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MONETARY POLICY REPORT
2012 Q1

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OBJECTIVE

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

In line with its Monetary Policy Document for the Period 2012-2014, the Bank of Albania is committed to achieving and maintaining annual inflation at 3.0%, with a tolerance band of +/-1 percentage point. The announcement of the quantitative inflation target aims at anchoring economic agents' expectations and reducing the risk premium.

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

Monetary Policy Report for 2012 Q1 was approved on 25 April 2012 by the Supervisory Council of the Bank of Albania. The economic analysis in this Report is based on the latest available statistical and qualitative data as at 13 April 2011.

I. FOREWORD BY THE GOVERNOR

During the first quarter of 2012, the Albanian economy continued to maintain the parameters of macroeconomic stability even in the context of the ongoing global economic crisis. International financial markets were characterised by high risk premiums, and despite measures taken to solve the public debt crisis in the euro area, signals for a normal progress in the short run were absent. These developments, as expected, provided a reining impact on our economy, being expressed mainly in the continuation of below-potential economic growth.

Annual consumer price inflation slowed down significantly in the first quarter of 2012. It averaged 1.1% in this period, down by 1.4 percentage points from the previous quarter. The rapid decline in annual inflation rates, having started since the third quarter of 2011, was driven mainly by the restrained food price rise over this period and stable prices of other consumer basket items.

Performance of inflation reflected the simultaneous action of supply and demand factors. On the supply side, the slowdown in international primary commodity prices and in inflation of our trading partners, combined with a stable exchange rate performance, transmitted reduced imported inflation rates in our economy. Simultaneously, administered prices provided a lower contribution. Also, pressures arising from production costs were contained. Demand-side pressures remained low, conditioned by the ongoing negative output gap.

Reduction of actual inflation rates, shifting down of inflationary pressures and below-potential aggregate demand growth, against the backdrop of a contained fiscal policy, made room for further increase in monetary stimulus of the economy during 2012 Q1. The Banka of Albania lowered the key interest rate twice, to 4.25%, the lowest historical level. This decision, besides being in line with the maintaining of price stability in the medium run, also provides appropriate conditions for promoting the private domestic demand.

According to latest data from INSTAT, the Albanian economy accelerated the growth rate in the fourth quarter of the previous year, posting a 3.8% annual growth. The economic activity upturn was driven mainly by increase in services output. The value-added of this sector surged 7.5% in annual terms, with a higher contribution by the branch of trade, transport and other services. Similarly, construction and agriculture sectors posted positive but low annual growth rates, 1.2% and 1.9%, respectively. Positive contribution to economic growth was also provided by the extractive industry and processing industry; however, they did not manage to offset the significant contraction in electricity, gas and water supply branch, hence resulting in negative contribution by the industrial sector to domestic product growth.

From the viewpoint of aggregate demand components, in the fourth quarter of 201, Albania's economic growth continued to be driven by foreign demand. Notwithstanding unfavourable developments in global economy, net exports in real terms posted higher growth for this period. Besides the foreign demand, public sector demand also provided a higher contribution in the form of increased capital expenditure. At the same time, private consumption and investments, though displaying signs of recovery, remained slow.

Real-economy statistics on the first quarter of 2012 are partially available. Indirect data suggest that aggregate demand has recorded positive growth rates, albeit significantly below the Albanian economy potential. Macroeconomic factors determining private consumption and investments, and a prudent fiscal policy sustain the assessment for contained growth in the domestic demand over the first quarter of the year. Moreover, lacking complete and real-term data on the developments in the external sector of the economy, assessments suggest that foreign demand contribution to economic growth will be lower than in the previous year.

Fiscal policy was consolidating over the first quarter of 2012, in line with its objectives to keep budget deficit and public debt in check. The contained fiscal approach was reflected in a minimum public spending over the first quarter of the year, with an annualised rate of 0.7%. Furthermore, fiscal revenues continued to grow at low rates, settling at 1.2% in this quarter. Budget deficit was ALL 11.5 billion, down by 2.5% from the first quarter of 2011.

Developments in foreign trade show reduced trade exchanges in annual terms during the first two months of 2012. The value of exports dipped by 20.5% over these two months against the corresponding period of a year earlier, reflecting the moderation of foreign demand and price developments in global markets. Imports also decelerated significantly their growth rates, posting a nominal annual growth of 1.8% during this period. These developments resulted in a widening trade deficit over the first two months of the year, with an annualised rate of 21.9%. It was determined mostly by electricity trade exchanges. Excluding this effect, merchandise imports would be lower on a year earlier and trade deficit would be down by 9.2% in annual terms.

Monetary analysis reveals the existence of contained monetary pressures on the economy. The underlying pace of monetary expansion was in line with economic agents' demand for real money. Annual M3 growth was 9.1% in February, unchanged from the previous year-end. Money expansion in the economy was supported by foreign-currency component, whereas domestic demand for money slowed down. The public sector showed lower demand for funding, in line with fiscal developments in the first quarter of the year. Furthermore, private sector demand for money increased at moderate rates, as evidenced by the slow growth rate of private sector loans, which was up

9.2% at end-February. The slowdown in lending reflected the low demand for bank loans by households and businesses and higher prudence by banks in lending, being materialised in tight credit conditions. However, supply-side factors determining lending provide appropriate conditions for further credit growth. The Albanian banking system remains well capitalised and liquid, capable of satisfying the private sector demand for financing.

Financial markets in the first quarter of 2012 were serene, reflecting the relatively low premiums of risk, liquidity and inflation. Interbank market interest rate followed swiftly the recent key interest rate cuts. Easing monetary policy signals were transmitted to deposit market as well, and are already expected to be transmitted to other segments of the market, in line with the transmission mechanism time lag. In the primary market, government security yields trended up, reflecting the developments in relevant structural demand and supply-side factors, without signalling any added inflation or risk premiums.

The so-far developments have not changed our basic projections for the economic outlook. Year 2012 is expected to be influenced by unfavourable developments in global economy, which may affect the Albanian economy as well. The external demand is expected to provide lower contribution over the course of the year, impacted by economic slowdown in our trading partners. Fiscal policy orientation towards further consolidation of fiscal parameters restricts the space for any substantial fiscal stimulus to foster the economic activity. Against this backdrop, private domestic demand remains determinant for the aggregate demand increase in the future. Overall, analyses suggest a better performance of private consumption and spending, helped also by the eased monetary policy stimulus.

The below-potential demand growth will continue to exercise low demand-generated inflationary pressures. At the same time, the balance of supply-side inflationary pressures is assessed as contained, against the backdrop of reduced imported inflation and anchored inflation expectations. Taking into account the so-far developments and expectations for the future, the Bank of Albania projections show that, with a 90% probability, the 2012 consumer price inflation will range within the 0.7%–2.8% band. Materialisation of this baseline scenario would be reflected in retaining the stimulating monetary policy stance over the course of the year. Moreover, the Bank of Albania remains heedful to future developments and ready to respond appropriately and timely, in order to comply with its inflation target.

II. EXTERNAL ECONOMY

In the context of improved conditions in financial markets, indirect indicators signalled further positive growth of economic activity worldwide during the first months of 2012. Nevertheless, the advanced economies showed weak economic growth, mainly affected by the debt crisis in the euro area countries and the structural factors. During the last month, the emerging economies recorded high growth paces. Inflation remained relatively low in the advanced countries and fell modestly in emerging economies.

II.1 ECONOMIC GROWTH AND MACROECONOMIC BALANCES

Preliminary and indirect indicators, and the signals arising from many strategic areas of the global economy, show that global economy improved in 2012 Q1. Against the setting of overall eased pressures in the global financial markets, signals for an improved global economy are elevated. However, the long-term economic growth outlook is conditioned by the addressing and resolving of structural obstacles, which may restrain the growth pace. Fiscal consolidation and balance adjustment in many developed economies is under process. The downward inflation worldwide has been partly affected by lower impact of price increase in energy products due to base effect.

Table 1 Selected macroeconomic indicators

Countries	GDP change		Unemployment rate	Inflation rate	
	Q4-11/ Q3-11	Q4-11/ Q4-10	February-11	March-12/ February-12	March-12/ March-11
USA	0.7	1.6	8.3[2]	0.3	2.6
Euro area	-0.3	0.7	10.8	0.1	2.7
Germany	-0.2	2.0	7.2[2]	0.3	2.1
France	0.2	1.4	10.0	0.8	2.3
United Kingdom	-0.2	0.8	8.1[1]	0.7[3]	3.4[3]
Japan	-0.6	-1.0	4.7	0.2[3]	0.3[3]

Source: ECB, FED and respective statistical institutes.

[1] December 2011

[2] March 2012

[3] February 2012

EURO AREA ECONOMY

The latest data released by Eurostat indicate that the euro-area economic activity contracted by 0.3% q-o-q during 2011 Q4, managing to maintain positive rates compared to the previous year. The contracted private consumption and investments affected the negative performance of the euro-area economy, whereas net exports provided positive contribution. Preliminary indicators on consumption and sales denote a weaker performance relative to the previous quarter. Consumer and business confidence indicators, and foreign trade have shown positive signs, which, along with easier financing conditions in the financial markets, may lead to an improved GDP over the period ahead. The ultimate addressing and resolution by representative authorities of the euro-area countries for facing and managing the sovereign debt crisis in the euro-area markets have boosted the economic agents' confidence. It is worth of note that the real-economy debt crisis, fiscal consolidation in financial and non-financial sector and elevated unemployment remain the main determinants to euro-area's economic growth for 2012. Inflationary pressures remain contained. Annual inflation was 2.6% in March 2012, from 2.7% in the last three months. Unemployment rate continued to increase in February, resulting 10.8%, from 10.7% in January.

UNITED STATES ECONOMY

Latest estimates on U.S. economic activity show that in 2011 Q4, it grew by 1.6% y-o-y and 0.7% q-o-q, compared to 0.5% in 2011 Q3. The U.S. economy, after the sluggish growth rates observed in 2011 H1, gained momentum in 2012 Q1, thus recording a more positive performance. Increased consumer spending, private investments in construction and inventories contributed positively to this performance, whereas net exports and public spending provided a negative contribution. Preliminary data for 2012 Q1 reveal an ongoing positive growth of the U.S. economy, based on increased consumption and employment, as well as improved confidence climate. Unemployment rate was 8.2% in March, from 8.3% in February 2012. Annual inflation dropped to 2.6% in March, mainly reflecting the subdued inflationary pressures on food items and energy prices. The improved labour market, particularly the increased employment in non-agricultural private sector, along with the recovered construction, shall support the economic growth in 2012.

BRIC ECONOMIES

Data on the economic activity of BRIC economies indicate that their annual growth rates continued in 2011 Q4 and in 2012 Q1. Brazil's economic growth owes to simulating fiscal package and monetary easing. The strengthening of Brazilian real continued to provide a free flow of imports, leading to an expanded trade deficit during the period under analysis. The Russian economy was affected by the increase in industrial production and in income from energy and raw materials in 2012 Q1. Also, the downtrend of annual inflation is expected to change over the months ahead due to increased government spending in the framework of parliamentary elections in 2012. In India, economy maintained positive annual growth, albeit at moderate paces due to the expansion of trade deficit and the increased public sector debt. Also, the Chinese economy was characterised by a moderate GDP growth rate during 2012 QI (+8.1%), but the initiative of Chinese government to use a fiscal stimulus package is expected to lead to increased consumer spending in 2012.

Table 2 Selected macroeconomic indicators for BRIC economies

Countries	Change of annual GDP			Annual inflation	
	Q4-2011	2011	2012[1]	2011	Mars-12
Brazil	1.4	2.7	3.0	6.6	5.2
Russia	3.5	4.3	3.3	8.5	3.7
India	6.1	7.0	7.0	9.1	8.832
China	8.9	9.2	8.13	5.4	3.6

Source: IMF, OECD, respective statistical institutes.
[1] IMF estimates, WEO January 2012, [2] February 2012, [3] 2012 Q1.

ECONOMIES IN THE REGION

Economic activity in the region was uneven over 2011 Q4. Italy, Greece and Croatia recorded descending GDP trends. Italian economy, characterised by a high risk premium on debt securities, contracted due to decline in industrial production and investments, though net exports provided a positive contribution. The Greek economy continued to shrink by about 7.5% during 2011 Q4. It is worth of note that the high unemployment rate (21%) and fulfilment of the last fiscal package requirements shall affect consumer and government spending in 2012. Turkish economy expanded by 5.2% in 2011 Q4, whilst net exports provided considerable contribution, by 3.2 percentage points. The economies of Serbia and the Former Yugoslav Republic of Macedonia, characterised by the highest unemployment rates in the region, have slowed down their positive growth rates, affected by the decreased private consumption during 2011 Q4. Data on industrial production, which serve as indirect indicators for 2012 Q1, signal slowing economic activity in the region due to difficulties in domestic and foreign demand.

Table 3. Economic figures for countries in the region

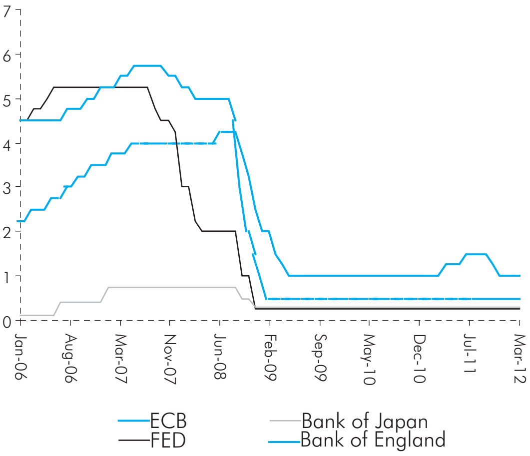
Countries	GDP change	Annual inflation	Unemployment rate
	Q4-11/Q4-10	March -12	January -12
Italy	-0.4	3.3	9.2
Greece	-7.5	1.7	20.72
FYROM	0.2	2.75	31.23
Serbia	0.8	4.9	24.02
Croatia	-0.2	1.31	13.9
Turkey	5.2	10.43	9.3
Kosovo	5.34	1.71	:
Albania	3.8	1.0	13.29

Source: Respective statistical institutes, IMF, EcoFin, EuroStat;[1]- February 2012; [2]- December 2011; [3]- November 2011; [4]- IMF projections, WEO September 2011; Unavailable data.

II.2 INTEREST RATE DECISIONS AND FINANCIAL MARKETS

The major 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%. The European Central Bank is an exception, as it lowered the key interest rate at the beginning of December by 25 basis points, to 1.00%.

Chart 1 Key interest rates

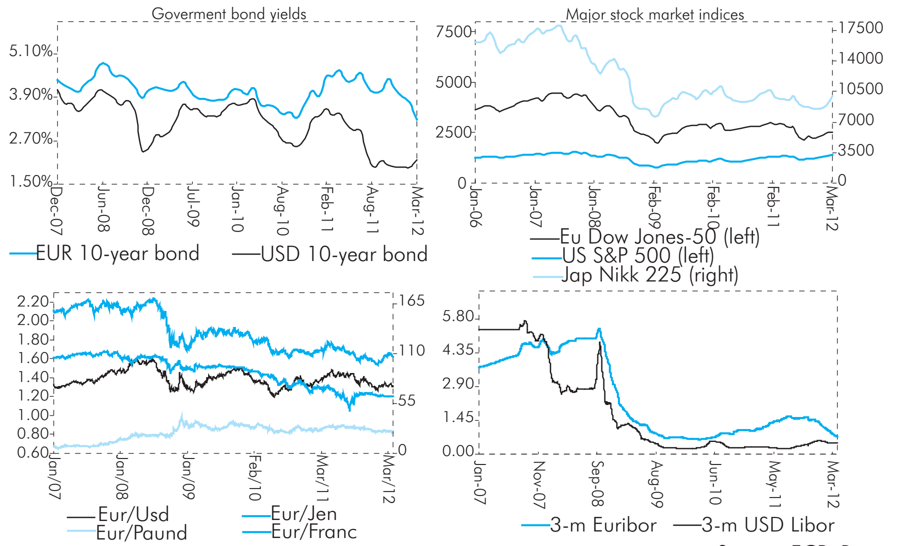


Source: ECB, FED, Bank of England, Bank of Japan

Interest rates in financial markets trended down during 2012 Q1. A detailed analysis shows that the demanded yields in capital markets decreased due to positive developments for resolving the euro-area sovereign debt crisis and the finalisation of some important political agreements to establish rules and measures for preventing and managing such situations in the future. On the other hand, the implementation by ECB of many "non-conventional" operations in its monetary policy, such as the conducting of two longer-term refinancing operations (LTROs) with a maturity of 36 months, the increase of collateral availability, and the reduction of reserve ratio, established a positive climate for financial agents, lowered interest rates in money market and in other segments. In U.S. financial markets, bond yields went down during this period, recording a slight increase only at the end of March. Their performance has mainly reflected the effects of investors' boosted confidence, and the factorisation of expectations for a higher economic growth in USA than in the euro area. The positive results, exceeding expectations in many business categories, and the above-mentioned factors related to the euro area, are also reflected in the major stock market indicators in U.S, Europe and Japan, being upward during these months.

Euribor rates of 1, 3, 6, and 12-month maturity marked 0.47%, 0.86%, and 1.50%, respectively, in March, down by 0.18 percentage point on average[1]. The 3-month U.S. dollar Libor rate decreased at 0.47% over this month, from 0.57% at end-2011. In foreign exchange markets, during these months, the euro gained ground against U.S. dollar, as well as against other main currencies (Swiss franc, Japanese yen), whereas the euro depreciated against

Chart 2 Exchange rate and some financial indicators in international markets



Source: ECB, Reuters

[1] *The decline was 0.16, 0.19 and 0.18 percentage points, respectively.*

U.S. dollar, q-o-q. In March, 1 euro was exchanged for 1.320 U.S. dollars, down by 0.2% compared to the previous month. A the same time, the euro depreciated by 2.77% compared to the pervious quarter.

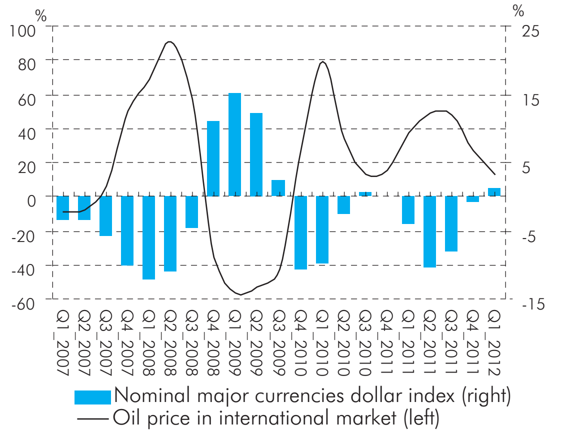
III.3 OIL AND PRIMARY COMMODITY PRICES

In 2012 Q1, the international oil market, supported by the U.S. dollar appreciation against some main currencies, was characterised by a decelerated oil price rise per barrel. Compared to the same quarter a year earlier, this price increased by 13.1% on average, to 118.5 U.S. dollar per barrel. Latest positive data on the U.S and Chinese economies, and the prolonged geo-political tensions in Middle East, encouraged the oil price rise in 2012 Q1.

Global oil demand in 2012 Q1 continued to be supported by India, China, Russia and Japan. Preliminary data show that the increased supply from USA, Brazil, China and Russia was followed by the growth of production quota at 35% for OPEC.

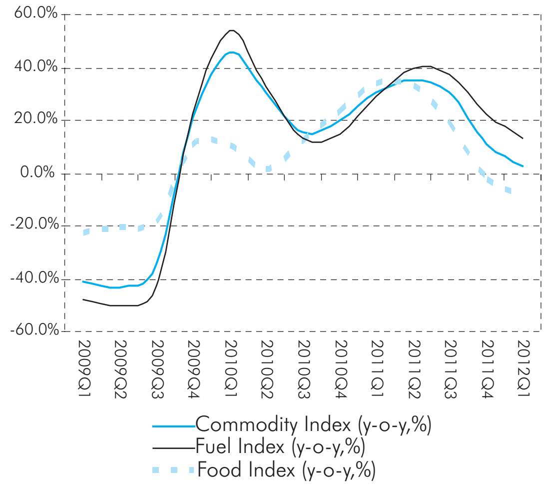
In 2012 Q1, primary commodity prices continued their downward trend having started since September 2011. Commodity Price Index marked an annual growth of 2.6%, considerably lower than in the previous quarter (11.1%). Fuel Price Index followed the same performance, recording an annual growth of 13.2% y-o-y. Food Price Index fell by 8.9% y-o-y, thus deepening the rates recorded in 2011 Q4. In March, these indices manifested positive upward rates compared to the previous month, thus reflecting both the geo-political tensions effect and the improved economic data for some countries.

Chart 3 Annual change of international oil price 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 1.1% in 2012 Q1, reaching the lowest level in the last decade. Consumer price inflation continued to fall sharply, responding to the strong downward effect of supply factors and low pressures from the domestic economy. In particular, food prices, whose increase affected the major part of inflation fluctuations last year, rose much more slowly during this period. Inflation fall was affected by the high base of comparison of past year's prices. This effect, albeit downward, is also expected to be present in the quarter ahead. On the other hand, internal inflationary pressures were low and contained, as shown by the performance of core and non-traded inflation.

In response to expected inflation developments, the Supervisory Council of the Bank of Albania cut the key interest rate twice during 2012 Q1, to 4.25%, taking it to the lowest historical level. This easing of monetary policy was undertaken against the backdrop of reduced inflationary pressures. It aimed at creating appropriate monetary conditions for meeting the medium-term inflation target, promoting, at the same time, the domestic demand and economic activity during this period.

III.1 CONSUMER PRICES, TARGET MEETING AND MONETARY POLICY

Annual inflation was 1.1% in 2012 Q1, about 3 percentage points lower than the previous year's figure. The pronounced reduction of inflation rates culminated in February 2012, to 0.6%, the lowest inflation rate in the last decade. Inflation increased to 1% in March, being considerably below the Bank of Albania' 3% inflation target.

Annual inflation in the last four quarters fluctuated within a broad band (1.1% - 4.1%)[2]. The relatively gradual reduction in inflation rates during July-November 2011, was replaced by a sharp fall in inflation from December 2011 onward. Beyond the expected statistical high base effect of comparison, inflation fall was driven by other factors as well, which have significantly affected the supply in the economy. While a year earlier, several supply factors arising from both domestic and external economy considerably increased the inflationary pressures, currently, the supply factors are assessed to have led to their alleviation. Specifically: subsiding annual prices of core food items in global market have alleviated the imported inflation pressures; the same role has been played by the stable national currency and its slight appreciation

[2] *The high volatility ranged from maximum (4.5%) to minimum (0.6%) rates, respectively, in February 2011 and 2012.*

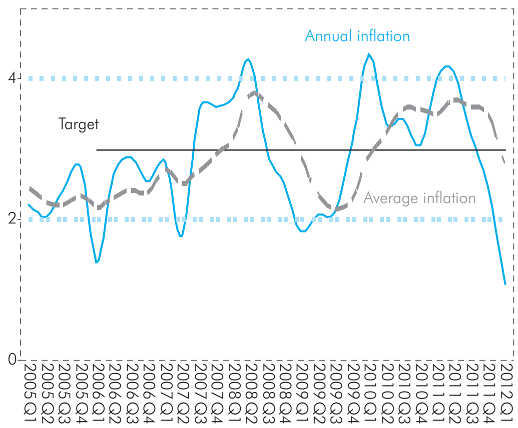
during the last 6 months; the assessment for an increased supply of domestic agricultural product has modified the seasonal effects in the favour of decline in related prices; the downtrend of economic agents' inflationary expectations is assessed to have mitigated the materialisation of second-round effects; and, the contribution of increase in regulated prices and the ones on which direct fiscal measures are applied, has marginally affected the annual inflation.

The economy demand, notwithstanding the signs of improvement in 2011 Q4, does not yet generate full capacity utilization, thus exerting contained inflationary pressures. In 2011, the economic growth was below potential, while indirect data on 2012 Q1 signal continuation of this phenomenon. Also, inflationary expectations as to one year ahead remained downward, fluctuating around 2.7% - 2.5% in 2012 Q1.

More structural factors relate to: enhanced competition in trade activity, following the entry of very large-area trade units, thus leading to downward prices for foods, in particular, and other consumer goods, in general; increasing orientation of Albanian consumers towards consumption of domestic food products. This upward preference for domestic goods, considerably present in large trade units, has led to trading goods at more moderate producer costs, with lower prices than import ones, particularly for foods.

Latest developments in inflation, other real-economy indicators, the labour market and costs, do not transmit any risk signals for existence of stable inflationary pressures in the economy. Also, the statistical high base effect of comparison shall be present, but downward in 2012 H1.

Chart 5 Annual inflation (in %)

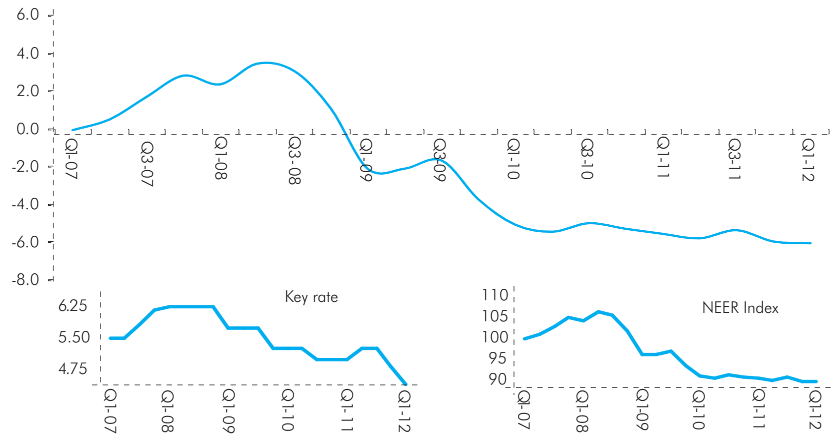


Source: INSTAT and Bank of Albania

Assessments of current and expected macroeconomic and macro-financial framework, which attests to low inflationary pressures, below-potential expected growth and moderate exchange rate volatility have oriented the Bank of Albania's monetary policy decisions. Along with the key interest rate cut, the Bank of Albania has injected liquidity by employing reverse repurchase auctions of 1-week and 3-month maturity at variable prices and fixed amount. The repurchasing interest rates were close to key interest rate, with minimum volatility and without identifying any pressures for liquidity increase.

Easing monetary conditions and improved liquidity in the banking system were reflected in the short-term money market segment. Interbank lending interest rates followed the key interest rate cut. On the other hand, its reflection in ALL-denominated deposit and loan interest rates appeared incomplete due to the time lag of monetary transmission mechanism and the still high risk premiums in financial markets. In particular, government securities market was under the pressure of higher reluctance by banks, in response to developments in international market, higher regulatory capital requirements, and tight prudential rates from international regulators. This development was reflected in the upward trend of government security interest rates, hence affecting the private sector credit interest rates when indexed into these instruments. The tightening of lending standards that characterised this sector has reflected the uncertainty surrounding the economic outlook at home and the economic and financial problems in Europe. On average, ALL-denominated loan interest rates resulted lower than a year earlier, but their response to easing monetary conditions was sluggish. Monetary Conditions Index in the economy has trended down since 2011 Q3.

Chart 6. Monetary Conditions Index (MCI)*

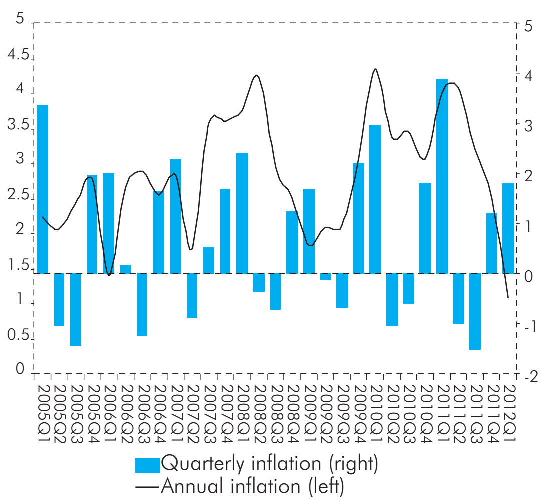


*The MCI is constructed using the performance of the key interest rate and the nominal effective exchange rate. In this series, an increase in the NEER implies exchange rate appreciation. In the MCI, an increase in this index implies tightening monetary conditions.

Source: Bank of Albania

III.2 INFLATION BY ITEMS

Chart 7 Annual and quarterly inflation (in %)



Source: INSTAT and Bank of Albania

Prices of goods and services were characterised by a declining inflation of some main items over 2012 Q1. Food prices, in particular unprocessed food prices and regulated prices, determined the low rate of headline inflation. The gradual decline in food prices, driven by the performance of prices in international markets, the domestic agricultural production and the stable exchange rate, reversed the annual inflation trend. On the other hand, non-food consumer goods inflation increased during this quarter, mainly due to oil price rise. Other items that have a lower share provided a low contribution to annual inflation rate.

Foods, which share about 43% of the CPI basket, contributed by only 0.1 percentage point to the formation of headline inflation, 2.8 percentage points lower than in the previous year. The changed direction of these goods' prices, compared with some previous months, reversed the pronounced rising price trend that characterised the period February 2011-July 2011.

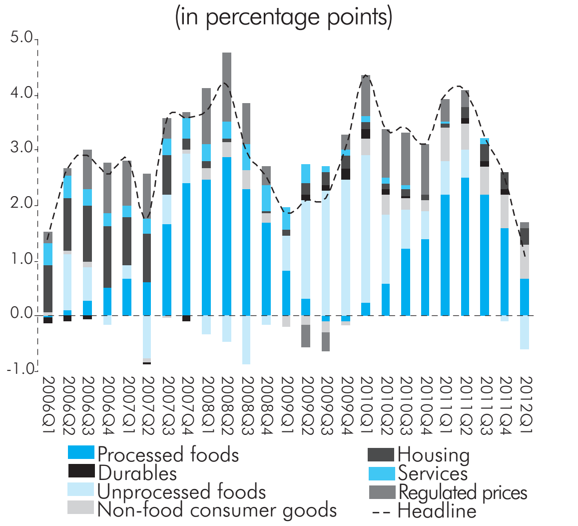
Processed food prices were stable, displaying a different performance from the same period of the previous year. This item's annual inflation was 9.6% in the previous year, falling to 2.9% during the current year. Therefore, its contribution to headline inflation fell to 0.7 percentage point in 2012 Q1, from 2.2.percentage points in the previous year. The further decline owed to gradually diminishing effect of grains price rise in international market. At end-quarter, the contribution of this sub-item descended to 0.1 percentage point, from 1 percentage point in July 2011. First quarter's end also highlighted a cancelling-out effect of the previous year's excise price rise for several goods. This effect resulted 0.4 percentage point. Also, an important factor determining the performance of this item's inflation is the stability in exchange rate appreciation, which has mitigated the pressures over merchandise import prices.

Unprocessed food inflation recorded a negative annual rate. This item's contribution to headline inflation was -0.6 percentage point, from +0.6 percentage point in the previous year. The related inflation was substantially influenced by fruit and vegetable prices. Though being upward, it was below its peak in the same period a year earlier.

Regulated prices contributed only 0.1 percentage point to headline inflation due to a higher water price in some districts of the country (particularly in Tirana) over February. This item's contribution, which had been substantially positive in the past, was minimised throughout 2011 to first months of 2012 due to unchanged electricity price for about two years.

Non-food consumer goods inflation increased in 2012 Q1, compared to 2011 Q4. Annual inflation was 3.0%, the peak in past five years, generating a considerable contribution to formation of headline inflation. This item's inflation reflected not only the oil price rise in domestic and international markets, but also the imposing of a two-stage fuel road tax. In this item, vehicle insurance price also rose significantly.

Chart 8 Key item contribution to annual inflation (in percentage points)



Source: INSTAT and Bank of Albania

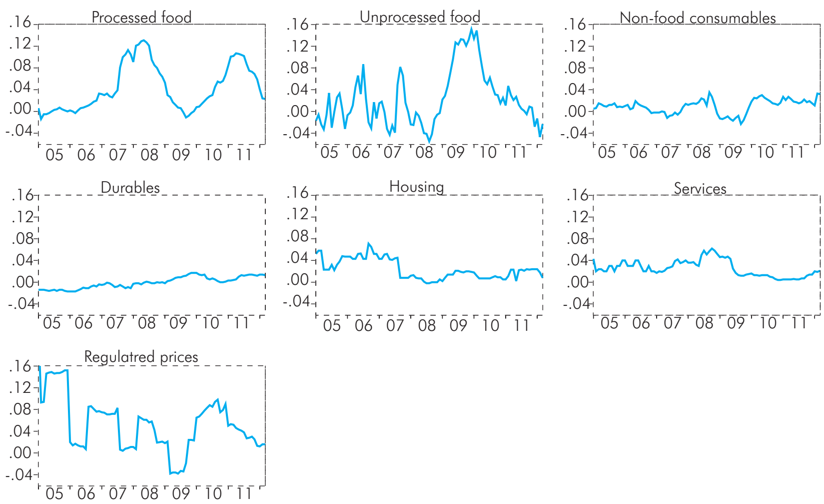
Table 4 Annual key item contribution to annual inflation (in percentage points)

	Q4-09	Q1-10	Q2-10	Q3-10	Q4-10	Q1-11	Q2-11	Q3-11	Q4-11	Q1-12
Unprocessed foods (pp)	-0.1	0.3	0.6	1.1	1.4	2.2	2.5	2.2	1.6	0.7
Bread and grains (pp)	-0.3	-0.2	-0.1	0.1	0.4	0.7	1.0	0.8	0.5	0.2
Alcohol and tobacco (pp)	0.2	0.1	0.2	0.2	0.2	0.5	0.4	0.4	0.4	0.1
Unprocessed food (pp)	2.5	2.6	1.3	0.9	0.5	0.6	0.5	0.0	-0.1	-0.6
Fruit (pp)	0.6	0.2	0.1	0.3	0.1	0.2	0.4	0.2	0.3	0.3
Vegetables(pp)	1.0	2.0	1.5	0.1	-0.7	0.1	-0.4	-0.6	-0.7	-1.2
Services (pp)	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.1	0.0	0.0
Administered prices (pp)	0.3	0.7	0.9	1.0	0.9	0.4	0.3	0.1	0.0	0.1
Fuels and energy (pp)	-0.1	0.4	0.4	0.4	0.4	0.2	0.3	0.2	0.1	0.0
Housing (pp)	0.2	0.1	0.1	0.1	0.1	0.2	0.3	0.3	0.3	0.3
Non-food consumer goods	-0.1	0.3	0.4	0.3	0.2	0.6	0.5	0.4	0.6	0.6
Durable consumer goods (pp)	0.2	0.2	0.1	0.0	0.0	0.0	0.1	0.1	0.1	0.0
Consumer Price Index (y-o-y, %)	3.1	4.3	3.4	3.4	3.1	4.0	4.1	3.2	2.5	1.1

Source: INSTAT and Bank of Albania.

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

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



Source: INSTAT and Bank of Albania

III.3 MAIN INFLATION TRENDS

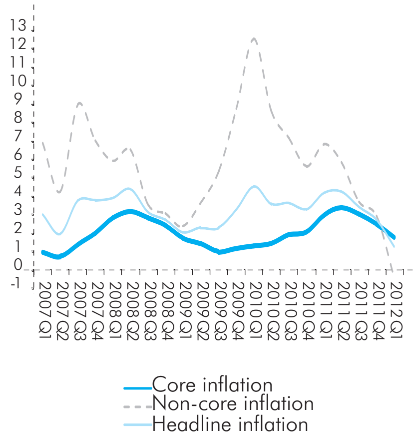
The sharp downward trend of inflation in 2012 Q1 was driven by rapid reduction of external inflationary pressures and the markedly diminishing effect of factors with a short-term impact on inflation. Annual core inflation[3], as the least volatile component, fell in January-March 2012, albeit within a narrow band of values. It averaged 1.8% in 2012 Q1, from 3% in the previous year. The gradually subsiding effect of bread and grains price rise, the high base effect of comparison with the previous year and the stable exchange rate mitigated the persisting inflationary pressures on the domestic economy. The core inflation contributed by 1.2 percentage points to annualised CPI increase, thus helping in maintaining low positive headline inflation rate during this quarter[4].

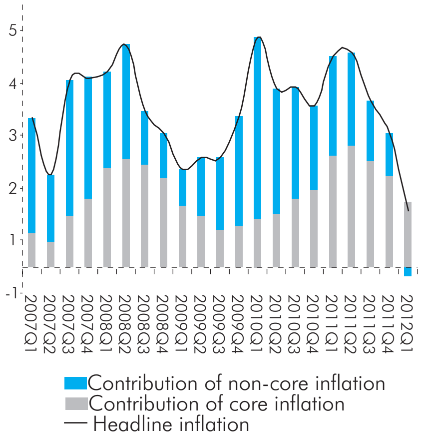
[3] *The average of two measures: permanent exclusion and trimmed mean, which were 2% and 1.4%, respectively.*

[4] *A year earlier, its contribution was about 2.1 percentage points.*

The low annual inflation rate in 2012 Q1 was triggered by a considerably downtrend of the short-term or non-core inflation component. For the period under review, it resulted -0.6% y-o-y, reaching a historically low rate in the last decade. The highest downside shock was observed in February, when the non-core inflation was -2.2%. Its shifting from positive to negative values over the last four months was mainly driven by the high volatility in vegetable prices, whose fall considerably exceeded the expected high base effect of comparison (down by more than 4 percentage points). Along with foregoing development, this quarter also highlighted the expectedly subsiding effect of the previous year's excise price rise, whereas water price rise impacted less than expected on the increased regulated prices index. The above-mentioned effects, whose outcome is translated into short-term inflation constituents, contributed to reducing the overall annual inflation to -0.1 percentage point in 2012 Q1.

Chart10. Annual core and non-core inflation rates (left) and their respective contributions (right)





Source: INSTAT and Bank of Albania

The national currency appreciation during October 2011March 2012, along with the receding annual increase in international food prices, mitigated the inflationary pressures, particularly those originating from abroad. Consequently, imported inflation made a considerably lower contribution to headline inflation. Annual inflation of tradable goods sector of the CPI basket was low during 2012 Q1 (0.4%), notably below its historical average over the past five years[5]. Hence, it contributed marginally to headline inflation formation (by 0.25 percentage points).

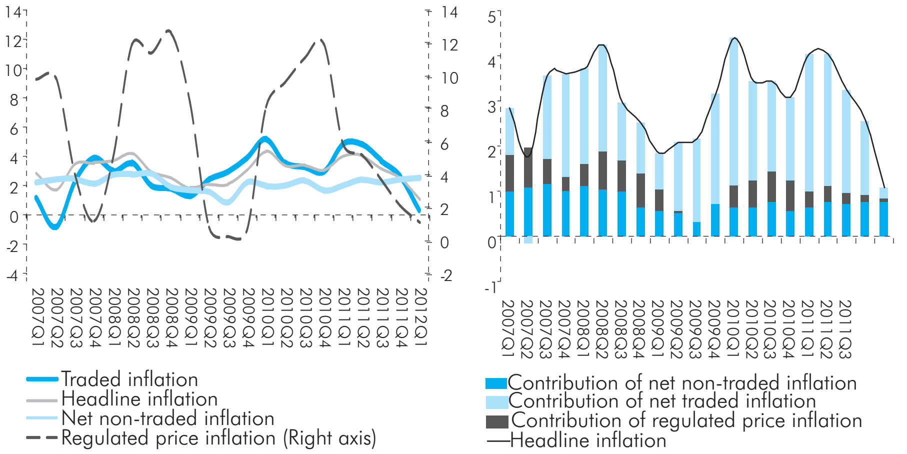
Net non-traded inflation[6] for the quarter under analysis was 2.5%, showing a downward trend during these months. As a result, this sector's contribution was 0.78 percentage point to the formation of headline inflation, exceeding that of the tradable sector, after about 5 years. The remainder of inflation,

[5] *The low level of the CPI basket sector in 2012 Q1, was affected by its negative value in February (-0.3%). The negative figures in time series of traded inflation and respective contributions were last seen in mid-2007. The annual inflation of tradable sector of the CPI basket resulted 3%.*

[6] *Excluding the regulated prices effect (electricity, water and hospital services bills).*

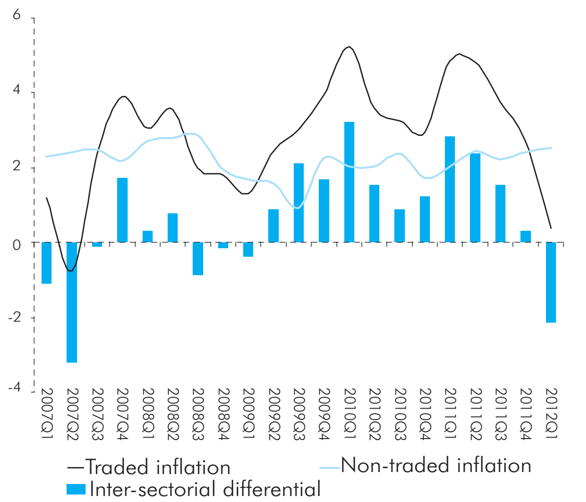
almost negligible, was formed by the regulated price sector of the basket, for the effect of water bill price rise.

Chart11. Annual inflation by sector (left) and respective contributions (right)



Source: INSTAT and Bank of Albania

Chart 12 Inter-sectoral inflation differential



Source: INSTAT and Bank of Albania

The pronounced downward inflation trend in 2012 Q1 was determined by rapid decline in externally-generated inflationary pressures, while internal factors and exchange rate provided a relatively stable effect.

The above developments show that the inter-sectoral inflation differential not only continued narrowing, but also reversed, from slightly positive in 2011 Q4 to negative in 2012 Q1 (-2.1 percentage points). This indicator was 2.8 percentage points in the previous year. As a qualitative and real-time proxy of imported inflation, it has contributed to reducing headline inflation by -0.53 percentage point. At the same time, domestic inflation, including regulated price one, provided a positive contribution by 1.6 percentage points to the formation of annual headline inflation over 2012 Q1[7], or about 0.4 percentage point higher than the contribution provided by core inflation.

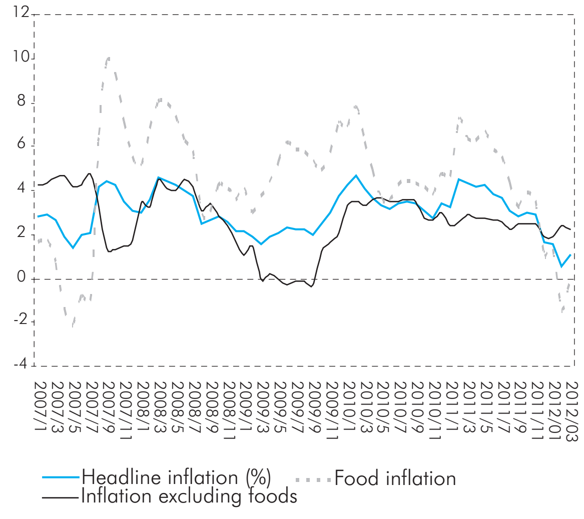
[7] Respective contributions in 2011 Q1 were 2.4 and 1.6 percentage points.

Box 1 Price volatility and monetary policy

Central banks that have price stability and maintaining of low positive inflation rates as their primary strategic objective, should consider factors impacting on inflation over the medium-term horizon, when compiling their monetary policy. Also, when making decisions and employing monetary policy instruments, central banks do not generally respond to transient factors, which usually subside within one calendar year. The essence of this consideration is that a central bank can not exert its control in the short run and should not, therefore, respond to consumer price volatility. Central banks bear responsibility for that part of inflation stemming from the impact of relatively stable factors that are constantly driven by the demand, unlike the developments that relate to temporary price increases and that are driven by supply-side transient factors or administrative decisions.

Inflation rate developments in early 2012 signal that the key factor to its formation was the high food price volatility, with a considerable share in the CPI basket. Headline inflation descent to minimum annual rates during this period was mainly driven by the negative contribution of foods and by the low or zero values of other basket components' contributions. Hence, quarterly inflation rate was 1.1%, almost 3.0 percentage points lower than the previous quarter's 4.0%. This rate was mainly driven by the fall in food price inflation. Excluding this item, inflation for 2012 Q1 would result close to 2%. A year earlier, inflation excluding food price inflation resulted close to 2% (while headline inflation resulted 4%). Both rates show that, excluding food price effect, inflation was stable (around 2%).

Chart 13 Headline inflation and its components



Source: INSTAT and Bank of Albania

This estimation shows that inflation is not a concern to monetary policy, only when headline inflation is driven by temporary supply-side shocks. This analysis is supported by the fact that the high share of foods in the CPI basket[1] produces a relatively high volatility in prices as long as food prices are more volatile, both in domestic and international market. Our monetary policy does not intend to respond to supply shocks, except when they bring about non-anchoring of inflationary pressures. In this context, a basket of less volatile prices would help monetary policy in communicating with the public, since it would reduce the short-term noise in inflation.

The Bank of Albania's decision-making over the period under review was conditioned by the fact that the situation of the demand-side inflationary pressures was dissimilar during the first two quarters of the past two years. A year earlier, inflation was high due to higher externally-generated inflationary pressures, higher prices for food, oil and primary commodities in international markets, as well as the exchange-rate depreciation and some recovery trends of the domestic demand. These inflationary shocks led to higher inflation expectations and the Bank of Albania responded by raising the key interest rate. During the current year, inflation fell below the Bank of Albania's target band due to low inflationary pressures from both demand and supply, economic agents' downward inflation expectations, hence diminishing the degree of materialisation of second-round effects from consumer prices in the economy. Based on latest developments and projections of macroeconomic indicators, the Supervisory Council of the Bank of Albania decided to cut the key interest rate twice during this year, bringing it down to *historical low of 4.25%. This move aimed at establishing appropriate monetary conditions to meet inflation target in the medium run and substantially boost future consumption and demand for money by the public and private sectors.*

[1] *The share of food items in the CPI basket is relatively high (about 43%); however, due to its revising, it has been downward.*

IV. MACROECONOMIC DEVELOPMENTS AND IMPACT ON INFLATION

Albanian economy grew by 3.8% in 2011 Q4, resulting in 3.1% growth for 2011. Despite this growth, aggregate demand was insufficient to fully use productive capacities of the economy. Unemployment rate picked up slightly in Q4. Below-potential growth of the economy was materialised into dampened pressures on increase in wages and other costs of production. On the other hand, downward inflationary pressures from international markets and the national currency's relative stability were translated into low increase in imported inflation. Against this backdrop, inflation deepened the downtrend in 2012 Q1.

Current and expected monetary conditions reveal that inflationary pressures from aggregate demand will remain weak during the current year. Economic agents' expectations on inflation remain anchored around Bank of Albania's target.

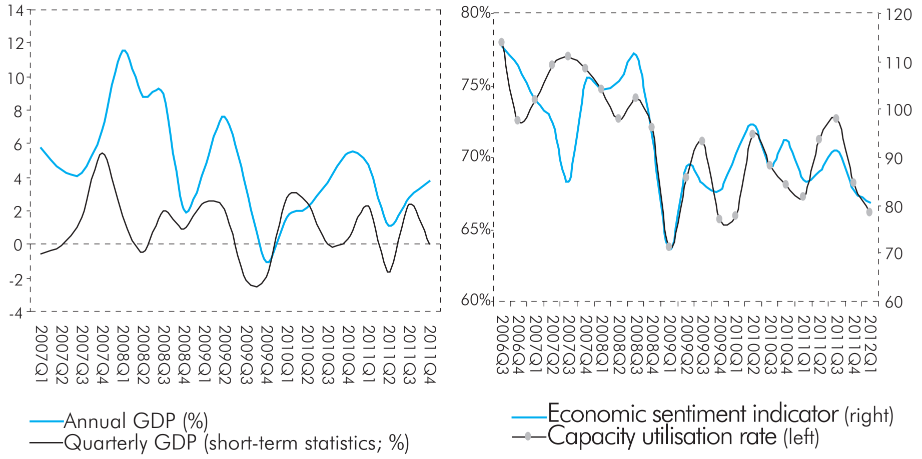
IV. GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

Albanian economy continued the decelerated trend observed over the past two years. According to preliminary data from INSTAT[8], annual GDP growth is 3.1%. External demand continued to sustain the economic growth, though at a lower rate than in 2010. On the other hand, domestic demand was contained and its contribution to economic growth resulted in uneven intensity across quarters, reflecting mainly the fiscal stimulus concentration.

The economic activity, after having hit the lowest growth rate by 1.1% in 2011 Q2, expanded progressively in Q3 and Q4, by about 2.8% and 3.8%, respectively. Despite the decelerated economic growth abroad, the net export volume accelerated its growth rate in Q4, providing a higher contribution to aggregate demand growth over this period. On the other hand, domestic demand components increased the dynamism over this quarter due to consumer demand recovery and added contribution made by the public sector to investments. The analysis of economy sectors depicts a higher contribution by services sector to economic growth in Q4, while the contribution by production sector was negative.

[8] *Output analysis by sectors of the economy addresses developments in the economy as at 2011 Q4, based on INSTAT's latest publications on "Quarterly gross GDP, publication on 2011 Q4", April 2012. According to this publication, the data for 2009 are not definitive; the data for 2010 are preliminary and the data for 2011 are flash. The publication includes not only data on quarterly gross GDP for 2011 Q4, but also the series revising for the first three quarters of 2011.*

Chart 14 GDP (annual and quarterly change, left); economic sentiment indicator and capacity utilisation rate (right)



Source: INSTAT and Bank of Albania

Indirect quantitative[9] and qualitative data, assessments and projections for developments in the country and abroad show that economic growth was slow in 2012 Q1, in line with its historical trend. The economic situation abroad, particularly in the euro area, creates an unfavourable external environment for Albanian export growth. Uncertainties around the economic growth, slow income growth, and relatively tight credit standards may negatively affect consumption and investments. On the other hand, fiscal agents' behaviour in line with the budget deficit objectives will restrict the fiscal stimulus and domestic demand in the short run. Favourable financial market developments affected by easing monetary policy are expected to create appropriate conditions for supporting private consumption and investments in the economy.

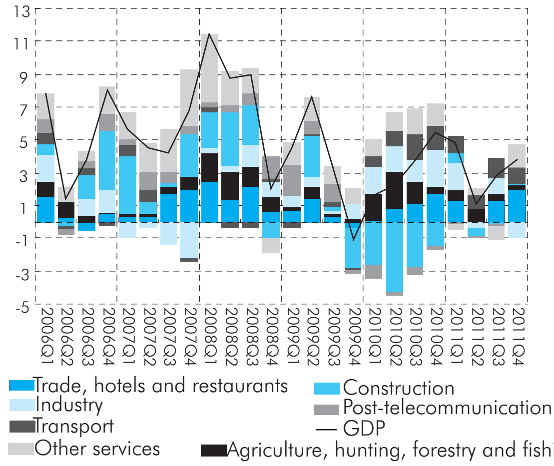
IV.1.1 OUTPUT BY SECTORS

GDP expanded by 3.8% y-o-y, in 2011 Q4, accelerating the pace of growth recorded a quarter earlier[10]. The services sector provided the major contribution by 4.4 percentage points to annual GDP growth. Agriculture, hunting, forestry and fishing, and construction also positively contributed by about 0.4 percentage point to economic growth. However, annual decline in the value-added of electricity, gas and water supply branch was translated into a negative contribution by the industrial sector and as a consequence, into a negative contribution by 0.5 percentage point of the manufacturing sector to annual GDP growth.

[9] *In 2012 Q1, credit to economy continued the slowdown having started since 2011 Q4. Also, VAT revenues indicate a lower economic activity in Q1. The value of merchandise imports recorded a low annual growth, by 1.85% over the first two months of 2012.*

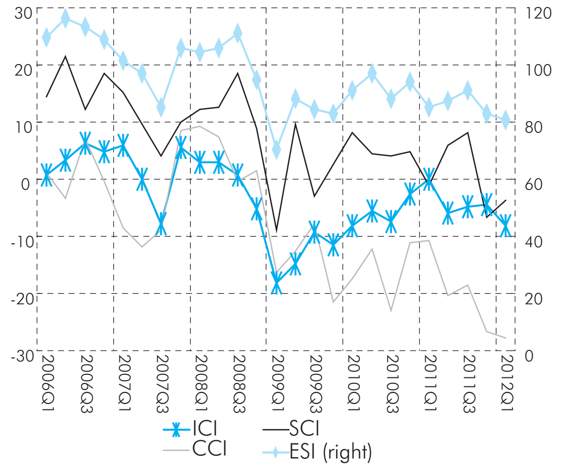
[10] *Also, based on a quarterly comparison, GDP for 2011 Q4 has resulted slightly higher, by about 0.1%, from 2.4% in 2011 Q3. Quarterly changes in GDP and value-added by branches have taken into account the seasonally-adjusted series based on INSTAT's latest publication: "Quarterly GDP, publication for 2011 Q4", April 2012.*

Chart 15 GDP (annual change, in %) and sectoral contribution (in percentage points) to annual GDP



Source: INSTAT and Bank of Albania

Chart 16 Economic sentiment indicator (long-term average = 100), industry, construction and services confidence indices (in balance, seasonally adjusted)

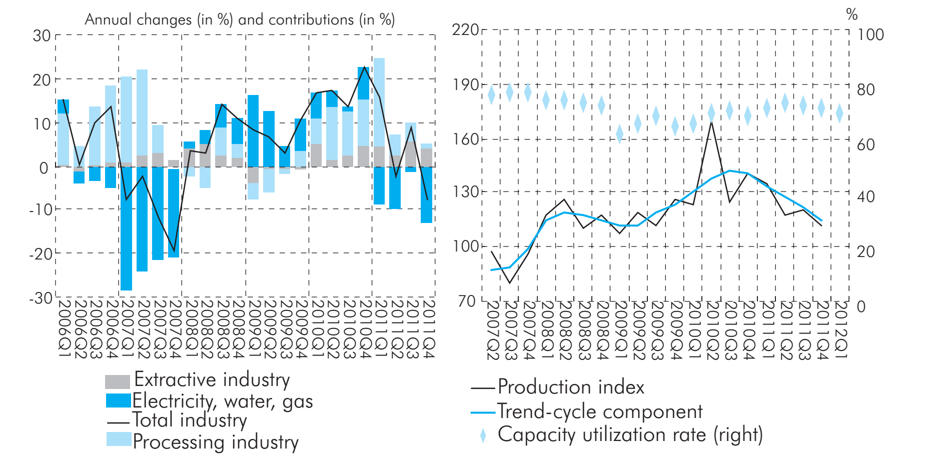


Source: INSTAT and bank of Albania

As regards domestic economic developments in 2012 Q1, confidence indicators signal a likely slowing economic activity. Though the level of the services confidence index has increased, the assessment of overall economic situation[11] for 2012 Q1 is more negative in terms of the dynamics of industry and construction sectors.

Value-added of industrial activities contracted sharply in 2011 Q4. More specifically, the value-added of the industrial sector was down by 7.8% on a year earlier and down by 5.8% on a quarter earlier. The exacerbation of the industrial sector reflected mainly the annual decline in economic value-added of electricity, gas and water supply branch, which contributed negatively by 13.0 percentage points to this sector's annual value-added.

Chart 17 Industrial sector, value-added and contributions by sub-branches (left); production index, its trend-cycle index* and capacity utilisation rate (right)

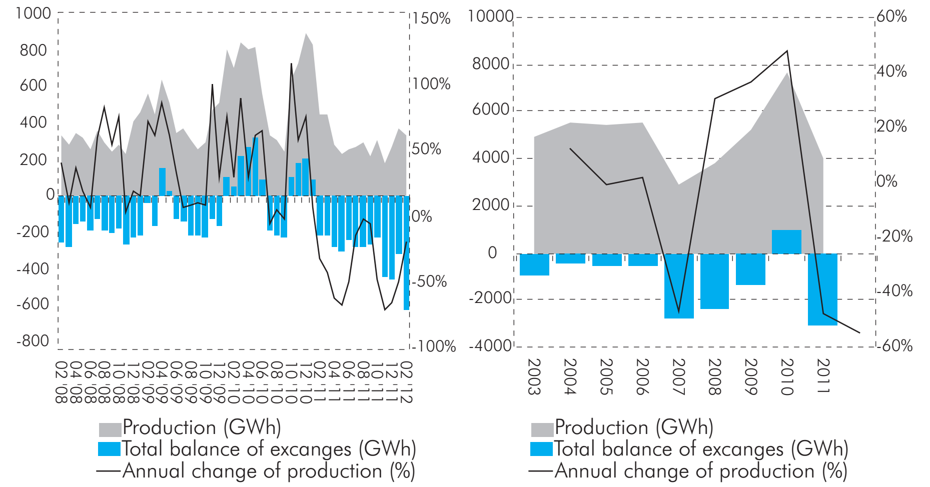


*Estimation of the trend-cycle component for the industrial production index and construction output index has been seasonally adjusted according to X-12 technique.
Source: INSTAT and Bank of Albania.

[11] *In 2012 Q1, the economic sentiment indicator fell by 2.5 percentage points on a quarter earlier, remaining 19.2 percentage points below its long-term average.*

Electricity production in 2011 Q4 declined by about 66.4% y-o-y, mainly as a consequence of decreased electricity generation from large-scale hydroelectric power stations. Overall, in 2011, the electricity production level fell progressively. The latest data show that during the period January-February 2012, the electricity production fell further by about 44.6% y-o-y. Total electricity exchange balance for the year-start resulted negative, to about -934.1 GWh. This balance was about -110.5 GWh in the same period a year earlier.

Chart 18 Main energy balance indicators, monthly data (left); 11-month cumulative data (right)



Source: AEC and experts' calculations

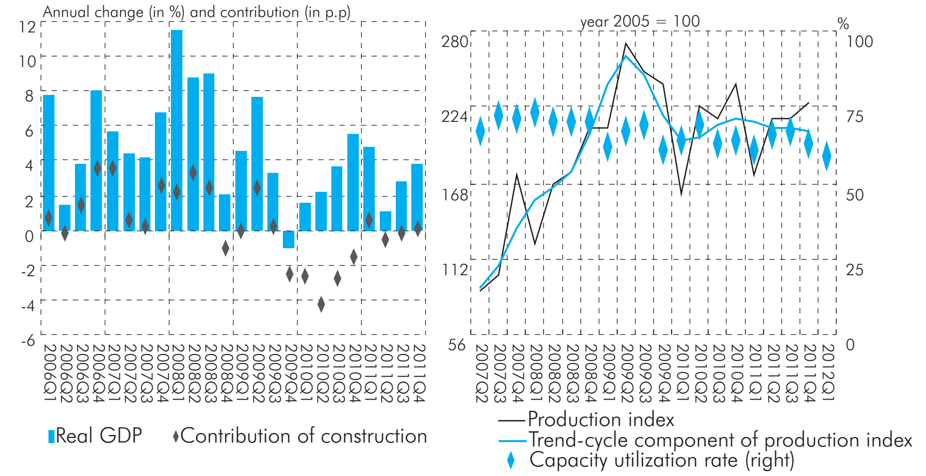
On the other hand, extractive and processing industry branches reflected positive upward growth of production index and turnover volume index, notwithstanding the decelerated value-added growth. The value-added in extractive industry increased by 38.2% y-o-y, while the processing industry increased by 1.5%, y-o-y.

In 2012 Q1, the decline in survey qualitative indicators[12] depicts the likely non-positive developments of activity in the industrial sector compared to the previous quarter.

Following the decline in 2011 Q2 and 2011 Q3, the construction index slightly improved in Q4. This sector's value-added as a share of GDP increased by 1.2% on a year earlier and contracted by 2.6% on a quarter earlier. The building permits indicator, which generally precedes developments in the construction sector, increased by 10% in 2011 Q3. Referring to this indicator's data disaggregated by type of constructions in the country, the higher number of issued building permits is mainly attributed to residential constructions.

[12] *Referring to survey indicators on orders, demand assessed by businesses, financial position and capacity utilisation rate in the industrial sector.*

Chart 19 Construction sector. Sectoral contribution to annual GDP (left); production index, its trend-cycle component and capacity utilisation rate (right)

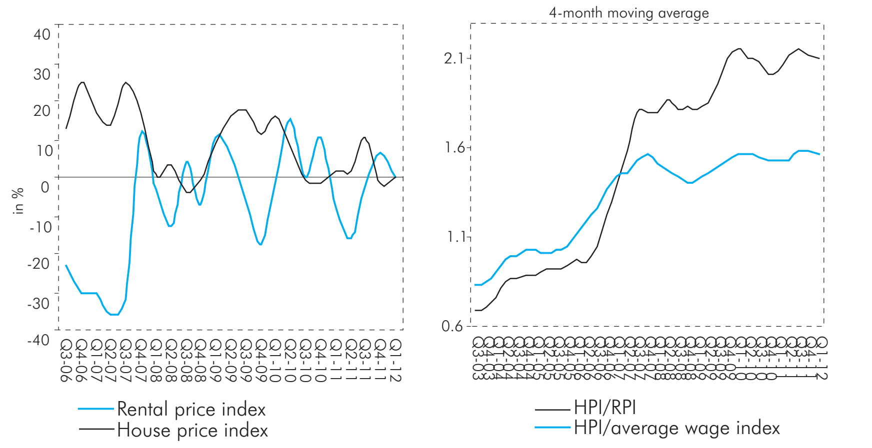


Source: INSTAT and Bank of Albania

Box 2 House price index and rental price index in Tirana, in 2012 Q1

In 2012 Q1[1], the house price index fell by 0.8% in real terms, in Tirana. The annual change in this index was -3.8% in 2011 Q4. Developments in this index during the last two quarters resulted in a slightly decreased price-to-rent ratio and price-to-average wage. The real annual increase in the rental price index during the last two quarters also contributed to the first ratio's decline.
House price index was determin ed by the sluggish demand for home purchases.

Chart 20 Annual change of house price index and rental price ratio



Source: Bank of Albania

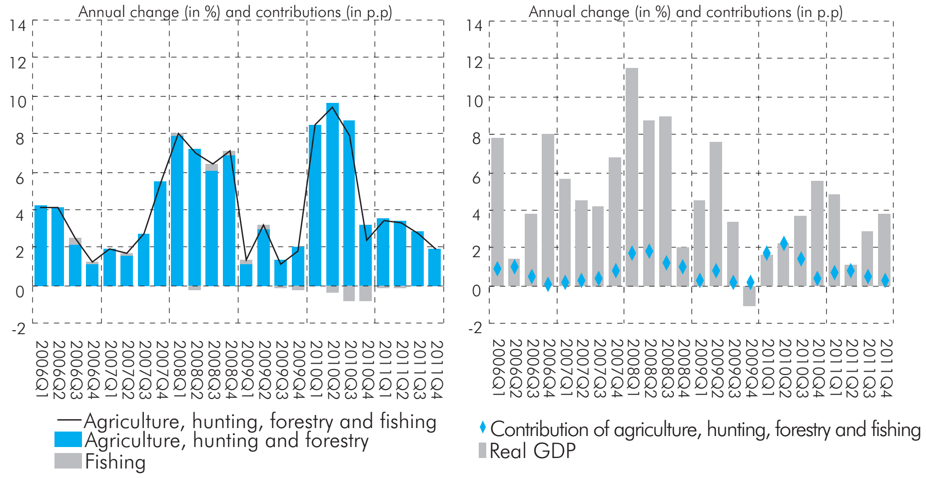
Information obtained from confidence surveys shows that construction businesses have reported a weak demand for construction over the past three years. Information obtained from bank lending activity also attests to decreased demand for home purchases. More specifically, households' demand for home purchase loans has been downward since 2011 Q1. On the other hand, based on construction confidence survey, construction sector inventories suggest a low likelihood for further house price reduction.

[1] House price index is constructed on the basis of announcements at "Çelesi" newspaper, starting from 1998. It includes information only for Tirana.

In 2012 Q1, the decreased construction confidence index on a quarter earlier signals a possible deterioration of this sector[13].

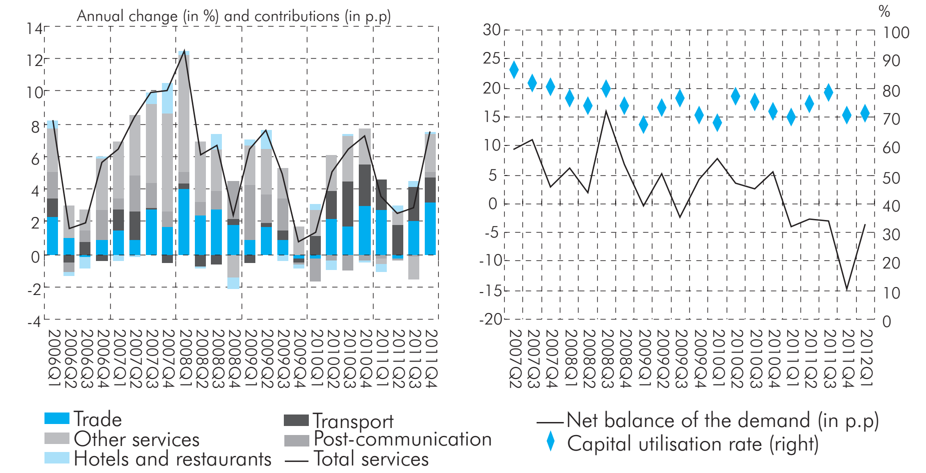
The value-added of domestic production from agriculture, hunting, forestry and fishing slowed down the 2011 positive rates. In 2011 Q4, the value-added expanded by 1.9% y-o-y, about 1.8 percentage points below the average historical rate for 2005 Q1 - 2011 Q3. The value-added of these activities increased by 0.9% q-o-q, a comparable rate to historical average.

Chart 21 Agriculture, hunting, forestry and fishing; value-added and contributions by sub-branches (left); sectoral contribution to annual GDP (right)



Source: INSTAT and Bank of Albania

Chart 22 Services sector. Value-added and contributions by sub-branches (left); demand and capacity utilisation rate (right)



Source: INSTAT and Bank of Albania

In 2011 Q4, the value-added of the services sector was 7.5% higher than in the same period a year earlier, or about 1.8 percentage points higher than the historical average for 2005 Q1 - 2011 Q3. On a quarter earlier,

13 *According to survey result, construction orders and capacity utilisation rates also declined, while the business demand and their financial position resulted more improved than in 2011 Q4.*

the value-added of services increased by 1.8% as a ratio of GDP, though remaining lower than the 2.7% quarterly rate recorded in Q3.

The more accelerated performance of the services sector in 2011 Q4 is mainly attributed to the dynamics of trade and other services[14]. More specifically, trade activities contributed to annualised growth of quarterly GDP by 1.8 percentage points, whereas other services by 1.3 percentage points. In the quarter under review, the value-added of trade branch increased by 9.7% y-o-y, significantly influenced by the wholesale trade[15]. At the same time, other services generated a 5.4% higher value-added in the economy than in the same quarter a year earlier, slightly exceeding the 5.2% long-term historical average. A detailed analysis on branches included in other services highlights that activities related to real estate, leasing and services to businesses have generated the highest contribution (by 5.7 percentage points) to annual value-added growth.

The value-added of transport branch decelerated the upward growth rate to 15.4%; however, it remained above the 8.5% historical growth rate. Positive developments in the air transport, auxiliary transport services and travel agencies[16] appear to have affected the overall performance of the branch. In 2011 Q4, the post and telecommunications branch also recorded positive growth rates, following the contraction having been recorded since end-2009. More specifically, the value-added of post and telecommunications as a ratio of GDP grew by 3.8% y-o-y and 3.3% q-o-q.

The latest qualitative data from business surveys show improved activity of the services sector in 2012 Q1.

IV.1.2 AGGREGATE DEMAND COMPONENTS

In 2011 Q4, aggregate demand conditions appeared improved, as also evidenced by the accelerated annual growth of gross domestic product. External demand increased its contribution to aggregate demand growth. Despite the unfavourable external economic environment, the volume of exports of goods and services strengthened the annual growth rate. On the other hand, the volume of imports shrank, resulting in an increased contribution of net exports. The more dynamic economic growth in this quarter was also supported by the recovery of the domestic demand, mostly formed by a positive public sector impulse in public investments.

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[14] *Branches included in other services, are: financial and monetary intermediation; real estates; renting and business-related activities; public administration, protection, social contributions; education; healthcare and other social activities; other collective, social and individual services.*

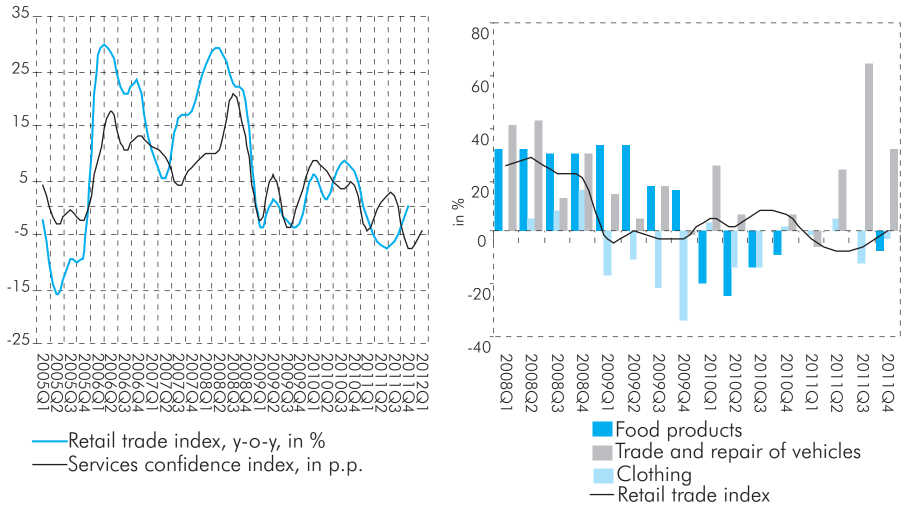
[15] *Turnover index of the wholesale trade volume increased by 10.4%y-o-y in 2011 Q4, exceeding the 7.5% long-term historical average.*

[16] *Air transport, auxiliary transport services and travel agencies generated a higher turnover index, 30.1%, 9.1% and 18.1%, respectively, on an annual basis.*

Partial data on 2012 Q1 support the assessment of slow economic growth in this quarter. Macroeconomic determinants of private consumption and investments (employment, future expectations, confidence level and credit conditions) show a restrained growth of domestic demand, against the background of fiscal agent's cautious stance. However, stimulating monetary conditions and financial assets accumulated over the preceding periods are sustainable sources expected to support increased consumption and private investments during this year. Exports dynamics is expected to decelerate, conditioned by the external demand outlook.

Private consumption appears to have slightly recovered in 2011 Q4, following the weak performance observed over the first three quarters of the year. Indirect quantitative and survey indicators attest to increased consumer spending in 2011 Q4. Real annual change of consumer goods imports was up 7.6%, unlike the negative rates recorded in the first three quarters of 2011. Annual change in the retail trade index also evidenced the same dynamics. Following the annual decline over three consecutive quarters, the level of this index rose by 0.2% in 2011 Q4. However, this change is below the 10.6% historical average of the annualised fourth-quarter changes. Detailed records on retail trade index show that households have decreased their spending for food and clothes but have significantly increased it for long-term durable goods. Qualitative data from consumer confidence survey confirm the same trend. Large purchases included in consumer confidence index improved significantly in 2011 Q4. Also, the confidence survey on trade shows improved confidence in 2011 Q4.

Chart 23 Indirect indicators of private consumption indices

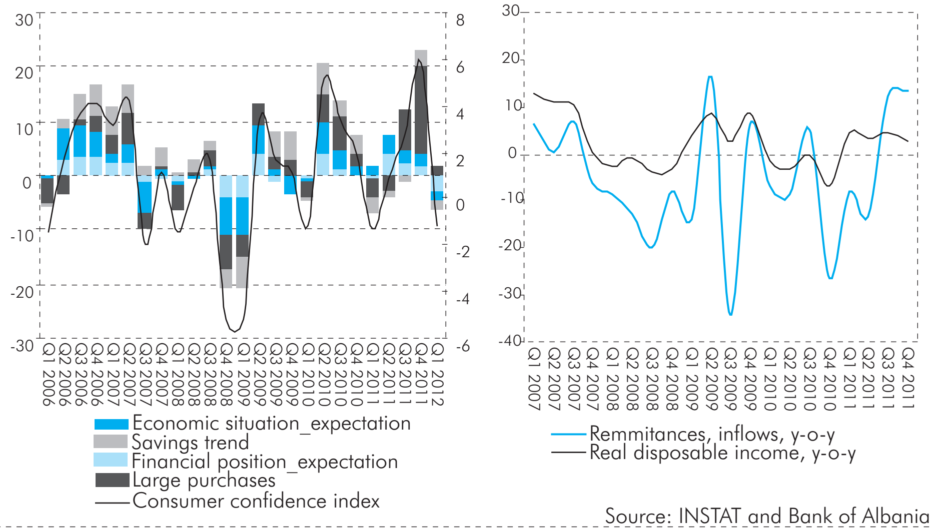


Source: INSTAT and Bank of Albania

Private consumption continued to be supported by disposable income in 2011 Q4. The disposable income index grew by 2.5% y-o-y, in this quarter, following the slowing trend noted after 2011 Q2. Although wage income picked up in Q4, it resulted downward when deflated with the CPI index. Remittances from abroad contributed positively to increasing private consumption, which was also supported by consumer loan growth in 2011

Q4. The propensity to save, which was upward in the first three quarters of 2011, slowed in 2011 Q4.

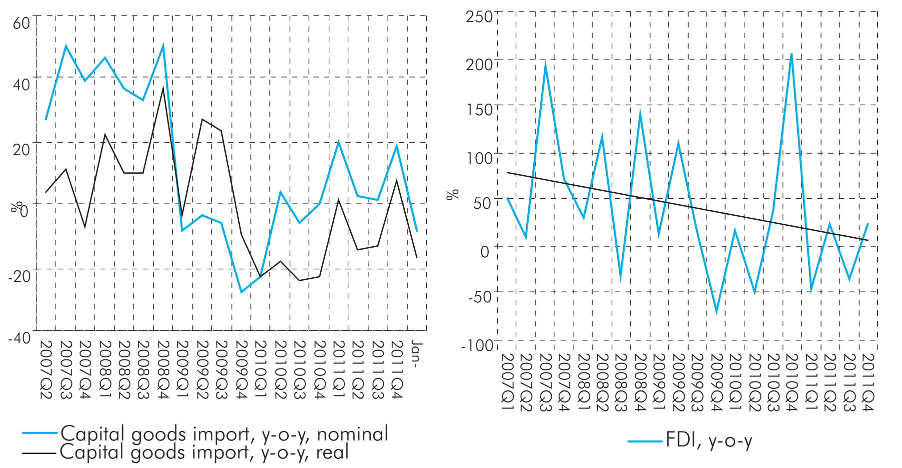
Chart 24 Consumer confidence index (deviations from the long-term average) and indirect consumer financing indicators



Source: INSTAT and Bank of Albania

The latest data from indicators used as proxies for private consumption, as well as from surveys, show a weak consumer spending over 2012 Q1. Foreign trade data show increased imports in consumer goods over the first two months of 2012 (up 6%, y-o-y). However, survey indicators suggest decline in large-amount purchases due to overall decreased consumer confidence and poor employment performance.

Chart 25 Quantitative indicators of private investments

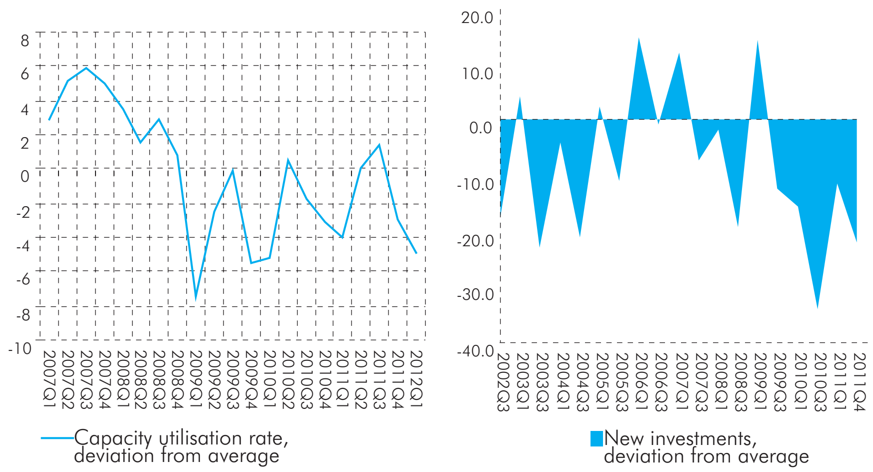


Source: INSTAT and Bank of Albania

The macroeconomic environment over 2011 did not stimulate private investments. Their low level is mainly attributed to demand-side factors. High uncertainty surrounding the economic outlook and low capacity utilisation conditioned businesses' new investments. Public investments carried out over the fourth quarter positively stimulated the growth of private investments in the economy over the same quarter. Other indicators also attest to positive developments of this component at year-end. After falling by about 13.2% in 2011 Q3, the import of capital goods rose by 7.7% in Q4, in real terms. Also, total issued building permits for residential and engineering constructions, which usually precede increase in construction sector investments with a several-month time lag, recorded quarterly growth over the third quarter. The same trend was also confirmed by foreign direct investment inflow (by 25%) in the fourth quarter.

Qualitative indicators of confidence surveys show a slower performance of private investments in the economy during 2011. Based on business confidence survey conducted in 2011 Q4, the balances for estimating the investments level for the last six months deteriorated in services and construction relative to the previous period. At the same time, the balance of investments in the industrial sector improved slightly.

Chart 26 Qualitative indicators of private investments



Source: Bank of Albania

Investment business loans slowed in the fourth quarter, reflecting the slowing qualitative demand and the banks' cautious stance in lending. On the other hand, survey data show tightening standards and exacerbating financial position of businesses.

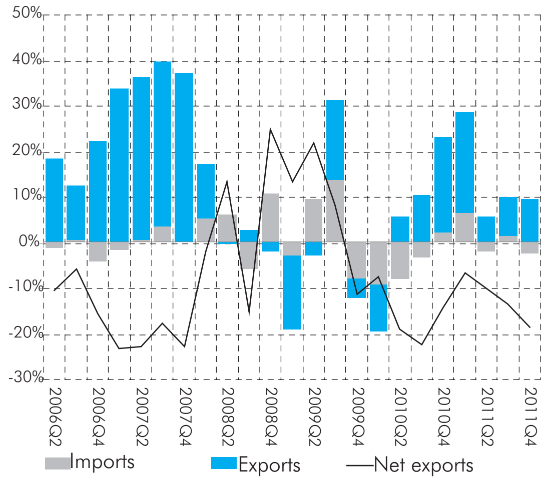
Based on preliminary data, private investments contribution to aggregate demand fell in 2012 Q1. Imports of capital goods fell by 16.6% y-o-y, in January-February 2012. Uncertainties surrounding the economic outlook and restricted financial sources (loans and financial position of businesses) will condition the private investments development during the current year.

IV.1.3 EXTERNAL DEMAND AND FOREIGN TRADE

Performance of indicators on the external sector of the economy, in real terms, reflected the narrowing net export deficit[17] in 2011 Q4, as compared to the previous year. The narrowing net export deficit was a consequence of decreased import of goods and services, down by 2.5% in real terms, and increased exports, up by 9.6% in real terms. The real-term trade balance was influenced by the decelerated to decreased performance of all constituents of this indicator.

Developments in the balance of import and export of goods and services, in real terms, have been materialised into increased positive contribution, hence increased aggregate demand for this period. Compared with a year earlier, this contribution decreased, as a consequence of economic growth slowdown in the country and abroad.

Chart 27 Annual performance of trade balance and main items in real terms



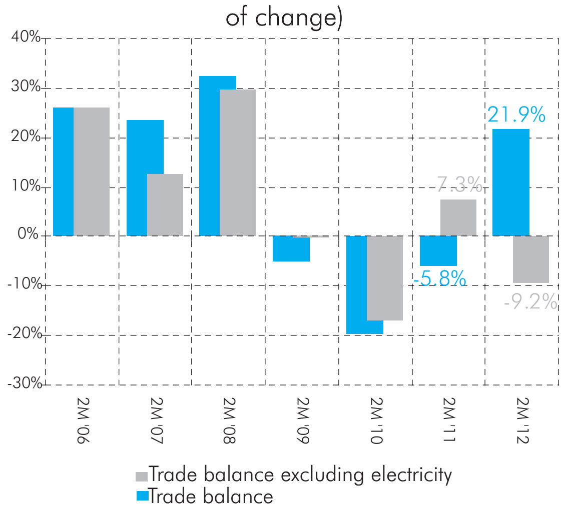
Source: General Customs Directorate, Bank of Albania and staff calculations.

FOREIGN TRADE

During the first two months of 2012, the performance of foreign trade balance was significantly conditioned by electricity trade flows. As a consequence of continuously unfavourable hydrological conditions in the country, the need for electricity to cover the domestic demand led to continuing import of electricity. Consequently, in cumulative terms, over the first two months of 2012, trade deficit widened by about 21.9% compared with the same period a year earlier. Excluding the effect of electricity trade flows, the trade deficit for the first two months of the year shrank by about 9.2% compared with the same period a year earlier.

In February 2012, the foreign trade balance resulted in a widening trade deficit by about 31.5% in nominal annual terms. Excluding the effect of electricity trade flows, the trade deficit narrowed by about 7.6% in annual terms. According to 10 main items, a substantial contribution of the trade deficit is evidenced in mineral fuels, oils and waxes item, as the main determinant to total trade deficit widening. On the other hand, the trade deficit narrowing in food and live animals, and in machinery and equipment items contributed to narrowing total trade deficit in February.

Chart 28 Trade balance (annual percentage of change)

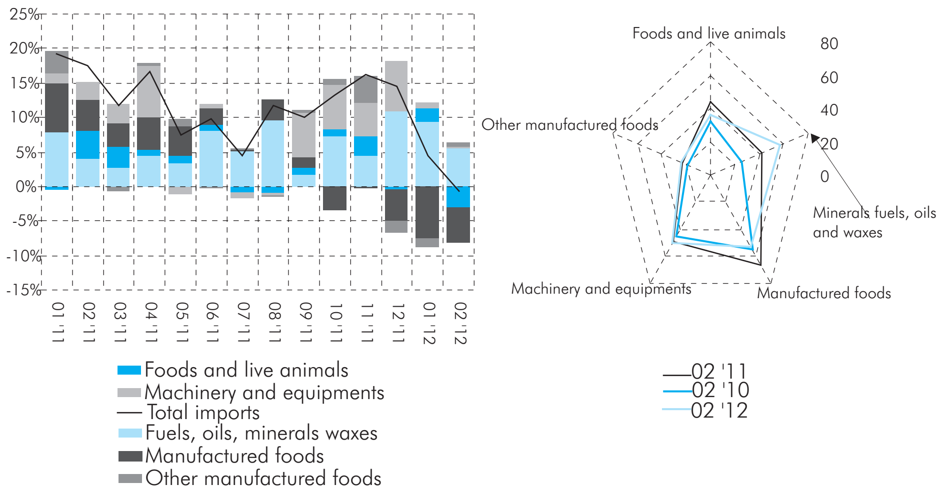


Source: Bank of Albania

[17] *For switching from nominal to real terms of merchandise imports and exports, we use the Unit Value Index from data on foreign trade volume. For services import and export, we use the Consumer Price Index of services, measured by the Bank of Albania.*

In February 2012, total imports declined by about 0.7% in annual terms. Their performance continued to be conditioned by import of electricity. Excluding this item, total imports declined by about 6.3% in annual terms.

Chart 29 Contribution by items to total imports (in percentage points, left); orientation of imports, in EUR millions (right)

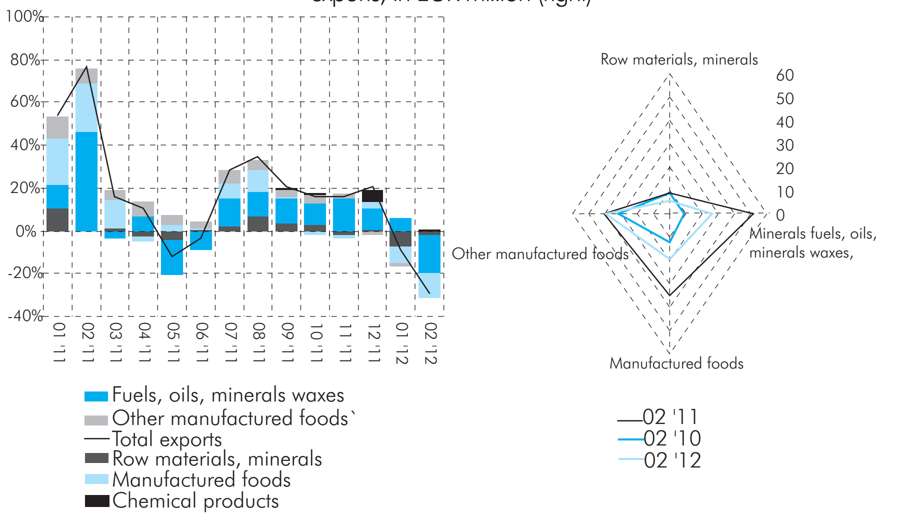


Source: Bank of Albania

The main contribution to decreasing total imports during February 2011 was made by the decline in import of goods included in manufactured goods and food and live animals. The latter was significantly impacted by entry of domestic products into the market. Imports of goods included in mineral fuels, oils and waxes item continued to contribute positively to total import growth. Within this item, the import of crude and processed oil, and electricity contributed 12.8% and 7.4%, respectively to total imports. According to final use in the economy, during February, imports of goods included in capital goods and intermediate goods fell by 13.1% and 3.2% in annual terms, respectively. The decline in import of goods included in capital goods item was driven by the fall in imports of capital goods, excluding transport equipment. Worth of note is also the continuing increase in imports of passenger transport vehicles and industrial vehicles. Imports of goods included in consumer goods item, in February, rose by about 11.6% in annual terms.

During the first two months of 2012, total exports reversed their trend compared with the growth rates recorded in 2011. After January's 8.7% decline in annual terms, the February's pace of decline in total exports accelerated to about 29.3%, compared with the same period a year earlier.

Chart 30 Contribution by items to total exports, in percentage points (left); orientation of exports, in EUR million (right)



Source: Bank of Albania

This trend of exports, along with the impact of the previous year's high base of comparison[18], remained under the influence of other important factors related to economic and financial situation of Albania's trading partners, and the average annual decline in base metal prices in international markets[19]. Other domestic factors, such as adverse weather conditions facing our country during the first two months of 2012, which led to insufficient domestic generation of electricity, also impacted on the same direction. The combined effect of the foregoing factors resulted in negative contribution of exports of goods included in mineral fuels, oils and mineral waxes, raw materials and minerals, and manufactured goods to total exports for February 2012. In the mineral fuels, oils and mineral waxes item, crude oil exports continued to yield a substantial contribution, accounting for 25.9% of total exports. Other manufactured goods, i.e., the export products item with the highest share in total exports, which includes re-exported products, continued to contribute negatively for the third consecutive month.

Albania's trade activity, measured by the flow of trade exchanges, following the decelerated growth recorded in January 2012, fell by 10.6% y-o-y, in February. Import coverage ratio resulted 37.7%, down by about 15.3 percentage points y-o-y. The analysis of geographical orientation of foreign trade shows that Albania's trade flows continued to be concentrated towards the EU countries. After recording a slight decline in January 2012, they grew by 3.1% y-o-y, in February 2012. On the other hand, the period under review attested to a significant decline in trade exchanges with CEFTA member states, by about 35.6% y-o-y.

[18] The previous year's high base effect of comparison is attributed to a substantial exporting activity of electricity.

[19] Based on the Metal Price Index, published monthly by the IMF. During February 2012, this index declined by about 19.2% y-o-y.

Box 3 Balance of payments highlights[I]

In 2011 Q4, the overall balance of payments registered a decline by EUR 6.2 million in foreign assets. Current account deficit posted EUR 348.7 million, recording 2.1% narrowing compared to the same period a year earlier. Over the quarter under review, it accounted for about 14.8% of nominal GDP[II]*, down by about 0.9 percentage point compared to the same period a year earlier. Capital and financial account surplus was about EUR 255.8 million, down by about 37.7% y-o-y. This item's foreign currency inflows managed to finance about 73.4% of the current account deficit recorded in 2011 Q4.*

Table 5 Main indicators of the balance of payments

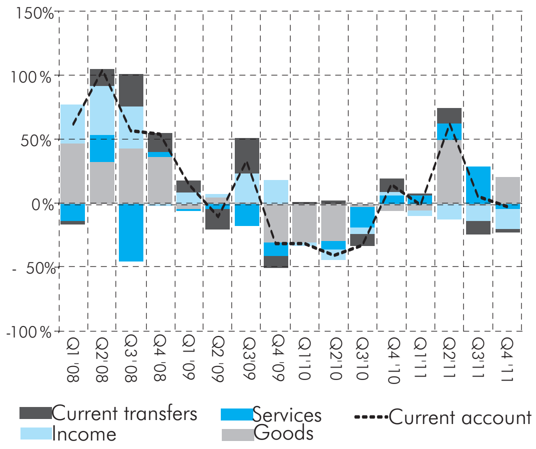
	Q4 '10	Q1 '11	Q2 '11	Q3 '11	Q4 '11
Current account (in EUR million)	-356.4	-220.9	-321.9	-253.9	-348.7
YOY	14.70%	-1.70%	62.80%	5.90%	-2.10%
/ GDP	-15.70%	-10.30%	-13.10%	-10.50%	-14.80%
Balance of trade	-584.9	-408.5	-581.4	-593.1	-658.6
Exports, f.o.b.	305.9	370.6	330.8	344.1	360
Imports, f.o.b.	-890.7	-779.1	-912.2	-937.2	-1,018.60
Balance of services	25.7	-17	-6.2	116.7	41.2
Credit	432.5	312.3	376.8	629.8	428.5
Debit	-406.9	-329.3	-383	-513.1	-387.3
Net – travel services	17.3	-43.5	-19.9	82.9	28.4
Balance of income	-34.8	-3.6	5.6	4.3	17.9
Credit	72.8	47.5	58.6	66.6	58.9
Debi	-107.6	-51	-52.9	-62.3	-41
Net FDI income	-77	-15	-9.5	-21	-7.1
Current transfers	237.7	208.2	260.2	218.2	250.8
Credit	280.1	238	287.6	245.6	279.1
Debit	-42.4	-29.8	-27.4	-27.5	-28.3
Net remittances	165.1	155	190.4	153.8	188.7
Current and financial account (in EUR millions)	410.9	242.9	199.8	222.7	255.8
YOY	487.60%	149.10%	6.60%	26.30%	-37.70%
/ GDP	18.10%	11.30%	8.10%	9.20%	10.90%
Capital account	30.2	19.1	31.5	6.5	27.8
Financial account	380.7	223.9	168.3	216.2	228
A. Liabilities	375	164	287.3	408.2	381.9
FDIs	230.3	83.3	212.2	158.4	288.1
Portfolio investments	303.3	0.2	5.2	5.2	5.4
Other investments	-158.6	80.5	70	244.7	88.5
B. Assets	5.6	59.9	-119	-192.1	-153.9
IHD	-2.2	-4.7	-1.7	-3.9	-19.8
Portfolio investments	-14.3	-6.6	-37.7	-54.5	0.4
Other investments	22.2	71.2	-79.6	-133.6	-134.5
Errors and omissions	71.3	-99.2	120.4	87.6	86.7
Reserve assets	-125.9	77.1	1.7	-56.4	6.2

Source: Bank of Albania.

Current account dynamics during the quarter under review was significantly conditioned by net exports and net balance of income. Net export deficit continued to grow by about 10.4% y-o-y, contributing about 16.3 percentage points to current deficit widening over this period. On the other hand, the improved net position of income account and of net transfers managed to offset the widening effect from net exports, leading to current deficit narrowing over the period under review.

During 2011 Q4, the net balance of services account resulted in EUR 41.2 million surplus, up by about 60.5% compared to the same quarter a year earlier. This account's improved balance, in real terms, was determined by a 63.7% increase, y-o-y, in net foreign-currency inflows to travel services sub-item. Other services and transport services sub-items also recorded an increasingly positive contribution. The annual analysis of the balance of services account has evidenced narrowing of this account's surplus by about 41.9% y-o-y. The decline in this account's foreign-currency inflows was more sensitive in 2011 Q2 and Q3, a period that corresponds to the tourism season.

Chart 31 Contribution by items to current deficit (in p.p.)



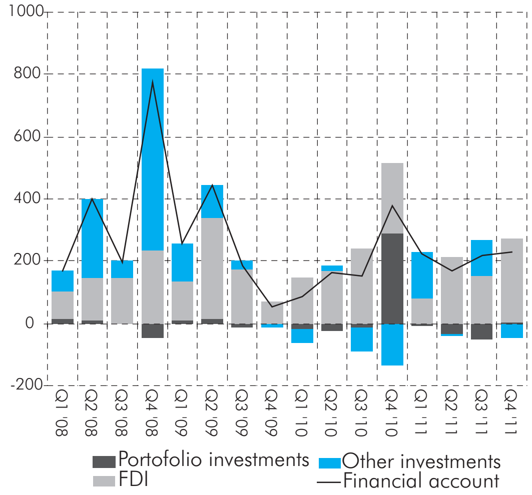
Source: Bank of Albania

Net current account balance continued to post a surplus for the third consecutive quarter. In 2011 Q4, this account recorded about EUR 17.9 million surplus, from EUR 34.9 million deficit in the same period a year earlier. These developments in the current account item were determined by decreased outflow of investment income, mainly from foreign direct investments. In 2011 Q4, the income outflows from foreign direct investments were EUR 11.6 million, from EUR 78.3 million in 2010 Q4. Though at a lower annualised level, income from employees' compensation impacted positively on total income account. In annual cumulative terms, in 2011, the income-account balance trend reversed, from about EUR 90.1 million deficit (net) to EUR 24.2 million surplus. Given the concerning situation in European countries, particularly in Italy and Greece[III], re-investing profit in the country might have been seen as more attractive than transferring it to countries of origin.

Net current transfers balance resulted in EUR 250.8 million surplus in 2011 Q4, up by 5.5% y-o-y. Net transfers from emigrants, constituting the main item of this account, increased by 14.3% in annual terms, during the quarter under review. The ratio of trade deficit financing from current transfers recorded 28.8% in 2011 Q4, i.e., almost equal to the one recorded in the same period a year earlier. In annual cumulative terms, in 2011, the current transfer account surplus increased about 1.6% y-o-y. The improved net balance of this account was determined by a pronounced decline in its financial outflows. In 2011, remittances inflows declined by about 0.5% y-o-y.

Net financial and capital account inflows recorded a positive balance by EUR 255.8 million in 2011 Q4, financing about 73.4% of the current account deficit recorded over this period. Relative to the same period a year earlier, capital and financial flows fell by about 37.7%, accounting for about 10.9% of nominal GDP. The decline in foreign-currency flows in annual terms was primarily determined by about 40.1% decline in annualized financial flows. Financial transactions in the fourth quarter posted EUR 228.0 million, down by about 40.1% in annual terms. As a ratio of nominal GDP, they were accounted for about 9.7%, down by 7.1 percentage points on a year earlier. Residents' liabilities to non-residents increased slightly by about 1.8% y-o-y. The moderation of growth rates of financial liabilities was a consequence of the high base effect of comparison to 2010 Q4, when the Eurobond was issued in international markets. Domestic assets invested in non-resident economies evidenced the role of other investments, particularly of loans, deposits and currencies sub-item.

Chart 32 Capital and financial account (net flows, in EUR billion)



Source: Bank of Albania

In 2011 Q4, net foreign direct investments (inflows – outflows) totalled about EUR 268.3 million, up by about 17.6% compared to the same period a year earlier. In the major part, the dynamics of foreign direct investments was dictated by their inflows. In 2011 Q4, foreign direct investments (FDI) inflows posted about EUR 288.1 million, up by about 25.1% y-o-y. According to investment instrument, FDI inflows in the form of property securities and profit re-investment increased by about 12.3% y-o-y. Also, unlike what was recorded in the first three quarters of 2011, the fourth quarter recorded capital inflows in the form of other capitals[IV] by about EUR 22.0 million. For the second consecutive year, the role of privatisation receipts remains modest in FDI inflows. In Q4, FDIs, excluding the privatisation receipts, increased by about 25.5% y-o-y.

Net portfolio investments posted EUR 5.8 million in 2011 Q4, down considerably from the same period a year earlier. The annualised decline in portfolio investments derived from the previous year's high base effect of comparison, which was determined by issuing Eurobonds on international markets. Also, unlike previous quarters of 2011, Q4 highlighted a significant decline in residents' portfolio investments in non-resident economies, in annual terms.

During 2011 Q, due to the growth of domestic assets invested in foreign economies, other investments account, net, posted a negative balance by EUR 46.1 million, down by 66.2% from the same period a year earlier. The increase in borrowing flow, as well as in deposits and currencies of foreign banking system in the country, led to higher liabilities of the domestic economy, by about EUR 88.5 million. A significant difference is observed as compared to 2010 Q4, during which Albania's liabilities in terms of other investments declined by about EUR 158.6 million. This difference is due to debt (principal) payments, which lowered our country's liabilities by about EUR 229.1 million. On asset side, in 2011 Q4, domestic claims on non-residents grew by about EUR 134.5 million. The growth of our assets invested abroad was due to higher banking system investments by residents in non-resident economies, and increased loans to finance trade.

Foreign reserve assets decreased by approximately EUR 28.6 million in 2011. At end-December 2011, foreign reserve stock posted EUR 1,912.0 million, sufficient to cover 4.4 months of import of goods and services.

I The latest data of the balance of payments belong to 2011 Q4.

II Nominal GDP used for 2003 – 2010 is the series published by INSTAT. For 2011, projections by Bank of Albania's Monetary Policy Department have been used.

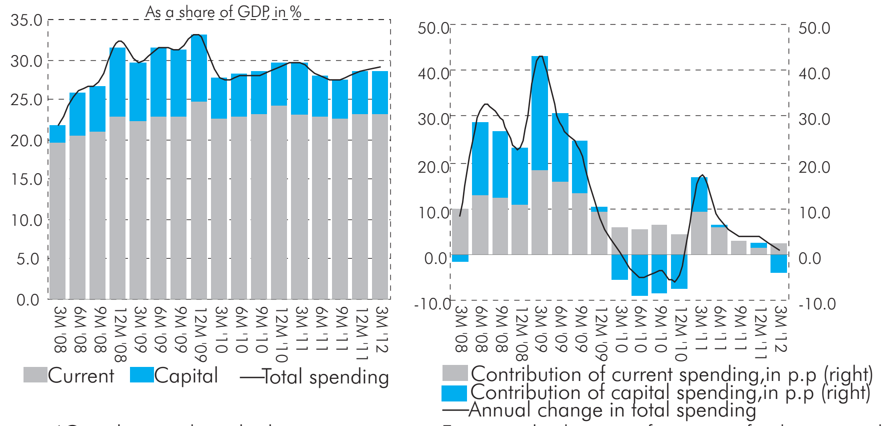
III Based on the data for 2010, about 67.3% of foreign direct investments stock is represented by EU countries. Greece and Italy are the countries with the highest share in total investments stock.

IV Other capitals (or debt transactions among companies) cover funds borrowing and lending, including securities and trade loans, between a direct investor and direct investment company, as well as between two direct investment companies that share the same direct investor.

IV.1.4 FISCAL INDICATORS AND FISCAL POLICY[20]

Fiscal policy was slightly consolidating in 2012 Q1, reflected in the narrowing budget deficit in annual terms. This fiscal policy stance is expected to continue even during the other quarters of 2012, conditioned by available fiscal spaces[21]. Against this setting, during 2012, the public sector is not expected to make added contribution to aggregate demand growth. Budget deficit generated during the first quarter reflected slow increase in budget expenditure and revenues.

Chart 33 Cumulative budget spending* (current and capital) to GDP, in %, (left) and annual change in budget spending, in %, and respective contributions of current and capital expenditure, in p.p. (right), 2008 Q1 – 2012 Q1



*Cumulative within a budget year time span. For example, the ratio of expenses for the six-month period is built on budget spending for January-June to GDP estimated for the same period.
In January and February, budget spending decreased in annual terms
Source: Ministry of Finance, INSTAT and Bank of Albania calculations

Budget spending totalled ALL 89.9 billion in 2012 Q1, or about 29.1% of GDP. It was down by 0.6 percentage point from the same period a year earlier due to lower capital spending.

Total expenditure realised in 2012 Q1 increased marginally by about 0.7% in nominal annual terms. This modest growth is mainly attributed to a higher level of expenditure carried out in March, thereby reversing the spending direction as compared to the first two months of the year[22]. However, it is worth of note that the budget spending trend over this period reflects, in part, even the base effect[23].

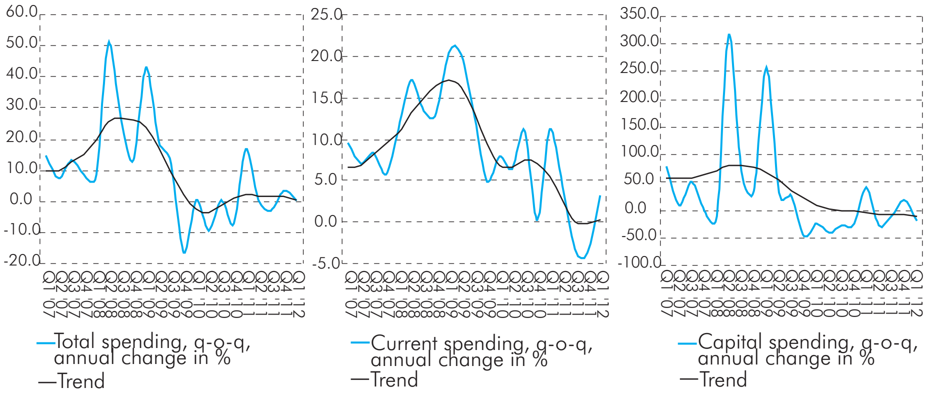
[20] *Data for the first quarter of the year are preliminary.*

[21] *Given that the public debt ratio to GDP is close to the 60% threshold provided under the organic budget law, there is no room for any likely increase in budget deficit. Therefore, the planned budget deficit for 2012 is about 10% lower than the 2011's figure.*

[22] *In January and February, budget spending decreased in annual terms.*

[23] *In 2011 Q1, total expenditure increased at a very high rate, by about 16.8% in annual terms, reflecting both current and capital expenditure growth.*

Chart 34 Annual change in quarterly expenditure by key items (from left to right: total, current and capital expenditures), 2007 Q1 – 2012 Q1*.

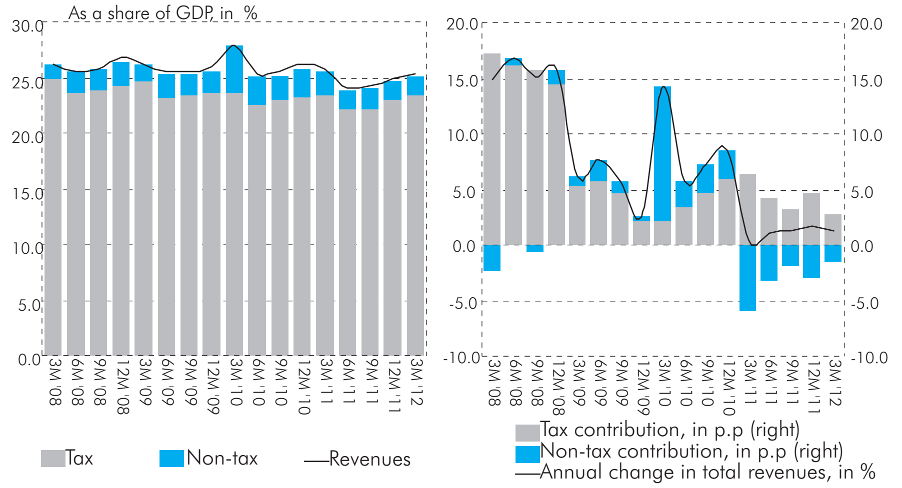


*The trend for the annual change of each item of fiscal indicators has been constructed according to Tramo/Seats correction method.
Burimi: Ministria e Financave dhe llogaritje të stafit të Bankës së Shqipërisë.

Current expenditure (which consists of personnel, interest, local government expenses, social security outlays, subsidies, economic assistance, operating expenses and maintenance costs) increased by about 3% in nominal annual terms. With the exception of local government spending and interest rate expenses, other items have positively contributed to current expenditure growth. However, the current expenditure trend has been determined by the performance of operating expenses and social security outlays.

On the other hand, capital expenditure contracted by about 17.6% compared to the same quarter a year earlier. Despite this item's low share in total expenditure (18%) and its high volatility, its performance determined the total expenditure trend for 2012 Q1. At the same time, although the capital and total expenditures percentage change was below the long-term trend, during the first quarter, they performed in line with the fiscal policy stance planned for this budget year.

Chart 35 Revenues by two main items as a ratio of GDP (left), and annual change in total revenues and contributions of two main categories, in pp (right), 2008 Q1 – 2012 Q1



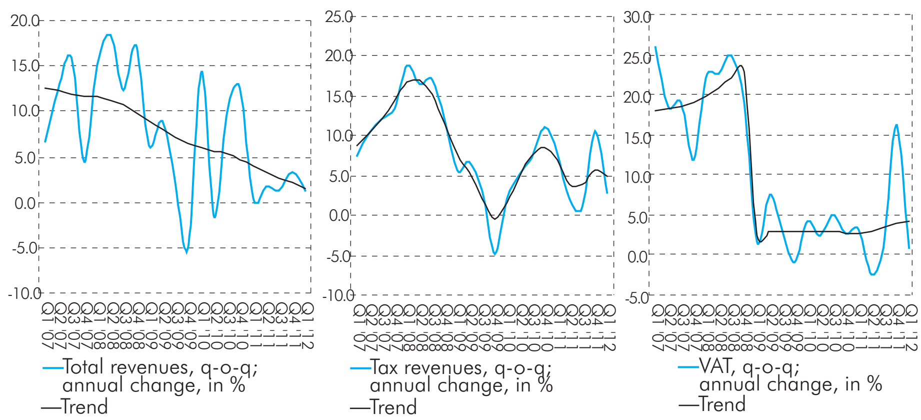
Source: Ministry of Finance, INSTAT and Bank of Albania calculations

Budget revenues in 2012 Q1 resulted in about ALL 78.5 billion, accounting for about 25.4% of GDP (or down by 0.4 percentage point from the same quarter a year earlier). Budget revenue performance in this quarter, remained similar to 2011's trend, reflecting, inter alia, the sluggish economic activity in the country.

Budget revenues over 2012 Q1 increased by about 1.2% in nominal annual terms. The contribution of non-tax revenues remained negative to annual change of total revenues in this quarter[24].

Tax revenues (including tax and customs revenues, social security contributions, as well as local government revenues), reached ALL 72.2 billion in 2012 Q1. In nominal terms, tax revenues were up by 3.0% from the same period a year earlier, however, this pace of increase remained below the long-term average.

Chart 36 Annual percentage change in quarterly revenues by main items (from left to right: total revenues, tax revenues and VAT revenues), 2007 Q1 – 2012 Q1



Source: Ministry of Finance and Bank of Albania calculations

VAT revenues, having the highest share in total revenues (by about 34% in 2012 Q1), increased at very slow rates (about 0.8%), in nominal annual terms. Available data[25] show that the slow performance of VAT revenues is mainly a consequence of decreased import value[26], signalling also the presence of sluggish consumption in this quarter.

Tax items, which are closely related to the country's economic performance (revenues from VAT, excises, profit tax, personal income tax) increased at modest rates, thereby recording below-average growth rates. Revenue behaviour reveals the impact of automatic stabilisers in the economy.

24 Non-tax revenues in 2011 reflected the base effect, while in 2012, contraction of non-tax revenues was driven by items related to earnings of budget and non-budget institutions (Bank of Albania included).

25 Imports and exports, VAT on tax and customs taxes, VAT refunding over the first two months of the year as well as the exchange rate for 2012 Q1.

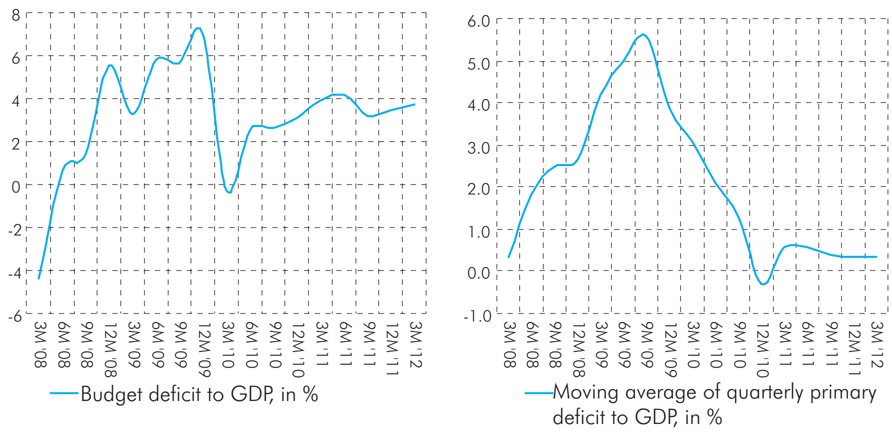
26 The two-month import value contracted by about 5% in annual terms.

Budget deficit resulted about ALL 11.5 billion in 2012 Q1, being marginally contracted by about 2.5% y-o-y. It accounted for about 3.7% of GDP, or about 0.2 percentage point lower than in the same period a year earlier.

Budget deficit financing is based mainly on security issuance in the domestic market. The increase in domestic borrowing for the first quarter was about ALL 8.2 billion. This increase consisted mainly in increased 12-month T-bill portfolio. Government's borrowing policy over this period was determined by security market actors' preference to partially replace the three and six-month T-bills and the two-year bonds with the 12-month T-bills. On the other hand, foreign borrowing (through projects) accounted for about 32% of total borrowing used to finance budget deficit over this period[27].

Current surplus, which is proxied by the spread between current revenue[28] and current expenditure, was about ALL 4.1 billion, accounting for about 1.3% of GDP in 2012 Q1. In annual terms, the current surplus was down by 1.2 percentage points.

Chart 37 Budget deficit to GDP (left) and primary deficit to GDP (right)*, 2008 Q1 – 2012 Q1



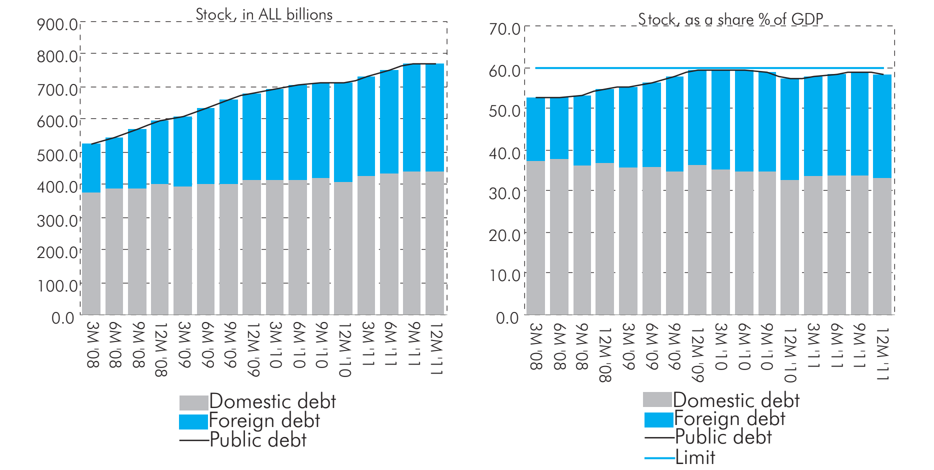
*The right chart has been constructed by taking into account the three-month primary deficit moving average (including 4 quarters) as a ratio of cumulative quarterly GDP.
Source: Ministry of Finance, INSTAT and Bank of Albania calculations

Primary deficit accounted for 0.3% of GDP in 2012 Q1, remaining similar to the level seen in three consecutive quarters. The public debt stock to GDP is expected to trend down until end-2012, if the overall budget deficit threshold (by ALL 41.1 billion) is observed, and given the assumption that public debt interest rates and the economic growth pursue a similar trajectory to that of 2011.

27 *Deficit financing weights are constructed without taking into account the government's liquidity in the account position, which moves to a negative sign (-) in deficit financing.*

28 *Current revenue classification is based on the Government Finance Statistics Manual, 1986, page 116, a standard that is currently applied for fiscal data reporting. Current revenues represent the difference between total revenues and grants, and capital revenues.*

Chart 38 Public debt (domestic debt and foreign debt), in ALL billion (left) and as a share of GDP (right), 2008 Q1 – 2012 Q1



Source: Ministry of Finance, INSTAT and Bank of Albania calculations

As at end-2011, the public debt stock to GDP was about 58.1%[29], up by 0.6 percentage point from end-2010's figure. The domestic debt stock, which accounted for about 57% of public debt, was about 33.1% of GDP, up by about 0.3 percentage point from the previous year. At the same time, foreign debt was about 24.9% of GDP, up by 0.3 percentage point from the previous year.

IV.2 THE LABOUR MARKET, WAGE AND LABOUR COST

Working age population was upward in 2011, but at lower growth rates in 2011 H2. Unemployment rate increased slightly in 2011 Q4. Over the past two years, it remained above 13%, thus conditioning the growth dynamics of nominal wage in the economy. The slow increase in wages dampened inflationary pressures in terms of the demand and cost per unit of output. For 2012 Q1, businesses expect a weaker increase in employment and wages.

THE LABOUR MARKET

The labour market indicators reflected improving signs during 2011 Q4. Data from the labour market balance show that the working age population increased by 1.45% on a year earlier. This was due to a higher number of employed people (by 1.7%), while the number of unemployed people remained almost unchanged during the period under review, -0.06%, on an annual basis.

More specifically, the number of employed people increased in the private non-agricultural sector by 6.7% compared to the previous year. In

[29] *Nominal GDP estimates for 2011 are based on the latest publication by INSTAT for GDP according to economic activity, at current prices (1996-2010). For 2011, the nominal GDP is forecasted on the basis of real growth and annual inflation by quarters, published by INSTAT.*

agriculture[30], this indicator remained unchanged for the second consecutive quarter. On the other hand, the number of employed people in the public sector continued the downtrend having started since 2010 Q4.

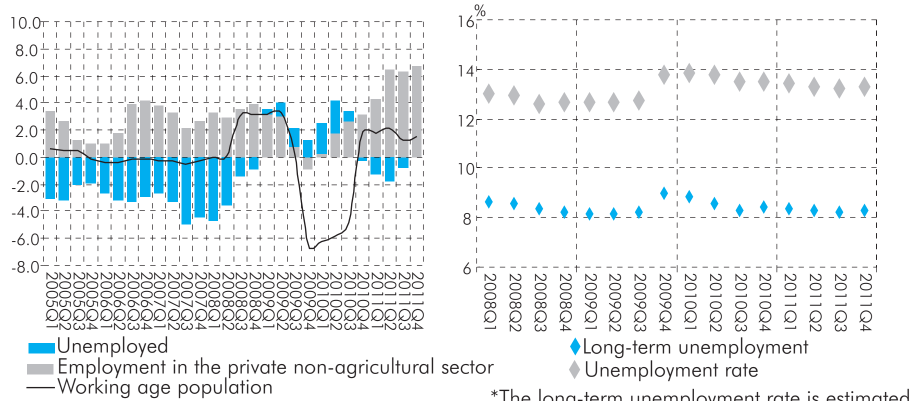
Table 6 Employment (annual and quarterly change in the average number of employed people)

	Annual change		Annual change				Quarterly change			
	2010	2011	2011				2011			
			T1	T2	T3	T4	T1	T2	T3	T4
Total economy	2.0	1.7	2.2	2.7	1.5	1.7	0.4	1.0	0.0	0.3
Private non-agricultural sector	3.1	6.7	4.3	6.5	6.4	6.7	1.7	3.8	0.1	1.0
Private agricultural sector	2.1	0.0	2.1	2.1	0.0	0.0	0.0	0.0	0.0	0.0
Public sector	-0.2	-0.6	-0.5	-0.9	-1.0	-0.6	-0.4	-0.2	0.0	0.0

Source: INSTAT and Bank of Albania.

The unemployment rate stabilised in 2011. It stood at 13.3% in 2011 Q4, slightly down on a year earlier (by 0.2 percentage point) and slightly up on a quarter earlier. The increase in the number of unemployed people in the economy during Q4 exceeded the increase in the working age population.

Chart 39 Employment, unemployment, and working age population (annual percentage change, left); total and long-term unemployment rate* (right)



*The long-term unemployment rate is estimated as a ratio of the average number of long-term unemployed people (unemployed for more than 1 year) to the working age population. The average number of long-term unemployed people is the arithmetic average of long-term unemployed people for the three respective months per each quarter. The source of data on long-term unemployment rate is the Ministry of Labour, Social Affairs and Equal Opportunities

Source: INSTAT, Ministry of Labour, Social Affairs and Equal Opportunities, and Bank of Albania

WAGES AND LABOUR COSTS

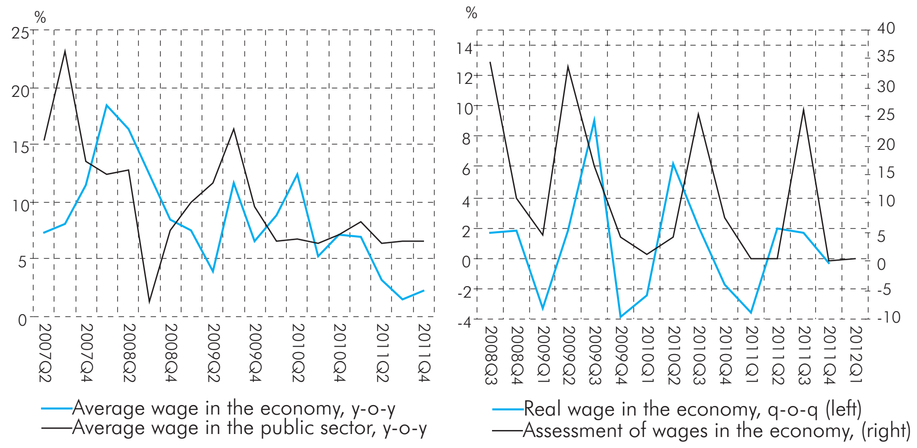
According to latest short-term statistics, the Average Wage Index[31] in the economy increased by 2.2% in 2011 Q4, y-o-y. Deflated using the CPI rise, the real wage decreased by 0.3% on a year earlier. Wage performance in Q4 was positively influenced by wage increase in production sector On the other hand, services wages continued the slowdown having started since 2010, being contracted in 2011 Q4. In this quarter, the nominal average wage in

[30] *The average number of people employed in agricultural private sector over the period 2008 Q3 - 2009 Q3 is estimated on the basis of the 2007 Labour Force Survey, and for the period 2009 Q4 - 2010 Q2 on the 2008 Labour Force Survey. Since 2010 Q3 it has been estimated on the basis of the 2009 Labour Force Survey.*

[31] *Wage index in the economy, or average wage, is measured as a ratio of the wage fund index to the employed number index. Source: INSTAT, "Short-term statistics", excluding agriculture. Data are quarterly.*

the public sector recorded ALL 48,000, or up by 6.7% y-o-y, whereas after being deflated with the inflation, it resulted up by 4.2%.

Chart 40 Annual performance of average wage by sectors (left); quarterly performance of real average wage and its assessment in the economy (right)

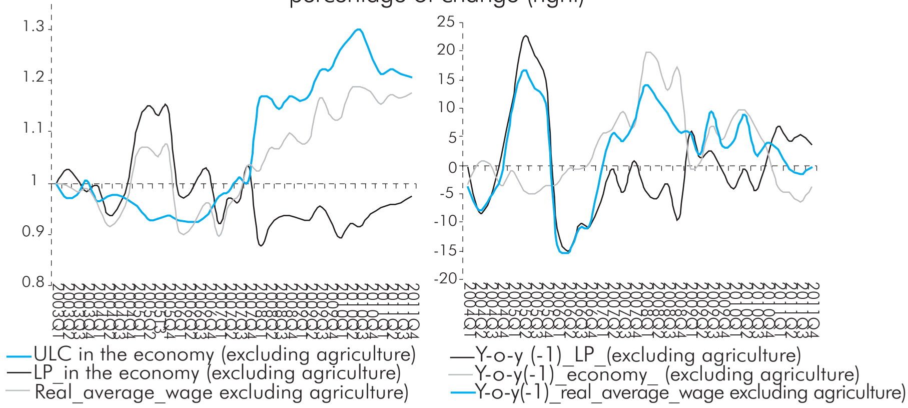


Source: INSTAT and Bank of Albania

Data from INSTAT generally confirm the signals revealed from survey results of business confidence in construction, industry and services sectors and in overall economy. In 2012 Q1, businesses expected decreased wages in industry and construction, and increased wages in services. According to business confidence survey, the level of wages in the economy will remain similar to 2011 Q4's figure.

In 2011 Q4, the Labour Productivity (LP) in non-agricultural activity continued to pursue a positive dynamics, up by 3.7% y-o-y. For 2011, the LP in non-agricultural businesses resulted on average up by 5% in annual terms. This indicator's performance was influenced by higher and positive value-added rates, versus the average decline in the employment rate for 2011.

Chart 41 Labour productivity, unit labour cost and real average wage (left); annual percentage of change (right)*



*The measures refer to labour productivity and unit labour cost of the economy, excluding agriculture. The estimates have used data from value-added (seasonally adjusted - INSTAT, GDP, 2011 Q4), as well as from short-term employment statistics and wages (INSTAT, Short-term statistics, 2011 Q4). These indicators exclude agriculture, therefore the value-added is considered excluding agriculture. Real average wage index is obtained after deflating it to the seasonally adjusted CPI (2011 Q4). For comparison purposes, the indicators are rebased on the value of each indicator in 2003 Q1

Source: Bank of Albania calculations

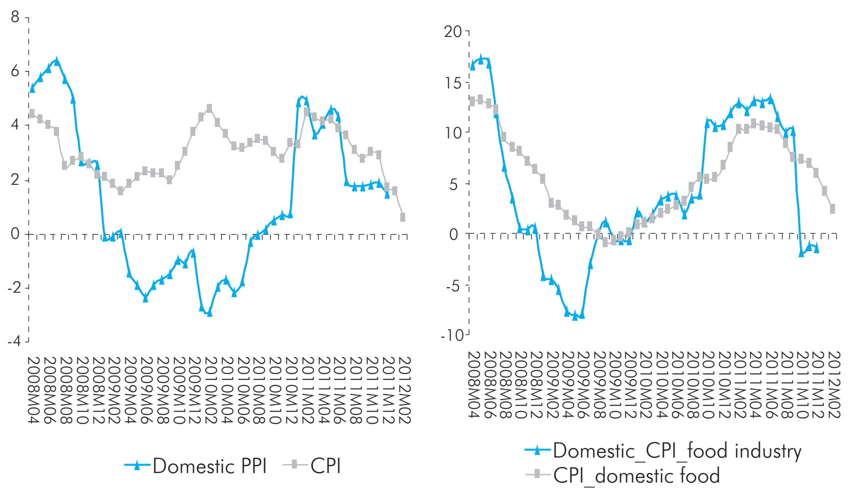
In the same quarter, the unit labour costs (ULC) in the economy, reflecting the positive LP rates and the annual decline in real average wage (excluding agriculture), continued to record negative rates (-3.9%). For 2011, the annual average change in this indicator was -4.8%, from 6.8% in 2010.

The performance of this indicator, in 2011 Q4, but also throughout 2011, supports the presence of some inflationary pressures generated from the labour market, wages and labour costs. Moreover, their trends signal a more rational behaviour of non-agricultural businesses with regard to labour force utilization efficiency and wages. They also declare that they worked below the average production capacity in 2011 and in early 2012.

PRODUCTION COSTS

Data from Producer Price Index (PPI) for 2011 Q4, signal further decline in inflationary pressures from the producer cost component in the economy. The annual growth dynamics of the PPI was contained, fluctuating from 2.2% in October to 1.8% in December 2011. In the meantime, the PPI of products destined for the domestic market recorded lower growth rates in the last quarter. At end- 2011, this indicator's annual percentage change was 1.5%.

Chart 42 Annual percentage change in domestic CPP and PPI



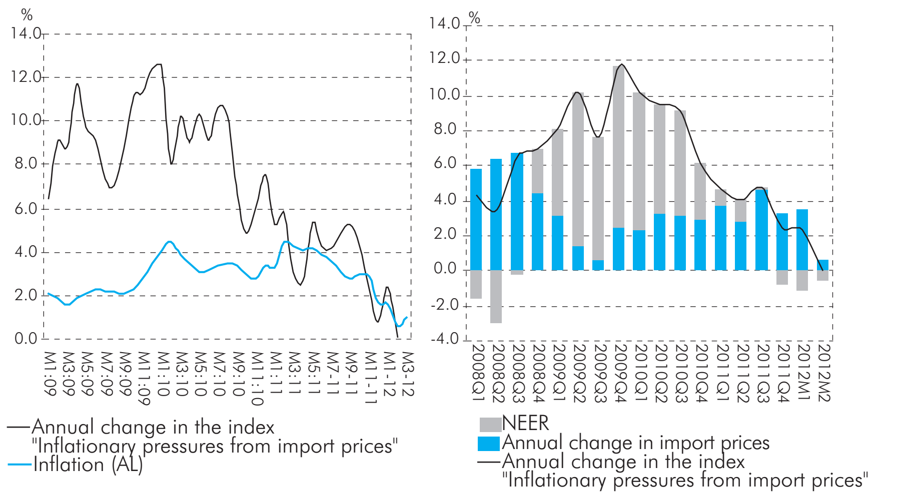
Source: INSTAT and Bank of Albania

Decreased pressures on the producer cost component were passed through to inflation behaviour in 2012 Q1. An important impact was made by annual decline in producer cost of foods industry. The annual decline in the PPI for products traded in the domestic market of this industry resulted -1.4% in 2011 Q4. According to empirical evidence, the impact of this decline has been reflected in rapidly contained price rise for processed foods from 2012 and onwards.

IV.3 IMPORTED INFLATION

The dynamics of short-term inflation, besides by the domestic costs, is also impacted by externally generated inflationary pressures. In order to assess the direction and magnitude of their impact, inter-sectoral inflation differential[32] and imported inflation[33] indicators are used. Based on these indicators, it is assessed that externally generated inflationary pressures have been downward since 2011 Q3, following their increase for about a two-year period, 2009 Q1 - 2011 Q2. This downward trend was further deepened in 2012 Q1, easing the headline inflation reduction at home over this quarter. The inter-sectoral inflation differential shows a negative contribution of the imported inflation by about 0.53 percentage point to headline inflation over this period. With regard to formation of this factor, the imported inflation analysis shows that the reduction of imported inflation over January-February derived also from the exchange rate appreciation, as well as from the low increase in the consumer prices in Albania's trading partners. The annual average growth of this index for the period under review was 1.2%, down by about 1.3 percentage points from 2011 Q4. An important role in easing externally generated inflationary pressures was also played by the nominal effective exchange rate (NEER) appreciation by 0.8% over January-February. Import prices, i.e., the other component of this index, provided the main contribution to growth rates. The annual rates of this component were +3.5% in January and +0.58% in February, signalling a pronounced decline in its rates due to a higher base effect of comparison registered over 2011.

Chart 43 Annual performance of inflationary pressures from import prices and domestic inflation (left), and import and exchange rate contributions (right)

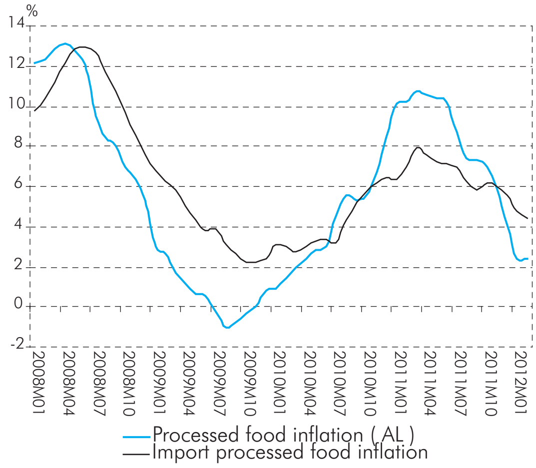


Source: Bank of Albania, INSTAT, IMF, OECD, EuroStat

32 Section 3.3 of this ratio includes the analysis of this indicator.

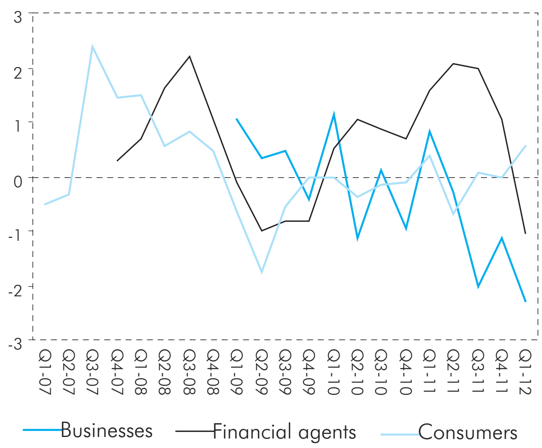
33 Imported inflation indicator is estimated as a weighted average of the consumer price index of 21 countries, using their import weights based on foreign trade data and adding the NEER index value for the respective month.

Chart 44 Annual inflation of processed foods and annual inflation of import food prices



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

Chart 45 Inflation anchoring indicator from various economic agents



Source: Confidence surveys and banks' surveys, Bank of Albania

Regarding imported goods prices that account for the largest share in the domestic consumer goods basket, food prices have determined the downtrend of the headline inflation. The annual average increase in import food price index for January-February was approximately 4.6%, from 5.9% in the previous quarter. This dynamics was also reflected in the slowing annual inflation rate of processed foods at home, in the first quarter.

IV.4 INFLATIONARY EXPECTATIONS[34]

Inflationary expectations stabilised around average long-term levels in 2011 Q4 and remained anchored within the Bank of Albania's target, in 2012 Q1. Expectations anchoring indicator[35] attest to low inflationary pressures from inflation expectations behaviour. This indicator for various agents of the economy recorded opposite directions in 2012 Q1; it recorded negative rates for businesses and financial agents, and positive ones for consumers. However, the size of increase for consumers is marginal. Businesses expected lower inflation rates than other agents of the economy in 2012 Q1, however, they expected a higher inflation than in the previous quarter. Financial agents, whose expectations are characterised by a markedly adaptive nature and a higher degree of persistence, expect a downward inflation rate for the second consecutive quarter in 2012 Q1.

IV.5 REAL-ECONOMY INFLATIONARY PRESSURES

The Albanian economy accelerated its growth rates in 2011 Q4, recording a 3.8% annual growth. The economic growth continued to be supported by external demand. Also, a better performance of the domestic demand over this quarter provided additional contribution to economic growth. Overall, during the year, the economic growth resulted 3.1% y-o-y, continuing the slowing trend observed over the past two years. Aggregate demand expansion was insufficient for the below-potential productive capacity utilisation in the economy. High unemployment and low capacity utilisation rate in the economy

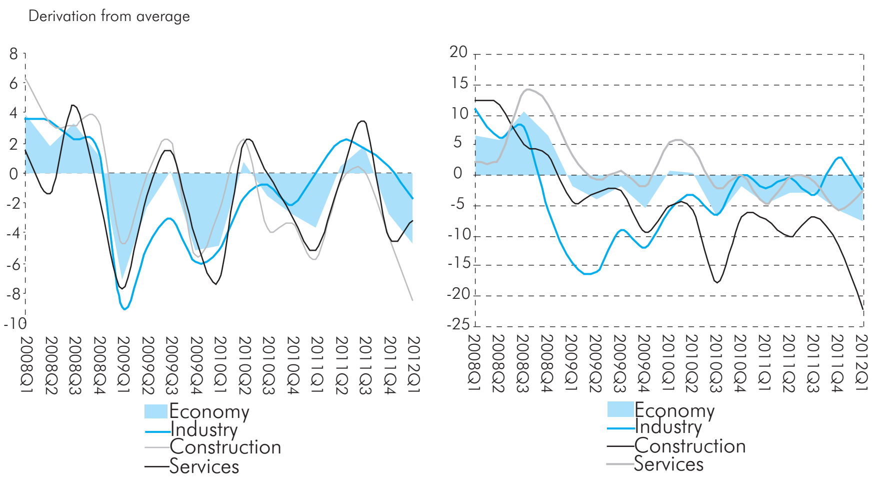
34 *The Bank of Albania measures economic agents' inflationary expectations through business and consumer confidence surveys and financial agents' expectations surveys.*

35 *This indicator is used to quantify the anchoring of expectations and is estimated by deducting the long-term average from the series level or the numeric inflation objective of 3% and dividing it with the respective standard deviation.*

materialise weak pressures for raising wages and other costs of the factors of production. On the other hand, externally generated inflationary pressures were downward due to the relative exchange rate stability. Conditioned by the low increase in domestic and foreign costs and against the background of anchored inflation expectations, inflation accelerated the slowing paces in 2012 Q1. The annual inflation rate averaged 1.1% in this quarter.

Besides the growth rate of the economy, during 2011 H2, partial and

Chart 46 Capacity utilisation rate in the economy (deviation from average, left) and employment estimates (deviation from average, right)



Source: Bank of Albania and INSTAT

qualitative data for 2012 Q1 signal its more contained performance over this period. Utilisation of the factors of production decreased further in 2012 Q1. Capacity utilisation rate for the economy fell by 4.7 percentage points from its historical average for this quarter. The labour market demand decreased in 2012 Q1. Reflecting the economic conditions, the increase in domestic costs will be in check, so as not to induce any added inflationary pressures. Inflation expectations remain anchored within the Bank of Albania's target. On the other hand, projections for stabilisation of primary commodity prices in international markets will mitigate the externally generated inflationary pressures. Hence, real-economy inflationary pressures are expected to be contained over the periods ahead.

V. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

Developments in money indicators show contained money growth during 2012 Q1. The foreign currency component provided the major contribution to money growth, offsetting the lower contribution of domestic credit. The deceleration in the growth rates of domestic credit components reflected the moderate private and public sector demand for money in this year-start. Lending activity was sluggish in response to economic agents' low demand for loans and banks' "selective" supply. Banks are pursuing more prudent lending policies as dictated by their parent banks abroad, strengthening of the regulatory framework at home and uncertainties about the future outlook. Being oriented towards fiscal consolidation, the public sector decelerated its demand for financing in annual terms, thereby providing lower contribution to money growth.

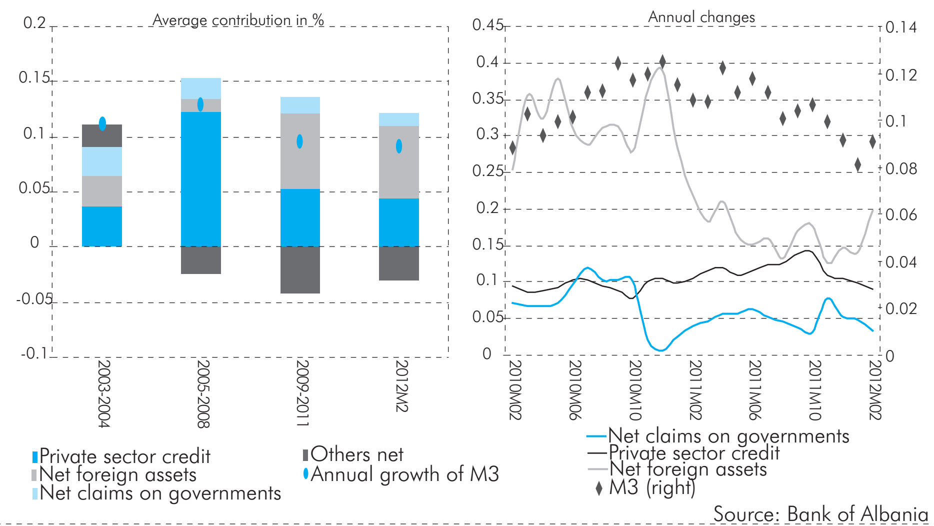
Financial markets were characterised by ample liquidity and were well-capitalised. However, their orientation towards averting credit risk conditioned the incomplete pass-through of the easing monetary policy signals into the economy. Despite the improved liquidity figures, the deepening of financial intermediation is largely conditioned by the high level of non-performing loans and sluggish credit demand from businesses and households. The exchange rate progressed in line with its seasonal performance over this period and followed the global market developments. Demand and supply for foreign currency was broadly balanced.

In the long run, money growth is assessed to be in line with the demand of the economy for real money. This indicator stands close to its last-two-year average, maintaining lower than pre-global financial crisis levels. Overall, monetary and financial developments signal contained pressures on domestic consumer prices in the medium run.

V.1 MONETARY INDICATORS

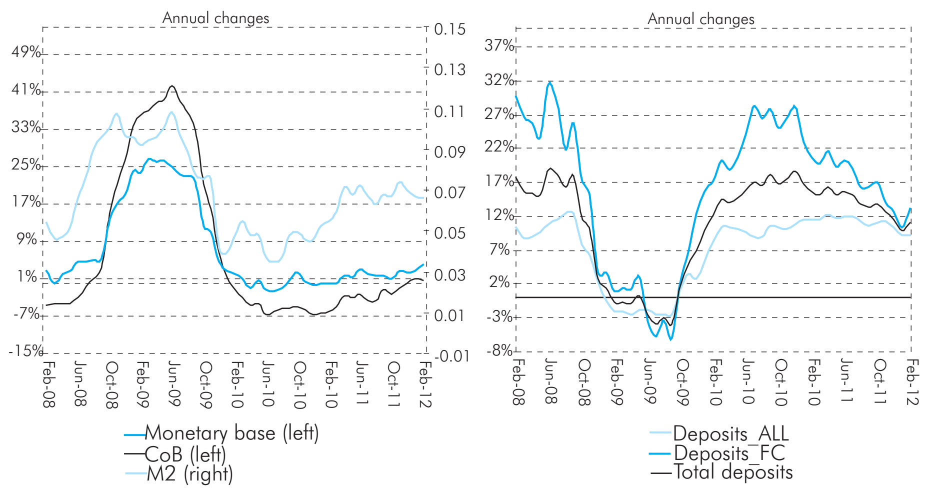
Money supply grew at an annualised rate of 9.1% in February, about 1 percentage point higher than in January 2012. However, the annual growth of broad money aggregate in the first two months of the year remained close to the average money growth in recent years, being considerably lower than the growth during the 2005-08 period. Unlike the year-end 2011, the foreign currency component provided a higher contribution to annual money growth, thereby offsetting the lower contribution of demand for money from the domestic economy. External sector developments were accompanied by higher foreign currency inflows into the banking system compared to the previous year, contributing by 6.5 percentage points to money supply growth. In the meantime, private and public sector demand for money manifested lower growth rates, providing less contribution to M3 growth, respectively 4.4 percentage points and 1.2 percentage points[36]. The lower annual contribution of the private sector to money growth reflects a low business and household demand for money and banks' reluctance to take risks. The fiscal sector also displayed a low demand for money, driven by the lower spending and orientation to keep a balanced fiscal position. Against this setting, M2 aggregate reduced its growth rates to 6.6% compared to 7.4%, the peak level recorded in November.

Chart 47 M3 aggregate and money demand components



Source: Bank of Albania

Chart 48 Monetary aggregates and deposits by currency (annual changes, in %)



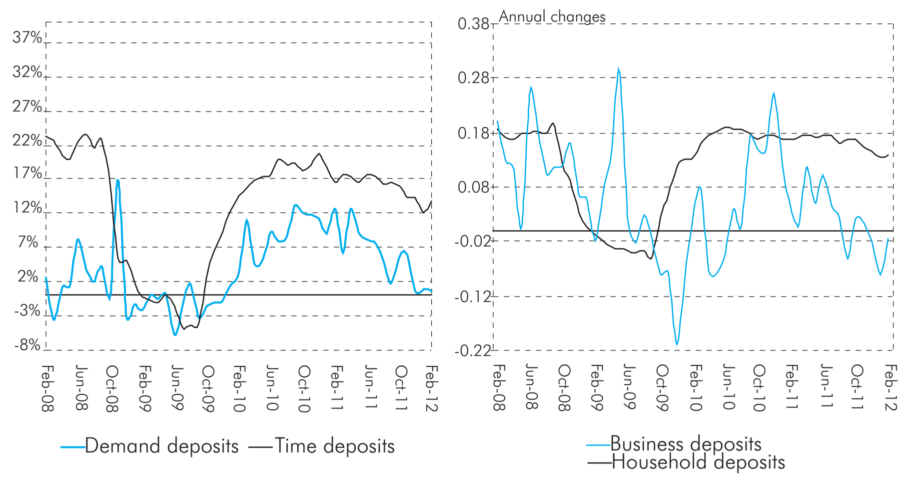
Source: Bank of Albania

36 The difference in contributions to total M3 aggregate growth is explained by the performance of other net assets of the banking system.

During January and February, currency outside banks pursued its seasonal behaviour, contracting by ALL 7.6 billion from December 2011. In annual terms, it remained almost similar to the previous year. Moderate annual growth rates of currency outside banks provide evidence for the strengthening of public confidence in banking institutions operating in Albania and the low household demand for liquid assets. The ratio of currency outside banks to M2 aggregate stood close to the lowest historical level of 29.1%. The most liquid money aggregate, M1 and base money, increased at an annualised rate of 1.4% and 3.9%, respectively.

In February, deposits were about ALL 5 billion higher than at end-2011, driven mainly by the increase in ALL-denominated deposits and household deposits. Compared to the previous year, total deposits were 11.1% higher. Vis-à-vis January's figure, lek-denominated deposits increased by ALL 3.4 billion in February, keeping their annual growth rate unchanged at 9.2%. Foreign currency-denominated deposits kept a similar level to end-2011. Their annual growth rate improved to 13.2%, or was 0.6 percentage point higher than in December. The improved annual growth rates in February were also driven by the contraction of foreign currency-denominated deposits in the previous year.

Chart 49 Deposits by maturity structure and economic agents (annual changes, in %)



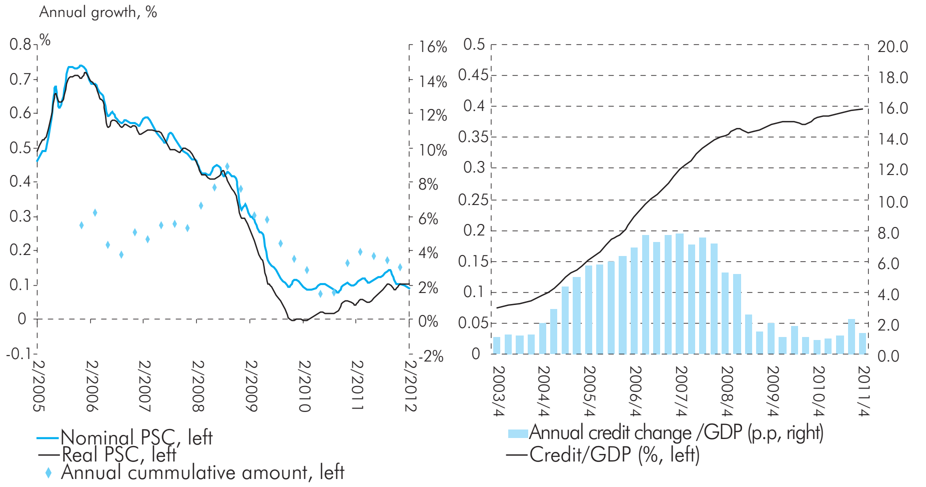
Source: Bank of Albania

Household deposits recorded stable annual growth rates, hence confirming households' propensity to save and, at the same time, the shift of savings to time deposits. The ratio of time deposits to total deposits peaked at 82% due to their stable annual growth for more than two years. In February, the annual growth rate of time deposits was 13.7%, or about 0.7 percentage point less than at end-2011. In the meantime, business deposits reflected the performance of economic activity and recorded moderate monthly growth. Compared to the previous year, they were slightly lower, by -1.3%.

PRIVATE SECTOR CREDIT[37]

Private sector credit was sluggish in January and February 2012, registering further moderation of its annual growth. Outstanding loans increased by about ALL 0.64 billion over the period under review, being driven by the slight growth of household loans, while business loans remained almost unchanged from end-2011's level. Annual growth of private sector credit continued to decelerate to 9.9% and 9.2%, respectively, in January and February, compared to 10.4% in December 2011.

Chart 50 Private sector credit and GDP



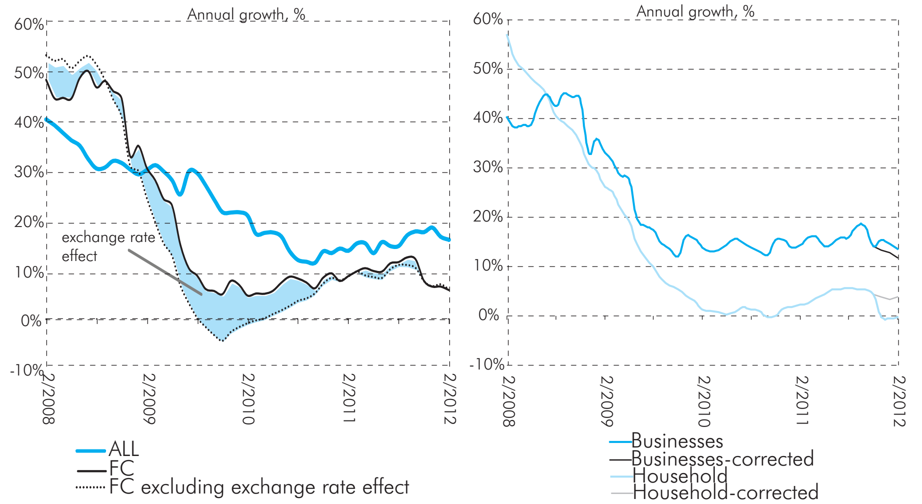
Source: Bank of Albania
Note: The exchange rate and inflation effect were excluded from the real growth of credit.

The moderate growth of private sector credit was a result of both credit demand and supply. Below-potential growth in 2011 and economic agents' uncertainties about their financial situation in the future determined a low demand for credit. In addition, the same factors, combined with the uncertainty about the future outlook of the European financial system under a new regulatory framework, were reflected in tightening bank lending standards. However, the annual growth of bank lending to the Albanian private sector remains among the highest in the region and credit continued to provide additional impulse to the economic activity at home. With the GDP data update, private sector credit-to-GDP ratio stood at 39.5% at end-2011. Its annual change was 1.4 percentage points, compared to 0.9 percentage point in 2010.

Private sector credit growth in January and February decelerated in all currencies. The impact of lek-denominated loans was, however, higher due to the high settlements of business working capital loans. In annual terms, the growth of lek-denominated loans fell to 16.6% in January and to 16.0% in February, compared to 18.5% in December 2011. After keeping a similar level in January to December at 6.6%, the annual growth of foreign currency-denominated loans slowed down to 5.9% in February.

[37] *The analysis of private sector credit is based on monetary data.*

Chartv 51 Private sector credit by currency (left) and customer (right)



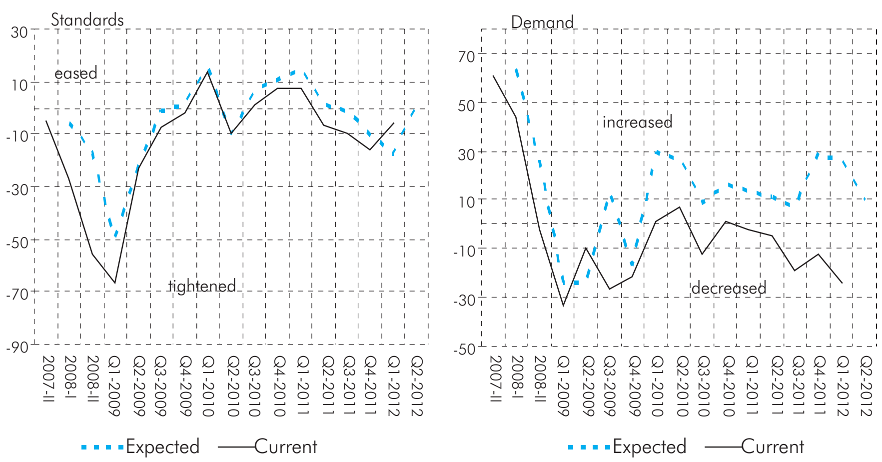
Source: Bank of Albania

Box 4 Summary of Bank Lending Survey Results for 2012 Q1[1]

According to the bank lending survey results, lending standards were tightened less on business loans in 2012 Q1. They, however, continued to tighten further on household loans. Broken down by business size, the lending standards were tightened on loans to large enterprises, while those on small and medium-sized enterprises did not change from a quarter earlier. By purpose of use, banks tightened the lending standards the same on large enterprises for working capital and investment purposes, and on household loans for house purchase or consumption purposes.

Specific business sector-related concerns, non-performing loans situation and the overall macroeconomic situation were the factors providing the main contribution to the tightening of lending standards on businesses in 2012 Q1. Banks' tight lending policy on business loans was mainly applied through higher commissions and collateral requirements.

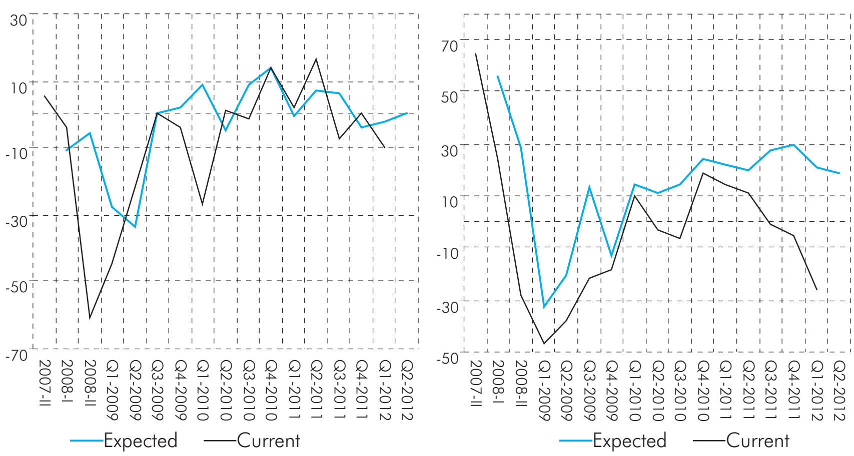
Chart 52 Lending standards and business demand for loans (net balance)



Source: Bank Lending Survey, Bank of Albania

According to bank experts, business demand fell considerably in 2012 Q1. This performance does not match with the banks' optimistic expectations for the loan demand stated in the previous quarter's survey.

Chart 53 Lending standards and household demand for loans (net balance)



Source: Bank Lending Survey, Bank of Albania

Bank experts do not expect the lending standards applied to businesses to tighten further in 2012 Q2. The lending standards are expected to remain unchanged for loans broken down by business size or purpose of use. Expectations for business loan demand in 2012 Q2 are positive but slightly lower than expectations for 2012 Q1.

The net percentage of banks reporting tightening lending standards on households in 2012 Q1 stood at 9.6%, hence worsening from 2011 Q4, when the lending standards remained unchanged.

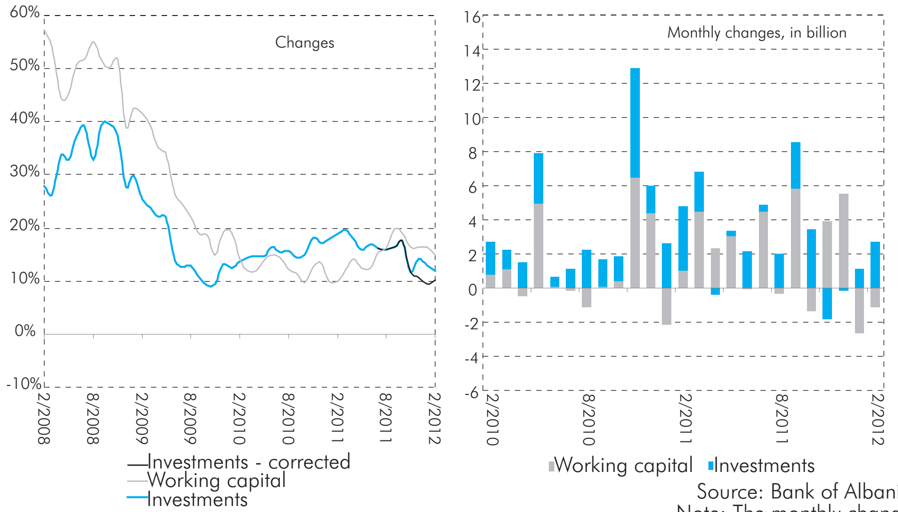
Non-performing loans situation, households' financial situation and developments in the real estate market were the factors providing the main contribution to the tightening of lending standards applied to households. Banks' tight lending policy was mainly applied through higher debt-to-income ratio, lower loan amount and higher collateral requirement.
According to banks' opinion, household demand for loans maintained its downward trend in 2012 Q1. This is far more pessimistic than banks' expectations in the previous survey.

Banks do not expect any substantial changes in the lending standards applied to household loans in 2012 Q2 (the net balance is 0). Expectations for household loan demand in 2012 Q2 are optimistic, albeit below the previous quarter's level.

[1] *The survey conducted in April 2012 covers the developments in lending activity during the first quarter of 2012 and banks' expectations for possible changes in lending during the second quarter of 2012. You may find a detailed analysis of Bank Lending Survey Results for the first quarter of 2012 at www.bankofalbania.org, under Publications.*

Business loans showed a poor performance in January and February 2012. Although new loans were about 15% higher than in the previous year, the high settlements of working capital loans and the low growth of investment loans were reflected in a negligible growth of the business loan stock compared to December 2011. Consequently, its annual growth moderated during these two months, standing at 13.5% in February. The effect of loan portfolio reclassification in December 2011[38] increased the annual change in business loans in the last three months by about 1.8 percentage points. Excluding this effect, the annual growth of business loans has been even slower, starting from November 2011. The moderation of growth in business loans is evident in both its portfolios by purpose of use. The annual growth of investment loans was 12.0% in February or 2 percentage points lower than in December[39]. Working capital loans registered an annual change of 15.0% in February, down by 1.5 percentage points from end-2011.

Chart 54 Business loans by purpose of use



Source: Bank of Albania
Note: The monthly change of investment loans in December 2011 does not include the increase arising from reclassification.

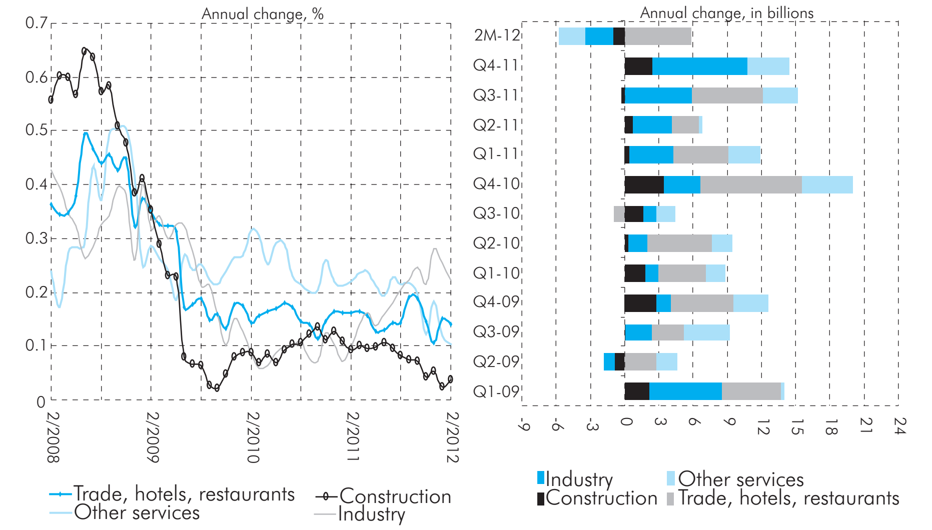
Sectoral data on loans show that lending to the trade sector increased in January and February. In the meantime, businesses operating under other sectors of the economy reduced their liabilities to banks over the period under review. Beyond the monthly volatility, the annual deceleration of business loans is evident in almost all the sectors of the economy, excluding the industrial sector whose related business loans maintain high annual growth rates, albeit lower in the past two months.

After keeping in January 2012 a similar level to December 2011, household loans grew by ALL 0.6 billion in February. Their annual change in the first two months was -0.5% and -0.3%, respectively, compared to -0.2% in December 2011. The effect arising from the reclassification of the loan portfolio

[38] In December 2011, the loan portfolio of one of the reporting banks was reclassified by purpose of use. This reclassification led to decline in the stock of household mortgage loans by ALL 5.77 billion and increase, to the same extent, in the stock of business investment loans in December.

[39] The effect arising from the reclassification of investment loans refers to an increase in their annual changes in December 2011 and January and February 2012 by about 3.5 percentage points.

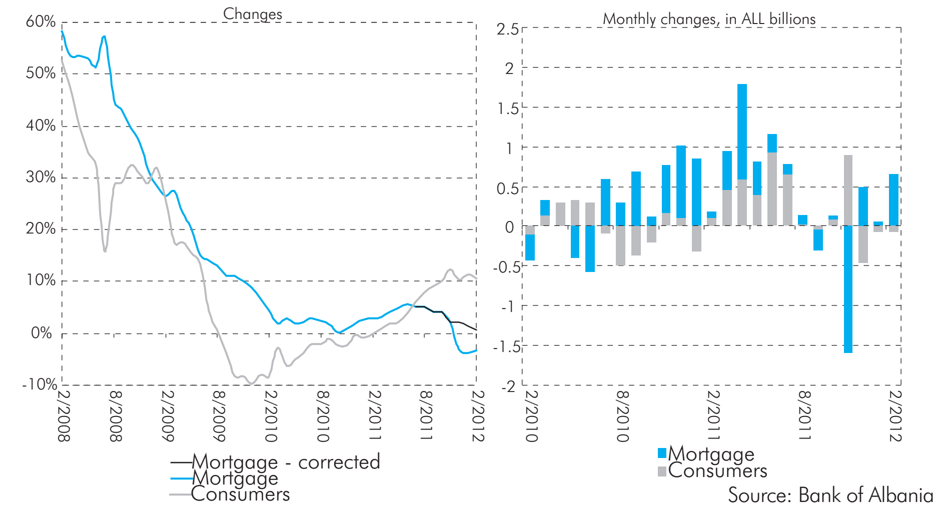
Chart 55 Business loans by sectors of economy



Source: Bank of Albania

materialised in the reduction of the annual growth rates of household loans by about 4.0 percentage points in the past three months. Adjusting for this effect, the annual growth of household loans remains positive, albeit more moderate than in 2011 H2.

Chart 56 Household loans by purpose of use



Source: Bank of Albania
Note: The monthly change of mortgage loans in December 2011 does not include the reduction arising from reclassification.

The slowdown in household loans, which had begun since 2011 H2, was driven by the performance of mortgage loans. Household demand for house purchase was low as a reflection of households' reluctance to make investments and engage in long-term financial commitments. Despite the increase in February, the constant contraction of mortgage loans in 2011 H2 determined a strong downtrend of their annual growth. As at end-February, the annual change of mortgage loans was -3.2% compared to -3.0% in December[40]. On the other hand, consumer loans kept a stable annual growth rate of 11.0% on average in January and February 2012.

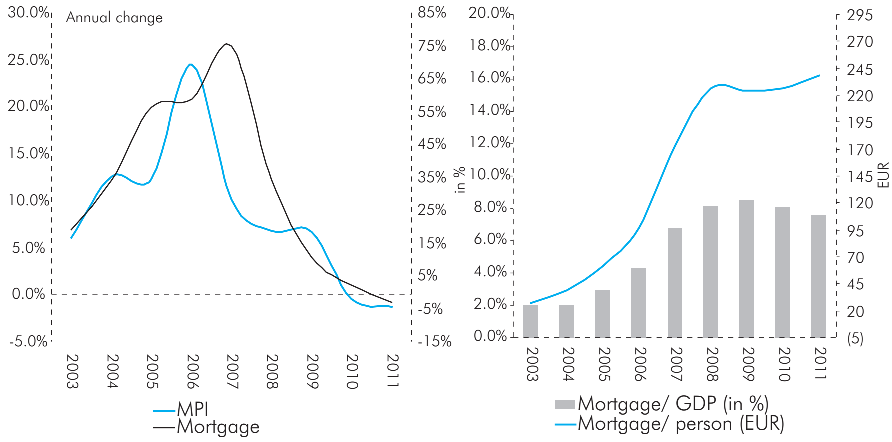
[40] *The effect arising from the reclassification of mortgage loans refers to a decrease in their annual changes in December 2011, and in January and February 2012, by about 5.2 percentage points. Adjusting for this effect, the annual growth of mortgage loans is positive, albeit slow.*

Box 5 House Prices and Role of Mortgage Loans in Albania[1]

In recent years, the economists have paid special attention to the dynamics of real estate prices in the economy due to their interference with many vital sectors. In particular, close attention has been paid to the impact of house prices on the financial sector. Real estate prices influence significantly the portfolio of financial intermediaries, which have backed up the major part of the loan portfolio with collateral. For this reason, the behaviour of house prices does not only affect the business cycle dynamics through its direct effect on aggregate demand, but also the performance of the financial system. Studies in the interdependence of mortgage credit and house prices are on the focus of many central banks, since this relationship has a significant impact on the development of monetary and credit indicators. Increasing the value of houses, as a result of a rise in prices, would lead to the increase in the collateral value, thereby allowing obtaining a higher credit, and therefore affecting the demand for goods and services, which in turn would exert inflationary pressures on the economy.

The paper entitled "House Prices in Albania and Role of Mortgage Loans" analyzes the impact of mortgage loans on house prices in the case of Albania. The interaction between these two indicators is of high interest to elaborate considering the important developments that the credit and house markets have experienced in recent years. This paper seeks to empirically evaluate the significance of credit growth to house price performance and vice versa.

Chart 57 House prices and mortgage loans



Source: Bank of Albania

In order to study the relationship between mortgage loans and house prices in the case of Albania, the authors have used a two-step estimation process through the Dynamic Ordinary Least Squares Method (DOLS), used by Engle and Granger. The selection of this method is believed to fit better the purpose of this study, since it considers the simultaneous dependence between variables and the short data series. According to this method, the long-term relationship is estimated as a system of simultaneous equations between mortgage loans and house prices similar to the method used by Fitzpatrick and McQuinn (2007).

Equation 1

$$Credit_t = \alpha + 2.4(Income)_t - 0.01\,(Interest\ rate)_t + 3(House\ prices)_t$$
$$+ \sum_{j=-18}^{16}\delta_{1,j}\Delta(Income)_{t-j} + \sum_{j=-18}^{16}\delta_{2,j}\Delta\,(Interest\ rate)_{t-j} + \sum_{j=-18}^{16}\delta_{3,j}\Delta(House\ prices)_{t-j} + \lambda ECT\_Credit_{\,t-1}$$

Equation 2

$$House\ prices_t = \alpha - 12.4(Income)_t + 3.1\,(Construction\ cost)_t + 2.3(Credit)_t$$
$$+ \sum_{j=-18}^{18}\gamma_{1,j}\Delta(Income)_{t-j} + \sum_{j=-18}^{18}\gamma_{2,j}\Delta(Construction\ cost)_{t-j} + \sum_{j=-18}^{18}\gamma_{3,j}\Delta(Credit)_{t-j} + \lambda ECT\_House\ prices_{t-1}$$

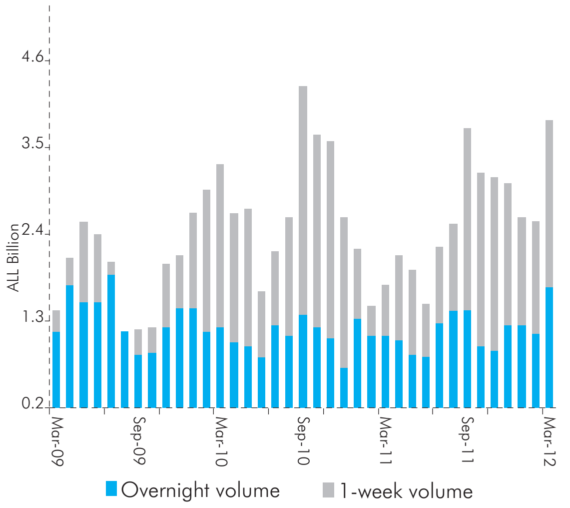
The results of this study support the statistically significant role of the growth in the mortgage loan portfolio to house prices and vice versa, over the period under review in the case of Albania. In the long-run, house prices, in addition to the loan amount, depend also on income per capita and construction cost. During this period, a 1% increase in mortgage loans raises the house price by 2.3%. whereas an increase in house price by 1% raises the mortgage loans by 3%. In the presence of a short-term disequilibrium, mortgage loans and house prices are adjusted in the following months, contributing to return to equilibrium. This adjustment, however, is slow and weak due to the existence of frictional costs in the functioning of the real estate market.

The statistically significant long-term relationship between the performance of these two variables highlights its importance to the economy and financial stability in Albania. Given the long-term nature of interaction between these two variables, the current series (of 12 years) is considered to be relatively short and it is still too soon to consider a stable relationship between house prices and mortgage loans. Developments in the real estate market continue to be conditioned by legal and institutional deficiencies in this market, such as concerns related to property rights, registration of land, legalisation etc. Addressing these concerns would provide a new impulse to the performance of the housing market and would provide the banking system with more room to develop and increase mortgage loans.

[1] Based on the paper entitled "House Prices and Role of Mortgage Loans in Albania" by E. Suljoti and G. Hashorva, presented at the Fifth Regional Workshop "Economic Research in South-Eastern Europe", Bank of Albania, November 2011.

V.2 FINANCIAL MARKET DEVELOPMENTS

Chart 58 Volume of interbank market borrowing



Source: Bank of Albania

INTERBANK MARKET

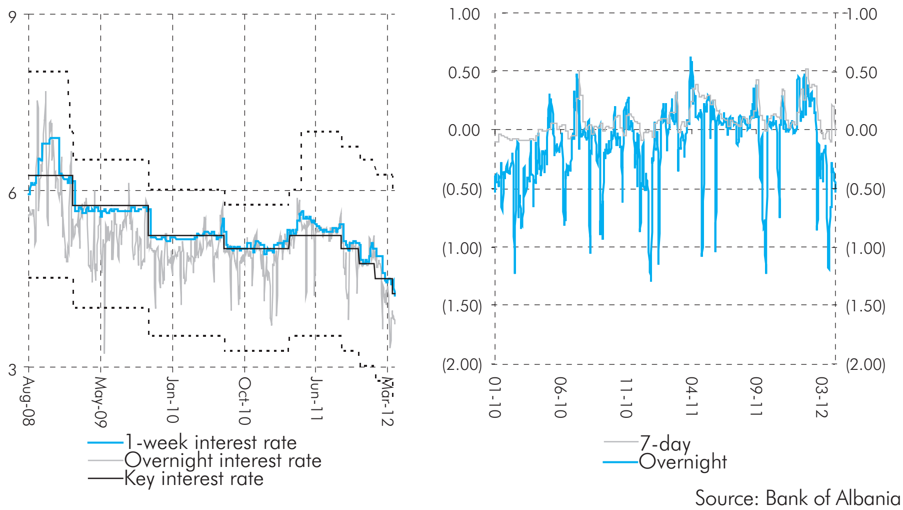
The interbank market was characterised by a downward performance of interest rates in 2012 Q1. The trading volume remained similar to the previous quarter and increased in March. Interest rates decreased for both maturities (overnight and 7-day) and concentrated mainly in the last two months of 2012 Q1. The Bank of Albania changed its key interest rate twice during this period, cutting it in both cases by 0.25 percentage point each. The response of interbank market rates was fast and in line with these changes. In March, they fluctuated around 3.80%-4.20%, or 0.30-0.80 percentage points below the key interest rate[41]. The volume of bank transactions in the interbank market pursued an increasing trend over the recent months, reflecting the higher use of this market to meet the short-term needs for liquidity and higher supply by some banks. The profile of transactions did not change during this quarter, confirming the preference for transactions of one-week maturity. However, a detailed analysis of the trading volume shows the reduction in one-week transactions and increase in overnight transactions, hence causing the average total volume to experience little change from the previous quarter. It amounted to ALL 3.25 billion, almost similar to the previous quarter.

At a system-level, the Bank of Albania continued to supply the market with liquidity through regular reverse repurchase agreements of one-week maturity. In addition, reverse repurchase agreements of 3-month maturity were also employed. The liquidity injected during this period averaged ALL 13.5 billion, compared to ALL 12.5 billion in the previous quarter. Interbank rates showed higher volatility[42] during these months, while their spread to the key interest rate increased. Interest rate fluctuations continued to be present mainly at certain time intervals corresponding to the days when required reserve was replenished. They also relate to factors of market positioning of individual banks. Overnight interbank market rate averaged 4.43% in 2012 Q1, compared to 4.80% in the previous quarter. One-week interbank rate dropped to 4.62%, or 0.38 percentage point less.

[41] *The second change of the key interest rate was made on 28 March, therefore this comparison takes into account the key interest rate of 4.50% that was effective until that date.*

[42] *The standard deviation of overnight interbank market rate was 0.5052 in 2012 Q1, compared to 0.2892 in the previous quarter. The spread between key interest rate and overnight and one-week interest rate was 36 and 23 basis points, respectively, from 18 and 10 basis points in the previous quarter.*

Chart 59 Interbank market rates (left) and their spread to the key interest rate (right)



Source: Bank of Albania

A higher liquidity supply in the interbank market, mainly during March, owed also to the choice of some banks to invest in the interbank market a part of their funds available from the securities market activity. Borrowing in March amounted to about 4.1 billion, thereby affecting the quarter's average.

Box 6 Interest Rates Response to Change in the Key Interest Rate

September 2011 marks the beginning of the Bank of Albania's monetary policy easing cycle. During September 2011-March 2012, the central bank cut the key interest rate through four moves by 1.00 percentage point to the lowest historical rate of 4.25%. More specifically, the cuts were made effective on 30 September (-0.25 percentage point), 1 December (-0.25 percentage point), 26 January (-0.25 percentage point) and 29 March (-0.25 percentage point). Monetary impulses aimed at creating the conditions for meeting the inflation target with a view to support economic activity and boost domestic demand.

Financial markets response was dissimilar at different moments. The interbank market followed each key interest rate cut almost in real time and to the same extent. In March, this market was characterised by higher liquidity and increased transactions, which pushed the interest rates further down.

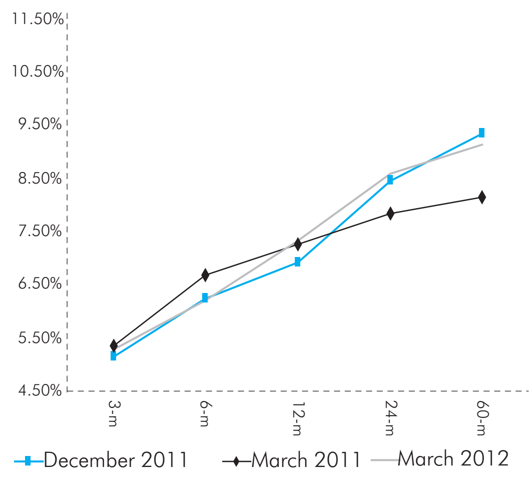
Table 7 Markets' response to monetary policy signals (in percentage points)

Cumulative change March 2012 – September 2011	Repo	Interbank market		Primary market			Deposits		Credit	
		1-day	7-day	3-month	6-month	12-month	12-month	Weighted average	12-month	Weighted average
	(1.00)	(1.35)	(0.91)	(0.26)	(0.57)	(0.34)	(0.30)	(0.51)	(0.17)	(0.29)

Source: Bank of Albania

In the primary market, T-bill yields initially responded to the easing monetary conditions. In December, the 12-month yield averaged 6.91%, from 7.68% in September. The decrease in the yield reflected both the key interest rate cut (-0.50 percentage point) and the lower demand to finance the budget deficit during this period. In 2012 Q1, the downward tendency of the yields shifted direction, although *the monetary conditions continued to ease. The yields increased on the instruments of almost all maturities in the primary market. Their performance was affected by the concentration of government demand for financing during this period and several banks' reluctance to invest in the primary market. These banks were conditioned by tight investment policies applied to banks operating in South-East European countries and higher capital requirements set for banks by the European supervisory authorities. Higher risk premium on investments in government securities also brought about the shift of the yield curve, while financial agents' surveys do not evidence the factorisation of inflationary expectations in determining the yields.*

Chart 60 Yield curve in the primary market



Source: Bank of Albania

The transmission of monetary policy signals into the credit and deposit market was slow. Interest rates on new ALL-denominated deposits fell slightly until January ,in order to keep the market share and attract the inflows characterizing the year-end period. Weighted average interest rate on deposits was 4.92% in January compared to 5.07% in September. After the key interest rate cut in January and the signal that the monetary stimulus would continue, the interest rate on ALL-denominated deposits decreased considerably (-0.36 percentage point) in February and preliminary data show that they decreased further in March and April.

Although the interest rates on lek-denominated loans are on average lower than in the previous year, the reflection of monetary conditions easing in this market is slow. Moreover, lending to the private sector continues to be characterised by tight lending standards, partly factorizing the uncertainties about the Albania's economic outlook and financial and economic concerns facing Europe. In 2012 Q1, the upward trend of T-bill yields, which are used as a reference rate for pricing loans, might have had an adverse impact on loan price easing.

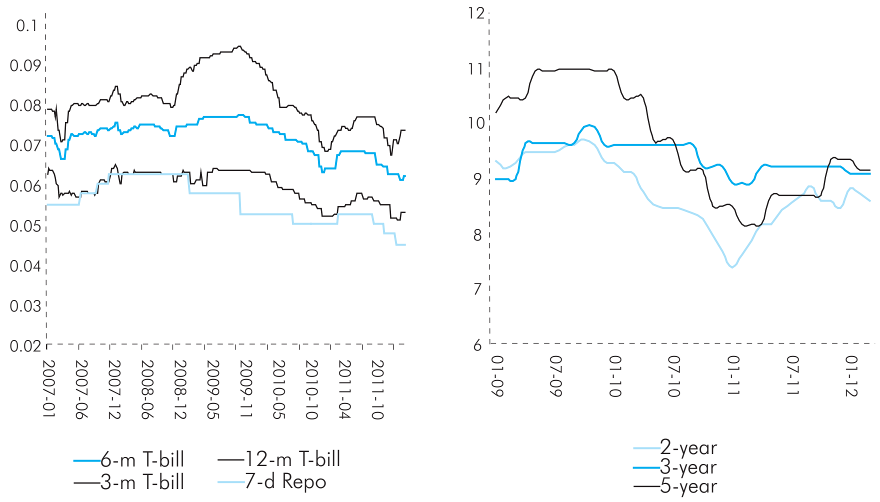
PRIMARY MARKET

Government security yields showed an increasing trend for all maturities in 2012 Q1. The 12-month yield, which is also used as a parameter for long-term interest rates on loans, reached 7.33% at end-March, compared to 7.11% in early January. The performance of yields was accompanied by the concentration of government demand for financing in the first quarter and the expectations for their easing in the second half of the year. In addition, in response to the new EBA regulations[43], some banks tightened the lending policies applied to the fiscal authority and were reluctant to invest in the primary market. This effect was partly offset by higher participation of individuals in T-bill purchase, being also driven by the increasing spread between return from this instrument and deposits[44]. Bid-to-cover ratio in T-bill auctions stood at 1.01 in the first quarter, compared to 1.31 in the previous quarter.

[43] *European Banking Authority.*

[44] *Given the lack of development in other financial market segments, deposits and government securities are the main investment tools for households' savings.*

Chart 61 Primary market yields



Source: Bank of Albania

Premiums of investment in longer-term instruments were higher and were translated into higher bond yields. 2-year yields reached 8.80% in January from 8.44% in December, mainly as a result of the maturing portfolio and non-fulfilment of the bid amount. Once the liquidity and competition in the auction grew higher, this indicator dropped to 8.56% in March. The margin spread over the reference rate of 5-year variable rate bond reached 2.08 percentage points, the peak in the past three years, although the provided liquidity was positive, hence exerting no pressures over the yields. The performance of bond indicators is also conditioned by the configuration of this segment, which is little competitive and liquid.

The increasing yields have also brought about the widening of spreads between the maturities and interest rates in other financial market segments. Based on financial agents' survey data, this trend does not provide evidence for pressures from inflationary expectations.

INTEREST RATES ON NEW DEPOSITS AND LOANS

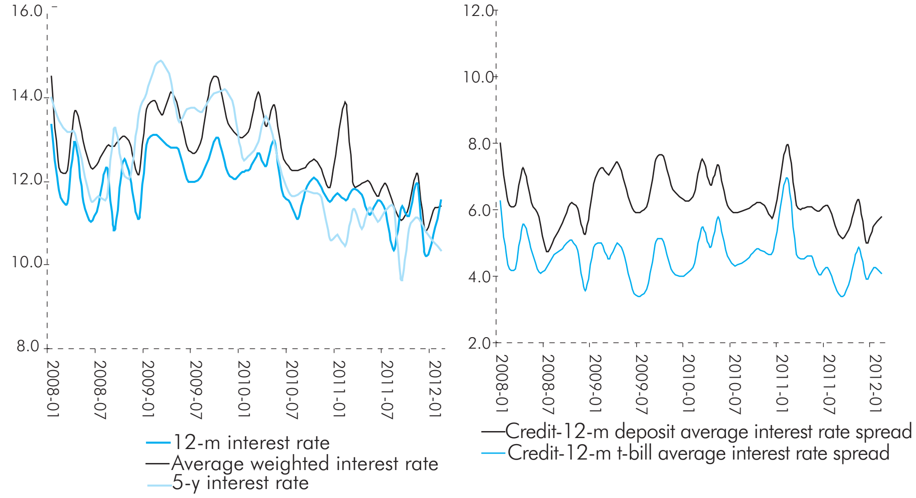
During January-February 2012, interest rates on new ALL-denominated loans were stable and generally lower than in the previous quarter. Weighted average interest rate on ALL-denominated loans was 11.35% in January and February, compared to 11.47% in 2011 Q4. However, loan pricing factorised the increase in banks' prudential measures[45]. This was also expressed in a higher intermediation margin in the first two months of 2012, which reflected the fastest pass-through of monetary policy easing to deposit rates. A similar signal is also expected to pass through to the interest rates on loans, observing the time lags of the transmission mechanisms.

Long-term interest rates on household residential mortgage loans showed a downward tendency. Short-term interest rates on business working capital

[45] *Box 5 "Summary of Bank Lending Survey Results for the first quarter of 2012".*

loans remained at almost similar levels. In addition to higher bank prudence, interest rates on ALL-denominated loans were also affected by the increasing trend of T-bill yields they are parameterised to.

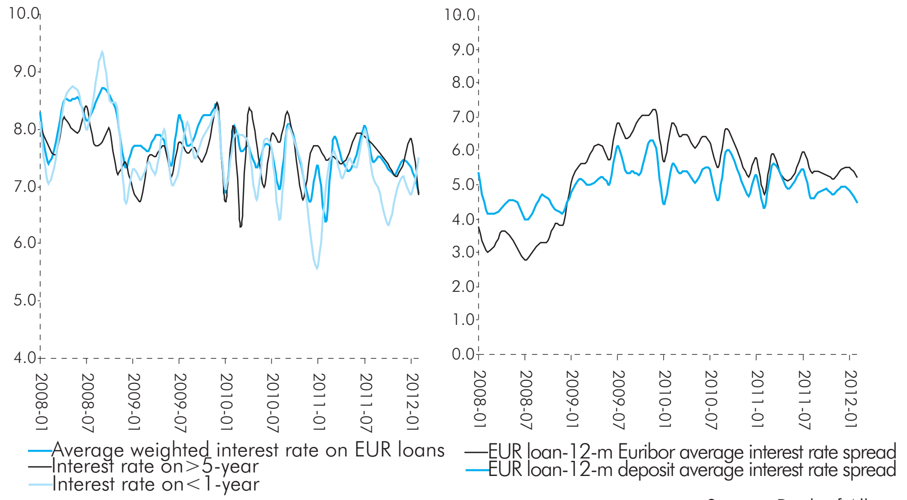
Chart 62 Interest rates on new ALL-denominated loans (left) and intermediation margins (right)



Source: Bank of Albania

Weighted average interest rate on new euro-denominated loans dropped to 7.11% in January and February 2012, compared to 7.32% in 2011 Q4. The performance of interest rates matched with that of Euribor interest rates in the international markets, which dropped considerably in the last two months. However, the margins applied to these reference rates are still high compared to the pre-crisis period, reflecting the tightening of lending standards. Moreover, the maintenance of relatively high interest rates on euro-denominated deposits conditioned, to some extent, the pricing of loan rates in this currency.

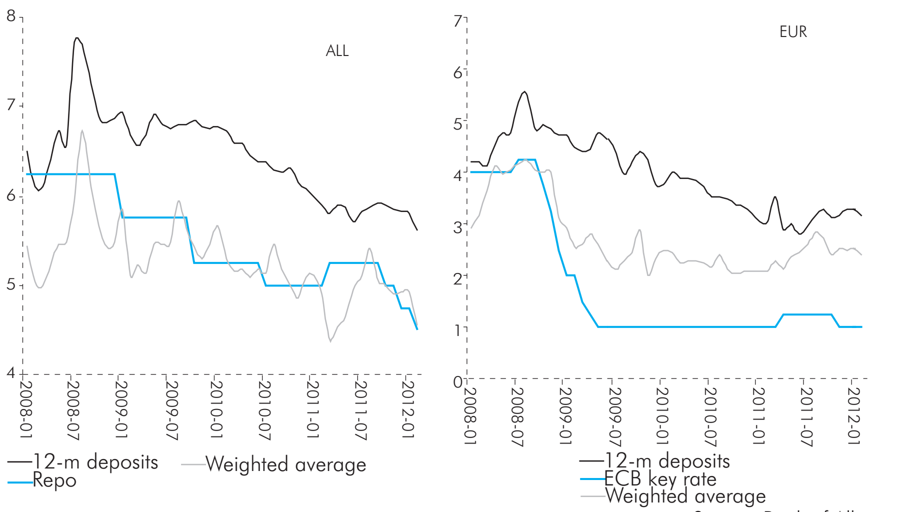
Chart 63 Interest rates on new euro-denominated loans (left) and intermediation margins (right)



Source: Bank of Albania

Once the monetary conditions easing cycle began in the economy, starting from September 2011, interest rates on new ALL-denominated deposits have pursued a downward tendency. In February 2012, their interest rate averaged 4.56%, from 5.07% in September 2011. Until January, interest rates on ALL-denominated deposits decreased at low margins and their relatively high levels were a driving factor for attracting deposits.

Chart 64 Interest rates on new ALL (left) and euro-denominated deposits (right)



Source: Bank of Albania

Following the slight seasonal increase in euro interest rates at end-2011, they decreased to 2.40% in February, from 2.52% in December. In order to maintain the competitive position and liquidity in euro, interest rates on euro-denominated deposits remain relatively high. Although the spread between interest rates on ALL and euro-denominated deposits has started to decrease, it remains higher than the pre-crisis level, thereby contributing to the stable domestic currency.

EXCHANGE RATE

Nominal effective exchange rate maintained its appreciation trend, albeit at more moderate rates, in 2012 Q1. The annual change of NEER[46] index averaged -0.6% y-o-y and 0.1% q-o-q.

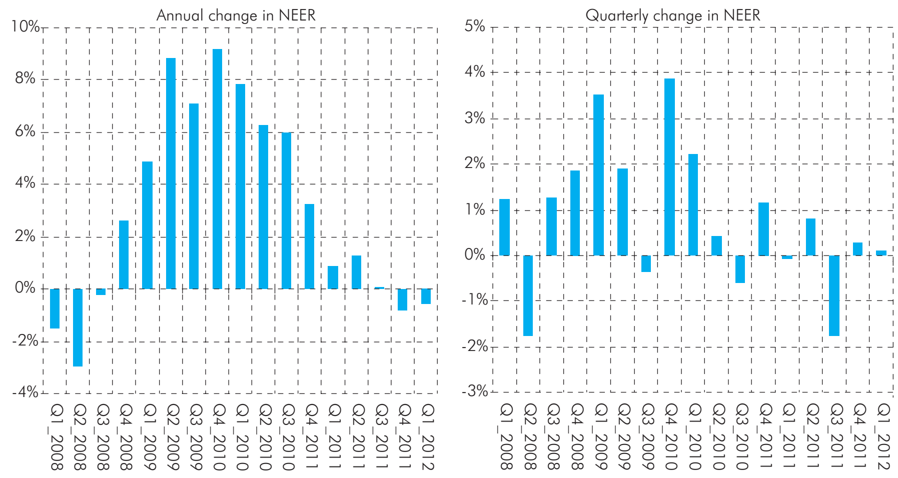
The dynamics of NEER index reflected the fluctuations in supply/demand ratio in the domestic market, manifesting the smoother seasonal effect[47] that characterises 2012 Q1. The decline in imports over January and February contributed to lower depreciation pressures in the foreign exchange market, hence keeping the lek relatively stable over the period under review. The appreciation trajectory of the US dollar against the foreign currencies in the international markets during the recent months is another factor contributing to appreciation of the NEER index.

[46] *NEER –Nominal effective exchange rate is calculated against the currencies of Albania's five major trading partners, namely Italy, Greece, Germany, Turkey and China. A higher NEER implies the lek's depreciation.*

[47] *The exchange rate generally depreciates in the first quarter of the year due to high demand for foreign currency from foreign corporations, which repatriate their profits at the end of the financial year.*

The foregoing developments are also confirmed by the Exchange Market Pressure index, which was stable in the first quarter, reflecting its stabilisation around 0.05 standard deviations from its historic average.

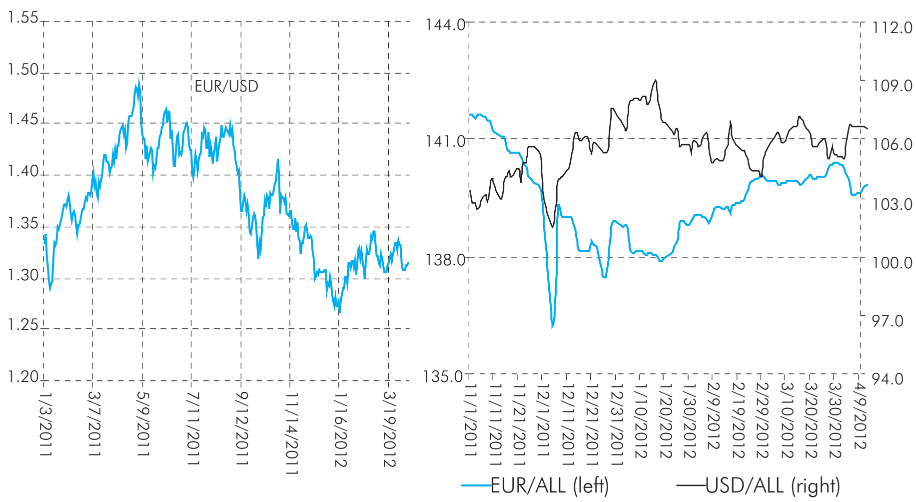
Chart 65 Lek's annual and quarterly changes in nominal effective terms (NEER)



Source: Bank of Albania

The individual performance of major currencies of the basket in the foreign exchange market for 2012 Q1 shows the depreciation of the Albanian lek against the US dollar (3.9%) and its slight appreciation against the euro (0.2%) compared to the same period in 2011. On the other hand, in quarterly terms, the lek reflects its weakening position against the US dollar, depreciating on average by 2.2%. In the meantime, it gained ground against the euro, appreciating by 0.4%.

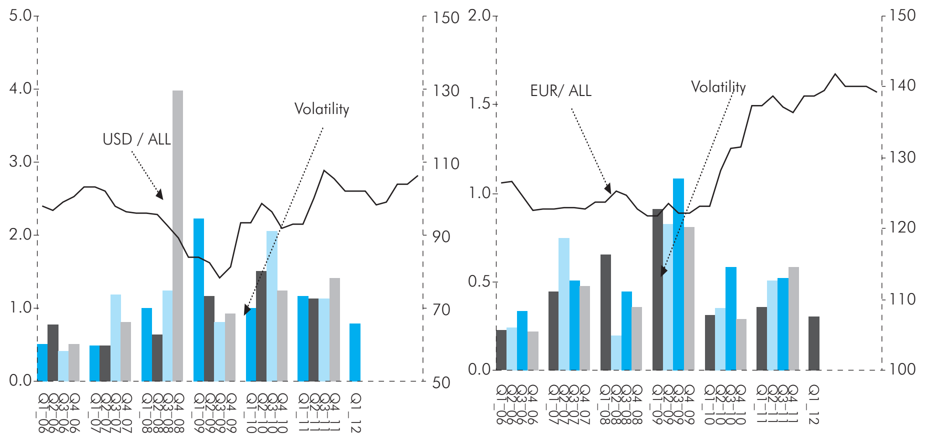
Chart 66 Daily EUR/ALL, USD/ALL and EUR/USD in 2012 Q1



Source: Bank of Albania

Given the lack of solution to the euro area crisis, the euro depreciated further against the US dollar during January to March. EUR/USD exchange rate dynamics appears to have been reflected in the Albanian foreign exchange market, with the EUR/ALL exchange rate often pursuing similar tendencies to EUR/USD exchange rate. The EUR/ALL volatility over the quarter under review remains similar to the one recorded in 2010 and 2011. The USD/ALL exchange rate dynamics over the period under review is in line with the performance of the US dollar in the international markets. The volatility index shows that the USD/ALL exchange rate ratio has been among the lowest in the past four years.

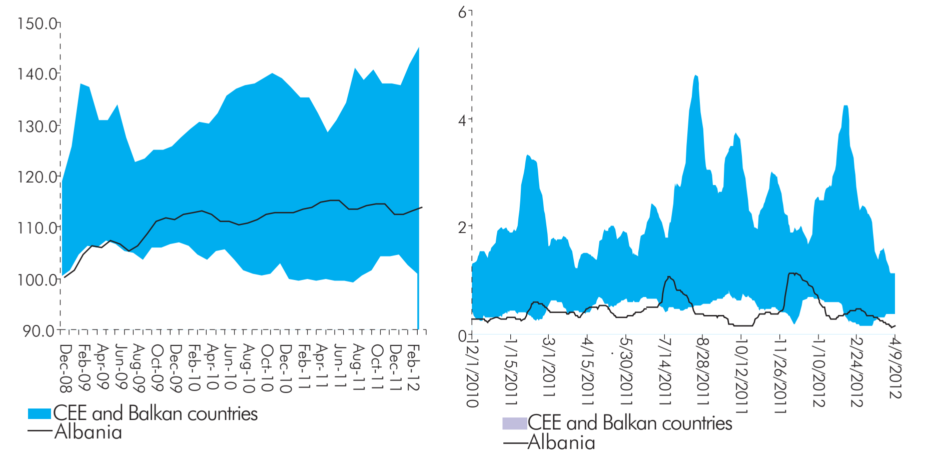
Chart 67 USD/ALL and EUR/ALL volatility, q-o-q



Source: Bank of Albania

In a regional context, the ALL/EUR exchange rate appears considerably more stable than the exchange rate performance of currencies in CEE and Balkan countries. The EUR/ALL exchange rate dynamics was relaxed almost throughout 2012 Q1. The graphical presentation of the volatility index in the case of the lek shows that it stands below the lower limit of the interval representing the countries of the region.

Chart 68 EUR/ALL exchange rate (base period: October 2008) and volatility compared to CEE and Balkan countries' currencies*



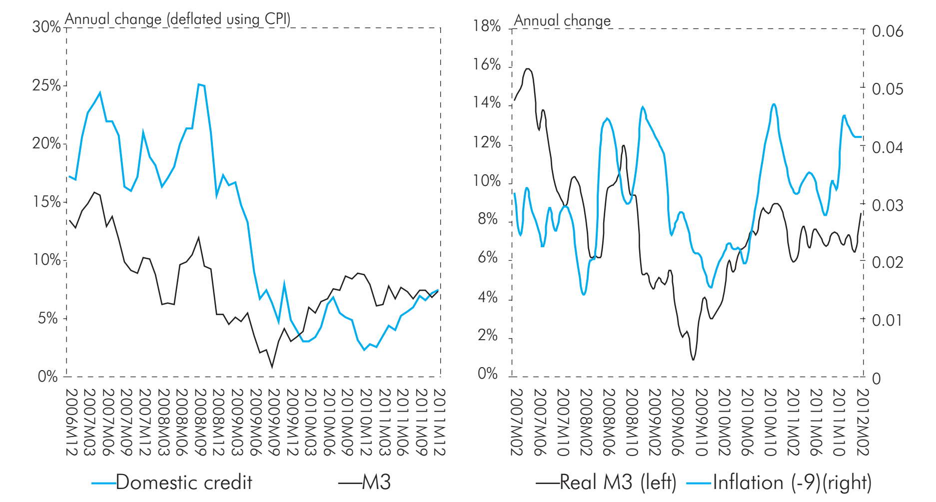
*The volatility of EUR/domestic currency exchange rate is measured as a 30-day standard deviation. The peaks and troughs of the volatility in each period show the maximum and minimum standard deviation of the exchange rate. The selected countries are: Poland, the Czech Republic, Hungary, Romania, Turkey and Serbia.

Source: Bank of Albania calculations

V.3 FINANCIAL INFLATIONARY PRESSURES

In January and February 2012, monetary assets grew by 7%, similar to the average of 2011. Domestic credit grew moderately driven by below-potential economic growth. It is assessed that money growth in the last 12 months stands on average below the historical average. In the medium run, money supply in the economy has balanced the demand for real money.

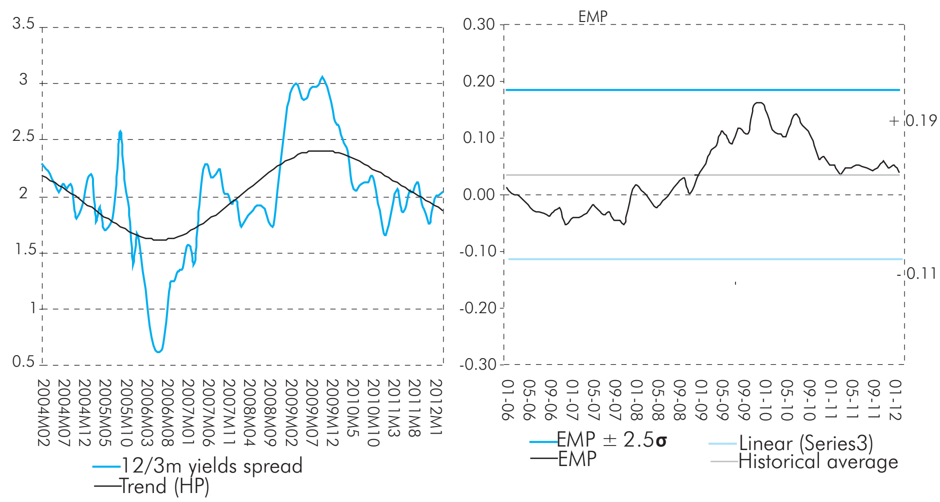
Chart 69 Money and inflation (in annual terms)



Source: Bank of Albania

Financial markets were relaxed in 2012 Q1, being characterised by a good level of liquidity, stable exchange rate of the lek against the major foreign currencies and downward cost of funds. On the fund investment side, the transmission of monetary policy stimulating signals was conditioned by lending activity. The weak credit demand from the economic agents was also coupled with banks' reluctance to play a more active role in financial intermediation against a background of restrained investment policies applied

Chart 70 Financial market pressures



Source: Bank of Albania

to banks operating in South-East European countries by their bank holding groups. Due to the latter, it is quite noticeable that the easing signals of the year-start did not fully pass through to the primary securities market. In the meantime, the proxy indicator for inflationary pressures, factorised in product prices by financial agents, continued to remain near the potential level.

Overall, developments in financial and monetary variables confirm that economic agents' inflationary expectations are well-anchored around the central bank's target. Moreover, they do not indicate added pressures on consumer prices at home in the medium run. They provide signals for a consolidated banking system stability, which serves and reinforces the macroeconomic conditions for meeting the primary objective for inflation.