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

MONETARY POLICY REPORT 2011 Q4

This Report refers to the Bank of Albania Monetary Policy Statement on 2011 H2, adopted by the Supervisory Council Decision No. 5 of 25 January 2012.

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Published by: Bank of Albania
Sheshi "Avni Rustemi", Nr. 24, Tirana
Tel: + 355 4 2419301/2/3; + 355 4 2419409/10/11
Fax: + 355 4 2419408
E-mail: public@bankofalbania.org

www.bankofalbania.org

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OBJECTIVE

The primary objective of the Bank of Albania is to achieve and maintain price stability. Promoting long-term investments, maintaining the purchasing power of money, enhancing the efficiency of fund allocation in the economy and safeguarding the financial stability are some of the benefits provided by an economic environment characterized by stable prices. This is the greatest contribution that the central bank can make 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 target for inflation aims at anchoring economic agents' expectations and reducing the risk premium.

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

Monetary Policy Report for 2011 Q4 refers to Bank of Albania Monetary Policy Statement on 2011 H2, adopted by the Supervisory Council of the Bank of Albania on 25 January 2012. The economic analysis in this Report is based on the latest available statistical and qualitative data as at 10 January 2012.

I. FOREWORD BY THE GOVERNOR

The Albanian economy faced challenges in 2011 as regards economic growth and maintenance of macroeconomic balances. Additional attention to public finance stability in euro-area countries is reflected in added risk premiums in international financial markets and reduced willingness to invest in emerging economies. Measures for addressing financial markets concerns have led to economic activity slowdown of our trade partners and are reflected in progressive deceleration of our exports growth rates. Moreover, higher food, fuel and primary commodity prices are translated into stronger foreign inflationary pressures, expansion of trade deficit and, potentially, weaker domestic demand as a result of negative effects on Albanian households' financial balances. Additionally, negative developments in the global arena are reflected in added uncertainties in the Albanian economy and negative impact on domestic consumption and investments. In spite of these shocks, the Albanian economy continued to grow in 2011, albeit at lower rates. This growth has reflected structural improvements of the Albanian economy, overall sound balances of economic agents, as well as utilisation of available capacities for macroeconomic stimulus and success to maintain macroeconomic balances.

Average annual inflation in the second half of 2011 was 2.9%, down by 1.1 percentage points compared with the first half of 2011. Downward inflation emerged in the second quarter and was then reinforced during the second half of the year. This resulted from reduced contribution of processed food, unprocessed food, and administered prices. In particular, food prices deviated from their seasonal behaviour in December, producing rapid curbing of annual inflation to 1.7%.

From the macroeconomic perspective, the downward inflation was influenced by both demand and supply factors, at the same time. On the supply side, slowdown of primary commodities price inflation in global markets and relative stability of the exchange rate were materialised in lower imported inflation. On the demand side, the below-potential growth of the Albanian economy continued to keep spare capacities in output factors – labour and capital – materialising in downward pressures on wages, output costs and inflation. Economic agents' expectations remain anchored around the Bank of Albania's target, owing to its reliable monetary policy, as well. Anchored expectations in the economy have reduced the so-called second-round effects, in other words, transmission of temporary shocks from higher primary commodity prices in global markets and output costs and higher consumer prices at home. They have provided higher flexibility for the Bank of Albania to pursue its stimulating monetary policy. Overall, these tendencies are expected to continue in the period ahead.

Reduction of inflationary pressures in 2011 and expectations for low inflation rates during 2012 motivated further easing of the monetary policy in the fourth quarter of 2011. The Bank of Albania cut the key interest rate twice, namely in September and November, down to the historic low of 4.75%. The Bank of Albania holds that the monetary stimulus increase will provide suitable financial conditions for compliance with its medium-term inflation target. Furthermore, eased monetary conditions serve to boost domestic demand, which remains fragile in the presence of higher uncertainties in the economy. In addition, it factorizes prudent fiscal policy for 2012 and expected curbing of public spending contribution to economic growth.

According to the latest data from INSTAT, the Albanian economy posted 0.5% growth in the second quarter, apparently slower compared with the growth rates in the first quarter.

By sector, economic growth in this period was sustained mainly by the positive performance of agriculture and individual branches of industry and services sectors. Value-added in agriculture was up 3.4%, providing significant contribution to the overall economic growth during the second quarter. On the other hand, the services sector's annual value-added was up by 1.8%, slowing down significantly from previous quarters' rates. Transport and financial intermediation were the main drivers of this sector, whereas most of other branches of the services sector contracted, year on year. Likewise, the industry sector shrank by 8.5% in the second quarter, after its positive performance in the last six quarters. Industry sector deceleration during this quarter was largely influenced by slashed output in "Energy, water and gas", whereas extracting and processing industry continued their upward value-added. After its surge in the first quarter of 2011, the construction sector contracted again in the second quarter, posting an annualised fall of 1.7%.

As regards aggregate demand, during the first half of the year, economic growth was supported mainly by the public sector and foreign demand, whereas domestic demand was lacklustre. Available data suggest that private consumption and investments were sluggish during the first half of the year, thus conditioning the below-potential growth of the economy during this period.

Private consumption continues to reflect consumers' reluctance to spend and their inclination to save. Domestic consumption has not totally reflected the higher available income generated by higher wages and employment rates, or the expansion of funding resources in the form of consumer loan growth during 2011. In particular, the fall of remittances during the first nine months of the year may have lessened consumption for a part of Albanian households. In addition, the relatively high import prices, which burdened Albanian households' budget in the first half of the year, may have impacted consumption negatively. Against this performance of consumption during the first half, the improved balances for large purchases – as suggested by the consumer confidence survey – and the increase in consumer loans granted during the second half, suggest for higher consumption in the third and fourth quarters of 2011.

Subdued consumer spending and presence of spare capacities in the economy dampened businesses' demand for new investments. In parallel, higher lending prudence by banks may have discouraged, in part, the demand for investment loans.

Foreign Direct Investments were down during the first three quarters of the year. Higher capital expenditures in the last quarter are expected to generate higher contribution to aggregate demand at year-end. In the meantime, the improved lending terms in 2012 are expected to be translated into higher support of the system with investment loans and higher contribution to economic growth by this component of aggregate demand.

Fiscal policy was stimulating in 2011, materialised in positive contribution of public spending to aggregate demand. Public spending and budget deficit growth rates moderated after the first quarter, settled at low levels in the second and third quarters, and recorded marked acceleration in the last quarter of the year. At the end of November, budget deficit was ALL 38 billion, reflecting the increase in public spending by 5.4% and the increase in budget revenues by 0.7% during this period. The acceleration of annualised budget expenditures in the last two months of the year owes primarily to higher capital expenditures during this period. Added prudence to fiscal sustainability, which characterises the 2012 budget, is expected to be reflected in lower contribution by the public sector to economic growth for 2012. Nonetheless, the Bank of Albania deems that this is an appropriate step to maintain macroeconomic stability and reduce risk premiums in the economy. Budget deficit narrowing in 2012 and its funding with domestic resources will generate more room for the expansion of lending to the private sector in this period.

Albanian economy continued to benefit from foreign demand in 2011, though at more moderate levels than in 2010. The annual growth of Albanian exports in value for the first eleven months of the year was 19.9%, implying slower rates compared with the corresponding period of a year earlier. On the other hand, imports accelerated their annual growth to 12.2%. Trade deficit widened by 8.1%, year on year, largely illustrating the negative effects of price rise in the global markets. A more detailed analysis of the trade deficit reveals that about 50% of its increase is created by the balance of electric energy exchange. Moreover, in real terms, according to third quarter's data, net exports deficit narrowed and contributed positively to aggregate demand.

The annualised contraction of net exports deficit is assessed to be resulting from imports of goods and services decline by about 4.2% in real terms and exports upsurge by about 8.6%.

Monetary indicators were in line with the developments in the economy's real sector. Our analyses and assessments suggest that the higher monetary supply is in accordance with economic agents' demand for real money, while monetary inflationary pressures in the economy are contained. The growth of M3 aggregate was slower in the second half of 2011, influenced by lower money creation in foreign currency. During July-October, the average annual growth of monetary assets in the economy was 10.4%. The contribution of private sector's demand for loans remained unchanged. At the end of November, its annualised growth was 10.9%. Crediting remains under the influence of low demand for loans and more prudent lending policies by banks. Economic agents' behaviour continues to be conditioned by uncertainty for the future, which, in turn, conditions spending and investments in the economy. On the other hand, credit supply is tight, as shown by the lending standards performance.

Financial markets during the second half of 2011 were calm and reflected relatively downward premiums on liquidity risk and inflation. Successive key rate cuts were swiftly reflected in the interbank market. In the primary market, government security yields dropped, reflecting the key interest rate cut as well as the low demand of the public sector for borrowing. Moreover, the transmission of monetary policy signals is expected to be extended fully to the deposit and loan market in accordance with the transmission mechanism time lags.

The Bank of Albania deems that a good part of the above-analysed tendencies will be present during 2012, as well. According to our baseline projections, the Albanian economy will continue to grow during the year ahead, albeit below its potential. The country's economic activity will be conditioned by the solution of the crisis in the euro-area countries, economic growth of our trading partners, and foreign investor's attitude to risk.

On the other hand, economic challenges in our trading partners may be transformed into positive opportunities for the Albanian economy. Albanian economy attractiveness with low unit labour costs, macroeconomic stability and financial soundness of businesses, households and the banking system may be reflected in more foreign direct investments. While our baseline projections factorize lower foreign demand contribution, the widening of Albanian exports market remains a potential scenario as well. Economic growth projections presume positive consumption and investments growth at home, in response to improvement of lending terms. The latter are expected to reflect the eased monetary policy of the Bank of Albania and reduced risk premiums in the financial system. Moreover, reduction of room for fiscal stimulus and maintenance of stable fiscal parameters will enable the private sector to create spare funds and cut down risk premiums for the economy.

Factorising our expectations for below-potential economic growth and lower imported inflation, as well as in the presence of the economy's expectations on inflation around the target, our projections suggest that, with 90% probability, consumer price inflation will range 1–3% during 2012. Monitoring continually the appropriateness of monetary conditions to its inflation target, in this development scenario, the monetary policy of the Bank of Albania is expected to maintain its stimulating nature in 2012.

II. EXTERNAL ECONOMY

The pace of global economic growth slowed in the second half of 2011. The recently pronounced financial market stresses related to deteriorating sovereign debt crisis of many euro-area developed economies have affected the overall climate of businesses' and consumers' confidence, restraining the economic recovery. In addition, emerging economies moderated the previous quarters' high growth rates. Generally, inflationary pressures worldwide were relatively low, remaining more pronounced in emerging economies than in advanced ones.

Economic developments in the world and particularly in our partner countries increase the possibility of their impact on the performance of the Albanian economy. Their slower economic growth may lead to a decline in foreign demand and hence lower contribution of Albanian exports. Also, the elevated unemployment in the euro-area countries, which has significantly affected Albanian emigrants as well, may lead to a decline in remittances. Moreover, the heightened stress in foreign financial markets has raised the risk premia demanded by investors, which may be translated into decreased investments flowing towards emerging economies. On the other hand, the slowdown of primary commodity price inflation in international markets and contained inflationary pressures worldwide are expected to contribute to diminishing imported inflation pass-through to the domestic market.

II.1 ECONOMIC GROWTH AND MACROECONOMIC BALANCES

Global economy slowed its growth rate in 2011 H2, compared with 2011 H1. The deteriorating sovereign debt crisis, extended to many developed economies, has negatively impacted the overall business climate and economic performance of these countries. Tensions related to this factor have been passed on to financial markets, thus contributing to further restraining of economic recovery. Emerging economies have registered more positive growth rates than the developed ones, albeit at more moderate rates than in the previous periods. Inflationary pressures worldwide have been relatively low, remaining more pronounced in emerging economies than in advanced ones.

Table 1 Selected macroeconomic indicators

Countries	GDP change		Unemployment rate	Inflation rate	
	Q3-11/ Q3-10	Q3-11/ Q2-11	November-11	December-11/ November-11	December-11/ December-10
USA	1.5	0.5	8.5[2]	0.0	3.4[1]
Euro area	1.4	0.2	10.3	0.1	2.8[4]
Germany	2.5	0.5	6.6[2]	0.7	2.1
France	1.6	0.3	9.7[3]	0.4	2.5
United Kingdom	0.5	0.5	8.3	0.1	4.8[1]
Japan	-0.2	1.5	4.5	-0.61	-0.5[1]

Source: Eurostat, respective statistical institutes.

[1] *Data for November.*

[2] *Data for December.*

[3] *Data for 2011 Q3.*

[4] *Forecast.*

EURO AREA ECONOMY

The latest data released by Eurostat indicate that the euro-area economic activity registered positive but decelerated growth rates in 2011 Q3. The annual growth by 1.4% is 0.3 percentage points lower than in 2011 Q2. Several factors that influenced the economic growth were the slow recovery of private consumption, shrinking investments and public spending contribution. Forecasts and indirect conjectural analyses show that this performance persisted in 2011 Q4. Throughout this period, business and consumer confidence indicators declined and were subsequently reflected in a non-positive climate of economic activity in the euro area. In 2011 H1, inflation rates were higher, mainly driven by rising prices of energy products, raw materials and foods. However, based on the euro-area main macroeconomic indicators, which speak about dim economic growth prospects for 2012, the euro-area inflationary pressures are expected to be contained over the course of 2012. Unemployment rate remained at historical highs in 2011, marking 10.3% in November 2011.

UNITED STATES ECONOMY

The U.S. economy performed positively in 2011. The latest estimates on the performance of U.S. economic activity show that in 2011 Q3, its growth rate gained momentum, posting more positive values than in 2011 Q2. U.S. GDP increased by an annual rate of 1.5%. Increased consumer spending and investments, with 1.7% and 1.3% respectively, gave the main contribution to this performance. In a more detailed analysis, both business and foreign-company investments have shown signs of increase throughout this year. Also, the narrowing of net export deficit in 2011 Q3 contributed positively to the annual performance of aggregate demand. Unemployment rate maintained its downward trend in 2011 Q4, to 8.5% in December 2011. Inflationary pressures were low and annual inflation rates have pointed to downward rates over the recent months, mainly reflecting the subdued energy price pressures. Annual inflation rate fell to 3.4% in November 2011.

BRIC ECONOMIES

Data on the economic activity of BRIC economies indicate that their annual growth rates continued into the third quarter, albeit at lower rates than in the second one. Russia is an exception, as its GDP expanded 4.3% in Q3, from 3.4% in Q2, supported mostly by rising consumer spending. Influenced by the aggravated economic outlook of several euro-area countries, China's and Brazil's annual GDP growth was 9.1% and 2.1%, respectively, in Q3. For Brazil, this represents the lowest annual growth since 2009 Q3. The strengthening of the Brazilian real and the contraction of domestic demand are two factors that have influenced the slowdown of Brazil's economic activity. Compared with the previous months, the Chinese economy highlighted slight decline in investments and a further slowdown in export growth rates. Influenced by reduced investments and high lending cost, India's economic growth rate continued to slide during the quarter under analysis.

Table 2 Selected macroeconomic indicators for BRIC economies

Country	GDP annual change			Annual inflation
	2011 Q3	2011 Q2	2011[1]	December 2011
Brazil	2.1	3.3	3.8	6.5
Russia	4.3	3.4	4.3	6.8[2]
India	6.9	7.7	7.8	9.1[2]
China	9.1	9.5	9.5	4.1

Source: IMF, OECD, respective statistical institutes.

[1] *IMF estimates, September 2011.*

[2] *November 2011.*

Inflationary pressures remained elevated throughout 2011 H2. Consequently, during the period under review, the national authorities intervened frequently to prevent overheating of respective economies. However, thanks to monetary and fiscal policies undertaken in these countries, the annual inflation rates have decreased in recent months.

ECONOMIES IN THE REGION

Annual economic growth rates in the region were uneven in 2011 Q3. With the exception of Kosovo, Turkey and the Former Yugoslav Republic of Macedonia, the other countries registered a moderate or negative growth.

During this quarter, the Greek economy contracted by 5% compared with 2010 Q3. Industrial production for October and November fell by an average of 10% y-o-y, presenting a continuing downward trend of GDP for the fourth quarter. Italian economy grew by only 0.2% y-o-y and shrank by 0.2% q-o-q, impacted by lower consumer spending and lower growth of private sector investments. Italy continues to face financial markets stress related to reduced market confidence in sovereign debt sustainability, which has led to increased overall financing cost for the government and businesses. In contrast, Turkey and the Former Yugoslav Republic of Macedonia registered accelerated growth rates of their respective economies in 2011 Q3. In Turkey, the accelerated industrial production growth helped expand GDP by 8.2% y-o-y. In the Former Yugoslav Republic of Macedonia, the increase in consumer spending and aggregate investments provided for a 2.3% economic growth rate.

Unemployment rate was up in Greece and Italy and down in Croatia and Turkey. Annual inflation was unchanged or downward in most countries in the region. Rising inflation in recent months remains Turkey's principal economic concern.

Table 3 Economic figures for regional economies

Country	Annual GDP change Q3:11	Annual inflation December-11	Unemployment rate November-11
Italy	0.2	3.3	8.6
Greece	-5.0	2.4	18.8[2]
FYROM	2.3	2.8	31.3[3]
Serbia	0.5	7.0	22.2[4]
Croatia	0.6	2.1	12.7
Turkey	8.2	10.4	8.3[2]
Kosovo	5.5[1]	3.6	:
Albania	0.5[3]	1.7	13.3[3]

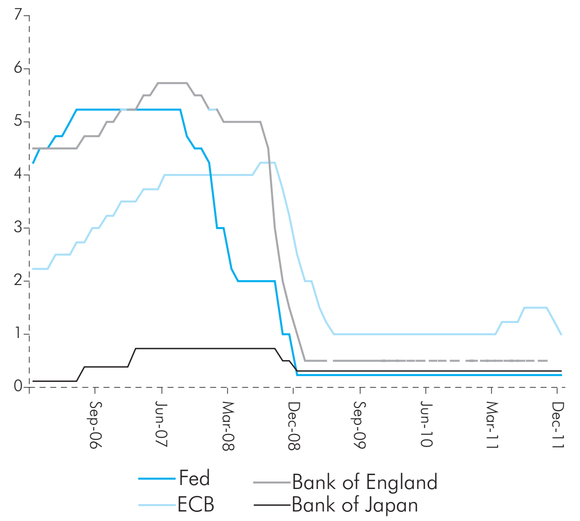
Source: Respective statistical institutes, Eurostat, EcoFin, IMF.
[1] IMF's projection for 2011.
[2] Data for September.
[3] Data for 2011 Q2.
[4] Data for April.
: Unavailable data.

II.2 INTEREST RATE DECISIONS AND FINANCIAL MARKETS

The major central banks left their key interest rates unchanged. The European Central Bank is an exception, as it lowered the key interest rate twice, by 25 basis points in November and December, to 1.00%. The other central banks kept their key interest rates unchanged: Federal Reserve at 0-0.25%, Bank of England at 0.5% and Bank of Japan at 0-0.1%. Except for the European Central Bank, which changed the interest rate four times during this year, the last change in major central banks was more than two years ago.

Interest rates in international financial markets trended up during these months and were characterized by high volatility. In euro-area money markets, the EURIBOR rates remained high, reflecting the heightened uncertainty surrounding market agents and the weak pass-through from the key interest rate cuts. U.S. dollar LIBOR rates went upward. In bond markets, the premia for financial securities of the euro-area countries increased in general, while those of the U.S. declined. The magnitude of the increase has been different, while it has affected even the securities of issuers rated as positive[1] by the rating agencies. Financial market stresses and the uncertainty about sovereign debt concern were more pronounced in the recent months, weakening the overall confidence in market agents. Bond yields for countries more exposed to sovereign debt crisis (Spain, Italy, etc.) continued to increase, expanding their spread with the yields

Chart 1 Key interest rates

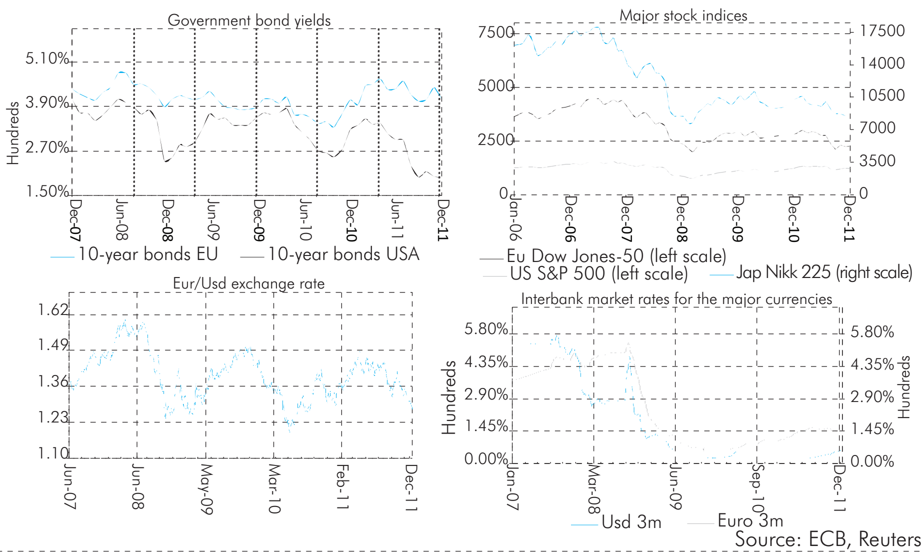


Source: ECB, FED, Bank of England, Bank of Japan

[1] AAA rating by Moody's, Standard&Poors, Fitch Ratings, etc.

on German government debt securities. The performance of stock markets during these months was similar to that of the bond markets. The major stock market indices of Europe and Japan declined, whereas those of the U.S. appeared better. In terms of activity profile, the reductions have affected mainly the prices of securities of banking and financial segment traded on stock exchanges.

Chart 2 Exchange rate and some financial indicators in international markets



Source: ECB, Reuters

Euribor rates of 1-, 3-, 6-, and 12-month maturity marked 1.14, 1.42, 1.67 and 2.0%, respectively, in December, down by 0.11 percentage points on average[2] from September, while the ECB key interest rate was lowered by 0.50% over the period. The three-month U.S. dollar Libor rate rose by 0.21 percentage points, to 0.57%.

In foreign exchange markets, during the quarter, the euro depreciated against the U.S. dollar. Moreover, during the period, the euro depreciated even against the British pound and the Japanese yen. In average terms, in December, 1 euro was exchanged for 1.348 U.S. dollars or down 4.57% from the third quarter.

II.3 OIL AND PRIMARY COMMODITY PRICES

In 2011 H2, oil price per barrel in the international market reflected an upward trend both annually and semi-annually, as a result of the high price rise in the third quarter of the year. Thus, the oil price per barrel rose on average 37% compared with 2010 H2. However, the lack of resolution to the crisis in the euro area and the downward revision of economic growth for OECD countries and the BRIC economies in September, resulted in reduced oil price in the last months of the year.

[2] The decline was 0.20, 0.11, 0.06 and 0.07 percentage points, respectively.

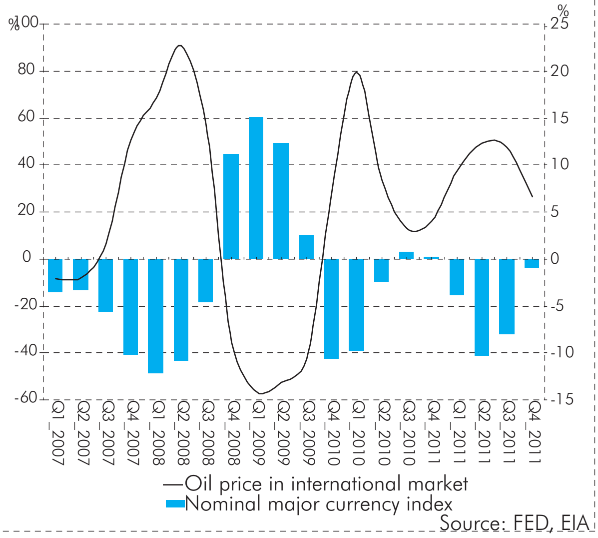
Global oil demand in 2011 Q4 increased slightly by 0.93% y-o-y, aided mainly by North American region and the BRIC countries. Over the same period, global oil supply resulted higher owing to higher production in North America and Russia.

Regarding the 2012 forecasts, based on the latest report by OPEC, world oil demand is expected to increase 1.07 million barrels per day. Meanwhile, world oil supply is expected to increase 1.03 million barrels per day, 35% of which will be supplied by OPEC.

Following the accelerated growth rates in 2011 H1, major price indices recorded weak or negative growth rates in 2011 H2, mostly influenced by uncertainty about the economic outlook, against the backdrop of high sovereign debt in advanced economies, thus, leading to subdued demand for these commodities.

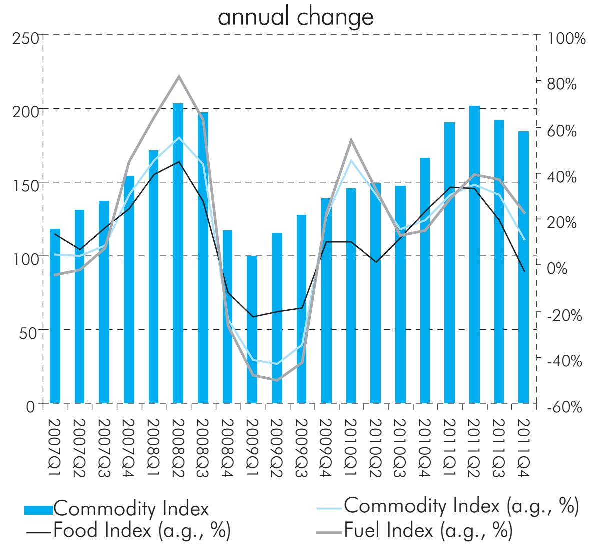
In 2011 H2, the Commodity Price Index posted an annual growth of 20%, while it decreased by 4% in semi-annual terms. Over the period under review, the Food Price Index posted an annual growth of 8%, while in semi-annual terms, it contracted by 8%. Fuel Price Index posted an average annual growth of 30% and remained unchanged compared with 2011 H1.

Chart 3 Annual change of oil price in international markets and nominal major currencies dollar index



Source: FED, EIA

Chart 4 Price indices by primary commodity and their annual change



Source: IMF

III. PRICE STABILITY AND BANK OF ALBANIA'S OBJECTIVE

Annual inflation averaged 2.9% in 2011 H2, pursuing a sharper downward trend in the fourth quarter. The weak inflationary pressures, mainly as a result of the seasonal factor of food prices, which was more intensive than in the previous years, particularly during December, contributed to a more favourable conjecture of prices of goods and services in Albania. In addition to these factors, the stable exchange rate towards a minimum depreciation and the complete cancelling out of the price rise effect in some goods at administered prices provided substantial impact on the performance of inflation. During 2011 H2, supply-side inflationary pressures receded sooner than forecasted, while domestic demand continued to exert downward pressures, materialized in the deepening of the negative output gap and below-historical average capacity utilization in the economy.

The Supervisory Council of the Bank of Albania cut the key interest rate twice during September-November 2011, to 4.75%. In the medium run, the alleviated monetary conditions will help boost economic activity and meet the inflation target. In parallel with the key interest rate cut, the Bank of Albania has supplied the banking system with the necessary liquidity in order to ensure the sound financing of the economy.

III.1 CONSUMER PRICES, TARGET MEETING AND MONETARY POLICY

Annual inflation averaged 2.9% in 2011 H2, close to the Bank of Albania's medium-term target, whilst in H1 it marked 4%. The downward trend of the annual inflation rate, which had begun since Q2, was more pronounced in 2011 H2. The continuous negative output gap and the moderate depreciation of the Albanian Lek[3], along with the base effect - triggered by the downward dynamics of the contribution of goods and services' items at administered prices and the sub-item of "Bread and grains" to headline inflation - were the key factors behind the materialization of this performance. The seasonal factor of food prices was more intensive than in the previous years, hence contributing to the alleviation of the inflationary pressures generated from the relatively high raw material prices in the global markets. The downward inflation trend in 2011 H2 was significantly affected by the actual inflation rate in December (1.7%), which did not respond to the high positive seasonality of unprocessed food prices[4].

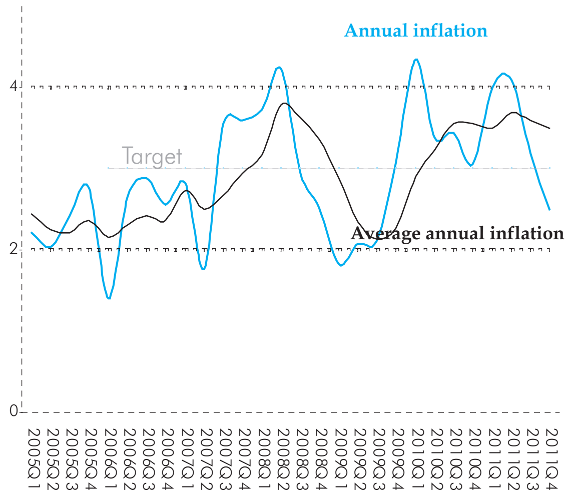
[3] *In certain periods during this semester, for example in December, the Albanian Lek appreciated against the Euro.*

[4] *The seasonal factor of the monthly inflation of "Unprocessed foods" for December over 2005-2011 is about +7% above the average trend. In fact, in December 2011, monthly inflation marked only +4.3%, that is, about 3 percentage points below the average seasonal effect.*

The contained inflationary pressures deriving from the domestic economy were driven by the sluggish demand, labour market, and the dynamics of wages and labour costs. In addition, the stable exchange rate towards a minimum depreciation was a determinant factor in curbing the imported inflationary pressures. The contained monetary asset growth supports the assessment for curbed monetary pressures on the performance of consumer prices.

At end-2011 H2, inflation[5] averaged 3.5%, down compared to end-H1 (3.7%). The signals for the receding inflationary pressures have been also triggered by the developments in core and non-traded inflation in the last six months. This development is also reflected in the consumer, business and financial market experts' inflation expectations, which have been descending.

Chart 5 Annual inflation and moving average (in %)



Source: INSTAT and Bank of Albania

In light of the downward inflation projections and anchored economic agents' expectations within the 2-4% band, the Supervisory Council of the Bank of Albania decided to cut the key interest rate by 0.25 percentage points each in September and November 2011. The repo rate of one-week maturity currently stands at an all-time low of 4.75%. The key interest rate cuts were followed by the continuous injection of liquidity, while the Bank of Albania expected more active actions from the financial and real sectors of the economy in order to fuel consumption and private investment. In the absence of the high fiscal stimulus, the generated monetary stimulus is expected to boost domestic demand by favouring the easing of lending standards and boosting consumption and private investment in the short run. This move will also contribute to maintaining inflation and the inflationary expectations close to the Bank of Albania's target in the medium run.

Over the last two years, monetary conditions in Albania have pursued an accommodative trend and have supported the economic activity. In 2011 Q4, Monetary Conditions Index evidenced the reinforcement of this trend as a result of the key interest rate cut by the monetary authority and the stable exchange rate.

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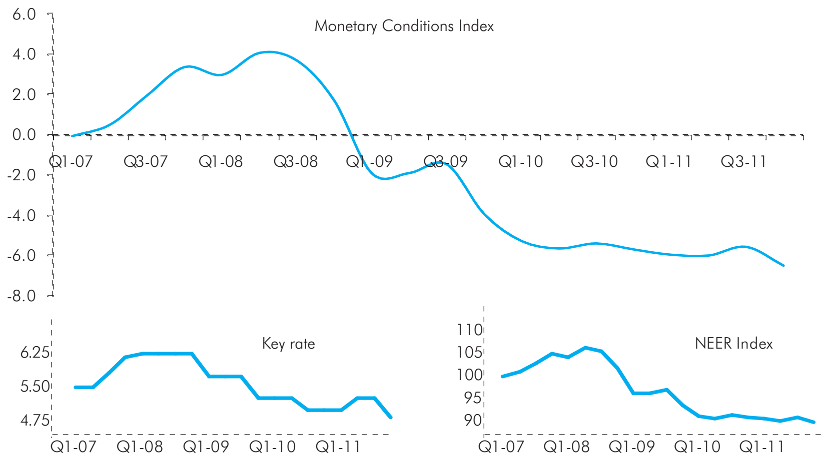
5 *Measured as a 12-month moving average, it signals the inflation trend. The statistical technique of the moving average enables the partial flattening out of the short-term volatility of the indicator it is applied on.*

Chart 6 Monetary Conditions Index (MCI, change from base year) *



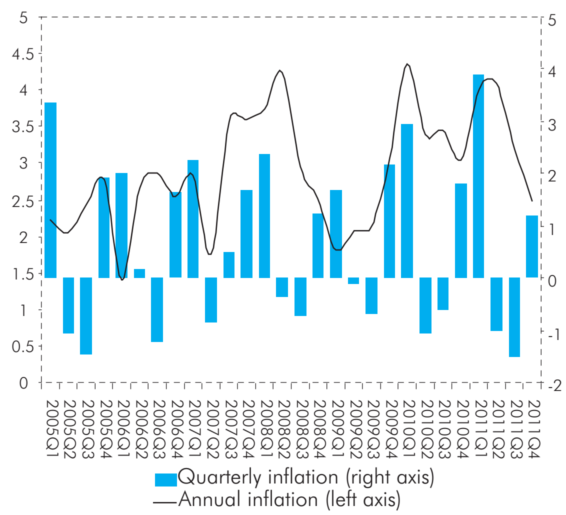
The MCI is constructed using the performance of the key interest rate and the nominal effective exchange rate. In this series, an increase in the NEER implies the appreciation of the exchange rate. In the MCI, an increase in this index implies the tightening of the monetary conditions.
Source: Bank of Albania

Pursuant to its primary mission, maintaining price stability in the medium run, the Bank of Albania's monetary policy will duly consider any significant demand and supply-side developments and the duration of the factors' effect.

III.2 INFLATION BY ITEMS

The performance of the inflation rate in 2011 H2 reflected the alleviation of the inflationary pressures originating from inside and outside Albania and the absence of factors having an increasing impact; hence creating a more relaxed environment in terms of the inflationary pressures. The lower volatility in the prices of commonly used goods (mainly foods) in the global markets and the more favourable conjecture of prices of goods and services in Albania contributed to the fall of the inflation rate. In addition, the completely subsiding effects of the 2010 price rise of some administered prices in August 2011 gradually pushed the inflation down to considerably lower rates than in 2011 H1. More specifically, after marking rates close to the upper tolerance band of the Bank of Albania, inflation fluctuated around its target and, in December, it marked an unusual rate of 1.7%.

Chart 7 Annual and quarterly inflation (in %)



Source: INSTAT and Bank of Albania

Inflation of goods and services' items divided by economic nature also shows a dissimilar performance to 2011 H1. 83%[6] of the average annual inflation of 2.9% in 2011 H2 was mostly formed by the contribution of "Processed foods" and "Non-food consumer goods". In the meantime,

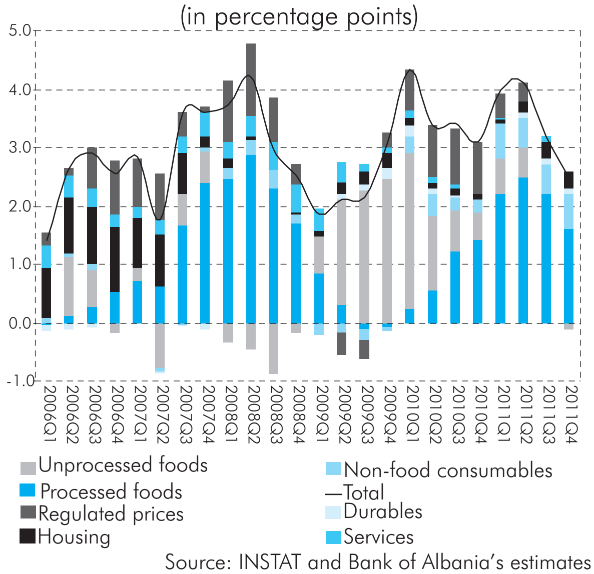
[6] *In 2011 H1, this contribution was 72%, while the other two important basket items made a contribution of 22%.*

other items generally having a significant share in the inflation rate, like "Administered prices" and "Unprocessed foods", made almost no contribution to the formation of the headline inflation rate for the period under review. The decline in the inflation rate in 2011 H2 was, by and large, considerably affected by the inflation of commonly used foods and consumer goods at administered prices.

As forecasted, the contribution of "Bread and grains"[7] in the domestic market began to fall in 2011 H2 due to the base effect caused by the rapid rise of their price starting from August last year. The contribution of other basket items has, in the meantime, remained almost unchanged. Coupled with the stable exchange rate, which in December showed an appreciation tendency, this factor gave rise to a downward contribution of "Processed foods" to the inflation rate compared to 2011 H1. The gradually higher contribution of processed goods' prices, confirmed throughout 2011 H1, as a result of their global conjecture and the higher excises on some goods, subsided as from August 2011, thus affecting substantially the fall of headline inflation. More specifically, annual inflation and the contribution of processed goods dropped from 10.1% and 2.4 percentage points, respectively, in 2011 H1, to 7.8% and 1.9 percentage points in 2011 H2.

Inflation of "Non-food consumer goods" is affected by the performance of oil price at home, which is determined by its price in the global markets and the exchange rate developments. The increasing tendency of oil price and Lek's depreciation against the U.S. dollar were also reflected in the oil price in the Albanian market. On the other hand, oil price in Albania during this half was also affected by several fiscal measures taken in September[8]. In addition to the oil price rise, this item's inflation was also affected by the rise in medicaments prices, which was most intensive in 2011 Q3[9]. As a result, while during the major part of the last 10 years, this item's average contribution to headline inflation ranged between 0.1-0.2 percentage points, in 2011 it reached 0.5-0.6 percentage points. The protracted effect of the rise in this item's prices continued to exert mounting pressures on domestic inflation during 2011 H2, quite opposite to the other items, whose effect was on the downside.

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



Source: INSTAT and Bank of Albania's estimates

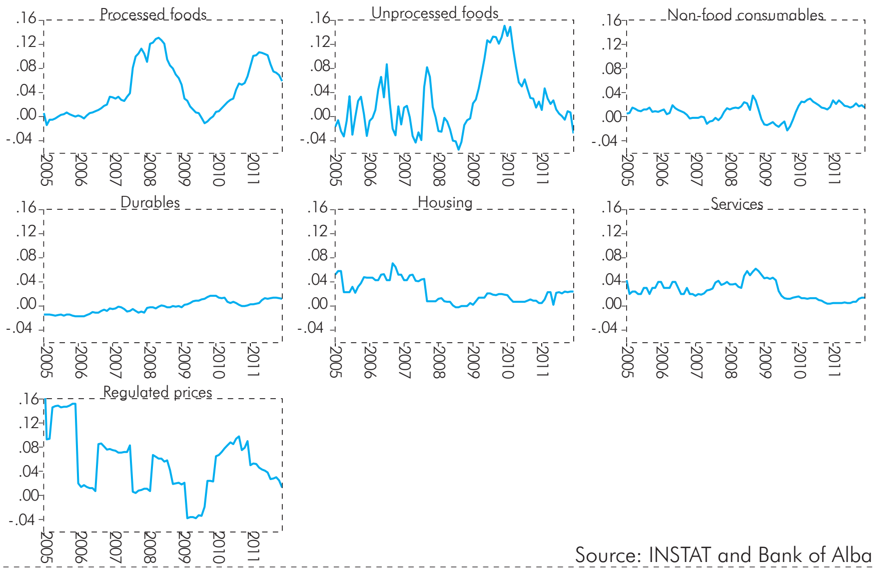
[7] At the end of the year, the contribution of this item dropped by 0.5 percentage points, while its contribution in July to headline inflation reached 1 percentage point.

[8] The application of the 5 Lek environmental tax levied on fuels in September raised the oil price much higher than the tax value.

[9] The higher medicaments price was mainly a result of the application of the VAT on medicaments.

Prices of "Unprocessed foods" fell y-o-y in 2011 H2, remaining within the fluctuations marked since June this year. This item's annual inflation marked -0.1 in H2, contributing also to the fall of the headline inflation rate by almost 0.5 percentage points. This item had not marked negative inflation rates and contribution since summer and autumn of 2008. This item marked particularly lower inflation rates in December this year. The lower inflation may have also been driven by the higher share of domestic production in meeting demand for these goods. In addition, Lek's appreciation against the Euro and the sluggish domestic demand provided their contribution to this item's prices. Its contribution to annual inflation was -0.1 percentage points compared to an average of 0.7 percentage points in the previous year.

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



Source: INSTAT and Bank of Albania

Concerning "Administered prices", worth noting is that this item's contribution to inflation is almost zero following the subsiding effects of the rise in its prices during 2010. The subsiding effect of the rise in electrical energy price in January 2010 and the gradually subsiding effect of the rise in the prices of some other goods (water, health services etc.) were both reflected over this second half of the year.

Table 4 Annual contribution of key items to annual inflation (in percentage points)

	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4
Processed foods (pp)	-0.1	-0.1	0.3	0.6	1.1	1.4	2.2	2.5	2.2	1.6
Bread and grains (pp)	-0.1	-0.3	-0.2	-0.1	0.1	0.4	0.7	1.0	0.8	0.5
Alcohol and tobacco (pp)	0.1	0.2	0.1	0.2	0.2	0.2	0.5	0.4	0.4	0.4
Unprocessed foods (pp)	2.3	2.5	2.6	1.3	0.9	0.5	0.6	0.5	0.0	-0.1
Fruit (pp)	0.5	0.6	0.2	0.1	0.3	0.1	0.2	0.4	0.2	0.3
Vegetables (pp)	0.9	1.0	2.0	1.5	0.1	-0.7	0.1	-0.4	-0.6	-0.7
Services (pp)	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.1	0.0
Administered prices (pp)	-0.4	0.3	0.7	0.9	1.0	0.9	0.4	0.3	0.1	0.0
Fuels and energy (pp)	0.0	-0.1	0.4	0.4	0.4	0.4	0.2	0.3	0.2	0.1
Housing (pp)	0.2	0.2	0.1	0.1	0.1	0.1	0.2	0.3	0.3	0.3
Non-food consumer goods	-0.2	-0.1	0.3	0.4	0.3	0.2	0.6	0.5	0.4	0.6
Durable consumer goods (pp)	0.1	0.2	0.2	0.1	0.0	0.0	0.0	0.1	0.1	0.1
Consumer Price Index (y-o-y, %)	2.1	3.1	4.3	3.4	3.4	3.1	4.0	4.1	3.2	2.5

Source: INSTAT and Bank of Albania

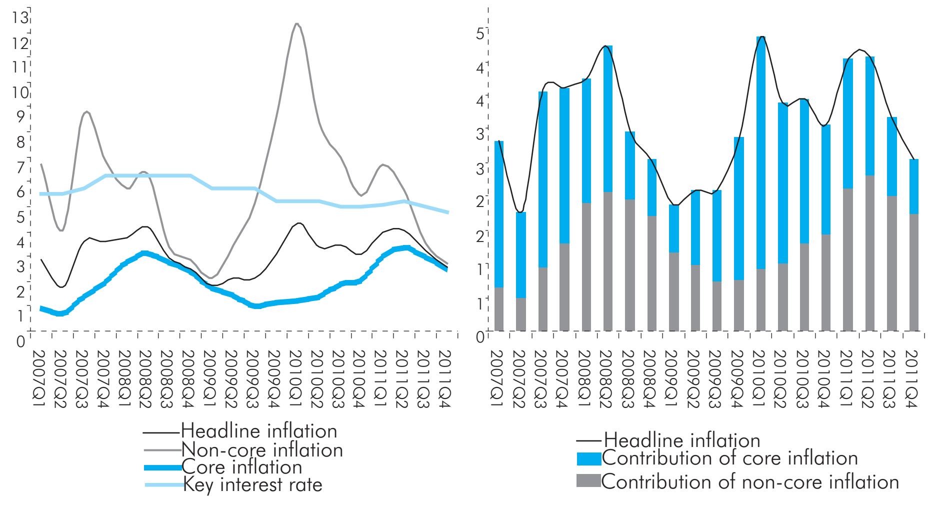
The other items continue to provide low contribution to the headline inflation rate, reflecting the sluggish consumer demand for these goods and services.

III.3 MAIN INFLATION TRENDS

Annual core inflation[10] marked 2.7% in 2011 H2, contributing by 66% to the formation of the annual headline inflation of the period under review. Core inflation pursued a more sluggish downward trend than headline inflation given the more persistent nature of the inflationary pressures it generates. In 2011 Q3 and Q4, it marked 3% and 2.5%, respectively, reflecting the subsiding effect of some stronger shocks generated from the prices of "Bread and grains" during the second half of the previous year and the stable exchange rate. Annual core inflation averaged 2.9% in 2011, converging towards the long-term average of headline inflation and the Bank of Albania's inflation target.

In addition to the long-term downward trend, the lower headline inflation rates over the period under review were also triggered by the short-term consumer price developments. Their volatility smoothed out considerably, being materialized in the reduction of non-core inflation rates to 3.5% and 2.7% in the last two quarters of 2011. On average terms, the short-term inflationary pressures formed about 34% of the headline inflation rate of July to December 2011. Annual non-core inflation marked 0.6% in December 2011[11], which is "an isolated" rate in the history of its series.

Chart 10 Annual core and non-core inflation (left) and their respective contribution (right)



Source: INSTAT and Bank of Albania

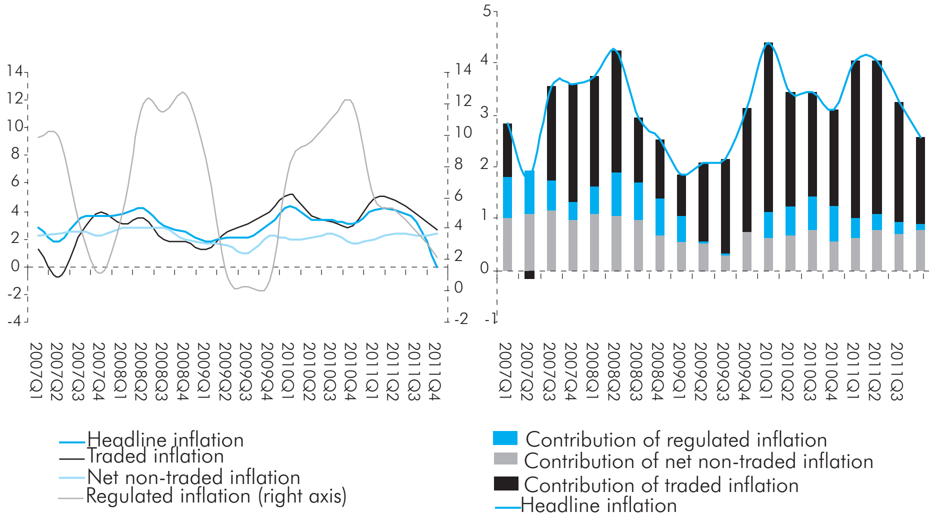
Core and non-core inflation shared similar profiles over the course of 2011, steering the shift of headline inflation towards the same direction. In 2011 H2, in particular, their respective inflation rates evidenced clear convergence.

[10] *Average of two measures (permanent exclusion and trimmed mean).*
[11] *The minimum rate since January 2003, when non-core inflation marked -0.4%.*

On the one hand, this behaviour has been triggered by the deceleration of domestic demand in economy[12] and, on the other, by the lower intensity of transitory supply-side shocks[13].

In 2011 H2, the rise in raw materials and primary commodity prices in the global markets curbed sooner than projected in summer the same year. This development led to receding inflationary pressures originating from outside the Albanian economy, quantified by the inflation of traded goods sector in the CPI basked. In 2011 H2, it marked 3.2% y-o-y, lower than in H1 but very close to its figure in the corresponding period of the previous year. Traded inflation was relatively low in 2011 Q4 (2.7%)[14], due to the figure marked in December 2011 (1.4%). The exchange rate behaviour has continued to support the smoothening out of fluctuations deriving from import prices into the Albanian economy. In 2011 H2, traded inflation formed about 68.2% of headline inflation.

Chart 11 Annual inflation by sector (left) and respective contribution (right)



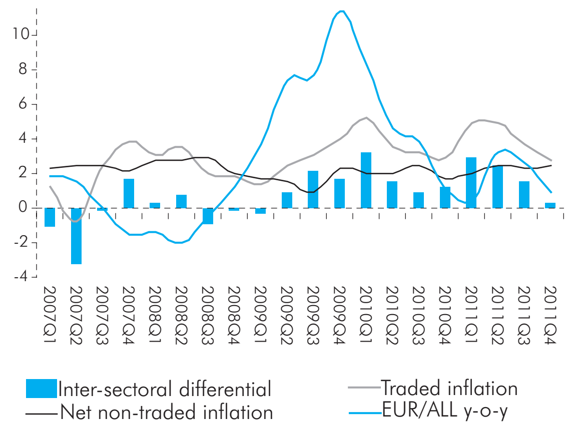
Source: INSTAT and Bank of Albania

The inflationary pressures deriving from the developments in the domestic economy have been materialized in close to historical average rates of non-traded inflation, net, compared to the regulated prices in the CPI basket[15]. It marked 2.3% for the period under review, forming about 25.4% of the annual headline inflation rate of 2011 H2[16]. Its fluctuations in the first half of the year gave signals for the emergence of second-round effects on inflation, which were partly smoothed out over the following months. This assessment is also evidenced by the behaviour of market agents' expectations for the curbing of inflation over a one-year time frame. At the end of 2011 and beginning of the current year, their expectations for inflation anchored closer to the Bank of Albania's 3% target.

[12] *Expressed in the core inflation trend.*
[13] *Expressed in the faster decrease of non-core inflation.*
[14] *The lowest since 2009 Q2, due to the high comparative base effect in 2008.*
[15] *Excluding the effect of movements in administered prices (electrical energy, water and hospital services).*
[16] *The remainder of inflation (6.4%) was formed by services at regulated prices, whose annual inflation marked about 2.1% in 2011 Q4, the minimum of the last two years' rates.*

The performance of inflation components by origin of creation of inflationary pressures in the economy is synthesized in the inter-sectoral inflation differential indicator. It shows that the second half of 2011 was characterized by a relatively fast narrowing of rates between the inflation of goods and services. Its rates have been decreasing over 2011, from 2.8 in Q1 to 0.3 percentage points at end-2011.

Chart 12 Inter-sectoral inflation differential



Source: INSTAT and Bank of Albania

This performance was simultaneously determined by the behaviour of these three components: curbing of the exchange rate depreciation, mainly in 2011 Q4; the relative stability of net non-traded inflation rates; and the deceleration of traded inflation, which was more pronounced at end-2011. Consequently, in terms of contributions, in 2011 Q3 and Q4, imported inflation formed 49% and 35%, respectively, of the annual headline inflation of each quarter, with an average contribution of 42% for 2011 H2.

IV. MACROECONOMIC DEVELOPMENTS AND IMPACT ON INFLATION

The latest data show that the economic growth in Albania decelerated in 2011 Q2. According to INSTAT's preliminary data[17], GDP grew at an annualized rate of 0.5% in this quarter. The sluggish and below-potential economic growth has been reflected in weak pressures on the raise of wages and curbing of second-round effects on inflation. In addition, the relative exchange rate stability, coupled with the receding inflationary pressures from the international markets, materialized in the decelerating trend of imported inflation. Against a background of anchored economic agents' expectations, inflation pursued a descending trajectory during 2011 H2. Based on these assessments and on our forecasts for the economic performance in Albania and abroad, aggregate demand is not expected to exert any inflationary pressures over the period ahead.

IV.1 GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

The decelerated annual growth in value added mainly attributes to the poor performance of the industrial sector and the contained growth of activity in the services sector. The sluggish aggregate demand has mainly reflected the fall of domestic demand, whilst net exports and the fiscal segment have lowered the positive contribution.

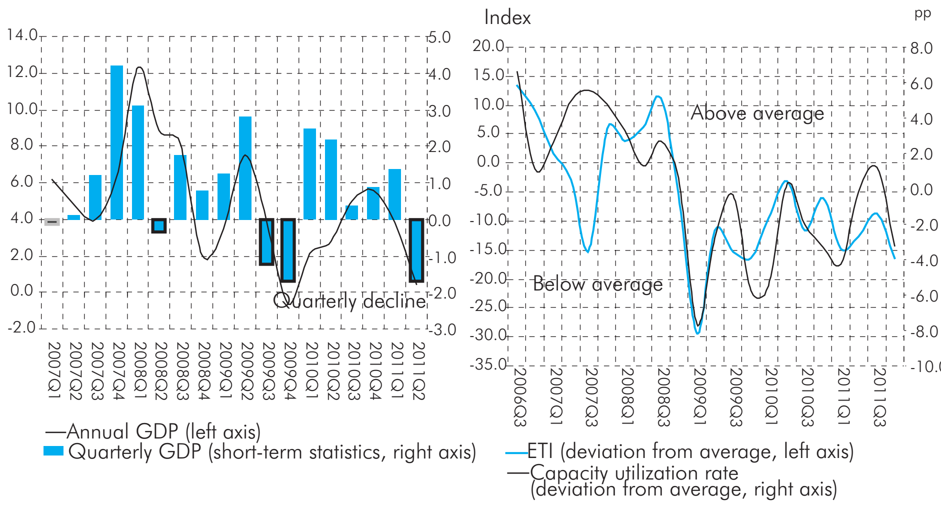
Following the progressive growth in the second half of 2010, the growth rates of economic activity decelerated in 2011 Q1 and Q2[18]. According to INSTAT's preliminary data, real GDP grew by 3.8% in 2011 Q1 and 0.5% in Q2. In light of the recent information on output in 2011 Q2, on the global economy developments and the signals obtained from the confidence surveys, our projections for economic growth in 2011 are lower than in the first quarter.

---

[17] *Gross Domestic Product in 2011 Q2. This publication also reports the revision of the economic growth figure for the first quarter of the year. GDP was revised upward to 3.8% from 3.4% as reported earlier.*

[18] *The low GDP in Q2 confirms the materialization of previously identified downward risks – consumption and investments could not offset the expected deceleration of net exports and the public sector – and the effect of transitory factors.*

Chart 13 GDP (annual and quarterly changes, left), economic tendency indicator and capacity utilization rate (right)



Source: INSTAT and Bank of Albania

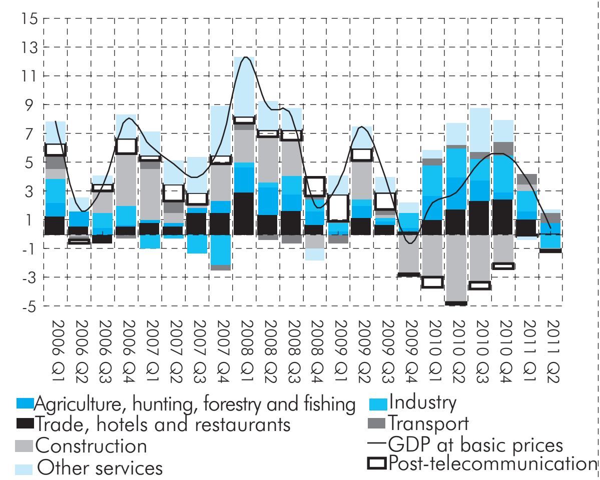
Quantitative and qualitative indirect data on 2011 Q3 and Q4 suggest that the growth of output continued to remain below its historical growth rate. Capacity utilization rate in almost all sectors of the economy fell considerably at the end of the year. The relatively high uncertainty[19] about the performance of domestic and foreign economy, in addition to the further reduction of the foreign demand and fiscal contribution and the slow growth of disposable income, will condition consumer spending and business investment in the future. On the other hand, the favourable developments in the financial markets due to the accommodating monetary policy are expected to reflect in adequate monetary conditions to fuel consumption and private investment in the economy.

IV.1.1 OUTPUT BY SECTORS

The deceleration of value added in 2011 Q2 mainly attributes to the poor performance of the industrial sector and the contained growth of activity in the services sector. On the other hand, the construction sector contracted further in Q2.

In the meantime, quantitative indirect indicators suggest that economic activity improved in 2011 Q3 and Q4.

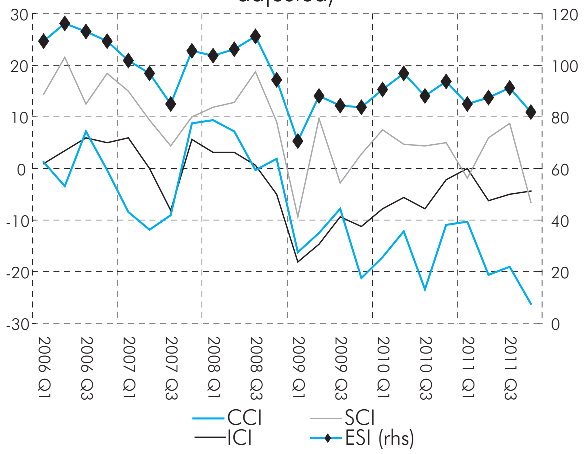
Chart14 GDP in economy (y-o-y changes, in %) and contribution of sectors (in p.p.) to its annual performance



Source: INSTAT and Bank of Albania

[19] The relatively high uncertainty is signalled by the decrease in the average Economic Sentiment Index by about 16.5 points in the last quarters of 2011.

Chart 15 Economic Sentiment Indicator (long-term average = 100), confidence index in industry, construction and services (in balance, seasonally adjusted)

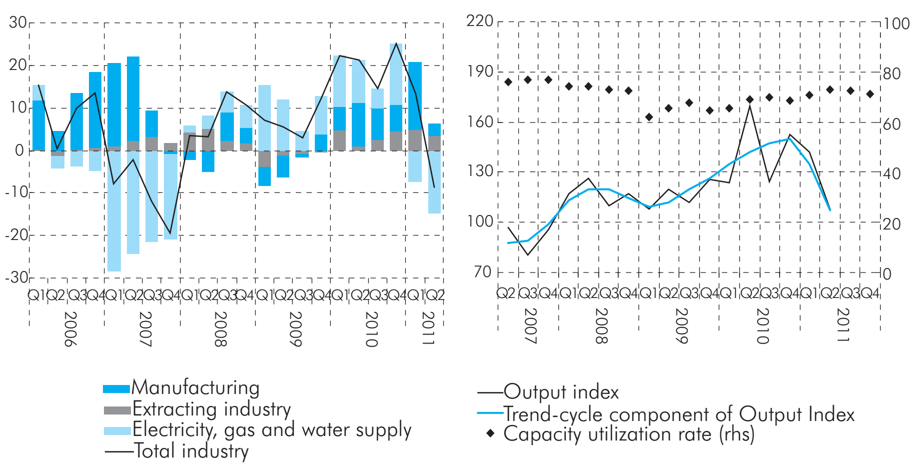


Source: INSTAT and Bank of Albania

Disaggregated by sector, value added in the industrial sector dropped y-o-y (8.5%) and q-o-q (13.2%) in 2011 Q2. The deteriorated performance of the industrial sector was mainly driven by the fall by 66% of value added in "Electrical energy, water and gas" compared to the previous year. This contraction reflected the annual decline of output in this branch by 42%. On the other hand, extracting and processing industry generated higher value added compared to the previous year. Their value added increased by 32.8% and 4.3% y-o-y, respectively.

The lower output in the industrial sector may reflect a combination of factors. In 2011 Q2, industrial output index continued to decelerate and marked an annual fall by 24.8%. Trend-cycle component[20] for this index pursued a descending tendency as well. On the demand-side, indirect indicators evidence the deceleration of domestic and foreign[21] demand for industrial products. More specifically, the lower growth of industrial turnover index by volume by 4.2% in 2011 Q2 and the lower demand as reported by the business surveys provide evidence for the fall of demand in the industrial sector. In addition, the lower increase in industrial exports[22] in 2011 Q2 evidences lower foreign demand in industry.

Chart 16 Industrial sector. Value added (y-o-y changes, in %) and contribution of sub-branches (in pp, left). Output Index (year 2005 = 100), its trend and cyclical component and the capacity utilization rate (in %, right)



Source: INSTAT and Bank of Albania

[20] *The trend-cycle component for the industrial output index and construction output index was assessed through the seasonal adjustment using the X-12 technique.*

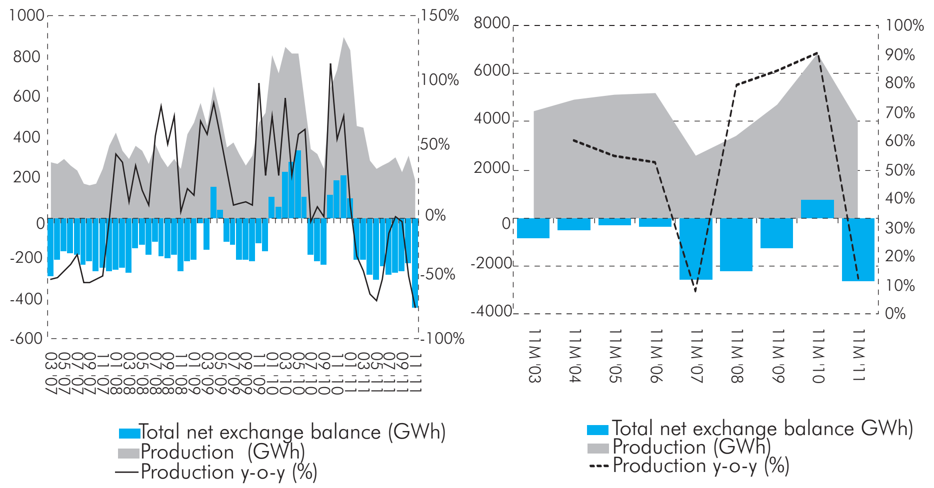
[21] *Foreign demand for industrial products has been proxied with the performance of major industrial exports.*

[22] *Referring to the annual performance of main industrial products exports.*

The relative improvement of the industrial confidence index suggests a more positive expected performance of the industrial sector in the remaining of 2011. Moreover, indirect quantitative indicators, like the annual increase of industrial exports in 2011 Q3 and of the cumulative VAT revenue collection for the manufacturing sector in Q3 and the eleven-month period of 2011, reinforce the optimistic business signals regarding the industrial activity.

The production of electrical energy fell by about 44.5% y-o-y during January-November 2011, mainly owing to the lower production in large hydropower plants (due to the unfavourable hydro conditions in Albania). The latest data show that in November 2011, the production of electrical energy fell by about 75.2% y-o-y.

Chart 17 Key electrical energy figures, monthly data (left), 11-month cumulative data (right)



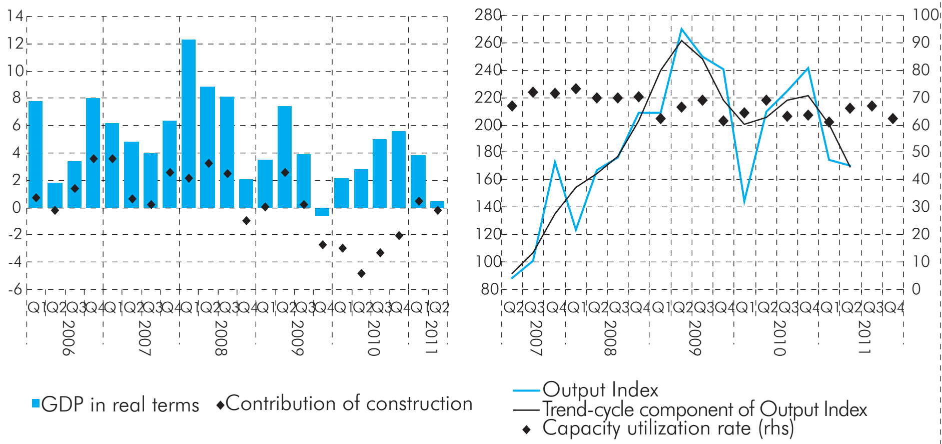
Source: Albanian Electro-Energy Corporation and experts' estimates

The total balance of electrical energy exchange for the period under review was negative at about 2632.3 GWh. In the corresponding period in 2010, the same balance was positive at about 740.9 GWh.

The volatility of value added in the construction sector did not stabilize in 2011 Q2. After its contraction in 2010 and the moderate growth in 2011 Q1, the construction sector's generated value added in Q2 was 1.7% lower y-o-y and 7% lower q-o-q. The low demand[23] led to the contraction of the construction volume by 9.7%. Based on the value of construction permits approved[24], it results that its annual decrease in 2011 Q2 is mainly a consequence of the contraction in construction for residential purposes. The trend-cycle component in the construction output index maintained the decrease recorded since 2010 Q4, thus not being reflected in the capacity utilization rate.

[23] *Deflated turnover index for this sector decelerated by 2%.*
[24] *Source: Quarterly Statistical Bulletin, INSTAT.*

Chart 18 Construction sector. Its contribution (in pp) to annual GDP growth (in %, left). Output index (year 2005 = 100), its trend and cyclical component and the capacity utilization rate (in %, right)



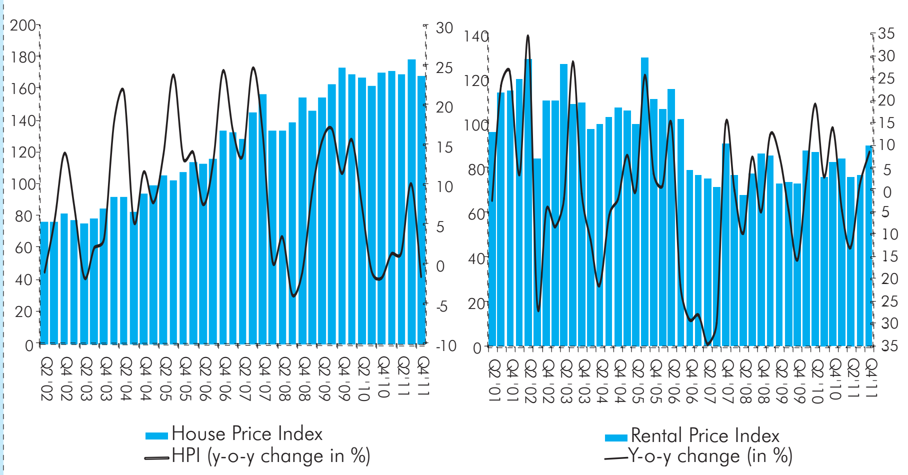
Source: INSTAT and Bank of Albania

*Box 1 Residential Market Prices in Tirana in 2011 Q4**

After the sharp annual increase in 2011 Q3, House Price Index dropped 1.4% in Q4, 11.6 percentage points lower than the increase in 2011 Q3. CPI-deflated, the real annual change was -3.8% in this quarter.

During 2011 Q4, Rental Price Index for Tirana increased sharply by about 8.8% in nominal annual terms. This increase confirms the ascending trend that had begun since the previous quarter. In real annual terms, the Rental Price Index rose 6.1%. Compared to the previous quarter, it rose about 17.3% in nominal terms and about 16.0% in real terms. The quarterly increase of this index partly owes to its seasonal behaviour in the fourth quarter.

Chart 19 House Price Index and Rental Price Index, and y-o-y changes, in %

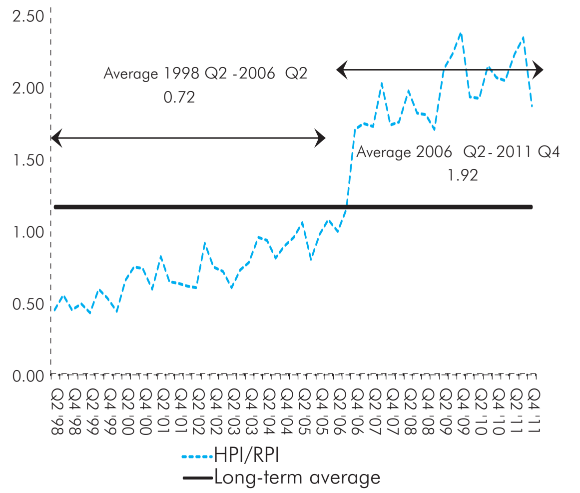


Source: Bank of Albania

The latest developments in the residential market show that their sale prices have started to fall compared to their rental prices. Price-to-rent ratio pointed to 1.86, down about 20% from the previous quarter and about 9.2% from the corresponding quarter in 2010. This ratio, albeit descending, remains above its historical trend.

**House and Rental Price Indices are constructed only for Tirana.*

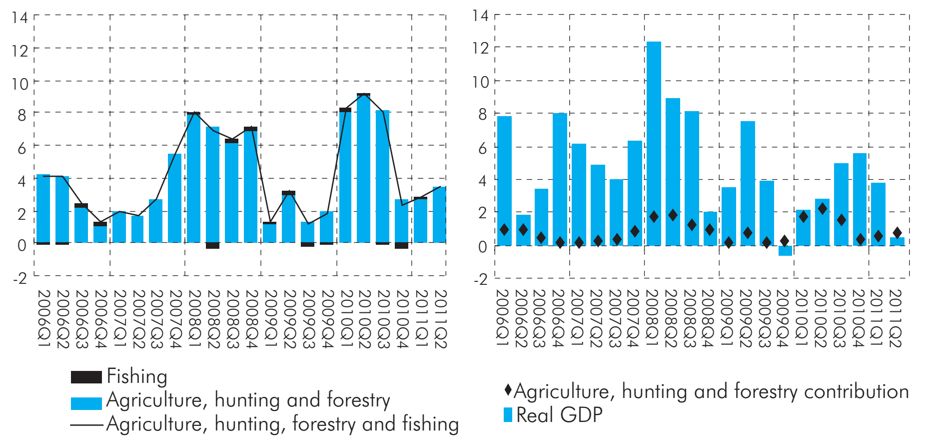
Chart 20 Price-to-rent ratio



Source: Bank of Albania

Construction Confidence Index improved slightly in 2011 Q3 compared to the previous quarter due to the more positive demand and orders in this sector. However, the contraction in the collection of VAT revenue in Q3 and the approval of a lower number of construction permits[25] in Q2 may suggest that the construction sector continued to perform sluggishly in 2011 H2. Surveys show similar results, with businesses being more pessimistic about the performance of construction in 2011 Q4.

Chart 21 Agriculture, hunting, forestry and fishing. Value added (y-o-y changes, in %) and contribution of sub-branches (in pp, left). Contribution of this sector (in pp) to annual GDP growth (in %, right)



Source: INSTAT and Bank of Albania

The activities of agriculture, hunting, forestry and fishing provided a positive contribution to value added in production during 2011 Q2, hence maintaining the ascending tendency shown since end-2010. More specifically, value added in these activities expanded by 3.4% y-o-y and 1.1% q-o-q,

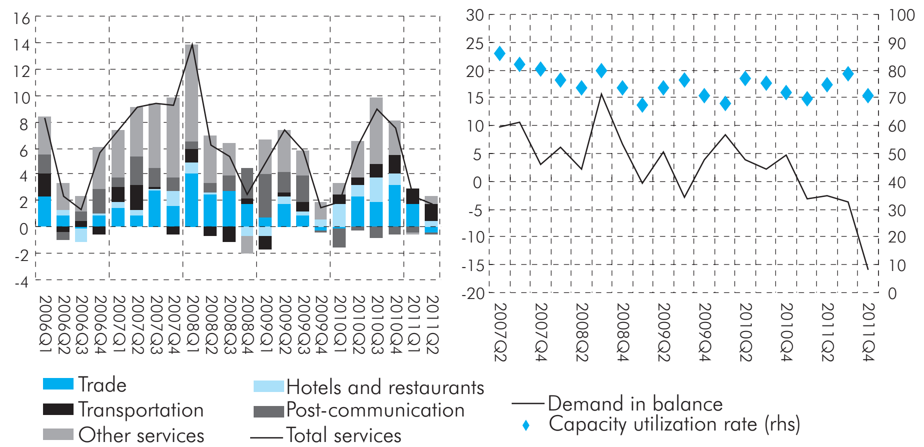
[25] *The number of approved construction permits generally precedes the developments in the construction sector.*

comparable to their respective long-term historical averages. Concerning the remainder of 2011, partial quantitative data[26] on Q3 signal the contraction of agro-industrial production by 7.8% y-o-y, while the latter's sales increased by a modest annual rate of 2% on real basis. The annual increase in investment, the number of economic units and employed persons in agro-industry is, however, expected to reflect in a positive impact on agricultural production in 2011 Q3 and Q4.

The value added of services sector decelerated its annual increase to 1.8% in 2011 Q2, about 4.2 percentage points below its historical average. This tendency was mainly a reflection of the sluggish domestic demand. On quarterly basis, value added of services pursued a positive trend, although the increase remains low at 1%. This sector, however, remains the main contributor to GDP growth.

The more sluggish dynamics of the services sector in 2011 Q2 attributes, to a large extent, to the developments in "Post and communication" and "Other services". The value added of post and communication services continued to fall, despite curbing the annual fall to 2.1%. This performance was affected by the annual decline in the turnover index by volume by 5% for the communication branch and by 6.5% for other quantitative communication indicators[27]. Concerning other services, their value added to GDP rose at a modest annual rate of 1.2%, owing mainly to some public sector services[28]. Value added of "Trade, hotels and restaurants" remained almost similar to the previous year due to the lower value added in retail trade[29]. Transportation continued to expand, providing the major contribution (about 0.7 percentage points) among the services activities to the annual real GDP growth.

Chart 22 Services sector. Value added (y-o-y changes, in %) and contribution of sub-branches (in pp, left). Demand (in net balance, pp) and capacity utilization rate (in %, right)



Source: INSTAT and Bank of Albania

[26] Source: Ministry of Agriculture, Food and Consumer Protection.
[27] It includes the annual performance of automatic phone calls and the updated number of users of communications services. Source: Quarterly Statistical Bulletin, INSTAT.
[28] It includes health services and other community services.
[29] The Turnover Volume Index in retail trade deepened the annual contraction to 7% in 2011 Q2.

Businesses operating in the services sector were more optimistic about the performance of their activity in 2011 Q3 than in Q4.

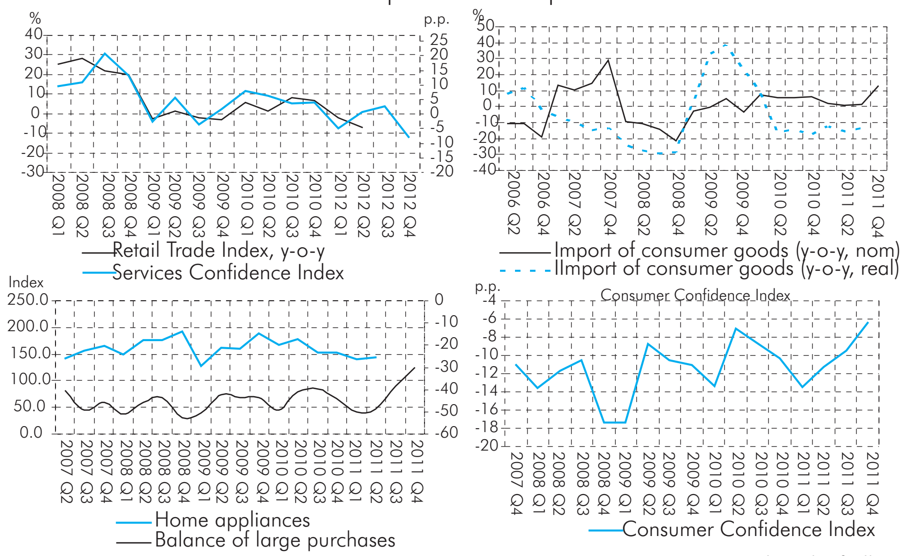
IV.1.2 AGGREGATE DEMAND COMPONENTS

The growth of aggregate demand was sluggish in 2011 Q2. Q-o-q, aggregate demand contracted by about 1.7%, thus subsiding the increasing trend of the last three quarters. The deceleration of the GDP growth was triggered by the lower contribution of net exports and the fall of domestic demand. Foreign demand stimulus is expected to fall during 2011 Q3 and Q4 and over the course of 2012. Against a background of a prudent fiscal policy, the recovery of consumption and private investment will be a determinant of the economic growth in 2012.

Private consumption is assessed to have performed poorly in 2011 Q2. Available data on private consumption suggest that its performance in the quarters ahead will be sluggish due to the restrained financial resources and the uncertainty about the financial situation and future economic outlook.

Retail Trade Index deepened its contraction in 2011 Q2, dropping by 6.8% y-o-y compared to the 2.1% drop in Q1. The low demand was mainly reflected in the fall of demand for durable consumer goods (-18% on average for 2011 H), whilst demand for foodstuffs was comparable to that in 2010 H1. Real consumer spending for the import of consumer goods has been also declining. Qualitative data on 2011 H2 obtained from confidence surveys reflect heightened uncertainty in the business and consumer decision-making, suggesting opposite directions. Consumer Confidence Index rose in 2011 Q4, although Services Confidence Index fell considerably. In line with the increase in consumer loans, the higher balance of large purchases in 2011 Q3 and Q4 in the Consumer Confidence Survey suggests higher consumption at the end of the year. Despite the optimistic consumers' assessments of large

Chart 23 Indirect private consumption indicators

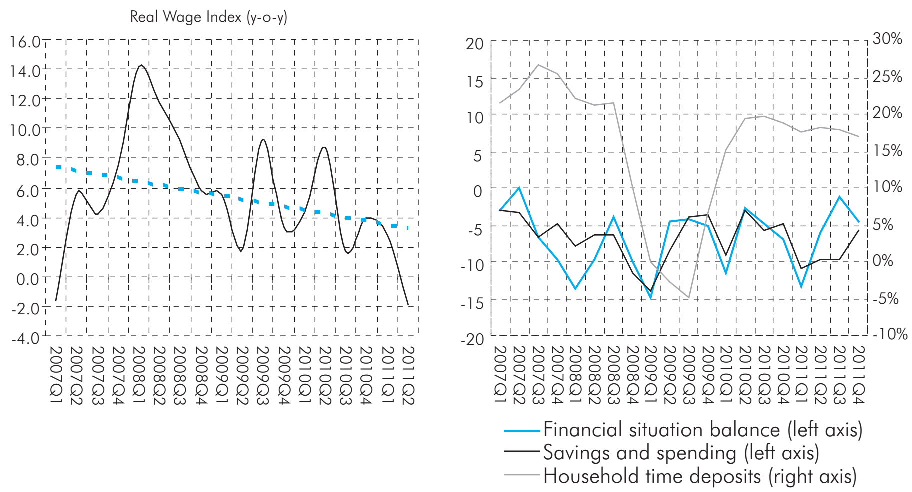


Source: INSTAT and Bank of Albania

purchases in Q3 and Q4, their financial situation, employment and economic developments are assessed negatively. In addition to their propensity to save, as stated in the Consumer Confidence Survey and reflected in the increase of time deposits and growth of T-bill portfolio, these assessments suggest that their consumer behaviour will continue to remain cautious.

Private consumption was mainly driven by domestic financial resources, whilst foreign ones in the form of remittances have been low. Real wage rose on average by about 0.6% y-o-y in 2011 H1. While in Q1 it recorded a positive annual growth rate of about 2.2%, in Q2 it dropped by about 1.8%. Private consumption was also supported by the growth of household loans, mainly in the form of consumer loans. On the other hand, remittance inflows, which fell on average by about 8.6% in the first nine months, made little contribution to private consumption. In addition, the worsened terms of trade made consumers pay more for the imported goods, thus lowering the available budget for the consumption of home-produced goods and services.

Chart 24 Financing of consumer demand

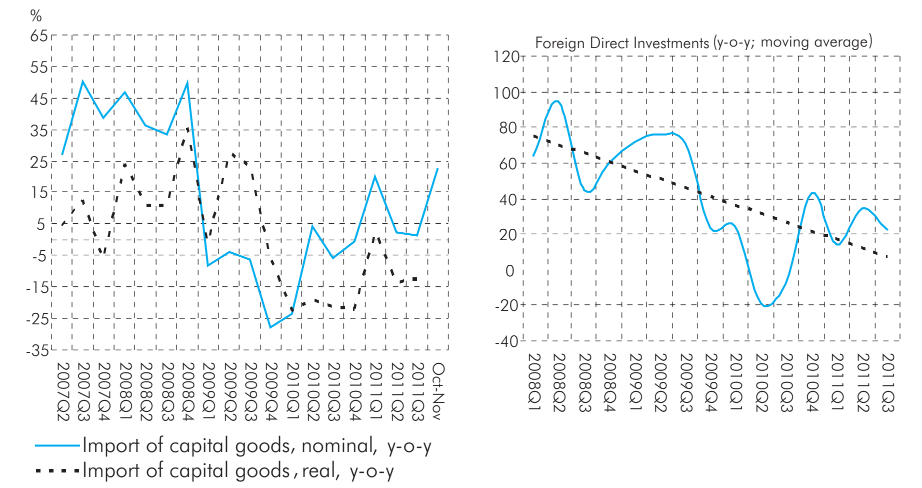


Source: INSTAT and Bank of Albania

Indirect indicators suggest that investment performed poorly too, as a reflection of the sluggish domestic and foreign demand, low business confidence and below historical average capacity utilization rate.

The recovery noted in 2011 Q1 diminished in the two quarters ahead. The import of capital goods decreased by about 13.3% and 12.6% in real terms, respectively, during this period. Public investment also declined, as reflected in the contraction of capital spending in 2011 Q2 and Q3. After increasing by 38.4% in Q2, net flows of foreign direct investments dropped by 29.3% in Q3.

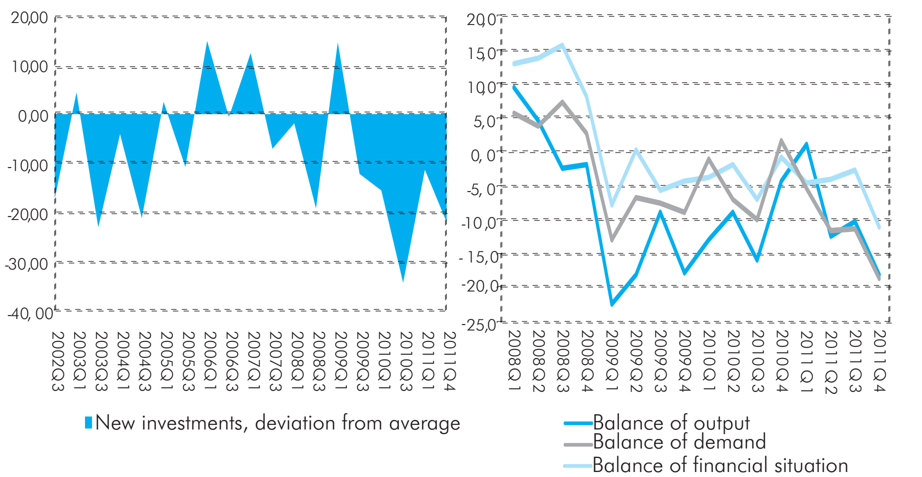
Chart 25 Indirect private investment indicators



Source: INSTAT and Bank of Albania

The decision to make new investments has been conditioned by the uncertainties about the future outlook in Albania and abroad, the low capacity utilization rate and the wavering business confidence. After increasing slightly in 2011 Q3, capacity utilization rate in the economy dropped by about 2.7 percentage points in Q4. The financial support to private investment in the form of loans has not been missing. Loans for investment purposes continued to expand in 2011 Q2 and Q3, though at lower rates than in the beginning of the year. Along the same line, loans for investment purposes decelerated their growth rates in October and November. According to banks' experts, lending standards applied to businesses[30] tightened in 2011 Q4 (see Box 3). On the other hand, as evidenced by the increase in capital spending in Q4, public investment contributed positively to the aggregate demand in this quarter.

Chart 26 Net balance of new investment (left); net balance of output, financial situation and demand (right)



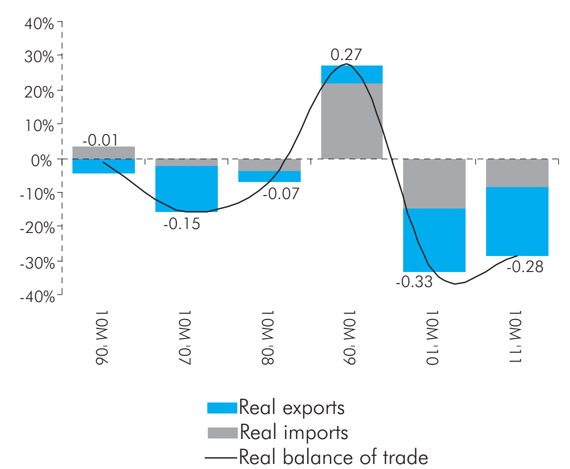
Source: Bank of Albania

[30] *According to Bank Lending Survey of 2011 Q3.*

IV.1.3 FOREIGN DEMAND AND EXTERNAL TRADE

The latest available data[31] on the key indicators of the external sector of the economy show that the net export deficit narrowed down in real[32] annual terms during 2011 Q3. The narrowing in the net export deficit was a result of the decline in the import of goods and services by about 4.2% in real terms, and of the increase in exports by about 8.6% y-o-y. The developments in the balance of import and export of real goods and services are assessed to have materialized in a positive contribution of this component to the growth of aggregate demand during this period.

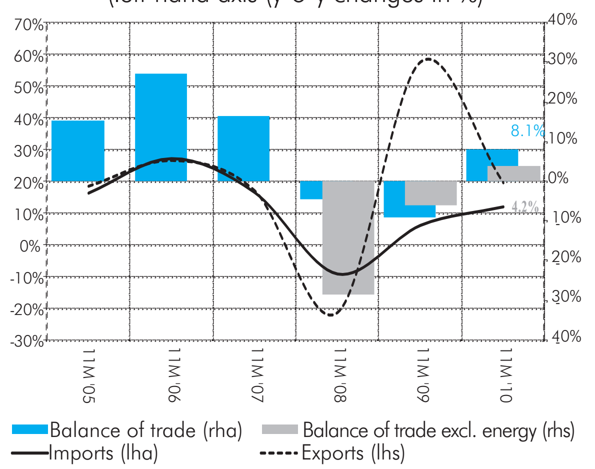
Chart 27 Balance of trade and key items in real terms



Source: General Directory of Customs, Bank of Albania and staff's estimates

During January-October 2011[33], the real balance of trade continued to narrow down for the second consecutive year. During the period under review, it narrowed down by about 28.8% compared to the corresponding period in 2010. The increase in real exports by about 28.7% during this period continued to provide the major contribution to the narrowing of the trade deficit. The decrease in real imports by about 5.0% affected in the same direction.

Chart 28 Trade deficit including and excluding electrical energy (right-hand axis), imports and exports (left-hand axis (y-o-y changes in %)



Source: External Trade Statistics, Bank of Albania

MERCHANDISE TRADE

Data on the performance of Albania's external trade balance in goods during January-November 2011 provide evidence for a shift in its trend recorded over the same period in the previous two years. After narrowing down in 2009 and 2010, merchandise trade deficit expanded by nearly 8.1% in annual nominal terms during the eleven-month period in 2011. The accelerated increase of exports over 2010[34] moderated significantly to about 19.9% y-o-y during the eleven-month period in 2011. On the other hand, the annual increase of the imports of goods accelerated to an average level of 12.2%, compared to about 6.4% in the corresponding period in 2010. Over the eleven-month period of 2011, trade flows in electrical energy continued to provide considerable effect on the widening of the trade deficit. Excluding this effect, the widening of the trade deficit for the period under review was only 4.2% compared to the previous year.

[31] The latest data on net exports cover 2011 Q3.

[32] In order to derive the value of imports and exports of goods in real terms from the nominal terms, we have used the unit value index obtained from the volume data of foreign trade. For the imports and exports of services, we have used the consumer price index of services measured by the Bank of Albania.

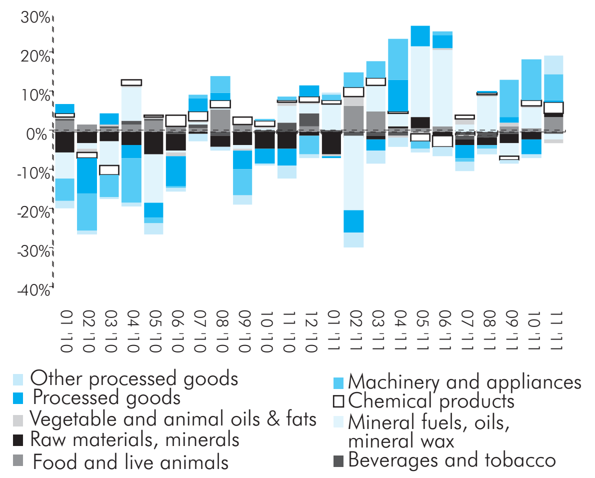
[33] The data on foreign trade volume are available as at October 2011.

[34] In 2010, exports increased by about 56.1% y-o-y. During January-November 2010, they increased by about 58.0% compared to the corresponding period in the previous year.

Trade exchanges increased by about 14.2% y-o-y over the eleven-month period of 2011. The ratio of imports coverage by exports for the period under review was 36.7% or about 2.4 percentage points higher than in the same period in 2010.

The monthly analysis of the external trade balance in goods shows the continued widening of the trade deficit for the fourth consecutive month. In November 2011, trade deficit widened by about 16.3% in annual nominal terms, compared to 11.6% in the previous month.

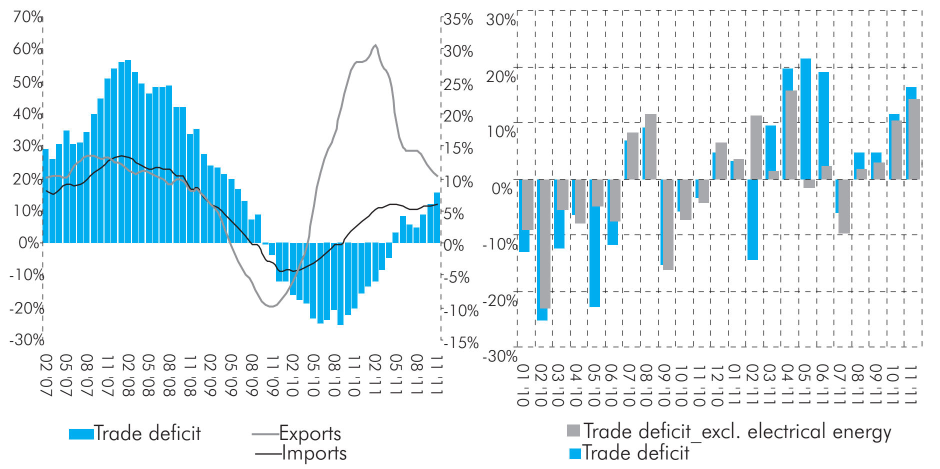
Chart 29 Contribution by item to trade deficit deepening/narrowing



Source: External Trade Statistics, Bank of Albania

Excluding the effect of trade flows in electrical energy, the trade balance expanded by about 14.2% y-o-y in November 2011. The subsiding growth rate of exports and the accelerating growth of imports led to further deepening of the trade deficit in goods over the period under review. Broken down by commodity items, "Machinery and appliances" continued to provide the major contribution to the widening of the trade deficit for the third consecutive month.

Chart 30 12-month moving sum of imports, exports and trade balance in y-o-y changes (left); trade balance in total and excluding electrical energy in y-o-y changes (right)

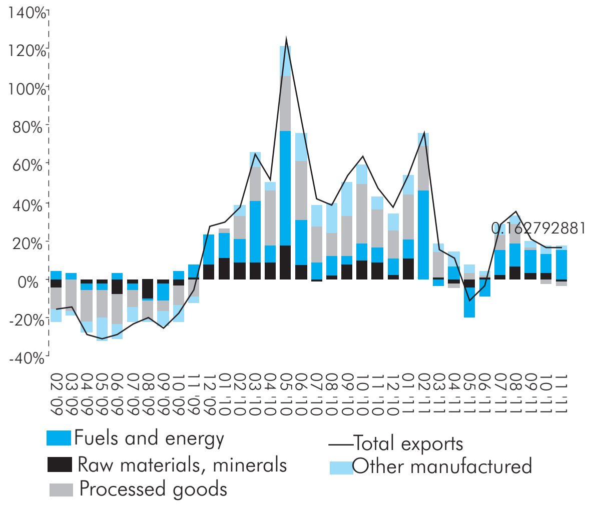


Source: External Trade Statistics, Bank of Albania

During November 2011, exports continued the previous months' upward trend, although at considerably lower rates compared to the previous ten months and 2010 average. The subsiding growth rate of exports owes, in part, to the high comparative base of the previous year[35]. In November 2011, total exports increased by about 16.3% y-o-y, which is similar to the previous month's growth rate. Exports of goods under "Fuels and energy" continued to provide the major contribution to the growth rate of exports in November,

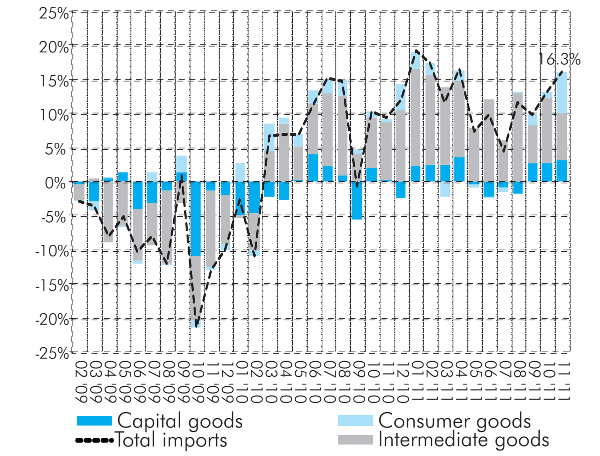
[35] *The average growth rate of exports in 2010 was about 56.1%.*

Chart 31 Contribution of four key items of Albanian exports to the annual growth of total exports



Source: External Trade Statistics, Bank of Albania

Chart 32 Annual changes in the import of goods and contribution to the annual growth rate of imports by final use in economy



Source: External Trade Statistics, Bank of Albania

by about 15.6 percentage points. Within this item, the export of crude oil[36] continues to make substantial contribution. It contributed by about EUR 26.0 million to Albania's total exports.

The export item having the largest share in total exports, "Other manufactured goods", which mainly includes re-exported textiles, maintained an upward trend in November, although at lower rates than in the previous year. This item's exports expanded by about 5.5% y-o-y, contributing by about 1.9 percentage points to total export growth. After a period of constant growth, exports of goods under "Raw materials and minerals" decreased by about 13.0% y-o-y. As in the previous month, the contribution of "Processed goods"[37] to total export growth[38] fell markedly in November. This item's exports declined by about 7.1% y-o-y in November.

In November 2011, imports' value maintained the stable upward trend shown for almost a year. Total imports increased by about 16.3% y-o-y. For the third consecutive month, imports of goods under "Machinery and appliances" provided the major contribution to the increase in total imports, by about 5.0 percentage points. Within this item, imports of goods under the sub-item of "Vehicles other than wagon" recorded sharp growth. The abolishment of customs duties on used vehicles is assessed to have provided substantial impact on this item's imports[39].

Broken down by their final use in economy, we note that the import of products under "Capital goods", "Consumer goods" and "Intermediate goods"[40] increased in November 2011. The import of intermediate goods, which has the largest share in total imports, recorded an annual growth rate of 11.6%. The import of capital goods continued to

[36] The export of crude oil accounts for about 73.9% of the export of goods under "Fuels and energy" for the eleven-month period of 2011.

[37] The main products exported in this item are the processed base metals of steel, cast-iron, iron and copper.

[38] In November 2011, this item's exports made a negative contribution of -1.9 percentage points to total exports, compared to the average monthly contribution by about 7.7 percentage points since early 2011.

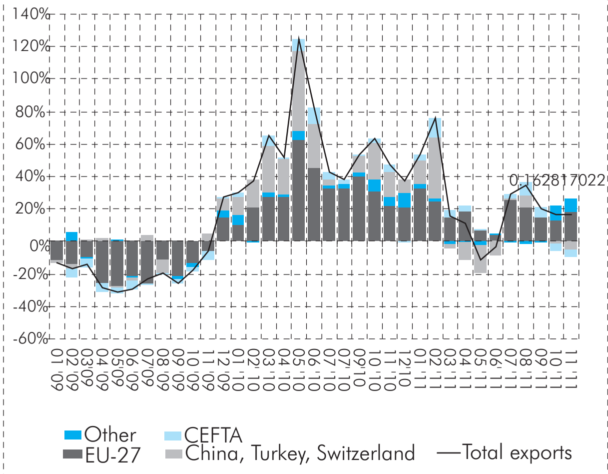
[39] In November 2011, the import of passenger vehicles in terms of value was about 2.7 times higher than in the corresponding period in 2010. The same tendency was also noted in the previous two months.

[40] This category includes processed and unprocessed foods and beverages for industry, processed and unprocessed industrial products, mineral fuels, oils, processed and unprocessed mineral waxes, capital goods, spare parts and accessories thereof.

increase for the third consecutive month. In November, this item's imports increased by about 25.0% y-o-y. Over the same month, the import of consumer goods rose by about 22.9% y-o-y.

Albania's trade activity, measured by the flow of trade exchanges with the trading partners, expanded by 16.3% y-o-y. By country of origin and destination, trade exchanges continue to remain concentrated with the EU countries, accounting for about 67.3% of Albania's total trade activity. Imports from EU countries[41] increased by 16.4% y-o-y, while exports to EU countries increased by 19.1% y-o-y. Following the continuous increase of trade exchanges with CEFTA member states[42] since March 2011, trade flows with these countries fell sharply by about 28.2% in November 2011. This is the second month in a row that Albania's trade exchanges with these countries declined y-o-y. On the other hand, trade exchanges with other trading partners like China, Turkey, Russia etc. continue to increase. Imports from these countries rose by about 24.6% y-o-y, while exports fell by about 33.9%.

Chart 33 Contribution to annual export growth



Source: External Trade Statistics, Bank of Albania

41 *In November 2011, imports from Italy and Germany continued to increase, whilst imports from Greece continued to decrease y-o-y. Cumulative imports from Greece over the eleven-month period in 2011 decreased on average by about 9.2% compared to the corresponding period in the previous year. Over the period under review, exports to Italy, Greece and Spain continued to record positive growth rates.*

42 *Bosnia and Herzegovina, Croatia, Macedonia, Moldavia, Montenegro, Serbia and Kosovo. Not included the countries joining the EU in 2007. Source: www.ceftatradeportal.com*

*Box 2 Balance of Payments Main Highlights**

*In 2011 Q3, the overall balance of payments registered an increase in foreign assets by about EUR 56.4 million. The current account deficit widened to EUR 272.4 million during this quarter, about 13.1% higher than in the same period in 2010. For the same quarter, it accounted for 11.4% of nominal GDP** or about 1.2 percentage points higher than in 2010 Q3.*

The analysis of the current account by its main items identifies the widening of the net export deficit as the key factor to have triggered the deterioration of this account position. The narrowing of the merchandise trade deficit by about 0.5% y-o-y could not offset the negative effect of the deterioration of the services account balance, thus resulting in the widening of the net export deficit by about 13.8% in annual nominal terms. Services account surplus narrowed down by about 33.5% compared to the corresponding quarter in 2010, contributing by about 25.1 percentage points to the deepening of the current account deficit. The narrowing services account surplus in annual terms was mainly a result of the higher residents' spending on personal travel for tourism and business purposes abroad. In the meantime, foreign inflows from personal travel services of non-residents into Albania dropped by about 12.0% over the period under review. The developments in this sub-item of the services account are assessed to have been impacted by the removal of the visa regime for Albania with the Schengen countries. The net balance of the income account recorded a surplus of EUR 17.6 million in 2011 Q3, mainly due to the lower foreign direct investment outflows. After nearly two years of continuous net deficit in the income account, its balance was positive in the nine-month period of 2011. The surplus in the current transfer account continued to narrow down in 2011 Q3, hence maintaining the trend that had started since 2010 Q4. In 2011 Q3, this account surplus narrowed down by about 4.2% y-o-y. The main sub-item in this account, remittance transfers, maintained the annual downward trend for the fourth quarter in succession. In the current quarter, remittance inflows declined by about 2.0% y-o-y.

Capital and financial flows, net, registered a positive balance of EUR 218.5 million in 2011 Q3 or 15.8% higher than in the corresponding period in 2010. As a percentage of nominal GDP, capital and financial flows, net, are estimated at 9.2%, up 1.2 percentage points y-o-y. In 2011 Q3, the surplus in the capital and financial account managed to finance about 80.2% of the current account deficit in this period. Net foreign direct investments (inflows – outflows) totalled EUR 166.4 million or 32.8% lower than in the corresponding period in 2010. In the nine-month period of 2011, cumulative net FDI flows were about 25.6% lower than in the same period in 2010. As at the end of 2011 Q3, net portfolio investments of residents in foreign economies increased by EUR 54.2 million. Other net investments contributed by about EUR 99.8 million to the increase in residents' liabilities to non-residents, mainly due to the higher private and public borrowing.

Table 5 Balance of Payments items

	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3
Current Account (in EUR million)	-245.2	-373.6	-229.6	-324.4	-272.4
Current Account (% of GDP)	-10.20%	-16.70%	-10.90%	-13.50%	-11.40%
Merchandise	-595.9	-584.9	-408.5	-581.4	-593.1
Exports, f.o.b.	270.3	305.9	370.6	330.8	344.1
Imports, f.o.b.	-866.2	-890.7	-779.1	-912.2	-937.2
Balance of Services	180	5.2	-32.2	-11	119.7
Credit	661	412.5	304.4	367.8	615.8
Debit	-481	-407.2	-336.6	-378.8	-496.2
Travel Services - net	171.3	17.3	-43.5	-19.9	82.9
Balance of Income	-19.9	-31.6	14.7	22.2	17.6
Credit	70.8	73.1	60	69.5	74.3
Debit	-90.7	-104.7	-45.3	-47.3	-56.6
FDI Income - net	-73.8	-73.7	-15	-9.5	-20.8
Current Transfers	190.6	237.7	196.4	245.9	183.4
Credit	233	280.1	238	287.6	225.9
Debit	-42.4	-42.4	-41.6	-41.7	-42.5
Workers' Remittances - net	135.1	165.1	153.1	189.4	132.6
Capital and Financial Account (in EUR mil)	193.7	433.1	184.6	192.7	218.5
Capital and Financial Account (% of GDP)	8.00%	19.20%	8.70%	8.00%	9.20%
Capital Account	22.6	30.2	19.1	31.5	6.5
Financial Account	171.1	402.8	165.5	161.2	212
FDI - net	247.4	244.4	42.2	221.5	166.4
Portfolio Investment - net	-6.6	286.8	-21.8	-23.2	-54.2
Other Investment - net	-74.8	-134.9	145.2	-37.1	99.8
Errors and Omissions	111.7	66.2	-32.1	130.1	110.3
Reserve Assets	-60.2	-125.7	77.1	1.7	-56.4

Source: Balance of Payments, Bank of Albania

* *The latest data on the balance of payments refer to 2011 Q3.*

** *INSTAT's nominal GDP for 2003-2009. Monetary Policy Department's projections at the Bank of Albania for 2010 and 2011.*

IV.1.4 FISCAL INDICATORS AND FISCAL POLICY

Fiscal policy was stimulating during the eleven-month period of 2011. Its approach was, however, not uniform across the quarters. The pace of fiscal expansion mitigated after 2011 Q1 due to a more cautious fiscal policy, expressed in lower growth rates of budget spending. In 2011 Q4, fiscal expansion is expected to accelerate, driven by the increase in current and capital spending[43]. In addition to the low comparative basis effect[44], the trend in spending has been also determined by its seasonal behaviour, which is reflected in a greater expected concentration in the last quarter of the year. Along the same line as the fiscal policy behaviour, public sector's contribution

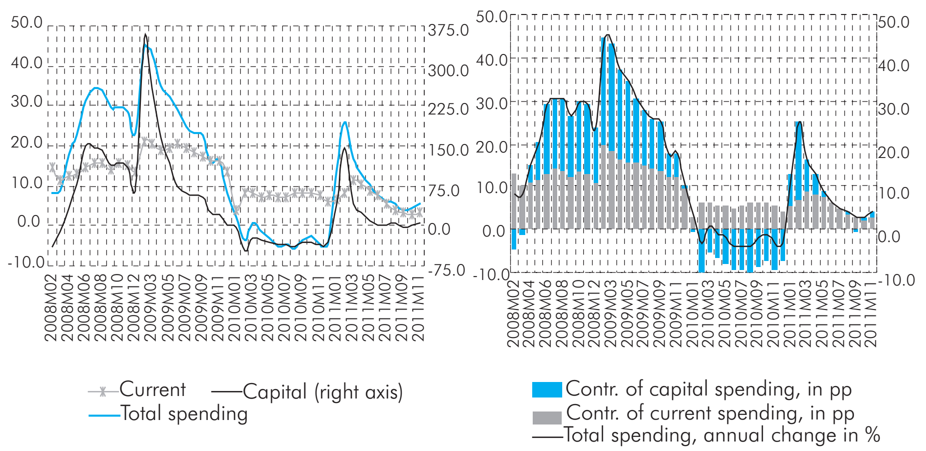
[43] *Total spending in the last two months (October and November) increased by 12% y-o-y, mainly due to the annual increase in capital spending. In the absence of data referring to the classification of spending by function for October and November, we approximate Government's final consumption through total spending on personnel, unemployment and different transfers.*

[44] *Budget spending contracted throughout 2010 in annual terms, hence setting a lower comparative base for 2011.*

to aggregate demand was high in 2011 Q1, to later reduce in the following two quarters and improve in 2011 Q4.

At the end of the eleven-month period, budget spending totalled ALL 333.5 billion, up 5.4% y-o-y. The increase in total spending was mainly driven by the increase in current expenditure. During October and November, however, capital expenditure also generated positive contribution to the increase in total budget spending.

Chart 34 Annual change in budget spending, current and capital, in % (left) and respective contribution of current and capital expenditure in pp (right)



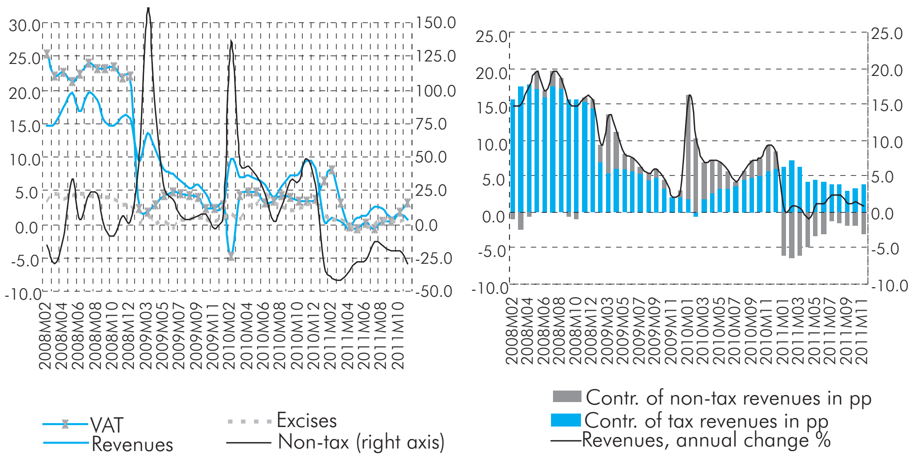
Source: Ministry of Finance and Bank of Albania staff's estimates

During January-November 2011, current expenditure, which are, to a large extent (about 73%), represented by personnel expenditure, social insurance expenditure and interest payments, increased by 3.1% y-o-y. Social insurance expenditure has recorded the highest and most stable increase over time. For the eleven-month period of 2011, this item's annual nominal growth rate was about 7.2%.

Over the same stated period, capital expenditure totalled ALL 58.3 billion, up 7% y-o-y. Their distribution across the quarters was not uniform, hence yielding high volatility in the annual growth rates. In 2011 Q2 and Q3, capital expenditure declined by 28% and 10%, respectively, y-o-y. Consequently, the growth rate of capital expenditure for the nine-month period was negative by about 2%. The last quarter, however, experienced a higher level of capital expenditure, which, in turn, is expected to reflect in a positive contribution of public investment to aggregate demand.

In the eleven-month period of 2011, budget revenues amounted to ALL 295.6 billion, up 0.7% y-o-y. The growth of budget revenues was slow during this fiscal year, reflecting the performance of economic activity and some effects arising from their classification approach. The poor consumption in Albania has reflected in sluggish growth rates of VAT revenues, which have the largest share (39%) in tax income (or 36% of total revenues). Non-tax revenues continue to provide a negative contribution to the annual growth rate of total revenues, which for the eleven-month period is estimated at about 3.1 percentage points. The trend of non-tax revenues, which over the course of 2011 provided a negative contribution to the growth in total revenues, is mainly a result of the classification of privatization receipts as component sub-items of non-tax revenues in 2010. Excluding privatization receipts from total revenues, budget revenues for the eleven-month period of 2011 result about 3.7% higher than in the previous year.

Chart 35 Annual change in total revenues and key items, in % (left) and contribution of key items to revenue growth, in pp (right)



Source: Ministry of Finance and Bank of Albania staff's estimates

Tax revenues (which include tax and customs revenues, social insurance revenues and local government revenues) amounted to ALL 272.4 billion in the eleven-month period of 2011. In nominal terms, this level is about 4.2% higher than in the corresponding period in 2010. VAT revenues provided the highest contribution to the growth in tax revenues (1.3 percentage points), followed by social insurance revenues (0.9 percentage points) and profit tax revenues (0.8 percentage points).

VAT revenues have grown at slow rates during this fiscal year, as a reflection of the sluggish consumption in Albania. During October and November, however, VAT revenues increased at faster rates, yielding an annual growth rate of 3.3% for the eleven-month period. Revenues from VAT on the imported goods increased by 8.7% for the same stated period, contributing positively to total VAT collected by about 6.4 percentage points. On the other hand, revenues from VAT collected on economic activity in Albania continue to record negative growth rates[45], suggesting a less favourable situation for individual sectors of the economy[46]. During the eleven-month period, excise revenues increased by 3.4% y-o-y. Similar to VAT revenues, they recorded sluggish annual growth over the course of 2011. Excise revenues levied on imported

45 *The revenues collected from the tax administration recorded negative annual growth rates in 2010. The same trend continued in 2011 as well.*

46 *According to Ministry of Finance's data, the construction and services sectors recorded negative growth rates of the VAT collected by the state budget, by 34% and 20%, respectively. The lower VAT from the services sector owes, among other things, to the lower interconnection and mobile phone tariffs.*

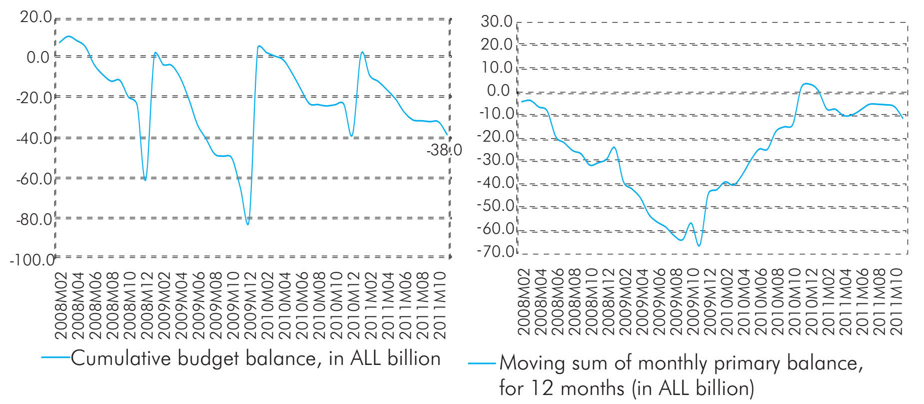
goods recorded negative growth rates throughout 2011, due to a lower total volume of imported goods subject to excise. Broken down by items, only the import of fuels and coffee registered an annual increase, which, however, pursued a descending trajectory after the first quarter of 2011.

Profit tax registered stable growth over this fiscal year. For the eleven-month period, it is estimated as being 13.3% higher than in the same corresponding period in 2010. This growth rate, however, appears more moderate (6.1%) if we exclude the profit tax of the Albanian Electro-Energy Corporation in May this year.

Budget deficit amounted to about ALL 38 billion for the eleven-month period, deepening by 65% y-o-y. It, however, has remained within the budget projection for 2011. The deficit created from the social contributions scheme exceeded the total budget deficit by about 34%. The current surplus, which is proxied by the difference between current revenues[47] and current expenditure, was estimated at ALL 18.1 billion, up 15.7% from the corresponding period in 2010.

The developments in revenue and expenditure items were also reflected in a primary deficit. The widening of the primary deficit is expected to translate into higher public debt for the remainder of the year unless it is balanced by a positive effect caused by the difference between economic growth and the interest rate on public debt.

Chart 36 Budget balance (left) and moving sum of the primary balance* in billions of ALL



*The primary balance represents the budget balance excluding interest payments, and it serves to precede the future dynamics in public debt. The moving sum of the primary balance is calculated as the sum of monthly primary balances for a 12-month period.

Source: Ministry of Finance and Bank of Albania staff's estimates

[47] *The classification of current revenues is based on the Government Finance Statistics Manual, 1986, page 116. This standard is currently applied for fiscal data reporting. Current revenues represent the difference between total revenues and grants and capital revenues.*

The structure of budget deficit financing was almost uniform across the first eleven months of 2011. More specifically, domestic borrowing through the issue of securities has the largest share in deficit financing (about 81%). Concerning the composition of domestic borrowing, long-term securities (consisting of bonds of all maturities) account for 63% of new issues over this fiscal year. On the other hand, foreign borrowing accounts for about 42% of total budget deficit financing over this period[48].

Table 6 Key fiscal indicators

	11 M 2011	Annual change		
	ALL billion	11M 2009	11M 2010	11M 2011
Total Revenues	295.6	2.2	9.4	0.7
Tax and Customs	210.1	1.5	6.2	4.3
VAT	106.6	2.3	3.4	3.3
Profit Tax	18.0	-5.7	0.8	13.3
Excises	36.0	1.8	14.1	3.4
Tax on Personal Income	24.8	12.4	0.0	2.4
Local Government	10.8	7.4	-4.4	1.4
Social Insurance (Contributions)	51.5	4.6	9.1	4.7
Non-Tax Revenues	20.7	-3.5	48.9	-29.6
Grants	2.5	68.8	10.3	-10.9
Total Expenditure	333.5	16.4	-4.9	5.4
Current Expenditure	275.0	16.4	7.7	3.1
Personnel	60.8	-3.6	5.2	3.3
Interest Payments	37.3	13.1	14.9	0.5
Social Insurance Expenditure	102.4	27.4	10.1	7.2
Local Government Expenditure	25.1	31.1	-9.7	-5.0
Capital Expenditure	58.3	22.8	-35.8	7.0
Budget Deficit	38.0	175.2	-64.2	64.8

Source: Ministry of Finance

IV.2 LABOUR MARKET, WAGES AND COSTS

Unemployment rate dropped in 2011 H1. It, however, remains high in historical terms, conditioning in turn the dynamics of the nominal wage rise in the economy. The sluggish rise in wages has alleviated the inflationary pressures in terms of unit labour cost. Businesses expect weaker employment increase in 2011 H2.

LABOUR MARKET

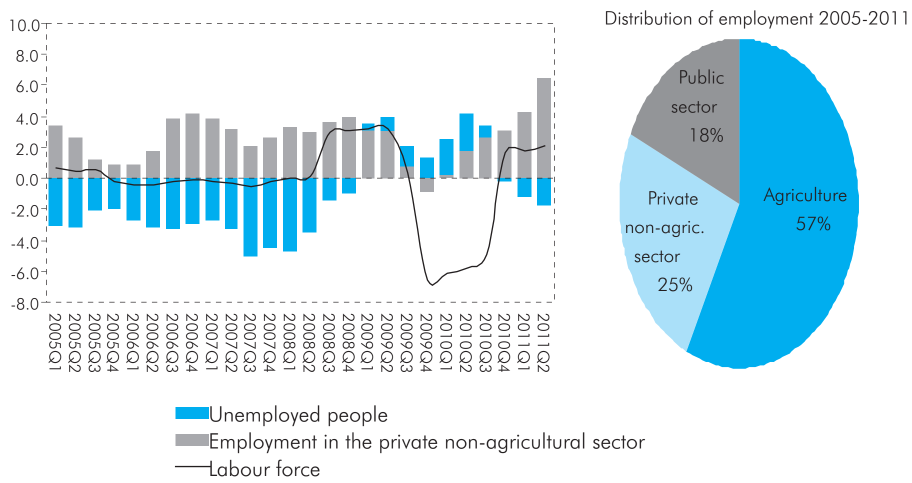
After marking a turning point upward in the last quarters of 2010, the employment rate[49] rose by about 2.2% and 2.7% y-o-y in 2011 Q1 and Q2, respectively. The increase in employment has been mainly driven by the private non-agricultural sector demand, while public sector demand has been decreasing. Employment in the private non-agricultural sector rose by 5.4% on average, while in the public sector it fell by 0.7% y-o-y in 2011 H1. The number of employed people in the agricultural sector, which attracts the

[48] *The Government's liquidity situation also appears as an item in the budget deficit financing. It is recorded with a negative sign in the domestic financing of the deficit. For the eleven-month period, this item accounted for about 24% of the total budget deficit.*

[49] *The latest data on the labour market refer to developments as at 2011 Q2.*

largest portion of labour supply, increased by about 2.1% in 2011 H1. This increase reflects, to a large extent, the comparison base effect to the previous year[50].

Chart 37 Labour force (in annual %, left) and average share of the number of employed people by sector (in %)



Source: INSTAT

In the absence of quantitative data, the assessment of the labour demand performance will be based on the business confidence survey results for 2011 Q3 and Q4. Concerning 2011 H2, businesses' willingness to hire provides evidence for a weaker increase of employment during this period. Businesses' reluctance to hire may reflect the sluggish output and the heightened uncertainties about the future outlook of demand. This behaviour is mainly observed in the construction and services sector.

Table 7 Assessment of employment from the confidence surveys, in net balances (in pp)

		2010		2011		
	Average since 2002	H1	H2	H1	Q3	Q4
Economy	-1	-1	-3	-5	-5	-7
-Industry	-5	-8	-4	-5	-9	-2
-Construction	-7	-14	-13	-18	-15	-18
-Services	3	7	2	2	1	-4

Source: Bank of Albania, Business Confidence Survey

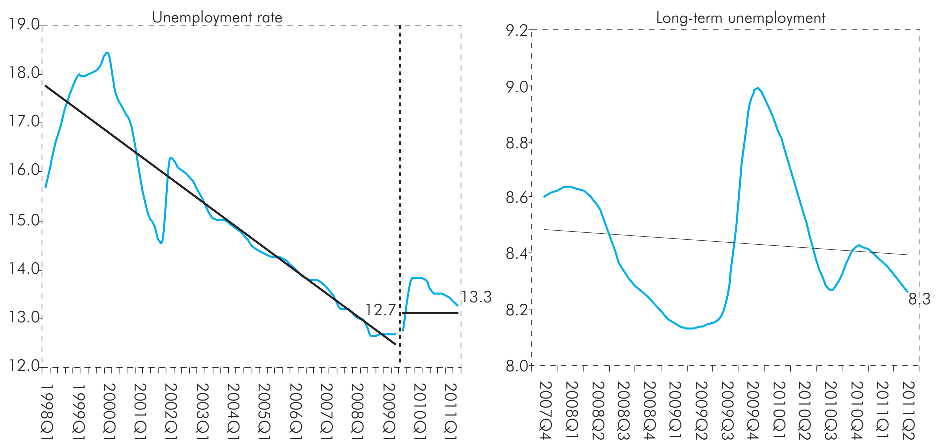
The unemployment rate, which serves as an indicator of the demand/supply ratio in the labour market and of the pressures over the raise in wages, dropped slightly in 2011 H1. The increase in employment, coupled with decrease in the number of unemployed people, led to the fall of the unemployment rate[51],

[50] *The average number of employed people in the private agriculture sector from 2008 Q3 to 2009 Q3 has been measured according to the 2007 Labour Force Survey; from 2009 Q4 to 2010 Q2 according to the 2008 Labour Force Survey; and from 2010 Q3 according to the 2009 Labour Force Survey.*

[51] *Unemployment rate is calculated as the ratio of the number of unemployed people to the labour force. An increase in the labour force, combined with the decrease in the number of unemployed people, is reflected in the decrease of the unemployment rate. On the other hand, the labour force is calculated as the sum of the number of employed people and the number of unemployed people. If the increase in employment is higher than the fall of unemployment, the labour force increases and, consequently, the unemployment rate falls.*

which stood at 13.26% in 2011 Q2. The lower unemployment rate, however, does not prove to be sufficient to bring it back to its historical downward trend.

Chart 38 Unemployment rate (%, left) and long-term unemployment (%, right)

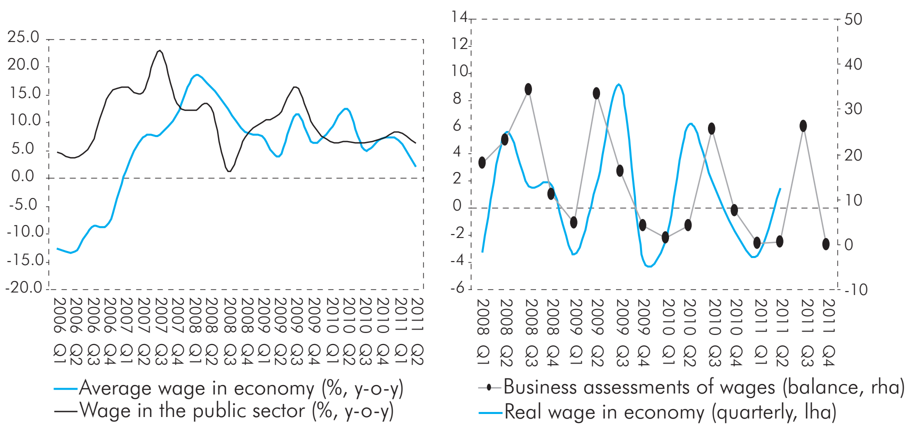


Source: INSTAT

WAGES AND LABOUR COSTS

The confrontation between supply and demand in the labour market yielded a more sluggish raise in wages in 2011 Q2. Based on the quantitative data of short-term statistics, average wage[52] in manufacturing and services rose by 2.2% in annual nominal terms over the same quarter. It rose at an annual rate lower than the second quarter's annual inflation, which is translated into a descending real average wage (-1.8%). Average wage in the public sector registered higher growth rates compared to the average wage in the economy. More specifically, in 2011 Q2, average wage in the public sector rose by 6.3% in nominal terms and by 2.1% in real terms.

Chart 39 Annual change of average wage by sector (left), quarterly wage and its assessment in the economy (right)



Source: INSTAT and Bank of Albania

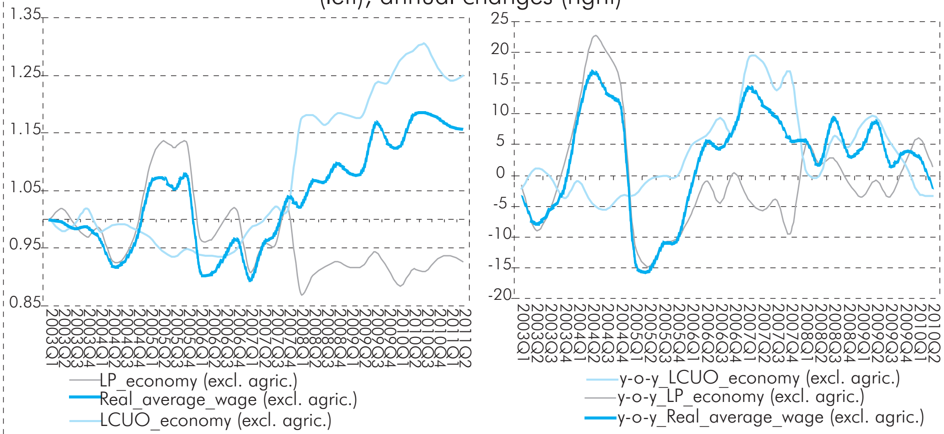
[52] *Measured as the ratio of the wage fund index to the employed people index, excluding agriculture. Source: INSTAT, Short-Term Statistics.*

The raise in minimum wage (to ALL 20,000) in 2011 Q3 is likely to reflect in the raise of the average wage in the economy[53]. This signal is also confirmed by the business confidence survey results, which show the raise of wages in all the sectors of the economy in 2011 Q3 and Q4.

The positive dynamics of Labour Productivity (LP) in the non-agricultural economic activity decelerated in 2011 Q2, hence registering a low annual growth (1.5%)[54]. This development reflected mostly the apparent deceleration of economic activity in Albania during this quarter, expressed in a low historical value added for the business activity (excluding agriculture). The performance of the LP suggests that non-agriculture-related businesses could not maintain the increasing tendency of the labour force utilization efficiency indicator, despite their efforts to adjust to the economic situation in the last two years.

Over the same quarter, the Labour Cost per Unit of Output (LCUO) continued to record a negative annual rate (-3.4%) as in the first quarter of the year. This performance was affected by the modest growth rates in labour productivity, while the real average wage has been falling.

Chart 40 Labour productivity, labour cost per unit of output and real average wage (left); annual changes (right)*



* The measurements refer to the LP and the LCUO of the economy, excluding agriculture. The calculations use data obtained from the value added (seasonally adjusted - INSTAT, GDP, 2011 Q2) and short-term statistics on employment and wages (INSTAT, Short-Term Statistics, 2011 Q2). These indicators do not include agriculture, therefore value added is considered excluding agriculture. Real average wage index is obtained after deflating it to the seasonally adjusted CPI. For comparison purposes, the indicators are rebased on the value of each indicator in 2003 Q1

Source: Bank of Albania's estimates

The above analysis shows that non-agriculture-related businesses have pursued a more cautious approach to wages and labour costs against a background of decelerated economic activity.

Hence, it is assessed that the current labour market conditions give rise to a moderate raise in wages and the labour costs, thus generating no added inflationary pressures from the labour costs and preventing the risk of wage-inflation spiral in the future in the economy. The developments in

[53] *According to the survey results, businesses state that the change in the minimum wage is usually reflected in their wage setting policies.*

[54] *In the previous two quarters, the LP recorded an annual change of 1.7% and 6%, respectively.*

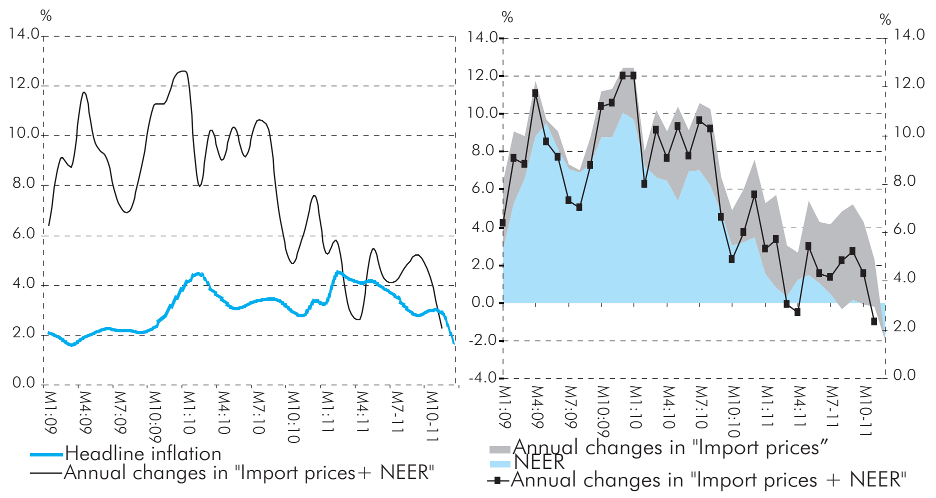
inflation, inflationary expectations and indirect demand indicators over 2011 H2 provide evidence about the assessment of inflationary pressures from the labour costs in the economy.

IV.3 IMPORTED INFLATION

The inflationary pressures on the level of prices in Albania, which arise from the fluctuations in the prices of our main international trading partners, have been assessed as declining during July-November 2011.

The aggregate Import Price Index and the NEER[55] expanded on average by 4.1% y-o-y during July-November, while in 2011 H1, it increased by 4.4%. The relatively stable exchange rate during 2011 has contributed to maintaining a moderate transmission of the increase in import prices into the Albanian market. Based on the NEER, the Albanian Lek appreciated by about 0.3% y-o-y in 2011 H2, while in H1 it depreciated by 1.1%.

Chart 41 Annual inflation rate, annual changes of "Import Prices + NEER" index (left) and contribution of import prices and the exchange rate to imported inflation (right)



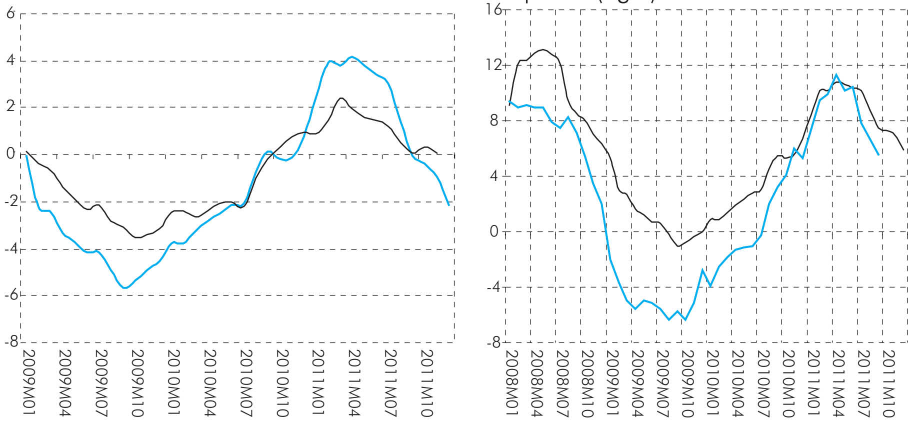
Source: Bank of Albania, INSTAT, IMF, OECD, EuroStat

The inflationary pressures deriving from the external economic environment, disaggregated for different CPI basket items, were assessed as declining for "Processed foods" during July-November 2011. This performance is confirmed by the similar annual trends of the indices, which show the volatility of import prices, such as: unit value index for exports of processed foods from EU countries to Western Balkan countries, and the food import price index. The latter[56] increased by an average of 6.3% y-o-y over this five-month period, compared to 7.2% in 2011 H1.

[55] *This index is measured as the weighted average of the CPIs of 21 countries, using their import shares based on foreign trade data, adding the NEER index value for the relevant month.*

[56] *This index is measured by weighing the food import price indices of 19 countries according to the share they have in Albania's food import. The shares have been updated for 2010, while the data on the food import for 2011 according to the country of origin are not available yet.*

Chart 42 Cycle-long-term trend of annual inflation of "Processed foods", annual inflation in food import prices (left); import price index versus the annual change in unit value index of EU exports* (right)



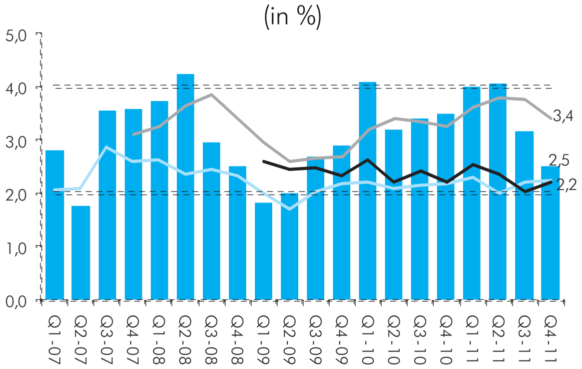
*This index is released on a monthly basis by Eurostat, and it includes Albania, Bosnia and Herzegovina, Serbia, Kosovo, and Former Yugoslav Republic of Macedonia. Source: Bank of Albania, INSTAT, IMF, OECD, EuroStat

The unit value index of the exports of processed foods from EU countries to Western Balkan countries expanded on average by 6.7% y-o-y in 2011 Q3, compared to 9.8% in 2011 H1. Worth noting is that over the recent months, both indices recorded lower growth rates in annual terms, reflecting this trend in the cycle of "Processed foods" as well.

IV.4 INFLATION EXPECTATIONS

Based on the latest results of surveys conducted with financial agents, businesses and consumers, expectations for the annual inflation rate continue to remain within the 2%-4% band, thus contributing to containing the inflationary pressures in the economy. The increase in the actual inflation rates in 2011 H1 reflected in higher financial agents' expectations for inflation in the future, but it did not prove to be stable. The latest data show that in 2011 Q4, financial agents' expectations were lower than in Q3. Their one-year-ahead inflation expectations fell by 0.4 percentage points, anchoring closer to the 3% target. The lower financial agents' inflation expectations, combined with the low and stable inflation expectations of private economic agents over the course of 2011, provide evidence for a lower risk of inflation shocks arising from the high inflation expectations.

Chart 43 One-year-ahead inflation expectations (in %)



Source: Business and Consumer Confidence Surveys, Financial Agents Survey

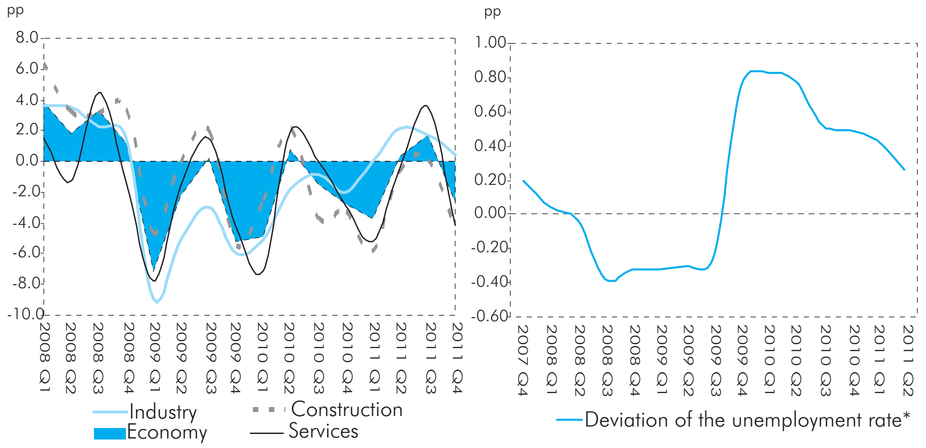
In 2011 Q4, financial agents expect the inflation rate after one year to be 3.4% on average. In the same quarter, businesses and consumers stated that they expect inflation after one year to be 2.2%.

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

The first half of 2011 was characterized by the economic growth and an improved employment figure. However, the performance of GDP in 2011 Q2 and the expectations for its performance in Q3 and Q4 suggest that the negative output gap may have deepened compared to the preliminary projection of Q1. Bank of Albania's assessments show that the Albanian economy continued to be characterized by non-utilized capacities over the remainder of 2011 and onward.

The below potential growth of the economy has reflected in weak pressures over the raise of wages and curbing second-round effects on inflation. In addition, the relative exchange rate stability, coupled with the receding inflationary pressures from the global markets, yielded a decelerating tendency of imported inflation. In light of these developments and the anchored economic agents' expectations, inflation pursued a descending trajectory in 2011 Q3 and Q4. Under these circumstances, the inflationary pressures deriving from the real economy are expected to remain receding over the period ahead.

Chart 44 Capacity utilization rate in economy (deviation from average, left-hand chart) and deviation of the unemployment rate (right-hand chart)



*Measured as the difference between the unemployment rate by quarters and the unemployment rate at the end of 2007. The selection of this rate as the average rate is based on the fact that during 2003-2007 the Albanian economy is assessed to have operated at its capacity, generating a real GDP growth of 6%.
Source: Bank of Albania, INSTAT

V. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

Monetary expansion in the economy showed signs of deceleration in the second half of 2011. This was mainly a result of the lower growth rates of banking system net foreign assets, while the contribution of the private sector credit and budget deficit financing were more stable. More specifically, the private sector credit growth continues to suffer from reduced demand for loans and relatively tight lending standards applied by banks. The Albanian banking system is well-capitalised and amply liquid. However, economic slowdown and non-performing loans increase have led to higher prudence by banks. The added prudence is materialised in tightened lending standards, especially on those that do not relate to the interest rate, such as collateral requirements, maturity term and credit size. It is also reflected in a more critical approach of the banking system to submitted business plans, especially from the construction sector, which has been a major receiver of credits over the past years.

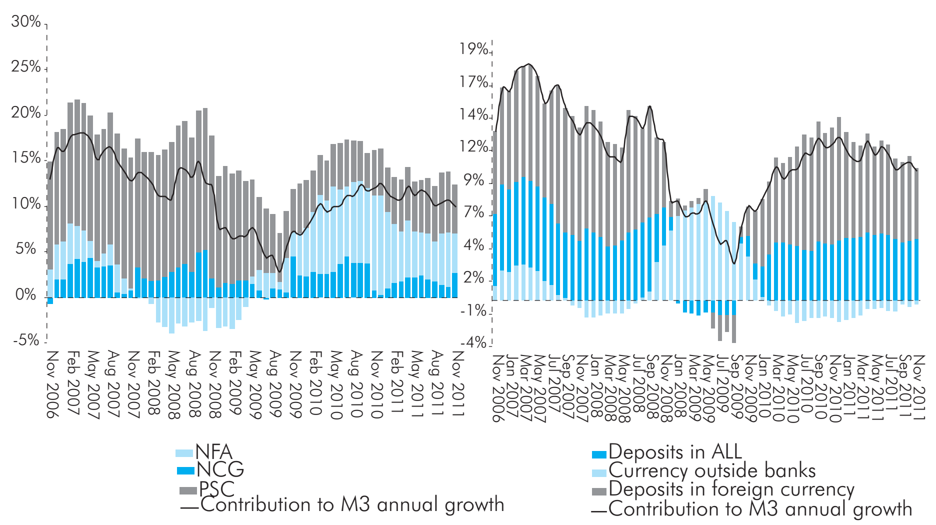
Financial markets have been overall calm and have enabled the transmission of monetary policy signals to the economy. Interest rates on ALL loans continued their downtrend, subsequently contributing to the ALL loan increase and shift of the loan portfolio structure from foreign currency to the national currency. The exchange rate has reflected an overall balanced performance of demand and supply for foreign currency.

Overall, monetary expansion in 2011 remains in line with the economy's real demand for monetary assets and is not assessed as a source of inflationary pressures on the economy. Moreover, liquidity indicators, exchange rate and inflation expectations signal contained inflationary pressures on the monetary sector.

V.1 MONETARY INDICATORS

The annual growth of broad money, the M3 aggregate, was 10.4% during July-November 2011, down 1 percentage point vis-à-vis the first half of the year. The M3 annual growth slowdown reflected the lower contribution, on average, of its foreign currency component, which was compensated, in part, by the higher contribution of the private sector credit. The contribution of the public sector's demand for borrowing was volatile on quarterly terms but remained within the forecasted range for 2011. On average, public sector contribution to money creation remained unchanged from H1. Despite the higher growth rates at year-start, private sector's demand for money does not represent stable improvement, hence, reflecting the sluggish performance of investments and consumption in the economy. On the liability side, monetary expansion was supported by the annual expansion of ALL deposits with rates similar to H1, while the lower seasonality of foreign currency deposit growth was reflected in the gradual slowdown of their growth rates.

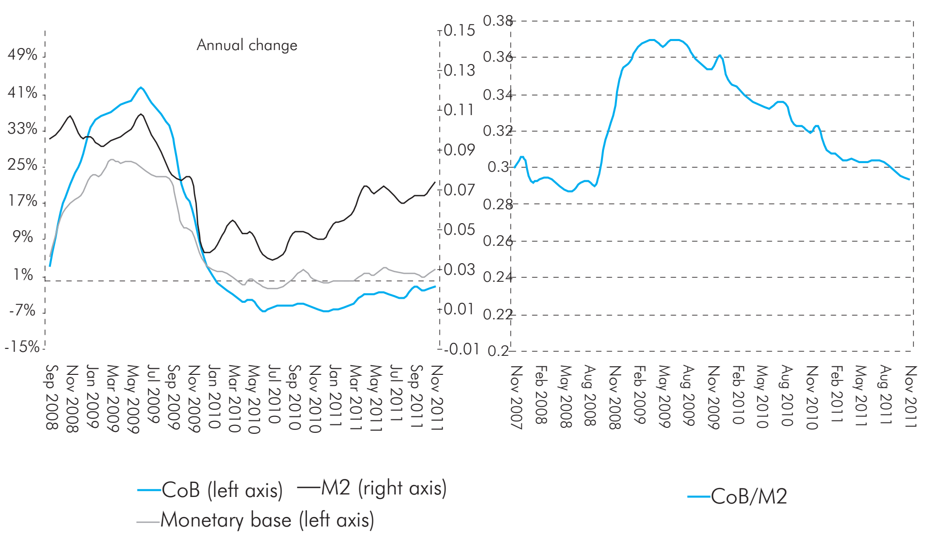
Chart 45 M3 aggregate and money demand and supply components



Source: Bank of Albania

The M2 aggregate in ALL grew 6.8% on average during July-November 2011, similar to H1 rates. M2 expansion was primarily sustained by money creation in ALL by the private sector, whereas the public sector showed low demand for monetary assets until October. The decreasing interest rates on ALL loans during 2011 appear to have supported the crediting of the economy in the national currency. On the other hand, M2's annual growth peaked at 7.4% in November, reflecting the public sector credit growth during the last two months of the year. The performance of economic activity, reduction of inflationary pressures on the economy and boosting of confidence in the banking system are reflected in the moderate demand for liquidity from the economic agents. Currency outside banks to M2 ratio was down to 29.4% in November, about 2.5 percentage points lower than in the corresponding period of 2010.

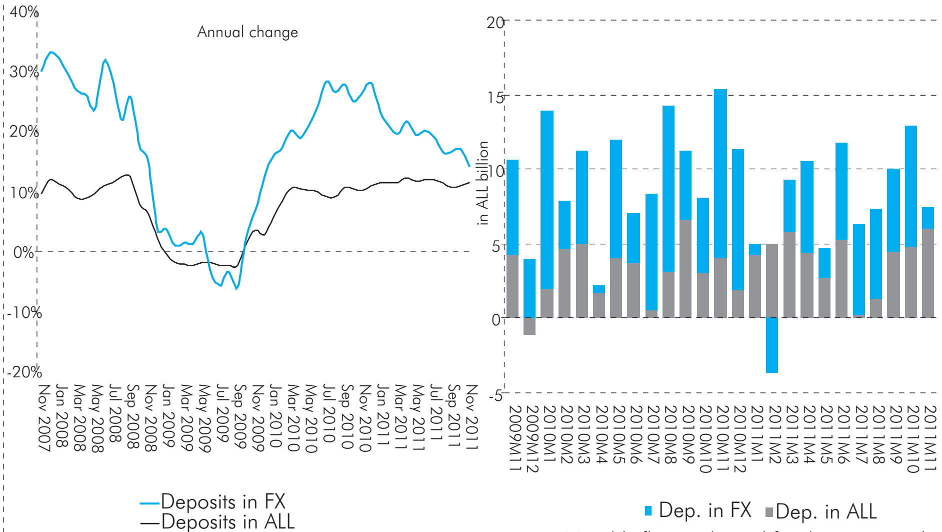
Chart 46 M2 aggregate and currency outside banks to M2 ratio



Source: Bank of Albania

Deposits in the banking system increased at slower rates compared with H1. Nevertheless, their increase, seasonally adjusted, shows better performance during Q4. ALL deposits showed stable annual growth by about 11.2%. In Q4, this increase was supported by higher money creation in the national currency. Foreign currency deposits increased at lower rates, in response to not only the lower creation of monetary flows in foreign currency, but also to the developments in the external sector and added uncertainties in the euro area. The annual growth rate of foreign currency deposits reached 14.1% in November, from 21% in H1. Excluding the exchange rate volatility in November, foreign currency deposits posted moderate monthly increase.

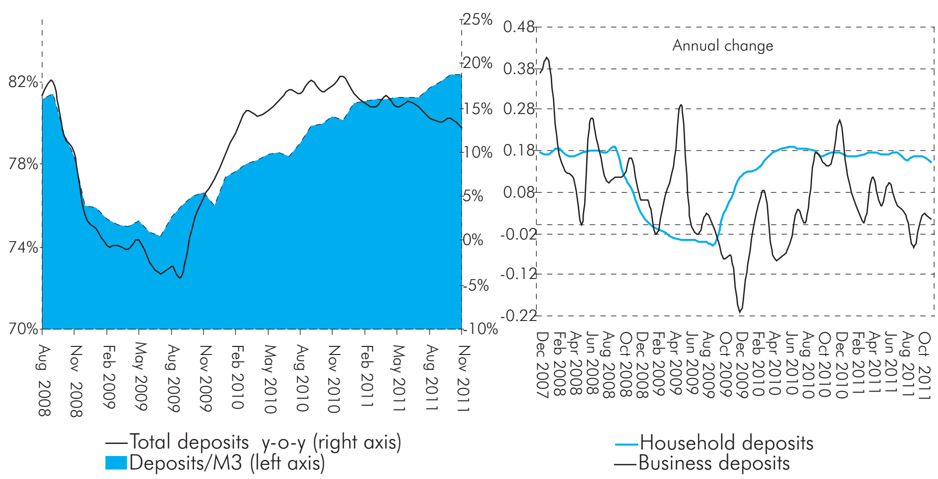
Chart 47 Deposits in total and by currency*



*Monthly flows adjusted for their seasonality
Source: Bank of Albania

The time structure of deposits illustrates once again the consumer's inclination towards saving, which appeared during 2011. Thus, time deposits were subject to higher increase and their share to total deposits, 81%, was up 2 percentage points in 2011. The average annual growth of time deposits

Chart 48 Deposits in total and by economic agents



Source: Bank of Albania

in October-November reached 15.3%, against the stable rate of 18% in the first three quarters. Demand deposit growth improved moderately by 5.3% on average compared with Q3, although the rates were lower than in 2011 H1.

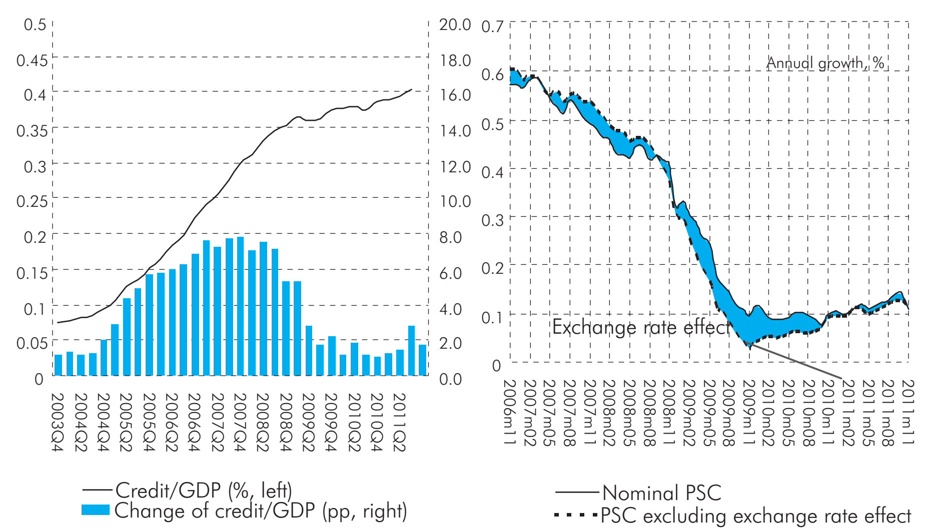
Deposits by economic agents confirm the steady growth of household deposits to 16%. Meanwhile, business deposits were in line with their seasonal behaviour and performance of economic activity at home. Increased business time deposits during H2 may illustrate businesses' lack of initiative to invest under the conditions of spare manufacturing capacities and weak consumption demand.

PRIVATE SECTOR CREDIT

In Q3 and in October, the annualised growth of private sector credit retained its slight upturn trend that had appeared in H1. It was 14.0% at end-September and remained unchanged in October. Excluding the exchange rate effect, the annual growth of private sector credit was 12.7% during these two months. Private sector credit to GDP ratio was 40.3% at the end of Q3 or 2.8 percentage points higher than a year earlier, thus reflecting higher impulse of the credit to economic activity as a result of its better performance in this quarter.

In November, the annual growth of private sector credit fell to 10.9%, in contrast to its tendency in the previous months. This behaviour, however, is conditioned mainly by the base effect of the high credit outstanding growth in November 2010, which is incorporated into the annual growth rates of November 2010 - October 2011. By currency and client, this base effect is particularly present in foreign currency and business loans, hence materialising in slower growth rates for these portfolios.

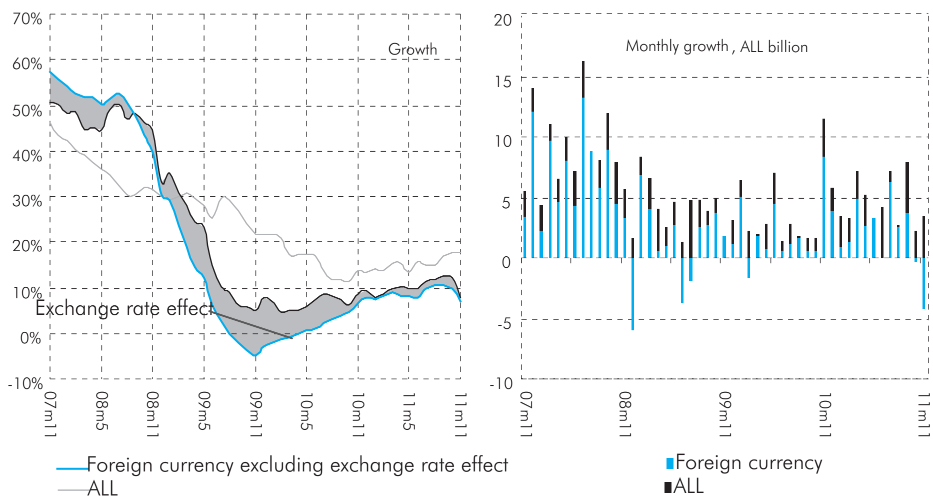
Chart 49 Private sector credit



Source: Bank of Albania

The annual slowdown of private sector credit growth rate in November was present mainly in loans to businesses. The annual growth rates of household loans were also dampened. Overall, credit performance in 2011 was volatile, giving signals that were not always clear on its performance in certain segments. Credit demand remains sluggish given the households' inclination to save and businesses' hesitation to invest. Credit demand by businesses was more inclined to fund the working capital, as making new investments is restricted by the existence of spare capacities due to below-potential economic growth. Similarly, credit standards are relatively tight. Surveys reveal that banks have increased their prudence in lending. In particular, banks' behaviour on lending is influenced by credit risk, which is higher, as evidenced by the non-performing loans situation[57]. Credit portfolio quality deterioration is conditioned by the sluggish economic activity and below-potential economic growth. Overall, it is in line with the performance of various sectors of the economy and their contribution to value added.

Chart 50 Private sector credit by currency *

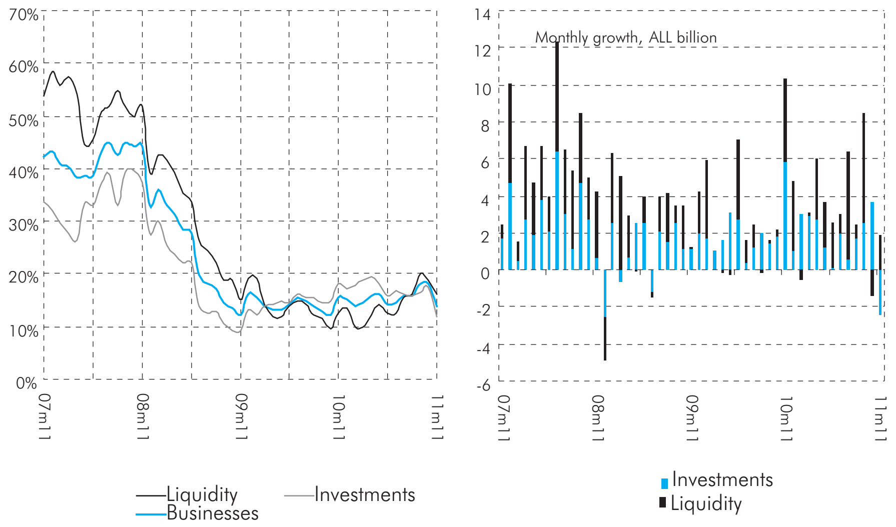


*Monthly flows in the credit analysis are adjusted for their seasonality.
Source: Bank of Albania

In contrast to the third quarter, the expansion of private sector credit in October-November was dominated by ALL loans. Since September, its annual growth has accelerated and reached 17.6% at end-November. The annual growth of foreign currency loans reversed the upward trend that had appeared in the previous months, decelerating during these two months. At end-November, the annual growth settled at 7.8%, from 12.5% at end-Q3. The annual growth rate, excluding the exchange rate effect, pursued the same trend reaching down to 7.2% in November. Moreover, in that month, the reduction of foreign currency credit outstanding compared with a month earlier owes to the exchange rate effect. Excluding this effect, the monthly increase in foreign currency loans in November was positive and that of the total credit was comparable to the average rates in the other months of the year. Business demand remains the primary source of foreign currency lending. On the other hand, foreign currency lending to households remains limited, both on demand and supply-side, reflecting the exchange rate risk factorisation by households and banks.

[57] *At end-2011 Q3, non-performing to total loans ratio was 18.0%, up 4.0 percentage points from end-2010. This ratio is affected both by the deterioration of the loan portfolio quality and contained crediting rates over the past two years.*

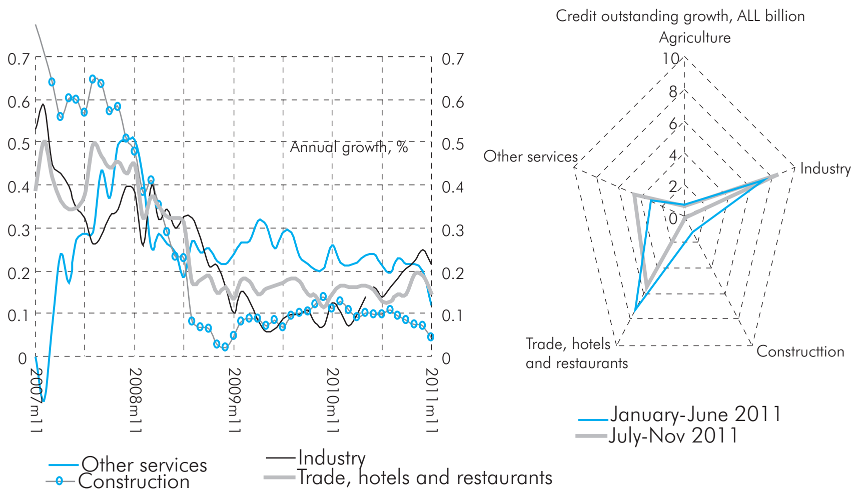
Chart 51 Business credit portfolio by purpose



Source: Bank of Albania

The expansion of lending to businesses in October and November was similar to Q2 but slower than in Q3. The annual growth of this portfolio was stable at 18.1% in October and down to 14.0% in November. The annual growth slowdown was present in credit for both working capital and investment purposes, though it was more pronounced in the latter. Year-on-year, investment credit growth was 11.8%, from 17.5% and 16.4%, respectively, in October and end-Q3. Loans for liquidity purposes dampened the annual growth rates to 16.3%, although they remained higher than in H1.

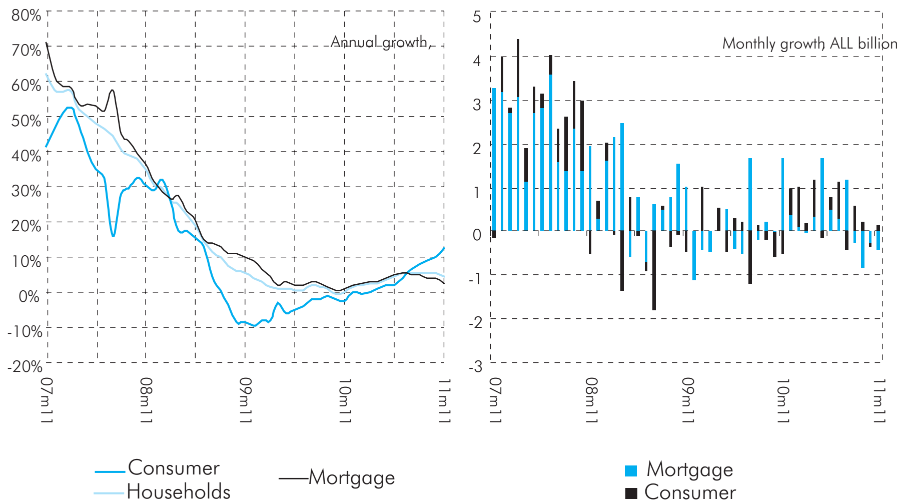
Chart 52 Business credit portfolio by sector



Source: Bank of Albania

The expansion of lending to businesses by sectors of the economy in October and November was in line with the previous months of 2011. Industry was the most credited sector, absorbing around 63% of the business credit growth during these two months. Other credited sectors include other services (transportation and telecommunications, financial intermediation, collective services). Business credit growth slowed in November across all sectors of the economy. Thus, the annual growth of lending to industry and lending to trade decelerated to 21.6% and 14.7% respectively in these months, though remaining at higher rates compared with H1. Lending to businesses in the sector of other services surged 12.3% in November, year-on-year. On the other hand, the construction sector remains the least credited, in response to the sector's weak economic performance during the past few years. The annual growth of lending to this sector continued to fall, settling at 4.3% in November.

Chart 53 Household credit portfolio by purpose



Source: Bank of Albania

In November, lending to households decelerated, albeit not at same rates as lending to businesses. Its annual growth, after remaining almost unchanged at 5.4% in October, dropped to 4.4% in November. Lending to households was dominated by mortgage loans, which, in November, slowed the annual growth to 2.3%, from 4.2% in the previous two months. In contrast, consumer loans improved their annual growth rates, especially in November. Annual consumer loan growth at end-November was 12.3%, from 9.1% at end-2011 Q3.

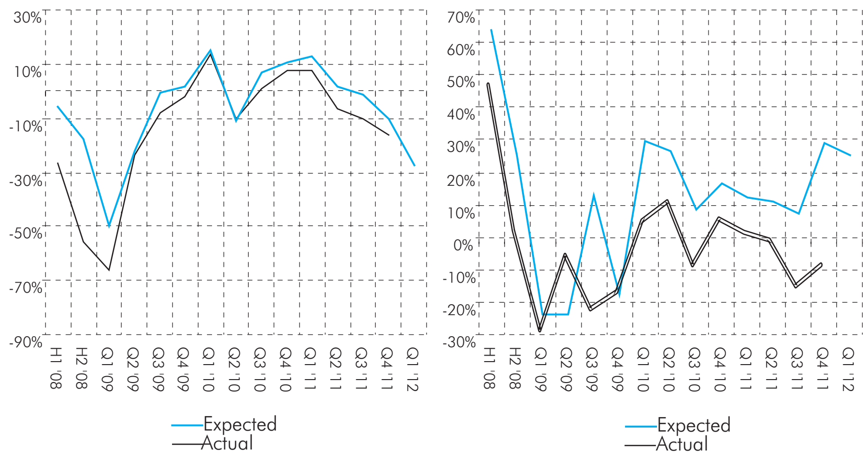
*Box 3 Summary of Bank Lending Survey results for 2011 Q4**

Survey results suggest that lending standards for businesses tightened even further in 2011 Q4 and standards for households were left unchanged from 2011 Q3. Compared with banks' expectations in Q3, these results are more optimistic for lending to households and somewhat more pessimistic for lending to businesses.

The main contributors to the tightening of lending standards to businesses were the situation of non-performing loans, the specific problems of the sector where the business operates and the overall macroeconomic situation. A combination of these factors increased the net percentage of banks in favour of tightening of the lending standards to 16%, or 6 percentage points higher than in the previous quarter. Banks tightened further their standards for small and medium-sized enterprises and working capital loans, whereas standards for corporate and investment loans were tightened less.

The tightening policies were implemented through increased requirements for collateral, higher margin for risk-rated loans and reduced maturity term and credit size. In contrast to Q3 and Q2, standards in Q4 were tightened also through higher commissions. Average credit margin decrease was the only standard that mitigated, to a certain extent, the lending standards.

Chart 54 Lending standards and business credit demand (net balance)

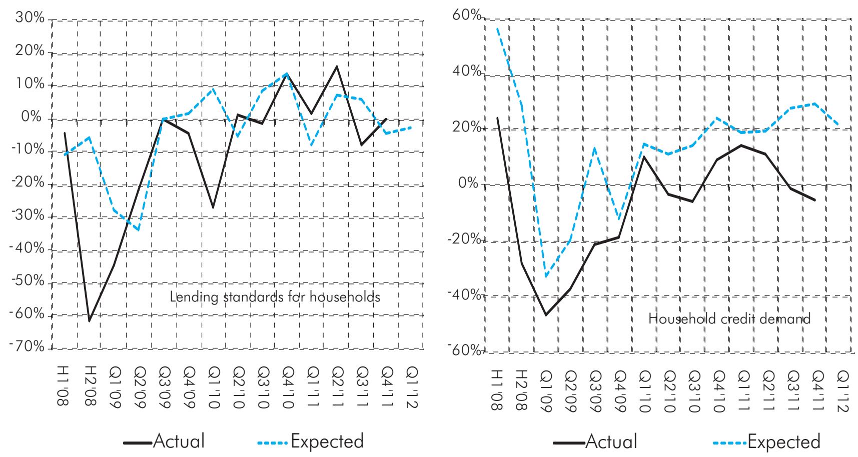


Source: Bank Lending Survey, Bank of Albania

Business demand for loans improved slightly in Q4, although its net balance remained deeply negative. The net percentage of banks stating higher business demand was -13.3%, from -23.7% in the previous quarter. The improvement in the net demand was also determined by the reduction in the negative contribution of factors related to investment loans. For the first time in this quarter, working capital loans did not contribute to boosting business demand for loans.

For 2012 Q1, banks expect standards to tighten both for investment and working capital loans. The tightening is expected to affect more the loans to small and medium-sized enterprises than the ones to larger companies. On the other hand, expectations for demand continue to be positive.

Chart 55 Lending standards and credit demand for households (net balance)



Source: Bank Lending Survey, Bank of Albania

In 2011 Q4, the standards of lending to households remained unchanged from Q3, both for house purchase and consumer loans. Contributing factors to the easing side of standards applied to household loans are competition and liquidity. Moreover, households' financial situation, non-performing loans and real estate market developments expanded their negative contribution to the easing of the lending standards.

Banks eased their lending policy by lowering the average credit margin. Credit size and collateral requirement confirmed a more tightened lending policy even in 2011 Q4.

Households' demand for credit continued its decline in 2011 Q4. The net percentage of banks stating lower household demand was 5.6%. This result is apparently more pessimistic than banks' expectations in the previous survey (Chart 2, right). House purchase credit demand dropped, whereas consumer credit demand increased.

Overall, banks do not expect further changes to lending standards for households in 2012 Q1. Expectations on demand remain optimistic.

* *The survey conducted in December 2011 refers to lending in 2011 Q4 and banks expectations for potential changes in lending in 2012 Q1. A detailed analysis of the Bank Lending Survey 2011 Q4 may be accessed in www.bankofalbania.org under Publications section.*

V.2 FINANCIAL MARKETS

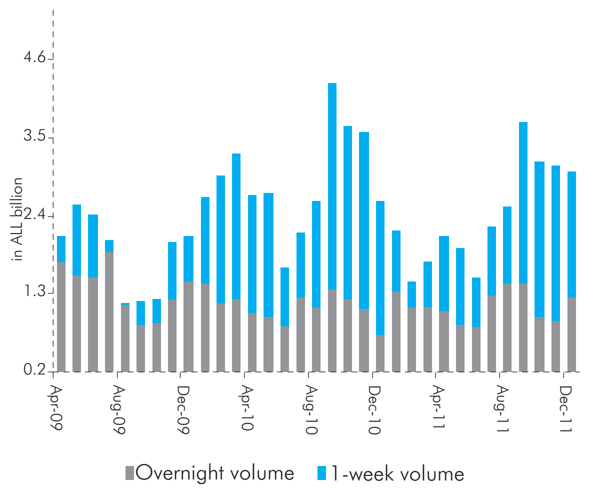
INTERBANK MARKET

In 2011 Q4, interest rates in the interbank market were downward whereas the volume exchanged between the banks in this market was up. In 2011 H2, the overall liquidity level continued to support the demand of interbank market agents. During this period, the Bank of Albania lowered the key interest rate twice bringing it down to 4.75%, which was reflected in the interbank market rates. The Bank of Albania has continued its regular open market operations to inject liquidity through reverse repo auctions of 7-day, 1-month, and 3-month maturity terms. On average, the transaction volume in the interbank market was higher than in 2011 H1, growing also in 2011 Q4. The increase in 1-week transactions in this period compensated for the slight decrease of overnight transactions, hence contributing to the total exchanged volume increase. Even in Q4, banks confirmed the shift of transaction volumes to the 7-day transactions.

The average volume of overnight transactions was ALL 1.06 billion or ALL 0.32 billion less than in Q3, whereas the 7-day transactions one was ALL 2.04 billion or ALL 0.52 billion higher. The total volume exchanged by banks was ALL 3.23 billion or ALL 0.23 billion higher than in Q3. The key interest rate cut by 0.25 percentage points at the end of September and November has been transmitted to the interest rates applied by the interbank market. The overnight interest rate was 4.80% in Q4, from 5.31% in Q3, whereas the 7-day interest rate was 5.0%, from 5.34%.

The spread between the overnight interest rate and the key interest rate was slightly up to 0.18 percentage points in 2011 Q4, from 0.10 percentage points in 2011 Q3. The increase in this indicator owes mainly to the low values of interbank interest rates for a certain period, when excess liquidity was not managed optimally by market agents. Overall, interest rates in this market ranged within the corridor established by the Bank of Albania and close to the key interest rate.

Chart 56 Volume of transactions in interbank market

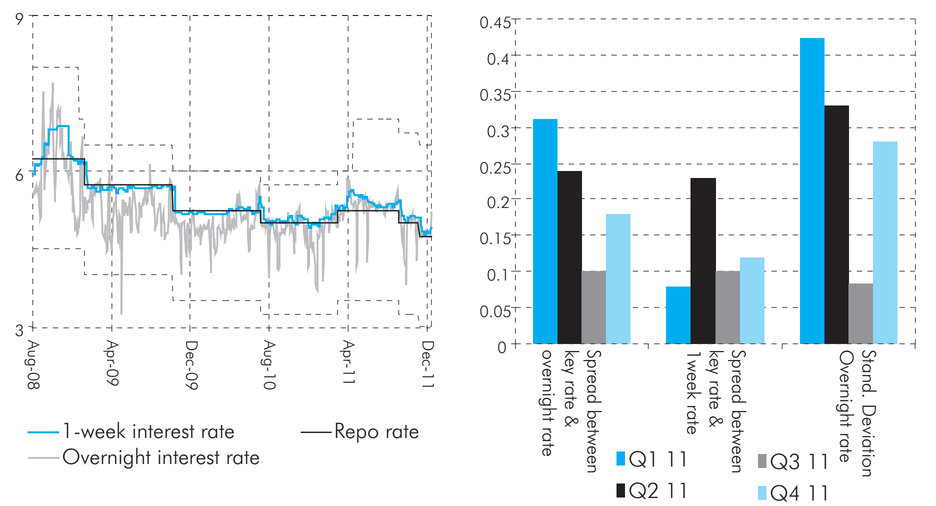


Source: Bank of Albania

PRIMARY MARKET

In contrast to the rest of the year, the last quarter was characterised by lower yields of government securities in the primary market. This trend is driven both by eased monetary conditions and lower short-term interest rates in the interbank market and low borrowing demand during this period. Key interest rate cuts at the end of September and November were gradually transmitted to the performance of yields for all maturity terms. The most pronounced drop was reflected in 12-month yields, suggesting an adjustment of its behaviour during 2011 H1.

Chart 57 Interbank market rates (left) and their spread with the key rate and standard deviation (right)

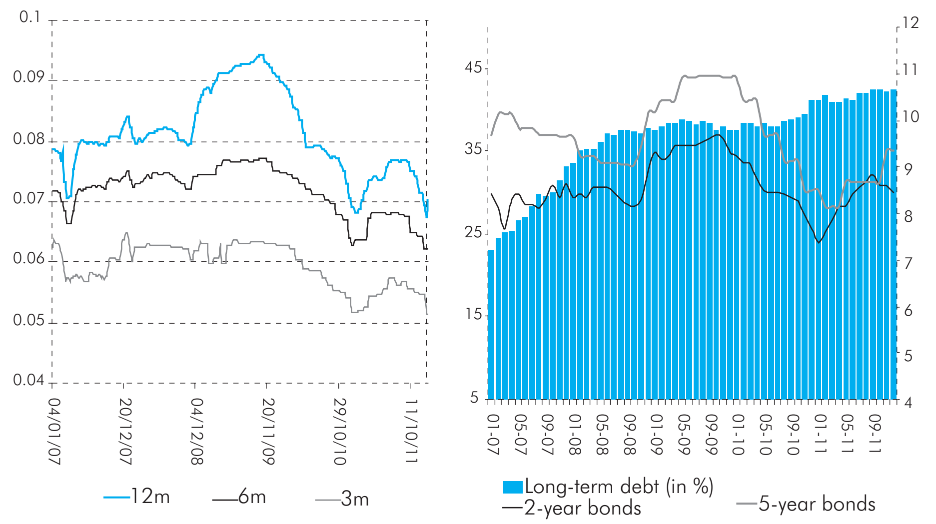


Source: Bank of Albania

Downward pressures in the T-bills segment were added also due to the lower issue of securities, which is reflected in higher bid/cover ratio[58] in 2011 Q4 (1.3 from 1.1 in Q3). In the longer-term securities, hesitation to invest is noted, leading to lower elasticity in the decrease of the yields for these securities. This market is less liquid and competitive and its indices are consequently affected by the behaviour of certain participants.

[58] *Measured as the ratio of participants bid to the total sum issued in T-bill auctions.*

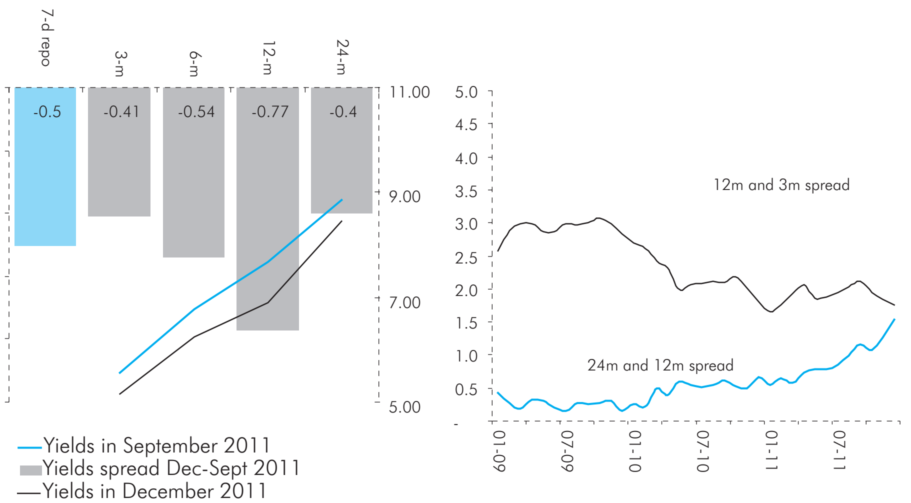
Chart 58 T-bill (left) and bond (right) yields in the primary market



Source: Bank of Albania

The 12-month yield was 7.04% at end-Q4, from 7.67% at end-Q3. The significant decline of this indicator contributed to price setting for longer-term securities instruments. In spite of this, this indicator's required premiums on these instruments were higher in Q4. The 2-year bond yield was down to 8.44% in December from 8.84% in September, whereas its spread over the 12-month yield expanded. In November's auction for 5-year bonds, the yield was 9.33%, reflecting the increase of the required margin to 1.80 percentage points, from 1.40 percentage points at July's auction.

Chart 59 Yield curve and yield spread*



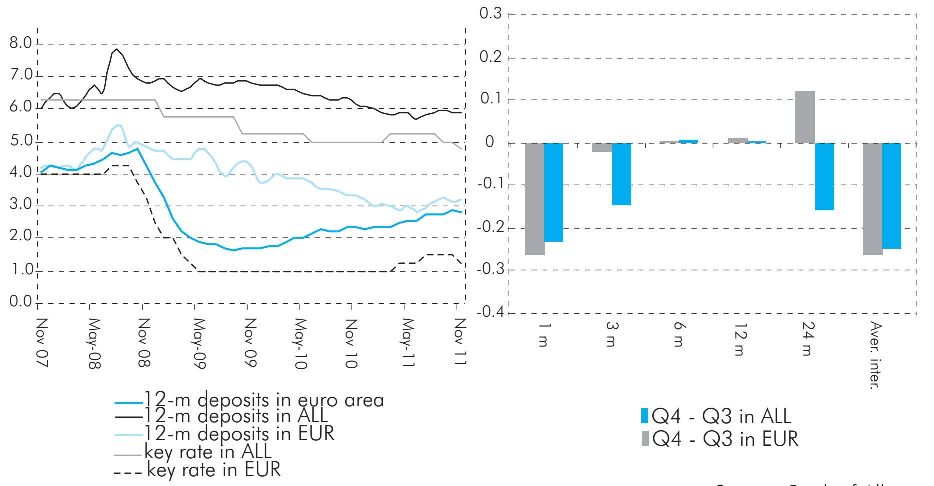
*7-day repo rate is the weighted average interest rate in 7-day reverse repos, with variable price.
Source: Bank of Albania

Yields' trajectory in the primary market shifted downwards in December, as a result of the simultaneous decline in yields. It appears more flattened, affected by the narrowing of short-term rates spread. The yields performance in the primary market does not evidence added liquidity and inflation risk premiums, which is also supported by the anchored expectations of financial agents.

INTEREST RATES ON NEW DEPOSITS

Following the upswing until end-August, due to the seasonal effect, the banking system applied slight and sequential decreases of ALL deposit rates for all maturity terms, in line with eased monetary conditions. The weighted average interest rate on EUR deposits followed the key interest rate changes by the ECB over these months[59]. It was upward until October owing to the increase of the reference rate and summer promotions and then slightly downward again. Nonetheless, the spread between Euro deposit interest rates in Albania and in other countries narrowed[60].

Chart 60 12-month deposit rates and key rate in Albania and euro area (left); quarterly change of ALL and EUR deposit interest rate by term (right)



Source: Bank of Albania.

The weighted average interest rate on ALL deposits was up 0.55 percentage points above the average of 2011 Q2, in July-August (5.26%). This increase was a result of seasonal promotions and new inflows in long-term deposits at higher interest rates (affecting the weighted value). In the following months, it fell to 4.91% (November). Preliminary data indicate that deposit interest rates continued their decline in December as well. The decline in weighted interest rates varied according to maturity terms. They were applied principally in the short-term for 1- and 3- month deposits, while banks continue to compete for market share in the long-term.

Interest rates on euro time deposits, during July-November, were in line with the dynamics of the national currency and driven by ECB's decisions in the international market. The weighted average interest rate on new euro deposits was 2.73% in July-August, 0.43 percentage points higher than the average of 2011 Q2. Later, they fell in Q4 reaching the average of 2.47% in October - November.

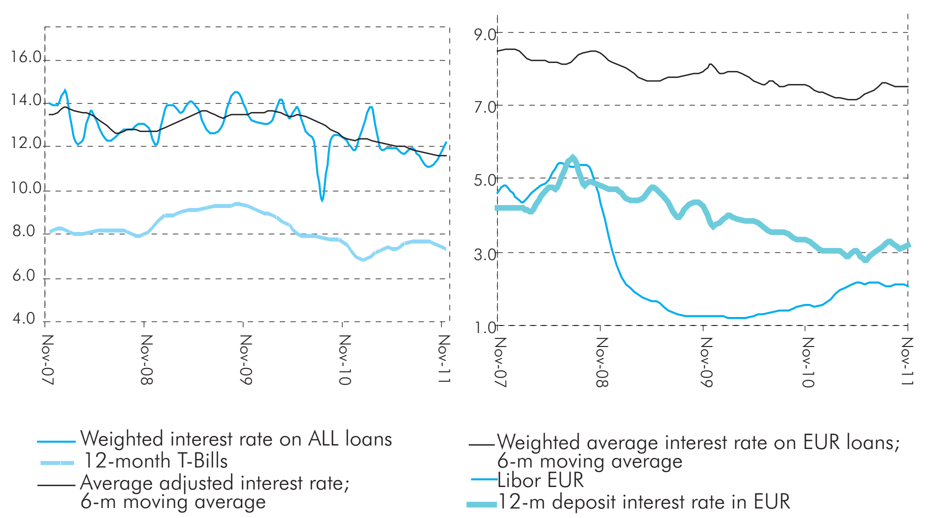
[59] *In April and July, the ECB raised the key rate respectively by 0.25 percentage points to 1.50%, but it was cut again in November and December back to 1.00%.*

[60] *Interest rates increase in Europe led to lower margins and further alignment of euro deposit interest rates at home with euro area rates.*

INTEREST RATES ON NEW LOANS

The period July-November 2011 continued to be characterised by eased lending standards in Albanian Lek by the banking system. Interest rates on new ALL loans were stable and close to low levels in this period. On the other hand, average interest rates on EUR loans rose slightly. The average interest rate on loans continues to be influenced mainly by the diversification in offers and preferential terms for special clients by some banks. In addition, the high reference rates[61] (until October) and the exchange rate risk remain contributing factors to the high margins on EUR loans.

Chart 61 Interest rates on new loans in Lek (left) and euro (right)



Source: Bank of Albania

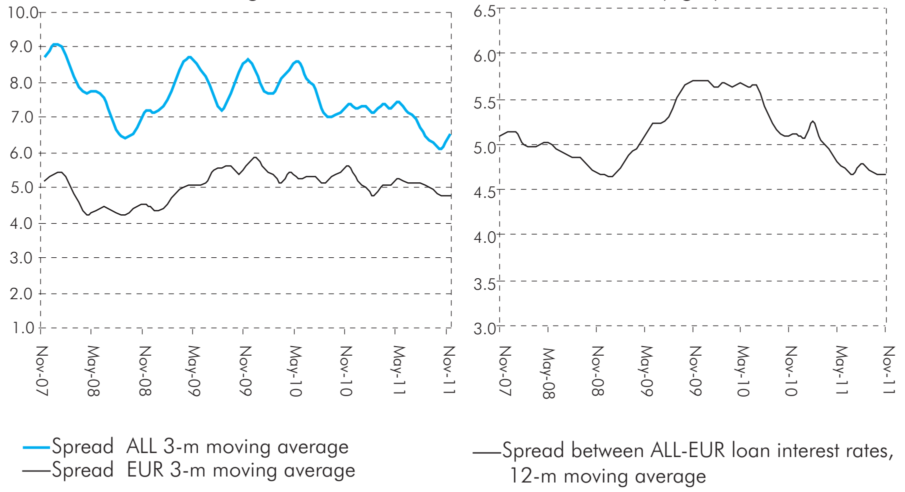
In 2011 H2, the average interest rate on ALL loans was down 0.79 percentage points from 2011 H1. On average, it was 11.60% during these months. Most of new ALL loans have served to support new investments by businesses and households. By maturity term, interest rates on shorter terms (0-1 year) and medium terms (1-3 years) declined the most. The weighted average interest rate on ALL loans increased in November (12.17%), remaining, however, at low levels compared with the previous years. The increase is driven by the preferential terms applied by some banks for special clients for working capital and investment loans[62].

The average interest rate on EUR loans surged during July-November, averaging 7.51% or 0.21 percentage points higher than in 2011 H1. This trend resulted mainly from the slightly higher reference rates and the application of higher prices on EUR loans for working capital purposes. Interest rates on the latter were up 0.15 percentage points on average, compared with H1. For longer-term maturity of over 5 years (mainly for immovable property), banks continue to apply relatively high rates on new foreign currency loans.

[61] *Reference rates are the Euribor and the cost of funds, calculated as the weighted average of euro deposit interest rates.*

[62] *In September, in a bank, a loan for investments was disbursed with a highly preferential rate, which brought the weighted average rate down. Later, this effect was eliminated and the interest rate increased staying close (but below) the average level of H1.*

Chart 62 Average intermediation rates in Lek and euro (left) and the spread between average interest rates on Lek and Eur loans (right)



Source: Bank of Albania

Intermediation cost in both currencies fell during July-November. This indicator for the Albanian Lek averaged 6.49 percentage points, from 7.27 percentage points in 2011 H1, reflecting, therefore, low ALL loan rates. The average euro intermediation cost averaged 4.89 percentage points, 0.20 percentage points lower than in 2011 H1. The spread between interest rates on ALL loans and EUR loans continued to show high fluctuation, although the average value continues to narrow. It dropped by 0.99 percentage points in July-November, compared with 2011 H1.

EXCHANGE RATE

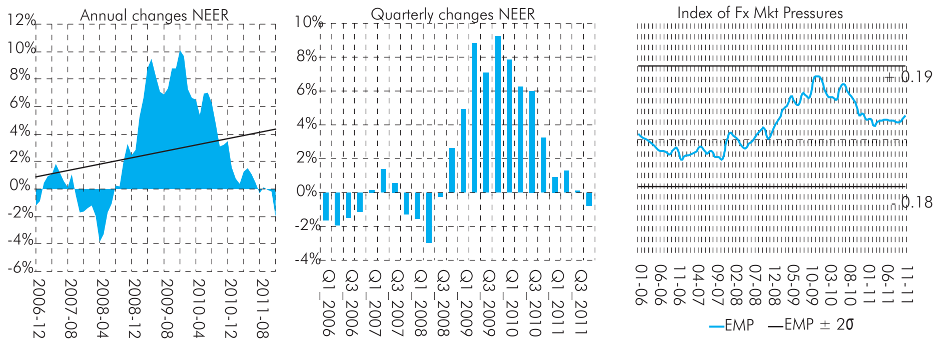
During 2011 H2, the performance of the Albanian Lek in nominal effective terms was characterised by slight depreciation or appreciation fluctuations remaining, on average, unchanged from the corresponding period of 2010. The annual change of NEER[63] ranged in the narrow interval of -2.0% and +0.5%, reaching higher appreciation values during the last months of the year. The appreciation pace is confirmed also by the analysis of NEER developments in quarterly terms. In Q4, the Albanian Lek appreciated 0.77%, whereas in Q3 it depreciated only 0.1%.

The quarterly NEER performance appears to have reflected the fluctuations in demand/supply ratio in the domestic market, transmitting the seasonal effect that characterises this period of the year, as well as the appreciation trajectory over the last weeks of the US dollar against foreign currencies in international markets.

The above-mentioned developments appear to be confirmed by the Exchange Market Pressure index, which was stable over the July-November period, reflecting its stabilization around 0.05 standard deviations from its historic average.

[63] *NEER – The nominal effective exchange rate is calculated against the currencies of our five main trading partners, namely Italy, Greece, Germany, Turkey and China. Higher NEER means depreciation of Lek.*

Chart 63 ALL annual and quarterly changes in nominal effective terms (NEER) and Exchange Market Pressure index



*EMP (exchange market pressure) is generated by the following formula:

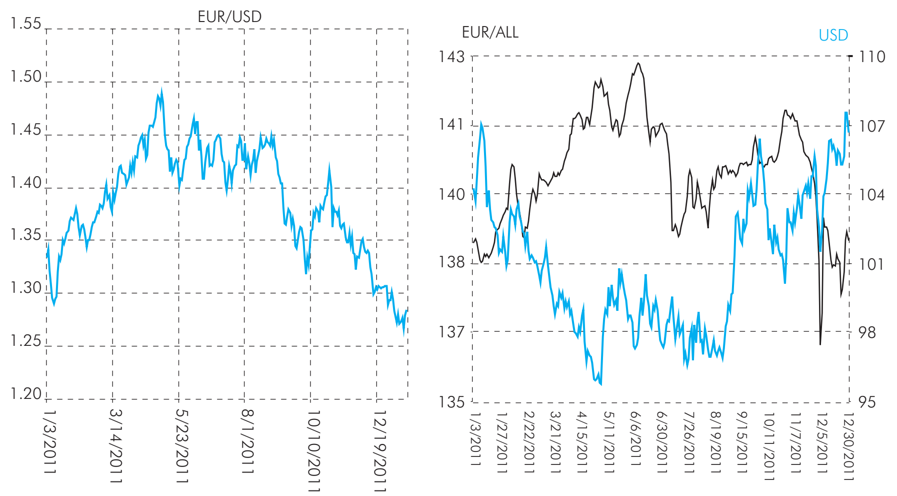
$$EMP_t = \left(\frac{1/\sigma_e}{((i/\sigma_e)+(1/\sigma_r)+(1/\sigma_i))}\right)\frac{\Delta e_t}{e_{t-1}} - \left(\frac{1/\sigma_r}{((1/\sigma_e)+(1/\sigma_r)(1/\sigma_i))}\right)\frac{\Delta r_t}{r_{t-1}} + \left(\frac{1/\sigma_i}{((1/\sigma_e)+(1/\sigma_r)+(1/\sigma_i))}\right)(\Delta(i_t - i_t^*))$$

with e=NEER, r=NIR and i= weighted interest rate for deposits in Lek and foreign currency. Higher index implies higher exchange market pressure.

Source: Bank of Albania

The individual developments in major currencies of the basket in the foreign exchange market, for the fourth quarter, reflects the depreciation of the national currency against the US dollar (1.9%) and the euro (1.0%), compared with the corresponding period of a year earlier. On the other hand, in quarterly terms, the Lek reflects the weakening of its position against the US dollar depreciating on average by 4.8%. Against the euro, it does not have any significant changes and settled on average at around 140 Lek per 1 euro. The seasonal inflows characteristic for the end-year period appear to have compensated the demand for foreign currency arising from imports and public institutions.

Chart 64 Daily EUR/ALL, USD/ALL and EUR/USD ratio during 2011



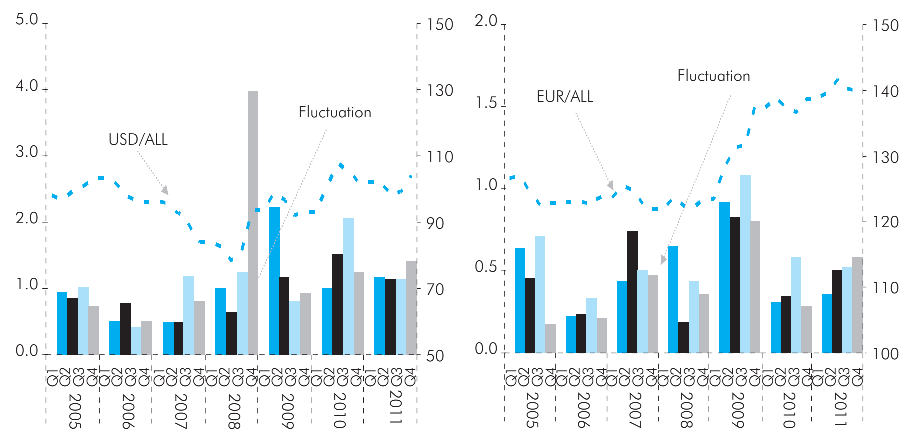
Source: Bank of Albania

Given the difficulties to find a solution on the euro area crisis, December was characterised by further depreciation of the euro against the US dollar. This was reflected more evidently in the local exchange market, where 1 euro was exchanged for 136-137 Lek during the first week of December from 140

Lek at end-November. The rapid depreciation of the euro against the Lek was short-lived and the exchange rate returned to more stable rates during the following weeks.

The USD/ALL ratio, during the period under analysis, was in line with the performance of the US dollar in global markets. Based on the fluctuation index, developments of this ratio are significantly more pronounced than in both the previous quarters of 2011 and the 2010 Q4.

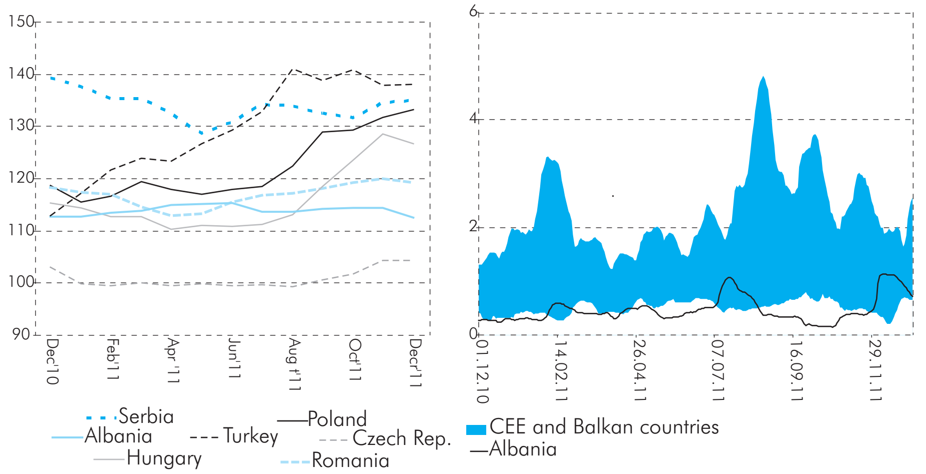
Chart 65 USD/ALL and EUR/ALL ratio fluctuation in quarterly terms



Source: Bank of Albania

In the regional context, ALL/EUR ratio is similar to most Central and Eastern Europe and Balkan country ratio. The dynamics of the EUR/ALL ratio has been considerably calmer throughout almost the entire second half of the year. The graphical presentation of Lek's fluctuation index is below the lower limit of the interval created by the countries of the region, while it exceeded it significantly only in December.

Chart 66 EUR/ALL ratio performance (Base period: October 2008) and fluctuation compared with CEE and Balkan country currencies*



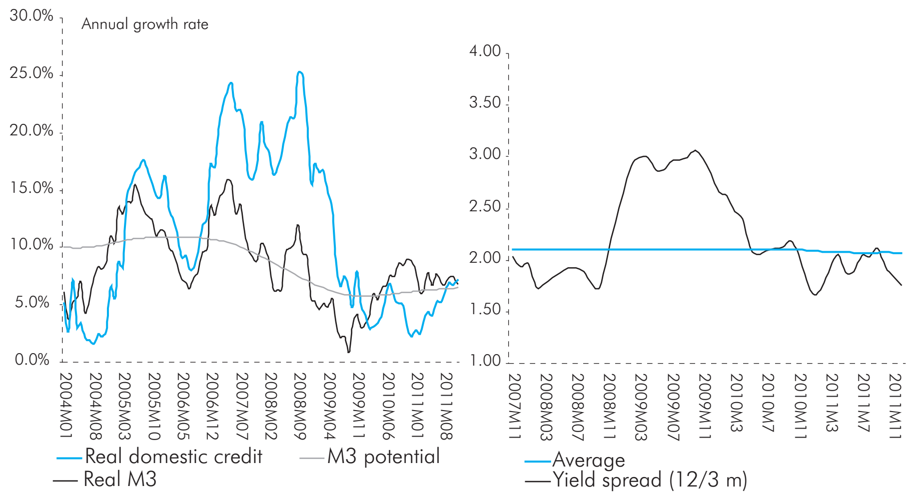
*Fluctuation of euro/national currency ratio is measured as 30-day standard deviation. Fluctuation peaks in each period represent the maximum and minimum standard deviation, by the relevant ratios. The countries included are Poland, the Czech Republic, Hungary, Romania, Turkey and Serbia.

Source: Bank of Albania estimates

V.3 ASSESSMENT OF FINANCIAL INFLATIONARY PRESSURES

Monetary developments for the medium-term period show that money expansion has accommodated the economic agents' real demand for money. In October-November 2011, the annual growth of M3 aggregate, adjusted for the price effect, was on average 7.1%, remaining unchanged from the preceding months. Despite the positive developments in the expansion of domestic demand for monetary assets, it continues to be significantly below the historic average. Overall, monetary developments confirm the insofar assessment for absent inflationary pressures from monetary developments at home.

Chart 67 Real M3 aggregate and domestic credit and yield spread



Source: Bank of Albania

Financial markets showed low volatility and were in line with the stimulating signals of the monetary policy in the 2011 H2. The good performance of liquidity, especially in the national currency, is reflected in the decline of interbank market interest rates, in the primary market of government securities and the credit market. The spread between 12-month and 3-month yields in the primary market of government securities shows that financial agents do not factorise added inflationary pressures in the economy in the coming months. At the same time, developments in the foreign exchange market do not reflect added pressures on the performance of prices at home in the future. Moreover, this performance confirms that the stability of the exchange rate has served to strengthen and consolidate the confidence in the financial system, offering higher support to the contained performance of prices in the period ahead.

VI. ALBANIA'S ECONOMIC OUTLOOK FOR 2012

Economic activity at home, over the past three years, has taken place amidst an unfavourable situation in the economy both worldwide and in our trading partners. The global economic and financial crisis had its impact on the Albanian economy, through increased risk premiums in internal and external financial markets, as well as an overall decrease of investors' readiness to invest in emerging economies, compared with the pre-crisis period. In spite of the shock, the main domestic macroeconomic balances resulted to be stable, thanks to the overall sound balance sheets of economic and financial agents and the appropriate response of macroeconomic, supervisory and regulatory policies. In particular, despite the presence of the slightly depreciated exchange rate and added uncertainties in the economy, the Bank of Albania managed to contain inflation around the 3% target band. Similarly, in terms of the macroeconomic activity, the impact of the global crisis was materialised only in the growth rate slowdown and not in deep economic recession as was the case in some countries of the region. The supply of the economy with liquidity by the Bank of Albania, cautious easing of monetary conditions, ongoing crediting of the economy by the banking system – an experience that was different from many countries in the region – as well as the utilisation of the fiscal room to fuel economic activity contributed to buffering the shock.

The effects of the unfavourable situation worldwide were, however, felt in the Albanian economy. By sector, the Albanian economy has reacted asymmetrically to the global economic and financial crisis. Hence, the construction sector, which had been a powerful driver of growth until 2008, has decelerated its growth rates, showing even signs of contraction. On the other hand, the industry sector has benefited during this period, thanks to the favourable price conjunctures in international markets, higher focus of external markets towards suppliers of low-cost products, ongoing structural reforms, depreciated exchange rate and higher support through loans by the banking system. Finally, the services sector has reflected more closely the performance of the domestic demand, showing higher stability of its growth rates and dampening the volatility of economic activity at home. Concerning aggregate demand components, economic growth over the last two years has been supported to a large extent by foreign demand and fiscal stimulus, whereas domestic demand in the form of consumption and investments has appeared weak. In the aspect of macroeconomic balances, the Albanian economy continues to be exposed to developments in foreign capital market developments, as a result of a relatively high current account deficit. Likewise, the increase of non-performing loans and fluctuations in sector development have led the banking system to revise the lending terms and practices on the tightening side, showing a rigid selection tendency on business plans and increasing lending prudence.

These developments will condition the economic activity and balances even during 2012. The sovereign debt crisis in euro area countries and measures taken for its resolution will condition significantly Albania's economic developments. However, factorising a rapid solution and the absence of proliferation of this crisis, the baseline projections of the Bank of Albania suggest that the Albanian economy will continue to grow in the year ahead. Economic growth will continue to remain below its potential, in line with the economic growth in 2011 and showing tendencies of improvement in the second half of the year. In the aspect of aggregate demand, projections for economic growth are conditioned by the increase of consumption and investments at home, in response to also the improvement of lending conditions as a result of an easing monetary policy pursued by the Bank of Albania and reduction of risk premiums in the financial system. The intensity and time of recovery of consumption and investments will condition to a considerable extent the economic growth for 2012. On the other hand, the contribution to the expansion of economic activity by the fiscal stimulus and external demand is expected to be downward. Room for fiscal stimulus has already reduced and the focus of the public sector has shifted towards maintaining parameters of fiscal stability, whereas external demand is expected to grow at slower rates, as a consequence of more contracting measures taken by our trading partners.

In this forecasted context of developments, the main indicators of macroeconomic stability are expected to remain stable. Below-potential economic growth, reduction of foreign inflationary pressures, anchored expectations of the economy and controlled monetary expansion will be accompanied by reduced inflationary pressures during 2012. Conditioned by the materialisation of the above scenario, our econometric models suggest that, with 90% probability of occurrence, consumer price inflation will range in the 1–3% band. In this development scenario, the monetary policy of the Bank of Albania will retain its stimulating nature during 2012. At the same time, the current account deficit is envisaged to remain stable and the overall balance of payments in equilibrium. In addition, according to budgetary projections and the level of budget deficit approved by the Albanian Parliament, public debt is envisaged to be stable.

Turning to monetary developments, M3 aggregate is forecasted to grow by 6.8% during 2012. This growth is judged to be in line with the demand of the economy for real money, reflecting, at the same time, the tendencies for increasing monetisation of the economy. Broad money expansion will take mainly the form of deposit growth, where deposits in foreign currency are forecasted to increase more rapidly by 10.4%. From the aspect of demand for monetary assets, lending to the private sector is expected to provide a higher contribution to monetary asset expansion. Lending to the economy is forecasted to grow by 11.8% during 2012, following the improvement of lending terms and credit demand recovery. Furthermore, the reduction of government demand for borrowing will provide more room for the private sector and will shift the increase of financial intermediation towards this sector. Lending is projected to be supported by the same expansion of both lending in foreign currency and in national currency. Soundness indicators suggest that the banking system remains well-capitalised and amply liquid to increase financial intermediation for the economy. Net claims on the public sector and foreign assets of the banking system are projected to grow 3.3%, respectively. The budget for 2012 projects lower budget deficit than in 2011 and the largest portion of the deficit is expected to be funded externally. Consequently, domestic borrowing to fund the fiscal deficit will be lower than in 2011. Foreign currency reserve of the Bank of Albania is envisaged to cover, on average, 4.2 months of import in 2012, while foreign assets of commercial banks are expected to conclude the year with a moderate growth.

The above setting forms the baseline scenario of expected developments by the Bank of Albania. In other words, it represents the trajectory with higher probability for the materialisation of the expected development of the Albanian economy. On the other hand, the evolution of the situation in the external or domestic economy may lead the Albanian economy away from this scenario. In particular, shocks that may arise from further deterioration of the situation in the euro area would affect economic growth and domestic macroeconomic balances, thus conditioning reactions on the opposite side of the monetary, supervisory and regulatory policy of the Bank of Albania. Similarly, slower-than-foreseen reactivation of domestic demand would be followed by further deceleration of economic growth, thus conditioning the pursuit of a more aggressive monetary policy by the Bank of Albania. Notwithstanding this and in any case, our monetary policy will remain oriented towards complying with our inflation target, while the supervisory and regulatory measures will aim at maintaining financial stability both at macro and micro level.