Bank of Albania

MONETARY POLICY REPORT
2011 Q1

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OBJECTIVE

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

In line with its 2009-2011 strategy, the Bank of Albania is committed to achieving and maintaining annual inflation at 3.0%, with a tolerance band of +/- 1 pp. The announcement of the quantitative target for inflation aims at anchoring economic agents' expectations and lowering the risk premium.

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

Monetary Policy Report for 2011 Q1 was approved on 27 April 2011 by the Supervisory Council of the Bank of Albania. The economic analysis in this Report is based on the latest available statistical and qualitative data as at 15 April 2010.

I. FOREWORD BY THE GOVERNOR

The Albanian economy had a positive performance in 2011 Q1. Economic activity increased, the main macroeconomic balances improved, and risk premiums and interest rates in financial markets dropped. Economic growth during 2011 relies on foreign demand for Albanian goods as well as on domestic demand. Consumption and investments in the country remain slow, beyond the seasonal effect that characterizes the first quarter. The rapid expansion of exports and the moderate increase of imports have led to an improvement in trade deficit, contributing to the balancing of demand and supply for foreign currency and retaining the national currency value. Demand-inflation pressures remain contained, due to the existence of spare capacities in the economy and controlled consumption, while the rise in import prices was a principal contributor to the rise of prices in the country.

In March 2011, inflation pointed to 4.3%. Inflation averaged 4.0% in 2011 Q1, 1 pp above the medium-term target for inflation. The country's economy continued to grow during 2010 Q4, and indirect available data suggest that it continued to be positive in 2011 Q1. On average, this growth is estimated to have been lower than the potential growth of the economy, suggesting that domestic demand-side inflation pressures were weak. The rapid price rise over the last two months was mainly due to the price rise of food and oil in the international markets, which triggered a slight increase of inflation pressures and the emergence of second-round effects in February. In response to this phenomenon, the Bank of Albania raised its key policy rate by 0.25 pp at the end of March 2011. Inflation expectations remain anchored close to the medium-term target of the Bank of Albania. In addition to the domestic demand, the relative exchange rate stability contributed to preventing further inflation increase.

More specifically, during 2011 Q1, inflation reflected a hike in the prices of some food items, further rise of oil prices as well as an upturn in medication prices. With the warm season approaching, domestic agricultural output is expected to contribute to an upward domestic supply, thus curbing the high pressures from imported goods' prices. The Bank of Albania notes that policies that would encourage domestic production and reduce the exposure of the Albanian economy to external shocks are necessary.

Annual inflation of traded goods was 4.9% in 2011 Q1, accounting for about 75% of headline inflation. The main rationales behind this behaviour were the actual and expected aggravated conjecture of commodity prices, the unusual geopolitical situation in large economies producing oil and agro-industrial products, as well as the unfavourable weather conditions that have damaged agricultural production. Non-traded CPI inflation, which reflects the domestic pressures, was 2% in 2011 Q1. This figure is close to that of the same corresponding period in 2010 and comparable to its historical average.

The inflation trend, excluding temporary effects on it, or core inflation, was close to 3.0%, reaching high historical values. This long-term inflation component shows that inflation expectations in the economy, albeit higher, remain well-anchored with the Bank of Albania's target.

In the future, the inflation pressures along the time span of the monetary policy effect are expected to be high, but their intensity will be downward over the course of the year. I will further elaborate on the factors that determine inflation developments and relevant risks.

World economy grew in 2011 Q1, although unemployment remains high. Economic growth is expected to intensify, mainly owing to the private sector, hence allowing for the withdrawal of the public sector.

As a result of high divergences across countries, authorities deal with diverse challenges. In advanced economies, the focus is on reducing public debt and adjusting economic agents' financial balances, while in emerging economies, the underlying risk appears to be about the overheating of the economy and the high growth of credit. Inflation pressures are on the upside due to supply-side shocks in oil and other commodities markets. On the other hand, as a result of a rapid growth of demand in some developing countries, prices of factors of production, such as energy, raw materials and labour, rose. Projections for the future reveal heightened uncertainties, as a result of social and political turmoil and natural disasters in some countries of the world. Price rises worldwide and the extent of their transmission to various economies have affected the decisions on interest rates applied by some central banks. Therefore, as a result of the expectations for an inflation rate above the target, the European Central Bank decided to increase the interest rate on the main financing operations by 25 bps. Likewise, interest rates in the international financial markets increased slightly due to the expectations for higher inflation.

Albania's GDP grew by 5.4% y-o-y in 2010 Q4, thereby narrowing the negative output gap significantly. Economic growth relied on external demand and was boosted in positive terms by a consistent recovery of the global economy. The acceleration of real GDP annual growth rate in Q4 was triggered by a higher positive contribution of industry. Meanwhile, value added of services and agriculture contributed positively, albeit at a lower level, to the annual real GDP growth. The latest data on 2011 Q1 obtained from the business confidence surveys, the external trade performance, and monetary and fiscal indicators, provide evidence for the continuous domestic economy recovery, mainly due to the positive contribution of the production sector.

Partial data available on private consumption suggest its rapid growth y-o-y during 2010 Q4. In the meantime, partial data on 2011 Q1 suggest a moderate contribution of consumption to the aggregate demand. 2011 Q1 surveys show heightened uncertainties about the future, thus affecting the stable growth of consumption in periods ahead. The Bank of Albania considers that there is room, in the short run, for the Albanian consumer to adopt a more rational behaviour towards expanding consumption. Investments performance is assessed to have been more stable over the last two quarters. The increase in the external demand for producing businesses, the positive expectations for demand in some producing sectors, as well as the easier lending standards in 2010 Q4 signal the persistence of the positive contribution of private investments during the current year. Nonetheless, capacity utilization remains low and domestic consumption situation unclear, suggesting that the economy continues to operate below its potential.

Government spending provided major contribution to keeping demand at positive levels in 2011 Q1, in contrast to the previous year behaviour. At the end of 2011 Q1, budget deficit reached ALL 11.8 billion, against the surplus of ALL 0.7 billion recorded at the end of the same corresponding quarter in 2010. During this period, budget spending increased in nominal terms by 16.8% y-o-y, mainly due to the increase in current spending. Similar growth rates over the quarters ahead would be translated into higher contribution of Government spending to the aggregate demand as compared to 2010. Developments in revenues and spending led to a drop in the primary balance to negative values during 2011 Q1, after an apparent improvement in 2010 Q4.

Albania's current account net position registered a deficit of EUR 373.6 million in 2010 Q4, or 16.4% as a percentage of nominal GDP. In contrast to the first three quarters of the year, when the current account deficit narrowed in annual terms, in 2010 Q4, it widened by 15.1% y-o-y. The rationale behind the widening of the current account deficit was the widening of the trade deficit, despite the high increase in the export of goods and services by 20.7% y-o-y. Foreign demand continued to support economic growth in the first two months of 2011. The good performance of exports contributed to narrowing the trade deficit by 5.9% y-o-y for this period. The average coverage ratio of imports by exports was estimated at the all-time peak of 47.3%. Trade exchanges registered an annual growth of 30.4% in January and February. Exports' value maintained their accelerated upward trend that had commenced in 2010 Q1, and expanded by 66% y-o-y. The three-digit annual increase in electricity exports provided the major contribution to this performance, while processed metal exports and re-exported textiles continued to contribute positively to the annual exports' value.

In the post-global crisis period, domestic economy is adapting to a new growth model, which requires significant structural changes. During this process of resource reallocation to the most efficient sectors of the economy, as well as of a more conservative behaviour of Albanian households towards consumption, the potential output is expected to be lower in the medium run. The analysis of demand components shows that the improved growth rates in the last two quarters may have narrowed the negative output gap significantly, but the existence of spare capacities in the economy even during 2011 suggests that the Albanian economy will continue to operate below its potential, hence generating weak domestic demand-side inflation pressures.

On the supply-side, the increasing productivity in 2010 Q4 and the more sluggish increase in the cost per unit of output generate lower inflation pressures on the labour factor-side. The inflation pressures on prices in Albania, which derive from the fluctuation of oil and food prices in global conjectures, are expected to continue throughout 2011 but they will be constantly declining. Due to the aggravated geopolitical situation in the world, the uncertainty surrounding these expectations remains high. The absorbing capacity of the domestic economy to these shocks and the avoidance of steady pressures on inflation will condition the future performance of the Albanian economy and the control of economic agents' inflation expectations.

The performance of monetary indicators reflected the slowdown of money supply in the first two months of the current year, confirming contained monetary inflation pressures. The M3 aggregate grew by 11.2% y-o-y on average. The foreign currency component of the money supply provided downward contribution to the growth of broad money; however, the high use of foreign currency in the banking system and the economy remains one of the weaknesses of the Albanian economy. As an expression of its interest in addressing this issue, in April, the Supervisory Council of the Bank of Albania decided to remove the remuneration of the required foreign reserve. This measure will effectively encourage banks to lower the cost of fund collection and will favour intermediation in domestic currency. Public and private economic agents' demand for money is higher. Our assessments indicate that the growth of money is in line with the private sector demand for real money. The performance of private sector lending corresponded to its seasonal behaviour at this period of the year, increasing on average by 10.1% y-o-y. Although credit developments have been slow so far, there are encouraging signs for a better performance of lending in the future. Private sector demand for credit, whose low level has been the primary obstacle for the revitalisation of lending, grew in 2011 Q1 and is expected to grow in Q2 as well. The banking system is sound and it enjoys good levels of liquidity to support the growing demand for credit, with even better lending standards. The Bank of Albania supports the banks' initiative to clean up their balance sheets, aiming at enhancing the transparency and creating free funds to support lending.

The overall performance of financial markets was positive in 2011 Q1. In light of its primary objective to maintain price stability, the Bank of Albania decided to raise the key interest rate at the end of March. This decision was reflected in higher interest rates in the interbank market, while it is expected to be transmitted into other markets in the period ahead. In parallel with this move, the Bank of Albania has supplied the interbank market with the necessary liquidity to ensure its smooth functioning. In the meantime, interest rates in the deposit market continued their declining tendency. Interest rates in the credit market were volatile; they increased for ALL credit and decreased for EUR credit. This performance, however, is considered to represent individual bank policies for certain segments of the economy. Lastly, the nominal effective exchange rate reduced its depreciation trend for the seventh quarter in a row. Our analyses indicate that, overall, the underlying factors of the economy are supporting a new exchange rate equilibrium, which, albeit higher than three years ago, is adjusting to domestic financial and economic equilibriums, and in turn enhancing the competitiveness of the Albanian economy in the international markets. The stable exchange rate has contributed to firming up financial stability at home further, exerting no pressure on banks' activity and conduct of economic agents.

Our future projections support the preservation of the positive performance of the Albanian economy in 2011. Consumption and private investments are expected to increase further, while the fiscal sector – albeit slower in 2010 – is expected to contribute positively to the economic growth. Notwithstanding this, the growth of demand is expected to remain below the potential of our economy in 2011.

This will keep the inflation pressures arising from the domestic economy on the downside and they are expected to offset the effect of rising import prices. The Bank of Albania is determined to take all the necessary measures in due time to observe its inflation target in the medium run.

II. EXTERNAL ECONOMY

II.1. ECONOMIC GROWTH AND MACROECONOMIC BALANCES

GLOBAL ECONOMY

Economic activity continued to grow in 2011 Q1, though unevenly across different countries, regions and sectors. These imbalances are a reflection of the economic and financial structures, the policies pursued to weather the crisis and the economic cycle phases the economies are in. This growth, however, seems to rely mostly on consumption and private investments and is becoming considerably less dependent on the fiscal stimulus. Indeed, against a background of high public debt figures and escalating inflation, monetary and fiscal policies are becoming more conservative. The inflation pressures have mounted due to the rise in the prices of agricultural products, oil and other commodities. The global-wide growth of demand contributed to elevated inflation pressures as well. The latter were higher in emerging and developing economies, which are highly dependent on food and energy prices. There is heightened uncertainty about the future outlook due to the social and political turbulence in oil-producing countries and the financial concerns in the peripheral euro area countries.

Table1 Selected macroeconomic indicators

	GDP change		Unemployment rate	Inflation rate	
Country	Q4 2010/ Q4 2009	Q4 2010/ Q3 2010	February 2011	March 2011/ February 2011	March 2011/ March 2010
USA	2.8	0.7	8.81	0.53	2.13
Euro area	2.0	0.3	9.9	1.4	2.7
Germany	4.0	0.4	6.3	0.5	2.1
France	1.5	0.3	9.6	0.8	2.0
United Kingdom	1.5	-0.5	7.82	0.3	4.0
Japan	2.6	-0.3	4.6	-0.13	0.03

Source: Eurostat, respective statistical institutes

[1] *Data for March.*

[2] *Moving average for December 2010 – February 2011.*

[3] *Data for February.*

EURO AREA

The upward economic tendency, which began in mid-2009, persisted in 2010 Q4. Euro area's economy expanded at an annualized rate of 2%. Consumer spending and the exports increase in certain countries, were the driving force of this growth. Preliminary data on retail sales and confidence indices suggest that the positive momentum euro area's economy is going through persisted in the early months of 2011 as well. The increasing domestic demand and exports are expected to continue to drive economic growth this year. Unemployment, albeit high, dropped slightly in February. Annual inflation continued to increase in 2011 Q1 and averaged 2.5%. To a large extent, this increase reflects the price rise in energy and raw materials in the global markets.

USA

US economic activity continued to grow in 2010 Q4. GDP expanded by 2.8%, triggered by the improvement in consumer spending, higher exports and aggregate investment. The growth rates of industrial production accelerated in Q4. Industry confidence survey results expect the growth rates to persist in 2011 Q1. The Fed continued to pursue an aggressively stimulating monetary policy through the implementation of a quantitative easing programme and the purchase of T-bills aiming at firming up the economic growth rates. However, the improvement in labour market figures still lags behind the performance of economic activity, and the unemployment rate remains high. Annual inflation in February rose to 2.1% due to higher food and energy prices.

BRIC ECONOMIES[1]

BRICs' economic activity continued to grow in 2010 Q4 and the early months of 2011. China's economy expanded at an annualized rate of 9.6% in Q4 due to higher industrial production and exports. The accelerated economic growth rates in India were triggered by the increase in aggregate investment and the decline in imports. In Brazil, the continuous export growth rates contributed to the annual performance of the economy. After the termination of the negative effects of droughts that swept across Russia in 2010 Q3, economic activity recovered in Q4 driven by the rise in energy raw material prices. On the other hand, the rapid economic growth in BRIC countries reflected in mounting inflation pressures in these economies, thus giving rise to higher food and oil prices in the global markets.

Table 2 Selected macroeconomic indicators for BRIC economies

Country	Real GDP y-o-y change			Annual inflation
	2010 Q3	2010 Q4	2011[1]	February 2011
Brazil	6.8	5.0	4.5	6.32
Russia	2.9	4.3	4.5	9.5
India	8.9	8.2	7.8	8.3
China	10.6	9.8	9.5	4.9

Source: IMF, OECD, respective statistical institutes
[1] IMF estimates, April 2011.
[2] Data for March 2011.

The central banks of China and India raised their respective key interest rates, while those of Russia and Brazil were kept unchanged. BRICs' policymakers were also faced with the rapid appreciation of their currency due to the high capital inflows, which may, in turn, hamper their economic growth.

[1] A grouping acronym that refers to the countries of Brazil, Russia, India and China.

REGIONAL ECONOMIES

Economic activity in the regional economies registered growth in 2010 Q4, except for Greece, which represents an essential exception. The downward trend of the Greek GDP, which commenced in 2008 Q4, accelerated further in 2010 and peaked in Q4. Greek GDP shrank at an annualized rate of 6.6%, driven by the accelerated decline in consumer spending and aggregate investment. On the other hand, the Italian GDP expanded by 1.5% y-o-y during the quarter under review. The increase in consumer spending and aggregate investment provided the major contribution to this growth. FYROM's[2] GDP expanded by 2.3% y-o-y in 2010 Q4, driven by the higher exports and investment, mainly from the construction sector. Turkish GDP expanded by 9.2% in 2010 Q4, driven mainly by the increase in consumer spending and private investment. Data on industrial production in the early months of 2011, which serve as indirect indicators on economic performance over the period under review, show its annual decline in Greece and FYROM and its annual growth in Italy and Turkey. Unemployment rate dropped in Italy, Turkey and FYROM, and increased in Greece. Annual inflation rate was up in Greece, Italy and FYROM; in Turkey, it pursued a downward trend. In line with the global tendencies, the inflation rate rose in all the regional countries.

Table 3 Economic figures for regional countries

Country	GDP change	Annual inflation	Unemployment rate
	2010 Q4	March 2011	February 2011
Italy	1.5	2.6	8.4
Greece	-6.6	4.3	15.13
FYROM	2.3	5.2	30.94
Serbia	1.7	12.62	20.05
Croatia	-0.6	2.6	19.6
Turkey	9.2	4.0	11.93
Kosovo	4.61	10.8	:
Albania	5.4	4.3	13.54

Source: Respective statistical institutes, EuroStat, EcoFin, IMF
[1] IMF's projection for 2010.
[2] Data for February.
[3] Data for January.
[4] Data for 2010 Q4.
[5] Data for 2010 Q3.
: Unavailable data.

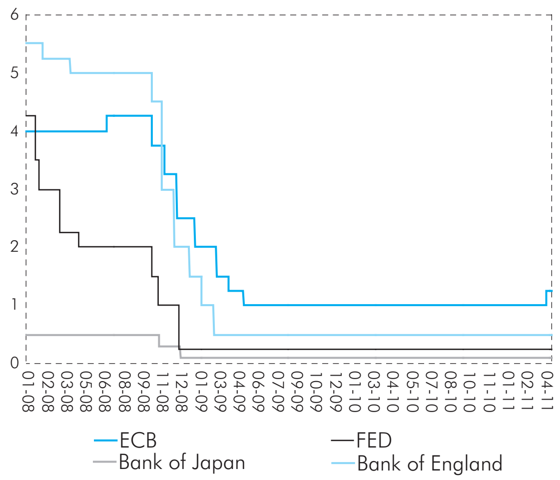
II.2. INTEREST RATE DECISIONS AND FINANCIAL MARKETS

The mounting inflation pressures and their reflection in the future outlook led the ECB to raise the key interest rate to 1.25% in April. This move followed a nearly two-year period of a highly stimulating monetary policy characterized by key interest rates at record lows. Although the key interest rate hike does not change the ECB's monetary policy stimulating nature, it does signal its will to curb the medium- and long-term inflation pressures. Central banks

[2] *Former Yugoslav Republic of Macedonia.*

of some major advanced economies kept their key policy rates unchanged. Hence, the Fed, Bank of England, and Bank of Japan kept the key policy rates unchanged at 0-0.25%, 0.5% and 0-0.1%, respectively.

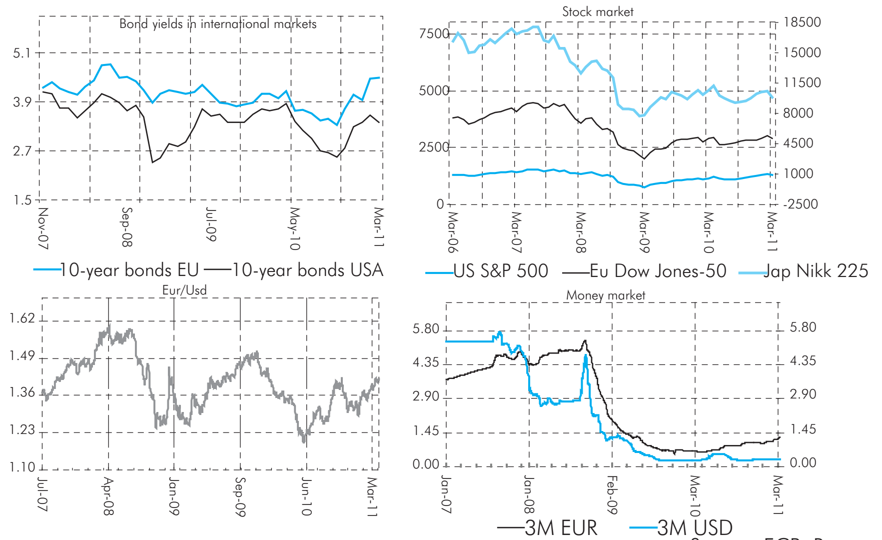
Chart 1 Key policy rates



Source: ECB, FED, Bank of England, Bank of Japan

Financial markets showed a slight upward tendency in 2010 Q4. Long-term interest rates in the euro area's money markets increased over the stated period. The rise in raw material and energy prices re-dimensioned market agents' expectations of key rates in the medium-term horizon and reflected in the increase in Euribor rates for all maturities. The ask yields in the bond markets continued to show a slight upward tendency for all categories of issuers[3] due to the positive results and optimistic signals for the economic outlook in the major euro area countries and the USA. The emergence of political upheavals in North African countries shifted a portion of security market demand to safe instruments. Subsequently, the upward tendency of bond yields in Europe and the USA curbed in the early part of the quarter, though their average remains well above the recent months' average. The main stock market indices increased over the stated period due to the positive results of a number of businesses and the improved market agent perception of the overall economic outlook.

Chart 2 EUR/USD (left) and LIBOR, USD, EUR (right)



Source: ECB, Reuters.

In March 2011, Euribor interest rates of 1, 3, 6 and 12 months averaged 0.90%, 1.18%, 1.48% and 1.93%, up by 0.10, 0.18, 0.23 and 0.40 pp, respectively, from December. The 3-month US dollar LIBOR interest rate rose slightly by 1 bps to 0.31%. The yields in the bond markets in Europe, Japan and USA increased and showed higher volatility than in the previous month.

[3] In this specific context, it refers to the countries of different sovereign risk ratings.

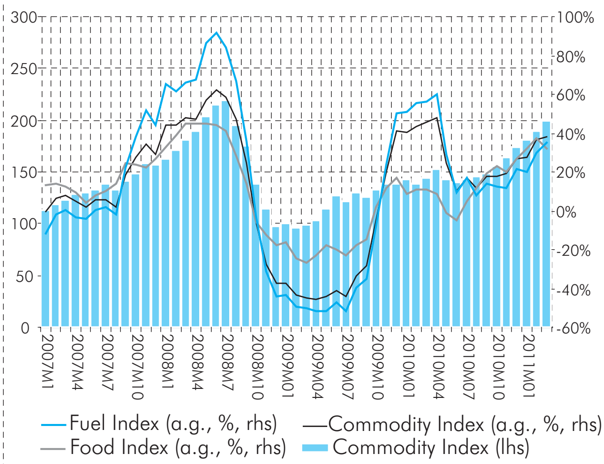
In the foreign exchange markets, the Euro continued to appreciate against the US dollar over the stated quarter. In the beginning of April, 1 Euro traded at USD 1.41 or up 6.1% from end-December. The Euro appreciated by an average of 0.72% over this quarter.

II.3. OIL AND PRIMARY COMMODITY PRICES IN THE INTERNATIONAL MARKET

The upward tendency of primary commodity prices, which had begun in mid-2010, persisted in 2011 Q1. The improved global economic output and future outlook were the main drivers of this rise. The Commodity Price Index rose 34.1% y-o-y in Q1 and 15% compared to the previous quarter. For the same stated period, Food Price Index rose 33.8% y-o-y and 10.4% q-o-q. Worth noting is that in March, it fell slightly in monthly terms due to the unrest in Libya and the natural disaster in Japan. For the same period under review, Fuel Price Index rose 28.5% y-o-y and 16% q-o-q.

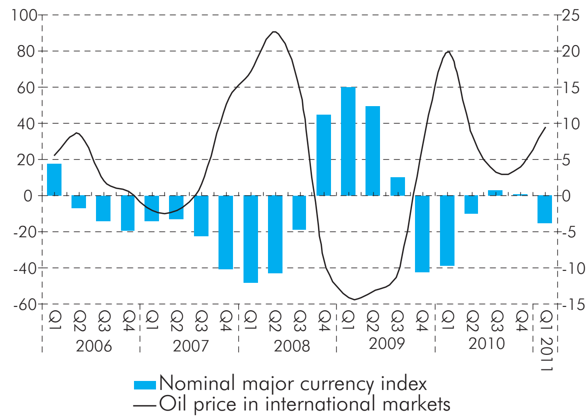
Oil price per barrel in the international market accelerated its upward trend in 2011 Q1. Compared to the same quarter in 2010, it rose by an average of 37.7% y-o-y, to USD 105/barrel. The main drivers of this rise were the depreciation of the US dollar against some of the major currencies and the geopolitical unrest in some of the major oil-exporting countries[4]. Given that some of the countries facing social and political turbulences are oil-producing countries, the uncertainty is expected to affect the price of oil in the international markets.

Chart 3 Price indices by primary commodity and their y-o-y changes



Source: IMF

Chart 4 Annual change of oil price in international markets and nominal major currencies dollar index



Source: Eurostat, EIA

[4] *The nominal major currency index, which is constructed by the Fed and includes 26 weighted foreign currencies expressed in USD, showed the depreciation of the USD by 3.9% y-o-y.*

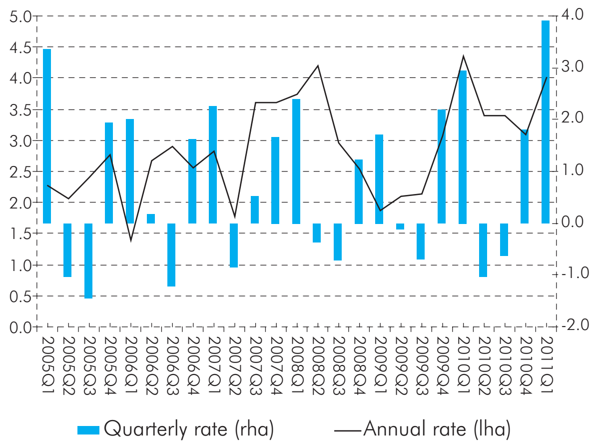
III. PRICE STABILITY AND BANK OF ALBANIA'S TARGET

The inflation pressures deriving from the external economy mounted in 2011 Q1 causing the average annual inflation rate to increase to 4.0%. The still weak domestic demand-side inflation pressures, the relative exchange rate stability and the anchored inflation expectations helped rein in the further increase of inflation.

The inflation pressures are expected to be high but less volatile than the current level. The Bank of Albania will continue to monitor them and aim at adjusting the monetary policy in view of observing its inflation target of 3%.

III.1.PRICES OF CONSUMER BASKET ITEMS

Chart 5 Annual inflation by quarters and quarterly inflation, in %



Source: INSTAT, Bank of Albania

Annual inflation averaged 4.0% in 2011 Q1, hence reaching the upper boundary of the tolerance band set by the Bank of Albania. This figure was affected considerably by the inflation of February and March, which marked 4.5% and 4.3%, respectively. Inflation in 2011 Q1 reflected the high prices of some (processed and unprocessed) food products[5], and the further price rise in some goods[6]. The seasonal behaviour was in line with the historical performance: q-o-q inflation rate was positive (3.9%) but higher than in the first quarters of previous years[7].

The price hikes in the last two months were by and large determined by the higher food and energy product prices in the global markets. Against a background of continuous hikes in primary and raw material prices in the global markets[8], the high share of imports in the domestic market supply led to an apparent increase of the CPI. The persistent historical peaks in the exchange rate in the last two years continued to exert additional pressures on inflation. Domestic agricultural output, which has a seasonal nature, began to boost the market supply in

[5] *The two food basket items "processed foods" and "unprocessed foods" contributed by 70% to the formation of headline inflation.*

[6] *Worth noting is the substantial rise in oil and medicament prices within the item of "non-food consumer goods", which formed around 15% of headline inflation in Q1.*

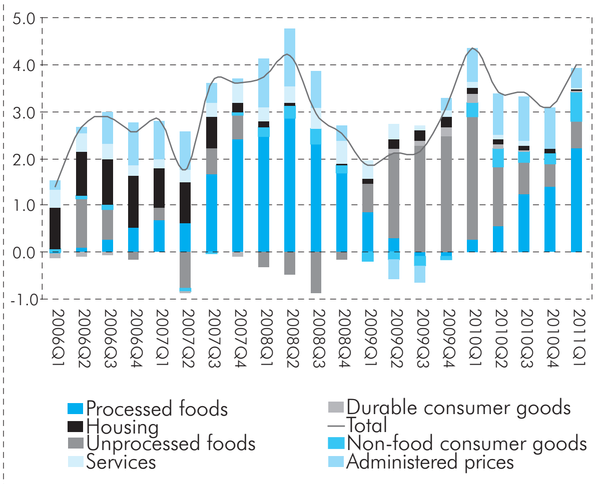
[7] *Based on CPI's seasonal performance, this quarter's inflation rate was 1.5 pp above the average rate of 2.4% during 2005 - 2010.*

[8] *Due to the geopolitical upheaval in some parts of the globe that curbed the supply for these commodities.*

March[9]. The price rise in some goods in particular, like medicaments and goods subject to excise, gave rise to higher inflation in Q1. In March, however, the inflation rate dropped slightly.

Annual headline inflation in Q1 was entirely formed from the contribution of "Processed foods", "Unprocessed foods", "Non-food consumer goods" and "Administered prices". The prices of "Housing", particularly rental prices, revitalized in March. Inflation of "Processed foods" and "Non-food consumer goods" maintained the quick increase that had begun in the preceding three months.

Chart 6 Contribution of key items to annual inflation, in pp



Source: INSTAT, Bank of Albania

The inflation rate of "Processed foods" approached its figures of 2008, a period that was characterized by very high prices of these goods. This item recorded double-digit inflation figures and provided a progressive upward contribution to headline inflation[10]. The global conjecture of processed food prices[11], coupled with the price rise of oil in the global market, gave rise to mounting inflation pressures in the Albanian market. Worth noting within this item is the price rise in "Bread and grains" and "Alcoholic beverages and tobacco", which contributed by 0.7 pp and 0.5 pp[12] to headline inflation.

The annual contribution of "Non-food consumer goods" to headline inflation was 0.6 pp in 2011 Q1. The price rise in the sub-item of "Health", due to the rise in medicament prices, drove this item's contribution to inflation in February and March to grow 0.2 pp higher. In addition, the sub-item of "Service to personal vehicles" registered an average increase of 11.4% y-o-y due to the further rise in oil price. The increasing tendency of oil price in the international markets during the past three months was also reflected in the prices at home, reaching their peak during this period. The extended effect of this factor, coupled with the food price rise, continues to exert additional pressures on domestic inflation, thus increasing the probability for the emergence of chain shocks to inflation.

[9] *Particularly, the contribution of "Vegetables" to headline inflation fell to 0 from 0.5 pp in February.*

[10] *In 2011 Q1, "Processed foods" formed 55% of inflation. Its contribution to inflation averaged 2.2 pp.*

[11] *At year-end 2010 and the early months of 2011, the rise in processed food prices, as reported by the latest data of Food and Agriculture Organization of the United Nations, was strong and exceeded the high levels registered in mid-2008.*

[12] *The contribution of "Alcoholic beverages and tobacco" has fluctuated around an interval of 0.1-0.2 pp during its historical performance.*

Table 4 Contribution of items to annual inflation, in pp

	Q1 2009	Q2 2009	Q3 2009	Q4 2009	Q1 2010	Q2 2010	Q3 2010	Q4 2010	Q1 2011
Processed foods (pp)	0.9	0.3	-0.1	-0.1	0.3	0.6	1.1	1.4	2.2
Bread and grains (pp)	0.6	0.2	-0.1	-0.3	-0.2	-0.1	0.1	0.4	0.7
Alcoholic beverages and tobacco (pp)	0.1	0.1	0.1	0.2	0.1	0.2	0.2	0.2	0.5
Unprocessed foods (pp)	0.6	1.8	2.3	2.5	2.6	1.3	0.9	0.5	0.6
Fruit (pp)	0.0	0.3	0.5	0.6	0.2	0.1	0.3	0.1	0.2
Vegetables (pp)	-0.3	1.4	0.9	1.0	2.0	1.5	0.1	-0.7	0.1
Services (pp)	0.4	0.3	0.1	0.1	0.1	0.1	0.1	0.0	0.0
Administered prices (pp)	0.1	-0.4	-0.4	0.3	0.7	0.9	1.0	0.9	0.4
Fuels and energy (pp)	0.4	0.0	0.0	-0.1	0.4	0.4	0.4	0.4	0.2
Housing (pp)	0.1	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.2
Non-food consumer goods	-0.2	-0.2	-0.2	-0.1	0.3	0.4	0.3	0.2	0.6
Durable consumer goods (pp)	0.0	0.1	0.1	0.2	0.2	0.1	0.0	0.0	0.0
Consumer Price Index (y-o-y, %)	1.9	2.1	2.1	3.1	4.3	3.4	3.4	3.1	4.0

Source: INSTAT, Bank of Albania

"Unprocessed foods" registered high inflation rates, rising markedly in February. Domestic production incapacity[13] to meet demand during this period and the consequent meeting of needs with imported goods were the main factors that led to higher food prices in the domestic market. Against a background of Lek's depreciation against the two major currencies, the higher imports of these goods were an additional risk. In addition, last year's floods and the unfavourable weather conditions may have created a gap between domestic supply and demand for these goods. The lower inflation in some of its sub-items[14] led to the decrease of the inflation rate in March[15]. Monthly inflation of "Unprocessed foods" marked -1.8% during this period, substantially lower compared to 8.2% in February, the peak rate since December 2005.

"Administered prices" contributed by 0.4 pp to headline inflation[16], hence reflecting the termination of the electrical energy price rise effect in January 2010. The other items continue to provide a low contribution to headline inflation. Prices of "Housing", particularly of "Rent" and "Imputed rent" spiked in March. This item's contribution to headline inflation was trivial throughout the course of 2010, whilst in March it rose to 0.3 pp.

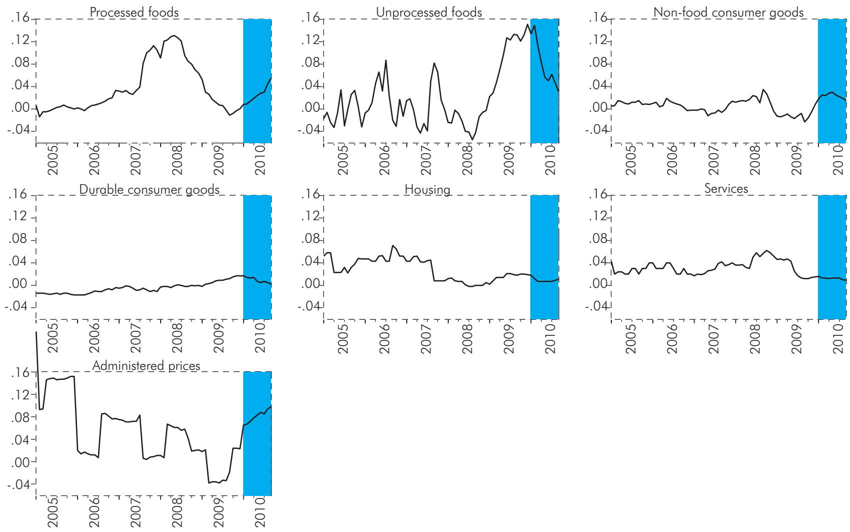
[13] *The Albanian market supply with agricultural products during this period of the year is, to a large extent, supplemented with import goods.*

[14] *The higher supply with seasonal domestic production met demand better during this period.*

[15] *In particular, the contribution of "Vegetables" to headline inflation fell to 0 from 0.5 pp in February.*

16 *In December 2010, this item's contribution to headline inflation was 1.0 pp.*

Chart 7 Annual inflation by items of goods and services, in %



Source: INSTAT, Bank of Albania

III.2.MAIN INFLATION TRENDS

Annual core inflation[17] came close to the figure of 3.0% in 2011 Q1, which is comparable to mid-2008 and one of the peak rates in the last decade. The increasing tendency of core inflation sharpened in February and March due to the continuous price rise in "Bread and grains"[18]. In addition, following the trend since fall 2010, the early months of 2011 faced subsequent price rises in other important sub-basket items core inflation is measured on; among them, the price rise in other processed food products, transportation services in response to the rise in fuel prices, further rise in pharmaceutical product prices due to the inclusion of pharmaceutical activities in the VAT scheme, and the price rise in "Rent" which contributed by 0.15-0.32 pp to core inflation[19]. In response to the rising tendency of prices, core inflation provided the peak historical contribution to the formation of headline inflation (52%). The rest of inflation was formed by the non-core component, which was 6.6% in 2011 Q1, markedly lower than in the same corresponding period in 2010, thus providing evidence for the important role the exchange rate plays in the short-term fluctuations in inflation.

Annual traded inflation marked 4.9% in 2011 Q1, accounting for 75% of the headline inflation figure. The current and expected severe conjecture of primary commodity and raw material prices, the unusual geo-political situation in important oil and agro-industry-producing countries, and the weather conditions, which hampered foreign and domestic supply with agricultural products, drove this sector's inflation higher in Q1. Despite the direct inflationary impact of these factors, traded inflation was 0.4 pp lower in

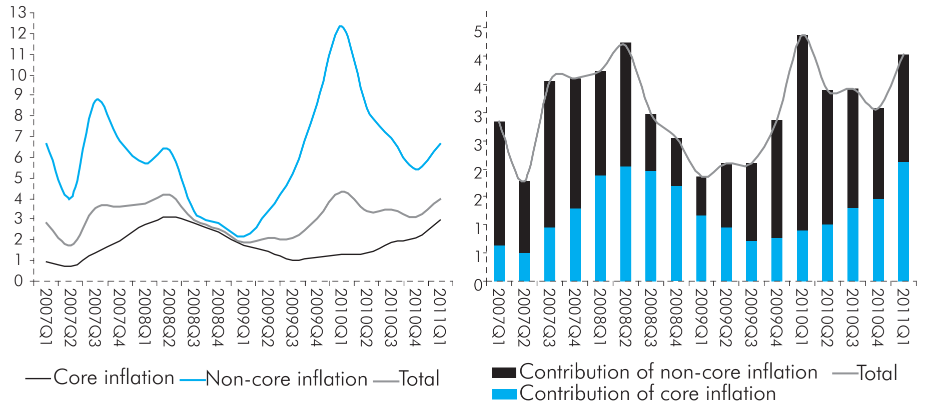
[17] *Average of two measures (permanent exclusion and trimmed mean).*

[18] *The exclusion of this sub-item from one of the core inflation measures would reduce the latter by 1.1 pp in the corresponding quarter.*

[19] *The share of "Rent" and "Imputed rent" in the CPI basket is 11%. These sub-items' share in core inflation is 14%.*

2011 Q1 than in the same corresponding quarter in 2010. By and large, this performance attributes to the more moderate depreciation of the exchange rate in Q1 compared to the same quarter in 2010.

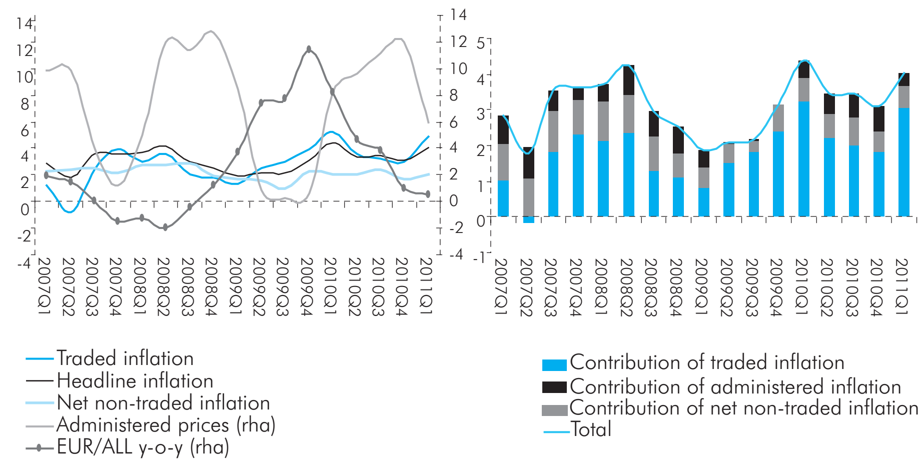
Chart 8 Core and non-core annual inflation (left) and their respective contribution (right)



Source: INSTAT and Bank of Albania

Non-traded inflation, net[20], of the CPI basket was 2% in 2011 Q1, quite similar to the same corresponding quarter in 2010 and comparable to the last five year's average (2.2%). It contributed by 16% to the formation of headline inflation. In terms of inflation and contribution, non-traded sector registered higher rates compared to the same quarter in 2010, due to the price rise in rent items[21]. In light of these developments, the difference between traded and non-traded inflation, net, widened in 2011 Q1.

Chart 9 Annual inflation by sector (left); respective contributions and EUR/ALL annual exchange rate (right)



Source: INSTAT and Bank of Albania

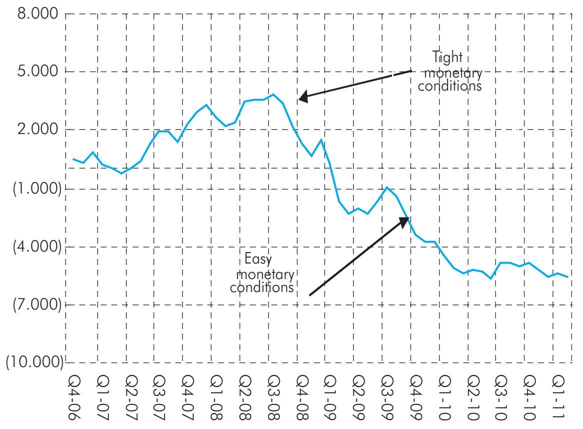
[20] *It excludes the effect of movements in administered prices (electricity, water and hospital services).*

[21] *Their average annual contribution to non-traded inflation was 0.4 pp. These items account for about 33% of non-traded sector, net, of the CPI basket.*

III.3.INFLATION AND MONETARY POLICY

The main macroeconomic policies, specifically monetary and fiscal policies, have fuelled aggregate demand in the last two years. Monetary and fiscal policies have, in a concerted manner, aimed at creating appropriate monetary conditions in order to ensure a stable economic growth and meet the inflation target in the medium run. The monetary conditions had a clear stimulating nature, reflected in the performance of interest rates and the exchange rate. The strong fiscal correction in 2010 H2 was coupled with the key interest rate cut.

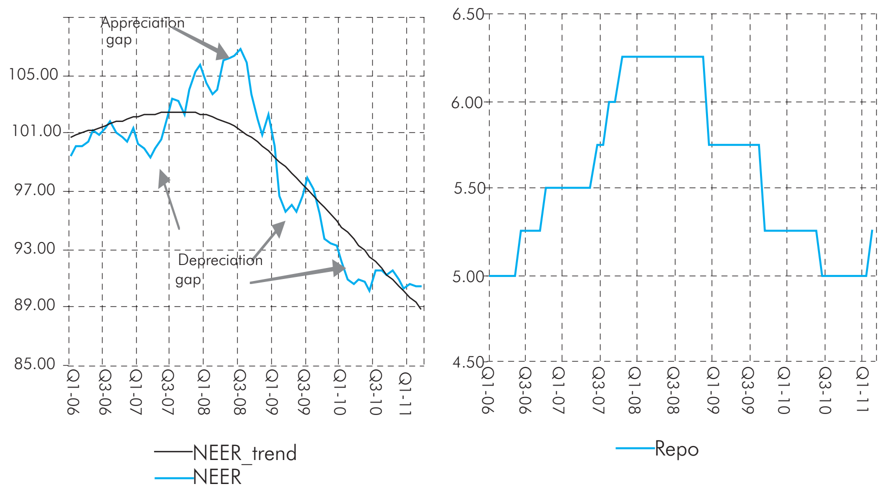
Chart10 Monetary Conditions Index (MCI; change from base year)



Source: Bank of Albania and staff estimates

The key interest rate cut helped lower the cost of lending to the economy. Meeting the market's liquidity needs helped the banking sector carry out its intermediation role, whilst the depreciated exchange rate contributed to balancing the external sector of the economy through higher exports and curbed imports.

Chart 11 MCI components, NEER (left) and Repo (right)



Source: Bank of Albania and staff estimates

The Albanian economy grew in 2010, while CPI inflation decreased in line with our projections and market agent expectations. On the other hand, the inflation pressures mounted in 2011 Q1. Average annual inflation was 1 pp above the Bank of Albania's target. The added inflation pressures originated mainly from outside the Albanian economy. They were triggered by the rise in raw material, food and oil prices in the global markets. Their impact on domestic inflation was, however, strong in response to the depreciated exchange rate and some signals for the recovery of domestic demand. Therefore, in February and March, the average inflation rate jumped over the Bank of Albania's target, while the inflation projections shifted on the upside for the remainder of the year.

Based on the current developments and projections of macroeconomic indicators, the Supervisory Council of the Bank of Albania decided to raise the key interest rate by 0.25 pp in March 2011 to 5.25%. This move aimed at creating more adequate monetary conditions for meeting the inflation target in the medium run. It signals the Bank of Albania's commitment to keeping inflation at around 3%, contributing, in turn, to the anchoring of inflation expectations and curbing the emergence of second-round chain phenomena. Even after this move, monetary policy and monetary conditions continue to be stimulating. In addition, they match with a higher expected contribution of the public sector to the growth of aggregate demand in 2011.

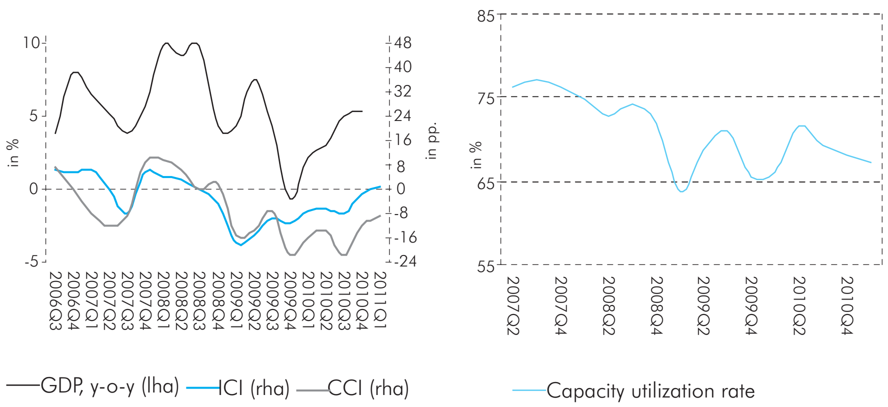
The reflection of this move has been more complete in monetary and Government security markets. Other financial market segments responded less to this move, hence being in line with their historical behaviour.

IV MACROECONOMIC DEVELOPMENTS AND IMPACT ON INFLATION

IV.1. GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

The Albanian economic activity expanded further in Q4, thus maintaining the growth registered in the first three quarters of 2010. Economic growth was principally driven by foreign demand, which was sustained by the continuous recovery of global economy and the stimulating exchange rate depreciation effect. Domestic demand also showed positive signals in 2010 Q4. The improved activity in manufacturing and greater banking system intermediation pushed domestic demand to recover over this period. The latest data on 2011 Q1 corroborate the persistence of economic activity recovery in Albania.

Chart 12 GDP annual growth, Industry and Construction Confidence Indices (left), Capacity Utilization Rate (right)

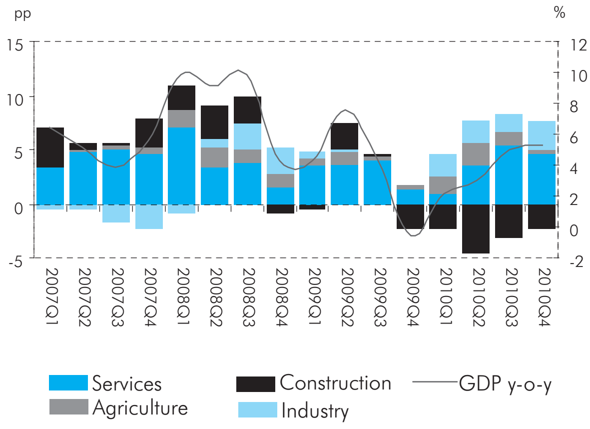


Source: INSTAT and Bank of Albania estimates

IV.1.1. OUTPUT BY SECTORS

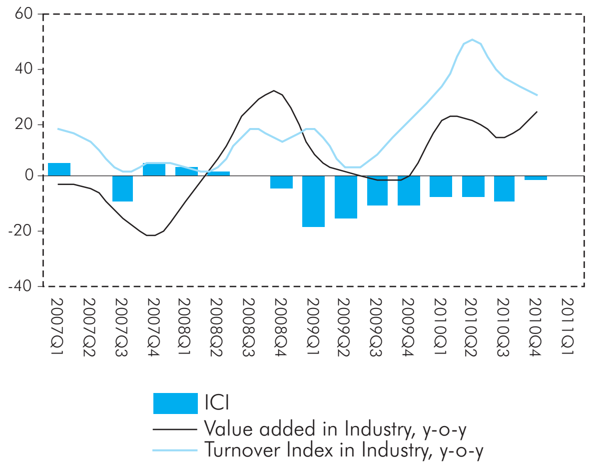
Economic growth in Albania accelerated in 2010 Q4, reflecting the positive performance of manufacturing and services, the increase in exports, and the low comparative base of the same corresponding period in 2009. Real GDP expanded by 5.4% in Q4, after growing at an annualized rate of 2.2%, 3% and 5%, respectively, in the first three quarters of 2010. Economic growth in Q4 was driven by the sharp increase in the contribution of industry, while value added in services and agriculture contributed to a lower extent to GDP annual growth.

Chart 13 Contribution of branches (in pp) to annual GDP growth (in %)



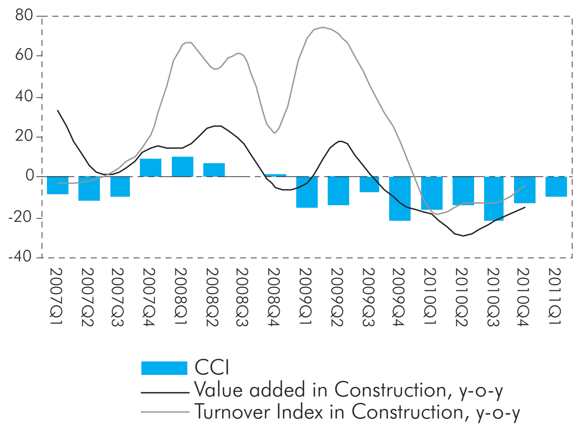
Source: INSTAT, Bank of Albania and its estimates

Chart 14 Value added, turnover index and Industrial Confidence Index



Source: INSTAT and Bank of Albania

Chart 15 Value added, Turnover Index, and Construction Confidence Index



Source: INSTAT, Bank of Albania and its estimates

GDP growth in 2010 Q4 was principally driven by the higher output in industry. The latter's contribution to GDP growth increased by 1 pp from the previous quarter (2.6 pp from 1.6 pp). In terms of value added, industrial activity expanded by 25% in Q4 compared to the same corresponding quarter in 2009. Average annual change in industrial production was 19.1% in the first nine months of 2010.

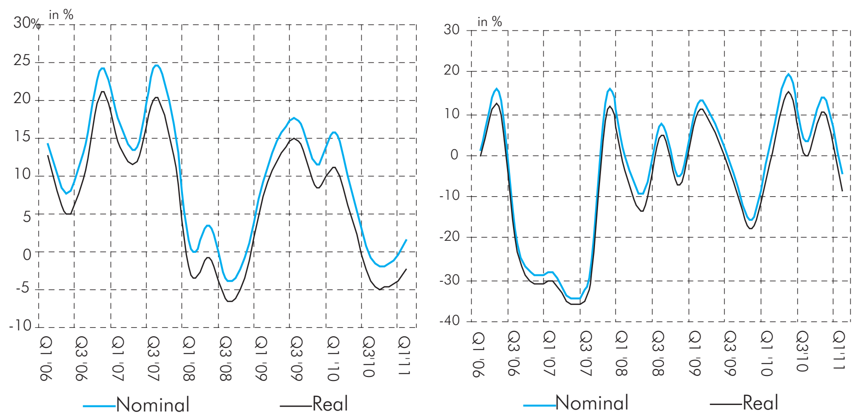
The higher industrial production noted throughout 2010 combined with an increasing tendency of order contracts and recovery of industrial exports. The exports of industrial goods increased by 50% in 2010 Q4. Based on information obtained from short-term statistics, the acceleration of the annual growth rates of value added in industry in Q4 was sharper in the sub-branches of "production of electricity, gas and water" and "extracting industry". The improved Industrial Confidence Index in 2011 Q1 and the optimistic business expectations for 2011 Q2 signal the persistence of growth in industrial production.

Construction decelerated its decline for the second quarter in a row in 2010 Q4. Value added in this branch dropped at an annualized rate of 14.4% in Q4, down by 6.8 pp and 9.2 pp compared to 2010 Q3 and H1. The latest quantitative data on loans for construction and residential purposes, the increase in the number of building permits approved for construction and engineering works, and other qualitative data obtained from surveys corroborate the continuous recovery of construction output in 2011 Q1. Construction Confidence Index improved in 2011 Q1 for the second quarter in a row.

*Box 1 Residential market prices in 2011 Q1**

Residential prices rose 1.5% in 2011 Q1 compared to the same corresponding quarter in 2010. They rose 0.9% compared to 2010 Q4. The annual nominal rise in Q1 terminated the declining trend of prices that had commenced in 2009 Q3. CPI deflated, House Price Index fell by 2.5%. A portion of this index's annual change, whose construction is based on the conversion of house prices expressed in EUR to ALL, reflects the depreciation effect of the Albanian Lek to the Euro. Adjusted for the exchange rate effect, the annual nominal price rise in the capital, Tirana, is 1.2%. In real terms, it is -2.7%.The developments in house prices in 2011 Q1 were triggered by the slight recovery in supply and demand. The number of building permits for new residential buildings increased in 2010 Q4 after the annual decline in the last four quarters. Despite this improvement, it continues to limit the future number of residential buildings available for sale, thus giving rise to high current sale prices.

Chart 16 House Price Index and Rental Price Index

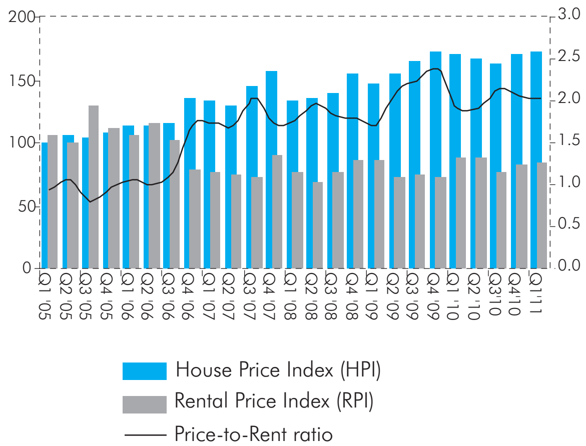


Source: Bank of Albania

The easier lending standards for residential purposes provide evidence for the growth of demand, which in turn may have triggered the slight rise of prices in Q1. However, the continuous rising tendency of residential prices would only occur provided that demand recovers at stable rates.

Rental Price Index showed higher volatility over the stated period compared to House Price Index. In 2011 Q1, it fell by 4.5% y-o-y, while in 2010 Q4, it rose 13.5%. Rental Price Index rose 1% q-o-q in Q1.

Chart 17 Price-to-rent ratio



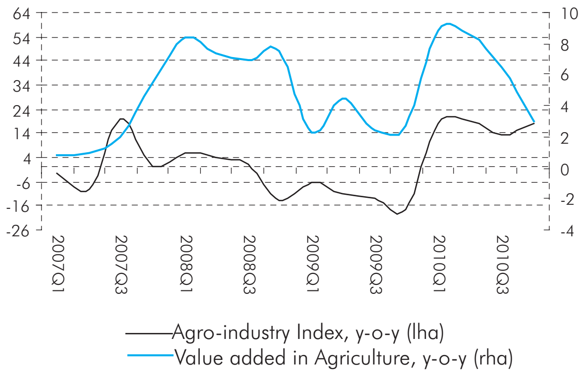
Source: Bank of Albania

The price-to-rent ratio was constant over the stated period due to the similar trend of its two constituents in quarterly terms. This ratio currently stands slightly above its historical trend.

* *The analysis of house and rental prices is based only on information about prices in the capital, Tirana.*

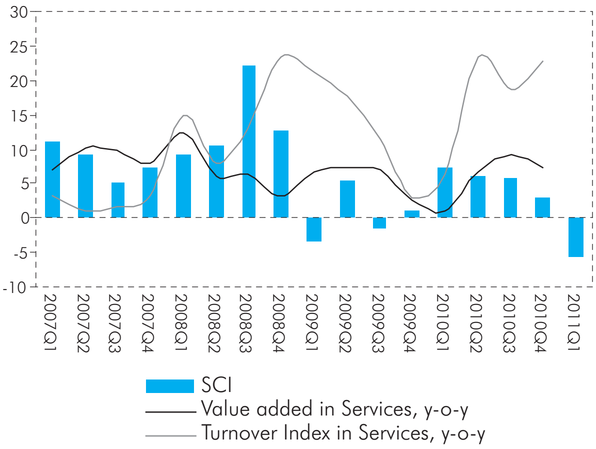
Value added of agriculture slowed down its annual growth rate in 2010 Q4. It increased by 3% compared to the average annual growth of 8.8% in the previous three quarters. Agriculture contributed by only 0.5 pp to real GDP growth in 2010 Q4. Agro-industry index, which decelerated its growth rate in 2010 Q2 and Q3, rose 15.5% in Q4.

Chart 18 Value added in agriculture and agro-industrial production



Source: INSTAT and Ministry of Agriculture, Food and Consumer Protection

Chart19 Value added, Turnover Index and Services Confidence Index



Source: INSTAT and Bank of Albania

After the high annual growth rates in 2010 Q2 and Q3, value added of services decelerated its growth rate in Q4. Although the annual change by +7.8% of value added in Q4 was nearly 2 pp lower than in Q3, it contributed by 4.6 pp or 65% to real GP growth. Comprehensive data by main branches show the deceleration of the growth rates in "Transportation" and "Other services". On the other hand, "Trade" registered positive growth in Q4, thus accelerating the growth rate of value added. Value added of "Postal and telecommunication services" continued to decline y-o-y, hence maintaining negative growth rates throughout the course of 2010. Based on short-term statistics, the worsening in "Postal and telecommunication services" was driven by the fall in "Telecommunication services". Services Confidence Index, which had registered rates above its long-term average throughout 2010, fell by 8.6 pp in 2011 Q1.

IV.1.2. AGGREGATE DEMAND COMPONENTS

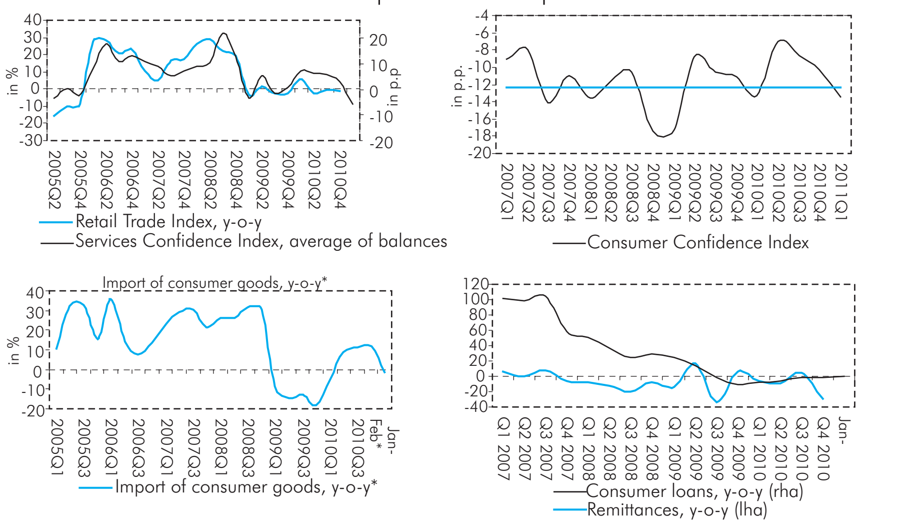
Aggregate demand grew by 5.4% y-o-y in 2010 Q4, hence maintaining its upward tendency commenced since Q1. Excluding the seasonal effect, aggregate demand grew by 1.2% q-o-q in Q4, down from 1.5% in Q3. The expanding economic growth, at a global level, has spurred demand for exports, which continued to contribute positively in 2011 Q1 as well. Secondary data obtained from official statistics and confidence surveys on 2011 Q1 attest to the low but increasing contribution of domestic demand. Besides the private sector of the economy, the public sector has provided additional contribution. Information on the accurate contribution of each component to aggregate demand growth is subject to a considerable level of uncertainty due to the structural changes in the last two years.

PRIVATE CONSUMPTION

As economic activity accelerated its growth rates in Q4, indirect data on private consumption suggest that it continues to contribute positively to aggregate demand. Information obtained from the import of consumer goods provides evidence for the growth of private consumption in Q4, which grew 6.4% y-o-y. CPI deflated, it grew by nearly 3%, compared to 2.3% in Q3. Retail trade volume index contracted by 1.1% in Q4, compared to -0.7% in Q3. The structural analysis shows that the decline of trade was sharper in food products and various household appliances, while repair of vehicles and clothing registered positive growth rates. Private consumption financing in Q4 was sustained by the rise of real wage by 4.8%, while workers' remittances fell by 29.4%. Private consumption financing through consumer loans was comparably low. Due to the maturing of this loan portfolio, outstanding consumer loans dropped by 1.4% in 2010 Q4.

Partial data on Q1 suggest a moderate contribution of consumption to aggregate demand. In January and February, CPI-deflated imported volume of consumer goods dropped by about 1.2%, while outstanding consumer loans terminated their decline over the same corresponding period. On the other hand, Consumer and Services Confidence Indices fell in 2011 Q1[22]. The fall in the latter provides evidence for the slow recovery of private consumption. The increasing trend of household time deposits, coupled with the higher savings, suggests added household prudence in terms of their consumption behaviour.

Chart 20 Indirect private consumption indicators



*CPI-deflated import of consumer goods.
Source: INSTAT, Bank of Albania and its estimates

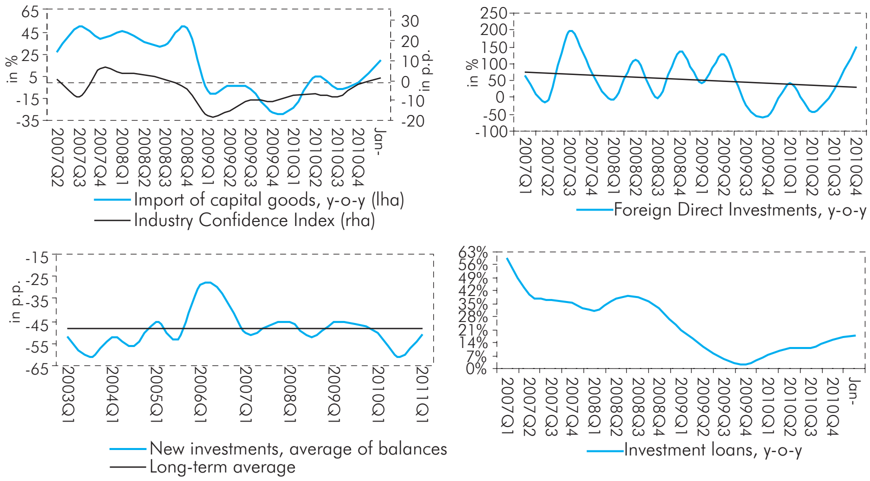
PRIVATE INVESTMENTS

Private investments contributed positively to the aggregate demand in 2010 Q4. Indirect data proxying investments provide evidence for their recovery in 2011 Q1 as well. The performance of investment was impacted positively by foreign demand and the improved business confidence in manufacturing. In addition, total building permits approved for residential construction and engineering works, which generally precede the increase of investments in

[22] *Confidence Indices' data are qualitative data obtained from surveys conducted among a representative sample of companies. Due to frequent structural changes in the economy, their results may not fully reflect the volume of activity in the sector they refer to.*

the construction sector by several months, registered sharp increase in 2010 Q4. However, the low capacity utilization rate, the slow easing of lending standards and the sluggish recovery of domestic demand curbed the more rapid resurgence of investments. Indirect data show the recovery of investments in 2010 Q4. After decreasing by 6% in Q3, the import of capital goods slowed the annual decrease down to 0.4% in Q4. On the other hand, investment loans grew 15.7% y-o-y in Q4. This growth rate, albeit low compared to its historical average, is 4.5 pp above that of Q3. Foreign direct investment inflows grew 149.7% in 2010 Q4.

Chart 21 Indirect quantitative data and data obtained from surveys of private sector investments



Source: INSTAT, Bank of Albania and its estimates

The latest data show that the import of capital goods and loans for investment purposes grew by 19.4% and 18% y-o-y, respectively, in January and February 2011. This performance signals the continuous recovery of private investments in 2010 Q1. Qualitative information obtained from confidence surveys confirm the resurgence of private investments in the economy. Based on Business Confidence Survey of 2011 Q1, the balance of new investments carried out over the last six months improved markedly compared to the previous six months. On the other hand, capacity utilization in economy decreased in Q1 to 67.2%, about 4.6% below the average. The adverse contribution of inventories to economic growth is expected to persist in 2011 Q1 as well. Based on Business Confidence Survey data, inventories continued to reduce in Q1.

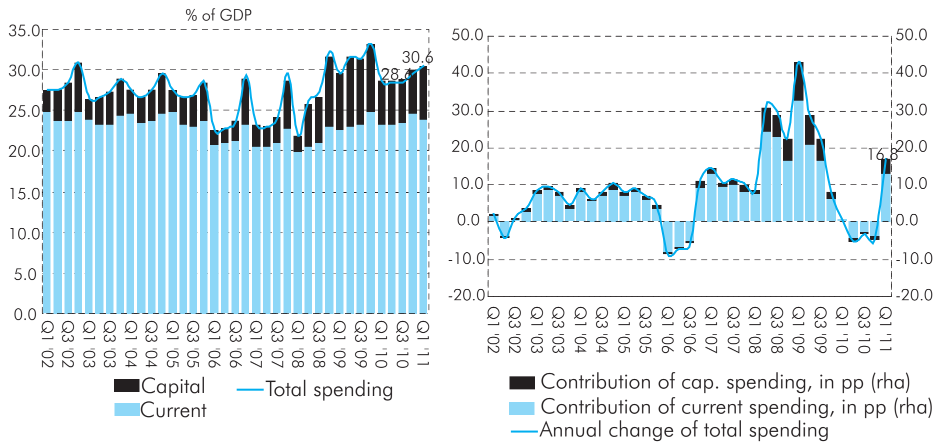
BUDGET SPENDING AND FISCAL POLICY

Budget spending increased by 16.8% y-o-y in 2011 Q1[23]. Current spending provided the major contribution to the increase in total spending, 13.1 pp. The maintenance of similar growth rates in the quarters ahead in 2011 is expected to translate into higher contribution of Government spending to the aggregate demand. As a percentage of GDP, total spending in Q1 was estimated at 30.6% compared to 28.6% in the same corresponding quarter

[23] *In 2010, cumulative budget spending contracted by an average of 3.1% y-o-y at the end of each quarter.*

in 2010. Capital spending as a percentage of GDP increased by 1.5 pp from the same corresponding quarter in 2010, and was estimated at 6.7% of GDP.

Chart 22 Budget spending (current and capital) as a percentage of GDP, in % (left), annual change of budget spending in %, and respective contributions of current and capital spending in pp (right)



Source: Ministry of Finance, INSTAT, IMF (World Economic Outlook, April 2011) and BoA's staff estimates

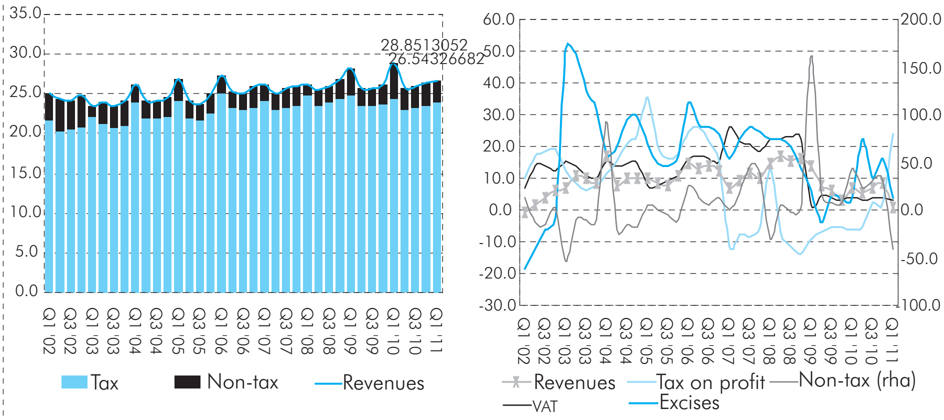
Public spending policy for the current fiscal year projects a different behaviour compared to the previous year. It projects a more rapid increase of current spending than in 2010, and higher capital spending compared to their reduction in the previous year. More precisely, in 2011 Q1, current spending increased by 11.6% y-o-y compared to 7.9% in the same corresponding quarter in 2010. Over the same stated period, capital spending increased by about 40% y-o-y compared to its contraction by 30% in 2010 Q1.

Budget revenues registered modest growth by 0.5% y-o-y in 2011. This tendency of revenues reflects the moderate increase of the main tax-related items and the decrease of non-tax revenues. In nominal terms, VAT revenues increased by 3.2% y-o-y, very close to the average of 3.5% in 2009 Q1-2011 Q1[24]. The fiscal package for 2011 has projected other additional changes, in addition to those of the previous year, which are expected to contribute positively to the collection of budget revenues. Among these changes, which will ultimately help in broadening the base of VAT-paying businesses, we may note: the inclusion of health services and medicaments into the VAT scheme (10% rate), and the further lowering of the annual taxable turnover threshold for businesses subject to VAT from ALL 5 million to ALL 2 million. It is, however, difficult to determine whether the changes in the fiscal package for 2011 have affected the performance of VAT revenues in 2011 Q1. Excise revenues, which account for about 10% of total revenues, increased by 3.5% y-o-y compared to the average of 7.3% in the last two years. The performance of excise revenues, however, is to a large extent determined by the performance

[24] *The average annual increase in 2009 Q1-2011 Q1 refers to the annual change in VAT revenues at the end of each quarter (which also encompasses the realization of the previous quarters of the same fiscal year) compared to the same corresponding period in the previous year.*

of imported goods subject to excise[25]. On the other hand, non-tax revenues contracted by 41.2% y-o-y compared to the same quarter in 2010[26].

Chart 23 Tax and non-tax revenues as a percentage of GDP (left) and annual change of total revenues and selected items, in % (right)



Source: Ministry of Finance, INSTAT, IMF (World Economic Outlook, April 2011) and BoA's staff estimates

As a percentage of GDP, budget revenues were estimated at 26.5% in 2011 Q1, compared to 28.9% in the same corresponding quarter in 2010. Non-tax revenues decreased by about 2 pp and accounted for 2.5% of GDP. Tax revenues maintained a similar share as in 2010 Q1 at about 24% of GDP.

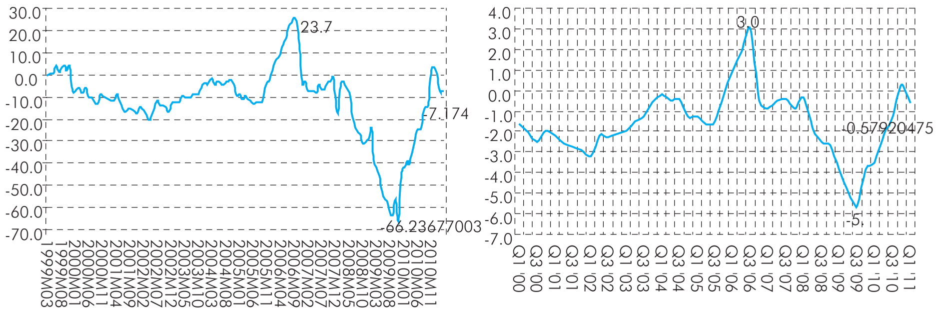
As at end-2011 Q1, budget deficit amounted to ALL 11.8 billion, compared to the surplus of ALL 0.7 billion at end-2010 Q1. This budget deficit corresponds to the gap between social insurance scheme revenues and expenditure. Budget deficit was principally financed by the issue of T-bills[27] and bonds of 2- and 5-year maturity. Other instruments employed to finance the budget deficit – like privatization receipts and foreign borrowing for projects – financed only a moderate portion of this deficit. The developments in revenues and expenditure were also reflected in the performance of primary balance over this period. After improving distinctly in 2010 Q4, the primary balance was negative in 2011 Q1.

25 *Data on imports' volume covering only the first two months show the considerable increase in the quantity of imported fuels and coffee. Concerning the imported quantity of other items, i.e. alcoholic beverages and tobacco and its by-products, they increased slightly y-o-y.*

26 *The key determinant in the behaviour of non-tax revenues is one of its components under "Other", which was markedly above its historical average in 2011 Q1. If we were to exclude "Other" from total revenues, considering it as having a temporary effect on the performance of revenues, budget revenues would increase by 6.7% y-o-y in 2011 Q1. The same application for 2010 Q1 shows an increase by 0.2% y-o-y in budget revenues.*

27 *T-bills of 3-, 6- and 12-month maturity issued in Lek, and T-bills of 9-month maturity issued in Euro, amounting to EUR 17.5 million.*

Chart 24 Primary balance, in billions of ALL (left)* and primary balance as a percentage of GDP (right)**



*The left-hand chart shows the moving sum of 3-month primary balance (the four quarters' sum) as a percentage of cumulative GDP.

**The right-hand chart has been constructed by taking into account the moving sum of monthly primary balance (including 12 months), expressed in billions of ALL.

Source: Ministry of Finance, INSTAT, IMF (World Economic Outlook, April 2011) and BoA's staff estimates

FOREIGN DEMAND AND CURRENT ACCOUNT

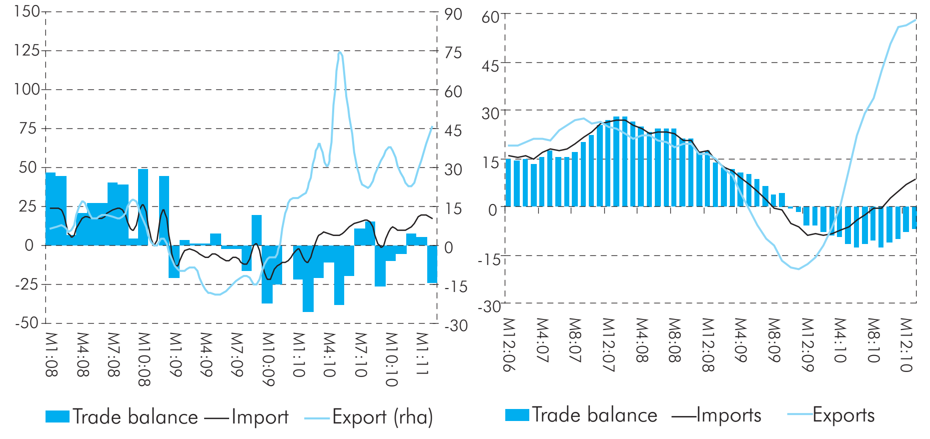
Albania's current account net position registered a deficit of EUR 373.6 million in 2010 Q4. Unlike the first three quarters of 2010, when the current account deficit narrowed in annual terms, in Q4, it widened by 15.1% y-o-y. As a percentage of nominal GDP[28], the current account deficit was estimated at 16.4%, or up 0.8 pp from 2009 Q4.

The widening of the net export deficit was the key factor that contributed to the deterioration of the current account net position. Although the export of goods and services increased by nearly 20.7% y-o-y, the increase in the import of goods by 10.4% y-o-y and services by 14.6% y-o-y contributed to the widening of the trade deficit. The higher net negative position of services account and the lower net positive balance of current transfers contributed adversely to the annual performance of the current account in 2010 Q4. The income account deficit widened by approximately 3.5% y-o-y, while current transfers dropped by 12.9% y-o-y. Workers' remittances declined by about EUR 3 million in 2010 Q4, and they were estimated at 7.2% of nominal GDP.

Data on foreign trade in January and February 2011 provide evidence for the narrowing of the trade deficit in annual terms. Although imports' value maintained the upward trend that had commenced in 2010 Q2, the sharp increase in exports' value contributed to the trade deficit narrowing by 5.9% y-o-y. The average coverage ratio of imports by exports was estimated at the historical peak of 47.3%. Trade exchanges registered an annual growth of 30.4% in January and February.

[28] *Nominal GDP for 2003-2009 refers to INSTAT. IMF's projection for Albania's GDP has been used for 2010, according to "IMF Article IV Consultation, 2010", July 2010.*

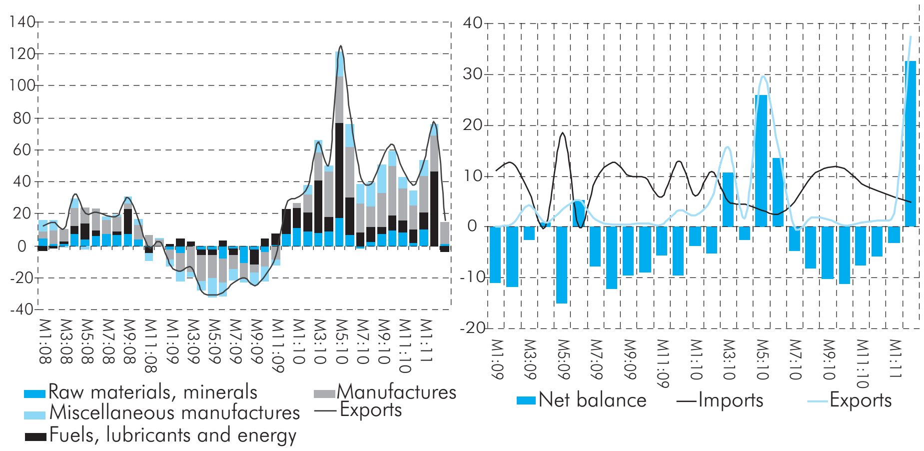
Chart 25 Imports' and exports' value and trade balance, annual change (left) and as a percentage of nominal GDP (right), and 12-month moving sum of their value, annual change (right)



Source: Bank of Albania, Customs Directorate

Exports' value maintained its accelerated upward trend that had commenced in 2010 Q1, and expanded by 66% y-o-y. The three-digit annual increase in electricity exports, which in February amounted to EUR 37.4 million, provided the major contribution to exports' performance. The big difference between production and consumption in Albania, coupled with high global energy prices, led to electricity exports scoring high levels. In the meantime, the increasing export rates of primary commodities and minerals (mainly chrome ore and cement) dropped slightly compared to 2010[29] due to the lower export of chrome to China in February. The exports of processed goods (processed materials of base metals, like iron, steel, aluminium and lead) and re-exported textiles continued to contribute positively to the annual exports' value.

Chart 26 Contribution of four key items of Albanian exports to the annual increase in exports' value (left) and import and export of electricity in absolute value (right)



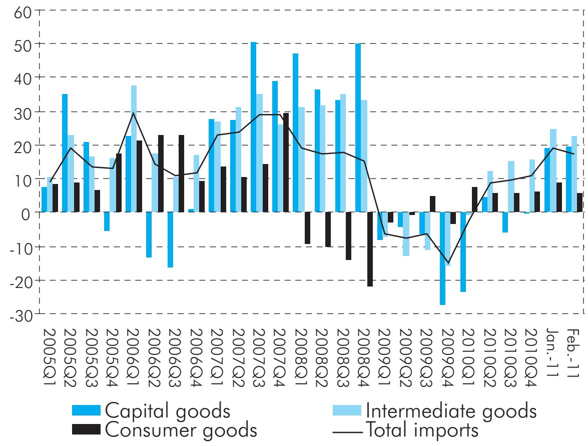
Source: Bank of Albania, Customs Directorate, ERE, Albanian Power Corporation (KESH)

[29] In 2010, this item's export increased by 67% y-o-y. In January and February 2011, it increased by 38% y-o-y.

In January and February 2011, imports' value increased by 18.4% compared to the same corresponding period in 2010. In terms of imports by their final use in economy, the import of intermediate and capital goods increased by 23.6% and 19.4% y-o-y, respectively. This performance owes principally to the higher industrial demand for imported products. The import of consumer goods increased by 5.7% y-o-y, due to the higher food prices in the global market in the early months of 2011.

Trade exchanges with EU countries accounted for nearly 63% of total trade activity in January and February, which is about 4 pp lower than in the same corresponding period in 2010. Exports of goods to Switzerland, China, Germany, Greece, Italy and Turkey registered an annual increase, while exports to Kosovo decreased. On the other hand, imports by origin increased annually from China, Greece, Italy, Bulgaria, Russia, France and Croatia, and reduced annually from Switzerland, Poland and Romania.

Chart 27 Annual change in the import of capital, intermediate and consumer goods, in %



Source: Bank of Albania

Capital and financial account recorded a positive balance of EUR 433.1 million in 2010 Q4. This positive balance was as much as four times higher than in the same corresponding period a year earlier, and it accounts for about 19.0% of GDP. Currently, the surplus in the capital and financial account succeeded in fully financing the current account deficit of this period, and increasing the reserve assets by about EUR 125.7 million. At end period, foreign reserve stock amounted to EUR 1,904.0 million, sufficient to cover 4.8 months of imports of goods and services.

Box 2 Potential Output and Output Gap

Potential output is the maximum level of goods and services an economy can produce on a sustained basis with existing resources without generating inflation pressures. The main resources are labour, capital equipment, and technological and entrepreneurial know-how, translated into productivity. Economists also refer to potential output as trend output or the production capacity of the economy.

The output gap is defined as the difference between the actual output of the economy and its potential output. A positive output gap means that the economy is operating above its capacity to sustain that level of production owing to excess demand. A negative gap means that there is excess supply – that is to say, spare capacity or slack in the economy – due to weak demand.

The output gap is an important variable for monetary policy as it is a key source of inflation pressures in the economy. When demand for goods and services presses against the economy's capacity to produce, this tends to put upward pressure on prices. When demand is weak, it tends to push prices down. Put another way, when the rate of inflation consistently comes in higher than expected, it is typically a sign that demand for goods and services is pushing against the limits of capacity. When *the rate of inflation consistently comes in lower than expected, it is generally a sign of weak demand and of spare or unused capacity.*

The Bank of Albania is equally concerned about too much or too little demand pushing inflation appreciably above or below the 3% target. When demand is expected to exceed the potential in the medium run (positive output gap) to the point that it consistently increases inflation above the maximum threshold, the Bank will raise the key interest rate. On the contrary, the Bank will lower the key interest rate to boost demand and prevent inflation from falling below the target.

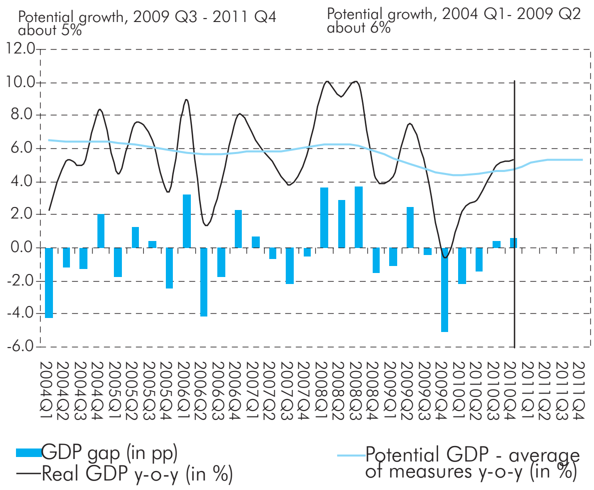
Although theoretically the situation may seem easily solved by monetary policy decision-making, in practice, the challenge stands in measuring the output gap. Unlike actual output, the level of potential output, and hence the output gap, cannot be observed directly, and so it cannot be measured precisely. Potential output and the output gap can only be estimated through the long-term trends of other important indicators, like the trend in employment, productivity, investment and inflows (workers' remittances and foreign direct investments). Such estimates, however, are subject to considerable uncertainty, especially when the economy is coming out of a deep recession or when major structural changes take place. For example, during the 2008-2009 recession, as a result of the crisis in financial markets, many countries had to re-estimate the level of potential output due to the economic structural adjustments. The re-estimate of potential output and output gap called for the need to re-estimate the balances and long-term trend of indicators that determine the level of potential output.

Given the difficulties in estimating the potential output and the output gap based on the long-term trends of macroeconomic indicators, the Bank of Albania also considers statistical techniques in order to get a better reading of the level of potential output. The use of different filters, like "Hodrick – Prescott Filter (HPF)" and "Kalman Filter (KF)", aim at creating series of potential output from the actual output series. Short-term fluctuations are excluded from the actual output series, and only the cyclical and long-term trend components are filtered, which, as explained above, are used by economists to estimate the potential output series. The series of potential output is constructed out of this series. The difference between actual and potential output represents the output gap. However, the filtering methods have their own limitations and requirements. They are clear statistical methods that are affected by the initial and final values as well as by the autoregressive processes of the series. They lack economic judgment or assessment. In addition, they require long time series in order to allow for more accurate estimates of the potential output. They are, therefore, complemented with estimates from semi- and fully-structural models, and, in their absence, with information obtained from other leading economic indicators.

The Bank of Albania complements the potential output estimates through the filtering methods (HPF and KF) with the information obtained from other indicators such as: capacity utilization rate, expected output, expected orders, expected investments and employment, expectations for lending and the level of long-term consumer investments, market agent expectations for inflation, etc. In order to get a better reading of the level of potential inflation pressures in the future, the monetary policy decision-making at the Bank of Albania – in addition to the numerical estimates of the output gap based on the filtering processes – makes wide use of judgment based on the above-referred indicators. In this way, it will determine whether the fall of demand from potential production capacities of the economy may push inflation appreciably above or below the 3% target in the medium run.

By applying three versions of the HPF (with different alpha coefficients) and KF, we have derived an average estimate of the potential output. Until 2009 Q2, it floated around the average of 6%. No additional inflation pressures were generated due to the short-term and non-systematic fluctuations of the output gap. Since 2009 Q3 and onward, the economy is considered as operating below its potential, with the deepest shock in Q4. The estimation shows that the post-financial crisis period would suggest a new level of potential output, lower than in pre-2009. The trend in potential output for this period floats around 4.7% and leans towards 5% in 2011. The improvements in the last two quarters may signal the recovery of demand, but they still do not push the economy to grow above its potential in the medium run, and hence, cause the inflation pressures to increase beyond the maximum threshold set by the Bank of Albania for inflation. This consideration is also based on the latest analysis of confidence indicators and other economic indicators, which do not signal any substantial increase in the capacity utilization in economy. The analysis also shows low and short-term fluctuations.

Chart 28 Annual GDP change (actual, potential, gap)



Source: INSTAT and Bank of Albania's estimates

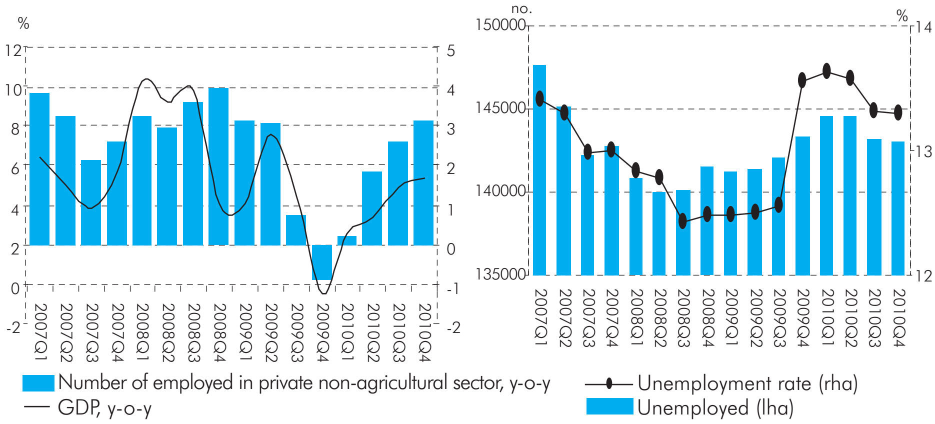
IV.2. LABOUR MARKET, WAGES AND LABOUR COST

The labour market showed signs of improvement in 2010 Q4. Employment figures continued to improve but the unemployment rate remained unchanged. Real wages rose in both the public and private sector. The developments in the labour market signal a more efficient use of labour resources during the economic activity.

After the deterioration in the labour market at the end of 2009, the increase in employment was gradual over the quarters in 2010, hence confirming the stabilization of the labour market conditions. Administrative data on employment in 2010 Q4 show its increase in all the sectors of the economy. Short-term statistics confirm the increase in employment by main sectors of the economy, albeit at lower rates than in 2010 Q3. Business survey results support the quarterly dynamics of employment shown by the short-term statistics.

The total number of employed increased by 1.74% y-o-y. This increase is principally attributed to the increase in the number of employed in the private non-agricultural sector, which in Q4 rose 3.13% y-o-y. This sector registered positive annual growth rates throughout 2010. By contrast, the number of employed in the public sector decreased by 0.15% y-o-y.

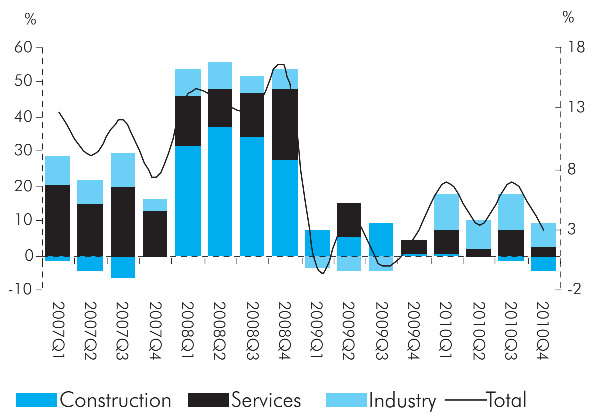
Chart 29 Changes in employment (left-hand axis) and GDP growth (right-hand axis) (left-hand chart), number of employed (left-hand axis) and unemployment rate (right-hand axis) (right-hand chart)



Source: INSTAT and Bank of Albania

A more comprehensive sectoral analysis based on short-term statistics shows that the number of employed in the private non-agricultural sector mainly increased in better performing branches. This increase was positive, albeit lower than in Q3. Industry was the major contributor to the annual increase. Employment in industry rose 6.4% in 2010 Q4. On the other hand, employment in construction continued its declining tendency that had commenced in Q2. The annual growth rate in 2010 Q4 was -4.1%, down 2.1 pp from the previous quarter. Employment in services slowed its annual growth down and rose 4.8 pp less than in Q3. In Q4, it rose 2.7%. This accelerated slowdown owes mainly to the considerable decrease in the number of employed in retail trade, which registered an annual decline by 10.4%.

Chart 30 Employment by main sectors



Source: INSTAT and Short-Term Statistics

Despite the improvement in the main labour market indicators, unemployment rate remained constant at 13.5% in 2010 Q4. Although the unemployment rate decreased over the course of 2010 H1, it did not reach the pre-crisis levels. However, at end-2010, unemployment rate was below the last five years' average.

WAGES

According to the latest short-term statistics, average wage index accelerated its growth in 2010 Q4, both in nominal and real terms. In nominal terms, the wage index in economy rose 8.2%. CPI-deflated, real wage rose 4.8% in Q4, due to the high wage rise in the services sector. In annual terms, real wage in services rose 17.9%, registering exponential growth in the sub-branches of trade, transportation and telecommunication. In 2010 Q4, average wage in the public sector was ALL 45,000. Real wage in the public sector rose 3.7% y-o-y.

Chart 31 Annual growth of wage indicators by sector and wage in the public sector, in %

Source: INSTAT and Bank of Albania's estimates

INSTAT data generally confirm the signals obtained from business confidence survey results for the sectors of construction, industry, services and the entire economy. Except for industry, businesses expect the rise in wages to slow down in 2011 Q1.

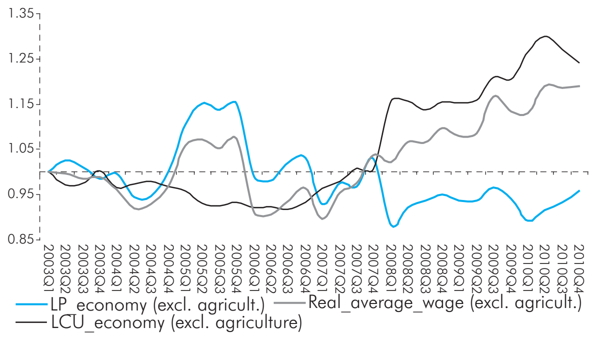
Chart 32 Wages and expectations for the economy and sectors

Source: INSTAT and Bank of Albania's estimates

LABOUR PRODUCTIVITY AND COST

Labour Productivity Index (LPI) increased by 1.9% y-o-y in 2010 Q4. This increase, albeit modest, followed the consecutive decreases since end-2009, hence reflecting more harmonized developments between economic activity and employment. Over the same stated quarter, the Labour Cost per Unit of Output Index (LCUOI) increased by 3% y-o-y. This figure confirms the curbing growth rates of the LCUOI and it mainly owes to the positive rates of labour productivity.

Chart 33 Labour Cost per Unit of Output Index and average real wage index*



Note: The indicators refer to manufacturing and services sectors (excl. agriculture).
*The measures refer to indicators of labour productivity and labour cost per unit of output of the economy, excluding agriculture. The estimations are based on value added data (seasonally-adjusted - INSTAT, GDP, 2010 Q4) and short-term statistics on employment and wages (INSTAT, Short-Term Statistics, 2010 Q4). These indicators do not include agriculture, therefore value added excludes agriculture. Average real wage index has been derived after deflating it with the seasonally-adjusted CPI. The indicators are rebased to 2003 Q1 for comparison purposes.
Source: Bank of Albania's estimates

Structurally speaking, the signals for the recovery of aggregate demand will be more pronounced if the growth of output continues to be supported by the increase in labour productivity in the quarters ahead. In addition, the increase in productivity would contribute to lowering the labour cost per unit of output by flattening the inflation pressures deriving from costs and enhancing the competitiveness of the Albanian economy.

Table 5 Wages, labour productivity and labour cost per unit of output

(Annual changes in %)	2009 Q4	2010 Q1	2010 Q2	2010 Q3	2010 Q4
Average wage in manufacturing and services*					
Nominal	6.5	9.2	13.3	5.1	8.2
Real	3.5	5.1	9.2	1.6	4.8
Real (seasonally-adjusted CPI)**	3.3	4.6	9.6	1.7	4.9
Average wage in the public sector					
Nominal	9.6	6.6	6.7	6.4	7.1
Real	6.6	2.6	2.8	2.9	3.7
Labour productivity in manufacturing and services*	-0.9	-4.7	-2.1	-3.3	1.9
Labour cost per unit of output in manufacturing and services*	4.3	9.8	12.0	5.1	3.0

Source: INSTAT and Bank of Albania's estimates
Note: Excluding agriculture; ** Annual change of "Average real wage" as in Chart 30 (seasonally-adjusted CPI).*

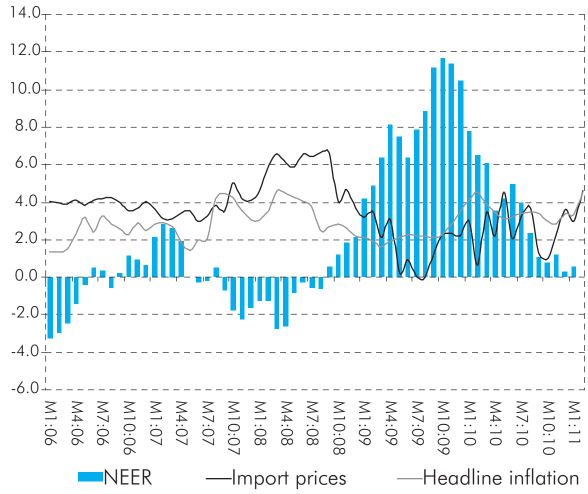
IV.3. IMPORTED INFLATION

The inflation pressures on prices in Albania, which derive from the fluctuation of prices in global conjectures, mounted in January and February 2011. Despite being slightly relieved by the relative exchange rate stability in y-o-y terms, the rise in food and energy prices gave rise to higher imported inflation over the stated period. The import price index[30] maintained the increasing tendency that had begun in November 2010 and, in January and February 2011, it rose by an average of 3.8%. The performance of this index confirms the similar tendency of imported inflation and the rate of headline inflation in Albania.

[30] *This index is measured by weighing the import share of 19 countries, according to their significance to foreign trade data, to the relevant CPI on a common basis.*

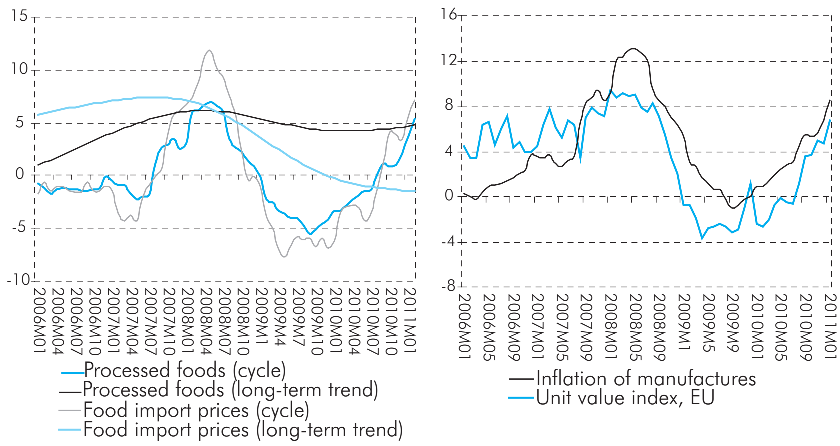
The tendency of imported inflation, disaggregated into seven main CPI basket groups[31], was upward for "Processed foods". This performance is confirmed by the two indices that show the volatility of import prices: unit value index for exports of processed foods from EU to Balkan countries, and food import price index[32]. The analysis of the cyclical structure of these two indices shows that they precede the developments in the CPI. Hence, the accelerated increasing pressures of food import prices on food prices in Albania in Q1 are expected to persist in the months ahead.

Chart 34 Annual import prices, inflation rate and ALL/EUR exchange rate



Source: Bank of Albania, INSTAT, IMF, OECD, EuroStat

Chart 35 Cycle - long-term trend of annual inflation of "Processed foods" and annual inflation of food import prices (left-hand chart); import price index versus the annual change of unit value index of EU exports (right-hand chart)



Source: Bank of Albania, INSTAT, IMF, OECD, EuroStat

IV.4. INFLATION EXPECTATIONS IN ECONOMY

Expectations for the annual inflation rate after one year showed a slight increasing tendency, but they, however, remained within the tolerance band of 2-4% in 2011 Q1[33]. Bank experts expect inflation after one year to be higher than as expected by businesses and consumers. In 2011 Q1, they expected it to be 3.6%, up 0.3 pp from the expectations in 2010 Q4.

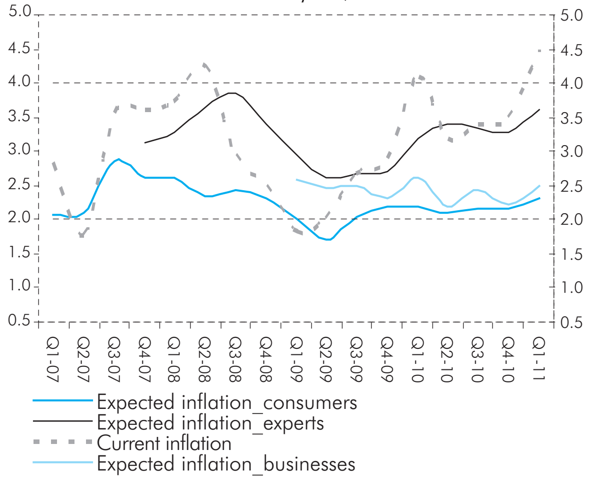
[31] *The disaggregation of the CPI basket into seven groups is made by BoA Monetary Policy Department experts. INSTAT disaggregates it into twelve groups.*

[32] *The first index is released by the European Statistical Institute – EuroStat on a monthly basis. The second index is constructed by weighing the food price indices of 19 countries according to their share in the Albanian food imports.*

[33] *The analysis of inflation expectations is based on business and consumer confidence survey and bank experts' survey conducted in 2011 Q1.*

Based on the latest data obtained from business and consumer confidence surveys in 2011 Q1, businesses expect inflation after one year to be 2.5%, and consumers expect it at 2.3%. These figures of expected inflation are slightly higher than in the previous period, but however, remaining within the lower half of the inflation target band of 2-4%.

Chart 36 Economic agents' expectations for inflation after one year, in %



Source: Confidence Surveys and Monthly Bank Expert Survey

IV.5. ASSESSMENT OF INFLATION PRESSURES IN THE REAL SECTOR OF ECONOMY

The Albanian economy continued to grow progressively in 2010. At the end of Q4, it expanded by 5.4%. The labour market developments were positive in Q4, reflected in the improvement of employment figures and the rise in real wages. Workers' remittances contributed less to the increase in Albanian households' wealth, while financing through consumer loans was more positive. Due to the interaction of the foregoing factors, consumer demand was positive in 2010 Q4. This is also confirmed by indirect indicators. Despite the positive contribution of consumption, consumers' uncertainties over the future outlook were high in Q4, which in turn will affect the sustainability of the growth of consumption in the periods ahead. Partial data on 2011 Q1, like CPI-deflated import of consumer goods, consumer confidence index, services confidence index, and the increasing tendency of household time deposits provide evidence for the small contribution of this component to aggregate demand, and subsequently, weak inflation pressures. Concerning investments, they were positive both in 2010 Q4 and 2011 Q1. This performance attributes to the growth of foreign demand and the easier lending standards, mainly in 2010 Q4. Businesses, however, report low capacity utilization rates due to the expectations for the sluggish recovery of domestic demand. In 2011 Q1, Government spending is reported to have contributed significantly to keeping demand at positive levels.

Taking into account – in addition to the foregoing factors – the expectations for lower levels of potential output in the aftermath of the global financial crisis, the improvement of the growth rates in the last two quarters may have narrowed the negative output gap significantly. On the other hand, however, consumers' reluctance to consume and the existence of spare capacities in the economy projected for 2011 suggest that the Albanian economy will continue to operate below its potential, hence generating weak demand-side inflation pressures.

On the supply-side, the increasing productivity in 2010 Q4 and the more sluggish increase in the cost per unit of output generate lower inflation pressures on the labour factor-side. Inflation pressures on prices in Albania, which derive from the fluctuation of oil and food prices in global conjectures, are expected to continue throughout 2011, although constantly declining. Worth noting is that due to the global geopolitical unrest, the uncertainty surrounding these expectations remains high. The absorbing capacity of the domestic economy to these shocks and the avoidance of steady pressures on inflation will condition the future performance of those sectors of the Albanian economy that still have spare capacities.

In the absence of abrupt shocks out of the scope of monetary policy impact, consumer prices are expected to be in line with the Bank of Albania's target for inflation. This projection is based on the persistent negative output gap and the anchored economic agents' expectations for inflation.

V. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

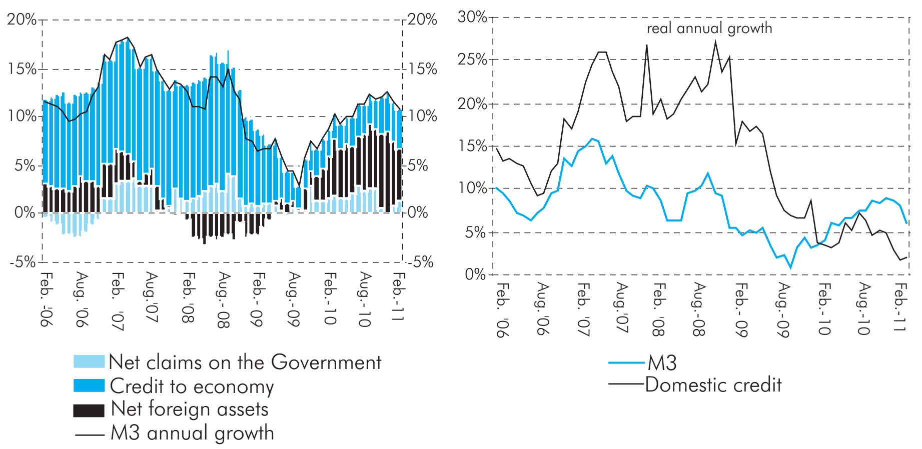
V.1. MONETARY DEVELOPMENTS

The performance of monetary indicators reflected the slowdown of money supply in 2011 Q1[34]. The developments in broad money were largely affected by the foreign currency component of money supply, which continues to provide the major contribution to the growth of money supply, albeit lower than in the previous quarter. Demand for money grew slightly compared to December 2010. Bank lending to private economic agents maintained the growth rates of the previous quarter but its contribution to the growth of demand for money remains moderate and below historical averages. In the meantime, the recovery of public sector activity in January and February drove fiscal agent's demand for domestic borrowing higher.

MONETARY INDICATORS

The long-term analysis of monetary indicators suggests that the growth of money remains at moderate levels, hence exerting no inflation pressures on the economy. Broad money indicator, M3, grew by about 11.2% y-o-y, which is slightly lower compared to the previous quarter's average of 12.1%. In real terms[35], M3 aggregate grew by an average of 7% y-o-y, reflecting its decline to 6.1% in February[36]. The lower contribution of foreign assets was also coupled with the increasing contribution of public and private economic agents' demand for money, hence determining the performance of broad money.

Chart 37 Contribution of M3 components on the asset-side; domestic credit and real M3



Source: Bank of Albania

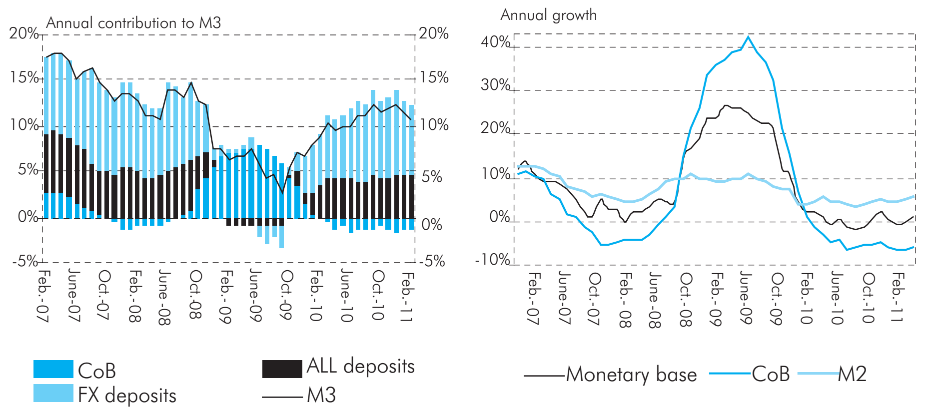
[34] *The analysis covers the period January-February 2011.*

[35] *Excluding CPI fluctuations.*

[36] *In addition to the lower growth of M3 aggregate, this decline reflected the higher inflation rate.*

Net claims on the Government grew on average by 2.6% and 4% y-o-y in January and February, about 2 pp higher than the average of November and December 2010. Public sector's contribution to the growth of broad money is, however, lower than its average contribution in the previous years. The developments in liquid money provide evidence for the further drop of currency outside banks – by 6.1% on average in January and February, which is in line with its seasonal tendency during this period of the year. High-powered money, the monetary base, registered a low y-o-y growth of 0.6% in January and February. Money multiplier rose to 3.53 in February from 3.46 at the end of 2010.

Chart 38 Contribution of money components on the liability-side and monetary aggregates



Source: Bank of Albania

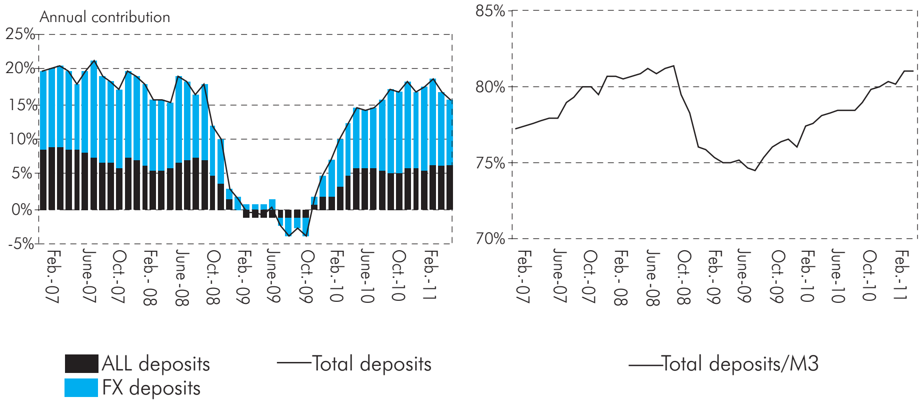
DEPOSITS

The creation of money flows on the deposit-side was downward compared to the previous quarter. In January and February, total deposit stock grew by 16% y-o-y or ALL 7 billion in absolute terms, compared to the growth by ALL 28 billion in 2010 Q4. Monetization of the economy, defined as the ratio of deposits to broad money, remains high and unchanged versus December 2010 at 81%.

The time structure of deposits shows faster growth of time deposits compared to demand deposits in Q1. This is also reflected in the higher share of time deposits to M3 to about 64.7% from the previous quarter's average of 63.2%. The growth of time deposits affected largely household deposits, which provided the major contribution to the growth of total stock in monthly and annual terms.

The composition of deposits by currency shows higher growth of ALL deposits compared to foreign currency deposits in January and February 2011. More specifically, ALL deposits grew by ALL 9 billion, while foreign currency deposits dropped by ALL 2 billion. The drop in the latter owes mainly to the performance of business deposits, particularly in February this year.

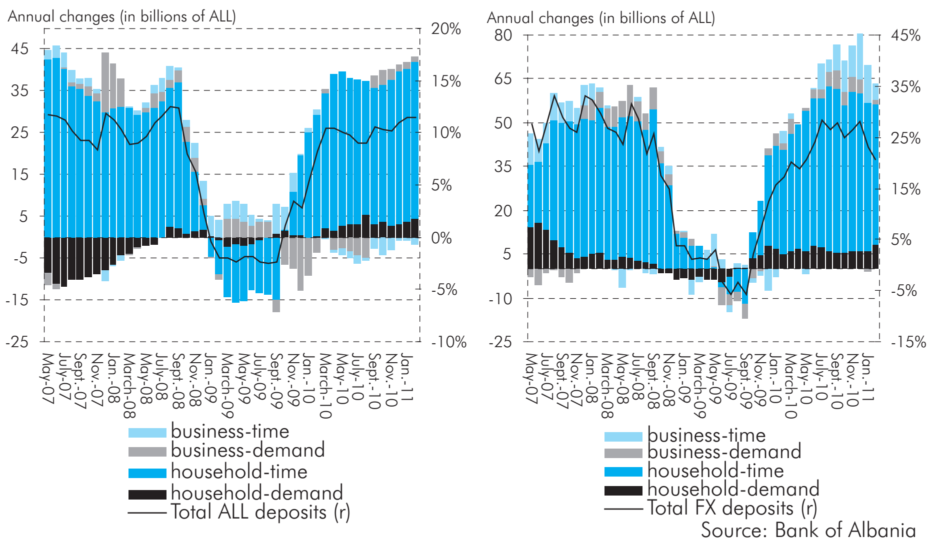
Chart 39 Annual contribution of deposits by currency to total stock, and deposits to broad money



Source: Bank of Albania

The seasonal tendency of the low economic activity – generally in the first quarter of the year – pushed businesses to use their deposits for financial purposes, thus giving rise to the fall of business deposits during this period, and particularly in February.

Chart 40 Annual changes of deposits by currency and economic agents



Source: Bank of Albania

PRIVATE SECTOR CREDIT

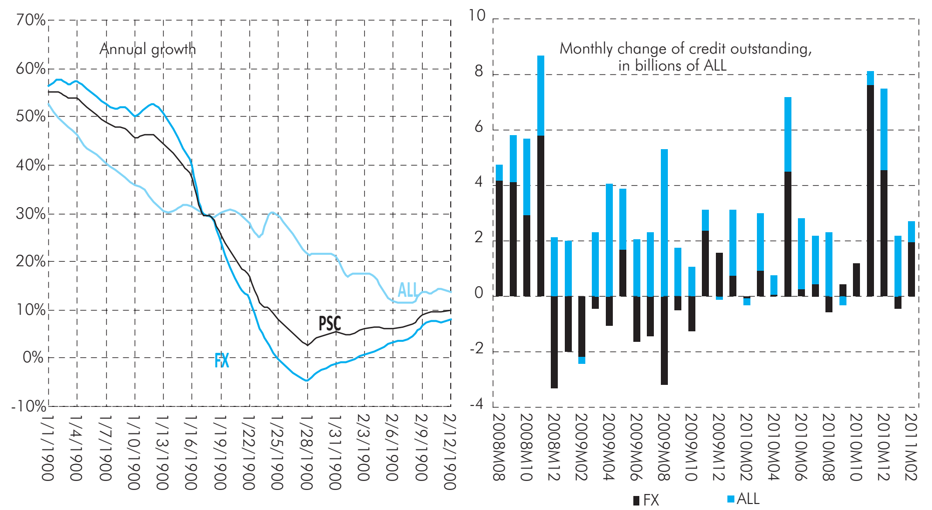
After the substantial growth of private sector credit in November and December 2010, it slowed down in January and February 2011, which is in line with its seasonal performance. Its monthly net flow of ALL 2.1 billion on average was comparable to the growth of credit for the most part of 2010. After remaining unchanged at 9.7% in January, private sector credit grew slightly to 10.0% at the end of February[37]. Private sector credit remains generally slow, with positive developments only in certain individual sectors of

[37] *The exchange rate effect is excluded from the credit figures in the remainder of the analysis. In nominal terms, private sector credit grew by 10.3% in February.*

the economy. It continues to suffer from the low demand of the private sector for loans – arising from the uncertainties surrounding the future outlook –, and banks' conservative behaviour, expressed in the relatively slight easing of lending standards for certain individual sectors of the economy.

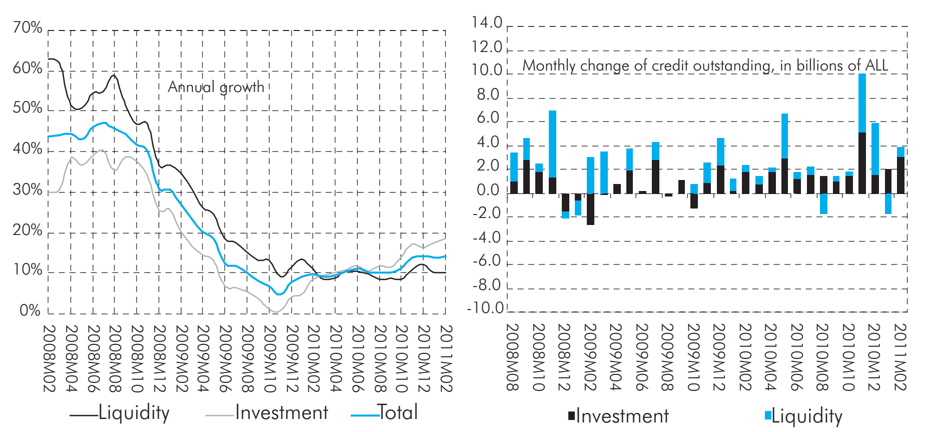
ALL credit accounted for the major part of the growth of private sector credit in January and February. It grew by an average of 14.0% y-o-y, hence maintaining stable rates since November 2010. Foreign currency credit was largely affected by the high settlements of foreign currency loans for working capital purposes, particularly in January. Its annual rate continues to maintain an upward tendency to 8.1% at the end of February.

Chart 41 Private sector credit by currency



Source: Bank of Albania

Chart 42 Business loans by purpose of use

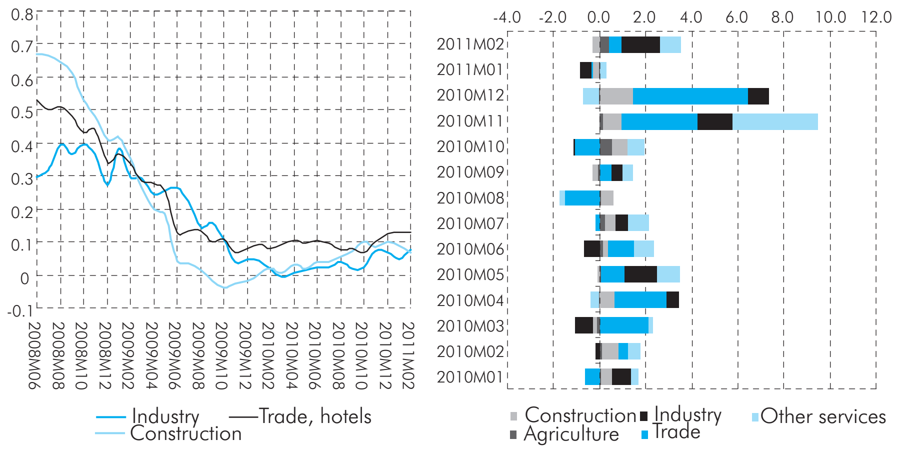


Source: Bank of Albania

After growing substantially in the last two months of 2010, business loans resumed their moderate growth rates in January and February 2011, hence confirming their seasonal tendency. The annual growth of business loans was relatively stable in the first two months of 2011. At the end of February, it stood at 14.2%, similar to year-end 2010.

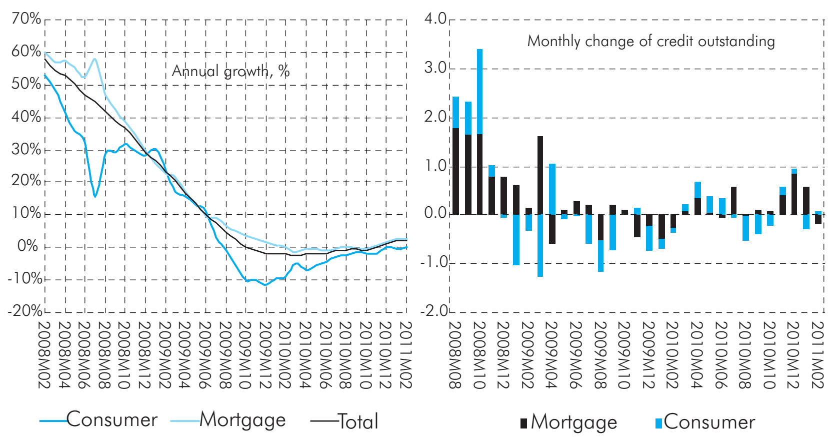
The growth of business loans in January and February was mainly triggered by loans for investment purposes. At the end of February, they grew by 18.4% y-o-y compared to 16.2% at end-2010. The annual growth rate of loans for working capital purposes fell to 10.0% from 12.2% at end-December 2011. Other services and industry benefited the major portion of loans in the first two months, followed by trade and agriculture. The net flow of loans to the construction sector was negative. At the end of February, their respective annual growth of loans stood at 18.6%, 7.7%, 13.0%, 39.0%[38] and 6.7%.

Chart 43 Business loans by sectors of economy



Source: Bank of Albania

Chart 44 Household loans by purpose of use



Source: Bank of Albania

38 *The high annual growth of loans to agriculture owes to the low base of this type of loans.*

The annual growth of household loans grew further to 2.2% in February compared to 1.2% at end-2010. The positive signals in household loans carried over to January 2011 from year-end 2010 did not persist in February. This portfolio contracted again after the average monthly growth by ALL 0.6 billion in November 2010-January 2011. Despite the improved labour indicators and the higher economic activity, lending to households continues to suffer from the low demand for loans against a background of perceived uncertainty about the future and the real estate market-specific concerns. In addition, bank lending standards to households remain tight in relative terms.

Mortgage loans were the major source of growth in household loans for the most part of 2010 and January 2011. However, due to the generally low household demand for loans and the termination of banking promotional offers to finance households in purchasing real estate, the net flow of mortgage loans was negative in February. They grew by 2.7% y-o-y in this month compared to 1.6% at end-2010. On the other hand, consumer credit outstanding continued to perform poorly in January and February 2011. Its annual growth rate was positive at the end of February, about 0.3%, mainly due to the base effect caused by the growth of this type of credit in March to June 2010. In addition to the foregoing factors, the still low growth rate of consumer credit reflects the fact that a considerable portion of this type of credit has reached the maturity. Hence, although new disbursed credit is similar as in 2007, the large settlements cause the effect on the balance sheet to be low.

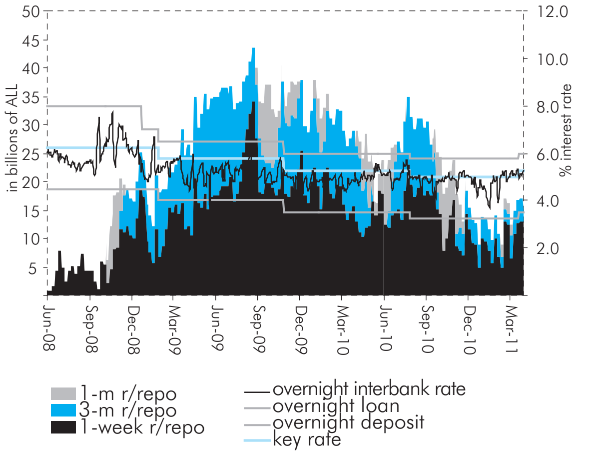
V.2. FINANCIAL MARKETS, INTEREST RATES AND EXCHANGE RATE

The overall performance of financial markets in 2011 Q1 was finalized by the raise of the key policy rate at the end of March. This decision was followed by higher interest rates in the interbank and primary market during Q1. In the meantime, interest rates in the deposit market continued their declining tendency. Interest rates in the credit market were volatile; they increased for ALL credit and decreased for EUR credit. This performance, however, is considered to represent individual bank policies for certain segments of the economy. Lastly, the nominal effective exchange rate reduced its depreciation trend for the seventh quarter in a row.

INTERBANK MARKET

Interest rates in the interbank market increased slightly in Q1, while the volume traded among banks declined. The increase in the interest rates affected the two most widely used maturities by banks and it was mostly concentrated in the last two months of Q1. In light of the current performance of inflation being above the announced target and assessing the outlook for inflation pressures on the upside, at the end of March, the Bank of Albania decided to raise the key policy rate by 0.25 pp. The activity of banks in the interbank market reduced over these months at a time when this market was mainly used to meet the short-term needs for liquidity. The volume of overnight transactions was slightly higher than in the previous quarter, while weekly transactions reduced, thus causing the total borrowing volume to decline.

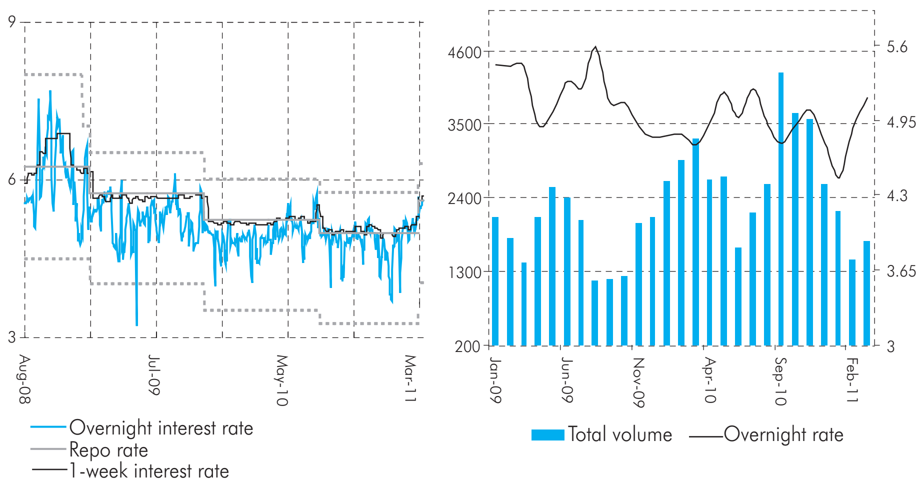
Chart 45 Liquidity volume provided by the Bank of Albania and overnight interest rate in the interbank market



Source: Bank of Albania

The Bank of Albania continued to supply the market with liquidity through reverse repo auctions of one-week maturity. The liquidity injected into the system was lower than in the previous periods. Reverse repos of one and three-month maturity were also employed. Interest rates were more volatile[39] over these months, while their spread to the key interest rate widened. The interest rates were mostly volatile in periods of required reserve replenishment and also due to the positioning of individual banks in the market. Although the average overnight interbank rates q-o-q were lower than in the previous quarter, they rose sharply in the first months of 2011 to 5.14% in March from 4.45% in January.

Chart 46 Interbank market rates (left) and average daily volume in the interbank market (right)



Source: Bank of Albania

Total borrowing volume in the interbank market reduced to ALL 1.89 billion or ALL 1.6 billion less than in the previous quarter. The average weekly borrowing dropped to ALL 0.69 billion from ALL 2.01 billion in 2010 Q4, which is relatively low compared to the previous quarters. Average overnight

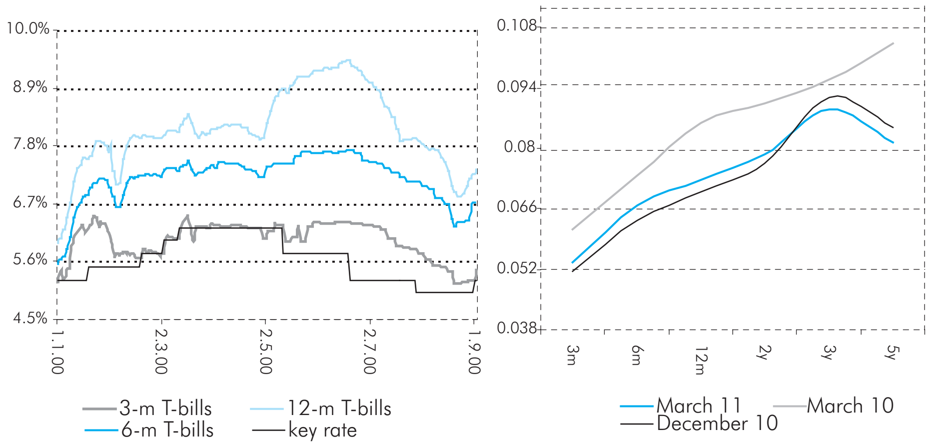
[39] *The standard deviation of overnight and one-week interest rates in the interbank market was 0.4227% and 0.1049%, respectively, in 2011 Q1, compared to 0.2432% and 0.0672% in 2010 Q4.*

interbank rate was 4.80% versus 4.91% in Q4. One-week interbank rate increased to 5.11% or 0.06 pp higher. The same interbank rates were 4.81% and 5.17% in the same corresponding period in 2010.

PRIMARY MARKET

Yields on Government securities in the primary market increased in 2011 Q1. This tendency began at end-May and was more pronounced in the following period. After a one-year period of continuous decrease, the performance of the yields shifted direction in Q1 and increased slightly for all maturities. Against a background of stable liquidity in the banking system, the increase of the yields is rather a reflection of the higher Government demand in the primary market auctions than of banks' higher perceived risk. Although banks' participation in auctions was generally positive, their demand for particular instruments fell, thus contributing to mounting pressures on specific yields. At the end of March, the yield on 12-month T-bills was 7.35%, up 0.44% from end-December. The yield on 3- and 6-month T-bills increased by 0.18% and 0.32% from their end-2010 average. T-bills of 9-month maturity were also issued at the end of March, whose yield was 6.39% or 0.34 bps higher than the previous issue.

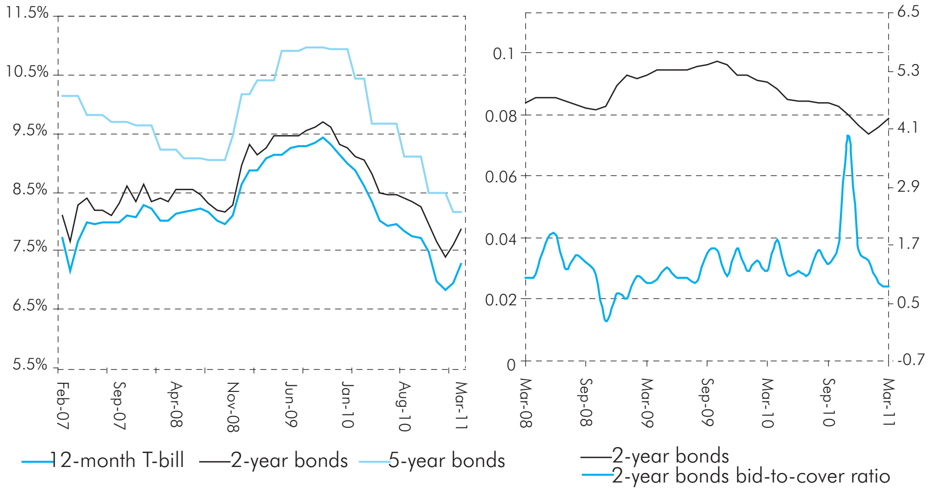
Chart 47 T-bill yields (left) and the yield curve (right)



Source: Bank of Albania

The performance of bond yields was slightly dissimilar to that of T-bills. The yield on 2-year bonds showed a similar performance to 12-month yields, while the yield on 5-year bonds dropped. At the end of Q1, the yield on 2-year bond rose 0.20 pp to 7.85%, while that on 5-year bonds dropped by 0.32 pp to 8.15%. Banks' demand for participation in bond auctions was often lower than Government's demand for funds. In addition to the increase in 12-month T-bill yields, the long-term debt securities are parameterized with, the lower banks' demand in bond auctions in the primary market pushed the ask yields on these instruments higher.

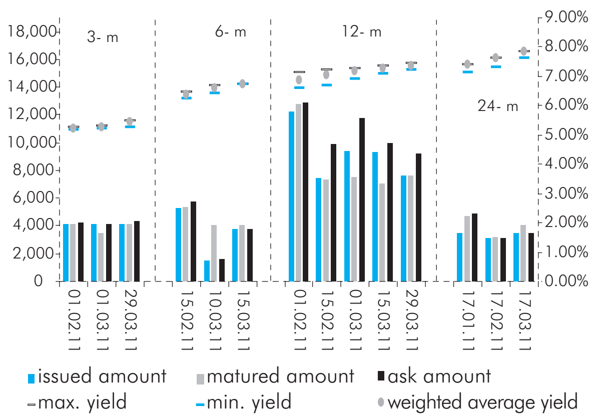
Chart 48 Bond yields (left) and bid-to-cover ratio of 2-year bonds (right)



Source: Bank of Albania

Worth noting is that the drop in the yield on 5-year bonds at a variable interest rate attributes, to a large extent, to its parameterizing with past yields on 12-month T-bills, which were below the current levels, as the ask margin increased compared to its past values. The more rapid increase in medium and short-term yields compared to long-term yields has also pushed the yield curve slope down from the previous quarter and has brought about its general increase. In the last auction held in early April, the yield on 3-year bonds increased by 0.29 pp to 9.19%.

Chart 49 Issues, maturities and security yields in the last primary market auctions



Source: Bank of Albania

INTEREST RATES ON NEW DEPOSITS

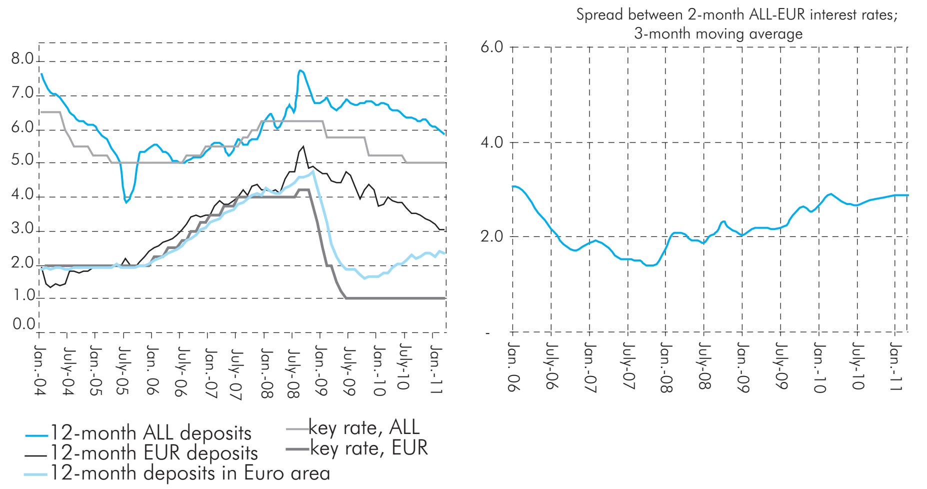
In January and February, the banking system continued to record slight drops in the interest rates on deposits denominated in the two major currencies and in all maturities. Yet, the weighted average interest rates registered marginal rises due to the increase in deposits at a higher maturity and interest rates in some banks in the system (due to the impact on the weighted average). After the decision to raise the key policy rate both by the Bank of Albania and the European Central Bank, banks are expected to change the interest rates. They are expected to lower the margins and, at the same time, keep their competition going to increase their market share.

Weighted average interest rate on ALL deposits was 5.01% in January and February or 0.03 pp above the average of 2010 Q4. This rise does not only owe to the year-end promotional offers, but mainly to the new inflows into long-term deposits of higher interest rate. Preliminary data show that the interest rate on deposits continued to remain at similar levels in March as well.

Regarding maturity, interest rates dropped for all maturities. The interest rate on 3-month deposits dropped by 0.20 pp q-o-q, while that on 6- and 12-month deposits dropped by 0.22 pp and 0.23 pp, respectively. Relative to the same corresponding period in 2010, the average interest rate on deposits was 0.46 pp lower in January and February 2011.

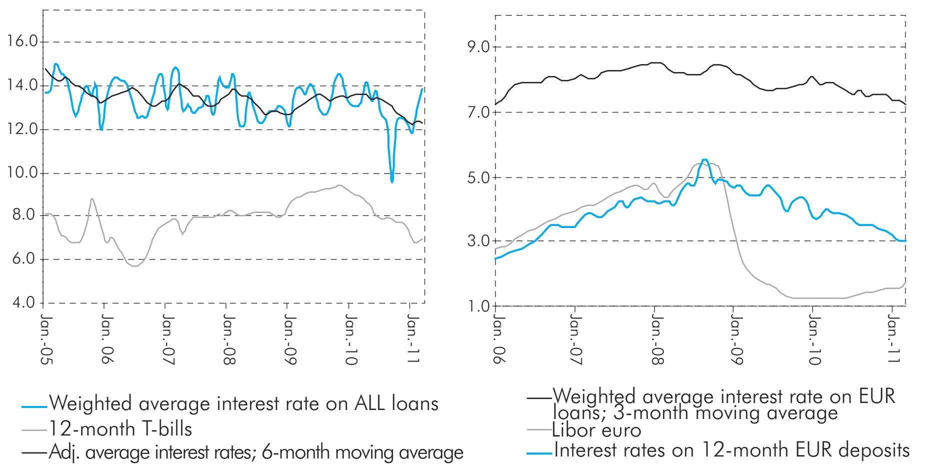
Interest rates on EUR time deposits pursued a similar dynamics as ALL deposits in January and February. Weighted average interest rate on new EUR deposits was 2.08% in the first two months, up 0.02 pp from the average in 2010 Q4. In terms of maturity, interest rates on 1-, 6- and 12-month deposits dropped by 0.04 pp, 0.36 pp and 0.25 pp, respectively. The high level of competition across those banks that use the interest rates on EUR deposits as cost of funds pushed other banks to continue to maintain high interest rates on EUR deposits compared to European market rates[40].

Chart 50 Interest rates on 12-month deposits and key policy rates (in Albania and Euro area)



Source: Bank of Albania

Chart 51 Interest rates on new ALL and EUR loans



Source: Bank of Albania

[40] Worth noting, however, is that the spread has been also narrowing considerably due to the higher interest rates in Europe.

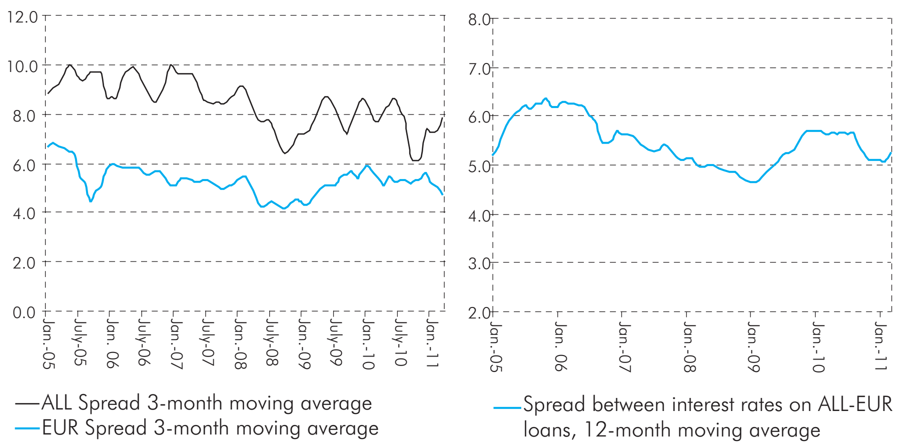
INTEREST RATES ON NEW LOANS

Interest rates on new ALL loans increased in January and February 2011. On the other hand, interest rates on new EUR loans dropped over the same corresponding period. Average interest rates on loans continue to be mainly affected by the diversification in offers and the preferential bank lending policy to individual clients in the two major currencies. In addition, the constant monitoring, the higher reference rates and the exchange rate risk continue to contribute to high margins.

In January and February, the interest rate on ALL loans increased along the same line as the increase in the 12-month yield. It averaged 13.40% but this high figure was affected by a considerable short-term loan amount at an interest rate highly above the system's average. Excluding this loan, the interest rate was 12.40%, being however 0.18 pp above the previous quarter. The higher average owes primarily to the interest rates applied by some banks to certain loans made mainly to businesses for working capital purposes. In the meantime, interest rates on long-term ALL loans for residential purposes dropped again.

Interest rates on EUR loans have been pursuing a downward trend since the year-end promotional offers. Interest rates on EUR loans dropped in January and February to an average of 6.88% or 0.36 pp below the average in 2010 Q4. They performed alike in terms of maturity as well, with medium-term loans extended by individual banks being mostly affected by the drop (pronounced drop in the interest rate on investment loans). In the meantime, banks remain reluctant to make new foreign currency loans of over 5-year maturity (residential mortgage lending). Interest rates on these loans increased by an average of 0.22 pp in January and February compared to the previous quarter.

Chart 52 Average intermediation rate for ALL and EUR (left), and spread between average interest rate on ALL and EUR loans (right)



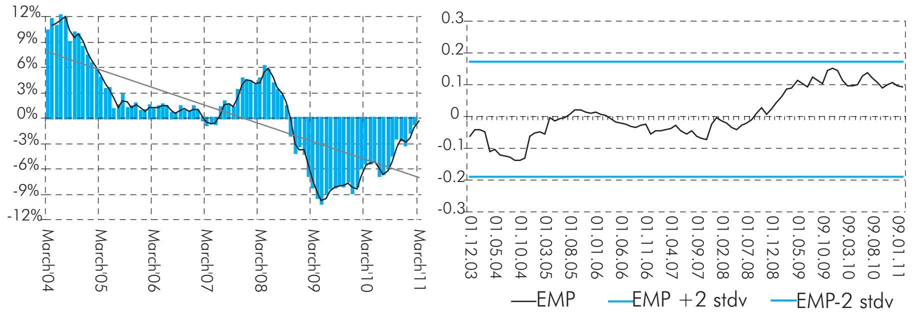
Source: Bank of Albania

Intermediation cost in ALL increased markedly in the first two months of 2011 as a reflection of the higher interest rates on loans. It pointed to 8.39 pp compared to 7.24 pp in 2010 Q4. Intermediation rate for the EUR averaged 4.80 pp in January and February, down 0.38 pp from 2010 Q4. The spread between interest rates on ALL and EUR loans continued to be highly volatile. In February, it widened by 1.90 pp.

EXCHANGE RATE

The nominal effective exchange rate continued to confirm the declining depreciation trend of the Albanian Lek in 2011 Q1. The annual changes in the NEER index fluctuated regressively on the depreciation side to a minimum of -0.04% in March, the lowest depreciation rate since October 2008. The average rates dropped by 1.94% y-o-y from the previous quarter and by 5.61% compared to the same corresponding quarter in 2010. The positive developments in the external sector of the economy, mainly due to the higher exports and the more prudent fiscal policies, provided the major contribution to the reduction of the depreciation rates compared to the previous year. In the macroeconomic context, the relative exchange rate stability in 2010-2011 seems to have reflected the re-dimensioning process of key determinants, thereby setting a new equilibrium, albeit higher than the previous one.

Chart 53 ALL annual changes (left) in nominal effective terms (NEER*) and EMP index** (right)



*NEER – Nominal Effective Exchange Rate, measured against two currencies according to an approximate share they have in trade with abroad, EUR (80%) and USD (20%). A positive change of the NEER implies the appreciation of the lek.
**The EMP (Exchange Market Pressure) index is generated by the following formula:

$$EMP_t = \left(\frac{1/\sigma_e}{\left((1/\sigma_e)+(1/\sigma_r)+(1/\sigma_i)\right)}\right)\frac{\Delta e_t}{e_{t-1}} - \left(\frac{1/\sigma_r}{\left((1/\sigma_e)+(1/\sigma_r)+(1/\sigma_i)\right)}\right)\frac{\Delta r_t}{r_{t-1}} + \left(\frac{1/\sigma_i}{\left((1/\sigma_e)+(1/\sigma_r)+(1/\sigma_i)\right)}\right)\left(\Delta\left(i_t - i_t^*\right)\right)$$

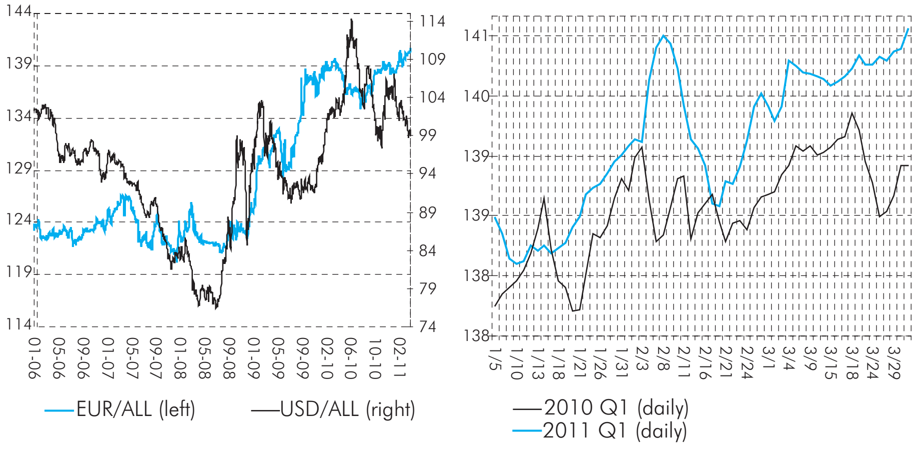
where, e=NEER, r=NIR and i= weighted interest rate on ALL and foreign currency deposits. A higher value of the index implies higher pressures in the foreign exchange market.

Source: Bank of Albania

The foregoing developments seem to be also confirmed by the Exchange Market Pressure Index, which, after increasing rapidly in 2009, was relatively stable throughout 2010. In early 2011, it normalized temporarily and showed a relatively high level of depreciation pressures.

The analysis of quarterly NEER index shows the depreciation of the ALL against the major currencies, mainly as a reflection of the termination of year-end foreign currency inflows effect and business-related seasonal effects. The exchange rate of EUR/ALL and USD/ALL showed that the domestic currency lost ground versus these two currencies, by 0.56% and 0.03%, respectively.

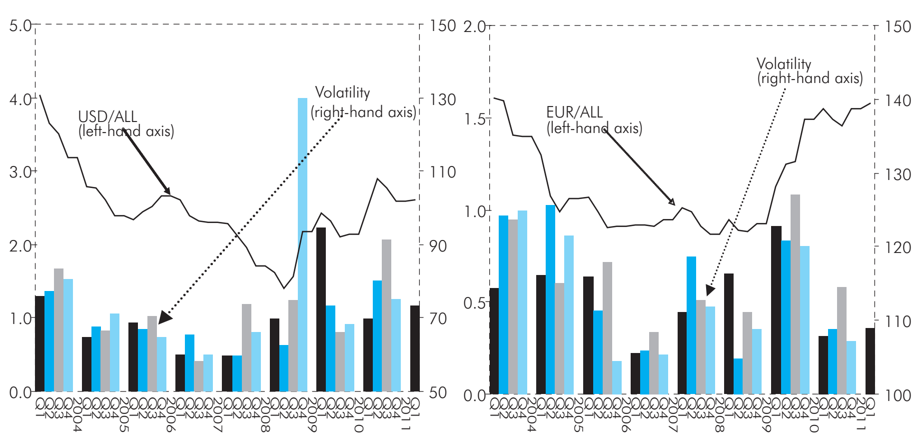
Chart 54 Daily EUR/ALL and USD/ALL exchange rate (left) and EUR/ALL for 2010 Q1-2011 Q1 (right)



Source: Bank of Albania

The positive performance of the ALL against the USD during this quarter is a reflection of the EUR/USD exchange rate in the international markets. The depreciation of the USD against the EUR by an average of 0.72% q-o-q reflects the non-optimistic outcomes regarding US economic growth and the European monetary policy response, which was preceded by the increase of the Euribor in the early months of 2011. Against a similar setting, this ratio is expected to preserve the cyclical performance as long as the fiscal strains loom on the horizon.

Chart 55 Exchange rate volatility* of ALL/USD (left) and ALL/EUR (right), q-o-q

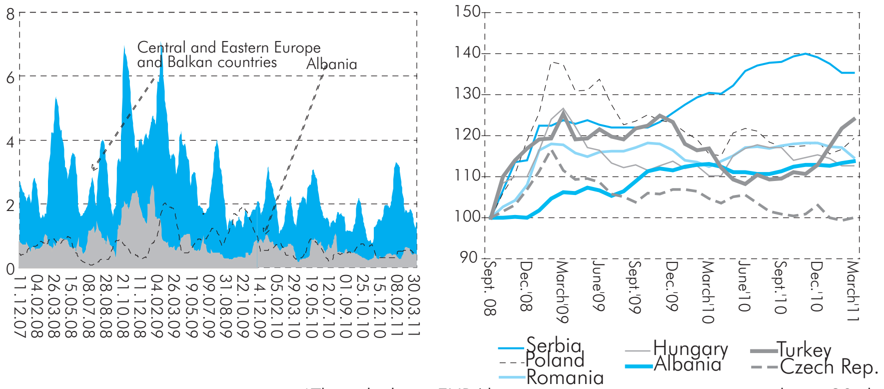


*Measured as the quarterly average of exchange rate volatility.
The latter is measured by the standard deviation indicator.
Source: Bank of Albania

On the other hand, the seasonal weakening of the ALL against the EUR shifted timely and concentrated mainly in March when the depreciation of the ALL averaged -0.4% in monthly terms. For the first time, this ratio reached the historical peak of ALL 140.14 per EUR 1. The foregoing developments in EUR/ALL in 2011 Q1 yielded a relatively higher exchange rate volatility than in the same corresponding quarter in 2010. The seasonal effect due to the closure of foreign companies' balance sheets (profits flowing out to the countries of origin), the termination of the year-end effect, and the higher Government spending contributed adversely to LEK's exchange rate in March.

In a regional context, the EUR/ALL was stable and showed a slight depreciation tendency. This performance of the ALL is in line with that of other currencies of Central and Eastern European and Balkan countries against the EUR. The dynamics of EUR/ALL appeared markedly smoother in 2011 Q1, reaching, by the end of the period, the lower limit in the extreme values range of the EUR/domestic currency volatility.

Chart 56 EUR/ALL performance and volatility* in comparison with Central and Eastern European and Balkan countries**

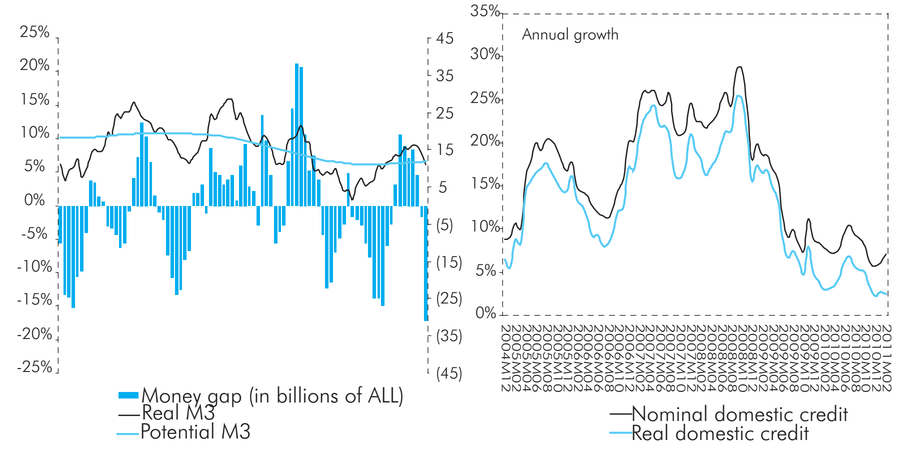


*The volatility in EUR/domestic currency ratios is measured as a 30-day standard deviation. The peak volatility in each period represents the maximum and minimum standard deviation of these ratios. The selected countries are Poland, Czech Republic, Hungary, Romania, Turkey and Serbia.
**This index was indexed to the base month of October 2008. The selected countries are Poland, Czech Republic, Hungary, Romania, Turkey and Serbia. These countries apply an exchange rate regime similar to Albania's (free-floating exchange rate regime).
Source: Bank of Albania

V.3. ASSESSMENT OF MONETARY INFLATION PRESSURES

Money growth rates in economy slowed down in the first months of 2011. Real aggregate M3 slowed its annual growth rates down from about 9% in 2010 Q4 to 6% in February. In addition to the more moderate needs of the economy for money, this slowdown is also a reflection of the higher CPI in February. The foreign currency component provided the major impact on the performance of demand for money, reflecting, to a large extent, the lower circulation of foreign currency in the economy, and the lower financing of banks abroad. Domestic credit grew moderately in nominal terms, due to the public and private sector demand for higher financing. The first months of 2011 provided evidence for the resumption of moderate growth rates of private sector demand for money. Public sector demand, in the meantime, improved compared to 2010 Q4. The performance of money indicators in the first months of 2011 corroborates the widening in the negative money gap, hence confirming downward pressures on inflation.

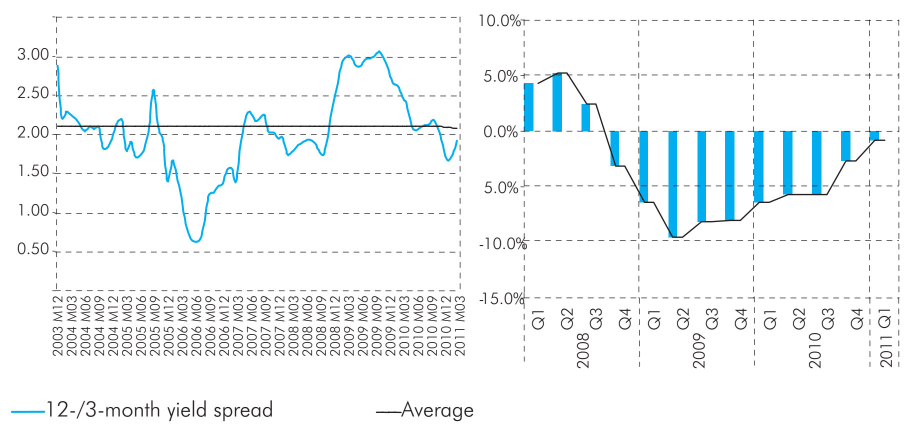
Chart 57 Annual performance of monetary indicators, in %, and money gap*, in billions of ALL



*Money gap is measured as the difference between real M3 and its potential, generated using the HP filter.
Source: Bank of Albania

The financial markets featured slight rises in the interest rates and a stable exchange rate in the first months of 2011. The higher interest rates in the financial markets were also a reflection of the monetary authority's decision to raise the key policy rate. In the primary market, the increase in interest rates was most apparent in 12-month T-bills. The spread between 12-month and 3-month T-bill rates has been increasing in 2011 Q1, but it however remains below the historical average. The wider spread is rather a reflection of the higher Government demand for 12-month T-bills, in response to the higher fiscal activity than the materialization of economic agents' expectations for mounting inflation pressures in economy.

Chart 58 Interest rate and exchange rate gap



*Quarterly annual changes of NEER index.
Source: Bank of Albania

The foreign exchange market experienced a slight and gradual depreciation of the exchange rate against the major currencies in 2011 Q1, mostly due to the seasonality of its behaviour during this period. However, in annual terms, the NEER[41] changes provide evidence for the gradual termination of the depreciation tendency, which reached the lowest levels since 2008 Q4, when the effects of the global financial crisis first emerged in Albania. The escalated termination of Lek's depreciation tendency against the major currencies contributed to further consolidating the financial activity of the banking system. In addition, foreign exchange market developments did not generate additional pressures on import prices in the Albanian consumer basket and, considering the lags in the exchange rate transmission channel, they do not signal mounting pressures in the three quarters ahead.

[41] *The composite exchange rate of ALL against EUR and USD.*