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

MONETARY POLICY REPORT
2011 Q2

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C H A R T S

OBJECTIVE

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

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

In view of achieving this goal and enhancing its transparency, the Bank of Albania prepares and releases its Monetary Policy Report. This Report is the Bank of Albania's main instrument 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 Q2 was approved on 27 July 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 July 2011.

I. FOREWORD BY THE GOVERNOR

The Albanian economy continued to grow during 2011 H1, although in the presence of added challenges generated by the internal and external economic environment. Tensions in global economies and financial markets, as well as increased prices of food and primary commodities, led to shrinkage of Albania's economic activity. The first factor raised the uncertainty of economic agents as well as risk premiums in financial markets, while high inflation imported from world markets decelerated domestic demand and increased inflation expectations at home. Despite unfavourable factors, Gross Domestic Product posted growth and main macroeconomic balances and financial stability remained stable.

According to INSTAT data, Albania's GDP growth was 3.4% y-o-y in the first quarter, supported by the fiscal stimulus of this period and foreign demand for Albanian products and services. On the other side, private consumption and investments continue to be slow, reflecting cautious consumer behaviour and existence of spare production capacities in the economy, respectively.

The Bank of Albania deems that economic activity posted similar growth even in the second quarter, but with higher contribution of the private sector and downward public sector and foreign demand.

Consumer prices were under added inflation pressures during 2011 H1, mainly due to import price increase in global markets. Average annual inflation during the first and second quarters of the year was 4.0% and 4.1%, respectively.

As regards the consumer basket items, prices of processed foods had the main impact on the formation of annual inflation. Their contribution to headline inflation floated around 55%, close to this indicator's all-time record. Inflation of non-food consumer goods, such as oil and other day-to-day consumer goods and services, was an added contribution to consumer price hike. On the other hand, the contribution of non-processed foods to inflation was stable.

Gradual upsurge of domestic food products supply during the second quarter offset the effect of these items' price rise in international markets. Lastly, administered prices and higher excise on some products had an increasing impact on annual inflation, albeit lower compared to a year earlier.

Concerning the macroeconomic aspect, a number of factors contributed to inflation over this period, with various degrees of intensity and opposite directions of action. Upward inflation pressures were generated mostly by conjunctures of raw material and primary commodity prices in international markets. Imported inflation was transmitted directly to increased consumer goods prices in Albania. It exercised additional pressures on producer prices and inflation expectations, but these second-round effects remained controlled. Furthermore, the negative output gap continued to exercise downward pressures on prices balancing, in part, the effect of import price increase. The expansion of economic activity continues to be below the potential of the economy, leaving unutilized capacities in the labour and capital markets. Under these conditions, inflationary pressures from the real sector of the economy remain controlled. This is also reflected in the performance of core inflation, which, although upward, remains anchored close to the Bank of Albania's medium-term inflation target.

Moreover, monetary indicators generated contained inflation pressures, reflecting also a prudent monetary policy of the Bank of Albania. In March, the Supervisory Council of the Bank of Albania decided to increase the key interest rate by 0.25 percentage points, to 5.25%. This decision was made in response to added inflation pressures of foreign origin. It aimed at preserving the anchoring of economic agents' expectations for inflation and minimising second-round effects. Even after this increase, domestic monetary conditions remained stimulating and provided the economy with the appropriate support at this stage of its development. In line with the action time-span, this move is considered to have been effective in signalling the commitment of the Bank of Albania to comply with its inflation target and keep inflation expectations under control. In addition, it kept the stimulating nature of the monetary policy and conditions unchanged, as reflected in comparatively low interest rates, ample liquidity in the banking system and exchange rates favouring the Albanian exports.

Let me now focus on the economic highlights defining the inflation performance and future outlook.

In line with its past year's performance, the expansion of the Albanian economy during the first and second quarters of 2011 relied mostly on the growth in industry and services sectors. Owing to foreign demand, industrial output increased by 12.3% y-o-y, providing the major contribution to the expansion of the economy in the first quarter. The services sector, topped by "Trade, hotels and restaurants", continued to support economic growth, although less than last year's quarters. This sector grew 1.8% y-o-y in the first quarter of 2011. The services sector performance is closely connected to consumer spending performance, which I will address later. After five quarters of contraction, the construction sector posted an annual growth of 4.6%, triggered by higher public investments during this period. Lastly, agriculture maintained growth and contribution rates similar to the last quarter of 2010.

Indirect data obtained from business surveys and monetary indicators suggest that this performance is and will continue to be along the same lines even during the second quarter and beyond.

On the demand-side, economic activity relied mostly on foreign demand and public spending, while private sector contribution was low.

Indirect data support the assessment for a weak private consumption performance during 2011 H1. In spite of increased disposable income and improved bank lending – as indicated by higher employment, real wage and consumer and house-purchase loans – consumer confidence was low. The Albanian consumer continues to be cautious in spending, displaying higher propensity to save over the past quarters. Naturally, this behaviour is a structural correction of the consumption model shown over the past years, but the slow performance of consumer spending also reflects added uncertainty about the future.

While the first component is welcomed, in the context of preserving macro- and microeconomic balances, the second component may and should be corrected: household consumption has the potential to grow and be stimulated in the short and medium run. Taking into account the high share of consumption in the GDP, its performance will substantially condition economic growth during this time span.

Private investments increased at moderate pace during 2011 H1 as illustrated by higher loans for investment and imports of capital goods. Although the financial conditions – availability, liquidity and bank interest rates – have improved significantly, the existence of spare capacities in the economy limits the demand of businesses for investment. In the short run, the position of economic activity operating below its potential conditions a slow performance of investments. In the medium and long run, investments performance will reflect developments in domestic and foreign demand. Given the need for a more competitive Albanian economy and its further orientation towards exports, stimulation of investment, increase of production capacities and adoption of more advanced processes and technologies should be priorities of the country's development policies, in the macro- and microeconomic aspects.

Public expenditures provided a positive contribution to the aggregate demand of 2011 H1. Following the last year's consolidated behaviour, the fiscal policy was stimulating during this period. Public spending increased by 7.4% y-o-y, led primarily by current expenditures, with an added positive contribution of capital expenditures as well. On the other hand, budget revenues were slow, increasing by 1.1% y-o-y. The differences between the growth rates of revenues and public spending materialised in the widening of the public deficit. In GDP terms, budget deficit at the end of 2011 H1 stands at 4.1% or about 1.5 percentage points higher than a year earlier. Expanded fiscal policy was more present during the first quarter of the year, while in the second quarter it was more moderate. Revenue and spending growth rates reduced during the second quarter, leading to the need for the revision of the 2011 budget, in order to preserve the parameters of public finance soundness in the medium and long run. On the other hand, measures to control budget deficit through the reduction of public spending implies modelling the fiscal stimulus during the second half of 2011.

Foreign demand continued to provide a positive contribution to the aggregate demand. Nevertheless, as expected, its positive impact was lower than a year earlier. During the first five months of the year, Albanian exports increased by 23.3% y-o-y, which is lower compared with 2010. On the other hand, the worsened terms of trade and domestic demand performance triggered the increase of imports in the first half of the year.

Value of imports increased 14.1% y-o-y during January-May, thus, leading to higher trade deficit. Following its narrowing in 2010, this deficit widened by approximately 8.8% y-o-y during this period.

Trade deficit widening, negative foreign currency flows in the services account and lower remittances reflected in the widening of the current account deficit in the first quarter. At the end of the first quarter, this deficit accounted for 11.8% of the GDP, illustrating the fragile position of the external sector of the economy.

The performance of the four demand components led to positive, but below potential, economic growth during 2011 H1. Unutilised capacities in the economy controlled producer prices and generated contained inflation pressures.

Monetary indicators analysis confirms our assessments for contained inflation pressures suggesting that money supply growth rates are moderate and in line with the economy's demand for real money. In average terms, M3 annual growth was 11.3% in January-May, triggered by a steady growth of deposits in the banking system. Demand for money is dominated by public sector's demand for funding, while the private sector's demand was more moderate. Lending to the private sector increased on average by 11.5% during the first five months of the year, about 1.5 percentage points higher than in 2010 H2. In contrast to previous years, lending is oriented more towards the national currency: ALL-denominated loans increased by about 14% as at May. Lending continues to be impacted by a moderate demand for loans, while the banking system has adopted prudent lending practices, with tightened lending standards for certain market segments.

Financial markets were calm reflecting low risk premiums and a good liquidity situation. In the interbank market, interest rates fluctuated close to the key interest rate, following its latest increase in March. The increase in the key interest rate is also followed by the yields in the Government primary securities market, and is reflected less in the ALL-denominated deposits and loans, due to factors of liquidity and risk accompanying financial intermediation. The yields curve has maintained its trend, indicating low inflation premiums in financial markets.

Summing up the expected economic performance, our projections and assessments suggest that economy will continue to grow in 2011 H2. Aggregate demand will be supported less by the public sector and foreign demand, while the private sector is expected to provide a larger contribution to the economy.

Nevertheless, economic growth is not expected to fill completely the negative output gap. The Albanian economy will continue to have spare capacities in the capital and labour markets, avoiding potential wage-inflation spirals and producing contained inflation pressures in the medium run. We deem that the monetary conditions are appropriate to stimulate economic growth, without generating additional inflationary pressures. Given the fragile equilibriums of the Albanian economy, this philosophy will continue to guide our activity in the period ahead.

In addition, imported inflation is expected to decline and administered prices effects are expected to be eliminated in the medium run. In the presence of anchored inflation expectations by economic agents, the Bank of Albania deems that consumer price inflation will gradually settle close to its target of 3% in the period ahead.

II. EXTERNAL ECONOMY

II.1. ECONOMIC GROWTH AND MACROECONOMIC BALANCES

The global economy continued to grow supported mostly by the positive upward growth in major emerging market economies. The economic growth of industrialised economies remained weak due to lower paces of aggregate demand expansion and high unemployment rate. Moreover, elevated sovereign debt in some of these countries, and recently, the increased new public borrowing cost induced uncertainty about the short-term sustainability of macroeconomic balances. Global inflationary pressures continued to edge up in response to higher primary commodity prices in international markets, more specifically, food and energy prices. These pressures turned out to be higher in developing economies. Monetary policy of these countries focused on avoiding overheating of the economy and maintaining sound growth rates of activity.

Table 1 Selected macroeconomic indicators

Countries	GDP change		Unemployment rate	Inflation rate	
	2011 Q1/ 2010 Q1	2011 Q1/ 2010 Q4	May 2011	June 2011/ May 2011	June 2011/ June 2010
USA	2.3	0.5	9.2[1]	0.2[3]	3.6[3]
Euro area	2.5	0.8	9.9	0.0	2.7
Germany	4.8	1.5	6.0	0.0	2.4
France	2.2	1.0	9.5	0.1	2.3
United Kingdom	1.8	0.5	7.7[2]	-0.1	4.2
Japan	-0.7	-0.9	4.5	0.1[3]	0.3[3]

Source: Eurostat, respective statistical institutes

[1] Data for June

[2] Moving average for March 2011-May 2011

[3] Data for May

EURO AREA ECONOMY

Euro area economy continued to maintain positive annual growth rates, though the long-term economic growth of its periphery economies continues to be at risk due to high accumulated sovereign debt. Hence, according to the latest data, the euro area economy expanded by 2.5% in 2011 Q1 relative to 2010 Q1. Boosted consumer spending and aggregate investments, up 1.1% and 4.2% y-o-y respectively, provided the main contribution to this performance. The latest data on economic performance for 2011 Q2 show a slower pace of GDP growth, driven by moderate growth of investments in some sectors of the economy. Simultaneously, the tension induced in some financial market segments, mainly in T-bills, may condition the progress of the euro area real economy.

Unemployment rate continued to remain at historically high levels in 2011, though slightly down on a year earlier. In the meantime, inflationary pressures were upward in 2011 H1, mainly owing to higher energy prices.

UNITED STATES ECONOMY

Most recent estimates of the U.S. economy in 2011 Q1 point to an ongoing annual growth, albeit at more moderate paces than in 2010. Gross Domestic Product expanded by 2.3% relative to 2010 Q1. The main driver behind this performance was the increased consumer spending and aggregate investments, up 2.7% and 7.3% y-o-y, respectively. The deepening of net export deficit in 2011 Q1 contributed adversely to the annual performance of aggregate demand. Moreover, persistence in unfavourable labour market conditions, manifested in low new-job creation rates in the economy, contributed to maintaining a softened upward pace of consumer spending in 2011 Q2. Average unemployment rate for 2011 H1 was 9% or down 0.7 percentage points from 2010 H1. Inflationary pressures were upward, as a consequence of elevated food and energy prices. Average annual inflation rate for the first five months of the year was 2.6%, or up 0.3 percentage points from the previous year.

BRIC ECONOMIES

BRIC economies continued to pursue an annual upward trend in 2011 Q1, albeit at somewhat more moderate paces than in 2010. According to the latest data, in 2011 Q2, China's economy expanded by 9.5% y-o-y due to accelerated growth of industrial output and construction industry. In the meantime, the accelerated industrial output growth in India contributed to its GDP expansion by 8.5% y-o-y, in 2011 Q1. Brazilian economy expanded by 4.2% y-o-y in 2011 Q1 due to the accelerated growth in aggregate investments and merchandise export. The latest data on Russian economy for 2011 Q1 demonstrate a y-o-y 4.1% GDP expansion.

During 2011 H1, inflationary pressures were upward in BRIC economies, hence heightening the concerns about the overheating of the respective economies and pursuit of a tight monetary policy. Consequently, the central banks of India and China decided to raise their respective key interest rates in June, whereas the central banks of Russia and Brazil raised them for the last time in May 2011.

Table 2 Selected macroeconomic indicators for BRIC economies

Country	GDP y-o-y change			Annual inflation
	2010 Q4	2011 Q1	2011[1]	June-11
Brazil	5.0	4.2	4.5	6.7
Russia	4.3	4.1	4.5	9.7[4]
India	8.2	8.5	7.8	9.1[4]
China	9.7[2]	9.5[3]	9.5	6.4

Source: IMF, OECD, respective statistical institutes

[1] IMF estimates, April 2011

[2] Data for 2011 Q1

[3] Data for 2011 Q2

[4] Data for May 2011

ECONOMIES IN THE REGION

In 2011 Q1, the economic performance of countries in the region highlighted uneven annual growth rates across the most industrialized countries and developing ones. During 2011 Q1, the Greek economy shrank by 5.5% relative to 2010 Q1. In the meantime, industrial output over April and May fell by an average of 11% y-o-y, leading to persistent contracting trend of GDP even in 2011 Q2. On the other hand, the Italian economy grew slightly by 1.0% y-o-y, driven by lower consumer spending and slow pace of growth in private sector investments. Seeking to ensure long-term sustainability of the country's debt position, the Italian government introduced a fiscal package, which is expected to reduce fiscal deficit by about EUR 48 billion by 2014. In contrast, Turkey and Former Yugoslav Republic of Macedonia posted accelerated upward growth rates of their respective economies in 2011 Q1. In Turkey, the accelerated growth in industrial output contributed to GDP expansion by 11% y-o-y. In FYROM, the accelerated growth of consumer spending and aggregate investments led to an economic growth rate of 5.1% y-o-y.

Unemployment rate rose in Greece and Former Yugoslav Republic of Macedonia and fell in Italy and Turkey. Annual inflation rose in Greece and fell in Turkey and Former Yugoslav Republic of Macedonia. In Italy, June's annual inflation rate remained unchanged relative to that of May.

Table 3 Economic figures for countries in the region

Countries	GDP change	Annual inflation	Unemployment rate
	2011 Q1	June 2011	May 2011
Italy	1.0	3.0	8.1
Greece	-5.5	5.2	16.2[2]
FYROM	5.1	4.1	31.2[3]
Serbia	3.4	12.7	22.2[4]
Croatia	-0.8	2.0	17.5
Turkey	11.0	6.2	10.8[2]
Kosovo	5.5[1]	9.2	:
Albania	3.4	3.9	13.4[3]

Source: Respective statistical institutes, EuroStat, EcoFin, IMF

[1] IMF's projections for 2011

[2] Data for March

[3] Data for 2011 Q1

[4] Data for April

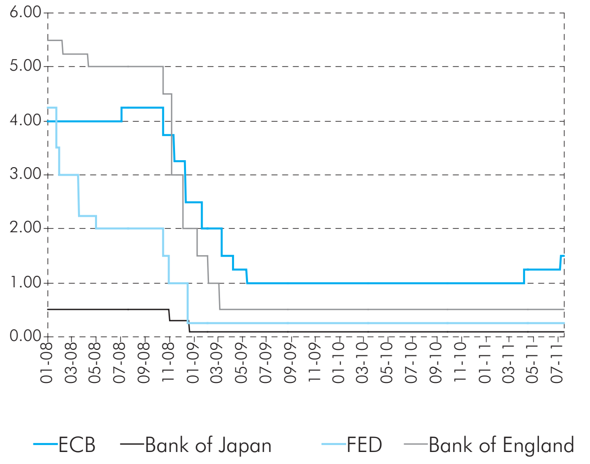
: Unavailable data

I.2. INTEREST RATE DECISIONS AND FINANCIAL MARKETS

The major central banks, except the European Central Bank, have kept their respective key interest rates unchanged. At its meeting on 7 July 2011, the Governing Council of the ECB decided to raise the key interest rate by 25 basis points to 1.5%. This decision was made to subdue inflationary pressures estimated as upward in the euro area member states and to maintain economic agents' expectations anchored around the ECB's 2% target. The latest ECB's key interest rate move was in April of the current year, raising it by 25 basis points.

Other central banks under review kept their key interest rates unchanged, aiming at providing further monetary stimulus to their economies. Hence, Fed's key interest rate is 0-0.25%, last changed in 2008; Bank of England's is 0.5%, last changed in 2009; and Bank of Japan's has been left in the range 0-0.1% since 2008.

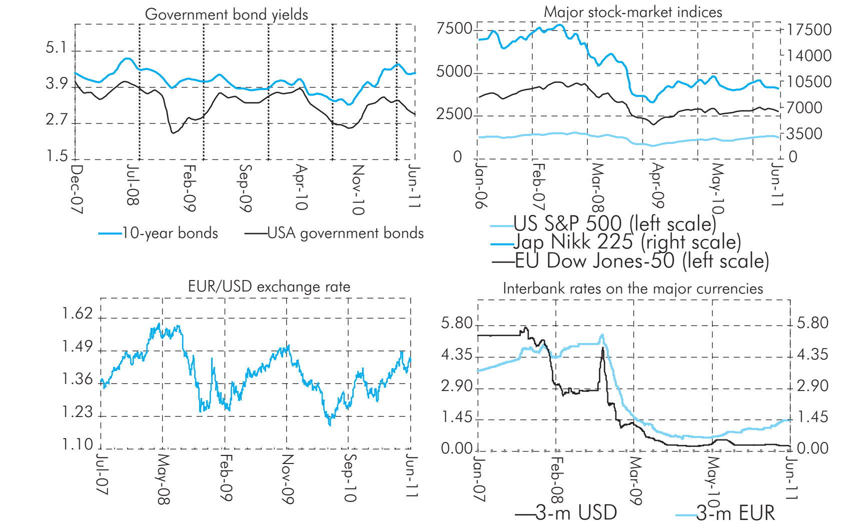
Chart 1 Key interest rates



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

Financial markets demonstrated a stable performance of indicators in line with economic agents' expectations and assessments. The euro area interbank market rates rose, transmitting the ECB's move set in early April. Interest rate lifts are marked for all maturity terms, whereas the winding-down effects of several facilities having been activated by the European Central Bank during the crisis continued to fuel this upward trend. Yields asked in government bond markets performed differently, reflecting market agents' assessments for categories of issuers. On the one hand, government bond yields continued to increase in countries with sovereign debt concerns (such as Greece, Ireland, Portugal and Spain); on the other hand, optimistic signals for the economic outlook in the major advanced countries and the onset of political upheavals in North African countries along this period, shifted a portion of security market demand to safe instruments. Consequently, during the past three months, the performance of bond yields in Europe and the U.S. pursued a downward trend. The main stock market indices were characterized by higher volatility than in the previous quarter. Even so, all in all, these markets reached positive values due to satisfactory results in a number of businesses and market agents' improved perception of the overall economic outlook.

Chart 2 Exchange rate and selected financial indicators in international markets



Source: ECB, Reuters

In June, Euribor interest rates of 1, 3, 6 and 12 months averaged 1.28, 1.49, 1.75 and 2.15%, up by 0.38, 0.31, 0.26 and 0.22 percentage points respectively, from March. The 3-month US dollar LIBOR rate fell slightly by 5 basis points to 0.25% in June.

In the foreign exchange markets, the Euro appreciated against the US dollar, British pound and Japanese yen during 2011 Q2. In early July, 1 euro was exchanged for 1.45 US dollar or up 2.56% from end-March. During this quarter, the Euro appreciated by an average of 5.23% on a quarter earlier.

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

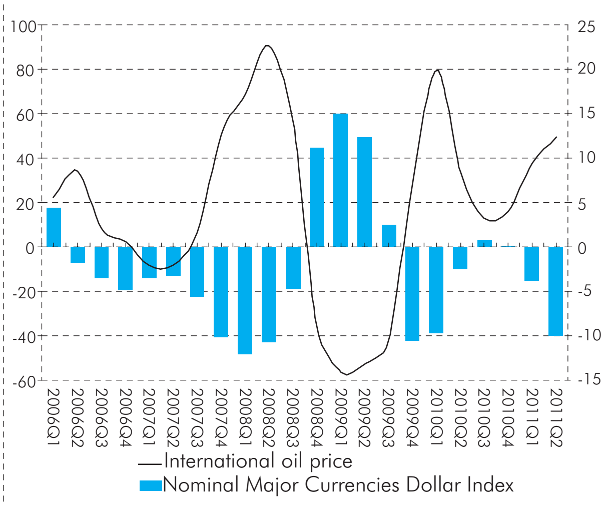
OIL PRICE

During 2011 H1, the average oil price per barrel in the international market accelerated its upward trend compared to 2010 H1. Thus, it picked up by an average of 43.7% y-o-y, to USD 111.2/barrel on average. However, the performance of the monthly average price of this product shows a downward monthly trend for May and June. The data related to the mitigated global economic growth released during 2011 Q2 and the reduced demand in China and the U.S. - the largest oil consumers - led to monthly decline in the average oil price over the past two months. Global oil demand increased approximately 1.7% y-o-y in 2011 H1, driven by a higher demand in the major emerging economies. Global oil supply also increased y-o-y during the period under review. Though the production quotas were estimated as downward by OPEC[1] member countries, the accelerated oil production in OECD countries, China and Russia, conditioned the global annual supply growth.

PRIMARY COMMODITY PRICES

The accelerated upward trend of primary commodity prices, which had begun since mid-2010, persisted in 2011 H1. Uncertainty about the economic outlook, against the backdrop of high sovereign debt-related concerns in advanced economies and various geopolitical tensions, made these indices pick up at high paces. Commodity Price Index and Food Price Index reached their historical peaks in 2011 Q1, whereas in 2011 Q2, both indices fell slightly q-o-q.

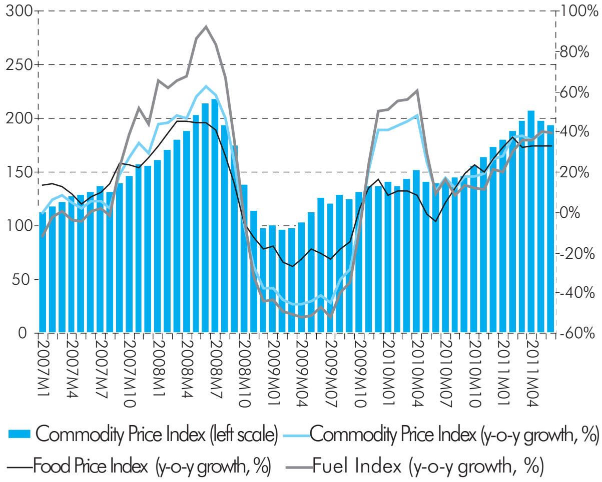
Chart 3 Annual change of international oil price and Nominal Major Currencies Dollar Index



Source: FED, EIA.

[1] *The accelerated reduction of oil production by Libya conditioned the reduction of total production quotas by OPEC member countries.*

Chart 4 Price indices by primary commodities and their y-o-y change



Source: IMF

During 2011 H1, Commodity Price Index marked a y-o-y growth by about 36.2%, whereas its six-month growth was 26%. During the period under review, the y-o-y growth of Food Price Index was 33.4%, while its six-month growth was 16.7%. Fuel Price Index also followed the movement of both other indices, marking a y-o-y growth by 33.7% and a six-month growth by 28.9%.

III. PRICE STABILITY AND BANK OF ALBANIA'S OBJECTIVE

Inflationary pressures were elevated during 2011 H1, driven by supply-side factors of foreign origin. Domestic demand generated relatively weak inflationary pressures due to the presence of negative output gap. Exchange rate depreciation at much lower paces than in the corresponding period of the previous year helped mitigate inflationary pressures in 2011 H1.

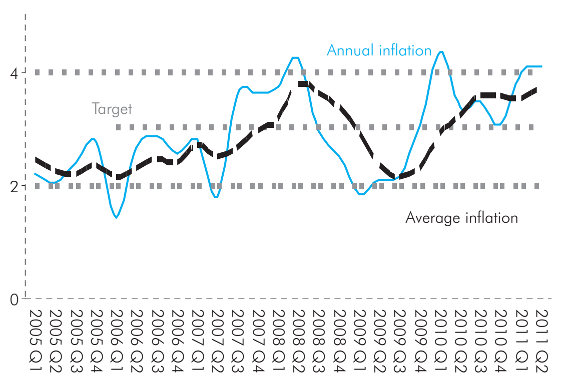
To curb market agents' rising inflation expectations and dwindle the materialization of second-round effects on consumer prices, the Bank of Albania's Supervisory Council lifted the key interest rate by 0.25 percentage points to 5.25% at end-March 2011.

Inflation was 4.1% in 2011 Q2. Inflationary pressures are expected to be high but gently volatile and downward over the monetary policy operation span. The Bank of Albania will keep on being prudent with regard to them, aiming at adjusting its monetary policy to attainment of its 3% inflation target in the medium term.

III.1. CONSUMER PRICES, TARGET MEETING AND MONETARY POLICY

Annual inflation averaged 4.05% in 2011 H1, remaining above the upper tolerance band set by the Bank of Albania for the medium-term objective. The high annual inflation rate was determined by February-May 2011's inflation. In June, it fell back to within the upper tolerance band (3.9%).

Chart 5 Annual actual and average inflation rate (in %)



Source: INSTAT and Bank of Albania

Despite the partly winding-down of several administered price rises effects, inflationary pressures remained elevated in 2011 H1. Persistent inflationary pressures became more evident in Q2, when average annual inflation hit 3.7%[2] or up 0.5 percentage points from the corresponding period a year earlier. Since autumn 2010, inflation rates have fluctuated within the 3.5%-3.7% range. These developments have been fuelled by upward primary commodity prices in international markets, pessimistic expectations for persistently elevated prices of global

[2] *Measured as a moving average of annualized q-o-q inflation for the last four quarters. This statistical technique seeks to capture the main tendency.*

agro-food products[3] and uncertainties induced from the depreciated position of the national currency against both major foreign currencies.

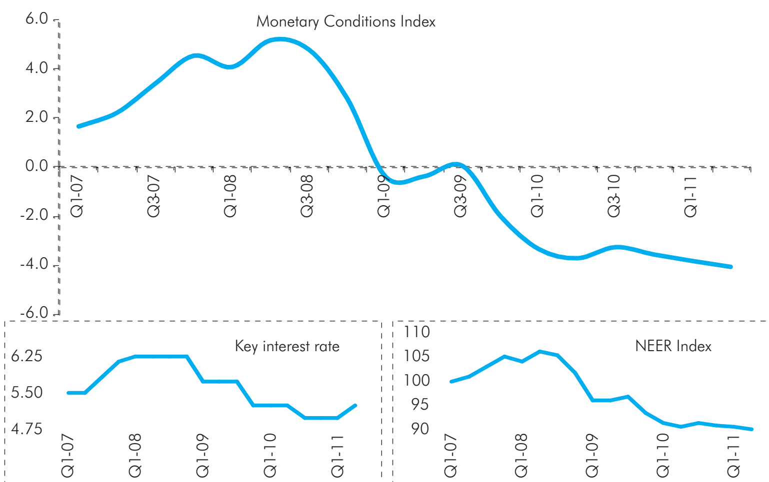
In 2011 Q2, the persistence of inflation was also confirmed by the upward trend of its long-term component and the relatively higher rates of non-traded inflation, net, of the CPI basket. The above trends were substantially determined by the materialization of second-round effects of rising primary commodity prices on those of services. Since early 2011, the main economic agents' upward inflation expectations backed the risk to commencement of an inflationary spiral with "high expectations" as the main argument. Inflation is estimated as upward in the past months, while domestic demand-induced inflationary pressures are judged to have provided low intensity.

Producer prices have increased since end-2010 onwards, mainly in food processing industry due to unfavourable conjuncture in international markets with regard to prices of primary commodities and auxiliary products in the relevant industry. It is assessed that producer prices influenced the price rise of the relevant CPI item in 2011 H1.

In April-June, the increase in the domestic supply of agricultural products produced significant seasonal effects, supportive to flattening the short-term inflationary pressures.

Consumer price volatility was mitigated by low depreciation rates of the national currency against the major foreign currencies. However, foreign trade developments over the first five months of this year attested to a continuing deterioration of trade deficit y-o-y. This development is likely to add pressures on the exchange rate in the periods ahead. Meanwhile, the contribution of imported inflation is estimated to have been substantial throughout 2011 H1, with a downward trend in Q2 due to the supply of domestic agricultural output.

Chart 6 Monetary Conditions Index (MCI, change on the base year)



Source: Bank of Albania

[3] FAO, monthly report released in July 2011; IMF, WEO, April 2011.

Stronger inflationary pressures are estimated to have been generated from the supply side. Combination and overlapping of the above factors' impact led to the identification of second-round effects and market agents' elevated inflation expectations. To prevent this phenomenon, the Bank of Albania lifted its key interest rate by 0.25 percentage points at end-March 2011. Based on the pre-emptive nature of monetary policy decision-making, it was judged that the key interest rate lift would help flatten the price volatility, whilst the size of this move would not depress the economic growth in the medium term.

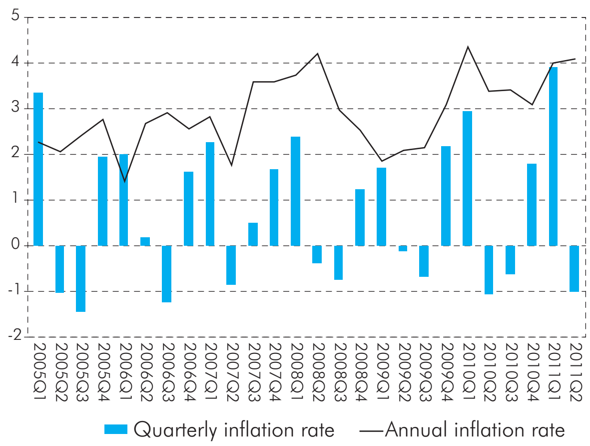
Monetary Conditions Index – expressed as the interaction of short-term interest rate and exchange rate performance – shows that during 2011, monetary conditions continued to be accommodative to economic activity. Slight depreciation of the national currency has supported external demand, while the key interest rate lift has tackled the elevated inflationary expectations without weighing on the domestic demand. The key interest rate move has been passed into the money market and partly into the deposit market; however, it has not provided any upward effect on private sector borrowing cost. Good performance of deposits has helped banks have ample liquidity and has made more room for their participation in lending. The Bank of Albania has been present in the interbank market by injecting the necessary liquidity through open market operations and exerting low pressures on banking system liquidity.

Remaining aware of the projections for fiscal indicators performance, monetary policy decisions will continue to be oriented towards curbing inflationary expectations in the economy. All in all, developments in the demand and supply and in the external sector of the economy signal the persistence of inflation risks to the country until the current year-end and a better situation in the first half of the next year. Forecasts for an ongoing negative output gap, against a background of below-potential capacity utilization rates, will help flatten inflation swings. Against the backdrop of non-optimistic future price conjuncture in international markets, the curbing of inflationary pressures generated from abroad will depend on the proactive and more competitive role of the domestic output in the markets.

III 2. INFLATION BY ITEMS

During 2011 H1, annual inflation of goods and services, divided by economic function, showed an upward trend relative to 2010 H1. Average annual inflation increased by 0.7 percentage points in this period. Following the rates above the upper bound of the tolerance band of February to May 2011, annual inflation fell back to the tolerance band in June. Annual inflation in 2011 H1 was formed chiefly from the contribution of processed foods (about 60%) and the rest from the low contribution of other CPI basket items. Besides the processed foods, non-food consumer goods also contributed on the upside over this period. Administered prices contributed on the downside. Unprocessed foods item demonstrated marked price volatility, first upward and then downward during the period under review. At the end of the period, the downward positive contribution of this item made inflation rate return slightly below the upper tolerance band of the Bank of Albania's target.

Chart 7 Annual and quarterly inflation rates (%)

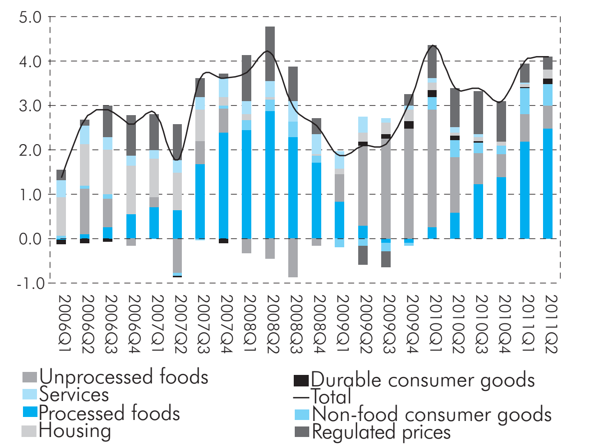


Source: INSTAT and Bank of Albania

During 2011 H1, annual headline inflation was formed mostly from the contribution of processed foods item. The upward trend of processed foods index, having started since August 2010, peaked in 2011 Q2. This quarter's inflation marked a double-digit positive rate (10.7%) or about 8 percentage points higher than in the corresponding quarter a year earlier. This item's inflation, after primary commodity price rises in the international markets, is and will continue to be determinant to annual inflation rates throughout 2011. Among the constituent items, bread and cereals, and alcoholic beverages and tobacco highlighted a price rise, contributing to headline inflation rate by 1.0 and 0.4 percentage points, respectively (or 35% of the headline inflation).

Supply-side shocks, which were partly offset by high seasonal behaviour of unprocessed food prices during the second quarter of the year, affected the domestic inflation negatively.

Chart 8 Contribution of main items to annual inflation (in percentage points)



Source: INSTAT and Bank of Albania calculations

Contribution of non-food consumer goods - the other item of inflation basket - increasingly gained ground in determining the headline inflation rate over this year, with the rise in oil and medicine prices. The upward trend of international oil prices over the past months was also reflected in the domestic market prices, which hit record highs over this period. Increase in medicine prices, particularly in the first quarter of the year, boosted the contribution of this item to headline inflation. Over much of the past ten years, this item's average contribution to headline inflation was 0.1-0.2 percentage points, whereas during this 6-month period, its contribution amounted to 0.5-0.6 percentage points. As a result, this item's contribution to the formation of headline inflation has increased, approaching that of unprocessed foods[4] - the most important item. Also, the prolonged influence of oil price rise, combined with the food price rise, has exerted additional pressure on the domestic inflation. Such behaviour would raise the potential for further materialization of second-round shocks to consumer prices.

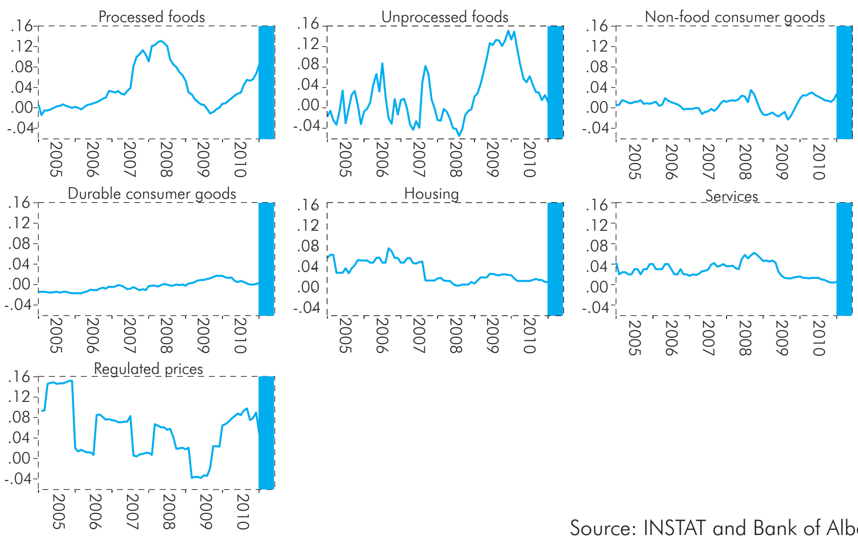
[4] *Fluctuations of unprocessed foods inflation, because of their seasonality, have historically determined the headline inflation rate.*

*Table 4 Annual contribution of main items to annual inflation (in percentage point)**

	Q2-09	Q3-09	Q4-09	Q1-10	Q2-10	Q3-10	Q4-10	Q1-11	Q2-11
Processed foods (pp)	0.3	-0.1	-0.1	0.3	0.6	1.1	1.4	2.2	2.5
Bread and cereals (pp)	0.2	-0.1	-0.3	-0.2	-0.1	0.1	0.4	0.7	1.0
Alcoholic beverages and tobacco (pp)	0.1	0.1	0.2	0.1	0.2	0.2	0.2	0.5	0.4
Unprocessed foods (pp)	1.8	2.3	2.5	2.6	1.3	0.9	0.5	0.6	0.5
Fruits (pp)	0.3	0.5	0.6	0.2	0.1	0.3	0.1	0.2	0.4
Vegetables (pp)	1.4	0.9	1.0	2.0	1.5	0.1	-0.7	0.1	-0.4
Services (pp)	0.3	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0
Administered prices (pp)	-0.4	-0.4	0.3	0.7	0.9	1.0	0.9	0.4	0.3
Fuels and energy (pp)	0.0	0.0	-0.1	0.4	0.4	0.4	0.4	0.2	0.3
Housing (pp)	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.2	0.2
Non-food consumer goods	-0.2	-0.2	-0.1	0.3	0.4	0.3	0.2	0.6	0.5
Durable consumer goods (pp)	0.1	0.1	0.2	0.2	0.1	0.0	0.0	0.0	0.1
Consumer Price Index (y-o-y, %)	2.1	2.1	3.1	4.3	3.4	3.4	3.1	4.0	4.1

Source: INSTAT, Bank of Albania

Chart 9 Annual inflation by items of goods and services (in %)



Source: INSTAT and Bank of Albania

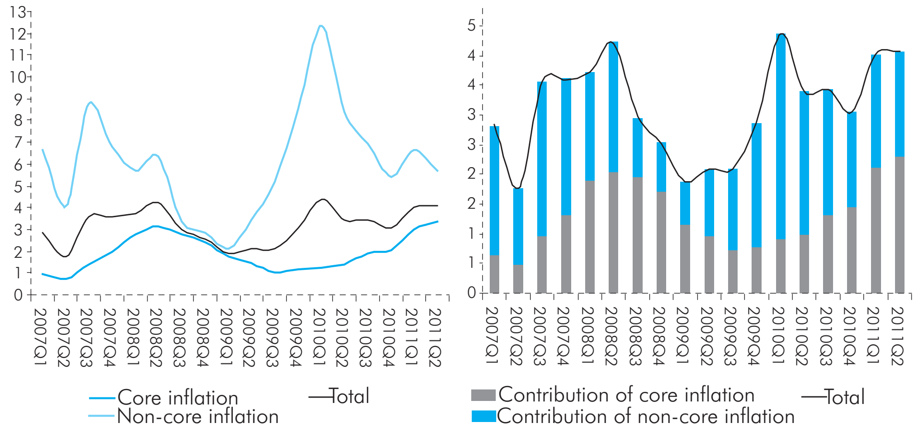
Unprocessed foods item was characterized by high inflation rates at year-start, which were later pushed down due to seasonal effects. Inflation rise was driven by insufficient domestic output to meet the demand for these goods, especially in winter. Moreover, coupled with the last year's floods and periods of bad weather, it damaged the supply of the domestic market with these products, affecting the market prices. On the other hand, increase in their imports boosted the chances for inflation to edge up, due to imported inflation impact transmitted from Albania's main trading partners' high prices for these products. In the second quarter, this item registered price cut, manifesting a different performance from the year-start. Specifically in June, this item's annual inflation dropped by 3.5 percentage points compared to this year's February. During the second quarter, the downward seasonal behaviour in prices of these goods pushed inflation curve down by several percentage points. The relatively high intensity of disinflationary impact of vegetables prices raised the possibility for pushing this item's inflation down, under the conditions when the imported inflation impact has been high over these past months.

In terms of other items' inflation, it is worth mentioning that administered prices pushed the headline inflation[5] down by 0.4 percentage points, reflecting the cancelling out of energy price rise in the past year's January and that of the price rise effect of several other items (such as, water, medical services, etc) that took place in this quarter. Other low-share items have generally contributed less to annual inflation rate.

III.3. MAIN INFLATION TRENDS

Annual core inflation[6] marked 3.2% in 2011 H1. During May and June, it reached the highest historical rates of its measurement (3.4%). Consumer price developments during the period under review confirmed the persisting upward trend of the long-term inflation component. In 2011 Q1 and Q2, core inflation reached 3% and 3.4%, respectively. The prise rise in some important CPI basket items used for core inflation measurement, mainly following February 2011, highlighted the presence of second-round effects on consumer prices. High persistence of core inflation in 2011 Q2 contributed about 57% to headline inflation formation. It is assessed as relatively high on a historical basis and on a quarter and a year earlier[7].

Chart 10 Core and non-core annual inflation (left) and their respective contributions (right)



Source: INSTAT and Bank of Albania

Non-core inflation resulted 6.2% in 2011 H1, down by 4 percentage points from 2010 H1. This development and its downward trend over the

5 In December last year, this item's contribution was 1.0 percentage points to headline inflation rate.

6 Average of two measures (permanent exclusion and trimmed mean).

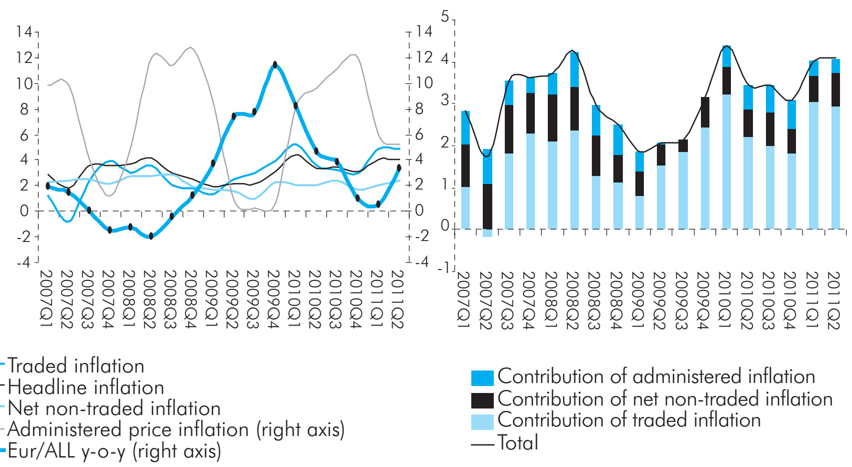
7 Up by 5 and 20 percentage points, respectively.

first two quarters of the current year[8] contributed to flattening the short-term consumer price swings. This behaviour was supported by a moderate annual depreciation of the nominal exchange rate, partial winding down of administered price pickups and the markedly seasonal behaviour of prices for several agricultural products, especially in Q2. As a result, the contribution of non-core inflation to the headline one reached 48% and 43%, respectively, for the first two quarters of 2011.

Annual traded inflation averaged 4.85% in 2011 H1. It did not mark any obvious fluctuations between the quarters[9]. International price rises in primary commodities and basic materials - agro-industrial and agro-food ones - and the projections for the persistence of their high values, pushed this sector's inflation up in February – May 2011. In the meantime, less depreciated exchange rate is one of the factors that mitigated this sector's inflation volatility on a year earlier. In light of the above developments, the annual contribution of traded inflation to headline one was 76% and 72% in 2011 Q1 and Q2, respectively.

Annual non-traded inflation, net[10], of the CPI basket, was 2.2% in 2011 H1, a higher rate than the past year's. This sector's inflation amounted to 2.4% in 2011 Q2, from 2% in 2011 Q1, contributing 19% and 16%, respectively, to headline inflation. The increase in non-traded inflation, net, of the CPI basket is assessed to have been driven by contagion price effect from prices of goods to services

Chart 11 Annual inflation by sectors (left) and respective contributions (right)



Source: INSTAT and Bank of Albania.

In response to inter-sectoral developments in consumer prices, inflation differential between the tradable goods and service[11] sectors, reached 2.4 percentage points in 2011 Q2, from 2.8 percentage points in 2011 Q1.

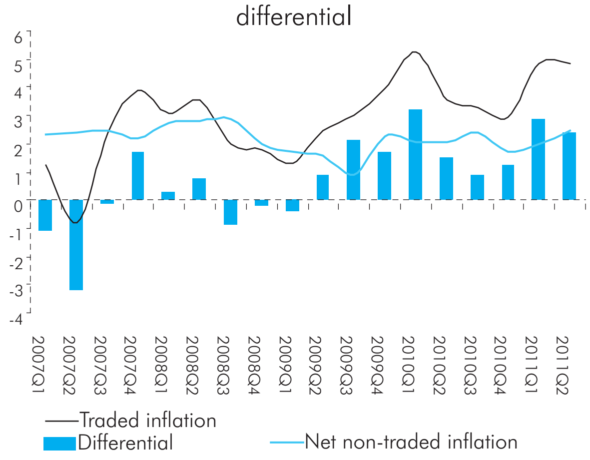
8 *6.6% and 5.7%, respectively.*

9 *In each quarter, this sector's inflation registered 4.9% and 4.8%, respectively.*

10 *Excluding the effect of administered prices (electrical power, water and hospital services) volatility.*

11 *Better proxied by net non-traded inflation.*

Chart 12 Performance of inter-sector inflation differential



Source: INSTAT and Bank of Albania

Translated into respective annualized contributions, this differential provides information on the intensity of inflationary pressures generated from import activity[12]. In 2011 Q1 and Q2, the annual contribution of imported inflation to the headline one accounted for 60% and 52%[13], respectively. The more moderate level in Q2 is an outcome of the mitigated pressure from abroad on food prices owing to a higher domestic supply and the moderate and stable exchange rate depreciation.

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[12] *It includes the combined impact of foreign inflation generated by import activity with main trading partner countries and exchange rate effect (depreciated in annual terms since December 2008).*

[13] *This estimate is based on the meaning of the differential indicator between prices of goods (more exposed to foreign competition and exchange rate volatility) and services (whose prices are set mainly in the domestic market). The latter do not exclude the contagion effects generated by raw material prices. The indicator of inflation differential and of relevant contributions assumes that the portion of non-traded inflation, net, is part of traded inflation. Making the difference, price setting effects in the domestic market are excluded from the traded inflation. As such, it informs only on the foreign price impact, combined with that of exchange rate, on headline inflation.*

IV. MACROECONOMIC DEVELOPMENTS AND IMPACT ON INFLATION

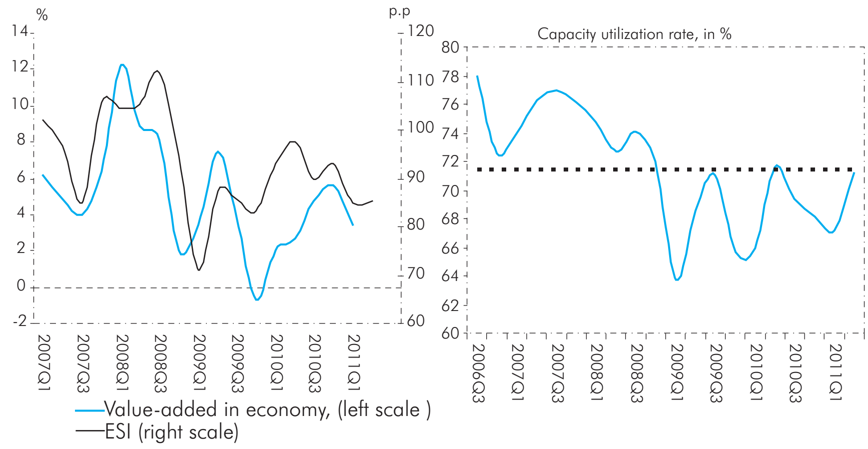
According to INSTAT, Albanian economy recorded an annual growth of 3.4% in 2011 Q1. On the one hand, this growth has been sustained by the higher economic activity in all the sectors of the economy, particularly in that of industry and services. Despite the upward trend, the expansion of economic activity in the country remains below the potential, confirming the so-far estimates of contained inflationary pressures stemming from the existence of a negative output gap. On the other hand, good performance of exports has continued to underpin the positive rate of economic activity expansion, albeit to a lesser extent, on a year earlier. Meanwhile, the fiscal sector stimulus policy has provided a positive impact on the domestic demand growth, offsetting the slow pace of investments and private consumption over this period. The latest data indicate the continuation of positive growth rates during the current period, which is expected to be backed more on private sector's contribution. These data also show that the need for restructuring the economy to enhance its competitiveness seems to have found an answer in the Albanian businesses' response. The effects of these changes, coupled with reduced uncertainties about internal and external environment, as well as with the increased funding from the banking sector, will contribute to a sustainable growth of Albanian economy in the future.

IV.1. GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

Gross Domestic Product grew by 3.4% in 2011 Q1. On the supply side, industrial sector was the main driver to annual GDP growth, whereas the service sector and construction and agriculture branches provided a positive contribution to the growth. On the demand side, the economic growth was sustained mostly by private sector expenses and investments. External demand growth, though positive, was downward, whereas private sector investments and consumption remained sluggish. Data from confidence indicators show a similar performance of the economic activity even for Q2.

According to INSTAT's data, Albanian economy recorded an annual growth of 3.4% during 2011 Q1, continuing to generate positive growth rates over this period as well. External demand provided less support to Q1's economic growth, being reflected in a slower expansion of Albanian exports and trade deficit widening over this period. On the other hand, domestic demand was broadly fuelled by rapid growth of public spending, while private consumption and investments performed sluggishly.

Chart 13 Annual GDP growth, Economic Sentiment Indicator and capacity utilization rate



Source: INSTAT and Bank of Albania.

IV.1.1 OUTPUT BY SECTORS

According to INSTAT's data, the economic growth in 2011 Q1 appeared more balanced as concerns its sectoral distribution. All the major sectors of the economy are estimated to have increased over this period, but the economic growth continued to be led by both industry and service sectors. Meanwhile, partly also in response to increased public investments, construction sector recorded a positive growth for the first time after a long period of contraction over 5 quarters.

Table 5 Contribution of branches (in percentage points) to annual GDP growth (in %)[14]

	2008	2009	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1
Agriculture, hunting, forestry, fishing	1.4	0.3	1.6	2.1	1.2	0.4	0.5
Industry	0.7	0.6	2.1	2.0	1.4	2.6	1.4
Construction	1.7	0.0	-3.0	-4.8	-3.3	-2.0	0.5
Services	4.0	2.6	1.3	3.4	5.4	4.6	1.0
GDP at basic prices	7.8	3.6	2.0	2.7	4.7	5.6	3.4

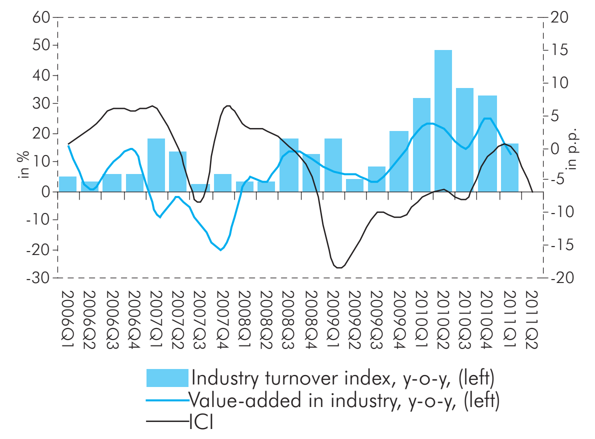
Source: INSTAT, Bank of Albania

Industry sector continued to affect the growth of gross domestic product to a greater extent than other sectors of the economy. Value-added in industry sector grew by 12.4% y-o-y. However, depressed industrial activity as a consequence of external demand restraint[15] was reflected in a decreased contribution of industry to annual GDP. Also, relative to 2010, the growth rate is down 8.3 percentage points. According to surveys' qualitative data, the deterioration of the new industrial orders index suggests a likely depressed industry for the rest of 2011.

[14] *Data in the table for 2008 and 2009 represent the year's contribution and average growth.*
[15] *Industrial exports include the main items of industrial products in EUR million.*

Analysed by sub-branches, in 2011 Q1, extractive and processing industries performed positively, while production of electricity, gas and water was contracted. More specifically, the extractive industry recorded the highest annual growth in terms of turnover by about 50% and in terms of production index by about 72%. Electricity, gas and water sub-branch pursued the opposite trend, marking an annual decrease of the turnover index by 14.3% and of the production index by 25.9%.

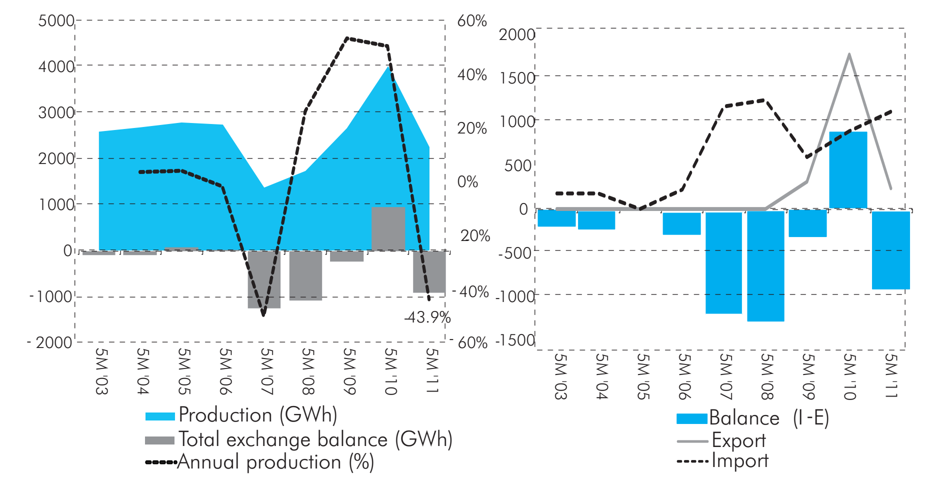
Chart 14 Value-added, Turnover Index and Industrial Confidence Index



Source: INSTAT and Bank of Albania

Electricity production in the first 5-months of 2011 fell by about 43.9% y-o-y, mainly due to decreased electricity generation from big power plant stations. Production generated from big power plant stations under concession and from private plants continues to mark positive growth rates (due to increased output and putting new plants in operation). During the first 5-month period of 2011, production from these plants grew by 10.9% y-o-y. Based on data from the AEC, during the period under review, the energy export was about 232.1 GWh, 7.6 times lower compared with a year ago.

Chart 15 Performance of main items of the energy balance

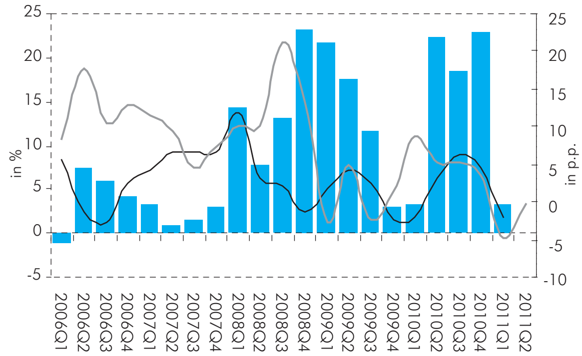


Source: AEC and Bank of Albania

Industry confidence surveys suggest a slower performance of this sector in Q2 of the year. Contraction of the main industrial exports for the first two months of Q2 may signal sluggishness in industrial activity, particularly in the one related to exports. Also, price rise in the global markets for a number of Albanian exports, mainly those related to mineral extraction and processing, is over, while the temporary nature of the rapid expansion of 2010's hydro energetic exports has been confirmed. Even so, industry sector represents one of the most credited sectors by the banking system, which will lead to a better performance of this activity in the medium run.

Value-added in service sector grew by 1.9% y-o-y, registering a slowed y-o-y growth compared to the three preceding quarters. This tendency is also confirmed by lower y-o-y growth rates in the turnover volume index of this sector. The contribution provided by services to annual GDP growth resulted 1 percentage point, significantly below its historical average.

Chart 16 Value-added, Turnover Index and Service Confidence Index

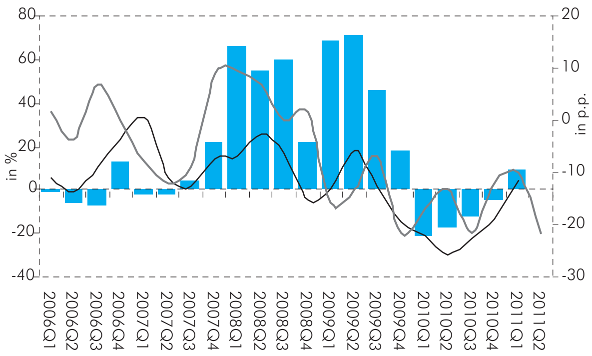


Source: INSTAT and Bank of Albania

At branch level, activities of "Trade, hotels and restaurants" and those of "Transport" marked positive y-o-y growth rates, 4.4% and 13.3%, respectively. The reverse dynamics was reflected by the branch "Post and telecommunication" and "Other services", which was reflected in the contraction of the valued added by 5.1% and 0.6% y-o-y, respectively. Based on the performance of the turnover volume index, the contraction of the sub-branch "Communication" by about 7.1% y-o-y has impacted on the non-positive performance of post and communication.

Service confidence index suggests an improvement of its performance in 2011 Q2, however, remaining below its historical average.

Chart 17 Value-added, Turnover Index and Construction Confidence Index



Source: INSTAT and Bank of Albania

Value-added in construction sector grew 4.8% y-o-y in 2011 Q1. Its improvement positively contributed by 0.5 percentage points to annual GDP growth. Indirect quantitative indicators, such as the turnover volume index in the construction branch, underpinned the better annual performance of this branch in this quarter. More specifically, turnover volume index was up 9% y-o-y, from an average of down 13.6% y-o-y in 2010. A more positive performance of construction owes primarily to expansion of engineering works[16], based on higher annual growth of the value of building permits approved for this category during the last quarter of 2010[17]. At the same time, the positive annual construction growth in 2011 reflected, inter alia, even the low comparison basis as concerns the number of building permits granted in 2010.

Construction confidence index was in line with the improved performance of this branch in 2011 Q1, while this indicator suggests deterioration of construction in Q2. According to business surveys, current and expected demand in the construction sector signal a less favourable situation of its

[16] *The category "engineering works" includes: transport infrastructure, water-supply, electric and telecommunication lines, complex buildings at industrial yards and other engineering works.*

[17] *Building permits granted during the current quarter are expected to reflect the performance of building activity in the following quarters.*

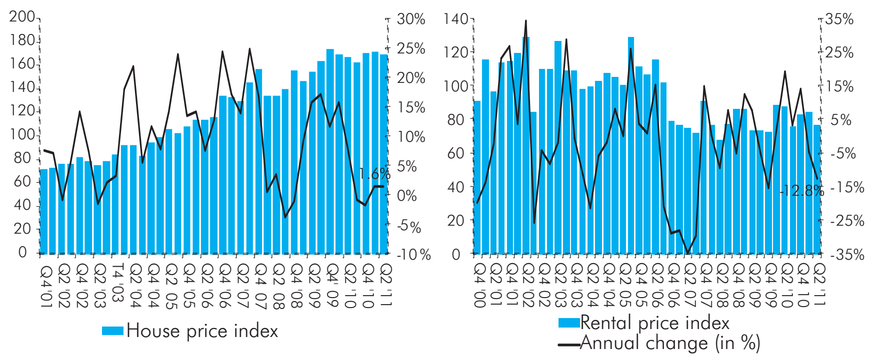
performance in Q2. Also, lending to construction activity resulted lower in April and May. On the other hand, rise in the number of residential building permits in 2011 Q1 is likely to provide positive effects on the performance of this branch during the current year.

Box 1 House price index and rental price index

House price index rose 1.6% y-o-y in 2011 Q2, maintaining the previous quarter's pace. Adjusted for the exchange rate effect**, house price index in Tirana has decreased by 1.2% in annual nominal terms and 5.0% in real annual terms.*

*House price developments in 2011 Q2 were influenced by a gentle recovery of the demand and supply. The number of residential building permits continued to grow in 2011 Q1. Improvement of this indicator for two consecutive quarters signals growth of future house supply. On the other hand, easer lending terms for house purchase*** in 2011 H1 led to increased demand, which in turn might have triggered the slight price rise in 2011 Q2.*

Chart 18 House price index and rental price index



Source: Bank of Albania

Rental price index has generally reflected a higher volatility over the past ten years, compared to House Price Index. In 2011 Q1, the rental price index for Tirana was down 4.5%, whereas in 2011 Q2, it dropped by 12.8% in nominal annual terms. In annual real terms, the rental price index fell by about 16.2%. The price-to-rent ratio was about 16.4% higher compared to the corresponding quarter a year earlier. During 2011 Q2, this ratio stood above its historical trend.

* *Analysis of house price and rent has considered only the information about prices in the capital, Tirana.*

** *A part of the annual change of the index, whose construction is based on converting flat prices from euro into lek, reflects the national currency's depreciation effect vs. the European currency.*

*** *Credit activity survey on 2011 Q1 and Q2.*

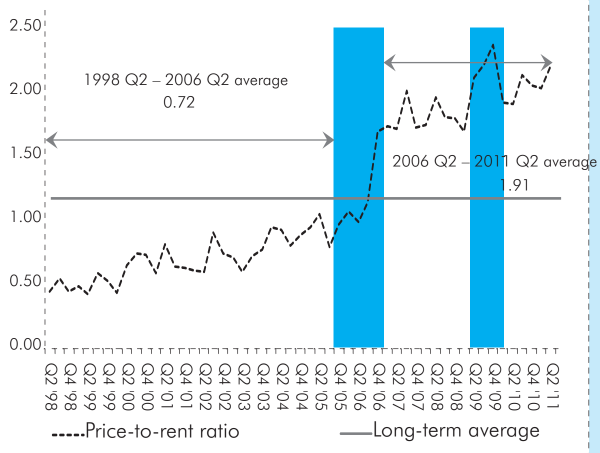
*Box 2 House prices in Tirana and their fundamental value**

Since 1998, house prices in the capital city have been constantly rising. Over this period, the house price index increased on average by about 9.2% y-o-y. Price rise has occurred in spite of the economic cycle. So, in the period to the onset of the global economic and financial crisis, the average annual growth rate of House Price Index (HPI) was about 9.3%. Upon the onset of the crisis and slowdown of the overall economic activity, the house price index in the capital city rose on average by 7.8% y-o-y.

This sector's developments have given rise to a number of comments and analyses, among which there is the idea of an overestimation of house prices in the capital city. One of the ways to see whether prices reflect the fundamental value of a residence is the price-to-rent ratio (HPI/RI). The fundamental value of a property may be considered the present value of income flows that it can generate in the future. Prices are considered over/under-estimated when the present value of a property differs greatly from its fundamental value. In a functional market, these income flows can be approximated to a house rent. Logically, one can speak about price overestimation, when we are in the presence of a relatively high and prolonged deviation of the HPI/RI from its long-term average. However, in practice, the fundamental value is impossible to be measured as long as it is difficult to make projections about future prices and rents and to determine the discount rate of these income flows. Therefore, the HPI/RI ratio is likely to be only a proxy in this regard.

*In the case of Tirana, there has been an ongoing upward tendency of price-to-rent ratio since the beginning of its measurement in 1998 Q1. The constant but contained increase in this ratio until the end of 2005 (this ratio is below 1 on average**) attests to a balanced rise in house prices in the capital, Tirana, due to the interaction of supply and demand in the market.*

Chart 19 Price-to-rent ratio



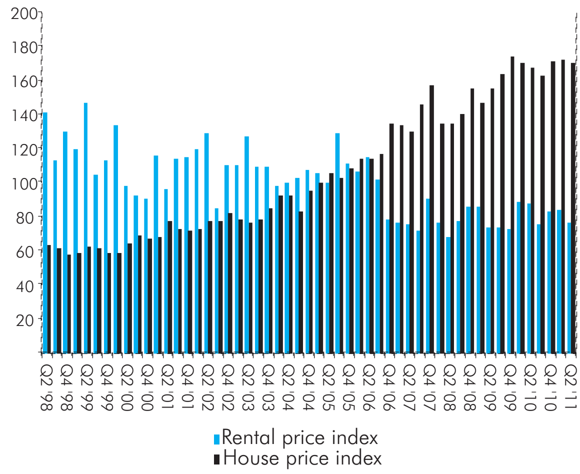
Source: Bank of Albania

Year 2006 highlighted an underlying growth or a jump in the price-to-rent ratio, which was due to the spread between both indices. In the period from the 1997 crisis to early 2006, the rent index marked high values, 112.1 on average. Since 2006, the average value of this index has been 79.2.

The same trend is observed even with regard to house price index in the capital city. In the period up to mid-2006, this index averaged 79.2. Since 2006 H2, this index has almost doubled to 151.6. Starting from 2006, we may observe a decline in the rent index and an ongoing growth of the house price index. This performance has also influenced the HPI/RI ratio, resulting to high levels for this period.

Casting a glance at the above data, one may draw the preliminary conclusion that house prices in Tirana have started to show signs of overestimation. This conclusion, however, should be cautiously managed and balanced with the likely limitations of analysis. First, this analysis assumes that Albanian families are indifferent or have constant preferences in time between purchasing a house and renting it. Moreover, it assumes that the source of demand for rent and house purchase is the same. Both assumptions are not necessarily accurate: Preferences for purchasing a house to renting it may change over time and families are likely to make choices not only driven by *financial motifs. Also, the potential demand for purchasing a house is extended to Albanian emigrants as well, who do not regard the rent as an option to the first option. Second, the analysis assumes that the financial market and the real estate market are perfect substitutes. In Albania's case, this assumption can be far from reality, as long as the financial market does not offer long-term instruments that can replicate the investment time frame that covers an investment in real estate. Third, the analysis abstracts from various factors, such as qualitative house improvements or problems with building permits. These factors are likely to have a non-symmetrical impact on the supply and demand ratios for house renting or purchasing, taking indicators away from their equilibrium values. Despite the analysis restrictions, the above reasoning, we think, provides a good starting point to judge on this issue.*

Chart 20 House price index and rental index



Source: Bank of Albania

* *The author of this Box is Merita Boka.*

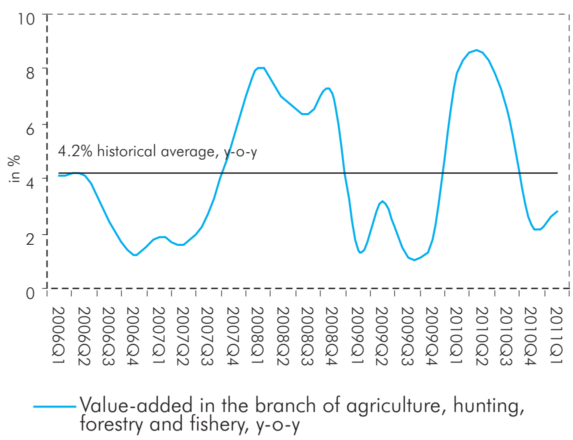
** *John Krainer, Chishen Wei, "House prices and its fundamental value", Federal Reserve Bank of San Francisco, 2004.*

In 2011 Q1, the value-added generated from agriculture, hunting, forestry and fishery branch to domestic output was up 2.8% y-o-y. Nevertheless, the extension of agricultural activity remains below its historical average and the pace recorded over 2010. Its contribution to annual GDP growth is estimated at 0.5 percentage points. This sector continues to suffer from structural problems, which make it difficult to access to domestic and foreign products markets and restrain its crediting from the banking system.

IV.1.2. AGGREGATE DEMAND COMPONENTS

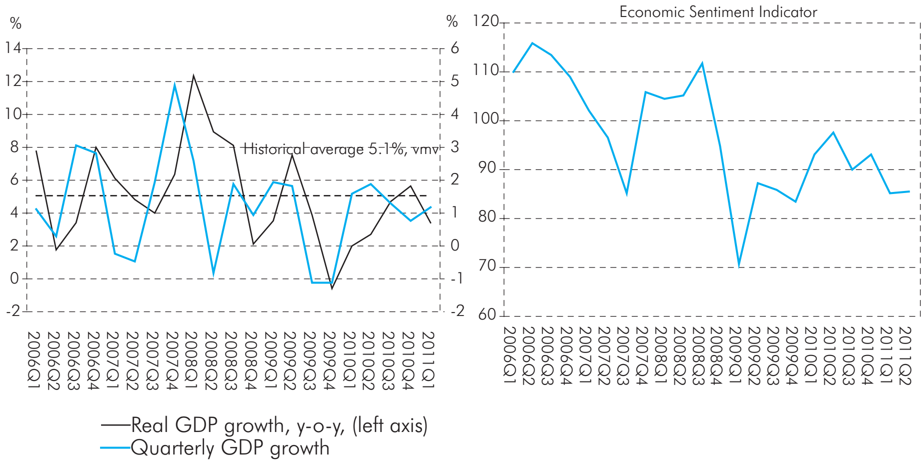
Based on preliminary data from INSTAT, the economic activity continued to expand in 2011 Q1. According to demand components, the economic growth was sustained basically from fiscal stimulus over this period, whereas external demand maintains a positive but downward contribution to aggregate demand. On the other hand, private consumption and investments had a sluggish performance. Private consumption remained contained due to a more cautious behaviour of Albanian families, whereas business investments continued to suffer from the uncertainty about the final demand in the future and higher risk premium.

Chart 21 Value-added in the branch of agriculture, hunting, forestry and fishery



Source: INSTAT

Chart 22 Annual and quarterly GDP growth (left), Economic Sentiment Indicator (right)

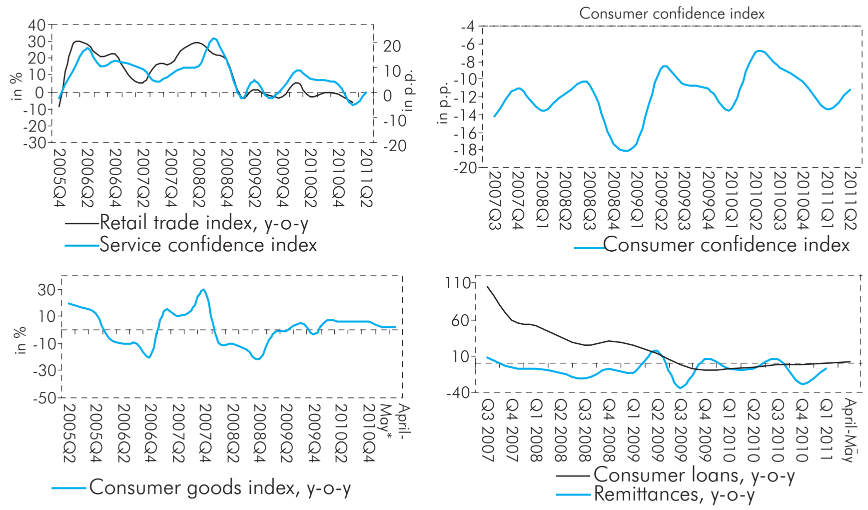


Source: INSTAT and Bank of Albania

PRIVATE CONSUMPTION

Indirect data available for private consumption show that it continued to provide a low contribution to aggregate demand growth. Quantitative indicators, which are used as a proxy for private consumption in the economy, slowed down the growth rates during the first quarter. Retail trade index contracted 6% in 2011 Q1, decreasing the demand for consumer and non-consumer goods, as well as for durable ones. Also, data on the import of consumer goods highlighted the same trend, leading to 2% y-o-y decline in real annual terms.

Chart 23 Indirect private consumption indicators



Source: INSTAT and Bank of Albania

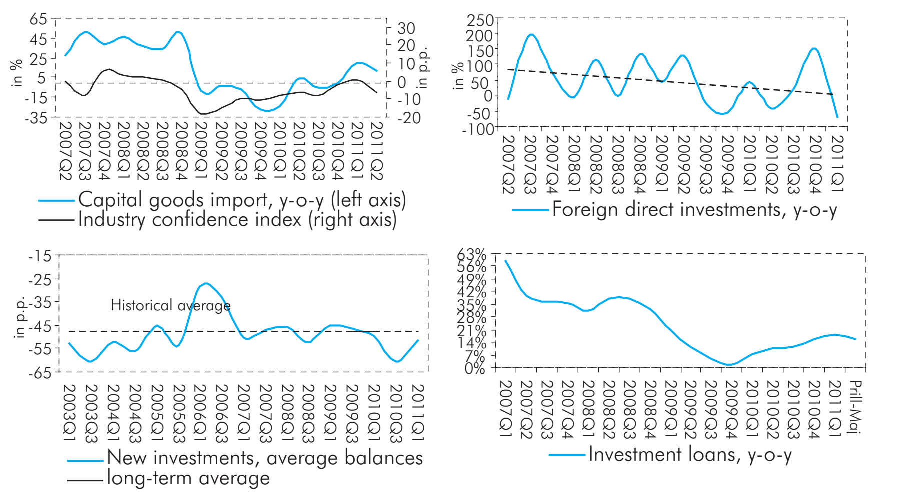
In 2011 Q1, private consumption financing was sustained by the growth of real disposable income. Wage index in the economy increased by 6.9%. In real terms, average wage in the economy increased by 3%, while remittance inflows fell by 8.2%. Data from surveys show that uncertainty about the economic and financial situation led to decreased consumer confidence indicators and increased propensity to save. The high level of households' time deposits, albeit lower than in 2010 Q4, shows that they are even more reluctant to spend. Private consumption financing through consumer loans remained low; outstanding consumer loans increased by 0.4% y-o-y in 2011 Q1.

Signals received from preliminary data on Q2 show a positive contribution of consumption to aggregate demand growth. Thus, during April-May 2011, the import value of consumer goods and outstanding consumer loans increased by 2% y-o-y. Also, consumer confidence and service sector indices rose in 2011 Q2[18]. Their improvement signals the private consumption recovery over this period, enabling optimistic projections even for the rest of the year.

PRIVATE INVESTMENTS

In 2011 Q1, private investments yielded low but positive contribution to aggregate demand. After the decline in two consecutive quarters, capital goods import grew by about 19.8% y-o-y. On the other hand, inflows of net foreign direct investments fell sharply by 67.5%, following the increase by 150% in the previous quarter. However, referring to investment instruments[19], inflows of investments rose by 7.2% y-o-y. Investment loan had a good performance in Q1 of the year, marking an annual growth rate of 18.4%.

Chart 24 Indirect private investment indices and inflows of foreign direct investments



Source: INSTAT, Bank of Albania

Investment performance has been favoured by external demand and continuing export growth, as well as by boosted business confidence in the manufacturing sector. Also, the injection of fiscal stimulus mainly in the form of capital expenditure should have encouraged private investments, in the form of a simple

[18] Data on confidence indicators are qualitative data obtained from surveys on a certain number of companies. Due to frequent structural changes in the economy, their results may not fully reflect the performance of the sector's activity.

[19] This item includes real estate securities, shares and profit re-investment. Decline in FDI is closely related to other capital instruments, i.e., investment outflows in the form of loans between inter-related companies.

tax multiplier. On the other hand, Albanian businesses continue to operate below the historical average capacity utilization rate in the economy, reducing their demand for short-term investments. In addition, the banking system has adopted a more prudential stance in terms of lending, and the funding conditions appear tighter compared with the global and financial pre-crisis period.

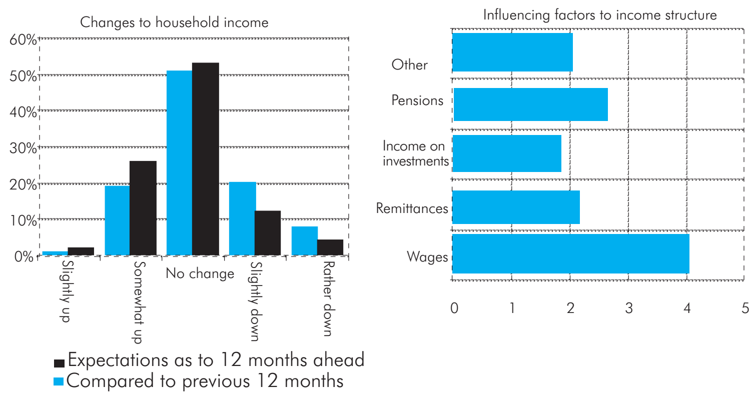
Indirect data on the performance of investments during Q2 make a complex picture. On the one hand, imports of capital goods and investment loans increased by 11.3% and 15.5% y-o-y, respectively, in April-May 2011. Also, increase in building permits for residences and engineering works in Q1, higher demand for house purchase loans and eased household loan standards may suggest the recovery of the activity. On the other hand, qualitative data obtained from business confidence surveys conducted in Q2 of the year show lower business confidence in industry and construction.

*Box 3 Business and consumer behaviour trends**

In business and consumer confidence survey in 2011 Q2, along with standard questions, survey participants gave information about some specific aspects. Consumers expressed their opinion about the change and structure of total household income, consumption and factors influencing it. Businesses informed about the restructuring processes undertaken in the last three years and to be undertaken in the months ahead, the reasons behind this choice and the income derived from these changes.

In the 2011 Q2 survey, the majority of consumers - about 51.3% of them - stated that the total household incomes have not changed compared to the previous 12 months. Even for the next 12 months, about 53.4% of consumers expect no change in the total household income. Meanwhile, about 28.3% of consumers expect their income to get higher in the next year.

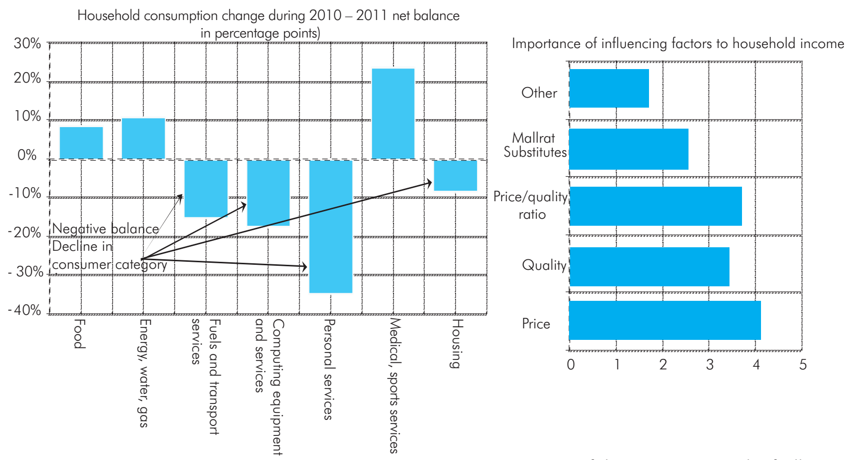
Chart 25 Total household income and influencing factors to income structure



Source: Consumer Confidence Survey, Bank of Albania

Consumers have assessed that wages and pensions are the most important factors influencing the income structure. Expectations for the increase in total income over *the next year may relate precisely with the expectations for administrative rise in wages and pensions in the 12 coming months.*

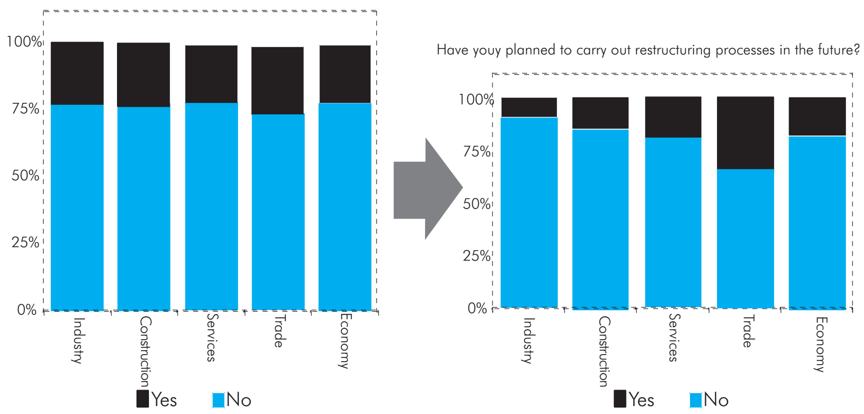
Chart 26 Household consumption structure



Source: Consumer Confidence Survey, Bank of Albania

During 2010-2011, household consumption structure presents decreased consumption for products, such as personal services (aesthetics, theatre, cinema, sport, travel, etc.), computer equipment and services, fuels and transport services. During that period, consumers reported increased consumer demand for medical services and education. Decisions for purchasing consumer goods of import and domestic ones are influenced significantly from product prices. The quality/price ratio ranks second as regards the significance in choosing between domestic and foreign goods.

Chart 27 Restructuring processes in the past three years and future expectations

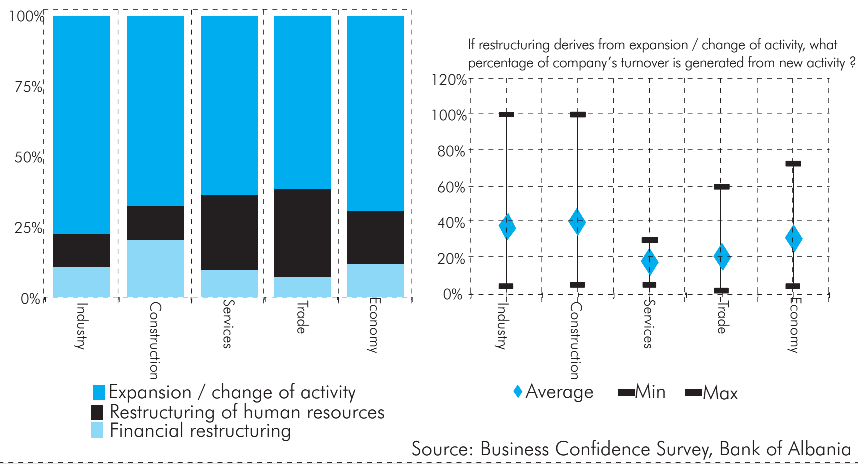


Source: Business Confidence Survey, Bank of Albania

Businesses: Taking into consideration the current international situation and the country's economic developments, on average 23.8% businesses operating in four main sectors of the economy (industry, construction, services and trade) have carried out restructuring processes over the last three years. Among businesses that have not yet carried out restructuring of their activity, on average 19.6% of them, have considered making such a step in the future. This is more evident in the trade *sector, where about 36.0% of businesses consider implementing a restructuring process in the future.*

Sector-related competition is assessed as the main motif behind the decision to undertake a restructuring process. Application of a new strategy, changes in firm's policies and technology renovations are some other factors that contribute to making this decision.

Chart 28 Area of restructuring and contribution of new activity to company's turnover



Source: Business Confidence Survey, Bank of Albania

The restructuring process has been applied mainly as an expansion or change of the existing corporate activities. Industry and construction sectors are more involved in this field of restructuring. To a lesser extent, enterprises have also applied the financial restructuring and that of human resources. Enterprises that have chosen to expand or change the activity report that, on average, about 28.7% of the company's turnover derives from the new activity.

* *The author of this Box is Merita Boka.*

BUDGET SPENDING AND FISCAL POLICY

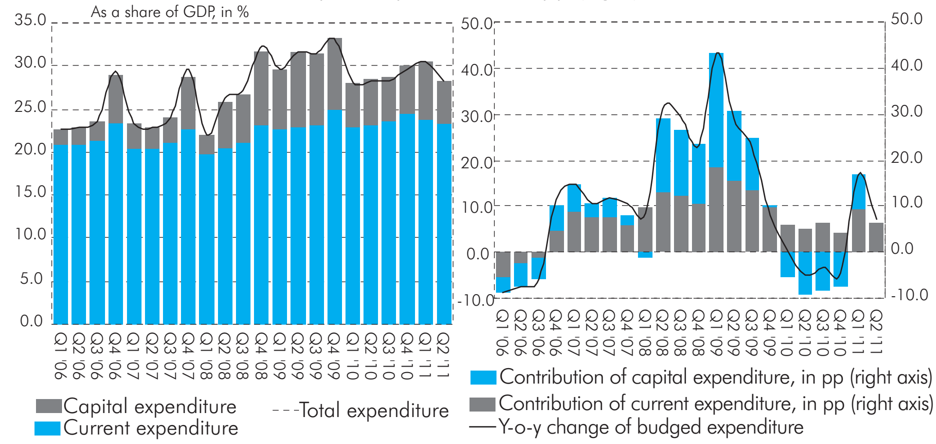
The fiscal policy reflected an expansionary nature in 2011 H1, being materialized in positive growth paces for both current and capital expenditures. The generation of a positive contribution of fiscal policy to aggregate demand growth (government final consumption and investment expenditures) is estimated to have been particularly evident in Q1 of the year. Fiscal data for 2011 Q2 show slower performance of both tax income and budget spending, thereby offering a somewhat dim picture of the progress of these indicators compared to Q1 of the year. The decelerated growth of budget spending in 2011 Q2 is expected to be translated into a lower impact of expenditures[20] on aggregate demand growth.

More specifically, total expenditures realized in H1 increased 7.4% y-o-y, significantly below the level of 16.8% marked in Q1. Current and capital expenditures realized during H1 of the year were up 7.4% and 0.1%,

[20] *Particularly, public investment expenditures, as proxied by total capital expenditure.*

respectively, from the corresponding period a year earlier. These rates are more moderate than the ones registered in Q1 of the year. Budget spending trend during Q2 of the year was mainly determined by the performance of capital expenditures[21]. At the same time, the annual growth rates of current expenditures slowed down to 4% in Q2 of the year, from 11.6% in the previous quarter.

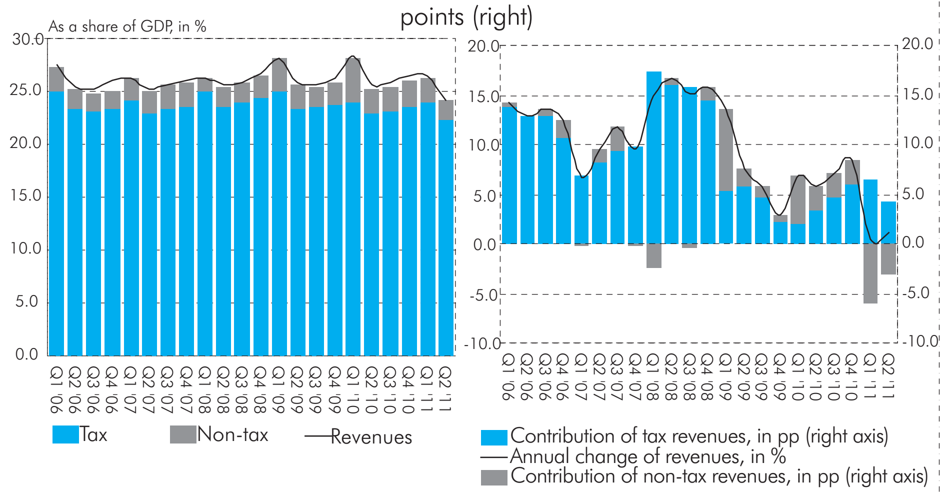
Chart 29 Budget expenditures (current and capital) to GDP, in %, (left) and y-o-y change of budget expenditure in %, and respective contributions of current and capital expenditures in pp (right)



Source: Ministry of Finance, INSTAT and Bank of Albania

Estimated as a share of GDP, budget expenditures for 2011 H1 resulted about 28.4%, up only 0.1 percentage points from the corresponding period a year earlier. Current and capital expenditures for the same corresponding period are estimated at about 23.3% and 5% of GDP.

Chart 30 Revenues according to two main groups as a share of GDP (left), annual change of total revenues and contributions of two main categories in percentage points (right)



Source: Ministry of Finance, INSTAT and Bank of Albania

[21] *Only during 2011 Q2, total expenditures contracted by 0.4% y-o-y, as a consequence of reduced capital expenditures by about 31% y-o-y.*

During 2011 H1, budget revenues increased by 1.1% y-o-y in nominal terms. The behaviour of total revenues, similar to Q1 of the year, remained subject to adverse impact of the performance of temporary revenues (enlisted under the item "Other" of non-tax revenues). Thus, if we do not take into account the temporary revenues, the annual revenue change results about 4.3% or about 2.2 percentage points higher than in the corresponding period a year ago.

Tax revenues in H1 recorded a nominal growth of around 4.7% y-o-y, from 7.6% in Q1 of the year. Tax revenues slowed the pace of the annual growth in Q2 of the year, mainly due to annual contraction of VAT and excise tax revenues. In Q2 of the year, VAT revenues were down 2.4% y-o-y, from up 3.2% in Q1. VAT revenue behaviour is related to the value of imports, the performance of goods production and services in the country, the performance of exports, as well as the manner of VAT payment. Thus, the growth rates of merchandise imports do not appear to have been passed-through at similar growth rates into VAT revenues during H1 of the year[22]. Non pass-through of the growth effect of imports value at almost the same extent into fiscal revenue growth appears to be a combination of the VAT revenue negative effect that VAT reimbursement brings about (as a consequence of export growth) and higher time lags in VAT payments on capital goods imports[23]. Excise tax revenues were down 6.6% y-o-y in Q2 of the year, compared with up 3.5% in Q1, due to a lower quantity of imported goods[24] subject to excise tax.

As a share of GDP, in H1 of the year, total revenues are estimated at about 24.2%, or roughly 1.4 percentage points lower than in the same period a year ago. Non-tax revenues represent the highest decline by 0.9 percentage points from a year earlier. Tax revenues as at 2011 end-H1 are estimated at about 22.4% of GDP, from 22.8% a year ago.

Performance of budget revenues in H1 of the year called for the revision of the 2011 budget plan. Thus, in order to observe the initial level projected for the budget deficit, at ALL 46.8 billion, the budget expenditure level has been corrected by about ALL 18.4 billion, due to a lower expected level of revenues, mainly for tax revenues.

Budget deficit was ALL 26.3 billion as at end-2011 H1, widening by about 69% y-o-y. The value of overall budget deficit fully coincides with the size of deficit incurred from the social insurance scheme[25]. As a share of GDP, budget deficit is estimated at 4.1% of GDP. Budget deficit financing over this period has been enabled mainly through the issue of treasury bills[26] and

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22 *VAT revenues on merchandise import represent about 75% of total VAT revenues.*

23 *It results from the "Monthly Fiscal Report" of April 2011, released by the Ministry of Finance that the postponing of VAT payments on capital goods import for the four-month period and VAT reimbursement influenced negatively on revenue collection, by about ALL 1.5 billion.*

24 *Basically, it reflects the reduced volume of the imported quantity of fuels.*

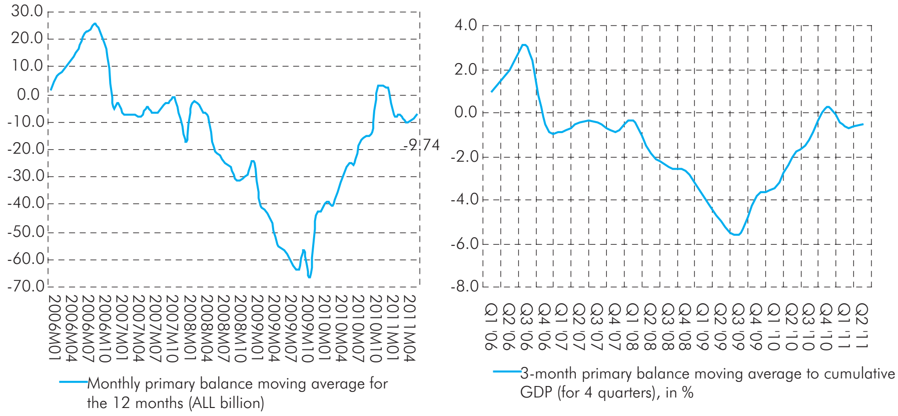
25 *The difference between social and medical insurance outlays and budget revenues accumulated from social and health insurance contributions is about ALL 26.2 billion.*

26 *.ALL-denominated treasury bills of 3-, 6- and 12-month maturity term, as well as Eurobonds of 9-month maturity term, at EUR 17.5 million.*

bonds of a two and five-year maturity term.

Developments observed on both income and expenditure sides are also reflected in the performance of the primary balance for this period. After a significant improvement of the primary balance in 2010 Q4, in 2011 H1 this indicator fluctuated within the band of negative values.

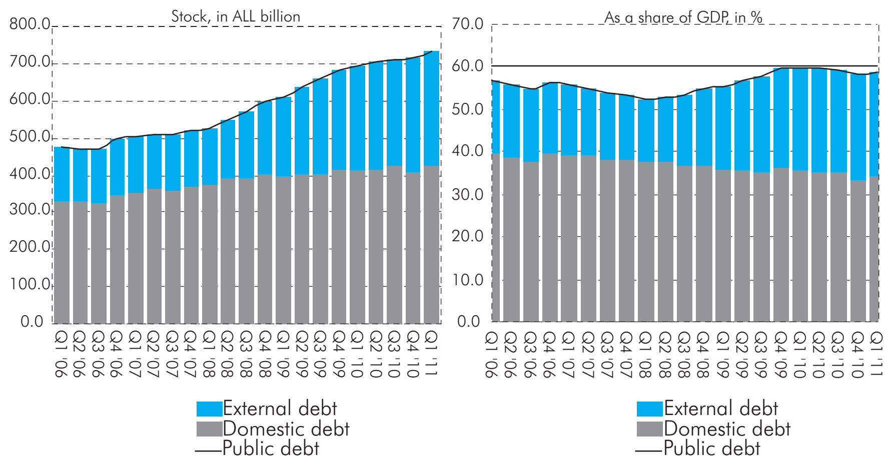
Chart 31 Primary balance in ALL billion (left) and primary balance as a share of GDP (right)



Source: Ministry of Finance, INSTAT and Bank of Albania

Primary deficit widening in 2011 H1 was reflected in the growth of public debt stock, which accounted for 58.8% of GDP as at 2011 Q1. Since end-2010, the growth of public debt stock has been fully due to growth of domestic debt stock, whereas the external debt has declined marginally.

Chart 32 Public debt in ALL billion (left) and as a share of GDP (right)

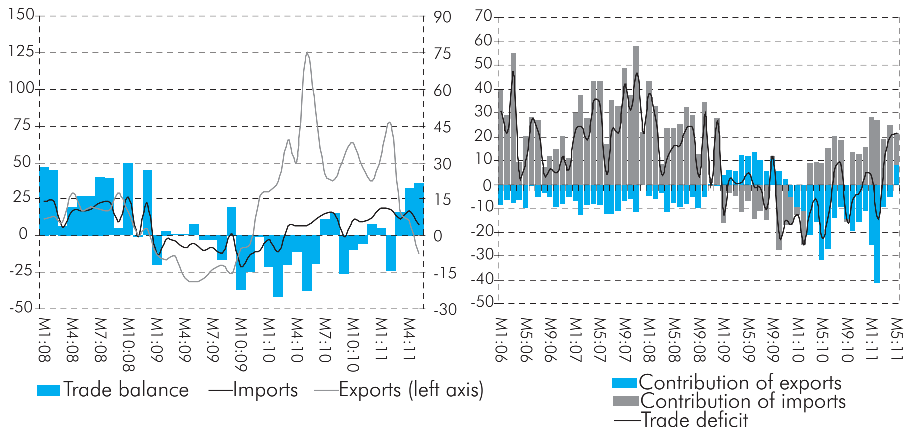


Source: Ministry of Finance, INSTAT and Bank of Albania

EXTERNAL DEMAND AND CURRENT ACCOUNT

Data on the performance of foreign trade balance in domestic goods for January-May 2011 attest to a changed trend on a year earlier. Hence, merchandise trade deficit, following the 2010 narrowing, widened by about 8.8% y-o-y in the first 5 months of the year. During this period, the accelerated annual export growth that had been experienced in 2010[27] was significantly moderated, at 23.3%. On the other hand, the y-o-y widening of merchandise import accelerated on average by 14.1%, from 7% in the previous year. The export-import coverage ratio for the first 5 months of the year was 39.5%, or about 3 percentage points higher than in the corresponding period a year earlier. Albania's trade activity, measured from trade exchanges with partner countries, widened by 16.5% y-o-y.

Chart 33 Value of imports, exports and trade balance (y-o-y change percentage) (left) and contribution of imports and exports to y-o-y trade deficit (right)



Source: Bank of Albania

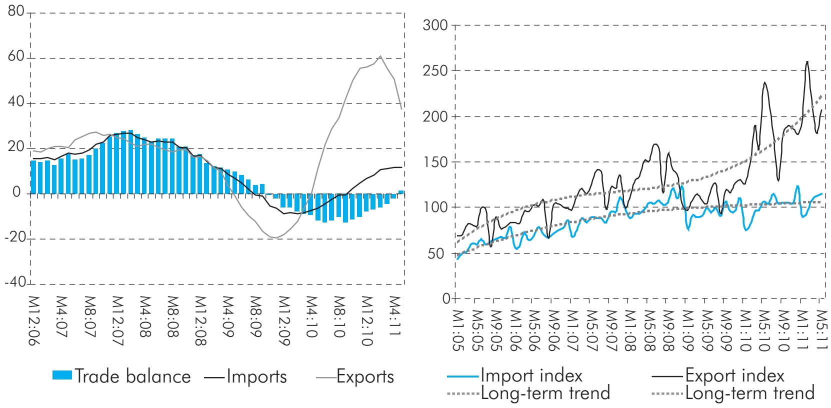
27 During 2010, annual export growth was 56.1%.

*Box 4 Terms of Trade and Trade Balance in Albania**

Albania's goods trade balance over years has been characterized by relatively high deficits. Identifying factors that impact on its performance is of primary significance in view of Albania's external position sustainability.

After a constant y-o-y widening of merchandise trade deficit during 2006-2008, in 2009 and 2010, the trade deficit contracted 5.9% and 7.8% y-o-y, respectively. Contribution profile of the annual performance of imports and exports changed over both these years. In 2009, the decline in import value by 9% y-o-y provided the main contribution to trade deficit reduction, compared to the contribution made by the decline in exports by about 18% y-o-y. In contrast, during 2010, though the value of imports widened by about 7% y-o-y, it was the annual export growth by about 56% that provided the main contribution to trade deficit reduction. In the meantime, cumulative data of foreign trade for the first 5 months of 2011 attest to the re-emergence of the widening trend of merchandise trade deficit, assisted by an upward contribution of imports to its annual performance.

Chart 34 Annual change of the 12-month moving average of imports, exports, and the value of trade deficit (left) and performance of import and export indices* (right)



*Values are fixed with December 2007.
Source: Bank of Albania

To identify the factors impacting on trade deficit performance, it is of importance to determine the effect the import and export prices make on its annual volatility over time. Albania is a small and open country, which competes in international markets mainly on export product price because of low qualification of goods it exports and high competition in foreign markets. In the domestic market, import demand is estimated to have low elasticity, against the backdrop of insufficient domestic supply capable of meeting the demand and competing on price and quality with imported goods. Consequently, the relative price of exports to imports, measured in terms of trade, is expected to have a substantial effect on trade deficit. This approach leads to determining the purchasing power of exports and measuring the unit of imported goods per unit of exported good. Terms of trade index is constructed by estimating the country's ratio of export price index to its import price index.

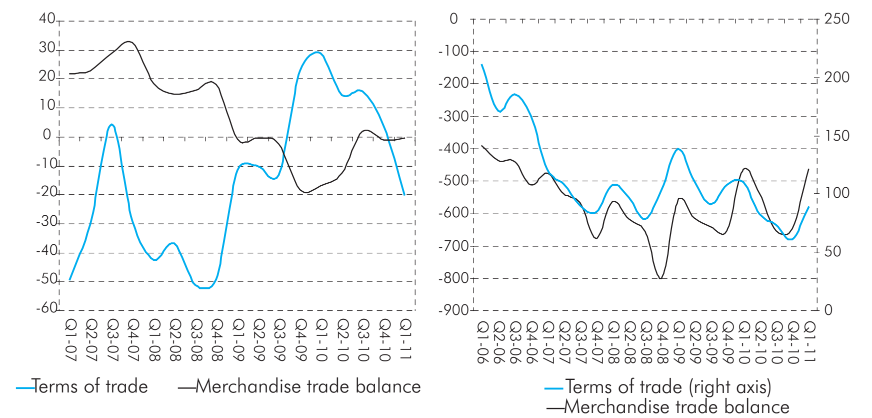
*ToT = (Export price index/Import price index)*100*

These theoretical aspects of the terms of trade also find support in the profile of their impact on Albania's trade balance. Statistical data show favourable terms of trade for the period 2008 Q4 to 2010 Q1, excluding only 2009 Q3. In annual terms, the terms of trade increased in 2008 Q4 to 2009 Q4. Upward rates were *higher in 2008 Q4 and 2009 Q1. Statistical analyses present a high negative correlation between the terms of trade, with a time lag of four quarters, and the merchandise trade deficit. At the same time, the econometric test on causality of both variables** shows the maintaining of the causality effect of the terms of trade on the merchandise trade deficit, with a four-quarter lag. This test becomes statistically insignificant if the tested lag exceeds the four-quarter period. The following table shows the results of two tests, where the second row presents the correlation between the annual performance of the terms of trade and the trade deficit, and the third row presents the statistically significant causality of the terms of trade and trade deficit by quarter.*

Lag in quarters	0	1	2	3	4	5
Correlation	-0.47	-0.62	-0.63	-0.68	-0.72	-0.54
Granger Test (TeT ₂ Trade deficit	:	:	Po	Po	Po	Jo

Finally, we conclude that trade deficit developments have since 2006 been influenced substantially by this indicator. However, the continuation of correlation between trade deficit and the terms of trade, and the identification of other influential factors have to be assessed in the future, after ongoing monitoring of both variables.

Chart 35 Merchandise trade balance and terms of trade index with a 4-quarter lag in annual terms (left) and in absolute terms (right)



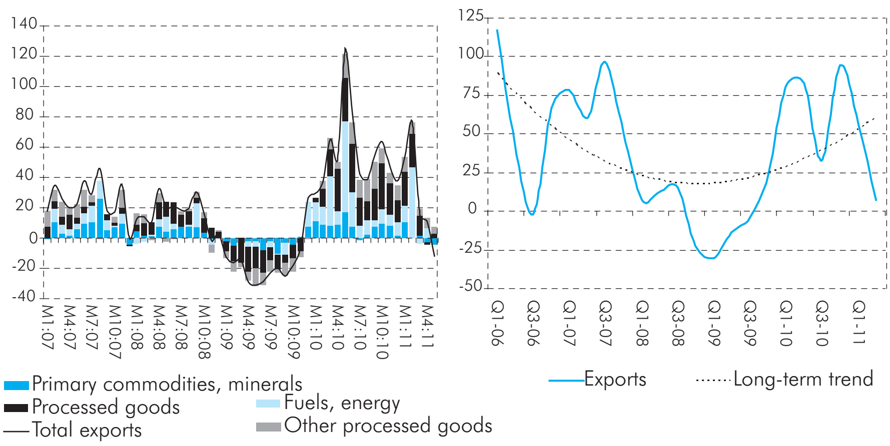
Source: Bank of Albania, Directorate of Customs

* *The author of this Box is Eglent Kika*

** *According to Granger-Causality approach.*

During January to May of this year, the value of exports continued its y-o-y upward trend that had started since 2010 Q1, but at comparably more moderate paces. The category of export products with the largest share to total exports value "Other manufactured goods", which includes mainly re-exported textiles, maintained a steady upward trend during the period under review. In annual terms, the exports under this category expanded by about 16.3%. A similar annual performance was also registered by the exports under the category "Manufactured goods"[28], up by 47.9% y-o-y. On the other hand, the annual growth rates of "Fuels and energy" were significantly moderated at 26.6%, from 132.5% in 2010. The main contribution to the decelerated growth rate was made by the y-o-y decline in electric power export over the first five months of the year. In the meantime, after an accelerated growth registered in 2010, the exports under the category "Natural mineral resources" decreased by 0.1% y-o-y, mainly due to the downward average price per unit of chrome ore in international markets. The annual upward trend of real exports for the first four months of the year[29] is estimated to have somewhat accelerated compared to the nominal performance. Thus, the amount of exports increased by about 41%, while their price per unit decreased by about 4.2%.

Chart 36 Contribution of four key categories of domestic exports to annual export value growth (left) and annual performance of real exports, at 2007 prices (right)



Source: Bank of Albania, Directorate of Customs

Imports value during the period under review continued its annual upward trend that had started since 2010 Q2, but at more accelerated paces than in the previous year. Widening of merchandise import for all the relevant categories is reflected in the division of imports according to their final use in the economy. Thus, import of intermediate goods, which has the largest share to total imports, registered an annual growth of approximately 19.5%. At the same time, similar upward trends were observed also in the import of capital goods. Meanwhile, since 2008, the performance of import of consumer goods has proved to be less volatile compared with the other two foregoing categories. During the first five months of 2011, this category of imports rose by approximately 1.8% y-o-y. Annual expansion of imports value over January to April 2011 was mainly driven by upward average price developments per unit of relevant categories. On the other hand, import quantity index showed an annual decline of the flow of imports over this period.

[28] *The main products exported under this category are base processed metals of steel, cast-iron, iron and copper.*

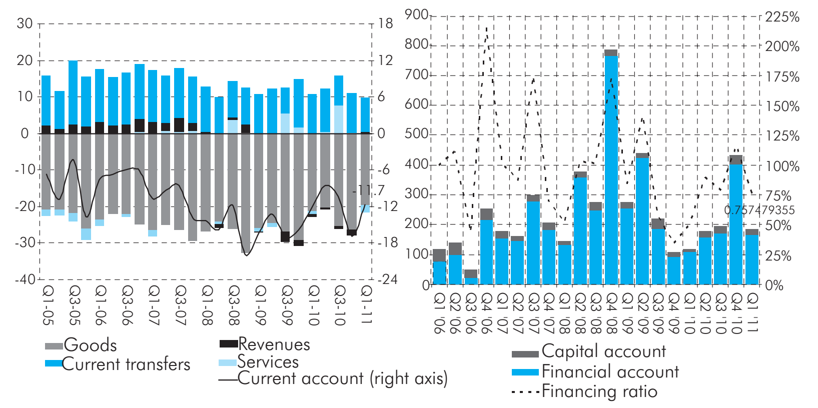
[29] *Data on the volume of foreign trade are available until April 2011. Real exports, or the ones at constant prices, are fixed with average unit value in 2007.*

Box 5 Developments in the balance of payments in 2011 Q1

During 2011 Q1, the overall balance of payments registered a decline in foreign assets by about EUR 77.1 million. At period-end, foreign reserve stock amounted to EUR 1,787.0 million, a sufficient level to cover 4.3 months of imports of goods and services.

Net current account position registered a deficit of EUR 246.4 million or about 11.7% to nominal GDP. Deficit value continued to expand y-o-y for the second consecutive quarter, and in 2011 Q1, it was 4.7% higher than in the same corresponding period a year earlier. However, its ratio to GDP over this quarter was down by 0.3 percentage points on a year earlier. The current account dynamics was broadly influenced by the performance of services and current transfer accounts. The combined deterioration of their net position relative to the same period of the previous year contributed to deepening the current account deficit. Merchandise trade deficit also widened by about 2.5% y-o-y. Contribution of net exports to the annual performance of aggregate demand was negative in 2011 Q1.

Chart 37 Current account indicators (as a percentage of GDP) and financial account (EUR million)



Source: Bank of Albania

During 2011 Q1, net foreign inflows in the capital and financial account resulted about EUR 186.6 million, up by about 59.2% y-o-y. As a share of nominal GDP, net capital and financial flows are estimated at about 8.9% or about 2.8 percentage points higher than in the corresponding quarter a year ago. Though in annual terms this account registered positive developments, the surplus registered in 2011 Q1 proved insufficient to fully finance the current account deficit. The financing ratio of the latter was 75.7%, about 25.9 percentage points higher relative to the corresponding quarter a year ago.

During 2011 Q1, net foreign direct investment flows (inflows - outflows) amounted to about EUR 53.4 million, down by 67.5% y-o-y. According to investment instrument, FDI inflows in the form of property securities (shares) and profit re-investment were about EUR 172.6 million, up by about 7.2% y-o-y.

Other capital instrument played an important role in determining FDI inflows in 2011 Q1. During that period, "Other capital" registered a capital outflow in the form of inter-company loans of EUR 115.1 million. In 2011 Q1, net flows of portfolio investments (inflows - outflows) posted EUR 20.9 million. Other net investments account was closed with a net positive balance, contributing by about EUR 134.6 million to the increase in residents' liabilities to the world.*

** According to the Balance of Payments Drafting Methodology, the "Other capital of direct investment" instrument covers the funds borrowing and lending between the direct investor and his enterprise in the country*

IV.2. LABOUR MARKET, WAGES AND COSTS

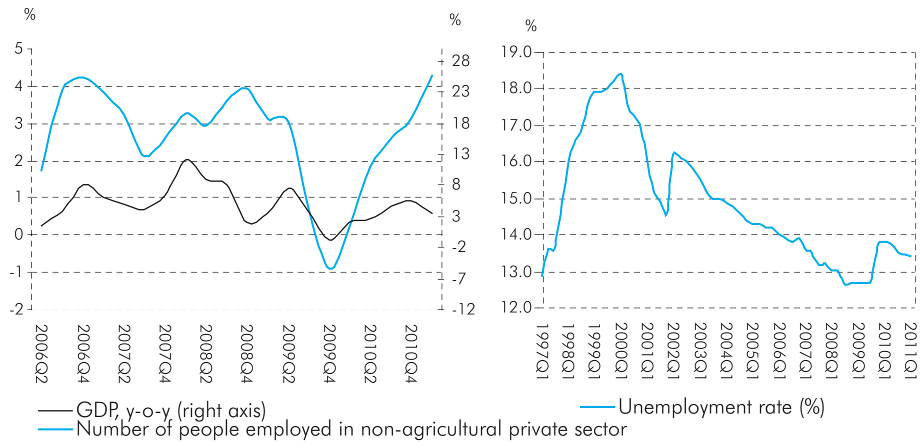
In 2011 Q1, the labour market continued the improving trend it had started since 2010. Though unemployment rate remained at an almost similar level, employment indicators increased over this quarter. Real wage followed the upward nominal wage trend over this period, even though inflation registered high rates. Developments in labour productivity and unit labour cost sustain the efficient use of labour force.

In 2010, increase in employment was stable, attesting to stabilized conditions in this market. In 2011 Q1, key labour market indicators continued their upward trend. Administrative data on the number of employees in 2011 Q1 show rise in this indicator of the economy. Business survey results support the quarterly employment dynamics.

According to workforce balance, the number of employees grew y-o-y at similar pace as in the previous quarter, settling at 1.7%. This growth was mainly due to expansion of non-agricultural private sector employment, which accelerated the pace of growth to 4.3%, around 1 percentage points higher than in Q4. As concerns the public sector, an annual decline (by 0.5%) is observed in the number of employees.

Despite the improvement in key labour market indicators, unemployment rate has remained constant at 13.4%. Though unemployment rate has decreased over the latest periods, it has not yet reached the levels of 2008.

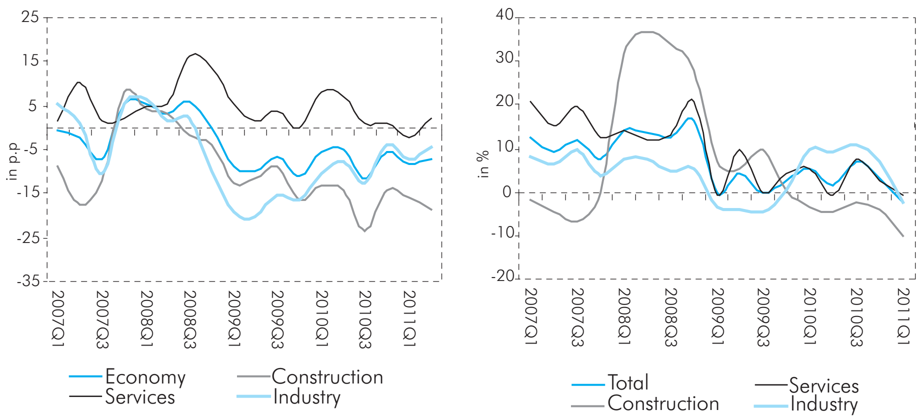
Chart 38 Changes in employment and GDP growth (left), unemployment rate (right)



Source: INSTAT and Bank of Albania

Based on data from 2011 Q2 confidence surveys, employment expectations are optimistic. Industry and service businesses are optimistic about employment in Q2 and expect further improvements in the next quarter. Construction and trade businesses are pessimistic about the current and expected employment.

Chart 39 Employment expectation by business confidence surveys (left) and employment by main sectors (right)

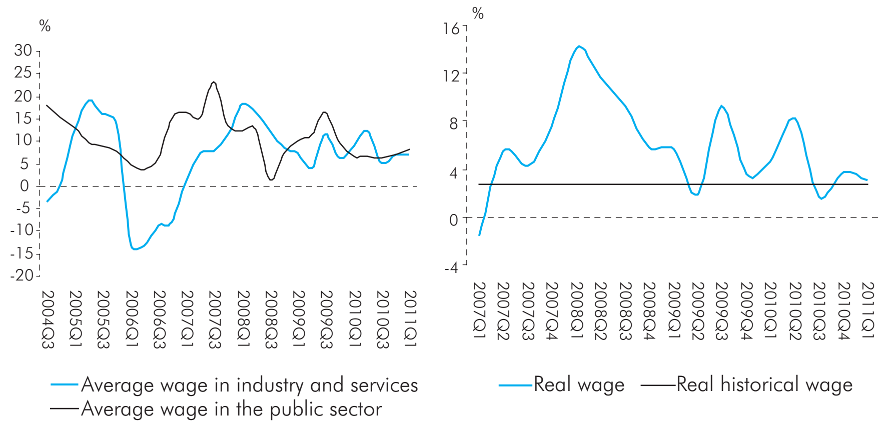


Source: INSTAT, Short-term Statistics and Bank of Albania

WAGES

According to INSTAT, in 2011 Q1, the average wage[30] in the economy increased 6.9% y-o-y. Compared with the previous quarter, the average wage remained almost unchanged. CPI-deflated real wage increased by 3.1% y-o-y, resting slightly below the 0.6 percentage points increase in the previous quarter. However, the annual growth of this indicator was above its historical average. At sectoral level, the average wage rose in all the major sectors of the economy. Thus, manufacturing sector wages have increased by 5.7% in nominal terms and by 2% in real terms. Service sector wages have increased in real and nominal terms by 14% and 9.8%, respectively. Within this sector, the wages in post and communication and trade branches have picked up

Chart 40 Y-o-y increase in wage indicators by sector and wage in the public sector (%)



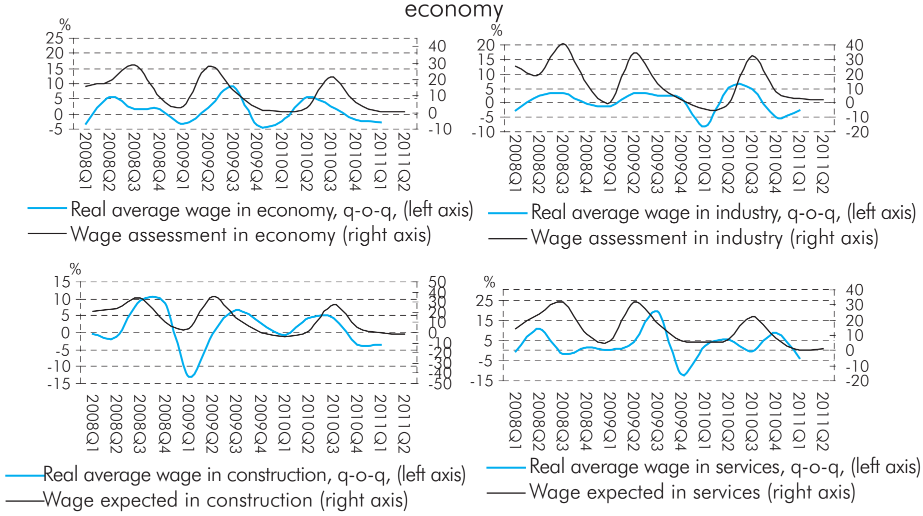
Source: INSTAT and Bank of Albania

[30] *Wage index in the economy, referred to as "average wage" is measured as a ratio of wages fund index to employees number index, whose source is the INSTAT's "Short-term Statistics", excluding "Agriculture". The data frequency is quarterly.*

significantly. Public sector monthly wage accelerated the annual growth rates in 2011 Q1. More specifically, the average wage in the public sector has picked up by 8.3% in nominal terms and up 3.8% in real terms.

So-far analyses reveal that INSTAT's short-term statistics have generally confirmed the signals obtained from the business confidence surveys. The 2011 Q2 business survey results signal that wages will remain constant in the periods ahead.

Chart 41 Quarterly wage performance and related expectations by sectors and economy



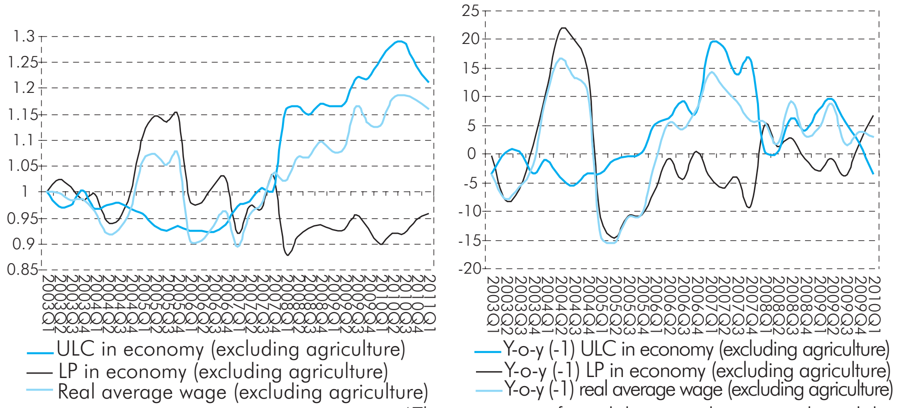
Source: INSTAT and Bank of Albania

LABOUR PRODUCTIVITY AND COST

During 2011 Q1, labour productivity index (LP) followed the increasing trend for the fourth consecutive quarter. The annual positive change of LP (6.5%) reflects the positive developments in the value-added in business activity (excluding agriculture) vs. employment rates in this activity. The performance of this indicator attests to the efforts of non-agricultural businesses for a more efficient use of the workforce. This development is assessed to be a consequence of the corrective process to adapt to the new economic reality following 2009.

In 2011 Q1, the unit labour cost index (ULC) continued its downward trend. After a long annual positive, albeit downward, dynamics, it declined by -3.3%. The turning point in the performance of the unit labour cost owes to positive annual rates of the labour productivity index. Meanwhile, over the same quarter, the real average wage has increased moderately y-o-y.

Chart 42 Labour productivity and unit labour cost indices, and the real average wage (left); annual change (right) *



*The measures refer to labour productivity and unit labour cost indices of the economy, excluding agriculture. The estimates are based on value-added data (seasonally adjusted – INSTAT, GDP 2011 Q1) and short-term statistics on employment and wages (INSTAT, Short-term statistics, 2011 Q1). These indicators do not include agriculture; therefore, the value-added excludes agriculture. Real average wage index has been derived after deflating it with the seasonally adjusted CPI. For comparison purposes, indicators are rebased on 2003 Q1's indicators

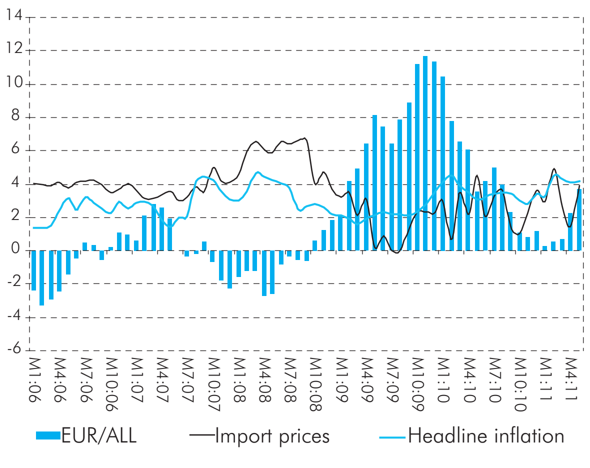
Source: INSTAT and Bank of Albania

Developments in the foregoing indicators show that non-agricultural businesses have been relatively more efficient in workforce utilization. This has helped this activity operate at more contained labour costs, in part flattening the inflationary pressures on the overall production cost.

IV.3. IMPORTED INFLATION

Inflationary pressures on prices in Albania, stemming from price swings in international conjunctures, were upward in January-May 2011. Import price index[31] maintained its upward trend that had started since November of the previous year, and for the first five months of the year, it rose by an average of 3.5% y-o-y. During the corresponding period of 2010, the annual increase in this index was estimated at 2.9%. Nevertheless, compared with the corresponding period of 2010, the relative exchange rate stabilization, measured by its annual performance, has helped maintain a gentle pass-through of import price rises into the domestic market. Annual national currency depreciation during the period under review vs. the common European currency was 1.5%, from 6.8% in the first five months of 2010.

Chart 43 Annual import prices, inflation rate and ALL/EUR exchange rate



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

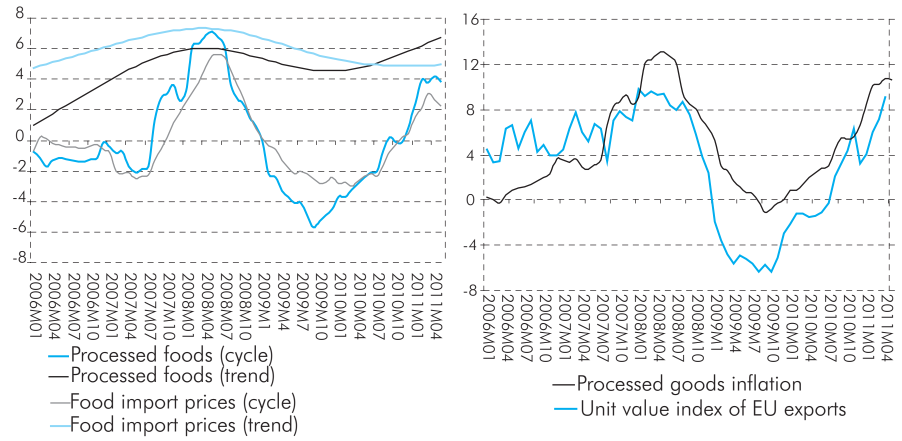
Imported inflation trend, disaggregated into seven main CPI basket groups[32], was upward for processed foods during the first five months of 2011. This performance is confirmed by similar annual

[31] This index is measured by weighting the import share in 21 countries, according to their significance to foreign trade data, to the relevant CPI on a common basis.

[32] The disaggregation of the CPI basket into seven main groups is made by the Bank of Albania's Monetary Policy Department experts, while INSTAT disaggregates it into 12 groups.

trends of indices, which show import price volatility: unit value index for processed food exports from European Union countries to Western Balkan countries, and food import price index[33]. The latter increased on average by approximately 7.2% y-o-y in January-May of this year. The average annual growth of this index for the corresponding period of 2010 was 2.4%. At the same time, unit value index for processed food exports from European Union countries towards Western Balkan countries expanded on average by 8% y-o-y for January to April of this year. Cyclic structure analysis of both indices shows that they precede the developments in the foregoing CPI index. Hence, the accelerated upward pressures of food import prices on Albania's food prices in the first five months of the year are expected to persist in the months ahead.

Chart 44 Cycle-long-term trend performance of annual processed food inflation and annual inflation of food import prices (left); import price index versus annual change of unit value index of EU exports (right)



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

IV.4. INFLATION EXPECTATIONS IN ECONOMY

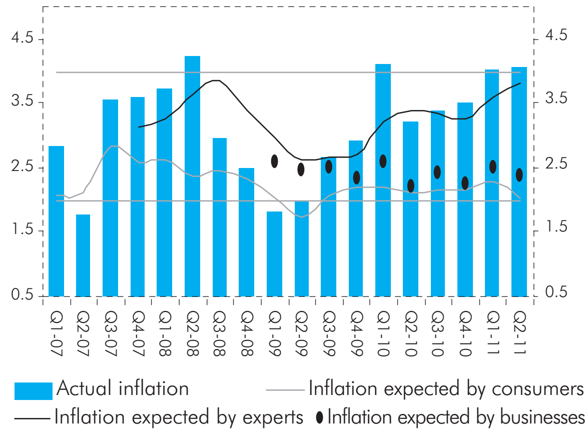
One-year-ahead inflation expectations have shown a slight increasing tendency; however, they remained within the tolerance band of 2-4% in 2011 Q2[34]. Bank experts' one-year-ahead inflation expectations are higher than companies' and households' ones. They expected it to be 3.8% in 2011 Q2, up 0.2 percentage points from the expectations in 2011 Q1.

Based on the latest data from 2011 Q2 business and consumer confidence surveys, businesses expect one-year-ahead inflation rate to be 2.4%, whereas consumers expect it to be 2.0%. These figures are slightly downward, however, remaining within the lower half of 2-4% inflation target band.

[33] *The first index is released by the European Statistical Institute - Eurostat, on a monthly basis, including Albania, Bosnia and Herzegovina, Serbia, Kosovo, and Former Yugoslav Republic of Macedonia. The second index is constructed by weighing the food price indices of 19 countries according to their share to food imports into our country. Weights are updated for 2010, whereas the data on food import for 2011 by origin are not yet available.*

[34] *The analysis of inflation expectations is based on business and consumer confidence survey conducted in 2011 Q2 and monthly bank experts' survey.*

Chart 45 One-year-ahead inflation expectations (in %)



Source: Bank of Albania surveys

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

The Albanian economy continued to grow in 2011 Q1, registering a 3.4% real GDP growth. This growth was achieved due to positive performance of all sectors of the economy, particularly industry and service sectors. Indirect indicators on the performance of demand components and manufacturing sectors, as well as empirical estimates, show that the positive growth will continue in 2011, albeit below its potential.

Household consumption has contributed positively, albeit marginally, to aggregate demand growth. Short-term future expectations have also continued to be conditioned by uncertainty about income realization and remittance flows.

Private investments are estimated to have grown at low rates during the second quarter of the year. However, during 2011 Q2, the capacity utilization rate approached its historical average. The relatively high unemployment rate suggests that the economy is still operating significantly below its potential. Assessments of the expected performance of investments are also conditioned by the ability of businesses to timely respond to the need for restructuring the economy in order to enhance competitiveness. Surveys show that about 43% of surveyed businesses have undertaken restructuring or think to do so in the future to respond to market conditions. Under these conditions, expansion of investments in some sectors may correspond to their gradual contraction in other sectors, without creating inflationary pressures on the side of output gap.

The need for fiscal correction in terms of maintaining the budget deficit and debt-to-GDP ratio was reflected in the fiscal plan revision in July, according to which the impact of fiscal spending on aggregate demand is expected to decrease in the rest of the year, hence another factor with a negative impact on inflation.

External demand, as already expected, contributed positively during the first half of the year, in spite of a gradual slowdown in exports. Due to risk to the upside for slower recovery of economic activity in some partner countries, the impact in the rest of the year is expected to be lower on a year earlier. On the other hand, the trade deficit widening signals added pressures on the exchange rate, and therefore, it constitutes one of the upside risks to inflation.

On the supply-side, the increasing labour productivity in 2011 Q1 and lower unit labour costs generate lower inflationary pressures from the labour factor-side. Unemployment index continues to remain at high levels and business surveys show decreased employment in key sectors of the economy. Though with the change in the economy structure, part of this unemployment may be structural, there is room for businesses to expand the labour factor utilization, without having to raise wages and thus, avoiding the wage-inflation spiral. Inflationary pressures on the domestic price level, which stem from oil and food price volatility in international conjuncture, are expected to be present, but constantly downward, during the current year.

In the absence of abrupt shocks beyond 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 anchored economic agents' expectations for inflation.

V. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

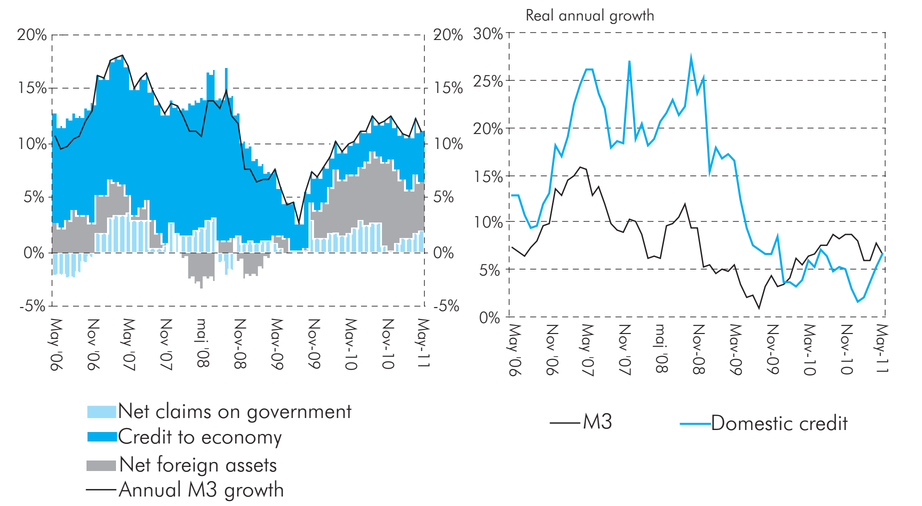
Monetary expansion registered higher growth rates in the second quarter of the year, supported mainly by the foreign currency component of money supply. High activity of the public sector contributed positively to broad money expansion, primarily through the national currency component. Lending to the economy continued to maintain moderate growth rates, driven mainly by the sluggish private sector demand for loans and uncertainties about the future outlook. Interest rates on ALL-denominated loans were steady and lower than in the previous quarter. Meanwhile, further deterioration of the loan portfolio quality did not favour further easing of lending standards. Financial markets were liquid and with an upward interest rate tendency in Q2 of the year. Key interest rate rise by 0.25 percentage points at end-March was passed into almost all market segments, but with a different intensity. Real money demand was weak, below its potential and did not generate inflationary pressures. Also, financial agents do not factor into added inflationary pressures in setting interest rates on financial products.

V.1. MONETARY INDICATORS

Broad money indicator, M3, grew by about 11.7% y-o-y in Q2, from 11.0% in Q1. In real terms, this indicator grew by about 0.4 percentage points, to 7.2% on average in this quarter; however, remaining below its average in the period preceding the spread of the global financial crisis effects in the country. Foreign currency flows generated by the external sector of economy continued to play a primary role in the broad money expansion, thus contributing by about 4.5 percentage points. At the same time, the growth of domestic credit to the economy by 6% in real terms, vs. an average of 2.4% in Q1, positively impacted on broad money expansion, thus reflecting primarily the public sector's expansionary policy.

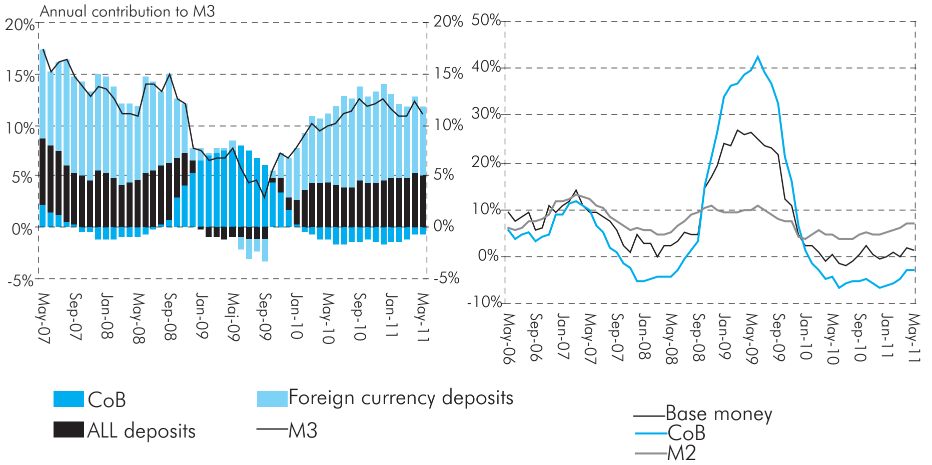
M2, the ALL aggregate, increased on average by 7.0%, from 5.5% in Q1 of the year. This indicator's growth was widely underpinned by fiscal agent's financing with domestic monetary and financial assets, reflected in the increase in banking sector claims on government and their contribution by an average of 1.9% to broad money expansion in Q2. Private sector lending reflected the steadier growth of national currency-denominated loan. In the meantime, increase in the currency outside banks due to realization of fiscal expenditures over this period influenced the expansion of this indicator in monthly terms, while it resulted still downward y-o-y. Monetary base growth averaged 1.5% y-o-y, from 0.4% in Q1 of the year.

Chart 46 Contribution of M3 components on the asset-side; domestic credit and real M3



Source: Bank of Albania

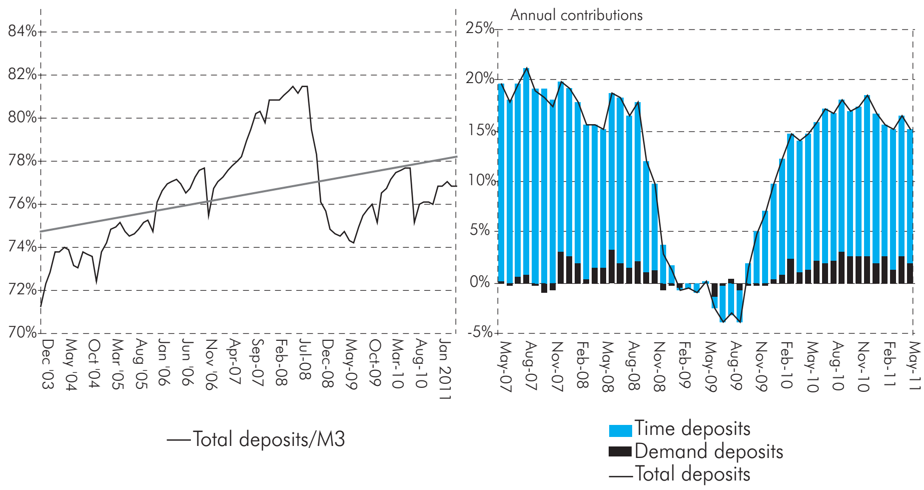
Chart 47 Contribution of money components (on the liability-side) and monetary aggregates



Source: Bank of Albania

Liability-side monetary flows show an average increase of deposits by 15.6% y-o-y. The Albanian economy remains well-monetized, with the deposit share to total money supply standing at 81.2%. Total stock of deposits in April and May grew by about ALL 12.6 billion, of which about 7.5 billion in ALL and 5.1 billion in foreign currency. The expansion of national currency deposits featured a more balanced distribution among months, while foreign-currency deposit growth was concentrated in April. In annual terms, ALL-denominated deposits grew by 15.7% on average, while those in foreign currency grew by 20.4%, reflecting, inter alia, the economic agents' boosted confidence in the banking system.

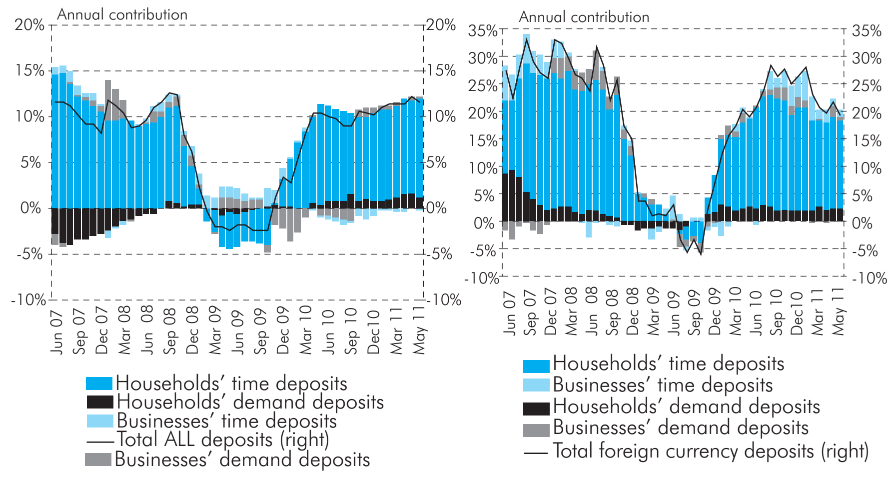
Chart 48 Total deposits vs. broad money; annual change of deposits by currency



Source: Bank of Albania

Time structure of deposits shows a shifting tendency towards time deposits. Thus, the ratio of demand deposits to time deposits fell to 24.2% at end-May, from 24.8% in March. Households' time deposits in ALL provided the main contribution to total stock expansion, while business deposits remained volatile for both ALL and foreign currency deposits, depending on their economic activity and their needs for liquidity.

Chart 49 Annual change of deposits by currency and economic agents

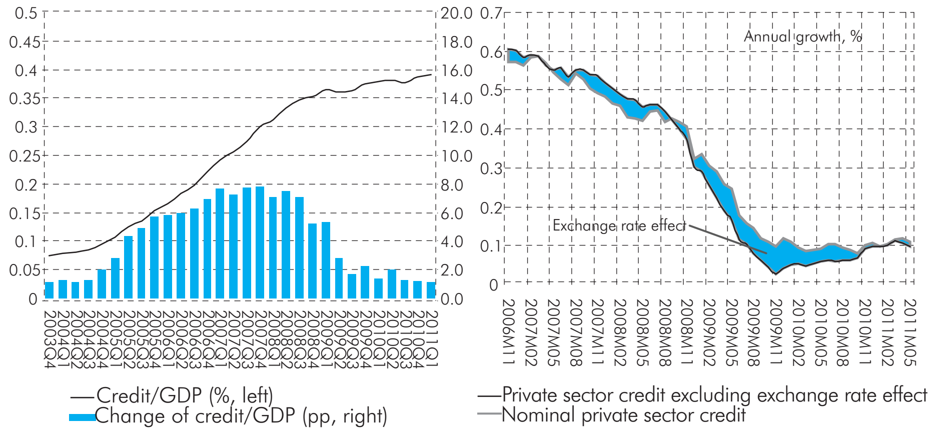


Source: Bank of Albania

PRIVATE SECTOR CREDIT

In April and May, private sector credit performed similarly as in Q1 of the year. In annual terms, it grew by 11.4% on average, or 1 percentage point more than in Q1. Adjusted for the exchange rate effect, the annual growth of private sector credit averaged 10.4%, remaining close to Q1's paces. However, over April-May, the business loan portfolio grew sluggishly, deviating from the observed historical seasonal behaviour. On the other hand, household loans pursued the recovery trend having started since H2 of the previous year. The sluggish performance of private sector credit is also reflected in the low impulse it has given to the economy. At the end of 2011 Q1, it accounted for 39% of GDP, with an annual change at historically low levels, by 1.2 percentage points.

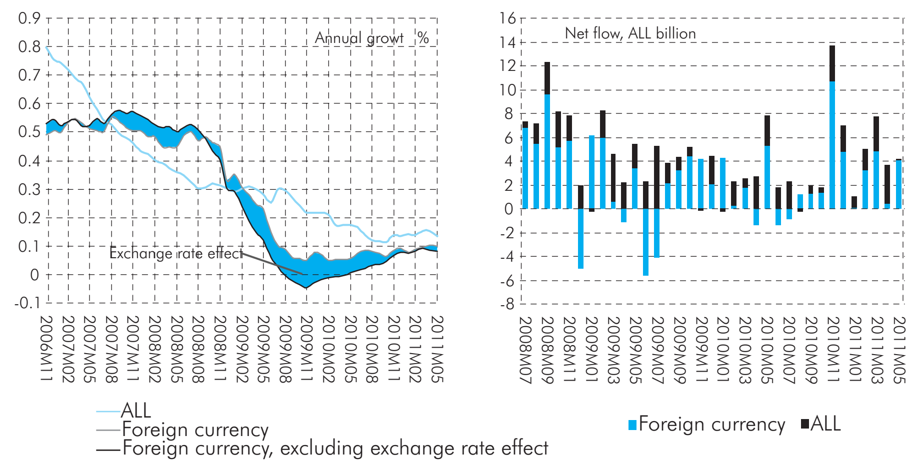
Chart 50 Private sector credit



Source: Bank of Albania

Developments in the private sector credit reflected the interaction of demand and supply-side factors. Despite the signals for loan demand recovery in certain segments, the level of economic agents' confidence remained low. The perceived uncertainty about the future continued to condition customers' orientation toward savings and their prudential conduct in terms of credit and expenditures. Also, the economy's operation below its full capacity gave rise to a low need of businesses for investment, and hence even for bank financing. On the other hand, banks remained cautious in terms of their lending practices. Such a stance is primarily motivated by the further increase in non-performing loans.

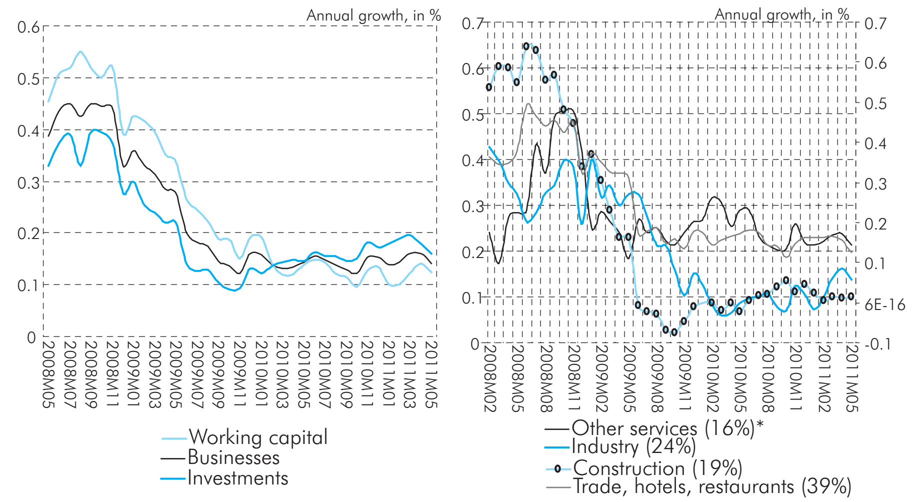
Chart 51 Developments in private sector credit by currency



Source: Bank of Albania

Expansion of private sector credit in April-May was dominated by FX loans, though to a lesser extent than in the previous months of the year. In annual average terms, this portfolio grew by 10.1%, about 1.3 percentage points higher than in Q1 of the year. However, adjusted for the exchange rate effect, the annual FX loan growth remained the same, at 8.2%. Meanwhile, even the ALL loans maintained the previous months' paces, averaging 14.4%. Businesses remained the main source of the demand for FX loans. Moreover, foreign currency lending to households remained contained for both consumption and real estate investments, reflecting a higher presence of foreign exchange risk.

Chart 52 Business loan portfolio by purpose of use



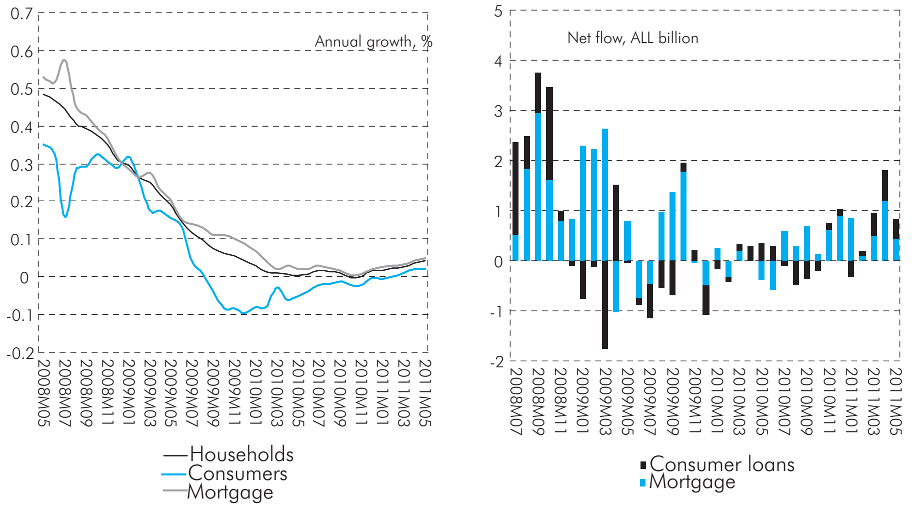
*In brackets, the share of business loans to outstanding credit.
Source: Bank of Albania

In April-May, business loans grew on average 15.2% y-o-y. Unlike in preceding months, the expansion of business loans over this period was entirely for working capital purposes. Over both months, this type of loan registered an annual growth of 13.4% on average, while investment loan slowed its annual growth rates to 17.0% on average.

The major share of business loans made in the first 5 months of the year was absorbed by industry and trade, both sectors with the largest contribution to Q1's economic growth. Construction loans and other service loans maintained stable growth rates, 9.7% and 22.5% y-o-y, respectively. Lending to trade, hotels and restaurants slowed to 14.2% y-o-y, from 16.2% in Q1 of the year. Meanwhile, lending to industry sector accelerated the annual pace, up 15% y-o-y.

Lending to households performed positively in April-May. Banks accommodated the recovery of household demand for loans by easing the lending terms and conditions. In late May, the annual growth of household loans was 4.3%, pursuing the upward trend having started since the end of the previous year. Mortgage loan remained the main source of the increase in household loans. Its annual growth was 4.9% in May. Meanwhile, recent months have highlighted a greater use of consumer loans. At end-May, their annual growth stood at 2.0%.

Chart 53 Household loan portfolio by purpose of use

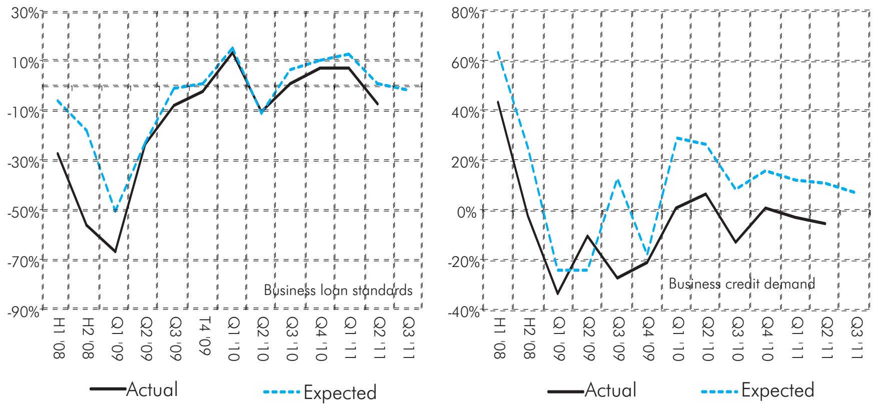


Source: Bank of Albania

*Box 6 Analysis of 2011 Q2 Bank Credit Survey**

During 2011 Q2, tighter business loan standards were applied to both categories, small and medium-sized enterprises, and big enterprises, compared to the previous quarter. According to loan use purpose, standards were tightened to almost the same extend, for both working capital and investment loans. The main drivers to tightening of business loan standards in 2011 Q2 were the NPLs situation in the banking system and specific sector-related problems of the firm. For 2011 Q3, bank experts expect a slight tightening of business loan standards.

Chart 54 Lending standards and demand for loans (net balance)



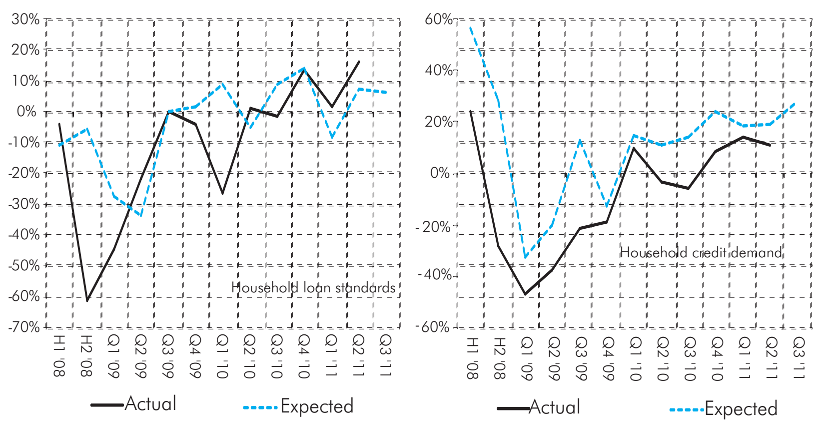
Source: 2011 Q2 Credit Activity Survey, Bank of Albania

Bank experts report that business loan demand in 2011 Q2 was lower than in the previous quarter. Loan demand from big enterprises declined compared with the previous quarter. Its net balance stood at -7.2%, from 0.7% in the previous quarter. Loan demand from small and medium-sized enterprises continued to increase. Its net balance stood at 2.3%, from -1.8% in the previous quarter. The use of alternative *funding sources and the financing of fixed investments are two factors that provided a negative contribution to the loan demand in 2011 Q2. Expectations for business loan demand in 2011 Q3 remain positive.*

Household loan standards remained eased, although at a lower level than in the previous quarter. According to purpose of use, lending standards to finance consumption and house purchase continued the easing trend that had started since the start of 2010 Q4. Bank experts reported that competition in the banking system, liquidity position and Bank of Albania's decisions contributed to easing the household loan standards.

Bank experts expect household loan standards to remain eased during 2011 Q3, at a slightly lower degree than the current level. This holds true for both consumer and house purchase loans.

Chart 55 Loan standards and household loan demand (net balance)



Source: 2011 Q2 Credit Activity Survey, Bank of Albania

During 2011 Q2, in line with the expectations stated in the previous survey, the household loan demand is reported as upward, although at a lower degree than in 2011 Q1. The net balance registered 11.3%, from 14.3% in the previous quarter. The need to finance consumption and house purchase, and bank credit standards remain key factors determining the demand for loan. Experts' expectations on household loan demand remain positive for 2011 Q3.

* *The survey conducted in July 2011 covers developments in the lending activity having occurred during 2011 Q2, as well as banks' expectations for possible changes in the lending activity in 2011 Q3. The detailed analysis of results from 2011 Q2 credit activity survey is accessed on: www.bankofalbania.org, publications section.*

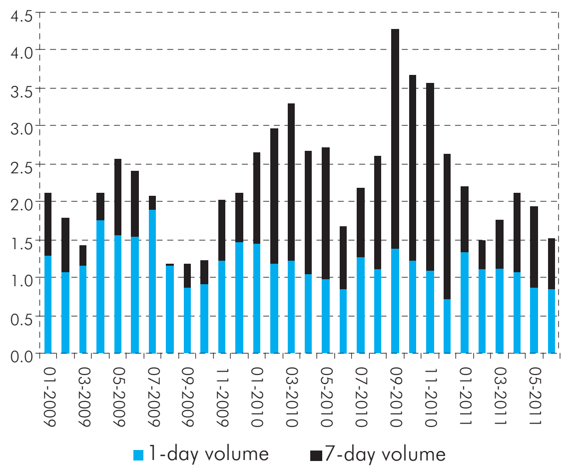
V.2 FINANCIAL MARKETS, INTEREST RATES AND EXCHANGE RATE

INTERBANK MARKET

During 2011 H1, the interbank market highlighted a steady level of banking system liquidity. Interest rates fluctuated within the corridor, which expanded in January once the overnight credit limit was restored to the previous levels, in response to stabilized liquidity situation[35]. The Bank of Albania continued to apply regular open market operations for injecting liquidity of 7-day and 3-month maturity terms. In June, liquidity demanded in auctions increased due to economy's higher demand for money. This pushed the auction rate up, however, without managing to determine its trend.

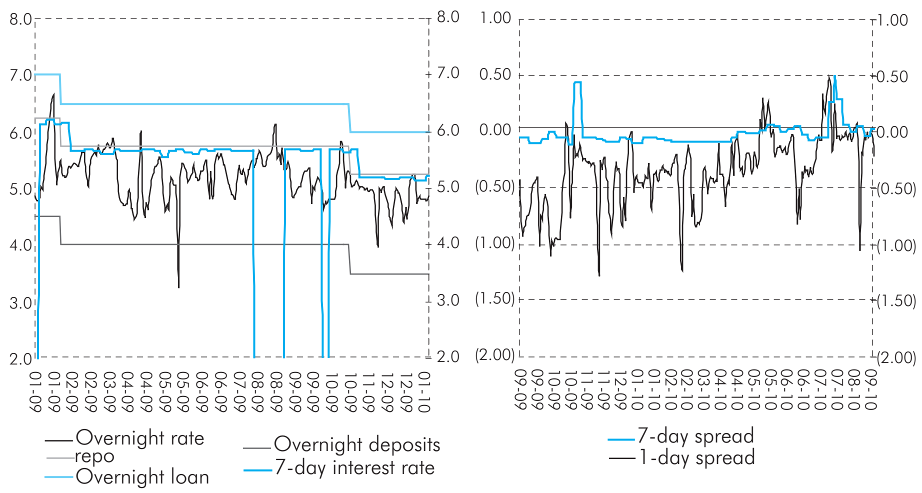
On average, the volume of transactions among banks was lower than in the previous year, which is reflected mainly in the decreased volume of 7-day transactions. During 2011, transactions profile was not alike. The second quarter highlighted a decreased level of daily borrowing and an increased level of 7-day one, as compared to the previous quarter, making the average level of borrowing similar for both periods. Average daily transactions volume totalled ALL 0.92 billion or ALL 0.26 billion less than in Q1, while weekly transactions volume totalled ALL 0.94 billion or ALL 0.31 billion more than in Q1.

Chart 56 Volume of interbank borrowing



Source: Bank of Albania

Chart 57 Interbank interest rate (left) and their spread from key interest rate (right)



Source: Bank of Albania

35 *Overnight loan interest rate is +1.75 percentage points above the key interest rate. In early 2009, this margin fell to +0.75 percentage points to address added pressures for liquidity in this period. Following the conclusion that these pressures are already flattened, it was necessary to restore the corridor to previous levels.*

In Q2, interbank borrowing rates increased in line with the monetary policy signal. Key interest rate rise by 0.25 percentage points at end-March was transmitted to interbank rate rise. In Q2, the overnight interest rate averaged 5.34%, from 4.80% in Q1, while the seven-day one averaged 5.47%, from 5.06%.

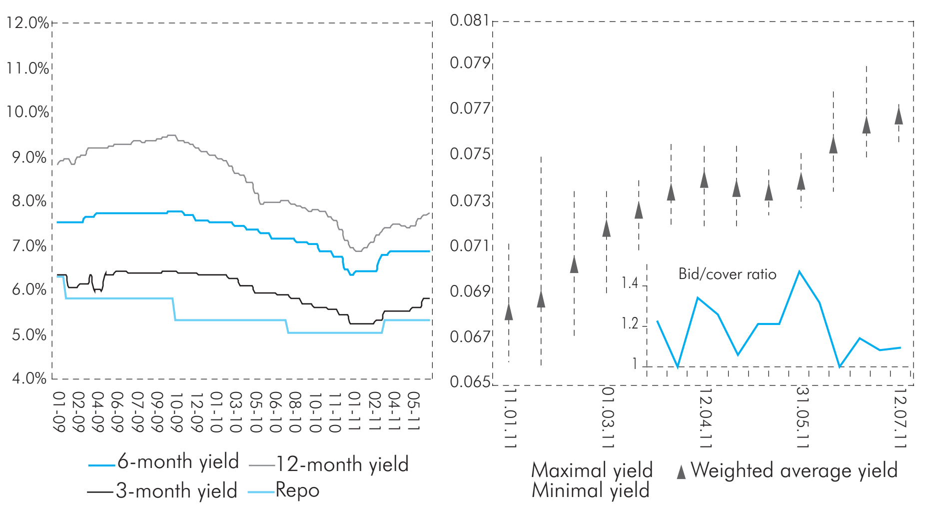
Interbank rates have fluctuated within the corridor set by the Bank of Albania and close to the key interest rate. The average spread between overnight interest rate and key interest rate narrowed to 0.24 percentage points in Q2, from 0.31 percentage points in Q1. Once, this indicator reached 0.64 percentage points as a consequence of the lack of liquidity required to meet the reserve requirement. Interbank liquidity shortages made the Bank of Albania intervene and provide liquidity to the market through regulatory operations (overnight reverse repo). In general, interbank rates were less volatile in Q2.

PRIMARY MARKET

Primary market yields have been relatively volatile. After their past year's reduction, they increased in 2011 H1. Yield rise in Q1 reflected mainly the higher government demand in primary market auctions. Furthermore, in April, primary market yields, particularly those of a short-term maturity, reflected the key interest rate change and stabilized at new levels during May. In June, upon the increase in issues of T-bill auctions, this indicator rose again to be stabilized in early July. The level of auction participants' bids was high and the bid-to-cover ratio resulted above 100% almost throughout the year.

At the end of Q2, the weighted average yield on 12-month T-bills amounted to 7.65% or up 0.30 percentage points from the end of Q1. The change is almost the same even for the 3-month maturity term, bringing about the yield curve shift. Relative to the previous year, this indicator is lower and its slope has flattened.

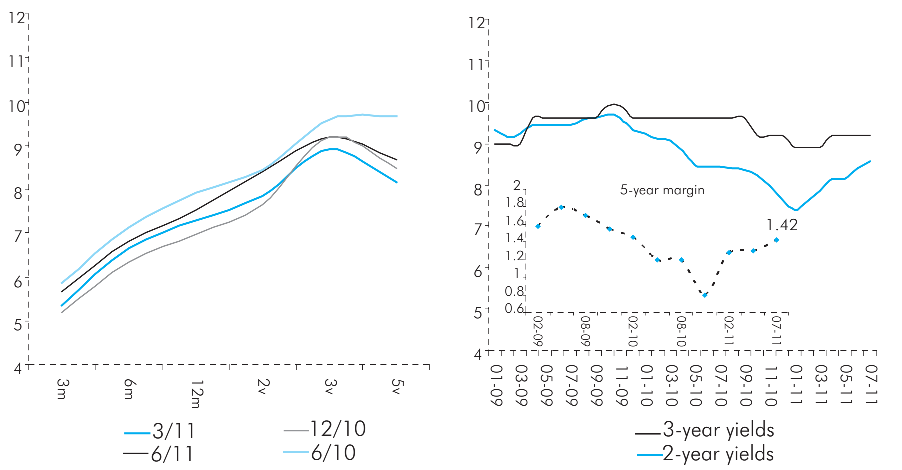
Chart 58 T-bill yields (left) and 12-month auction results in interbank market (right)



Source: Bank of Albania

Bond yields underwent the same upward trend as T-bills', albeit at a higher spread margin. Besides bond reference rate rise (12-month yield), the lower competition in this market has also been factored into the setting of this yield. At the end of Q2, 2-year bond yield was 8.40%, up 0.55 percentage points from the previous quarter's end. The 3-year bond yield registered 9.21% in early July, almost similar to that of April and up 0.31 percentage points from January's auction. In terms of 5-year floating rate bonds, the ask margin increased in Q2's auctions. In early July, this margin was 1.42 percentage points, from 1.28 percentage points in February's auction.

Chart 59 Primary market yields (left) and bond yields (right)



Source: Bank of Albania

INTEREST RATES ON NEW DEPOSITS

Upon the corroboration of improved liquidity indicators, new deposit interest rates started to be corrected, reflecting a downward trend in 2011. These rates rose significantly in 2009 and remained at those levels, in order to preserve their market share. In 2010 H2 and 2011 Q1, interest rates on new deposits decreased.

This trend changed slightly in April-May, when the banking system registered interest rate rise on deposits denominated in both major currencies. Following the decision on raising the key interest rate by the Bank of Albania and the European Central Bank, banks marginally moved their interest rates up. Taking into consideration the period of the year, the changes were insignificant, since banks were not very active on the threshold of summer.

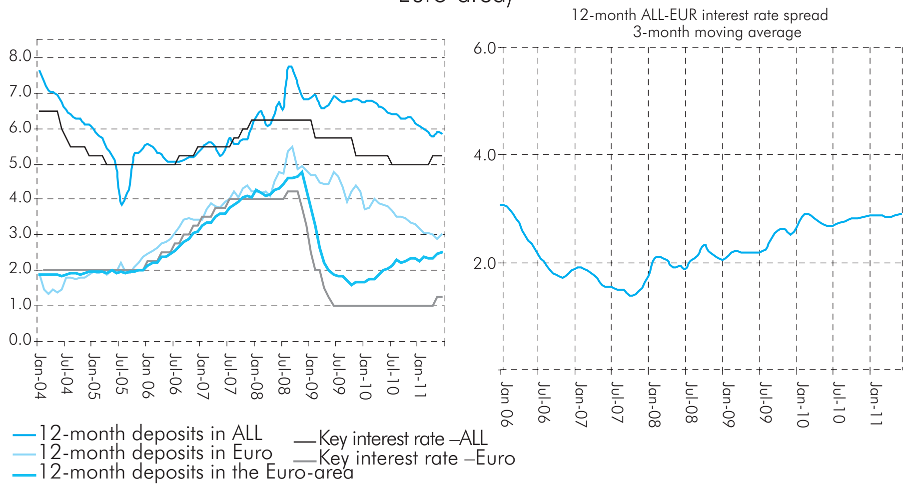
Weighted average interest rate decrease was consecutive up to March[36]. Then, it started to pick up slightly in April-May. Weighted average interest rate on ALL deposits registered 4.59% in April-May, or 0.22 percentage points below the 2011 Q1's average. This is so because in January-February, deposits registered high interest rates due to year-end promotional offers (which lasted up to February) and new inflows of long-term deposits (at a

[36] *The key interest rate rose by 0.25 percentage points at end-March.*

higher interest rate), but compared to March, interest rates were upward. Preliminary data show that deposit interest rate remained at the same levels even in June.

In terms of maturity, the same performance is observed in average terms. The 3-month deposit interest rate fell only 0.03 percentage point q-o-q, while those of 6- and 12-month deposits fell by 0.05 and 0.01 percentage points.

Chart 60 12-month deposit interest rates and key interest rate (in Albania and in the Euro-area)



Source: Bank of Albania

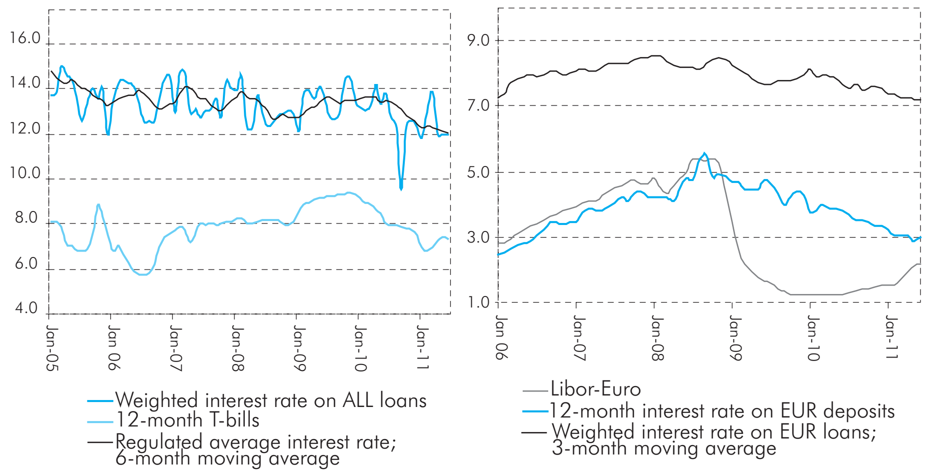
During April-May, interest rates on EUR time deposits pursued the same dynamics as ALL ones. Weighted average interest rate on new EUR deposits registered 2.23% during both months, up 0.08 percentage points from 2011 Q1's average. In terms of maturity, interest rates on 1-, 6- and 12- month deposits increased by 0.27, 0.22 and 0.14 percentage points, respectively, only in May. The high level of competition among the banks that use the EUR deposit interest rates as the cost of funds, and the increase in the European market interest rates, encouraged banks to maintain high interest rates on EUR deposits.

INTEREST RATES ON NEW LOANS

Interest rates on new ALL loans were stable and close to low levels in April-May. They have remained almost at similar levels since March (11.93%). On the other hand, interest rates on EUR loans increased slightly over this period. Average loan interest rates continued to be primarily influenced by diversified offers and preferential bank lending policies for individual clients. Also, reference rate rise and exchange rate risk are factors that continue to contribute to maintaining high margins for EUR loans.

In April-May, interest rate on ALL loans fell, narrowing the 12-month yield spread. It averaged 11.96% during these months, down 0.95 percentage points from the previous quarter's level[37]. The major share of new ALL loans was extended for meeting the short-term needs of enterprises, whilst the latest months highlighted a higher frequency of ALL-denominated mortgage loans to households. In terms of maturity, a higher interest rate cut was applied to short-term and mid-term loans.

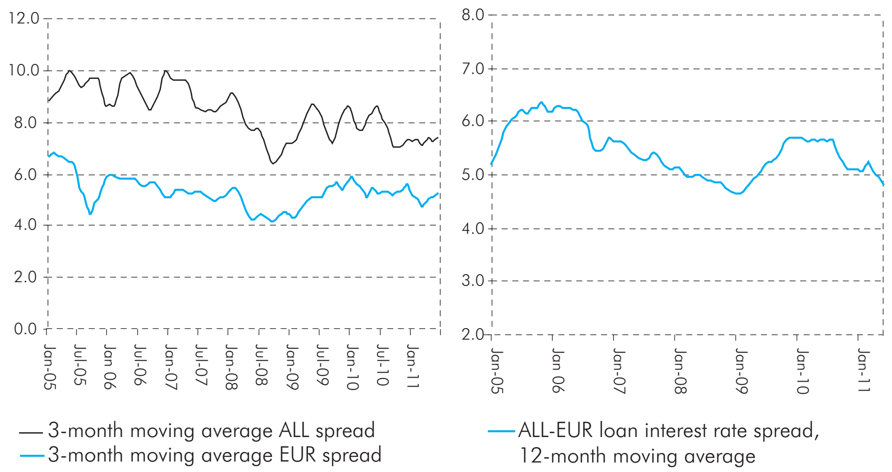
Chart 61 Interest rates on new ALL and EUR loans



Source: Bank of Albania

Interest rates on EUR loans increased slightly. In April-May they averaged 7.36%, or 0.15 percentage points above the 2011 Q1's average. This trend was influenced by upward reference rates. In the short-term (working capital loan to enterprises), the interest rate performed similarly as the national currency, falling in average terms. In the long-term (of over 5-year maturity term, mainly for real estate), banks remained reluctant to make new foreign currency loans. Interest rates on these loans fell on average by 0.08 percentage points in April-May, compared to the previous quarter.

Chart 62 ALL and EUR average intermediation margins (left) and average interest rate spread between ALL and EUR loans (right)



Source: Bank of Albania

[37] *It averaged 12.91% in Q1, but this high value was influenced by a short-term loan at a considerable amount and at an interest rate much higher than the average in the system. Excluding this loan, the interest rate was 12.19%, being however 0.23 percentage points above the April-May level.*

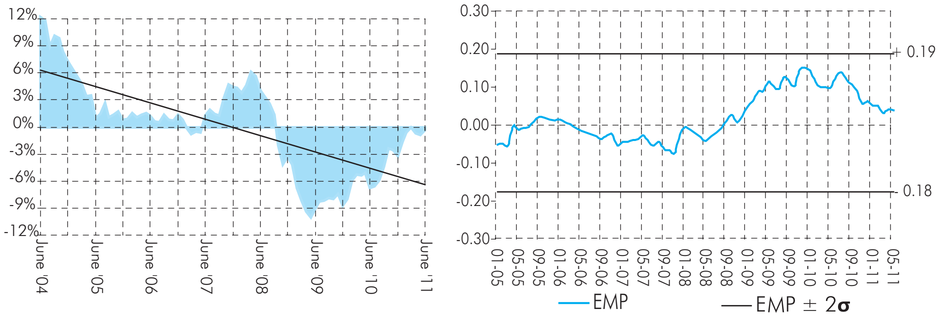
Intermediation cost in ALL maintained the same levels during April-May, reflecting the stabilization of ALL loan interest rate. It pointed to 7.37 percentage points over the latest months, from 7.39 percentage points in 2011 Q1. Intermediation rate in euro averaged 5.13 percentage points, up 0.07 percentage points from the previous quarter. The spread between interest rates on ALL and EUR loans remained highly volatile, as a consequence of reciprocal offers. It fell by 1.10 percentage points in April-May, compared to the previous quarter.

EXCHANGE RATE

The nominal effective exchange rate continued to confirm a downward trend of the national currency's depreciation rates even in 2011 Q2. Throughout 2011 H1, the index was stable and preserved low depreciation tendencies. Changes in NEER index, similarly as in 2011 Q1, registered a slight depreciation, with a minimum value of -0.35% in June. In Q2, average rates fell by -0.53% y-o-y from the previous quarter and by -0.64% from the corresponding quarter of 2010, due to a relatively higher demand for foreign currency and less foreign currency remittances and FDI inflows.

The foregoing developments seem to be also confirmed by the Exchange Market Pressure Index, which, after an accelerated increase in 2009, was relatively stable throughout 2010. In the meantime, even during 2011 Q2, it reflected a drop from the previous quarter and a stabilization of depreciation pressures, at 0.04.

Chart 63 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 foreign trade, EUR (80%) and USD (20%). A positive change of the NEER implies the lek's appreciation.

**EMP (Exchange Market Pressure) Index is generated by the following formula.

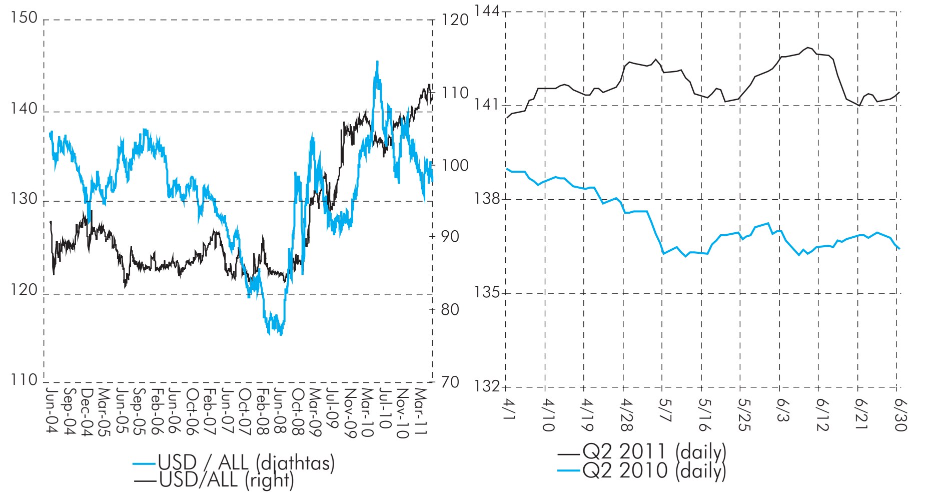
$$EMP_t = \left(\frac{1/\sigma_e}{((i/\sigma_e)+(1/\sigma_r)+(1/\sigma_i))}\right)\frac{\Delta e_t}{e_{t-1}} - \left(\frac{1/\sigma_r}{((1/\sigma_e)+(1/\sigma_r)(1/\sigma_i))}\right)\frac{\Delta r_t}{r_{t-1}} + \left(\frac{1/\sigma_i}{((1/\sigma_e)+(1/\sigma_r)+(1/\sigma_i))}\right)(\Delta(i_t - i_t^*))$$

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

Source: Bank of Albania

The analysis of individual developments of the major currencies in the domestic FX market, as compared to the previous quarter, shows that the national currency lost ground vs. the euro, by 1.64%, and gained ground vs. the dollar, by 3.58%. On the other hand, in annual terms, the lek appreciated vs. the dollar (-8.77%) and depreciated vs. the euro (3.28%).

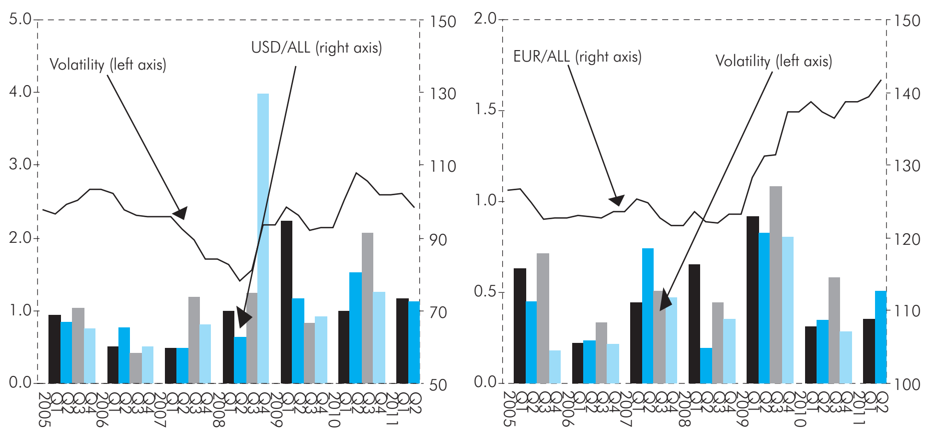
Chart 64 Daily EUR/ALL and USD/ALL exchange rate (left) and EUR/ALL for 2010 Q2-2011 Q2 (right)



Source: Bank of Albania

The seasonal depreciation of the national currency vs. the European currency was driven by increased public sector demand and imports, and by reduced pre-seasonal inflows that characterize the period. The lek's depreciation vs. the euro averaged 0.35% in monthly terms. For the first time in June, this ratio reached the historical peak of ALL 142.84 per EUR 1. The foregoing developments of EUR/ALL in this quarter yielded relatively higher exchange rate volatility than in the same corresponding quarter in 2010.

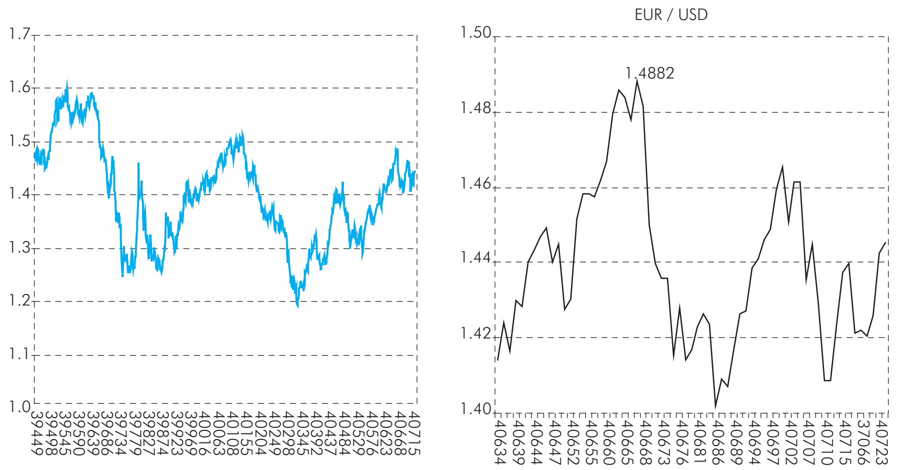
Chart 65 Exchange rate volatility* of ALL/USD (left) and ALL/EUR (right) q-o-q



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

The positive performance of the ALL vs. the USD during this quarter has reflected the EUR/USD developments in the international markets, presenting similar levels as in December 2009. In early May, EUR/USD exchange rate reached the peak for this quarter, 1.4882. The depreciation of the USD vs. the EUR by an average of 5.31% q-o-q reflects the positive wave of financial markets in terms of the Greek debt restructuring and not so much optimistic outcomes regarding the U.S. economic growth, following the results presented by Fed at end-April.

Chart 66 Daily EUR/USD in 2008-2011 (left) and in 2011 Q2 (right)

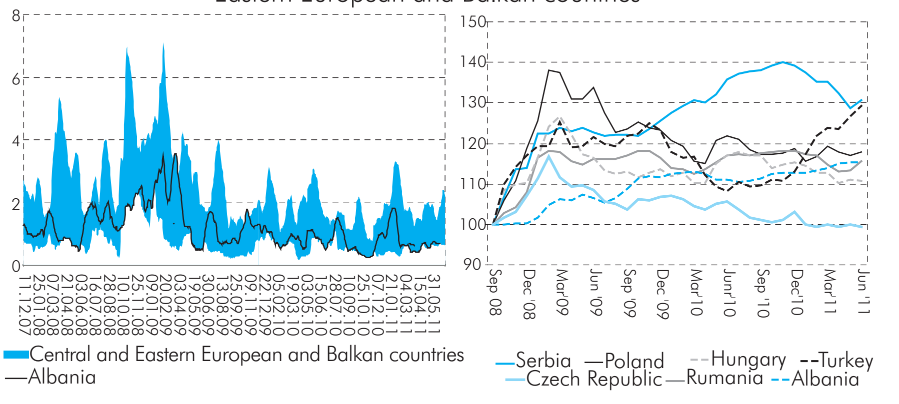


Source: ECB

The country's political situation following the 8th of May elections and lack of stability in the global financial markets are factors that have adversely affected the lek's exchange rate during this quarter.

In a regional context, the ALL/EUR performance appeared markedly positive compared with other countries' average. Over this quarter, the lek reached the lower limit in the range of extreme values of the euro/national currency volatility.

Chart 67 EUR/ALL performance and volatility* compared to the Central and Eastern European and Balkan countries**

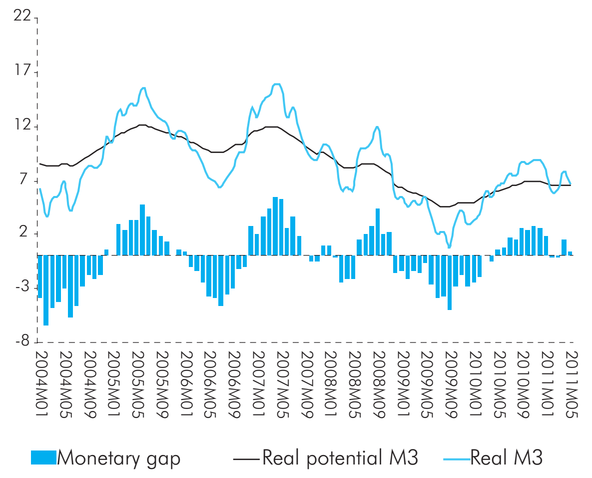


*The volatility of EUR/national currency ratios is measured as a 30-day standard deviation. The peak volatility in each period represents the maximum and minimum standard deviation of these ratios. The selected countries are Poland, Czech Republic, Hungary, Romania, Turkey, and Serbia.
**Performance of the ratio is 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 that of Albania (a free-floating exchange rate regime).
Source: Bank of Albania

V.3. ASSESSMENT OF MONETARY INFLATION PRESSURES

In 2011 H1, monetary developments attested to a stable monetary expansion rate at average levels of the previous year. During this period, the real money demand growth averaged 6.9% y-o-y, vs. 6.8% y-o-y for the whole 2010. Meanwhile, compared to the potential level of money supply derived from statistical approaches[38], it is observed that the actual monetary expansion rate is somewhat lower than the potential. Against a background of sluggish economic activity recovery, the negative gap of monetary expansion corroborates a low money demand from the economy. Relative to 2011 Q1, Q2 highlighted a moderate resurgence of the domestic real money demand. This performance has substantially reflected the fiscal agent's more active behaviour in the economy, whilst the private sector's real money demand has remained weak. All in all, the performance of monetary indicators corroborates contained inflationary pressures from the monetary sector.

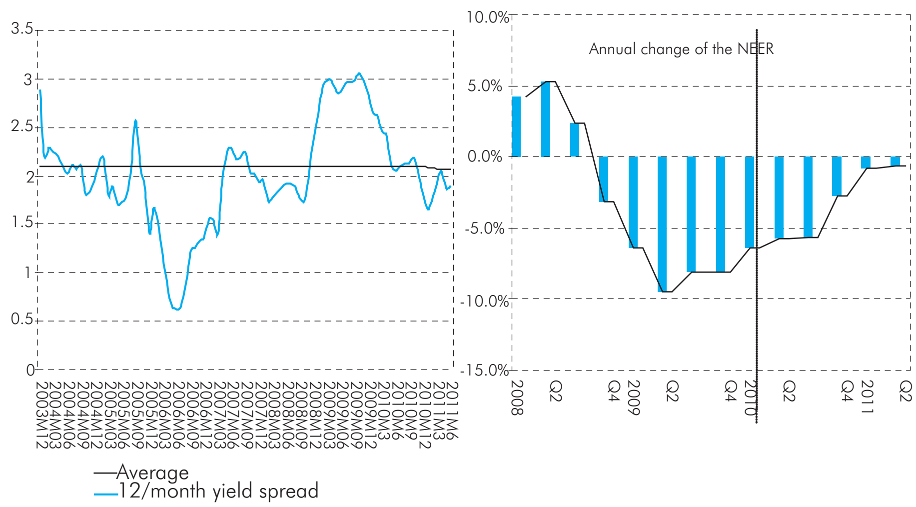
Chart 68 Real money demand and potential gap (in %)



Source: Bank of Albania

Financial market developments highlighted a tranquil situation in 2011 H1. Primary market yield spread, following a slight rise at end-Q1, decreased and settled markedly below its historical average throughout Q2. The performance of interest rate spread reflected financial agents' eased expectations for the country's inflation rate. The latest move by the monetary authority, which raised the key interest rate slightly at end-Q1, contributed to easing financial market agents' inflation expectations and lifting interest rates on financial products.

Chart 69 Interest rate spread and foreign exchange market developments



Source: Bank of Albania

Along with the primary market, the foreign exchange market was stable in 2011 H1. This market's movements reflected the interaction between foreign currency demand and supply, without displaying any significant deviation from their seasonal behaviour and end-2010 trend. In Q2, the nominal effective exchange rate of the lek vs. both major currencies, maintained the same

[38] *Potential money demand/supply growth is measured as an average of the annual changes of M3 potential series, estimated through several statistical approaches, such as HP with* λ *coefficient of variance, Tramo and SEAT, etc.*

moderate depreciation level as in Q1, thus contributing to maintaining the lowest depreciation level y-o-y since the onset of the 2008 global financial crisis. Exchange rate stability contributed to safeguarding the financial stability and simultaneously to better performance of consumer prices in the country.

VI. ECONOMIC AND MONETARY OUTLOOK

Macroeconomic developments in 2011 H1 were generally positive, in spite of ongoing supply-side pressures on consumer and primary commodity prices. The Albanian economy grew by 3.4% in 2011 Q1, following the 3.8% growth in 2010. Unlike last year, the contribution of external demand was lower, whilst fiscal policy provided an important stimulus to the economy. Recovery of the domestic demand, mainly from the fiscal component, also brought about expansion of imports, leading to trade deficit widening over 2011 H1; however, without causing any supply and demand imbalances in foreign exchange market and any significant fluctuations in the national currency value. Average inflation was 4.05% for this period, 0.05 percentage points above the Bank of Albania's upper limit. Detailed analyses of its components show that external shocks were the main driver to inflation rise, while the persistent negative output gap and anchoring of inflation expectations have offset these shocks. In response to upside risk to inflation expectations, in March, the Bank of Albania lifted its key interest rate by 0.25 percentage points, a move that has been transmitted to financial markets.

In 2011 Q1, fiscal stimulus provided a considerable support to economic growth, in terms of increasing both capital and current expenditures. This increase has offset the weaker than expected performance of consumption and investments, which, however, are estimated to have increased. Consumer spending was affected by uncertainty about the future and in consequence, by consumers' higher reluctance to spend and their higher propensity to save. Factoring consumer response into, private investments decelerated, while the manufacturing process featured spare capacities in both capital and labour factor input. External demand for Albanian goods and services continued to support the growth of exports. However, their growth pace has decelerated considerably on a year earlier.

In 2011 H1, financing terms were also less favourable than the ones expected six months ago. Remittances were down by 11.7% in 2011 Q1, and as a consequence of the still high unemployment rate in the Euro area, there are no signals for their recovery in Q2. Foreign direct investment inflows rose compared with the past year, in spite of increased global risk aversion. Meanwhile, domestic financial conditions remained relatively tight, owing to uncertainty about the internal and external environment. However, deposit growth and improved liquidity and balance sheets of the banking system have made room for lending to the private sector of the economy.

During that period, the Albanian economy was faced with constant pressures from foreign markets of food and primary commodities, especially oil. Other internal factors, such as higher excise tax and change in tax policy on medicines and liberal professions have also contributed to additional costs to the Albanian consumer, leading, in turn, to the materialisation of second-round effects, though at a slight extent. As a result, economic agents' expectations for inflation have risen compared to their historical performance, in spite of a persistent negative output gap. The decline in external pressures over 2011 H1 and the supply of the Albanian market with domestic products, gradually brought inflation back to the tolerance band in June, a trend expected to continue in the rest of the year. The lek's depreciation and its impact on inflation continued to be moderate in 2011 H1; however, the trade deficit widening trend constitutes one of the upside risk scenarios to inflation.

Given the present and expected performance of the main drivers to economic growth, the positive growth rates are expected to likely continue in 2011. Stabilization of political situation in the country is expected to revive investments and consumption, which would benefit in turn from improved banking system liquidity and banks' growing orientation to profit generation. The existence of spare capacities in the labour market made room for businesses to expand production without raising wages, while improved employment figures are expected to affect consumption. On the other hand, in view of meeting the public debt and budget deficit objectives, the contribution of fiscal spending is expected to drop markedly during the rest of 2011, thus making more room for private sector financing by the banking sector. The contribution of external demand may be lower than expected six months ago due to a high uncertainty surrounding the economies of partner countries. However, the expansion of the export base and the upward labour productivity tendency would wane the effect of the downward demand. In 2011 H2, monetary developments will focus on the growth of the private economic agents' money demand. Annual growth of the broad money aggregate, M3, is expected to swing around 10%. Monetary conditions are expected to boost aggregate demand and underpin the revitalization of the economy. The expected improvement of the macroeconomic climate, eased credit conditions by commercial banks and increased bank liquidity, coupled with increased economic activity, are expected to stimulate the expansion of credit to economy in the rest of 2011. On the other hand, the foreign currency demand and supply ratios are expected to be generally balanced. Private sector credit is expected to grow by roughly 12% y-o-y in 2011, of which about 25 billion in ALL and 30 billion in foreign currency.

Despite the more positive expectations for 2011 H2, uncertainties surrounding the outlook for economic developments are still in place. They surround, in particular, the outlook for the external sector of the economy and especially the current account and, subsequently, the exchange rate. A further downturn in the Euro area and increased risk premiums worldwide, may restrict the amount and cost of funds invested in the form of FDI and foreign borrowing. Persistent pressures on food and primary commodity markets, which will be present even during 2011 H2, against a background of the national currency depreciation, would weigh on the cost of living, being materialized in second-round effects. On the other hand, the restitution of stable consumption and investment growth rates is conditioned by a synchronized response by businesses, customers, banks and policy-makers in the country to the challenges facing the economy.

Within this framework of economic outlook, inflation is expected to remain both under the impact of the negative output gap and under the pressure of foreign markets, but the latter is expected to fall by year-end. Higher growth rates of the domestic demand in 2011 H2 are expected to further narrow the negative output gap; however, they will not thoroughly eliminate it. Consequently, the downward demand-side pressures are likely to be present in 2011. The interaction of the foregoing factors is expected to create an environment with balanced inflationary pressures, which would contribute to keeping annual inflation rates within the Bank of Albania's target in 2011.