributions of its components; contributions of imported inflation and domestic inflation to annual headline inflation  38
Chart 27  Inflation expectations of different agents and Expectations Anchoring Index  38

4. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS  39
Chart 28  Bank of Albania open market operations and interbank rates  40
Chart 29  Primary market yields  40
Chart 30  Interest rates on new lek loans  41
Chart 31  Interest rates on new euro loan and deposits  42
Chart 32  Lending standards applied to businesses and households  43
Chart 33  Business and household demand for loans  43
| Chart 34 | Annual change in NEER, Exchange Market Pressure Index and bilateral exchange rate | 44 |
| Chart 35 | Lending to the economy versus value added and nominal GDP | 45 |
| Chart 36 | Lending to businesses by currency and purpose of use | 46 |
| Chart 37 | Lending to households by currency and purpose of use | 47 |
| Chart 38 | Different indicators on exposures of banking groups operating in the region | 48 |
| Chart 39 | Performance of monetary aggregates | 49 |
| Chart 40 | Performance of deposits included in M3 and total deposits | 50 |
The primary objective of the Bank of Albania is to achieve and maintain price stability. Promoting long-term investments, maintaining the purchasing power of money, enhancing the efficiency of fund allocation in the economy and safeguarding the financial stability are some of the benefits provided by an economic environment characterized by stable prices. Stability is the greatest contribution by the central bank to sustain a stable and long-term economic growth.

In line with its approved Monetary Policy Document, the Bank of Albania is committed to achieving and maintaining annual inflation at 3.0% in the medium term. The announcement of the quantitative target for inflation aims at anchoring economic agents’ expectations and reducing the risk premium.

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

The Monetary Policy Report for the fourth quarter of 2014 was adopted by the Supervisory Council as the Monetary Policy Statement for the second half 2004, on January 28 2015 (Decision No.2). The economic analysis in this Report is based on the latest available data as of 15 January 2015.
1. STATEMENT BY THE SUPERVISORY COUNCIL

In the second half of 2014, the Albanian economy improved, but overall inflationary pressures remained weak and inflation continued to stand below Bank of Albania’s target. Although upward, aggregate demand is still insufficient to ensure complete utilisation of production capacities in the economy and generate stable growth of employment, wages, profit margins and final prices in the economy. Supply-side factors, such as imported and primary commodity prices, and the performance of inflationary expectations continued to provide low pressures on consumer prices. In the fourth quarter, as a result of a fall in imported inflation, the trajectories of economic growth and inflation diverged.

The overall economic environment, characterised by weak inflationary pressures, below-potential economic growth, and high risk premiums in the financial market dictated the implementation of an accommodative monetary policy during the last quarters. The accommodative policy further strengthened during the period, through the lowering of the key interest rate, the provision of forward guidance on maintaining the simulating monetary policy in the future, and the continued injection of liquidity into the banking system. In response to this simulating policy, financial markets were characterised by interest rates trending downward. Financing costs of the banking system and interest rates on lek loans fell to their historic low in the quarter under review. In response to the monetary policy transmission, the performance of lek loans improved in the last two quarters of 2014. However, the full transmission of monetary policy into the economy continues to suffer from the businesses’ reluctance to engage in long-term investments and the banking system’s risk aversion.

Economic growth in the third quarter of 2014 and its assessments for the fourth quarter were on up side of our expectations. By contrast, inflation performed on the down side of our projections in the fourth quarter of 2014. Although our medium-term forecasts did not change considerably, in the short-run, the expected performance of economic growth has shifted upward, whereas that of inflation has shifted downward. The Supervisory Council deems that the current and expected developments in the economy reiterate the need for pursuing a stimulating monetary policy. Medium-term forecasts and return of inflation to target remain conditioned by the recovery of private consumption and investments. Under these circumstances, the Supervisory Council deemed it necessary to lower the key interest rate further, down to 2.0%. This move provides adequate conditions for the return of inflation to target and of the economy to equilibrium in the medium-term horizon.
Following is an analytic overview of current and expected economic developments, and a more comprehensive discussion on the monetary policy.

Inflation in December 2014 stood at 0.7%, falling sharply, dictated by the low rise in food items and the continuing decline in oil price. The latter lowered further the production and transport costs in goods and services. From a macroeconomic standpoint, the sluggish aggregate demand continued to determine the low inflation rates. The strong deceleration of inflation over the last quarter of 2014 seems to be mostly attributable to the fall in imported inflation. The external environment of the economy exerted disinflationary pressures on the Albanian economy, a trend expected to persist in 2015 as well.

Our projections suggest that inflation will rise gradually, converging to our target of 3.0% in the medium term. This result remains subject to our projections for a rapid return of the economy to equilibrium. Economic growth is expected to strengthen and the labour market and wages to improve. Imported inflation is expected to remain sluggish over the medium term, whereas inflation expectations are expected to shift gradually towards Bank of Albania’s target.

The economy performed in line with our expectations in the second half of 2014. Real value added by sectors of the economy recorded an annual increase of 3.3% in the third quarter of 2014, accelerating compared to growth recorded in the first and second quarters. Sectorial structure of production growth was balanced, as shown by the increasing positive contribution by both services and production sectors. Indirect available data suggest that economic growth continued over the fourth quarter of 2014. Based on these assessments, the Bank of Albania expects a progressive improvement of economic growth in the period 2014-2016.

On the expenditure side, economic growth was mainly driven by consumer spending and less by private and public sector investments. The improved confidence in the economy, low interest rates and credit expansion, increased employment and the payment of arrears by the public sector are estimated to have supported private sector spending in the last quarters. Our estimations suggest this performance will continue in the future.

External demand was sluggish and the exchange of goods and services with our trading partners provided a net negative contribution of 3.8 percentage points to economic growth in the third quarter of 2014. Real net exports deficit expanded by 18% in the third quarter of 2014. This performance reflects the slow increase in Albanian exports, compared to a faster increase in imports. From a macroeconomic perspective, the slow increase in exports reflects the sluggish demand by our trading partners, as well as supply-side shocks in some sectors of production. On the other hand, the increase in imports mostly reflects the improvements in domestic consumption and investments. For the last quarter of 2014, our projections point to a minimum negative contribution of real net exports to aggregate demand.
Fiscal policy was consolidating during 2014. This policy was manifested in the contraction of the budget deficit, which mainly reflected the rapid growth in revenues. Budget deficit in the first 11 months of 2014 amounted to ALL 41.3 billion, or 35.1% lower than the planned level for this period, and 31.9% lower than in the previous year. As of November, public revenues grew by 12.6% in annual terms, whereas total expenditures increased by about 5% in annual terms. Despite the consolidating nature, fiscal adjustment was uneven throughout the year. This adjustment was concentrated in the first half of year, being considerably loose in the third quarter; the fourth quarter is estimated to have produced a positive fiscal stimulus. The Bank of Albania continues to support fiscal consolidation. The improved sustainability of public finances lowers risk premiums in the economy. It provides conditions for the implementation of a more simulating monetary policy and increases the effectiveness of its transmission to the economy.

Reflecting on projections for low inflationary pressures and the presence of unutilised production capacities in the economy, the Bank of Albania lowered the key interest rate by 0.25 percentage points in November 2014. That was the third move towards easing the monetary conditions during 2014. The monetary stimulus contributed to lowering interest rates and improving financing conditions in the economy. Meanwhile, government borrowing costs increased slightly due to demand-supply disequilibrium in this market. Interest rates applied on loans to the private sector trended downward throughout the year, reflecting the improved growth paces of loans in the second half of 2014. At the end of November, annual credit growth stood at 3.8%, from 1.6% at the end of the third quarter of 2014. In response to Bank of Albania’s accommodative monetary policy, lek loans recorded 9.3% annual growth in November, revealing a much better performance than foreign currency loans. Notwithstanding the improved tendencies, lending continues to remain sluggish due to supply and demand-related problems. On the demand side, below-potential economic growth and real-sector uncertainties make businesses postpone their investment plans and financing demands. On the supply side, credit performance is negatively affected by: the high level of non-performing loans, which burden banking system’s balance sheets; the high risk premiums in specific sectors of the economy, which render these sectors less attractive for crediting; and the conservative policies implemented by parent banks, which impose tight crediting policies in Albania. Bank of Albania’s analyses and projections suggest that lending will recover slowly during 2015.

Our macroeconomic projections point to the closure of the negative output gap and a gradual return of inflation to target in the medium-term period. In the baseline scenario, annual inflation is expected to range within 1.2 - 3.8% four quarters ahead, with a 90% probability of occurrence, and to return to Bank of Albania’s target of 3.0% in the medium term. The gradual return of inflation to target will be driven by economic growth and its return to equilibrium.
The above scenario is surrounded by risks, of which we would like to highlight the following:
Firstly, the European external economic and financial environment remains challenging. In this regard, banks’ risk appetite and willingness to lend to the private and public sectors in the Eastern European countries, including Albania, appears still low. A further deterioration of this outlook would require implementing further corrective measures and searching for new financing sources.

Secondly, our forecasts are largely subject to expected improvements in consumption and private investments. Through the easing of financing standards in the economy, the monetary policy creates adequate conditions to stimulate them. However, the steady growth of consumption and investments will depend on the further improvement of the business climate and the deepening of structural reforms, which boost productivity in the economy and enhance the effectiveness of the monetary policy.

Based on the available information, the Supervisory Council of the Bank of Albania decided to lower the key interest rate by 0.25 percentage points, to 2.0%. The transmission of this decision into the financial markets will create adequate monetary conditions to support economic growth and the return of inflation to target. Moreover, based on baseline scenario projections, the Supervisory Council deems that achieving the inflation target in the medium term will require maintaining the eased monetary conditions over some quarters ahead.
In 2014 Q4, inflationary pressures remained low. Inflation averaged 1.3%, down compared to the previous quarter and below the Bank of Albania’s target. This trend was largely dictated by the pronounced fall of inflation in December, due to the slow increase in food prices and reduction in oil prices.

Projections for low and below-target inflation have kept the monetary policy stimulating. In November, the Bank of Albania decided to lower the key interest rate to 2.25% and continued to inject the needed liquidity to the banking market. The resultant direction of macroeconomic policies remains stimulating. However, private demand has not yet manifested stable growth paces, due to households and businesses’ reluctance to consume and invest, also reflecting the tight financing supply by the banking system. Looking ahead, the Bank of Albania deems that maintaining the current trend of monetary conditions will contribute to economic growth, and will enable the return of inflation to target in the medium term.

2.1 INFLATION TARGET AND MONETARY POLICY

In the last quarter, average inflation rate fell at 1.3%, from 1.7% in the previous quarter. The low value recorded in December drove inflation downward. The pronounced fall of inflation in this month reflected the low rise of food prices and the continued fall of oil price.

Demand-side factors continued to determine the low inflation rates. The weak aggregate demand did not fully utilise the production capacities of the Albanian economy, while creating weak pressures on the increase in wages, production costs and profit margins. On the other hand, inflation fell in the last quarter, especially in December, due to the progressive weakening of supply-side factors, and particularly to the fall of imported inflation.

Based on the low inflationary projections and the assessments on the sluggish domestic demand in the medium term, the Bank of Albania lowered the key interest rate by 0.25 percentage points, bringing it down, to the minimum rate of 2.25%, as at end-November. That was the third easing of monetary conditions throughout 2014. Also, the forward
guidance for the implementation of an accommodative monetary policy helped increasing forecast and security in financial markets, anchoring inflation expectations, and lowering the real long-term interest rates.

The eased monetary policy offset the consolidated fiscal policy implemented throughout the year, by maintaining simulating macroeconomic policies. Monetary stimulus provided grounds for the reduction of interest rate and the improvement of financing conditions in the economy. Interest rates applied to lek loans trended downward over the year, reflecting the faster increase of this type of loans in 2014 H2. As a result of the better performance of loans, consumption and private investments during this period improved.

Expectations for low inflationary pressures call for the implementation of a simulating monetary policy during the upcoming year. The eased monetary conditions will contribute to the growth of the domestic demand and the return of the economy to equilibrium.

### 2.2 INFLATION BY ITEM

Over the fourth quarter, inflation fell, determined almost entirely by the performance of food and oil prices. Inflation of “Unprocessed food” item reduced considerably during the period under review; its contribution was 0.7 percentage points lower, falling due to the low inflation of this item in December. Unprocessed food grew by 3.4% during December in monthly terms, or 3 percentage points lower than the average of this indicator during the last five years. In particular, the contribution of this item fell as a result of the 0.7 percentage points drop in “Vegetables” sub-item during December, thus providing negative contribution and inflation rates.

“Processed food” contribution rose compared to the previous quarter. Annual inflation returned to positive figures (although considerably low 0.5%). In more concrete terms, the movement in the prices of these commodities was attributable to the increase in tobacco prices. This item provided a contribution by 0.2 percentage points to headline inflation. Notwithstanding the declining contribution of “Unprocessed food” item, both food items continued to determine about 70% of the total rate of inflation.

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2 “Unprocessed food” contribution fell from 1.5 percentage points to 0.8 percentage points.
Other items continued to be characterised by low inflation rates, in spite of price fluctuations in some of the constituent goods and services.

Table 1: Contribution of key items to annual inflation (in percentage points)

<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Processed foods (pp)</td>
<td>0.6</td>
<td>0.5</td>
<td>0.3</td>
<td>0.1</td>
<td>-0.1</td>
<td>-0.2</td>
<td>-0.1</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Bread and grains (pp) *</td>
<td>0.0</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.0</td>
<td>-0.1</td>
<td>-0.1</td>
<td>-0.1</td>
<td>-0.1</td>
</tr>
<tr>
<td>Alcohol and tobacco (pp)</td>
<td>0.2</td>
<td>0.1</td>
<td>0.2</td>
<td>0.1</td>
<td>0.1</td>
<td>0.3</td>
<td>0.3</td>
<td>0.3</td>
<td>0.3</td>
</tr>
<tr>
<td>Unprocessed foods (pp)</td>
<td>1.0</td>
<td>1.7</td>
<td>2.0</td>
<td>1.5</td>
<td>1.5</td>
<td>1.6</td>
<td>1.3</td>
<td>1.5</td>
<td>0.8</td>
</tr>
<tr>
<td>Fruit (pp)</td>
<td>0.5</td>
<td>0.3</td>
<td>0.4</td>
<td>0.8</td>
<td>0.7</td>
<td>0.7</td>
<td>0.2</td>
<td>0.4</td>
<td></td>
</tr>
<tr>
<td>Vegetables (pp)</td>
<td>0.2</td>
<td>1.2</td>
<td>1.5</td>
<td>0.5</td>
<td>1.1</td>
<td>0.9</td>
<td>0.6</td>
<td>1.2</td>
<td>0.2</td>
</tr>
<tr>
<td>Services (pp)</td>
<td>0.2</td>
<td>0.2</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.2</td>
<td></td>
</tr>
<tr>
<td>Regulated prices (pp)</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.1</td>
</tr>
<tr>
<td>Fuels and energy (pp)</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Housing (pp)</td>
<td>-0.2</td>
<td>-0.1</td>
<td>-0.1</td>
<td>-0.1</td>
<td>0.0</td>
<td>0.3</td>
<td>0.3</td>
<td>0.2</td>
<td>0.1</td>
</tr>
<tr>
<td>Non-food consumer goods</td>
<td>0.5</td>
<td>0.0</td>
<td>-0.3</td>
<td>-0.4</td>
<td>-0.2</td>
<td>0.2</td>
<td>0.2</td>
<td>0.2</td>
<td>0.0</td>
</tr>
<tr>
<td>Durable consumer goods (pp)</td>
<td>0.2</td>
<td>0.1</td>
<td>0.1</td>
<td>0.0</td>
<td>0.0</td>
<td>0.1</td>
<td>0.1</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Consumer Price Index (y-o-y %)</td>
<td>2.4</td>
<td>2.5</td>
<td>2.2</td>
<td>1.5</td>
<td>1.5</td>
<td>1.9</td>
<td>1.6</td>
<td>1.7</td>
<td>1.3</td>
</tr>
</tbody>
</table>

Source: INSTA'T and Bank of Albania.
*The table presents some of the main items.

In this quarter, “Non-food consumer good” fell and in December inflation and its contribution returned at negative values. Oil prices, has been falling for some months both in the domestic and international markets. Annual inflation of “Fuels” stood at about -6% in December, lowering by 0.2 p.p. this category’s contribution.

“Goods and services at regulated prices” returned to positive inflation rates and positive contribution to the headline inflation. This increase was attributed to the rise of 22.2% in university tuition fees and provided additional contribution by 0.2 percentage points to headline inflation. “Services” increased its contribution mainly due to the increase in communication tariffs.
3. MACROECONOMIC DEVELOPMENTS

The general incoming inflationary pressures were weak over 2014. From the macroeconomic perspective, the sluggish aggregate demand continued to determine the low inflation rates. It did not fully utilise production capacities of the Albanian economy, while creating weak pressures for the increase in wages, production costs and profit margins. In parallel, supply-side factors have been on the down side during the last quarter. Imported inflation was downward, due to the price fall in international markets, while inflationary expectations remain at low historical levels.

The economy contracted temporarily in the second quarter and grew 3.3% in the third quarter. On the demand side, the domestic private demand supported the economic growth, whereas public sector and external demand did not contribute to the growth. Our assessments suggest a somewhat lower growth in the fourth quarter, although the fiscal stimulus has been increasing in this period. In 2014, the Bank of Albania deems that the Albanian economy recorded a higher growth compared to the previous year, albeit economic activity at home continued to remain below potential.

Overall, the expected forthcoming developments will maintain the trends observed during 2014. The external economic environment, characterised by the weak performance of trading partner countries, the disinflationary trends in the euro area and the high risk premia in the financial markets, does not favour the economic growth and the return of inflation to target. However, our forecasts show a progressively improving economic growth in the forthcoming years, supported by the recovery of the domestic demand. The implemented accommodative monetary policy and the better financing conditions created by the Bank of Albania will help domestic demand to recover. The Albanian economy is expected to return to potential within some quarters, while inflation is projected to converge to the target in the medium term. The Bank of Albania assesses that risks to this forecast are mainly shifted downside. The sustainable return of the economy to potential will require maintaining simulating macroeconomic policies, while stable and long-term growth of the Albanian economy will call for the intensive continuation of structural reforms.
3.1 EXTERNAL ECONOMIC ENVIRONMENT

3.1.1 ECONOMIC GROWTH AND MAIN MACROECONOMIC BALANCES

Global economy reflected positive performance and higher growth paces in the second half of the year. The dynamics of preliminary and indirect indicators of the last quarter suggests that the global economic will grow faster and will be mainly supported by growth in advanced economies. The rise in unemployment rates in advanced economies appeared to have stopped and have frequently been downward. Nevertheless, inflationary pressures declined considerably due to the continuing fall in primary commodity and energy prices. Forecasts suggest an upward GDP in 2015, albeit at contained paces, while the balance of risks appears on the downside, due to the geopolitical tensions in Middle East and Eastern Europe.

Table 2 Selected macroeconomic indicators

<table>
<thead>
<tr>
<th>Countries</th>
<th>GDP change</th>
<th>Unemployment rate</th>
<th>Inflation rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>1.0</td>
<td>2.4</td>
<td>5.6¹</td>
</tr>
<tr>
<td>Euro area</td>
<td>0.2</td>
<td>0.8</td>
<td>11.5</td>
</tr>
<tr>
<td>Germany</td>
<td>0.1</td>
<td>1.2</td>
<td>5.0</td>
</tr>
<tr>
<td>France</td>
<td>0.3</td>
<td>0.4</td>
<td>10.3</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>0.7</td>
<td>3.0</td>
<td>5.9²</td>
</tr>
<tr>
<td>Japan</td>
<td>-0.5</td>
<td>-1.2</td>
<td>3.5</td>
</tr>
</tbody>
</table>

Source: ECB, Fed, Eurostat and respective statistical institutes.
¹ December 2014; ² September 2014; ³ November 2014.

EURO AREA ECONOMY

Latest publication by Eurostat on economic growth in euro area for the third quarter of 2014 showed 0.2% and 0.8%, quarterly and annual growth, respectively. Domestic consumption, which returned into positive territory after a long period, provided the main positive contribution to GDP formation. Investments resulted neutral, while net exports were negative. The latest leading indicator of GDP performance for euro area, and the preliminary and indirect estimations on the performance of sales, new orders and industrial production suggest growth even in the fourth quarter, although at a moderated pace. Indicators of the Business and consumer confidence survey appear optimistic, thus balancing the expectations of the economic agents. In these months, ECB executives focused their attention also on the downward inflation. Its rates fell considerably and forecasts for 2015 show that inflation will fluctuate at low rates throughout the year. In this context, the possibility for the ECB to implement other easing policies [quantitative easing] seems closer.

³ These assessments mainly refer to the latest monthly ECB report, December 2014, and the analysis of leading PMI indicators for GDP by Markit, 12 January 2015.
4 Second estimate for the third quarter of 2014”, 05 December 2014.
UNITED STATES ECONOMY

Economic growth in the United States accelerated in the third quarter, reinforcing the opinion that domestic economy has made a turning point after the economic and financial crisis. Economic activity was dictated by the increase in both consumer and federal government spending. The decrease in private investments and local government spending decelerated somewhat the economic growth. The fall in imports offset the contraction in exports. Data from more frequent indicators, such as retail sales, production activity and labour market indicators suggest that the rapid economic growth continued in the fourth quarter of year. In this period, inflation stood below Federal Reserve’s target.

ECONOMIES IN THE REGION

The Italian economy remained in recession in the third quarter of year, recording the third consecutive quarter of negative growth. The low domestic demand, government spending and investments provided negative effects to economic activity, while the increase of external demand reduced somewhat this effect. By sectors of the domestic economy, agricultural production, industrial production and construction shrank, while services provided a neutral contribution.

Economy of Greece exited recession in the third quarter of year, recording a quarterly growth for the first time since the beginning of the crisis. The low comparative base of a year earlier drove to positive growth in almost all components of GDP. Thus, the increase in consumer spending, investments and net exports offset the contraction in government spending in this quarter. The outlook, however, remains unclear, due to the political uncertainty in the country.

Economic growth in Turkey continued to slow down in the third quarter of the year, reflecting the weak domestic demand. Consumer spending and private investments did not contribute to economic growth. The latter was driven by the high government spending and the rapid increase in exports. Net imports, contributing negatively to the economic growth, declined. Preliminary data of trade, industrial production and confidence indices suggest that economic growth was low in the third quarter of the year.

FYROM’s economy maintained the expansionary pace in the third quarter of the year. Total investments, mainly urged by government investments, were the main driver to growth. Net exports and consumer spending slowed down their increase, thus providing less contribution to the overall economic performance. By sectors, industrial production slowed down, while construction increased slightly after some quarters of stagnation. Indirect data from retail sales and production suggest a lower economic growth in the last quarter of the year.
3.1.2 PRIMARY COMMODITY PRICES

During the fourth quarter, oil price per barrel continued the downward trajectory started since August 2014. Brent crude oil price quickly fell both in annual (30.0%) and quarterly (25.0%) terms. In international markets an oil barrel was averagely traded at USD 62.4, the lowest value in the last five years. The continued price fall reflected the persisting increase of production in USA, ample supply by other producing countries and the weak global demand for oil. Related to the forecasts for 2015 and 2016, based on the U.S Energy Administration Information report, the average price per barrel is expected to be USD 57.6 and 75, respectively.

The primary commodity prices6 shrank, both in annual and quarterly terms, by 20.2% and 16.9%, respectively, driven by the performance in oil price. Food prices dropped by 7.4% in annual terms, and by 5.0% in quarterly terms. These developments were mainly dictated by the appreciation of the U.S. dollar in the foreign exchange markets7, the broad supply for these products and the absent demand-side pressures. The average primary commodity prices are expected to stay at lower rates compared to those for 2014.

3.1.3 MONETARY POLICY AND INTEREST RATES

The major central banks kept their key interest rates unchanged, respectively, the European Central Bank at 0.05%, the Federal Reserve at 0.15%, the Bank of England at 0.5% and the Bank of Japan at 0-0.1%.

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5 Data referring to the EIA monthly report, January 2015.
6 Primary commodity and food prices refer to monthly indices published by IMF.
7 According to Fed’s nominal index, during 2014 Q4, the U.S. dollar appreciated 6.0%, in quarterly terms, against major currencies in the international markets.
In the euro area money market, Euribor rates decreased further in this quarter, whereas U.S. dollar LIBOR rates maintained the same level. Eonia daily rate of interbank market in euro positioned in a negative territory since November, by reflecting the accommodative liquidity policy implemented by ECB. In capital markets, bond yields for advanced economies with maximum rating (AAA) fell again these months, mainly influenced by the indirect indicators for the economy. The latter confirmed that the return of the strong economic growth is far. Bond yields of countries, which are obliged to implement fiscal consolidation (Italy, Spain, Portugal and Greece) also fell slightly, affected by the ECB confirmation on the implementation of the simulating monetary policy and the results achieved in the respective public balance sheets. In the foreign exchange markets, the euro depreciated, during these months, against the U.S. dollar (5.7% q.o.q), Chinese Renminbi (6.4% q.o.q) and against British Pound (0.6% q.o.q), and appreciated against Japanese Yen (3.5 q.o.q). In bilateral average terms, in December, one euro was traded at USD 1.2331, depreciating 1.4% from a month earlier, and 10.2% from the previous year.

**3.2 GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND**

In line with our assessments and projections, economic activity returned into positive growth rates in the third quarter of 2014. The increase of the added value in the economy was at a broad base, and present almost in all sectors of the economy. On the aggregate demand-side, the increased domestic demand was assessed as the main economic growth component. The simulating monetary conditions, the enhanced economic agents’ confidence
and the reduced risk premia, drove the domestic demand, whereas the external demand was weaker than expected. The fourth quarter is expected to be characterised by overall similar developments, albeit private demand is expected to slow down, while fiscal stimulus to increase.

The new incoming economic information renders revises slightly up our assessments for the expected economic growth during 2014. On the other side, the expected performance trajectories for 2015 and beyond, have not changed considerably. Economic activity is expected to further improve in this period, supported by the increased demand of the private sector, the improved financing conditions and the medium-term improvement of the economies in trading partner countries. However, risks associated with this scenario remain on the downside.

The real value added by sectors grew annually by 3.3% during the third quarter of 2014. Economic performance improved during this quarter, from the expansion of 1.4% and the contraction of 0.4%® recorded in the first and second quarters of the year, respectively. Beyond the base effect of comparison with a weak quarter a year earlier, the available information suggests that the consumer demand improved in this period, reflected on the high contribution of services to the growth of the added value. In addition to services, the production sector provided positive contribution to economic growth in this quarter, by establishing a balanced structure of the output growth.

On the expenditure side, economic growth was mainly driven by the consumer demand and less by the investing activity of private and public sectors. The improved confidence in the economy, the low interest and inflation rates, increase of employment and the payment of arrears are estimated to have supported the expenditure in private sector during the last quarters. Public sector’s behaviour remained oriented towards fiscal consolidation, but less pronounced over the second half of the year. On the other hand, external demand resulted weak and the net contribution of economic and trading exchanges with partner countries is estimated to be negative.

In balance, the information available showed that the positive growth rate continued in the fourth quarter, but at a slower pace from a quarter earlier.® Year 2014 is estimated to record higher growth rates than in the previous year.

The insofar fluctuations of economic growth are projected to shift and be replaced by an upward trend in the medium term. Domestic demand is expected to be supported by the eased monetary conditions, the improved confidence and financing conditions and the reduction in risk premia. External demand is expected to strengthen, reflecting the global economy recovery, providing space for the growth of Albanian exports.

® Publication of national estimates for 2013 led to reviews of the quarterly series of the value added to the economy.  
® Economic analysis and the assessments of aggregate demand for Q4 are based on the updated fiscal indicators, the external trade, credit and deposits till November and confidence indicators for 2014 Q4.
Nevertheless, medium-term economic growth is projected to be slow compared to historical rates, being conditioned by the free capital capacities in the capital and labour markets and the recovery of risk appetite in the financial markets and lending to the private sector. The persistence of structural reforms to encourage investing activity, to address structural problems of the labour market and to simulate the increase of productivity and competitiveness of our exports will provide the necessary conditions for a sustainable economic growth and for the expansion of our economic potential.

3.2.1 SECTORAL OUTPUT\textsuperscript{10}

Except for transport, annual growth of value added was driven by the expansion of the activity across all branches of the economy. The services sector gave the major contribution to the expansion of economic activity by 1.9 percentage points. The growth of value added in this sector was driven by the rapid expansion of trade. The production sector contributed by 1.4 percentage points to the total growth of value added. The activities of this sector - construction, industry, and agriculture - increased the value added in the economy by 0.8, 0.4 and 0.2 percentage points, respectively. Survey results, as shown by the upward trend of the Economic Sentiment Indicator and other confidence indicators, suggest that the performance of economic activity will remain positive in 2014 Q4.

\textsuperscript{10} The quarterly performance of output is analysed in terms of the real gross value added, until 2014 Q3. INSTAT published the data on 9 January 2015. INSTAT’s quarterly assessment of economic performance does not include the quarterly estimates of taxes and subsidies on products. The quarterly analysis is, therefore, not addressed in terms of GDP. Discrepancies in the annual rate of the value added by branches referred herein, compared to the previous monetary policy report, arise from the preliminary publication of the annual gross value added for 2013 and update of basic data used in the assessment.
The performance of the industry sector was positive in 2014 Q3. Value added of industrial activity grew 2.4% in annual terms, after falling by the same rate in Q2.

The branch of ‘extractive industry’ continued to contribute most, by 1.9 percentage points, to the improvement of the performance of the industry sector. In the quarter under review, the value added by the ‘extractive industry’ grew 0.9% in annual terms, estimated to have contributed by 0.5 percentage points to the expansion in industry. Survey indicators for the industry sector stopped the upward trend in Q4, suggesting for a slowdown of the activity in this sector.
Value added by ‘construction’ recorded 7.5% annual growth in Q3, contributing 0.8 percentage points to the real growth of value added in the economy. The shift of direction in the performance of construction, from strong contraction in H1 to positive performance in Q3, is attributed to the base effect\(^1\), increase in the number of building permits\(^2\) and the positive effect from the payment of Government arrears for infrastructure works\(^3\). The analysis of the approximate value of building permits reveals that construction expanded mainly in residential and other buildings; it was also affected positively by the realisation of engineering works in infrastructure.\(^4\) The upward trend of business survey indicators in construction signal that positive developments in this sector will continue in the fourth quarter.

\(^{1}\) The technical application of the base effect concept analyses unusual deviations of quarterly/monthly rates of an economic indicator from its historic average pace for the impact on the performance of the annual rates of the indicator. The annual growth of value added in construction by 7.5% in Q3, from the sharp decline 21.4% in Q2, owes largely to the positive impact by the base effect. In 2013 Q3, the value added in construction fell 21.7% in quarterly terms, significantly lower than the average rate of growth recorded in the third quarters during 2009-2012. Its deviation contributes to the opposite direction to the annual growth generated in 2014 Q3.

\(^{2}\) In Q3, 98 building permits were approved for residential buildings and 24 for other buildings. The total number (122) of granted permits is up from the number of permits approved in the first two quarters of the year, 58 and 39 permits. This indicator performed better compared to the respective periods in 2012 and 2013; it remains, however, below historic levels. The data on building permits refer to INSTAT’s quarterly statistical bulletins.

\(^{3}\) Payment of Government arrears to businesses for public works in infrastructure (such as construction and reconstruction of roads, schools, etc.) was high in June and July 2014. This may have contributed positively to the activity of businesses that operate in the construction sector, in Q3.

\(^{4}\) Civil engineering works include constructions related to transportation infrastructure (such as roads and motorways), water supply, electrical and telecommunication lines, industrial facilities, etc.
In Q4, the price-to-rent ratio fell 0.2 percentage point and 0.1 percentage point compared to the previous quarter, and the previous year, respectively. This ratio continues to fluctuate close to the average of the last six years.

‘Agriculture, hunting and forestry’ recorded 1.2% annual growth of the value added, in 2014 Q3. The growth rate remains, however, below the historic average of 4.6% of expansion in the agricultural sector. Unfavourable weather conditions affected the factual level of agricultural output in the Q3.\(^{15}\)

**Services sector** continued to drive economic growth in Q3. The value added by the branches of services recorded 3.7% annual growth, pursuing an upward trend during the year. Services stood above the historic average growth rate, by 2.1%, mainly owing to the more positive performance of ‘trade’ and ‘other services’. Thus, ‘trade and other services’\(^{16}\) contributed by 1.6 and 1.1 percentage points, respectively, to

\(^{15}\) Rainfall in June and July contributed negatively to agricultural output.

\(^{16}\) Other services include: ‘Financial activities’, ‘Real estate, leasing and business services’, ‘Public administration and defence’, ‘Education’, ‘Healthcare’, and ‘Other collective, social and personal services’. More positive developments in this branch are present in healthcare and other services, social and personal.
the value added in the economy. Meanwhile, “transport” continued the strong contraction that had started in 2013 Q4\(^{17}\), thus reducing the value added in the economy by 1.1 percentage points in the quarter under review. Confidence indicators for the services sector suggest that positive trends will continue in 2014 Q4.

3.2.2 AGGREGATE DEMAND

Aggregate demand grew in 2014 Q3, mainly as a result of the expansion of private consumption and, to a lesser extent, of the increase of private investments and public sector consumption. On the other hand, the contribution of the net foreign demand is estimated as negative, mainly affected by the expansion of imports in goods and services during this period.

Available data point to a positive performance of aggregate demand in Q4, although at a lower pace than in Q3. The structure of economic growth is estimated to remain skewed towards domestic demand, whereas foreign demand is assessed as weak. Based on the disposable information and our analyses, the Bank of Albania deems that economic growth during 2014 and 2015 has and is expected to record progressive growth compared with the previous year.

Private consumption contributed positively to aggregate demand growth in Q3. The increase in consumer spending reflected primarily the increase in spending for nondurable goods and less so the increase in services and durable goods.

\(^{17}\) The exit from the market of the Albanian airline company Belleair in 2013 Q4 provided a negative shock to the value added generated by the air transport, which drove the performance of the total transport activity. In 2014 Q4, the negative statistical effect from the comparison with a higher base during the first three quarters of 2013 is largely cancelled out. Thus, the negative shock from air transport is expected to decelerate to a lesser extent the activity in other branches of transport.
as shown by the indicators of national accounts and other indirect indicators\textsuperscript{18}. The retail trade index surged 6.4%, mainly due to the contribution by the group of foods, in Q3.\textsuperscript{19}

Private consumption grew driven by the higher confidence and willingness of consumers to spend a larger portion of their income. Subdued uncertainties and more optimistic expectations for employment opportunities, according to confidence survey data for Q3, are a stimulus for boosting consumer spending. Also, in Q3, the employment-to-population ratio increased 1.8 percentage points compared to Q2. The easing of lending standards and terms throughout the past year, especially on consumer credit, has also contributed positively to consumers’ decision to spend. Their inclination to save has continued in Q3, but the annual growth of households’ savings in deposits and Government securities was lower during 2014 than in the previous year.

Developments in the sources of financing the private consumption in Q3 were not uniform. On the one hand, higher income from remittances and consumer credit, protected from low inflation rates, supported private consumption. One the other hand, in Q3, wages fell across the main branches of the economy.

The increase in private consumption is estimated to have decelerated in Q4, as consumers’ optimism declined. After rising in Q3, the consumer confidence index and the balance of major purchases fell at the end of the year.

\textsuperscript{18} Based on data on the gross value added according to the production method, the value added of the services sectors, excluding trade, increased 0.73% in annual terms, from 1.1% on average in H1. Moreover, imports, in terms of value, of automobiles fell 5.1% in Q3, based on foreign trade data.

\textsuperscript{19} The index of the volume of sales in the group ‘foods, beverages, tobacco in unspecialised and specialised outlets’ surged 10.1% in annual terms, providing the major contribution to the index of retail sales.
Also, based on the lending survey, the easing of lending standards slowed down in Q4. Other quantitative indirect indicators support the rise in private consumption, especially the increase in imported foods and revenues from the value added tax\(^{20}\). In contrast to the downward trend of the first three quarters, food imports rose 7.2% during October-November, in real annual terms.

Recovery of private investments continued in Q3, although they contributed less to aggregate demand growth compared to previous quarters. Production-side data suggest for a positive contribution of investments, mainly in the construction sector. In addition, investments in machineries and equipment, whose imports expanded 5.3%, provided positive contribution. The capacity utilisation rate in the economy rose 1.9 percentage points during the quarter under review, affected positively by the higher capacity utilisation rate across all the constituent sectors.

The boosted confidence in the economy, improvement of businesses financial situation, and increase of demand for investment loans contributed positively to businesses inclination to make new investments. The increase of orders in the industry and construction sectors, as well as the downward uncertainties for the future were additional drivers to the increase in investments.

Indirect data reveal a further increase of private investments and positive contribution to aggregate demand in Q4. Import of machinery and equipment hiked 27% in annual terms for October-November. Investment loans continued to rise in these two months, after the positive turn in Q3. Confidence survey data corroborate the rise in private investments, especially in the construction sector. In a longer term, the performance of this component of the aggregate demand for machinery and equipment showed a 27% increase in annual terms.

\(^{20}\) According to data for October and November 2014, revenues from the VAT were up 8.1% in annual terms. The rise was 29.3 and 13.4%, respectively, in Q1 and Q2.
demand will depend on the speed of the further recovery of aggregate demand and easing of lending standards.

Fiscal indicators and fiscal policy

The increase in the public debt and the further deterioration of the fiscal position in recent years has necessitated changing the direction of the fiscal policy, in order to preserve the stability of public finance. The consolidating fiscal policy for 2014, expressed in the narrowing of the budget deficit, was achieved mainly as a result of the increase in budget revenues. However, the fiscal consolidation was realised unevenly throughout the year. In H1, the budget deficit contracted significantly, driven by the performance of both revenues and budget expenditure. In Q3, the size of fiscal consolidation moderated compared to H1, as this process was sustained only by the increase in budget revenues. In the meantime, the increase in budget expenditure in Q4 is expected to generate a positive fiscal stimulus.

The trajectory of budget expenditures that proxy the final consumption and gross formation of the Government’s fix capital suggests a negative contribution to aggregate demand growth during H1. This contribution is, however, estimated to be positive for H2, mainly as a result of the high concentration of capital expenditure in the last quarter.

After the first half, the pace of increase in budget expenditure shifted to positive territory, to accelerate towards the end of the period. Thus, for the 11-month period, total expenditure amounted to around 5% higher in nominal annual terms. For the same-stated period, current expenditure increased by 1.6%, whereas the capital ones amounted to 24.1% lower than in the previous year. Payment of arrears contributed most (around 7.5 p.p.) to the increase in total investments during the 11-month period. Excluding the payment of arrears, budget expenditure during the 11 months amounted to around ALL 343.9 billion, or 2.6% lower than in the previous year.

From the quarterly perspective, fiscal developments were rather uneven during 2014. Thus, after contracting in Q1 and Q2, total expenditure in Q3 surged by around 12% in annual terms, as a result of payment of arrears, and the higher levels of current expenditure. In the last two months, expenditure were up around 25.7% from the same period in the previous year, mainly due to the higher capital and operational expenditure.

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21 This part of the year reflects also the statistical effect of the comparative base.
22 Until the end of November, around ALL 26.5 billion were paid as arrears. Almost half of them consists in the payment of tax obligations. Around 33% represent payment of arrears for infrastructure works.
In contrast to expenditure, budget revenues recorded higher and steady growth rates throughout the period. Until the end of the first 11 months, budget revenues amounted to around ALL 329.2 billion, or 12.6% higher than in the previous year. The increase in total revenues is dedicated almost entirely to tax revenues.

The high level of revenues along the first 11 months of the year reflects the combination of a number of factors. First, amendments to the tax legislation for 2014 are estimated to have improved the dynamics of tax revenues this year. Thus, in the first 11 months of the year, revenues from the corporate profit tax, excise, national taxes and other revenues from the local government increased 42.2%, 15.9%, 16.9%, and 14.6%, respectively, in annual terms. The increase in these four items formed around 49% of the increase in tax revenues for this year.

Second, the higher formalisation of the economy and the improved efficiency in collecting tax revenues have driven, to a large extent, the increase in tax revenues during this period. One of the indicators suggesting an enhancing efficiency of tax administration is the VAT productivity, which is improved from a year earlier. Revenues collected from the VAT surged around 14.1% for the first 11 months of 2014, at the same time accounting for around 42% of tax revenues increase. Unlike in previous years, this item was affected positively by the VAT applied on both imported goods and on domestically-produced goods and services. Thus, in the first 11 months of the year, the latter contributed by around 3.8 p.p. to the increase in total VAT

23 Main changes to the fiscal package for 2014 consisted in: rise of the profit tax rate to 15% (from 10%), increase in excise for existing goods, and expansion of the applicable base; increase in gasoil and diesel vehicle circulation tax, by ALL 10/litre from a year earlier; amendments to VAT exemptions, though keeping the VAT rate unchanged for supplies of goods and services; higher property tax.

24 Overall, for all businesses, profit for 2014 adjusted for the tax rate, is assessed as lower than in the corresponding 11 months of 2013, by around 5.1%.

25 This indicator is calculated with the following formula: Productivity = (VAT revenue)/GDP*1/τ (τ is the VAT rate), during the first three quarters of 2014, improved to 0.44, from 0.41 on average in 2013.
revenues. Trade and services sectors had the highest share in the increase of domestic VAT revenues. At the same time, these two sectors accounted for around 80% of the expansion of the taxpayers base during this period, albeit the unchanged legal regulations from a year earlier. Meanwhile, the VAT on imported goods contributed by about 10.7 p.p. to the increase of total VAT, reflecting the increase by about 8.6% in imports during the first 11 months. Third, the dynamics of revenues during 2014 reflects the statistical comparative effect against the previous year, when revenues recorded negative annual growth rates.

Budget deficit for the first 11 months of 2014 amounted to ALL 41.3 billion, or around 35.1% below the planned level for this period. The difference from the planned level arises due to the failure to comply with the planned schedule for some of the items in the budget expenditure. In annual terms, the budget deficit for the 11-month period narrowed 31.9%. Budget deficit dynamics was not uniform across the quarters. Its narrowing was sharper in 2014 H1, largely reflecting the previous year’s comparative base effect. In Q3, the reduction of the budget deficit was moderated compared to the two previous quarters. In the meantime, in Q4, the budget deficit is expected to expand in annual terms, reflecting the upward trajectory of budget expenditures in this period.

Budget deficit was financed through both domestic and foreign resources. The main item in the domestic financing of the deficit consisted in the issue of debt instruments in the domestic market of government securities. Long-term instruments had the largest share in the increase in government securities portfolio during the period, improving the profile of debt settlement and fiscal

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26 In previous years, this item had provided negative contribution to total VAT.
27 Number of businesses included in the VAT scheme was up 11.6% from a year earlier, with most of them operating in the services and trade sectors.
28 Only in October-November, total expenditures surged around 25.7% from the same period in the previous year, driven mainly by capital expenditure.
vulnerabilities in the future. Foreign borrowing, which mainly consists of IMF’s loan disbursement (to pay Government arrears), was another main tool to finance budget deficit during this year.

External demand and external trade

Data on the external sector of the economy for Q3 show that the real net exports deficit continued to expand for the sixth consecutive quarter. The deficit deepened at the annual rate of around 18%. In terms of impact on the economy, the performance is assessed to have given a negative contribution by 3.8 percentage points to the annual change of aggregate demand. For Q4, our projections suggest for a minimum negative contribution of real net exports to aggregate demand, to close the year with an average contribution by -1.5 percentage points.

The latest data on net exports for Q4 include only trade in goods for October and November. Trade deficit in goods in these two months widened by around 17.2% in annual terms. The accelerated expansion of imports gave the most substantial contribution to this performance. In the meantime, the growth pace in export of goods was low. Trade activity during these two months points to an expansion by around 6.5% of trade flows, compared to the same period in the previous year. The coverage ratio of imports by exports was at 43.5%, or around 3.5 percentage points lower than in the previous year.
During October and November, the value of export of goods was up around 0.5% in annual terms. According to detailed data on foreign trade of goods, the main contribution was given by the annual expansion of exports in the category ‘textile and footwear’ by around 20.2%. This category includes re-exported goods. Another positive contribution was given by ‘food, beverages and tobacco’, whose exports stood around 23% higher, compared to the same period a year earlier. Within this category, the performance was driven by the accelerated growth in exports of agricultural products. The export in products under ‘construction materials and metals’ fell in annual terms, as a result of the decline in metal prices in international markets. However, the largest negative contribution to the value of exports, by around 7 percentage points, was given by the accelerated decline in exports in the category of ‘minerals, fuels and electrical energy’. In this category, the accelerated oil price fall in international markets contributed to both the value and volume of exported oil.

Imports increased around 9.3% in annual terms, during October and November 2014. The increase in imports of goods under ‘machineries, equipment and spare parts’ by around 27% was the main driver of the annual performance of total imports. Exports in ‘construction materials and metals’ performed similarly, expanding by around 18% in annual terms. The performance of imports for these categories provides an indirect description of domestic consumption and investments during Q4. Expectations for the continuation of the dynamic activity of re-exporting industries in the upcoming months is reinforced, as the upward trend is maintained for imports of materials used for production in these industries. In the meantime, while the import in annual terms of electrical energy increased in these two months, total imports under the category ‘minerals, fuels and electrical energy’ fell. Similar to the performance of exports, the fall of oil prices in international markets resulted in lower imports, in terms of value.

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29 The oil price per barrel in international markets fell on average 23% during October and November, whereas the average price per barrel for Albanian oil fell by around 21.1%.
The exporting activity for Albania continues to rely mainly in trading partners such as Italy, Malta, Kosovo, Spain, Greece and Turkey. The origin of imports remains diverse, with the EU countries having the major share in the total.

**Box 2 Balance of Payments Developments during 2014 Q3**

Albania’s net current account balance recorded a deficit of EUR 316.4 million in 2014 Q3, maintaining an upward trend for the fourth consecutive quarter. During the quarter under review, current account deficit increased around 66.2%, in annual terms, and was estimated at 12.8% of nominal GDP.

By item of the current account, similar to H1 performance, the deterioration of the deficit in net exports and primary income contributed to the expansion side. Meanwhile, secondary income, which increased slightly compared to the value in the previous year, contributed to the narrowing side.

In this quarter, the external demand did not help maintain the uptrend in the exports of goods and services. Imports of goods and services performed similarly, but the pace of decline was more moderate than that of exports. The balance of the primary income account remained in negative territory for the third consecutive quarter, deepening further the registered deficit compared to 2014 H1. On the other hand, during this quarter, secondary income registered around 3.0% increase, especially the annual growth of remittances by around 1.9%.

**Table 4. Balance of Payments Indicators**

<table>
<thead>
<tr>
<th>Item</th>
<th>2013 Q2</th>
<th>2013 Q3</th>
<th>2013 Q4</th>
<th>2014 Q1</th>
<th>2014 Q2</th>
<th>2014 Q3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current account (in EUR million)</td>
<td>-285.0</td>
<td>-190.4</td>
<td>-336.2</td>
<td>-260.8</td>
<td>-324.6</td>
<td>-316.4</td>
</tr>
<tr>
<td>y-o-y (%)</td>
<td>13.2</td>
<td>-23.2</td>
<td>63.3</td>
<td>16.7</td>
<td>13.9</td>
<td>66.2</td>
</tr>
<tr>
<td>/ GDP (%)</td>
<td>-10.9</td>
<td>-8.2</td>
<td>-13.4</td>
<td>-11.1</td>
<td>-12.2</td>
<td>-12.8</td>
</tr>
<tr>
<td>Goods and services</td>
<td>-442.5</td>
<td>-394.9</td>
<td>-518.1</td>
<td>-396.8</td>
<td>-468.8</td>
<td>-459.8</td>
</tr>
<tr>
<td>Exports, f.o.b.</td>
<td>805.6</td>
<td>981.0</td>
<td>960.3</td>
<td>609.7</td>
<td>753.0</td>
<td>842.1</td>
</tr>
<tr>
<td>Imports, f.o.b.</td>
<td>1248.1</td>
<td>1375.9</td>
<td>1478.4</td>
<td>1006.5</td>
<td>1221.8</td>
<td>1301.8</td>
</tr>
<tr>
<td>Travel - net</td>
<td>-31.5</td>
<td>26.1</td>
<td>34.0</td>
<td>-21.8</td>
<td>10.6</td>
<td>32.0</td>
</tr>
<tr>
<td>Primary income</td>
<td>-11.0</td>
<td>22.2</td>
<td>0.0</td>
<td>-7.1</td>
<td>-28.6</td>
<td>-44.5</td>
</tr>
<tr>
<td>Credit</td>
<td>35.7</td>
<td>40.2</td>
<td>33.4</td>
<td>29.2</td>
<td>25.8</td>
<td>28.3</td>
</tr>
<tr>
<td>Debit</td>
<td>46.7</td>
<td>18.0</td>
<td>33.4</td>
<td>36.3</td>
<td>54.3</td>
<td>72.8</td>
</tr>
<tr>
<td>Net FDI income</td>
<td>-20.1</td>
<td>6.2</td>
<td>6.9</td>
<td>-15.9</td>
<td>-31.4</td>
<td>-51.3</td>
</tr>
<tr>
<td>Secondary income</td>
<td>168.4</td>
<td>182.3</td>
<td>181.9</td>
<td>143.0</td>
<td>172.9</td>
<td>187.8</td>
</tr>
<tr>
<td>Credit</td>
<td>200.5</td>
<td>216.5</td>
<td>213.5</td>
<td>170.2</td>
<td>201.7</td>
<td>221.0</td>
</tr>
<tr>
<td>Debit</td>
<td>32.0</td>
<td>34.2</td>
<td>31.6</td>
<td>27.3</td>
<td>28.8</td>
<td>33.2</td>
</tr>
<tr>
<td>Net remittances</td>
<td>129.6</td>
<td>152.5</td>
<td>140.1</td>
<td>115.9</td>
<td>134.8</td>
<td>155.4</td>
</tr>
<tr>
<td>Capital account</td>
<td>4.8</td>
<td>15.0</td>
<td>18.2</td>
<td>22.5</td>
<td>15.3</td>
<td>20.7</td>
</tr>
<tr>
<td>Net borrowing/net lending</td>
<td>-280.2</td>
<td>-175.4</td>
<td>-318.0</td>
<td>-238.3</td>
<td>-309.3</td>
<td>-295.8</td>
</tr>
<tr>
<td>Financial account</td>
<td>-262.4</td>
<td>-70.9</td>
<td>-226.1</td>
<td>-231.3</td>
<td>-225.4</td>
<td>-140.7</td>
</tr>
<tr>
<td>y-o-y (%)</td>
<td>213.8</td>
<td>78.4</td>
<td>-16.2</td>
<td>82.5</td>
<td>-14.1</td>
<td>98.5</td>
</tr>
<tr>
<td>/ GDP (%)</td>
<td>-10.0</td>
<td>-3.0</td>
<td>-9.0</td>
<td>-9.8</td>
<td>-8.5</td>
<td>-5.7</td>
</tr>
<tr>
<td>Direct investments</td>
<td>-270.5</td>
<td>-307.0</td>
<td>-231.2</td>
<td>-192.6</td>
<td>-144.5</td>
<td>-188.9</td>
</tr>
<tr>
<td>Portfolio investments</td>
<td>104.4</td>
<td>6.2</td>
<td>-18.1</td>
<td>12.8</td>
<td>12.3</td>
<td>-14.2</td>
</tr>
<tr>
<td>Financial derivatives</td>
<td>1.1</td>
<td>0.0</td>
<td>-2.4</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Other investments</td>
<td>-183.8</td>
<td>195.4</td>
<td>18.6</td>
<td>-11.1</td>
<td>-115.8</td>
<td>-91.6</td>
</tr>
<tr>
<td>Reserve assets</td>
<td>86.4</td>
<td>34.5</td>
<td>7.1</td>
<td>-40.3</td>
<td>22.5</td>
<td>154.0</td>
</tr>
<tr>
<td>Errors and omissions</td>
<td>17.8</td>
<td>104.5</td>
<td>91.9</td>
<td>7.0</td>
<td>83.9</td>
<td>155.1</td>
</tr>
<tr>
<td>Net borrowing/net lending</td>
<td>-280.2</td>
<td>-175.4</td>
<td>-318.0</td>
<td>-238.3</td>
<td>-309.3</td>
<td>-295.8</td>
</tr>
</tbody>
</table>

Source: Bank of Albania.
Net inflows in the capital account increased to EUR 20.7 million, from EUR 15 million in 2013 Q3. Net flows in the financial account doubled compared to the same quarter a year earlier, financing 44.5% of the current account deficit. Net foreign direct investments in this quarter dropped by around 38.5%, on an annual level\(^{\text{31}}\). On the other hand, other net investments were assessed with expanded liabilities by around EUR 91.6 million, due to the rise in liabilities in the form of central government debt.

The overall balance of payments saw increased foreign reserve assets by about EUR 155.1 million in 2014 Q3. At the end of September, the stock of the foreign currency reserve stood at around EUR 2.21 billion, sufficient to cover 5.3 months of imports of goods and services and 182% of the short-term foreign debt.

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

Inflationary pressures from the real economy remain weak. Domestic demand continues to grow below the potential of the economy, in line with the cyclical weakness in Albania’s main trading partners. The unutilised capacities in the labour and capital markets are reflected in weak pressures for the rise of wages and production costs, as well as in low core inflation rates.

Our projections show that inflation will return to Bank of Albania’s target in the medium-term horizon, in line with the gradual closing of the negative output gap and the time lag of the monetary policy transmission.

Low rates of inflation and the main trend of inflation show that their developments were dictated not only by positive shocks from costs, but also from weak pressures from demand. Our assessments show that the output gap remained negative during 2014, albeit with a tendency towards closure. This assessment is corroborated by new data from the labour market for Q3 and confidence surveys for Q4. Unemployment rate dropped by around 0.3 percentage points to 17.4%\(^{\text{31}}\). Moreover, businesses report higher utilisation of production capacities in the last two quarters of the year. However, the capacity utilisation rate remains below the historic average rate and unemployment continues to maintain high rates. These developments generate low pressures for the rise in wages, labour and production costs in the economy. Dictated by its performance, economic agents’ inflation expectations remain on the down side.

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\(^{\text{30}}\) Estimation of foreign direct investments of quarterly frequency during the year is based on the data that are taken by banks and are not included in the information on borrowing/lending in the foreign direct investment relationship in Albania. This information is provided only by the annual survey of Foreign Direct Investments (FDI) at the enterprises, which is published in September of the successive year. Due to the data taken from this survey, FDIs values are reviewed for each quarter. Thus, FDIs value for each quarter of 2014 shall be reviewed after the FDIs survey for 2014.

\(^{\text{31}}\) Labour market data are based on Labour Force Survey and short-term statistics, as published by INSTAT. The unemployment rate is the ratio of the number of persons unemployed and the number of persons in the labour force.
Productivity, wages, labour costs

The relatively high increase of the employment index during the first nine months of 2014, against the positive but moderate dynamics of economic activity growth, was reflected in the negative dynamics of the index of labour productivity in non-agricultural sectors. The annual change of this indicator in Q3 was -7.2%. However, its drop in this quarter was significantly lower compared to the average of 2014 H1, due to the higher growth of the value added in this quarter.

In the same quarter, the indicator of the average wage in the economy in Q3 deepened the down trend that had started at the beginning of 2014. The annual fall of this indicator was around 5% and 6.6% in nominal and real terms in this period. The drop of wages in the private sector had a broad basis, noted in the main branches of the economy such as industry, construction and services.

The performance of real wages and labour productivity was reflected in an evident deceleration of annual rates of the cost of labour per unit of output (0.6%).

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32 Indicators of labour productivity and unit labour costs are proxies calculated by the Bank of Albania, based on data of short-term statistics 2014 Q3 (INSTAT). They include: employment index, turnover and wages fund, for non-agricultural activity.

33 It has significantly reflected the government’s reform to formalise the labour market.

34 Wage index in economy, also referred to as the ‘average wage index’, is calculated as the ratio of wages fund index to the employment index. Source: Short-term statistics on enterprises SASh, INSTAT.
Inflation long-term expectations and short-term shocks

The downward trend of the negative output gap in 2014 Q3 was reflected in upward rates for long-term and domestic inflation. The annual core inflation for this quarter was 0.34%, returning thus to positive territory. Despite the evident reduction of the annual headline inflation in December, the core inflation rate resulted unchanged from the previous month (0.4%). Moreover, the annual inflation of the non-tradable sector of the CPI for Q4 stood at 2.1%, standing higher as a result of the annual increase of prices for some services.\(^35\) These developments point to the rising demand-side inflationary pressures, although these pressures remain weak in historic terms.

Headline inflation for the quarter under review was affected by very low values of its short-term components, especially those recorded in December. The annual non-core tradable inflation rates resulted 3.2% and 0.9%\(^36\), respectively, reflecting primarily the weak rise in unprocessed foods, being totally deviated from the season.

\(^35\) During 2014 Q4, the upward annual inflation in the services for education and communication purposes contributed around +0.5 p.p. and +0.3 p.p. respectively, to the formation of the net non-tradable inflation.

\(^36\) For December 2014, non-core and tradable inflation rates resulted around 1.2% and 0.2%, respectively, standing among the lowest rates for the month of December in the last decade. The aggregate effect of the fiscal package, which scored almost zero in this month, was excluded from the tradable inflation (changes in the excise tax on tobacco, vehicle circulation tax, removal of VAT on medicaments).
3.4 IMPORT PRICES AND IMPORTED INFLATION

Inflationary pressures generated from consumer prices in Albania’s trading partners were downward over Q4. ‘Foreign prices’\(^{37}\) for the period under review expanded on average 3.4% in annual terms, from 4.3% in the previous quarter. In the presence of disinflationary pressures in Europe, imported inflation was mainly generated from Turkey and Russia, which recorded an expansion of the imported volume. In contrast to Q3, the Albanian lek depreciated slightly in nominal effective terms in November-December (0.4% and 1.1%, respectively), thus increasing the role of the Imported Inflationary Pressures Index (IIPI).\(^{38}\) Reflecting these two components, the IIPI recorded 3.6% annual increase, slightly lower than that recorded in Q3.

The downward foreign inflationary pressures were the main reason for the fall of headline inflation in Q4. Imported inflation gave a negative contribution by -0.1 percentage point to headline inflation, whereas the contribution of domestic inflation was relatively steady, 1.34 percentage points. The gradual reduction in October-November of the positive contribution by imported inflation was followed in December by imported deflation in our economy, estimated at -0.6 percentage points, to the headline inflation. In the meantime, although low in historic terms, domestic inflation remained positive and stable ranging around 1.3 percentage points.

\(^{37}\) It is a proxy of imported inflation pressures, comparable to tradable 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’ (i.e., not only ‘Food’) of Bulgaria, Germany, Greece, Italy and Turkey. Some goods marked annual price rise, while the import share with respective countries has increased. This has led to increase in the final value of the index (weighted average of above-mentioned CPIs with their monthly import shares).

\(^{38}\) IIPI is calculated as the annual increase in Import Price Index and NEER index for the respective month. Imported inflation pressures impact inflation with 1-3 month lag. This index is, however, influenced by the fiscal measures taken by foreign countries, which do not necessarily affect the domestic import prices.
INFLATION EXPECTATIONS

Businesses, consumers and financial agents’ short-term inflation expectations for Q4 remain below the 3.0% inflation target of the Bank of Albania. Financial agents’ short-term inflation expectations fell by 0.2 percentage point, down to 1.9% in Q4. Also financial agents’ medium-term expectations (for inflation two years ahead) fell by 0.1 percentage point, posting 2.2%. By contrast, the quarterly dynamics of consumers’ expectations was upward. Their expectations rose by 0.2 percentage point in Q4, but remained below their historic average. Businesses expectations remained almost unchanged over the last two quarters, but at low levels, compared to other economic agents.

The analysis on inflation expectations is based on the results of the quarterly businesses and households survey and the monthly financial agents expectations survey.
4. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

Monetary and financial conditions eased in 2014 Q4. Liquidity pressures were subdued and banking system’s liquidity indicators improved. Interest rates on private sector borrowing maintained the downward trend in Q4; however, they were not yet reflected in steady growth of private sector demand for credit. Conversely, public sector demand for financing grew in Q4. Security yields increased during this period also due to lower participation of banks in Government security auctions. Overall, the growth of money supply in the economy suggests weak inflationary pressures.

4.1 FINANCIAL MARKET DEVELOPMENTS

Interest rates in the interbank market maintained a downward trend in 2014 Q4. Liquidity pressures were subdued, while the accommodative monetary policy contributed to downward interest rates throughout the year. Bank of Albania’s key interest rate cut at the end of November was immediately reflected in the interest rates on interbank transactions in December. Daily interest rates in the money market fluctuated close to - often below - the key interest rate. Overnight interest rates were steadier during this quarter, whereas the spread between them and the key interest rate remained similar to the previous quarter. The Bank of Albania continued to conduct regular liquidity injection operations in the banking system. Reverse repo of seven-day, one-month and three-month maturity was the main instrument used. The liquidity injected into the system was slightly higher than in the previous periods, while the auction yield was continuously close to the key interest rate.

In Q4, the overnight interest rate averaged 2.38%, or 0.09 percentage point lower than in the previous quarter, whereas the seven-day rate dropped to 2.40%, from 2.52% three months earlier. Banks increased the volume of daily transactions by 0.2 billion (1.9 billion) and the volume of one-week transactions by 0.7 billion (6.8 billion) from Q3.

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40 In Q4, the standard deviation of the overnight interbank rate was 0.174, from 0.080 in Q3.
41 The spread between the overnight rate and the key rate was 6 basis points in Q4, similar to Q3.
Primary market government security yields

After a long period of decrease, yields in the primary market shifted upward in Q4. The increase in the yields was noticeable in T-bills and other long-term Government instruments. Starting from the end of September, the yield on 12-month T-bills and other shorter maturities increased, influencing the yield curve slope. Banks’ demand in auctions was often lower than the issued amounts, adding, in turn, upward pressures on the yields. After a positive approach and active presence in the first half of 2014, banks were reluctant to participate in auctions in the last months of the year. Rather than to the liquidity situation and revision of expectations for the general economic situation, this approach was attributable to the tighter policies imposed on banks by the EU-based parent banks. On the other hand, Government demand for financing was higher in Q4, adding the pressures on the yields.
The 12-month yield reached 3.45% at end-December, from 3.22% at end-September. The 3-month yield increased sharply, whereas the 6-month yield was steadier. The 3-month T-bill rate averaged 3.12% in 2014 Q4, from 3.02% in Q3. The increase was also influenced by Government’s more frequent use of this instrument in short-term financing during this period. The yields on 3-, 5- and 10-year fixed-rate bonds benefited from the greater interest in the respective auctions and managed to maintain the previous months’ level. On the other hand, 2- and 7-year bonds increased across the months, ending the year at 5.04% and 7.85%, from 4.89% and 7.77% at end-Q3. The lack of demand most notably affected the yields on variable-rate instruments\(^{42}\), at a time when, besides the increase in the 12-month yield used as an index, the margins over this index also increased. More specifically, 5-, 7- and 10-year variable-rate bond yields increased by 0.14, 0.03 and 0.15 percentage point over the index.

**Deposit interest rates and terms of financing\(^{43}\)**

Interest rates on lek deposits maintained a downward trend in 2014 Q4. The interest rate on lek deposits averaged 1.65%, or 0.14 percentage point lower than in Q3. The 12-month lek deposit interest rate was 1.57% in November, down 0.16 percentage point from Q3. The decrease in interest rates on lek deposits extended across all main maturities. Euro deposit rates were steadier but slightly lower. 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 0.62% in October and November, from 0.65% in 2014 Q3. Interest rates applied to new lek loans continued to fall in October and November\(^{44}\). In the bank lending survey, banks stated that they expect the

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\(^{42}\) Total bid-cover ratio averaged 0.35 in 2014 Q4.

\(^{43}\) The latest official data on new deposit and loan rates are as of November 2014. The last quarter has been proxied by the average of October and November.

\(^{44}\) Their performance was volatile, often due to the share and price applied by individual banks; however, these moves did not affect the downward trend.
interest rate on lek loans to continue to fall in 2015 Q1. The margins between interest rates on loans and other lek instruments narrowed, mainly due to lower loan rates. Unlike the previous quarter, interest rates on business lek loans decreased more than those on household lek loans. The long-term interest rate, which mainly relates to investment loans, decreased to 7.4% on average in October and November, from 7.9% in Q3. The medium-term segment also recorded a decline by 0.25% from Q3, to 10.31% during October and November. Long-term interest rates fell on both business and household loans, supporting mortgage loans and investment loans.

The spread between long-term interest rates on new loans and 5-year bond yields narrowed notably to 0.82 percentage point in October and November, from 1.27 percentage points in Q3. The spread between interest rates on lek loans and deposits also narrowed in the last two months.

Euro interest rates were volatile, whereas their average level remained almost similar to the previous quarter. Interest rates on the long-term segment have been decreasing for several months, while the other segments have been volatile and on the uptrend. Interest rates on household loans decreased, whereas those on businesses increased. The spread between euro loan and deposit interest rates continued to widen due to fast reduction of the latter.

Despite the lower interest rates, the other lending standards applied by the banking system remained tight. Their slight improvement throughout 2014 was subdued in Q4.
Box 3 Summary of Bank Lending Survey Results

Bank lending survey results in 2014 Q4 showed slight changes, skewed to the tightening of lending standards applied to businesses, and slower easing of lending standards applied to households.

Chart 32 Lending standards applied to businesses and households (net balance)

After easing in the first half of the year, bank lending standards applied to businesses were slightly tightened in 2014 Q4, mainly due to tighter standards applied to lending for investment financing purposes. Concerning households, banks reported considerably lower easing of standards relative to the first half of the year, both to home purchase and consumer loans.

The performance of bank lending standards was positively affected by factors relating to bank liquidity situation, competition in the banking system and Bank of Albania’s policies. Some of the factors contributing to the tightening of lending standards included households and businesses’ financial situation, non-performing loans and specific problems facing the business sector environment.

Chart 33 Business and household demand for loans (net balance)
Banks applied the tightening policy on businesses by widening the margin on risky loans and reducing the loan size. Banks applied the easing policy on households by extending the maturity and increasing the loan size.

Banks stated that business and household demand for loans increased in 2014 Q4. Concerning households, the net percentage of banks stating increased demand was lower than in the previous quarter.

Banks’ expectations for 2015 Q1 are similar to their assessment of the situation in 2014 Q4. The lending standards applied to businesses and households are expected to improve slightly, while demand is expected to remain weak.

Exchange rate

The Albanian lek depreciated slightly in 2014 Q4. The NEER\textsuperscript{45} index recorded an average annual increase of 0.3% for the period under review, from the decrease of 1.8% during January-September 2014. Despite the depreciation of the euro against the Albanian lek, the considerable depreciation of the latter against the U.S. dollar seems to have kept the index at a similar level to 2013 Q4. In real terms, the Albanian lek continued to appreciate (0.3%) due to faster decrease of inflation in euro area trading partners relative to domestic inflation. In line with the above developments, the exchange market pressure index did not show added pressures on the domestic currency.

In 2014 Q4, one euro was traded at ALL 139.74 on average, or 0.5% less y-o-y. Despite the wider trade deficit for the period under review, the higher annual foreign inflows signalled by deposits and euro’s depreciation in the

\textsuperscript{45}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 the lek’s depreciation.
international markets seem to have also weakened its position in the domestic market. Fourth-quarter dynamics provide evidence of a sharper appreciation of the euro against the lek, particularly during December (by 0.5% from the average in October), driven mainly by the higher economic agents’ demand for foreign currency. This performance was also reflected in the absent seasonal effect that characterises the end of the year.\textsuperscript{45}

The U.S. dollar continued to gain ground against the lek, both in annual (8.4%) and quarterly terms (6.1%), reflecting the euro/dollar exchange rate trajectory in the international markets in Q4. One U.S. dollar averaged ALL 114, one of the peak rates in the past two years.

\section*{4.2 LENDING\textsuperscript{47}}

\textbf{Lending to the economy} continued to grow in October and November. At the end of November, annual credit growth was 3.8%, from 1.6% at end-Q3. A notable growth of lending in lek versus a sluggish performance of lending in foreign currency was a positive and stable development, contributing to a better transmission of the monetary stimulus into the economy. In annual terms, lending in lek grew 9.3% in November, whereas lending in foreign currency shrank 0.9%, y-o-y.\textsuperscript{48} The improved annual dynamics was mainly attributable to the cancelling out of the statistical effect arising from the unusual shrinkage of lending in October 2013. The monthly performance of lending was weaker than in 2014 Q3, whose positive moment did not extend beyond August.\textsuperscript{49}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{chart35}
\caption{Lending to the economy versus value added and nominal GDP}
\label{chart35}
\end{figure}

\textsuperscript{45} At the end of December, euro to lek exchange rate did not fall below ALL 139.87.
\textsuperscript{46} For a detailed analysis on lending activity, see: “Tendencies in lending - 2014 Q3” on www.bankofalbania.org
\textsuperscript{48} Excluding the exchange rate effect.
\textsuperscript{49} The exchange rate effect on the monthly performance of lending was particularly sharp in November. Total lending grew around ALL 5 billion in October and November. Excluding the exchange rate fluctuations, lending grew ALL 4 billion, denominated almost entirely in the domestic currency.
Beyond the monthly fluctuations and statistical effects, lending to the economy, particularly to the private sector, remained low. Credit-to-GDP\(^{50}\) ratio was estimated at 37.4\% at end-Q3, or around 0.6 percentage point lower, y-o-y. Lending to the private sector saw segmented growth and its steady recovery continued to be hampered by the economic agents’ high risk aversion. Banks remained prudent about lending, particularly about lending to businesses. On the other hand, demand for credit was more concentrated in the short-term segment.

Business loans were the main driver of the growth of lending to the private sector. They registered a positive flow in these two months, mainly in the form of short-term financing. At the end of November, business loans grew 5.1\% in annual terms, or 2.4 percentage points higher than at the end of Q3. The improvement of business loans was most notable in working capital loans and less in investment loans. At the end of November, these two portfolios grew 5.9\% and 3.6\%, respectively, in annual terms. During these two months, banks mainly lent to all branches of the industry sector, and the construction sector.

Lek-denominated business loans grew at a steady pace during 2014. Their annual growth reached 12.0\% in November, from 0.9\% at the end of 2013. The positive performance of lek business loans in October and November was seen in both short- and long-term maturity. After shrinking for almost two years, foreign currency-denominated business loans made a small contribution to the growth of business loans in the last four months. As a result, the share of lek business loans stood at 34.9\% at the end of November, up 1.2 percentage points\(^{51}\) from end-2013.

Lending to households remained sluggish in October and November. Consumer loans were the only to register a positive flow, whereas mortgage loans shrank.

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\(^{50}\) Bank of Albania staff estimate of nominal GDP.

\(^{51}\) The exchange rate effect has been excluded from this figure.
At the end of November, household loans grew 0.9% in annual terms, from 0.4% at end-Q3. Mortgage loans shrank in annual terms, recording an average rate of -0.5% in October and November. The annual growth of consumer loans improved further to 6.2% in November, as a result of the positive performance of this portfolio during these months.

![Chart 37 Lending to households by currency (left) and purpose of use (right)](chart)

Note: The exchange rate effect has been excluded from the contribution of foreign currency lending.

Source: Bank of Albania.

The opposite performance of lek and foreign currency lending was even more notable in lending to households. In the last four months, lek loans recorded an average annual growth of 6.1%, making added contribution to the growth of household loans relative to the previous months of 2014. It was accelerated by the growth of consumer loans and the stable contribution of mortgage loans denominated in lek. Conversely, foreign currency loans, excluding the exchange rate effect, continued to shrink, being 3.9% lower y-o-y, in November. Increased household awareness for foreign currency borrowing, coupled with the narrower spread between lek and foreign currency loan interest rates, skewed household demand for loans towards the domestic currency. The share of lek household loans stood at 50.6% at the end of November, or 2.4 percentage points higher than at end-2013.

**BOX 4 CESEE BANK LENDING SURVEY RESULTS, 2014 H2**

In the context of Vienna Initiative, the European Investment Bank (EIB) conducts a half-yearly bank lending survey for CESEE countries. Unlike similar surveys conducted in most CESEE countries, the survey conducted by the EIB includes a section on European parent banks’ opinion on their investments in CESEE countries, their approach to these investments and future strategies. The last survey was conducted in September and covers 2014 H2. The following presents the main conclusions of this survey on parent banks’ opinions on the region and Albania. The opinions of their subsidiaries in Albania are generally in line with the results obtained from the bank lending survey conducted by the Bank of Albania and, therefore, have not been included in this box.

52 The exchange rate effect has been excluded from this figure.
Cross-border banking groups operating in the CESEE region continued to restructure and reduce their investment at the group level, primarily via sales of branches and other assets. They generally remain committed to their investment in the region; however, they continue to discriminate in their country-by-country strategies. About half of surveyed banks have reduced their exposure to the CESEE region. Roughly one third of the groups expect to expand their exposure to these countries and another one third of them expect to continue to reduce their operations further. The profitability of subsidiaries in the countries of the region is emerging as a challenge; expected returns on assets for these operations have been decreasing compared to overall group results. Banks are also reviewing their assessments of the individual potential of markets in the region. At the end of their assessments, there might also be some strategic refocusing over the medium term.

Survey results suggest that the slow recovery of credit is attributable to both demand and supply-side factors. Banks expect demand to recover faster than supply in the CESEE countries. Funding resources and liquidity are no longer a concern for lending as the subsidiaries have replaced parent bank funding with domestic deposits. Credit quality, at both group and local level, is the biggest constraint on lending growth, together with regulation.

In the case of Albania were surveyed five European banks, whose Albanian subsidiaries account for 54% of total assets in the domestic banking system. Group assessment of the Albanian economy points out that economic recovery is at risk, with the high level of non-performing loans being the key concern.

Four out of five surveyed international banks operating in Albania continue to engage in the sale of assets at the group level. The deleveraging process has slowed down for these banks, but around a third of the groups indicate that they intend to further reduce their group-wide loan-to-deposit ratio. Parent banks continue to view Albania as a country with a low/average market potential and most of them are not satisfied with their positioning in the market.

Groups operating in Albania are generally more selective in their local strategies. Returns on equity and assets are lower than the CESEE average. However, there are signs for possible improvement in a longer-term period. Return on assets proved to be better for some parent banks operating in Albania, compared to overall group operations, and a small proportion of groups indicated their willingness to expand

*Return on Assets (adjusted for cost of risk) compared to overall group operations; Return on Equity (adjusted for cost of equity) compared to overall group RoE.

activities in Albania. Despite the fact that at least two of the surveyed groups report that they intend to reduce their operations in Albania, this number is lower than in the March 2014 survey.

Chart 38 shows the answers of the banking groups for the entire region. Based on this comparative view, we note that the region is divided into two groups: The first group, which mainly includes Central European countries and generally more developed than the rest of the region (Czech Republic, Poland, Bulgaria and, sometimes, Romania) are rated better than the rest of CESEE countries. This group does not include Hungary, whose poor performance is largely affected by the more deteriorated economic conditions. Albania is part of the second group of countries, mainly Southeastern European countries, along with Serbia, Croatia, and Bosnia and Herzegovina. This group is perceived by the European banks as countries with weaker market potential and lower profitability. This remark signals the possibility of a structural/geographic factor in the assessments of European banks of their operations in the countries of the region. Within this narrower region, Albania is ranked comparably better in terms of market potential and positioning. According to this survey, the profitability indicators place Albania in a non-competitive position relative to other neighbouring countries.

### 4.3 MONETARY INDICATORS

After the slowdown in 2014 Q3, broad money recorded an average annual growth of 1.6% in October and November. This improvement reflected the growth of lending to the private sector, whereas the contribution of public sector financing remained negative and almost similar to the previous two months. The foreign currency component continued to make the largest contribution to M3 growth. M2 aggregate recorded positive annual changes in these two months, reflecting the stable growth of lek credit. The lower interest rates on deposits shifted money to its most liquid components. In annual terms, M1 aggregate grew 11.7% at the end of November, or up around 2.7 percentage points from the end of 2014 Q3. Currency outside banks also grew in monthly and annual terms, maintaining a high ratio to M2 aggregate, at 29.5%.
The performance of monetary aggregates was broadly affected by below-potential economic growth and weak demand of economic agents for bank funding. They also continued to be affected by the structural shift of monetary assets to financial assets falling outside the definition of broad money. The latter are mainly represented by time deposits with a maturity of above two years and household investments in Government securities.53

Deposits included in broad money54 recorded an average annual growth of 1.0% in October and November, curbing their further slowdown. During these two months, lek deposits grew around ALL 5.0 billion, generally affected by the growth of demand deposits of private businesses and households. Foreign currency deposits shrank ALL 5.5 billion55, reflecting the decrease in time deposits of private businesses and households. Lek deposits continued to shrink, albeit at a lower rate than in the previous year, shrinking around 0.6% in November. Foreign currency deposits slowed down further, recording an annual growth of 2.4% in November.56

Deposits continued to shift from time to demand deposits, both in the Albanian lek and foreign currency. In parallel, the performance of deposits during these two months was also affected by the growth of time deposits with a maturity of above two years, particularly in the Albanian lek. Time deposits with a maturity of above two years have grown around ALL 13.3 billion since the beginning of 2014, bringing their share in total time deposits to 7.0%, or 2.0 percentage points higher than at the end of 2013.

53 The ratio of these investments to total household investments was 16.1% in November, from 14% at the end of 2013.
54 Demand deposits and time deposits with a maturity of less than two years.
55 Excluding the exchange rate effect, foreign currency deposits shrank ALL 7.0 billion in monthly terms.
56 Excluding the exchange rate effect, foreign currency deposits grew 1.2% in annual terms, displaying sharper slowdown.